BANCA D'ITALIA
EUROSISTEMA

16/12/2019

1. The supervision of Banca Popolare di Bari

In 2010, Banca Popolare di Bari (BPB) was the subject of inspections that resulted in a 'partially unfavourable' assessment. In particular, the assessments highlighted shortcomings in BPB's organization and in its internal credit checks. The Bank of Italy prohibited BPB from expanding its business and imposed a specific capital requirement on it.

In 2011-12, the Bank's supervisory action focused on the effectiveness and functioning of the internal controls system. BPB's management was reminded of the need to strengthen the safeguards in place to counter the liquidity and compliance risks detected during the inspection. It was further requested that BPB's Internal Audit Function conduct a specific assessment.

In 2013, BPB was once again the subject of targeted inspections of credit risk, corporate governance, the internal controls system, and compliance-related issues. The assessments highlighted improvements compared with the findings of the 2010 inspection. However, they also underlined some persistent weaknesses, which BPB planned to address through a number of remedial measures. The Bank of Italy's banking supervisors asked BPB's Internal Audit Function and Board of Statutory Auditors to conduct a specific assessment of the effectiveness of this remedial plan. The assessment found that the measures adopted and compliance with their scheduled timing were appropriate overall. Given the actions taken and the reports provided by the Internal Audit Function and Board of Statutory Auditors, in June 2014 the abovementioned restrictive measures were lifted.

In July 2014, the Bank of Italy authorized BPB to acquire control of Banca Tercas; to guarantee its sustainability, the operation was accompanied by a contribution of €330 million to BTB by the Interbank Deposit Protection Fund (FITD). This amount was determined based on a specific due diligence and negotiations between BPB and the FITD. BPB's involvement in the acquisition of the Tercas group amounted to a 'bail-out' operation designed to protect the interests of depositors and to revamp the business of the Abruzzo-based group.

In the spring of 2015, the FITD's intervention in favour of BPB was disputed by the European Commission owing to its alleged State-aid nature. To overcome this obstacle, the abovementioned intervention was replaced with a contribution for the same amount by the newly-established 'voluntary branch' of the FITD. The execution of this operation, however, delayed the integration of Banca Tercas with BPB, with significant repercussions on the business of both banks. Only in 2019 did the EU General Court annul the Commission's decision on the alleged State aid to Banca Tercas. The EU Commission decided to appeal against the judgment.

From a strategic standpoint, the acquisition of Tercas was part of BPB's drive to expand along Italy's Adriatic coastline, as outlined in its business plan. The plan provided for a multi-year recapitalization programme to support the development of the banking group, something that the Bank of Italy had also called for, when it had asked BPB to devise specific measures to maintain appropriate capital ratios.

In the two years 2014-15, BPB strengthened its capital position by €550 million overall, comprising new share issues (€330 million) and the placement of subordinated bonds (€220 million).

In connection with the reform of the *popolari* banks (Decree Law 3/2015 and Law 33/2015) and the less favourable outlook for profitability, BPB's meeting of shareholders, which had been convened to approve the 2015 annual accounts, decided to reduce the unit share price from €9.53 to €7.50. This led to discontent in the shareholder base and requests to sell shares: as at 20 December 2016, these requests concerned 38.9 million shares, equal to one quarter of the share capital. An important development in this respect was the entry into force, in 2014, of EU rules on prudential supervision imposing stricter limits on share buybacks than in the past.

In the early months of 2016, the Bank of Italy requested that BPB carry out an inquiry into the possible links between loans and subscriptions of the abovementioned new shares and bonds (a loans-for-shares phenomenon commonly referred to as *operazioni baciate*).

In June 2016, the Bank of Italy began another round of inspections focusing on BPB's capital adequacy and credit profiles. They ended in November 2016 with a 'partially unfavourable' assessment. The inspections highlighted significant delays in the implementation of the measures to strengthen own funds compared with the stated objectives and the need to reinforce the system of credit checks. It was also found that the guidance and control activities of the parent company's supervisory and management bodies were not fully adequate in dealing with the growing complexities stemming, among other things, from the widening of the operational perimeter that followed the acquisition of the Tercas group. No significant evidence emerged of loan-for-share transactions. The Bank of Italy's inspections also found irregularities in areas pertaining to Consob's remit (transparency of conduct in the field of investment services, especially regarding the placement of financial instruments during the abovementioned capital increase of 2014-15), for which Consob subsequently imposed administrative sanctions amounting to around €2 million.

In December 2016, the Council of State suspended the implementation of the reform of the *popolari* banks. This had the effect of halting the transformation of BPB into a limited liability company (a process that was instead completed by most of the *popolari* banks concerned by the reform). This removed an important condition for raising equity capital, as raising funds on the market was hindered by the fact of being a cooperative bank and by the one person, one vote principle. Also given the high degree of uncertainty surrounding the regulatory framework, a voluntary transformation into a limited liability company at that stage could have affected the orderly management of possible requests for reimbursement on the part of withdrawing shareholders, posing risks to the stability of BPB's capital position.[1]

In its letter of 15 March 2017, the Bank of Italy underlined that BPB needed to strengthen its capital and governance by taking on persons with specific banking and financial skills. It also called on BPB's president to confirm his intent to resign, which he himself had expressed in his letter of February 2017. Lastly, the request to strengthen its credit segment and reduce costs was reiterated. The requests made to BPB's management to strengthen the bank's capital were repeated at the meeting of 28 September 2017 and in an intervention letter dated 8 November 2017.

In the early months of 2018, pending its obligatory corporate transformation, which would have allowed BPB to manage the reimbursement of its shareholders in the event of their withdrawal, the bank drew up alternative corporate transformation plans designed to eliminate the risk of reimbursement and suggested possible mergers with other less significant *popolari* banks in central and southern Italy. The Bank of Italy's analysis highlighted, nevertheless, the significant legal risks of these plans, which were therefore put aside. On a number of occasions during 2018, BPB reported contact with investors potentially interested in buying a stake, contacts which did not, however, materialize.

[1] Voluntary transformation from *popolare* to a limited liability company would have granted shareholders the right to withdraw and to the reimbursement of the value of the shares.

Various meetings then took place with the management of BPB, at which the Bank of Italy repeated the need to inject more capital, increase profits, maintain an adequate level of liquidity, and carefully evaluate if there were sufficient provisions against non-performing loans, in particular those in the 'unlikely-to-pay' category (owed by firms experiencing temporary difficulties).

In 2018 the corporate transformation process went through alternating phases.[2] In the meantime, the bank's financial situation deteriorated more quickly: the first half of the year closed with a consolidated loss of around €140 million (the 2017 financial year ended close to balance), as a result of goodwill impairments and provisions against the main credit exposures; capital ratios fell below the target values that had been set by the Bank of Italy (see the Appendix).

In its letter of November 2018, the Bank of Italy highlighted the inadequacy of the corporate restructuring process and invited the governing bodies to report on any developments in their search for potential investors in the parent company and on the progress made in the planned merger with other *popolari* banks. Moreover, it requested BPB's's internal control functions to check the accuracy of the classification of and provisions made against exposures towards the largest groups involved.

The deterioration of the loan portfolio and basically stagnant business situation led to a consolidated loss of €430 million at the end of the 2018 financial year. The capital ratios declined further, to a level below that of the capital conservation buffer.

At the start of 2019, there were strong disagreements between, on the one hand, the president of the Board of Directors and the members answerable to him and, on the other hand, the members of the Internal Control and Risks Committee and the president of the Board of Statutory Auditors. This situation led to a complete managerial and operational stalemate.

In June 2019, the Bank of Italy began administrative sanction proceedings against BPB and some of its managers and former managers, in relation to shortcomings in controls on the lending process.

In the second quarter of 2019, following the introduction of the tax incentive contained in the Growth Decree, the BPB intensified its attempts to achieve a merger.[3]

In the first half of 2019, at numerous meetings held in quick succession, the Bank of Italy emphasized the need for those in charge of BPB's governance to remain united during such a delicate phase. Moreover, in view of the partial renewal of the Board of Directors, in May 2019 the Bank of Italy sent a letter of intervention to BPB's Board of Statutory Auditors and to its Board of Directors underlining the need to add some members with the necessary prestige, reputation and appropriate experience in the field. The Board of Directors underwent a partial change in its membership at the end of July 2019.

On 18 June 2019, extensive inspections were begun at the parent company. The inspections initially concentrated on the changes in governance, which took place at the end of July, before

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[2] Following the favourable ruling of Italy's Constitutional Court in March 2018 and the decision of the Council of Ministers, BPB recommenced its obligatory corporate transformation. In October 2018, this process was interrupted once again when Italy's Council of State confirmed the stay and requested a specific ruling from the EU Court of Justice on the compatibility with basic EU law of the principles of the *popolari* banks' reform and of supervisory rules on the withdrawal of shareholders and limits on reimbursement. To date, the Court of Justice has not given its opinion.

[3] This incentive was intended to encourage mergers between companies in southern Italy (including banks) with a tax break obtained by transforming some types of deferred tax assets (DTAs) into tax credits. The compatibility of this tax incentive with EU law on State aid is still being considered by the European Commission.

turning to the analysis of credit quality. The findings, made official in December, show that the new governance structure was incapable of adopting the corrective measures required to get past the operational standstill sufficiently quickly and effectively so as to rebalance BPB's profitability and financial situation. Very significant capital losses also emerged, bringing BPB's capital ratios down below minimum prudential requirements.

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During the period in question there were many exchanges of information between the Bank of Italy and Consob, documented in numerous reports of meetings and about twenty formal letters. There have also been numerous and on-going exchanges with the judicial authorities. The worsening of the financial situation of BPB was also brought to the attention of the Finance Minister on several occasions (letters of 27 February, 3 May, 2 October and 26 November 2019).

2. The importance of Banca Popolare di Bari for the local economy

The bank has a customer base of just under 600,000, including more than 100,000 firms that account for around 60 per cent of loans (about €6 billion). Customer deposits amount to €8 billion, of which €4.5 billion are for stand-alone deposits of less than €100,000 and as such are protected by the Interbank Deposit Protection Fund (FITD).

The bank has significant shares in Puglia, Basilicata and Abruzzo's lending and funding markets (around 10 per cent).

The bank's deeply-rooted presence and status as a national cooperative bank has facilitated the broad distribution of financial instruments issued. It has around 70,000 shareholders holding 2,500 shares on average, corresponding to €5,900 according to the last price recorded on the Hi-MTF market prior to the recent suspension (€2.38). More than two thirds of the bank's senior and subordinated debt, worth €300 million in total, is held by private and retail investors.

In a liquidation scenario involving the reimbursement of depositors (without the sale of assets and liabilities to another intermediary), the impact of this failure would be very considerable, on both the local economy and on savings.

A liquidation would primarily imply reducing the value of the shares to zero, which would exacerbate the legal disputes with shareholders, already substantial because of how the 2014-15 capital increases were placed (€550 million, almost entirely subscribed by retail customers), which Consob deemed inconsistent with the regulations on investment services and which it sanctioned. The same thing would happen to subordinated loans (about €290 million, of which €220 million placed with retail customers).

Initial estimates show that it would also hit all ordinary creditors and deposits of more than €100,000 not attributable to households and small firms, with the risk that a portion of the deposits exceeding €100,000 made by this category would also be affected.

The FITD would have to reimburse protected depositors to the tune of around €4.5 billion, against a financial endowment that will amount to €1.7 billion in December 2019. This would necessitate the full activation of the €2.75 billion worth of funds subscribed in August 2019 by the FITD with a pool of banks, and intended to swiftly provide the Fund with resources for reimbursement. Repayment of these funds could require extraordinary contributions from the banking system, which would lead to significant losses.

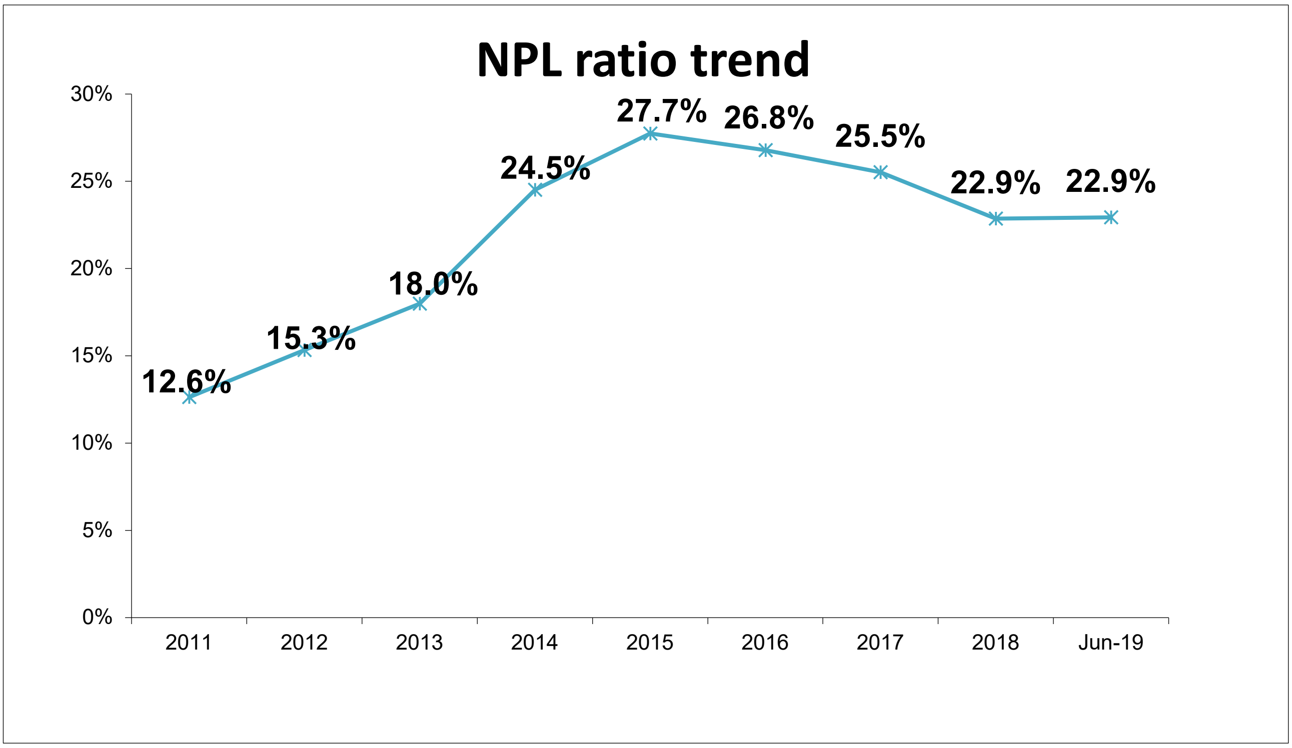
Selling the bank's assets would mean blocking operations, which would greatly prejudice the continuity of funding for households and firms; it would have a considerable impact locally, partly in light of the considerable share of loans disbursed by BPB in the regions where it operates (which, as mentioned previously, equates to 10 per cent). There would also be a significant impact on employment as the bank has about 2,700 employees, and the weak local economy would find it difficult to absorb such numbers. The BPB crisis could also undermine the confidence of depositors with other small local banks, triggering a contagion effect.

All these factors make it impracticable to liquidate the bank without selling its assets and liabilities; this last option means finding a bank interested in purchasing all the corporate assets, which could be particularly problematic given both the difficult local economic conditions and the bank's own situation.

Selling the assets and liabilities would in any case be impossible (due to a lack of interested counterparties) without considerable and non-repayable State aid to cover the losses on sales and, depending on the transferee's requirements, the restructuring costs and capital requirements made necessary by the capital absorbed by the asset purchases, similar to what happened for the liquidation of the Veneto banks.

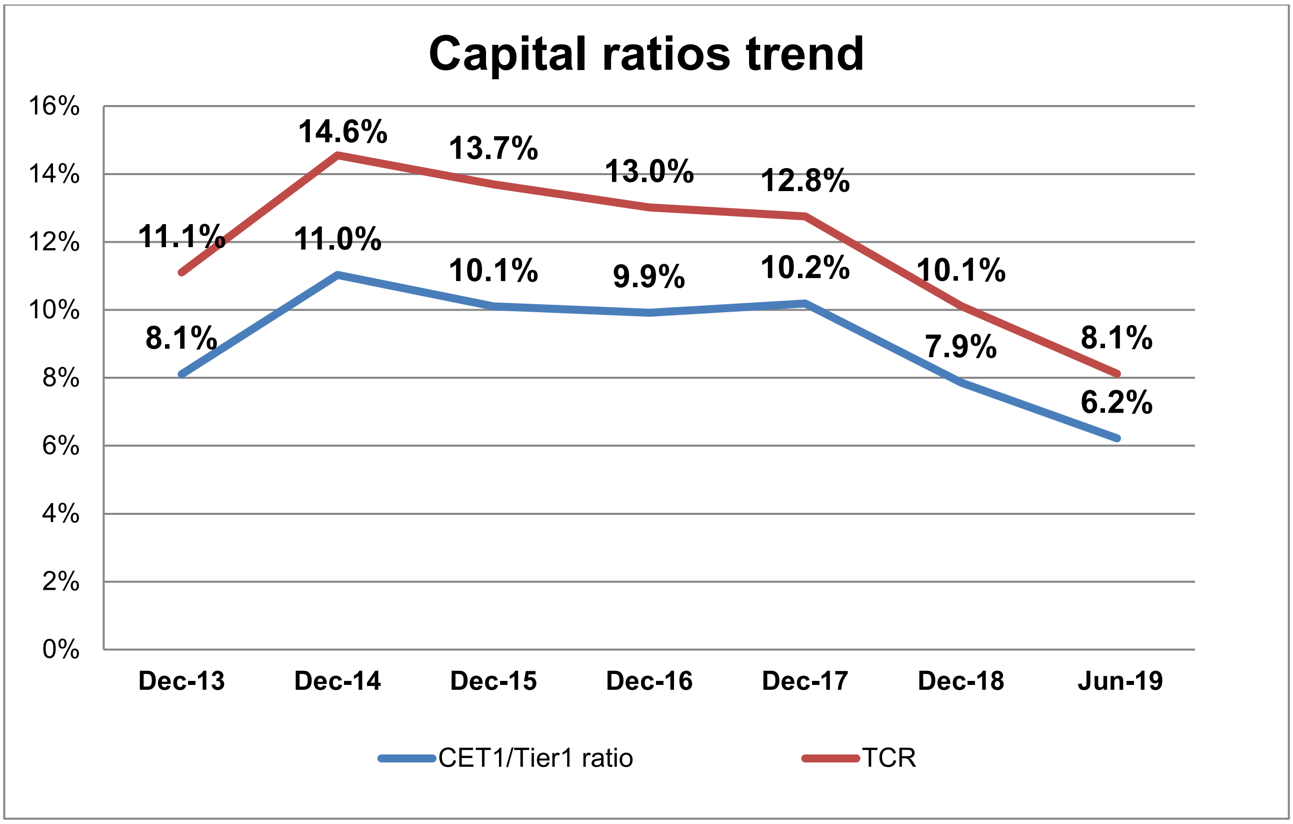
Appendix

Credit risk



Coverage ratios	2011	2012	2013	2014	2015	2016	2017	2018	June - 19
Total non-performing loans	39.6 %	41.3%	39.9%	46.4%	48.9%	45.1%	40.0 %	36.8 %	38.7%
Bad debts	58.6 %	60.8%	60.8%	60.5%	65.0%	62.5%	58.6 %	56.6 %	53.0%
Unlikely to pay	14.0 %	23.9%	19.8%	30.9%	30.0%	29.2%	25.9 %	33.5 %	36.5%
Past due	4.7%	6.0%	6.2%	6.6%	9.2%	9.5%	8.6%	9.9%	12.9%

Capital adequacy



Profitability

Profitability indicators	2013	2014	2015	2016	2017	2018	06/2019
ROE	1.9%	3.2%	-31.3%	0.7%	0.2%	-63.0%	-16%
Cost/income ratio	70.3%	66.1%	90.7%	87.7%	82.3%	93.3%	107%