BANCA D'ITALIA
EUROSISTEMA

Quaderni di Ricerca Giuridica

della Consulenza Legale

Towards a new framework for banking crisis management. The international debate and the italian model

Giuseppe Boccuzzi

ottobre 2011

numero 71

Quaderni di Ricerca Giuridica

della Consulenza Legale

Towards a new framework for banking crisis management. The international debate and the italian model

Giuseppe Boccuzzi

Number 71 – October 2011

The economic and technical analysis that forms the basis of the Bank of Italy's central banking and supervisory activity is accompanied increasingly by legal research into credit and monetary issues and, more generally, into the institutional aspects of economic activity.

Within the Bank, the Legal Department, in addition to handling disputes and providing advice, isentrusted with the task of carrying out research into legal matters relating to banking.

The "Legal Research Papers" (Quaderni di ricerca giuridica) are intended to be an instrument for the dissemination within the Bank and the banking system of studies produced mainly by members of the Legal Department and stemming from research of specific interest to the Bank.

They represent the opinions of the individual authors and therefore do not represent the official positions adopted by the Bank of Italy.

Editorial board:

Marino Perassi, Bruno De Carolis, Olina Capolino, Stefania Ceci, Marco Mancini, Enrico Galanti

Editorial assistants:

Roberta Pilo, Rosario Mendola

FOREWORD

The recent financial crisis reopened a wide debate over the management and resolution of banking crises. Following the global turmoil, a new set of principles and rules has been explored, both at national and international level, in order to overcome the flaws that emerged in the legal systems and to address the crises of systemically important institutions, preventing new cases of bail out at taxpayers' expensies.

Drawing on the analyses made by economists and regulators, the paper looks at the most relevant banking crises in the US and in Europe, highlighting, case by case, the new tools employed by governments and central banks as well as their possible drawbacks.

The paper includes a comprehensive reconstruction of institutional frameworks as they were before and after the reforms that followed the financial crisis. In this context, a special focus is given to the initiatives currently on the international agenda, which aimes at setting up a common framework to be implemented by national authorities.

The work focuses on the efforts made at European level to introduce new resolution tools, both in going concern (bail-ins) and gone concern (transfer of assets and liabilities, bad banks, bridge banks), while a specific in-depth analysis has been made with reference to the reform proposals concerning the SIFIs (Systemically Important Financial Institutions), in light of the ongoing international debate to reduce moral hazard.

Specific emphasis has been given to the Italian crisis management and resolution model, which has not been adequately investigated so far in the international economic and juridical literature, even though the model has been in force since 1936 with an unquestionable success. The essay highlights, however, that some of the newly-issued resolution regimes have followed the basic lines of the model as a frame of reference.

INDEX

Preface. 9

INTRODUCTION

1. Some preliminary notions about banking crises. 15
2. Before and after the international financial crisis: the watershed. 21
3. About the financial crisis. 23
4. Rethinking the overall design of the financial system. 29
5. The Italian crisis management framework. 33

CHAPTER 1
THE MANAGEMENT OF BANKING CRISES BEFORE THE INTERNATIONAL FINANCIAL CRISIS

1. The experience of recent decades. 35
2. The process of the internationalisation of the banking sector and the initiatives to set up an international regulation. 36
3. The EU regulatory framework for dealing with cross-border insolvencies. 40
4. The EU Deposit Insurance discipline. 46

CHAPTER 2
FROM “IDIOSYNCRATIC” TO “SYSTEMIC” BANKING CRISES

1. The systemic characteristic of the crises. 51
2. Banks’ insolvencies in the U.S.A. 52
3. The banking crises in Europe. 68
4. The lessons learned from the crisis. 85
5. Current international responses. 88

5.1 The global debate. 88
5.2 European initiatives. 91
5.3 Current changes in institutional settings and financial regulations in various countries.. 95

CHAPTER 3
TOWARDS A NEW FRAMEWORK FOR CRISIS MANAGEMENT AND RESOLUTION

1. Fixing the components of a new framework. 119
2. Which principles and objectives? 119
3. Which target intermediaries? 120
4. Which model for banking crisis management and resolution? 122

4.1 Crisis prevention. 122
  4.1.1 Macro-prudential supervision. 124
  4.1.2 Micro-prudential supervision. 125
  4.1.3 Other measures. 130
  4.1.4 Strengthening internal and supervisory controls of banks. 137
4.2 Early intervention. 141
4.3 Crisis management and resolution. 146
  4.3.1 Going concern solutions. 149

4.3.2 Gone concern solutions. 152
4.4 Liquidation. 155
5. Cross-border issues for internationally banks. 155
5.1 A single crisis management rule-book for European banks? 155
5.2 Which model for cross-border banking insolvency? 157
5.3 The EU group resolution: who is in charge of managing the crisis? 160
5.4 The critical issue of intra-group asset transferability 161
6. Sharing the burden of the crises (who pays the costs?). 165
6.1 The role of deposit insurance schemes. 166
6.1.1 The first step of the reform. 166
6.1.2 The second step of the reform. 167
6.2 Bank Resolution Funds. 174
6.3 The tax on financial transactions (the Tobin tax). 178
6.4 The proposal for a private European Fund (Mr. Profumo's proposal). 179
6.5 Public intervention. 181

CHAPTER 4
THE MANAGEMENT OF BANKING CRISES IN ITALY. THE CONSOLIDATED SPECIAL RESOLUTION REGIME

1. A general picture of the Italian special framework. 183
1.1 Main characteristics of the supervisory and crisis management system 183
1.2 The preventative nature of intervention tools. 186
1.2.1 The supervisory approach. 186
1.2.2 Corrective action. 190
1.3 Crisis management: general principles 192
1.4 An overview of special proceedings. 193
1.5 The discipline of banking group crises. 195
1.6 Deposit insurance schemes. 196
2. Special administration 196
2.1 The main features of the proceeding. 196
2.2 Starting requirements. 197
2.3 The effects 198
2.4 Aims of the procedure and tasks of the special administrators 199
2.5 Procedural steps 200
2.6 Powers of the Bank of Italy. 201
2.7 The conclusion of the special administration 202
2.8 A tool for "emergency" situations: provisional management. 202
2.9 The regime of non-EC banks' branches. 203
3. Compulsory administrative liquidation 204
3.1 The objectives and the main features of the proceeding. 204
3.2 Starting requirements. 204
3.3 The opening of the proceeding and its effects. 205
3.3.1 The administrative steps for the opening of the proceeding. 205
3.3.2 The effects. 205
3.4 Powers and functioning of liquidating bodies. 206
3.4.1 The assessment of bank's liabilities. 207
3.4.2 The liquidation of assets. 208
3.4.3 Payments to creditors and the restitution and allotment of assets. 209
3.5 The powers of the Bank of Italy 210
3.6 Composition with creditors. 211
3.7 The conclusion of the proceeding. 212

4. The discipline of banking group crisis 213
4.1 The banking group: definition and general discipline. 213
4.2 Consolidated supervision. 214
4.2.1 The banking and financial institutions included within the scope of consolidated supervision. 214
4.2.2 Cros-border cooperation between authorities: the provision of the colleges' of super visors. 215
4.3 The management of banking group's crises.. 216
4.3.1 General remarks. 216
4.3.2 The special administration of the parent undertaking. 217
4.3.3 The compulsory administrative liquidation of the parent undertaking. 217
4.3.4 The special administration and compulsory administrative liquidation of group entities. 218
4.4 Procedures applicable to individual companies. 219
4.5 The coordinated management of the proceedings. 219
4.6 Jurisdictional competences. 220
4.7 Groups and companies not entered in the register. 220
5. Deposit insurance schemes. 220
5.1 The origin and evolution of the deposit DGSs in Italy. 220
5.2 The new regulation following European legislation. 222
5.3 The operational aspects of Italian deposit insurance schemes. 228
6. Public intervention in Italy 229
6.1 Public intervention tool. 229
6.2 Guidelines for public intervention. 231
6.3 The two cases of public intervention in the '90s. 232
6.3.1 The case of Sicilcassa. 232
6.3.2 The case of Banco di Napoli (BN) group. 235
6.4 Current framework. 240

CHAPTER 5
WHERE ARE WE GOING?

1. Where are we now? 243
2. The need for clear principles and rules for the future. 246
3. How will the new prudential measures be judged? Will the outlined solutions be Effective? 249
4. What else can we do? 251
4.1 The "too big to fail" issue. Which rules? 251
4.1.1 SIFIs. 252
4.1.2 Prudential requirements for SIFIs 253
4.1.3 Living wills. Something new under the sun? 255
4.1.4 The resolution measures. Who pays the costs? 257
4.1.5 Coordination vs. integration at the EU level. 259
5. The institutional of the special resolution regime. 260
6. Possible innovations in the Italian framework. 261
7. Which model is coming out of this process? From the Bankruptcy Law to the Banking Law. 268
8. Concluding remarks. What kind of financial system will come into effect after the crisis? 269

BIBLIOGRAPHY

PREFACE

1. The financial crisis that engulfed the developed world from 2007 to 2009 reopened for policymakers, jurists and economists the debate - at the international and domestic level - on how to handle banking crises given the complex and particular problems that derive from the systemic and global nature of the phenomena. The management and resolution of banking crises have always been sensitive issues: when a bank fails a wide range of interests is involved; primarily those of depositors. Depending on the size, complexity and business of the bank, disruptive effects may influence the financial system as a whole and the economy, too. For this reason, in almost all countries, banking crises have been generally dealt with according to a special regime that is considerably different from the ordinary bankruptcy proceedings used for non-financial firms. The intensity of the special regime can vary according to a country's legal system, traditions and experiences.

But something new happened this time. Peculiarities and complexities further increased: the driving mechanisms, manifestations and solutions were very different from anything else experienced in the past. We might say that the recent financial crisis represented a clear break, because of its uniqueness and magnitude, compared with any previous experience. For the first time, banking crises were nor isolated neither regarded as national events: they became "global" in their systemic relevance and diffusion because of the close interconnection between intermediaries, financial systems and markets. The effects on the real economy, too, spread worldwide. It seemed that things had changed, changed utterly.

New action had to be taken by Governments and regulators, not comparable with those adopted during previous banking crises. New philosophies and strategies had to be followed and new instruments put in place to limit systemic disruptions. This is crystal clear looking at the wide scope and size of the responses given by Governments and financial authorities: the use of public financial resources, loosened monetary policy, emergency liquidity assistance, capital injection, "toxic" assets relief for banks, guarantees and fiscal policy. Market economy principles and values were set aside: public interventions became the rule and private solutions the exception. But such measures could only be a temporary remedy to the emergency. Major reforms of banking were needed to prevent such tsunamis in the future.

A three-year lag from the beginning of the financial turbulence can be considered a sufficiently long period for a systematic reconstruction of the crisis, to explain how it was dealt with, what lessons have been learned and which tools can be activated in order to avoid such inauspicious events from reoccurring in the future. These objectives inspired this book, being aware of the difficulties in dealing with such issues, involving many disciplines and various institutional settings, under continuous change in almost all countries along with the initiatives taken and the arrangements settled at an international level.

In this attempt, a key to the interpretation, a thread of the past three years' events and of regulators' initiatives to respond to the crisis, reside in the systemic nature of the crisis, whose size and effects had never been seen before, as well as in the public interventions needed to bail out banks, entailing expenditures no longer sustainable for public finances. Moreover, the build-up of the moral hazard because of public rescues looks like another challenge for policymakers.

2. As a starting point, after some introductory remarks on the general concept of banking crisis and the main aspects of the recent financial crisis, I deemed it necessary to sketch a brief outline of the international regulation of banking crises as it was before the financial crisis (chapter 1), just to better understand what happened after. It was an inadequate legal and institutional framework, but it was increasingly widening in scope according to the evolution of the European banking system.

Its inadequacy emerged clearly during the financial crisis, when significant banking disruptions occurred, which required exceptional resolution measures and changes in the regulations in most countries (chapter 2). This brief reconstruction of banking crises aims at the ambitious goal of a better understanding of the very essence of the recent financial disorders as well as at enlightening the technical instruments employed to work out specific problems. Such an exercise should prove crucial to understand the course towards which policymakers are moving in reforming the financial sector, with the purpose of strengthening the effectiveness of the regulatory response, if any, in handling the crisis without costs for taxpayers.

The peculiarity of the analysis is the multiplicity of aspects to deal with and the disciplines – economic and juridical – involved in such a complex phenomenon. A flourishing literature that has developed over the past three years has investigated the main causes and features - macroeconomic and microeconomic - of the financial crisis. Disorders have been well explained in all their facets, highlighting the responsibilities and the shortcomings emerged in institutional settings and regulation, but not always with coinciding conclusions.

In particular, the doctrine has substantially shared the views of policymakers and has supported the measures taken during the crisis. No doubt that the strategies put in place by Governments, central banks and supervisors to tackle the crisis turned out to be successful, mainly because of the fruitful action plan concerted within the various international bodies (G20, IMF, Financial Stability Board, Basel Committee on Banking Supervision, European Commission). Essentially, these strategies were based on the injection of public financial resources (based on Treasuries and Central Banks instruments) for the bailing out of insolvent financial institutions, considered "too big or too complex or too interconnected to fail". The view according to which there were no credible alternatives to this action has been generally shared.

After that phase, the main question to be asked is how can we avoid this in the future. After these public rescues, the risk of *moral hazard* has been further

spreading across the global financial system. The "too big to fail" concerns have increased, because banks have now become even bigger as a result of the mergers realised to solve the crisis. Different views have gathered on these issues, especially with regard to preventative measures and financing. Anyway, there is now, for the first time, a clear perception that the reform of prudential regulation and banking crisis management, which is seen as an appropriate response, should be realised, taking into account the cross-border nature of the crises and the global perspective. Improvements in domestic institutional settings and regulations are also deemed essential, but only if they are included in a coherent framework shared at international level.

When crisis events occur, they represent breaking points of existing balances, but they prepare the ground for new settings in the future, bringing new values and principles. History teaches us that structural reforms have always followed pervasive crises, as happened after the Great Depression of 1929, and the recent financial crisis can be compared, to some extent, to that event. This is what the international community is expecting from the current crisis. But the main question raised is whether the lessons learned by the financial crisis have laid the foundations for a new system or not.

Over time, different views of the optimal structure of financial reform have emerged. In some way, this is normal because each country has its own institutional, juridical and regulatory features. That is why unequal stages of evolution have been observed in the reforming process in a number of issues across different countries. Indeed, significant steps have been taken in prudential supervision, achieving an agreement on more stringent and rigorous rules (Basel 3 and the enlargement of the boundaries of the regulation), while the achievements of a common framework for crisis management and resolution of large cross-border banks are viewed as more challenging. In fact these topics imply, to some extent, profound changes to company and insolvency laws, which are deeply rooted in domestic frameworks. Traditionally, there has always been a high concern by Governments on such sensitive issues.

The debate is still underway, especially for cross-border large and complex financial institutions, with the aim of reaching, if not a harmonised framework, at least shared views, common principles and a mutual set of tools in order to coordinate actions when insolvencies occur. There is the feeling that more advanced objectives can only be reached in the medium-long run.

The challenge of an integrated system depends also on the fact that an ideal model does not exist. This makes policymakers more cautious in pushing for profound changes in their own domestic regulations, which are obviously considered as the most properly and suitably designed. The new framework that is taking shape from the international debate, especially from the EU proposals (chapter 3), has raised many concerns because of its relevant impact on company, bankruptcy and banking laws at a national level. In some countries, these proposals influence the institutional model of crisis management and the administrative authorities' powers, which are bound to significantly increase in

respect to judiciary. Very delicate and complex issues are raised by the possible effects of such powers over shareholders and creditors' rights.

3. Another objective of this work is to outline the Italian regulation and experience in the management of banking crises (chapter 4). With its consolidated special resolution framework the Italian model can be considered the precursor of many of the solutions now being proposed at international level. It has been, moreover, the reference model for many countries wishing to adopt or to change their own crisis management systems. But, in this field not just the theoretical approach but the practices followed make the real difference.

Almost all the resolution instruments envisaged in the new framework have been employed in the Italian crisis management experience, based on the application of two special proceedings, provided for by Banking Law, i.e. special administration and compulsory administrative liquidation. Moreover, the Italian framework is one of the few legal systems providing for a specific regulation of banking group crisis. However, some refinements might be necessary if the new rules proposed by international bodies were to be approved, especially regarding resolution tools and administrative powers for resolution, which could imply the contribution of private parties to losses outside a formal insolvency proceeding. Other relevant issues include interactions among existing deposit insurance systems and a possible bank resolution fund. It cannot be excluded that some adjustments in institutional settings are needed.

The Italian framework does not provide for a specific instrument for public intervention because the Bank of Italy's advances employed until the mid-1990s to cover losses following banking liquidations are no longer available. In some way this is acceptable because banking crises should no longer be resolved with public funds, especially with central banks' resources. This is an issue to be dealt with through international arrangements, which should establish in which case and to what extent recourse to public intervention is feasible in the presence of deposit insurance systems or resolution funds.

4. The most relevant lesson learned is that countries can no longer afford another turmoil like the 2007-2009 global crisis, whose effects are not yet concluded, firstly in terms of economic recession and secondly in terms of public balance sheets deficits. Public monies cannot be used to bail out banks and moral hazard has been exacerbated during the crisis. New instruments should be put in place as well as a new role for supervisory and resolution authorities. New institutional settings may be necessary.

The reforming process is now on course, but a clear understanding of its directions has not yet been reached. The current debate has highlighted many points of view and different approaches, especially for the "too big to fail" issue. Some are in favour of structural and more radical changes, while others support lighter ways of intervention, counting on the market to resolve problems by itself.

We should be aware that rewriting the rules is a hard task because of the complexity of the issues involved. There is a high risk of over-regulation and striking the right balance is not an easy job.

Anyway, it is worth underlining that institutions, rules and controls are critical factors in order to ensure a sound and prudent banking system. Whatever effective a system may be, failures cannot completely be excluded, but at least contained to an acceptable level. Above all, the accuracy and correctness of human behaviour play an essential role as a premise for sound and safe management. Operators' behaviours should be sustained by ethical values and principles, aimed at aligning private goals to social objectives in the delicate financial sector, characterised by strong externalities and disruptive effects in the case of failures. As a consequence, the correct alignment of the incentives of all stakeholders involved in financial activity is the best defence against pathological events.

5. Finally, at the end of my brief preliminary remarks, I would like to underline that the management and resolution of a banking crisis is a long and complicated process that requires the ability to orchestrate rapid responses as well as to take care of the various interests at stake.

To some extent, this complexity is related to the banking business as such, because of the nature of stakeholders' interests and the seriousness of the effects of a crisis, whatever may be the size of the bank. Moreover, as one crisis is never equal to another, different situations need different solutions, although within a clear and predetermined framework, so that a "one size fits all" approach cannot be followed. Eventually, it is fundamental to rapidly address the causes of a bank's problems and to find a suitable solution to minimise direct and indirect costs, or to restore its soundness when it is still possible.

This was my personal experience in the management of banking crises at the Bank of Italy for many years: a very challenging professional and life experience, enriched by extraordinary human, institutional and professional relationships.

Finally, I would like to thank my colleagues Francesco Cannata, Mario Quagliariello, Giampaolo Sarnataro and Raffaele Jandoli for their comments, especially Carmelo Brunetto, with whom I discussed many of the issues dealt with in this work and for his substantial contribution.

The views, findings, interpretations and conclusions expressed in this book are entirely mine and they do not involve the responsibility of the institution to which I belong.

INTRODUCTION

1. Some preliminary notions about banking crises.

Banking crises have a long history. Failures in the financial markets have occurred all over the world and in each historical period, for different causes and with various forms of manifestation and solutions. Over long time horizons, crisis phenomena may present similar features. In the recent financial crisis, the events that took place have also been compared with those of the 1929 Great Depression,[1] in terms of the number of failing banks, of the effects on the real economy and subsequent reforms of financial systems that followed anywhere.[2]

However, apart from some inevitable similarities, each crisis event - individual or systemic – has its own peculiarities, from which specific lessons can be learned. Crisis events have always been accompanied by debates about the role of public powers and the nature of instruments available to deal with them. Modalities for public intervention can be different depending on how policymakers want to distribute the costs of the insolvencies. Public authorities may also decide not to intervene in order to leave to the market and to the ordinary rules of the insolvency proceedings the task to resolve the crisis and the consequent conflicts arising from the cost distribution problems. This issue was also raised during the recent financial crisis, when Governments decided to make a massive use of public money in order to avoid major disruptions in the internationally integrated financial system.

Before looking into the innumerable issues raised by the recent financial crisis and at its impacts in terms of banking crises and of the institutional reforms currently underway, some conceptual clarifications might be done.

A preliminary question regards the notion of banking crisis. Is it so clear what a banking crisis is? It seems an obvious concept, but in reality it is not so obvious, because crises may present many facets. During the financial turmoil, the concept of banking crisis entered widely into the common language. In some cases, a banking crisis was clearly identified, because it manifested itself through a bank run or by a public announcement of some regulatory or State interventions. In these cases, depositors and other stakeholders had a direct perception of what a banking crisis is. In other cases, which are the majority, there is no such external perception, so the public cannot develop a clear understanding of the real situation that the bank is facing.

There is a real possibility that the term "crisis" is used to describe phenomena of different nature and scope. In some cases, the situation in question may not be

---

[1] R. MASERA (edited by), *The Great Financial Crisis. Economics, Regulation and Risk*, Bancaria Editrice, 2009.

[2] J.K. GALBRAITH, *A Short History of Euphoria*, Penguin Books, 1994.

a proper crisis, but a simple manifestation of weakness, which does not endanger the stability and its autonomous presence in the market.

But even among regulators and experts the concept of banking crisis is not unambiguous, and in this case not only because of a lack of information. Even the technical language tends to use different terms to define the same phenomena. In many instances in place of *bank crisis* we use synonyms such as *weak bank*, *problem bank* and *insolvent bank*; moreover, when talking about the measures to be taken to remedy the crisis, we use the terms *recovery*, *reorganisation* and *rehabilitation* to indicate that the crisis is reversible and that the bank can return to viability; when we talk about resolution and liquidation, we refer to solutions that are more suitable for insolvent banks.

One of the main approaches to this issue is to consider its economic and juridical aspects. From an economic point of view, a crisis is a complex phenomenon that may be caused by a variety of factors and have different shapes and sizes. Because of such complexity, it is difficult to put its various configurations into legal formulas; this justifies the tendency of legislators not to use legal definitions, but to limit the discipline of the phenomenon to the assignment of the necessary powers and tools for intervention to the competent authorities. Trigger events for interventions are often defined in very broad terms. This means giving the same authorities the discretionary power to evaluate the multiform situations that can occur and to intervene for minimising the costs for stakeholders, according to the priority principles established by law.

The analysis of the economic substance of the crisis is crucial because the comprehension of the real factors and features of it is a preliminary task in order to decide how to effectively intervene. But the juridical profile is not less important, because it defines the legal possibilities for intervention, the tools available and the interests to protect according to predefined rules and principles.

Basically, when we talk about a banking crisis, we refer to a business crisis; in that respect, a financial firm is a normal enterprise in a competitive market. So, even in the financial sector, a crisis is a "normal" phenomenon, an inevitable consequence of selection in a competitive market. The occurrence of a certain number of insolvencies in the banking sector is thus physiological to the functioning of the market and is acceptable if the stability of the entire financial system is preserved. Individual insolvencies can easily be resolved by ordinary instruments, with the specific aim to protect depositors and, possibly, other stakeholders' interests. When crises take "systemic" sizes, their resolutions become more complex, in that special instruments and measures have to be activated to achieve more comprehensive objectives, such as the reduction of the disruptive effect on other operators and on the whole economy or the preservation of essential banking functions.

As for other firms, we can identify the characteristics of banking crises through the analysis of the causes, the forms of manifestation and the solutions.

As to **the causes**, the experience reveals that for a weak bank troubles can derive from a combination of coexisting factors, both external and internal to the bank. In many cases problems at a bank emerge as a consequence of a primary driving factor, but subsequently other factors may interact, triggering a more complex process of deterioration of the situation, so that the initial weaknesses turn into a proper crisis.

The external factors may be represented by changes in the economic environment, in the business cycle, in the conditions of financial markets, in the demand for financial products and services by customers or in the increasing level of competition among banking operators. But, most importantly, a crucial factor may be the loss of confidence in a bank by savers and investors, who are no longer willing to provide funding, even if the bank is still solvent. The latter is the most worrying event, because it can undermine the foundations of banking activity, since no bank can survive without market confidence.

The internal causes are related to weaknesses that characterise the bank's functioning at different levels and may include: i) strategic issues (mistakes in setting up the business plan, the market position, the organisational structure and the internal control system, the staff composition, etc.); ii) mismanagement (mistakes or incapacity in the implementation of operational and decision-making processes, definition of levels of responsibilities, administrative and accounting procedures, risk management); and iii) fraud (irregular or illegal transactions, behaviours, violations of laws and regulations pertaining the banking sector, financial facilities to insolvent debtors, irregular securities transactions, lack of independence in business management).

With regard to **the forms of manifestation**, in theory it is possible to distinguish three categories of crises for banks, as for other commercial firms, but with different effects and consequences:

– *economic crisis*: this is when the bank is facing profitability problem, which can be defined as an imbalance between costs and revenues and, therefore, as an incapacity to make profits. In this situation the bank continues its daily activity still meeting its obligations. Usually, this doesn't lead to legal procedures. But this situation cannot last for long, because over time it can hit the capital turning into an irreversible crisis;

– *capital crisis*: in the banking sector the capital represents a key element for the stability of the bank. It is the reference parameter for the growth of the banking activity and, if properly designed, (should be) the appropriate incentive for risk-taking. When the firm has lost or is likely to lose most or all its capital, it is in a particularly serious crisis where Civil Laws as well as the special banking regulation generally require immediate interventions, up to the liquidation of the bank;

– *liquidity crisis*: this is a mismatch between financial flows that may lead to the incapacity of the bank to meet its obligations; in these cases the bank needs to improve its funding capacity. Banks can face two types of liquidity

risk: i) the *funding liquidity risk*, if the bank is not able to raise funds because of the negative perception of other intermediaries about its own financial health; or ii) the *market liquidity risk*, if the bank is not able to dispose of its assets on the market, meaning it will be forced to a fire sale with consequent losses.[3] The crisis then becomes externally visible because the firm is defaulting.[4]

In practice, this is an artificial distinction because it is rarely possible to recognise factors producing a pathological situation. More frequently, causes are strictly interlinked. It can happen that a crisis initially caused by an income imbalance subsequently affects the capital and eventually the liquidity profile. But the process can also go the other way.

Apart from the generic meaning of the term "crisis", which is normally used to indicate a wide range of distressed situations, the concept of *bank insolvency* is more precise and this is generally used to define a situation in which the crisis is irreversible or could become irreversible (i.e. the bank is failing or is likely to fail). Every country has its own definition of insolvency. In Italy, there is a legal definition of insolvency, provided for by article 5 of the Bankruptcy Law, applicable also to the banking sector, according to which the entrepreneur is insolvent "*when (s)he is no longer able to regularly meet his obligations. The state of insolvency manifests itself with non-fulfilments or other exterior events which show that the debtor is no longer able to regularly meet his obligations*". The peculiar notion of insolvency in the banking sector is consolidated in jurisprudence, which gives relevance to the irreversibility of the crisis, according to a forward looking judgement about the capital deficit and the capacity of the bank to meet its obligations. A bank's insolvency is normally declared after the opening of compulsory liquidation, following a proposal by the liquidator. Other countries may have broader or stricter definitions of insolvency. In the banking sector, we also use the concept of "*regulatory insolvency*", which gives relevance to the shortage of the capital of a bank as a trigger for resolution. It does not mean that the capital has been entirely lost, but that it has reduced below a certain threshold provided for by the regulation, so that this level may represent, from a legal point of view, a trigger for bankruptcy or liquidation proceedings.

As already stated, every crisis has its own history and peculiarities. If we try to offer a definition, we can say that - in contrast to the other phenomena of pathology or irregularity that a bank can face during its life in a competitive market - the *crisis expresses a profound alteration in the economic, financial and patrimonial conditions of the bank, which requires appropriate and timely interventions to remove the real causes and minimise its negative effects to depositors and other relevant stakeholders.*

---

[3] M. BRUNNERMEIER-L.H. PEDERSEN, *Market Liquidity and Funding Liquidity*, Review of Financial Studies, 22(6), 2008, pp. 2201-2238,

[4] G. BOCCUZZI, *La crisi dell'impresa bancaria. Profili economici e giuridici*, Giuffrè editore, Milano, 1998.

This definition highlights the fundamental elements of a banking crisis, putting in evidence that crisis does not consist in whatever problem a bank may face, but involves a profound deterioration of the technical profiles of the bank, which requires a rapid and effective intervention. It stresses the importance of "time" as a key factor in the management of a banking crisis: the earlier the assessment of the real situation of the bank and intervention are made, the more the solution of the crisis will be effective. Indeed, the rapidity with which a crisis is detected inside and outside the bank is crucial, before the deterioration process leads to an irreversible crisis with structural connotations.

This depends in the most part on the effectiveness of the governance structure of the bank and on the mechanisms and instruments for the prevention of the emergence of the crisis. That is why prudential regulation is increasingly stressing the importance of risk management and internal control systems, considering them as two pillars of the good governance of the bank. Moreover, it emphasises the strategic role of corporate bodies - the board and the audit committee - and the importance of a more structured interconnection with the executive level in these fields. Effective corporate governance, risk management and organisational and control systems are essential for the sound and prudent management of the bank and, consequently, crisis prevention. In particular, they are of prominent importance in the "twilight zone", namely that transitional and ambiguous condition in which a bank lies when facing financial difficulties and when crucial decisions must be taken by the governing bodies in order to go on in the business or to cease. At this stage, the continuation of the bank's business implies risks of civil liabilities or even criminal prosecutions for directors. In other words, this is the delicate phase in which company law may play a role in addressing problems through the recourse to alternative restructuring schemes before the area of bankruptcy.

Furthermore, the definition puts in evidence the strict interrelation between causes and solutions, in the sense that if we don't intervene to remove the causes we can keep on running the bank, but only for a short period, because problems will re-emerge with greater magnitude, after having wasted the financial resources injected in the attempt to rescue it. Finally, it emphasises the importance of the protection of depositors, first, and of the other stakeholders eventually. Whether and how to protect other stakeholders - or, in other words, who has to pay for the cost of the crisis - depends on the seriousness of the bank's situation, because the blanket is not so large to cover everybody, unless policymakers decide to establish specific instruments to give wider coverage to all creditors and other vested interests with specific resolution measures and financial resources.

As to **the solutions** of crises, the basic issue is to identify, as early as possible, the characteristics of a bank's problem to answer three fundamental questions: *"who intervenes", "when to intervene" and "how to intervene"*. The first pertains to who is responsible and has the power to initiate and manage the crisis; the second is related to the identification of triggers for crisis management; and the third regards the instruments available to manage the crisis.

With regard to possible solutions (how to intervene), we can distinguish between:

a) *market solutions,* when they are achieved with no external support (e.g. reorganisation, capital increase, merger and acquisition (M&A) by another bank at market conditions);

b) *assisted solutions*, when they are achieved with external support, for example by the Deposit Insurance Systems (DISs) in favour of a M*erger and Acquisition* (M&A) or a Purchase and Assumption (P&A) transactions or by the State through financing or guarantees in favour of bad banks created to separate bad assets from good assets;

c) *public solutions*, when they are achieved through direct State intervention that can range from capital injections into the bank to its nationalisation. This is the most efficient way of public intervention in respect to forms that cover losses for the benefit of previous shareholders at the end of the reorganisation process. Direct intervention would allow the State to reorganise the bank and after the recovery process to sell the shares on the market, thereby recovering the money injected for the bailout. In this way, State intervention has a temporary nature and represents an incentive for public powers to commit to the best recovery of the bank with the aim of giving it back to private investors at market conditions. This is what has happened in many cases in the past as well as during the recent financial crisis, where States (especially in the US) are recovering the public resources injected into the banks to some degree.

As for the actors responsible for implementing the solutions (who intervene), it should preliminarily be underlined that crisis management is, in the first place, a task entrusted to a bank's shareholders and managers, because they should monitor the early signs of weakening in the bank's technical equilibrium and swiftly intervene through adequate measures. If the bank's management is unable or fails to intervene, this delicate and complex task passes to the competent authorities, which are called upon to take action according to the powers provided by the law and regulations. In so doing, they have to put in place a highly skilled and experienced team to appropriately deal with situations that very often look so complex and that umprecedented solutions need to be tailored to the situations. Crisis management is strictly linked to supervision, but it is different from it.

For this purpose, we can distinguish between:

– *self-adopted solutions*, when achieved by the bank itself, without any support and with a minimum involvement of the supervisory authority. It is possible to distinguish between: i) rehabilitation through self - restructuring and ii) rehabilitation through aggregations with other banks (M&A). Bank rehabilitation is, therefore, the action taken by the bank's management, also directed by the supervisory authority, to overcome the economic, financial and capital stress;

– *authority-led solutions*, when the solution is guided by the authorities and normally achieved by the submission of the distressed bank to official proceedings (administrative or judicial): the conservatorship or the special administration and other forms of official intervention we can find in the international experience. In this case, a bank restructuring is necessary. There is a broad set of techniques for restructuring insolvent banks whose shareholders are unable or unwilling to inject the required capital to restore the bank's soundness under the conditions and within the timeframe set by the regulator. The most common techniques include M&A, good bank/bad bank separation, purchase and assumption (P&A) transactions and bank nationalisation.

Liquidation is the last resort. A bank should be liquidated only when regulatory authorities have attempted to restructure it without success. In a few rare situations, there may be a bank liquidation where regulators have determined that intervention or restructuring is unfeasible and that the bank should be wound down without restructuring.

In liquidation, an entity ceases to exist as a going concern. All ongoing obligations are terminated. The enterprise's assets are assembled, converted into cash and distributed to creditors. Attention will be paid to the different kinds of transactions that can be taken to avoid the breakup of the business unit. In cross-border crises, coordination and information sharing with other authorities are essential to smooth the effects of liquidation on payment and securities settlement systems and financial markets.

2. Before and after the international financial crisis: the watershed.

Banking crises over recent decades have widely been regarded as essentially a micro phenomenon: they were considered to be a problem of "individual" banks in crisis. Only in very few circumstances did crisis events have systemic implications in countries or regions (US Savings and Loans Association in the '80s and early '90s;[5] Scandinavian banks in the '80s; Asian banks in the '90s; Argentinean banks in the early 2000s), with exceptional costs for taxpayers. In fact, even though not expressly provided for in legislation, a non-written rule of public intervention has always been applied for the purpose of reducing the disruptive effects on financial systems and real economies. But even in these "systemic" events the consequences of the crises did not spill over at international level. So, the problem of how to deal with them was, for the most part, a domestic issue.

[5] FEDERAL DEPOSIT INSURANCE CORPORATION, *Managing the Crisis: The FDIC and RTC Experience 1980-1994*, Washington DC, August 1998; FEDERAL DEPOSIT INSURANCE CORPORATION, *Resolutions Handbook: Methods For Resolving Troubled Financial Institutions In The United States*, Washington DC, 1998.

In such a context, each country had its own legal framework for crisis management, with many differences existing among them. But this feature was not felt as a serious drawback, because the international size of banking crises was rather limited and the issue of an institutional and regulatory framework was not considered a priority. From a broader perspective, moreover, there was not a clear will to ensure convergence among insolvency laws for international firms, as a form of defence of national prerogatives in such a delicate and complex issue. As an example of this approach, we can quote the long preparatory work of the European directive on the reorganisation and winding up of credit institutions (Directive 2001/24/EC of 4 April 2001). But the same may be said about the work at the United Nations (United Nations Commission on International Trade; UNCITRAL) for the implementation of the principles and standards concerning the insolvencies of international enterprises.

Indeed, the initiative to create an European framework to regulate banking crises can be traced back to the mid-70s. The hesitations and postponements that characterised the process witness of the lack of unified approaches among Member States. This situation was probably caused by different circumstances. On one side, there was the belief that a crisis in a bank operating internationally was a remote possibility and thus as something outside the expectations of a single country. On the other side, with the ongoing negotiations for a European Convention on bankruptcy, some countries supported the idea of leaving to those negotiations the regulation of banking crises as well. This reflected the conception that a bank-specific framework was not necessary.

A decisive urge to resume work on the directive was essentially triggered by two events. Firstly, the collapses of banking and financial institutions in some countries, especially in the aftermath of the defaults of Banco Ambrosiano (1982), BCCI (1991) and Barings (1995). Secondly, the achievement of the Single European Market and the consequent need of a new legislation for banks. This was particularly important if we consider that, as a result of the principle of free establishment, not only large banks but also medium-sized and small ones could operate with branches outside their home countries.

Furthermore, there was an increasing awareness among policymakers, regulators and operators that the financial system was going through a long period of large and fast transformations. Globalisation, internationalisation, increasing financial integration, new intermediaries and markets, innovative financial instruments and new banking' business models were creating a context of major complexity. New problems and challenges were emerging for regulators and supervisory authorities, which were called to face a new context, requiring attention to innovative phenomena and an increasing capacity to understand them and to deal with the possible instability of individual banks through new and effective instruments. But, nobody would have imagined the explosion of a crisis involving the global financial system.

The financial crisis has changed the general feeling and made evident the need for a more effective and internationally regulated banking crisis management.

Since the global financial system is dominated by complex cross-border or systemic intermediaries, there is now a strong awareness of the necessity to strengthen instruments that deal with financial crises at a national level to reach uniformity and to coordinate actions in the broader international context. This new approach is the result of the new transmission mechanisms of turbulence evidenced by the crisis and of the huge consequences on banking systems, public finances and economies that the crisis produced all over the world, in some way comparable only to that of 1929. Extraordinary measures were adopted by Governments, supervisors and central banks to resolve banks' insolvencies, with exceptional costs for taxpayers: capital injections, asset relief programs, guarantees on assets and liabilities and liquidity support. Even more challenging has been the debate on how to prevent crises in the future. That is why the financial crisis represents the watershed between the "before" and "after". It is common opinion that after the financial crisis nothing will be as it was before.

3. About the financial crisis.

The characteristics of the crisis have been in-depth analysed during the period of turmoil. Its scope and impact were so large that a basic question hovered during the debate that has accompanied the design and implementation of remedial measures. How was it possible that policymakers, economists, regulators, supervisors, and international organisations failed to foresee what was to come? Many are the answers to this question.

One of the explanations pertains to the theoretical approach of economists and regulators, who were excessively confident in the self-regulating and self-correcting capacities of the market, while many warned about the bubble mounting in the subprime mortgage market. Mistakes were made in the analysis and interpretation of the functioning mechanisms of the financial system and in the consideration of possible market failures.[6] Indeed, in the past two decades there had already been a clear evidence of crises generated by bubbles in certain activities or sectors of the international financial system. These experiences provided many economists with the grounds to theorise the process through which speculative bubbles and booms may cause panic and then turn into a crisis, with serious consequences on real activities and employment.[7] According to this

---

[6] J. STIGLITZ, *Freefall. America, Free Markets, and the Sinking of the World Economy,* W.W. Norton & Co., 2010; R. SHILLER, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about it*, Princeton University Press, 2008; N. ROUBINI, *The rising risk of a systemic financial meltdown: the twelve steps to financial disaster*, RGE Monitor, February 5, 2008.

[7] C.P. KINDLEMBERGER- R. ALIBER, *Manias, Panics, and Crashes. A History of Financial Crises*, Hoboken, NJ: John Wiley & Sons, 2005. For an interpretation of Kindlemberger see P. SAVONA, *C.P. Kindleberger. I Momenti d'oro dell'economia*, Collana a cura di P. Savona, Luiss University Press, 2009; R. SHILLER, *Irrational Exuberance*, Princeton University Press, Second Edition, 2005. About the relationships between the financial crisis and politics and public institutions and, more in general, the negative effects of the current market economy on the capitalist democracy, R. A. POSNER, *The Crisis of Capitalist Democracy*, Harvard University Press, 2010. In Italian, R.A. POSNER, *La crisi della democrazia capitalista,* Università Bocconi Editore, 2010.

analysis, bubbles are deviations in the prices of assets, stocks or commodities from "fundamentals" and they have been defined as an upward movement of prices over a period of 15 to 40 months that is bound to implode. Another assumption is that these implosions of bubbles are inevitable. As a consequence of this approach, in contrast to that asserted by the "black swan" theory[8], crisis events are predictable.[9] According to this view, financial cataclysms are as old and as ubiquitous as capitalism itself and are not only predictable but also preventable and, with the right medicine, curable. From previous crisis episodes, we can recognise and grapple with the inherent instability of the global financial system, understand its pressure points and plan for the immediate future. In this sense, many lessons could have been learned from the events that had occurred in different geographic areas (Mexico, Thailand, Brazil, Great Depression), which have much in common with the recent financial downturn.

Since no banking crisis comes out of the blue, there is no doubt on the general incapacity to foresee and interpret the clouds that were largely looming on the horizon. The contributions of economists and rule-makers, however, have turned out to be of essential importance in explaining - even though *ex-post* - the various aspects of the crisis and in triggering the debate aimed at detecting possible solutions, with the objective of preventing them from occurring in the future.

Many observers have underlined the objective difficulty in understanding ex ante the complex transmission mechanisms of the crisis and, perhaps, when the problems started to emerge with the collapse of the US subprime mortgage market - or, subprime follies, as it has been recognised[10] – a sort of underestimation of the possible effects. Others have pointed out the specific responsibilities of some countries and authorities in minimising for some time the scope of what was looming.[11] Serious shortcomings in some countries financial supervision in those countries – owing to the deregulation processes seen in the past two decades - also interacted with the pathological phenomena that were starting and developing over time. Fraud also contributed to bringing about the crisis.[12]

We now have a better knowledge of the complex mechanisms that led to the meltdown of the international financial system. There is not a single cause or a specific event that could be considered the root of the problems, given the huge size, complexity and scope of the phenomenon, whose main causes reside

---

[8] N.N. TALEB, *The Black Swan: The impact of the Highly Improbable*, Random House, 2007.

[9] N. ROUBINI-S. MIHM, *Crises Economics. A crash course in the Future of Finance*, Penguin Audiobooks, 2010.

[10] D. SMITH, *The age of instability. The Global Financial Crisis and What Comes Next,* Profile Books Ltd, 2010.

[11] R. LEVINE, *Finance and Growth: Theory and Evidence*, Handbook of Economic Growth, 2004; S.B. WADHWANI, *What mix of monetary policy and regulation is best for stabilising the economy?*, in The *Future of Finance*, 2010.

[12] About causes and responsibilities of the US financial crisis, see ANGELIDES COMMISSION, the *Financial Crisis Inquiry Commission* established in May 2009 by the Fraud Enforcement and Recovery Act (FERA).

in credit and real estate bubbles. As it has been observed,[13] "to look for the main cause is like peeling an onion. Each explanation gives rise to a new question at a deeper level". Anyway, the investigation on the drivers of the crisis is essential for the purpose of finding the (a)etiological measures of intervention and avoiding its occurrence in the future. Together with macroeconomic imbalances at the global level, disorders essentially originated in the rapid expansion of credit, especially in subprime mortgages in the USA, through a complex mechanism of securitisation. It was generally thought that the "*originate to distribute*" business model, in which loans were packaged - through the securitisation process - into complex structured products sold all over the world, would have achieved a major diversification and dispersion of risks, because of their wide and capillary distribution to investors. Nothing turned out to be so wrong, because when the housing market in the USA collapsed, the value of these structured products abruptly slumped, with consequent losses for investors, banks and financial institutions, which had accumulated huge amounts of these financial products in their portfolios. So, the "originate to distribute" model was actually an *"originate, distribute and then acquire somebody else's credit securities, so that when the music stopped the biggest losses actually arose on the balance sheets of banks and investment banks".*[14]

The same mechanism led to the transmission of the problems to other asset classes and markets, which became illiquid, inducing many operators to fire sales with huge losses. The lack of disclosure on where these assets were booked led to a loss of confidence among investors and financial institutions, which were no longer willing to lend to each other, giving rise to the subsequent market liquidity crisis. In this context, particularly worrying was the drying-up of the interbank deposit market.

As to regulatory and supervisory failures, there is a broad consensus that, among others factors, the "*faulty triad*" (capital standard, accounting standard, credit rating agencies) was to blame. As it has been underlined, the first lesson learned from the crisis was that "*before the crisis, governments, regulators and the financial services industry had for years been affected, in more than one dimension, by a sort of collective and pervasive blindness. The tremendous macroeconomic imbalances that had been accumulating for years, market developments also stemming from regulatory mistakes that had made regulators' knowledge obsolete, the new and crucial role of intermediaries' balance sheets for the transmission of monetary policy, were all phenomena that were either ignored or downplayed in their importance. Surprisingly, though it was widely recognized that risk was being priced and traded globally, this did not lead to*

---

[13] J. STIGLITZ, *Freefall. America, Free Markets, and the Sinking of the World Economy,* W.W. Norton & Co., 2010.

[14] A. TURNER, *What banks do? Why do credit booms and busts occur and what can public policy do about it?*, in *The Future of Finance*, The London School of Economics and Political Science, 2010, available on futureoffinance.org.uh. According the Author, it was a rosy vision "the assertion that securitisation not only made individual banks less risky, but the whole system more stable, because risk was dispersed into the hands of precisely those investors best suited to manage different combinations of risk".

greater international cooperation in financial regulation".[15] Again, it has been recognised that "*we failed to recognise the extent to which savings-investment imbalances, the growth of complex securitised credit intermediation, changing patterns of maturity transformation, rising embedded leverage, a burgeoning shadow banking sector, and rapid credit-fuelled growth, had created large systemic vulnerabilities*".[16]

We can identify the following shortcomings in regulation and in the management of banks:

i) the low quality of capital, largely composed of a wide range of instruments that were not loss-absorbing in case of failure;

ii) the build up of the leverage of financial institutions, associated with an excessive risk-taking, especially in trading book transactions and securitisation's positions, for which the capital requirements were less severe. The crisis has demonstrated that banks reported high levels of Tier 1 capital ratio associated with high levels of on and off balance sheet leverage, triggering in this way a mechanism that determined a progressive increase in profits in normal times and a multiplier of losses when market conditions deteriorated. This is a very challenging issue, which opened a debate on the Modigliani-Miller theory about the appropriate financial structure of a firm;[17]

iii) the distorted incentives built into the remuneration schemes of managers, which were linked to short-term profits without the consideration of long term risks, and, more in general, the serious weaknesses in the corporate governance of financial institutions: insufficient board supervision and control over management; poor risk management, without the consideration of systemic risk; and ineffective controls by shareholders over risk-taking. As underlined, "*risk management practices were often poor, relying on over-simplistic mathematic models; governance arrangement – the role of the boards, risk committees and risk managers – were often inadequate, as sometimes was supervision by regulatory authorities*".[18]

iv) the extent of maturities transformation by banks and other financial institutions, with longer term assets booked against short-term liabilities. In

[15] M. DRAGHI, *Challenges to Financial Stability and the Proposals of the Financial Stability Board*, 12th Conference of the ECB-CFS Research Network "*Learning from the Crisis: Financial Stability, Macroeconomic Policy and International Institutions*", hosted by the Einaudi Institute for Economics and Finance.

[16] M. DRAGHI, *Financial Stability in the global environment? Learning the lessons from the market crisis*, Keynote Speech at IOSCO's Annual Conference, June 10 2009. See also F. CANNATA-M. QUAGLIARIELLO, *The role of Basel II in the Subprime Financial Crisis: Guilty or Not Guilty?*, CAREFIN Working Paper, Università Bocconi, N. 3, 2009.

[17] F.MODIGLIANI-M. MILLER, *The cost of Capital, Corporation Finance and the Theory of Investment*, *American Economic Review*, 1958; F. MODIGLIANI-M. MILLER, *Corporate Income taxes and the cost of capital: a correction*, *American Economic Review*, 1963.

[18] A. TURNER, *What do banks do? Why do credit booms and busts occur and what can public policy do about it?*, in *The Future of Finance*, 2010.

general, an undervaluation of market liquidity risk brought about many bank insolvencies because there was an expectation that the market would have provided the financial institutions with the necessary liquidity at any time;

v) the unregulated and opaque development of the derivatives market, especially of credit default swaps (CDS), which concentrated within the portfolios of a few dealers giving rise to huge counterparty credit risk;[19] and

vi) the pro-cyclicality of financial regulation and accounting rules, which resulted in a lack of capital buffers to use in times of stress.[20]

Furthermore, even though not directly responsible for the crisis, we must mention the uncontrolled development of hedge funds and other unregulated structures constituting a "*shadow-banking system*" (SIVs, ABCP conduits, CDOs and CLOs). These also posed a systemic risk, which banks used to free up their balance sheets by exposures and underlying risks in order to circumvent the capital charges. In particular, the impact of hedge funds and private equity before the crisis was considered largely beneficial, but for a long time it had been underestimated how their activity has contributed to spreading or amplifying risks in the financial system.

Finally, we should also consider the role of rating agencies, whose evaluations on the creditworthiness of companies, Governments and sophisticated financial products - as now generally recognised - contributed to the financial crisis, underestimating the difficulties of complex financial instruments issuers to reimburse their debts.

From a supervisory point of view, the most serious shortcoming in the management of the financial crisis was the lack of preventive and corrective action. Both banks and authorities were found unprepared to the crisis. In the countries where problems had originated, events occurred abruptly and

---

[19] L.A. STOUT, Risk, *Speculation, and OTC Derivatives: An Inaugural Essay for Convivium*, in Accounting, Economics, and Law, A Convivium, Volume 1, Issue 1, 2011;

[20] On the analysis of the complex factors of the financial crisis, see FINANCIAL SERVICES AUTHORITY, *The Turner Review. A regulatory response to the global banking crisis*, March 2009; FINANCIAL SERVICES AUTHORITY, *A regulatory response to the global banking crisis*, Discussion Paper, DP09/2, March 2009. Furthermore, very significant is the reconstruction of the causes of the financial crisis made by the Basel Committee, according to which *"One of the main reasons the economic and financial crisis became so severe was that the banking sectors of many countries had built up excessive on- and off-balance sheet leverage. This was accompanied by a gradual erosion of the level and quality of the capital base. At the same time, many banks were holding insufficient liquidity buffers. The banking system therefore was not able to absorb the resulting systemic trading and credit losses nor could it cope with the re-intermediation of large off-balance sheet exposures that had built up in the shadow banking system. The crisis was further amplified by a pro-cyclical deleveraging process and by the interconnectedness of systemic institutions through an array of complex transactions. During the most severe episode of the crisis, the market lost confidence in the solvency and liquidity of many banking institutions. The weaknesses in the banking sector were transmitted to the rest of the financial system and the real economy, resulting in a massive contraction of liquidity and credit availability. Ultimately the public sector had to step in with unprecedented injections of liquidity, capital support and guarantees, exposing the taxpayer to large losses*" (BASEL COMMITTEE ON BANKING SUPERVISION, *Strengthening the resilience of the banking sector,* December 2009).

simultaneously, when it was too late to intervene because crises were already in their final stages. There was no early stage in which supervisors could prepare appropriate measures, according to the nature and the severity of the crisis, so paving the way to public support as a last resort. Similarly, in other banking systems that were consequently hit by insolvencies, supervisors were also unable to tackle such huge phenomena and they had no chance to arrange timely interventions. Ordinary reporting instruments from banks to supervisory authorities revealed ineffective, and extraordinary informative mechanisms had to be devised on a daily basis.

These extraordinary events required the adoption of special measures by policymakers, regulators and supervisors. Central banks had to intervene with exceptional (unconventional) facilities to provide markets with liquidity, at (very low) fixed interest rates, for unlimited amounts and with long maturities. The extension of these measures was so wide that these are still in force and, as it has been underlined,[21] many European banks actually depend on the liquidity assured by the Eurosystem, so that some *zombie banks* could exist in the market for a certain period of time. It is a task of national central banks to identify them and to coordinate actions with an "exit strategy" still to be designed and implemented, even though we don't know when a way out could really take place. In this respect, uncertainties and concerns still prevail among policymakers and operators about the prospects of the real economy. They seem to support the thinking that liquidity assistance from central banks could continue until clear signs of economic recovery will emerge, in a context where indications of an inflation risks are not so strong.

Another important consequence of the crisis is that liquidity problems turned into solvency problems for many banks all over the world, with different intensities. Special measures and instruments were adopted to bail out banks of very large size and with cross-border activity. Private mechanisms turned out to be insufficient and public finances had to be activated to cover great losses and prevent large and complex financial institutions from failing. These bailouts were considered inevitable since those banks were "*too big*" or "*too interconnected*" or *too complex to fail,*[22] and Governments were concerned for the dramatic consequences of the default on the whole financial system and real economy.[23]

As a consequence of these public interventions, some of the fundamental principles of market economy were questioned, such as the consolidated "*constructive ambiguity*" principle, according to which there should be no

---

[21] M. DRAGHI, Opening address at the Bank of Italy Conference "*The Mezzogiorno and economic policy in Italy*", Rome, 1 October 2010.

[22] R. CONT-A. MOUSSA-A. MINCA-E. BASTO, *Too Interconnected to Fail: Contagion and Systemic Risk in Financial Networks*, Lecture presented at the IMF, Washington D.C., May 2009.

[23] Public support to failing banks in 2009 was 51.9% of GDP in UK, 32.2% in Spain, 20.6% in Germany, 18.4% in French, 1.3% in Italy. See F. SACCOMANNI, *L'Unione Europea di fronte alla crisi globale: le implicazioni per le banche, la finanza e la politica economica*, Speech at the EU Berliner Gesprache, Bundesministerium der Finanzen, Berlin, 8 February 2011.

certainty about State support in the case of the insolvency of a big bank. New EU principles were issued by the European Commission, in accordance with article 87, par. 3, lett. b) of the Treaty, which allowed State aids when these are necessary "to remedy a serious disturbance in the economy of a Member State"; furthermore, new assessment methodologies were defined for rescuing and restructuring firms in difficulty (see chapter 2).

These interventions had wide scope and extension; public finances were put under stress, in terms deemed no longer sustainable. Now we are aware that in the future it will be no longer possible that taxpayers are charged with the costs of banks' insolvencies, which should fall under the responsibility of the same bankers according to the "*polluters pay*" principle. The main issue is, therefore, to identify the appropriate regulation and instruments to make it possible, so that no systemic crises can in the future come out of the blue. The preservation of market discipline and the minimisation of moral hazard are also imperatives for policymakers. In designing the new framework we should consider that moral hazard can only be reduced, not eliminated at all, because the fact that the banking system is regulated and supervised make it unavoidable.

4. Rethinking the overall design of the financial system.

A lot has been written on the international financial crisis, whose effects have probably not yet ended, especially in terms of the effects on economies. As said, worries about a recessive economy and unemployment in the major developed economies still seem to justify a continuing loose monetary policy and the availability of central banks' extraordinary liquidity assistance to financial institutions. So, the objective of this work is not to go back over the causes of the financial crisis, but to look into what should be done to prevent these phenomena from occurring in the future and to intervene, when needed, without recourse to public finances. This should be the strongest commitment for policymakers.

There are very strong expectations at global level for changes in international and national banking systems. The behaviours of bank managers and supervisors have been under scrutiny over the past two years in that, as underlined, the crisis has highlighted a human drama, regarding the fallibility of people who were thought to be too big to fail.[24]

As long as things go well nobody question the regulatory and supervisory framework; but when things turn sour, beyond the analysis of the causes and ways of intervention, the search for what didn't work and who's to blame and the tendency to make some changes become inevitable. This explains why, historically, the major reforms in regulation and supervision and changes in institutional set-ups have followed the crises.

---

[24] A. R. SORKIN, *Too Big To Fail. The Inside Story of How Wall Street and Washington Fought to Save the Financial System – and Themselves*, Penguin Group, 2009.

In this case, we might say that every cloud has a silver lining, since lessons learned from the financial crisis are the foundations for change. We know that something that was once believed unrealisable has happened and could happen again in the future. A broad analysis of the causes of the banking crises and a brief overview of the solutions adopted to deal with them is unavoidable, insofar as they represent the backdrop from which to move in order to understand what could happen and to design an appropriate legal and institutional framework for the improvement of tools to manage such events. For this purpose, due consideration is given here to the ongoing work put forth by various international bodies, Governments, regulators, supervisors and central banks in order to reshape the financial system.

It is now clear that systemic crises (characterised by the simultaneous occurrence of many banking crises or by a general market distress that may jeopardise financial institutions) not only affect domestic financial systems but may spill over across national borders, with the consequent involvement of many countries both in crisis management and resolution and in sharing the burden. Consequently, we can no longer rely on the traditional paradigms in the assessment of the causes, effects and solutions of the crises. Indeed, in a globalised financial system, different types of crisis phenomena exist: causes are not only or not necessarily idiosyncratic, but they can come from the market. In contrast to past experiences and beliefs, market and funding liquidity risk can be autonomous sources of crisis that can end up in a bank's insolvency. The solutions are more complex and can hardly be reached without external support, especially without State backing - unless alternative mechanisms based on private contributions are found - if we want to avoid the disruptive effects on financial systems and economies. It is now evident that the purpose of a harmonised framework for the management of a systemic crisis should cover not only the final stage of insolvency but also encompass all phases, from supervision to the resolution of failing banks, because not only is orderly resolution imperative but so is prevention.

The objective is to strengthen the financial system in order to make it better equipped to manage new and more complex as well as and more resilient to market distress. In addition, authorities have to improve their armouries with more effective powers of intervention. If, despite the reinforced apparatus of instruments that will be arranged, crises should happen, an appropriate "toolkit" should be in place to deal with them in a timely and effective way in order to avoid taxpayers' sacrifices and to minimise the costs for all stakeholders as well as the disruptive effects on markets and economies.

For policymakers, it is not just an issue to fine-tune the current framework, but it is a complete rethinking of the whole design of the financial system. Many theoretical positions have recently been developed on this issue, with different recipes. Structural or functional approaches are sharing the playing field.

Whatever the modality of the reshape will be, what seems to be incontrovertible is that a global approach should be followed, and that a wide range of areas of intervention should be considered, because the objective is not only that to

introduce new tools for future crises, but, mainly, to reduce the probability of their occurrences. As underlined, the reform of the financial system *should be based on a comprehensive system, which would extend, in a proportional way, to all actors, intermediaries, markets and activities that embed potential systemic risk, also to avoid the problems of unsupervised "parallel" banking system.*[25]

In this vein, many policymakers and observers have proposed to respond to the structural problems highlighted by the crisis with structural remedies.[26] They have backed the abolition of the universal bank model and the return to the distinction between commercial banks and investment banks for the purpose of avoiding conflicts of interest between deposit-taking activity and trading activity, as it was in many countries before the liberalisation process of recent decades (in the USA with the *Glass-Steagall Act* of 1933, abolished with the *Gramm-Leach-Bibley Act* of 1999). In the course of the debate, different configurations of a new business model have been proposed, based not only on a clear-cut distinction between "*utility banking*" (or *narrow banking*)[27] and *investment banking* (or *casino banking)*, but also on different combinations of the two activities, with the second one limited within certain thresholds in order to reduce risks. Another opinion supports the idea of reducing the sizes of the banks, in order to avoid adverse incentives in risk management, because in the case of insolvency the banks will be bailed out.

These proposals have received ambiguous and not unanimous support by policymakers. Many regulators have opposed these ideas, because of the lack of timeliness and ineffectiveness of the proposed measures. Until now, there has not been a clear tendency in the implementation of changes in national legislations.

In alternative to the changes in business models and structures of the banks, it seems to gain more consensus the introduction of stronger prudential rules that, leaving unchanged the model, aims to make it work better. Therefore, specific proposals of changes in regulation, supervision, crisis management and resolution should be grounds for interventions. Innovations in banking legislation and insolvency law in many countries could be necessary. Moreover, they should cover all financial institutions, irrespective of their natures and sizes, even though major innovations should regard large and more complex banks as those with systemic implications.

---

[25] P. TUCKER, *Shadow banking, capital markets and financial stability*, Remarks at a BGC Partner Seminar, London, 21 January 2010.

[26] For an interesting and critical examination of the factors and the responsibilities of the financial crisis and the structural changes needed, N.N. TALEB, *Robustezza e fragilità. Che fare? Il Cigno Nero tre anni dopo*, Il Saggiatore, 2010. This is a new book published in Italy, but it constitutes an added section on *"Robustness and Fragility"* to the previous *The Black Swan: The Impact of the Highly Improbable*, Random House, 2007.

[27] J.R. BARTH-R.D. BRUMBAUGH Jr-J.A. WILCOX, *The repeal of Glass-Steagall and the Advent of Broad Banking*, Economic and Policy Analysis Working Paper 2000-5, April 2000; G. BENSTON, *The separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered*, New York, Oxford University Press, 1989; R.J. PHILLIPS-A. ROSELLI, *Narrow banking: a Proposal to Avoid the Next Taxpayer Bailout of the Financial System*, in ApertaContrada. Riflessioni su Società, Diritto, Economia, avalaible on website www.apertacontrada.it, 2009.

The key assumption is that if we want to reduce the probability of banking crises it is essential for supervisory authorities to strengthen prevention, with new rules aimed at better addressing risks. In this direction, more effective instruments are necessary for the supervision of systemic banks, so that we can no longer use a "*one size fits all*" approach. New forms of interaction and dialogue between supervisory authorities and intermediaries are necessary, aimed at increasing the bank's awareness of its risks ensuring that firms are well structured, in terms of organisation, internal controls and risk management, to more effectively deal with risks, market complexity and other negative events. Dialogue and cooperation are important between supervisory authorities and banks; for systemic banks, they are of paramount relevance. The Pillar II of Basel 2, appropriately revised, should be the framework for such an interaction.

Early intervention should be strengthened with a more articulated and sophisticated "toolkit". Here, the involvement of supervisory authorities has to be much more intrusive, and it could even lead to the replacement of the management for the preparation and implementation of a recovery plan. In addition, the provision of liquidity by central banks as a lender of last resort plays an essential role.

When a bank is failing, an effective crisis management and a resolution framework is crucial. The main problem is to identify, as earlier as possible, the characteristics of the banking crisis and to answer the three already mentioned fundamental questions: *"who intervenes", "when do they intervene" and "how do they intervene*. This should be based on a definition of principles and objectives in order to give the market and operators a clear *ex-ante* picture of the authorities' behaviour and of the actors that will bear the costs of the crisis. It is now clear that there should not be banks that cannot fail because, as it has been observed,[28] "if some banks are thought to be too big to fail,…. they are too big", in the sense that they are too big to exist or they should be subject to limitations in what they can do. In case of failure of a large bank, the only concern for policymakers should be to lead it to an orderly winding down process. The consideration of the wide range of interests involved in a banking crisis, however, requires more advanced and effective tools for resolution, because in some circumstances and for certain financial institutions continuity in the provision of key financial services, especially for credit to the economy, must be preserved, upon the condition that the relative costs should be charged to private stakeholders.

Cross-border issues are critical. The financial crisis has shown a high degree of interconnection among economies and the existence of "spillover" effects (externalities), which require a stronger coordination of interventions, especially at the EU level, considering the increasing integration among financial institutions and markets. Here the problems to work out are more complex, because they

---

[28] M. KING, Speech held at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 17 June 2009, available on the website http://www.bankofengland.co.uk./publications/speechs/2009/speech394.pdf.

not only imply the introduction of supplementary measures in each country's legal system, but also require agreements at global level on how to deal with international banking crises and on the roles of the different authorities involved. At the EU level, this problem is no longer deferrable, because it is a fundamental aspect of the single community market.

These issues are now being debated at international level.[29] Many international bodies (Financial Stability Board, Basel Committee on Banking Supervision, European Commission, and International Monetary Fund) are working on these topics; a lot of reports have clearly analysed and put forward possible solutions to reinforce regulation, supervision and crisis management, especially for systemically important financial institutions (SIFIs), which may disrupt the financial system and cause losses for taxpayers. The scope is very wide, but the national approaches to these delicate issues are not always the same. Of course, designing a new system is something different from implementing it, because the existing frameworks are very different one from another and the range of innovations is very wide, including the areas of supervision and crisis management. These should move together in a coherent way because the latter is a qualified component of the former, and this explains the reason of the existence of a special regime in the financial sector.

It is important to underline that just some years ago it would have been unrealistic to think about a convergent framework for international banking crises, which could limit sovereign rights. After the financial crisis the situation has significantly changed. The difficulties encountered in dealing with such complex financial institutions and the severe consequences on public finances have notably increased awareness at international level. Policymakers and regulators now understand the necessity to elaborate and implement a new juridical and institutional system to deal with banking crises, with the purpose of preserving financial stability when the unavoidable disturbances of systemic magnitude affect national and international financial systems.

Many questions have been raised during this period: are we going in the right direction and in a fast and effective way? Can we reach a consensus among countries for the implementation of the necessary measures? Will there be balanced solutions for cross-border crisis handling, where the decision-making process is essential and burden sharing issues arise?

5. The Italian crisis management framework.

In the second part of this work, a description of the Italian framework for banking crisis management will follow. It is an interesting model to examine as it is based on a special regime for banking crises. The main procedures were

---

[29] For an analysis of the various issue related to the financial crisis and possible remedies, see V.V. ACHARYA-M. RICHARDSON, *Restoring Financial Stability. How to Repair a Failed System*, John Wiley & Sons, Inc., 2009.

introduced as early as 1936 by the Banking Law and they have proven effective despite the extensive transformation process that has characterised the Italian banking system especially in the past 20 years. These procedures were partially modified by the 1993 reform of the Banking Law (legislative decree n. 385 of 1 September 1993), which followed the privatisation of the banking sector.

A general overview of the crisis management system will be presented, highlighting the central role of the Bank of Italy, in its supervisory capacity, in the treatment of all different pathological phenomena concerning the banking system. Its strength definitely resides in its capacity to coordinate supervisory activities with the central bank's liquidity provision, which worked successfully in many situations, especially during the financial crisis. In the few cases in which the '90s banking crises were dealt with through public support, they were resolved with no considerable costs for taxpayers and ended with the privatisation of banks.

The enduring validity of the Italian special crisis management framework despite the profound changes in regulation and market dynamics is based on the flexibility in law provisions, which allows a great adaptability of the instruments to the changing environment, where competition rules and market discipline play a primary role. During the crisis some measures were adopted, along the lines agreed in the international coordination, in order to deal with the extraordinary and specific problems emerging. Supplementary changes to national legislation could nonetheless be necessary in light of the evolution of the international teamwork for regulation, supervision and crisis management, especially for those aspects concerning the treatment of large and complex financial institutions and their systemic implications on a cross-border basis.

CHAPTER 1

THE MANAGEMENT OF BANKING CRISES BEFORE THE INTERNATIONAL FINANCIAL CRISIS

1. The experience of recent decades.

A concise description of the international framework for banking crisis management as it was before the outbreak of the 2007 global financial crisis is essential to better understand the national stances emerged during and after the turmoil and to catch the very scope of the evolution of theoretical and practical national approaches in managing the banking insolvencies in that period.

It is to be noted firstly that the age "before the financial crisis" refers to a period lasting approximately two decades, in which relevant innovations and a significant process of international integration took place in the financial markets. Regulation has been following and, in some cases, anticipating this process, especially at the EU level, where a single market was the main objective of the European authorities. Banking crisis management was a part, although not a essential one, of this objective, considering the very long time it took to draw up a European directive in this field and the partial achievements in terms of the effectiveness of the solutions identified, as it was, undoubtedly, a result of many compromises.

In particular, during the 80s and 90s national frameworks on crisis management were essentially referable to two basic models:

- the judicial model: in countries such as the United Kingdom, France, Spain and Germany, and in some ways also the USA and Canada, banks were put under judicial procedures, whereas the supervisory authorities retained a number of powers within this framework, such as the appointment of liquidators and the authorisation or conduct of sales of assets;

- the administrative model: in other countries, such as Italy, Greece, Portugal and Finland, special procedures were adopted and managed by the administrative authorities. In these cases, judicial authorities were entrusted with powers to sort out conflicts among parties involved in the proceedings.

At that time, the merits of each one of these models were strongly disputed. Those backing the first model strongly opposed any departure from the general bankruptcy law for commercial firms, assuming that banks were similar to other firms operating in a competitive market. According to this theory, the possibility of ruling out a bank from the market under certain circumstances was deemed to be an essential element of market discipline. On the contrary, those opting for the administrative model stressed the peculiarities of the banking business, so justifying the provision of a special crisis management regime for banks as well as the central role carried out by the supervisory authority or by other administrative

authorities.[30] In particular, this approach emphasized the wider range of interests involved in the banking business, which deserves stronger protection than those related to industrial or commercial firms, and confers to a banking crisis some specific characteristics, such as:

i) the size and nature of liabilities: normally, for a bank, the ratio between liabilities and own funds is much higher than for other firms; moreover, banking intermediation consists of taking deposits from the public. People entrusting savings to the bank generally are not professional investors and, in general, they are unable to assess properly the quality or riskiness of the banking assets on which the reimbursement of deposits depends;

ii) the monetary function of banks' liabilities: deposits are immediately convertible into money; the stability of these liabilities, and consequently of the bank, depends also on depositors confidence. If the depositors lose confidence, there could be a run on the bank, with all its obvious consequences;

iii) a close network of relationships among financial intermediaries, which entails the risk of infection/contagion or a high probability of a transmission of troubles from one entity to another, so triggering a systemic crisis, i.e. " the domino effect"; and

iv) tight relationships between banks and the productive system: collapses in the financial system pose a serious risk to the real economy.

2. The process of the internationalisation of the banking sector and the initiatives to set up international regulations.

In the past two decades, a significant process of integration and internationalisation in the financial markets has taken place. This has led to the consolidation of intermediaries, whose non-domestic activities have remarkably increased, both through financial relationships with foreign entities and the setting up of subsidiaries or branches. Market integration along with financial innovation has led to a growing level of competitiveness.

Because of these factors, cross-border and cross-sector banks, so-called "*global players*" or large and complex financial institutions (financial groups, industrial firms with relevant financial activities) have undergone a strong and continuous process of development.

This phenomenon has changed the traditional model of banking remarkably. Owing to new regulations, the financial activities performed by banks have also significantly changed, entering into new and diversified sectors and types

[30] E. HUPKES, *Insolvency - why a special regime for banks, in Current Developments in monetary and financial law*, Vol. 3, IMF, 2003; G. BOCCUZZI, *La crisi dell'impresa bancaria. Profili economici e giuridici*, Giuffrè, Milano, 1998.

of products that entail more complex risk factors. This process has inevitably raised more complex problems about a bank's risk management, organisation and internal control systems as well as about supervisory authorities.

Unlike the growing international exposure of firms, the harmonisation process of national legislation has definitely revealed inadequate, leaving financial transactions subject to national laws. Moreover, considering in particular the significant developments and convergences achieved in the prudential regulation (Basel 1 and 2), it is to be noted that the sole insolvency law has remained strictly related to national regulations, even though the sensitiveness of this issue has been increasing all over the world. In particular, it has been evident that in a changing environment, the increased process of internationalisation and the growing size and complexity of a bank's structure determine the gap between global finance and national regulations, resulting in uncertainties and conflicts on the applicable law and on the enforcement of contracts. As a result, the financial system has proven more vulnerable than it was in the past.

The implications of crises affecting enterprises or groups of them - and the effects of those specifically involving banks or groups of them - have assumed scope and characteristics that have overcome national boundaries, as a consequence of the changes taking place in the international economy, especially, in the financial sector. The financial industry has rapidly spread at international level in the aftermath of deregulation and ICT progress as well as a consequence of innovations in markets, instruments and services, which have increased the speed and volume of transactions. Consequently, many financial institutions and businesses have grown internationally.

In this context, there was an increasing attention from the international financial community towards policies and legal, institutional and regulatory frameworks to effectively deal with insolvency in general and with bank crises in particular. Thus, a number of initiatives were put in place at an international level with the aim of identifying homogeneous rules of behaviour and procedures for cooperation among all players in insolvency proceedings. Such initiatives, mainly based on sharing information, include works by UNCITRAL and INSOL (International Insolvency Practitioners Association) on the study of international insolvency, whose findings have been debated in many international meetings and resulted in the publication of a series of papers. Specifically, these studies have identified common principles and recommendations to be applied to all types of insolvencies, not only in the financial sector, and have established guidelines on cooperation, recognition and access for international insolvency proceedings with the aim of making them orderly, speedier and more efficient. An important achievement of UNCITRAL in this area is its "Model Law on Cross-Border Insolvency" (the "Model Law"),[31] adopted in 1997, which provides

---

[31] UNCITRAL, *Model Law on Cross-Border Insolvency with Guide to Enactment*, United Nations Publications, New York, 1999. For guidance and advices in the design of a national insolvency law, UNCITRAL, *Legislative Guide on Insolvency Law*, United Nations Publications, Vienna, 2005. Moreover,

for the insolvency of a single firm with a presence in foreign jurisdictions. It is a model that countries may voluntarily incorporate into their domestic legal frameworks.

The model aims to reach universal consensus on certain features of a modern insolvency system, offering an opportunity to introduce supplements, improvements and uniformity at an international level. Its main principle is that the discipline applicable has its foundation in the home country's insolvency law. Moreover, the UNCITRAL framework disciplines the collective representation of creditors and the control over debtor's assets and business by a court or a public official. The model detects some essential rules of cooperation in terms of the following: access by the administrators of a foreign insolvency before the court of the State involved; the criteria and consequences of the recognition of a foreign insolvency; transparency for foreign creditors in starting (or in participating in) an insolvency proceeding; cooperation between courts of different States; powers of courts and administrators to obtain assistance abroad; coordination with the concurrent foreign insolvency proceedings.

However, difficulties in the full implementation of these principles remain, because of the lack of an international treaty aimed at translating these principles into binding rules. Moreover, the UNCITRAL model does not apply to entities for which special insolvency regimes may exist under national law, in particular, banks and insurance companies. Finally, it does not apply to corporate groups comprising legally distinct subsidiaries or affiliates.

It is worth noting that the United Nations' attention to this important issue has been fuelled by the financial crisis, since further guidelines have recently been issued by UNCITRAL in the field of cross-border insolvency cooperation, with the objective of providing judges and stakeholders with information on good practices in insolvency proceedings for cross-border coordination and cooperation.[32] Moreover, the insolvency of corporate groups is currently the subject of a separate UNCITRAL project, aimed at preparing a legislative guide on the treatment of cross-border enterprise groups in insolvency.[33] An enterprise group is "two or more enterprises that are interconnected by control or significant ownership". This will provide, inter alia, the possibility of the joint application and procedural coordination of proceedings of different legal entities in a group, appointment of single administrators, implementation of a joint reorganisation plan and consolidation of assets.

UNCITRAL, *Legislative Guide on Secured Transaction. Terminology and recommendations*, United Nations Publications, Vienna, 2009.

[32] UNCITRAL, *Practice Guide on Cross-Border Insolvency Cooperation*, July 2009. Available on http:/www.uncitral.org/uncitral/index.html.

[33] UNCITRAL, *Legislative Guide on Insolvency Law. Part three: Treatment of enterprise groups in insolvency*, Press release 21 July 2010. On this issue, see BANK OF ITALY, *Insolvency and Cross-border Groups. Uncitral Recommendations for a European Perspective?*, Legal Research, No 69, February 2011; L. PANZANI, *L'insolvenza dei gruppi di società*, Università di Buenos Aires, II Congreso International de Derecho Comercial y de los Negocios, Buenos Aires, 1-4 June 2009.

As to bank insolvency, many international bodies have analysed the phenomenon to define principles, guidelines and best practices for regulators and supervisory authorities. Far reaching objectives of harmonisation and international convergence have been put aside to pursue an easier goal, namely seeking a common language by identifying tools, ways of cooperation and coordination in crisis management and being prepared if such an event occurs. Something that now, with hindsight, could seem to be doomed.

The initiatives of these international financial institutions can be divided into two broad categories:

– setting up guidelines and good practices, mainly directed to countries that needed to strengthen their banking resolution frameworks;
– defining initiatives to address the major challenges for developed countries, namely confronting the uncertainties stemming from the cross-border size of the banking business.

In this connection, it is worth mentioning the various initiatives that took place towards the end of the '90s and the beginning of the 2000s in the various fields related to banking crisis management.

In 2001, the Financial Stability Forum issued a report on "*Guidance for Developing Effective Deposit Insurance Systems*", which identified principles and criteria to support countries wishing to adopt or reform an explicit DIS.[34]

In March 2002, the Basel Committee, following the mandate of the Financial Stability Forum, published a report on "*Supervisory Guidance on Dealing with Weak Banks*". This useful document was built on the experiences of the technical staff of supervisory authorities and central banks that were involved in crisis management. It aimed at developing guidelines for dealing with problems in individual banks, providing a tool-kit offering practical guidance in the areas of problem identification, corrective action, resolution techniques and exit strategies for weak banks.[35]

After this report, another group organised by the World Bank and the IMF worked on the "*Bank Insolvency Initiative*", seeking to identify an appropriate legal, institutional and regulatory framework for dealing with a bank's insolvency in the context of systemic crises.

From the same perspective, the Bank for International Settlements and the G10 gave rise to a study on the "*Legal and Institutional Underpinning of the International System*", aiming at identifying deficiencies in the legal underpinnings

---

[34] FINANCIAL STABILITY FORUM, *Guidance for Developing Effective Deposit Insurance Systems*, 24 September 2001, available on www.fsforum.org.

[35] BASEL COMMITTE ON BANKING SUPERVISION, *Supervisory Guidance on Dealing With Weak Banks,* March 2002, available on www.bis.org. For an analysis of this report and other international initiatives for cross-border insolvency, see A. DE ALDISIO, *Banking crises management: an overview of the international debate*, Fondo Interbancario di Tutela dei Depositi, Working Paper n. 7, September 2003.

of the financial system of industrialised countries, which may undermine the fair and efficient resolution of financial and non-financial firms.[36]

3. The EU Regulatory Framework for dealing with cross-border insolvencies.

Many of the European legislative initiatives adopted over the past 10 years have marked a process that has lead to significant developments in the field of financial crisis in order to protect the relevant stakeholders. As a result of this process, we can say that a *special insolvency law for finance* has been taking place.

The main legislative measure is the Directive on the 'Reorganisation and Winding up of Credit Institutions' (2001/24/EC of 4.4.2001), which recognised the principle of the peculiarity of banking crisis procedures. This is a specific directive for banks, while a year before the EU had already approved a regulation on insolvency proceedings for commercial firms (2000/1346/EC of 29.5.2000).[37]

The banking Directive is aimed at governing crisis procedures for banks that have a head office located in one of the EU States and branches in other Member States. In such cases, the coordination of Member States' bankruptcy regulations gets compulsory.

Two basic principles are followed here: the *unity* and *universality* of the procedures. According to the Directive, the administrative or judicial authorities of the "home Member State" (the Member State where the intermediary has its head office) are empowered to decide on the implementation of reorganisation measures or winding-up proceedings. The measures are mutually recognised and are fully effective throughout the Community without any further formalities. This option is coherent with the general principles of Community regulation of the banking sector (Directive 2006/48/EC), on which basis banks and their EC branches are deemed to be single entities and come under the supervision of the competent authorities of the State in which authorisations were given (the so-called "single European license").

---

[36] BANK FOR INTERNATIONAL SETTLEMENT, Contact Group on the Legal and Institutional Underpinnings of the International Financial System, *Insolvency Arrangements and Contracts Enforceability*, 2002, available on www.bancaditalia.it.

[37] G. BOCCUZZI, *Direttiva comunitaria in materia di risanamento e liquidazione degli enti creditizi. Commento ai Titoli I, II, III, IV (art. 28, 29 e 33)*; M. PELLEGRINI, *Direttiva comunitaria in materia di risanamento e liquidazione degli enti creditizi. Introduzione al Titolo IV (artt. 20-27-30-32)*; R. CERCONE, *Direttiva comunitaria in materia di risanamento e liquidazione degli enti creditizi. Le eccezioni all'applicazione della lex concursus (titolo IV, artt. 20-27-30-32)*, in G. ALPA-F. CAPRIGLIONE (a cura di), *Diritto Bancario Comunitario*, UTET, Torino, 2002; E. GALANTI, *The new EC Law on Bank Crisis*, International Insolvency Review, 2002, Issue 1, 49; J.P. DEGUEE, *The Winding up Directive Finally Establishes Uniform Private International Law for Banking Insolvency Proceedings*, in European Business Review, 2004, 1, pp. 99 ss.; E. FERNANDEZ-BOLLO-C. ARNAUD, *Défaillance des établissements de crèdit*, in Rev. Droit banc. et financ., 2000, pp. 369 ss.; A. CAMPBELL, *Issues in Cross-Border Bank Insolvency: The European Community Directive on the Reorganization and Winding-Up of Credit Institutions*, in www.imf.org/external/np/leg/sem/2002/cdmfl/eng/campb.pdf.

In order to grant a full application to the aforesaid principles, the Directive provides for the mutual recognition of the officials appointed by the competent authority (special administrators, liquidators) as well as their entitlement and powers to manage the procedures. No secondary proceedings may be started by the other Member States, unlike the European Insolvency Regulation referred to earlier.

In other words, the procedures are fully effective in the entire EU according to the "home Member State" principle and with reference to all the bank's assets and relationships (*lex concursus*). According to this principle the home country law regulates procedural aspects (composition, appointment and powers of the organs of the procedure, carrying out the proceeding, etc.) as well as substantial aspects (effects of the procedure on the rights of third parties, on pending contracts, etc.).

It should, however, be pointed out that the application of *lex concursus*, or the rule under which the home Member State law determines the effects of the proceedings is not rigid in character, since there are rules - through reference to a law of another Member State - geared to avoiding that such effects could conflict "with the norms generally applied in the context of economic and financial activity of the credit entity and its branches in other member States" (Consideration 23). The need for flexibility arises from the specific will of the Community to provide special protection to certain aspects, such as labour contracts, transactions of particular goods and regulated markets where financial instruments are traded (Consideration 24). Finally, it is expressly underlined that the transactions carried out in the payment and settlement systems come under Directive 98/26/EC of 19 May 1998, on settlement finality in payment and securities settlement systems.

So, by the derogation of *lex concursus*, the effects on specific contracts and rights are regulated by Member State laws, within which they originate. Derogations may be identified for broad categories:

i) *lex contractus*: the law applicable to some contracts before the opening of the procedure (employment contracts, netting agreements, repurchase agreements, transactions on regulated markets);

ii) *lex rei sitae*: the law where the good object of the contract or the right is located or the good is registered; this is for immovable property and registered goods;

iii) *lex register*: the law applicable to a centralised deposit system or register where rights are recorded (enforcement of proprietary rights on dematerialised financial instruments); and

iv) *lex fori*: the law of the country where the judicial controversy is pending.

Information sharing among authorities and implications on third parties rights are aspects of paramount importance in this context, in light of the powers and the responsibilities to adopt measures granted to home Member States and their potential effects throughout the Community. In particular, home Member

States that intend to open a reorganisation measure have an obligation to inform without delay, by any available means, the competent authorities of the host Member States. In cases of urgency communication could be after the opening of measures, provided it is immediately after. This information will be channelled through the supervisory authority, even when the judicial authorities can adopt a particular measure.

Along with the work on the reorganisation and winding up of banks, steps have been taken on the Convention on Bankruptcy, which leads to a specific regulation, a different legal instrument to regulate insolvency at the EU level that needs no further implementation in single countries. Thus, on 29 May 2000, even before the approval of the Directive on banking crises, Regulation 2001/1346/EC on insolvency procedures was issued.[38]

This burst of legislative activity on the delicate matter of insolvency led to the issue of the 'settlement finality' Directive (Directive 98/26/EC of 19 May 1998), which aimed to regulate the finality of transfer orders inserted by intermediaries in the payment and securities clearing systems to safeguard the functioning of these systems, and to the Directive on the reorganisation and winding up of insurance companies (Directive 2001/17/EC of 19 March 2001).

The EU Directive on settlement finality in payment and securities settlement system (SFD) considers some relevant factors including the systemic risk inherent in payment systems that operate based on several legal types of payment netting, in particular multilateral netting. It also considers the importance of reducing the risk associated with participation in securities settlement systems, in particular where there is a close connection between such systems and payment systems. It is evident that the crisis of a participant in a payment and settlement system may have serious consequences on the system itself and widespread effects on other intermediaries (the domino effect).

The most prominent provision in the Directive is the legal enforceability of transfer orders and netting even in the event of insolvency proceedings against a participant, as they are binding to third parties, provided that transfer orders are entered into a system before the moment of opening such insolvency proceedings. For this purpose, the moment of opening of insolvency proceedings coincides with the moment in which the relevant judicial or administrative authority handed down its decision. It is specified that no law, regulation, rule or practice

[38] At a general level, it should first be noted that the Directive on banking and the Regulation on insolvency reflect the same fundamental approach and are based on the same principles (unity and universality of the winding up proceedings, home country responsibility). A major difference is the provision in the Regulation for the opening of 'primary' procedures (opened by the home country) and 'secondary' procedures (opened by the host country), with precise mechanisms for co-operation, whereas the banking directive tends towards the full realisation of the principles of unity and universality of procedures, establishing the extraterritoriality of reorganisation and winding up adopted by the home country Authorities and the related effects. Nevertheless, as said, the numerous problems that a rigid application of the home country discipline can give rise to, because of diversities, at times very great, that exist between the different regulatory frameworks, especially in specific laws and judicial relationships are not neglected, rather they are resolved through appropriate provisions for derogation.

on the setting aside of contracts and transactions concluded before the moment of opening of insolvency proceedings will lead to the unwinding of a netting.

The Directive also provides protection, to some extent, to transfer orders that are entered into a system after the moment of the opening of insolvency proceedings and are carried out on the day of the opening of such proceedings. However, they are only legally enforceable and binding to third parties if, after the time of settlement, the settlement agent, central counterparty or clearinghouse can prove that they were not aware, nor should have been aware, of the opening of such proceedings.

The moment of the entry of a transfer order into a system is defined by the rules of the system. If there are conditions laid down in the national law governing the system as to the moment of entry, the rules of that system must be in accordance with such conditions.

Member States may provide that the opening of insolvency proceedings against a participant cannot prevent any funds or securities that are available on the settlement account of that participant from being used to fulfil that participant's obligations in the system on the day of the opening insolvency proceedings. Furthermore, Member States may also provide that such a participant's credit facility connected to the system can be used against available, existing collateral security to fulfil that participant's obligations in the system.

Insolvency proceedings cannot have retroactive effects on the rights and obligations of a participant arising from, or in connection with, its participation in a system earlier than the moment of opening such proceedings.

In the event of insolvency proceedings being opened against a participant in a system, the rights and obligations arising from, or in connection with, the participation of that participant will be determined by the law governing that system.

Furthermore, the directive provides for the insulation of the rights of holders of collateral security from the effects of the insolvency of the provider. Indeed, the rights of i) a participant to collateral security provided to it in connection with a system and ii) the central banks of the Member States or the European Central Bank (ECB) to collateral security provided to them are not affected by insolvency proceedings against the participant or counterparty to the central banks of the Member States or the ECB that provided the collateral security. Such collateral security may be realised for the satisfaction of these rights.

Where securities (including rights in securities) are provided as collateral security to participants and/or the central banks of the Member States or the ECB, and their right (or that of any nominee, agent or third party acting on their behalf) with respect to the securities is legally recorded on a register, account or centralised deposit system located in a Member State, the determination of the rights of such entities as holders of collateral security in relation to those securities are governed by the law of that Member State.

Finally, very important for the European financial system is the Directive on financial collateral arrangement (2002/47/EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements - FCD). This aims at eliminating differences between national laws in the validity and enforceability of collaterals that guarantee cross-border financial transactions. This reduces informative costs, the uncertainties on the applicable law and the related risks. With the Directive, it is possible to improve the legal certainty in the domestic and cross-border use of collateral and, consequently, the increase of the integration, efficiency and stability of a financial system.[39]

These objectives are reached through:

i) the limitation of administrative burdens for financial collateral constitution. This means that the only perfection requirement that national law may impose should be that the financial collateral is delivered, transferred, held, registered or otherwise designated as being in the possession or under the control of the collateral taker. According to this provision, Member States cannot require that the creation, validity, perfection, enforceability or admissibility in evidence of a financial collateral arrangement or the provision of financial collateral under a financial collateral arrangement are dependent on the performance of any formal act.

ii) the improvement of the certainty and rapidity of procedures for the enforcement of collaterals, also in case of the submission of a debtor to an insolvency proceeding. On the occurrence of an enforcement event, the collateral taker should be able to realise any financial collateral provided under, and subject to the terms agreed in, a security financial collateral arrangement: i) by the sale and the appropriation of the financial instruments and by setting off their value against, or applying their value in discharge of, the relevant financial obligations; ii) cash by setting off the amount against or applying it in discharge of the relevant financial obligations.

    An enforcement event means an event of default or any similar event as agreed between the parties on the occurrence of which the collateral taker is entitled to realise or appropriate financial collateral or a close-out netting provision comes into effect;

iii) the disapplication of certain insolvency provisions, so that a financial collateral arrangement, as well as the provision of financial collateral under such an arrangement, may not be declared invalid or void or be reversed on the sole basis that the financial collateral arrangement has come into existence, or the financial collateral has been provided:

    (a) on the day of the commencement of winding up proceedings or reorganisation measures, but prior to the order or decree making that commencement; or

---

[39] About the Financial Collateral Directive and its implementation in Italy, see G. BOCCUZZI, *Rischi e Garanzie nella Regolazione Finanziaria*, Cacucci Editore, Bari, 2006.

b) in a prescribed period prior to, and defined by reference to, the commencement of such proceedings or measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures.

Member States must ensure that where a financial collateral arrangement or a relevant financial obligation has come into existence, or a financial collateral has been provided on the day of, but after the moment of the commencement of, winding up proceedings or reorganisation measures, it is legally enforceable and binding to third parties if the collateral taker can prove that he or she was not aware, nor should have been aware, of the commencement of such proceedings or measures.

Where a financial collateral arrangement contains:

(a) an obligation to provide financial collateral or additional financial collateral in order to take account of changes in the value of the financial collateral or in the amount of the relevant financial obligations; or

(b) a right to withdraw financial collateral by providing, by way of substitution or exchange, financial collateral of substantially the same value, the provision of financial collateral, additional financial collateral or substitute or replacement financial collateral under such an obligation or right will not be treated as invalid or reversed or declared void on the sole basis that:

    (i) such provision was made on the day of the commencement of winding up proceedings or reorganisation measures, but prior to the order or decree making that commencement or in a prescribed period prior to, and defined by reference to, the commencement of winding up proceedings or reorganisation measures or by reference to the making of any order or decree or the taking of any other action or occurrence of any other event in the course of such proceedings or measures; and/or

    ii) the relevant financial obligations were incurred prior to the date of the provision of the financial collateral, additional financial collateral or substitute or replacement financial collateral.

The two described Directives on settlement finality and on financial collateral have been amended in limited areas by the Directive 2009/4/CE of 6 May 2009[40] to strengthen the protection of settlement systems and financial collateral arrangements in order to incorporate the developments underway in financial markets and regulations.

In particular, the amendments to the finality Directive aimed to extend its provision to cross-border interoperable post-trade systems (and the responsibility

[40] Directive 2009/44/CE of the European Parliament and of the Council of 6 May 2009 amending Directive 98/26/EC on settlement finality in payment and securities settlement system and Directive 2002/47/EC on financial collateral arrangements as regard linked system and credit claims, Official Journal of the European Union L 146/37, 10.6.2009.

of systems' operators) that took place after the implementation of the Directive 2004/39/EC on markets in financial instruments and the industry-sponsored European "Code of Conduct for clearing and settlement". Therefore, changes concern the explicit protection of the SFD as regards night-time settlement and linked systems.[41]

Amendments to the FCD aim to broaden the regulation to the new types of collaterals used in the marketplace, in particular credit claims,[42] which are eligible for the collateralisation of central bank credit operations. With the new provisions of the Directive the use of such instruments will be facilitated throughout the Community, thus enhancing market liquidity.

4. The EU Deposit Insurance discipline.

The European legal framework on banking crisis management has been completed with the DIS regulation as a mean to keep depositors safe from the effects of a banking insolvency.

The first step by the European Community in the field of deposit insurance has been the Recommendation 87/63 of 22 December 1986, which aimed to ask Member States to introduce in each country, until further harmonisation, deposit insurance schemes.

Afterwards, Directive 94/19/EC of 30 May 1994 brought broader and more coherent regulation to the matter. According to the Directive, DISs aim to protect depositors by eliminating or minimising the risk that their cash will not be returned in the event of a bank default.

The immediate and direct effect of a deposit insurance scheme is to shield less financially-sophisticated depositors - generally small depositors - from losses if a bank goes bust. From a broader perspective, the role of a DIS is crucial in maintaining financial stability. That is why from a macroeconomic view DISs support the other two cornerstones of the financial *safety net*: regulation and supervision and the lending-of-last-resort.

This dual function of deposit insurance schemes clearly emerges from the Directive, which states that "deposit protection is an essential element in the

---

[41] According to the directive "interoperable system" means two or more systems whose system operators have entered into an arrangement with one another that involves cross-system execution of transfer order. In the case of interoperable systems, each system determines in its rules the moment of entry into its system, in such a way as to ensure that the rules of all interoperable systems are coordinated in this regard. It is provided for that one system's rules on the moment of entry shall not be affected by any rules of the other systems with which it is interoperable.

[42] Credit claims are intended as pecuniary claims arising out of an agreement whereby a credit institution grant credit in the form of a loan. For the purposes of the directive, for credit claims, the inclusion in a list of claims submitted in writing, or in a legally equivalent manner, to the collateral taker is sufficient to identify the credit claim and to evidence the provision of the claim provided as financial collateral between the parties.

completion of the internal market…"… and an indispensable supplement to the system of supervision of credit institution". The definition of the objectives contained in the Directive is particularly meaningful insofar as it is evident that deposit protection is as essential for the purpose of the completion of the single banking market as are prudential rules in order to strengthen the stability of the banking system and protect savers. Strictly connected to this is the obligation of Member States to introduce officially recognised DISs.

The definition of a "minimum" set of general principles and rules was a fundamental choice that Member States have had to comply with; they have been left the autonomy to define the institutional and operational setting of the deposit guarantee schemes (DGSs), taking into account the peculiarities of each legal framework.

In this context, the minimum harmonisation has regarded the following fundamental issues:

i) the **responsibility of the *home country*** deposit guarantee system for the reimbursement of depositors of branches located in the Community. This relates to the application to deposit insurance of the *home country control* principle provided for by the second banking coordination directive regarding the responsibility for the supervision of branches located abroad. In this way, the connection between the supervision of branches and the responsibility for the reimbursement of depositors in case of failure is affirmed;

ii) the **mandatory nature of a bank's participation in a DIS**. Art. 3, par. 1, provides for that no banks authorised in a Member State can raise deposits without participation in an officially recognised DIS. The provision is that if a bank does not comply with the obligations deriving from its participation in the DIS, it should be excluded from the system itself and the withdrawal of its banking licence should follow. So, the **membership of** a DIS becomes a requisite for the performance of banking activity;

iii) the **level of the protection**, established as 20.000 euros for the aggregate deposits of each depositor. The view is to safeguard small depositors, considering they are not able to evaluate, because of a lack of information, the bank's financial policy and, therefore, its degree of stability. For this purpose, the Directive does not provide a maximum level of protection, so allowing Member States the chance to apply protection higher than the Community minimum. It also provides specific cases of exclusions from the guarantee related to certain subjects or objects.

    The Directive also introduced the principle of **coinsurance,** meaning that depositors are not fully repaid, but are to bear a certain percentage of their deposits, even when the amount is lower than the coverage limit. In this way, small depositors must also partially share the cost of the bank's failure. It attributes to Member States the faculty to limit the protection up to a determined percentage of deposits, provided that this percentage is equal to

or greater than 90% of the total of deposits if the amount to reimburse does not reach 20.000 euros (article 7, par. 4).

Given the possibility of different levels of protection within the Community for the purpose of eliminating or reducing distortions in competition, a corrective measure has been provided for. A specific norm provides for the possibility, for branches of banks operating in countries offering a higher level of protection, to participate in the deposit guarantee system of the host country for the purpose of supplementing the guarantee offered by the home country's deposit guarantee system (so-called *topping up*).

iv) **the time limit for reimbursement.** According to article 10, deposit guarantee schemes should reimburse verified claims by depositors in respect of *unavailable deposits*[43] within three months of the date on which:

- the competent authorities have determined that the credit institution concerned seems to be unable, for reasons that are directly related to its financial circumstances, to repay the deposit and has no current prospect of being able to do so. The competent authorities make this determination as soon as possible at the latest 21 days after first becoming satisfied that a credit institution has failed to repay deposits that are due and payable; or
- the judicial authority has made a ruling for reasons that are directly related to the credit institution's financial circumstances which has the effect of suspending depositors' abilities to make claims against it, should that occur before the aforementioned determination has been made.

Only in exceptional circumstances can a guarantee scheme apply to the competent authorities for an extension of the time limit. Such an extension, however, cannot exceed three months. The competent authorities may, at the request of the guarantee scheme, grant no more than two further extensions, neither of which can exceed three months.

The positive implications of the Directive is that it led, on one hand, to the introduction of DGSs in countries where these systems were lacking; on the other hand, it induced other countries to modify existing DGSs according to the new rules. The main outcome has been a substantial convergence among European DGSs. However, this is not a full harmonisation, consistent with the general principle inspiring the Directive to harmonise only the essential aspects, leaving to single countries the option to freely regulate non- harmonised aspects.

[43] 'Unavailable deposit' means a deposit that is due and payable but has not been paid by a credit institution under the legal and contractual conditions applicable thereto.

However, in the spirit of European legislation, DGSs must not represent a tool for competition at an international level, because competition has to play on other grounds, not in the field of the protection of depositors.[44]

[44] During the financial crisis the Directive 94/19 has been amended by the Directive 2009/14/EC. Moreover, a new EU proposal is being approved, with significant innovations (see Chapter 3).

CHAPTER 2

FROM "IDIOSYNCRATIC" TO "SYSTEMIC" BANKING CRISES

1. The systemic characteristic of the crises.

The global financial crisis has seriously jeopardised financial stability and the real economy in a great number of countries whose banking systems have been affected by disorders of various intensities depending on the specific sensitivity to risk factors and on the variety of sources and mechanisms through which the crises originated.

It is to be noted, for instance, that this global turbulence has not severely hit those financial systems whose banks were to a lesser extent or not at all related to those risks factors and mechanisms. One of the most critical effects of the financial crisis was an unexpected increase in the market liquidity risk, especially after the collapse of Lehman Brothers, which drove a dramatic evaporation of liquidity in the financial system, with serious disturbances: even firms that had been considered solid until then were placed under pressure. Under such unfavourable circumstances, the economic downturn was a likely outcome because the financial stress abruptly restricted the available lending to enterprises and households (*credit crunch*).

In the aftermath of the financial crisis a great number of banks have suffered troubles. In this context, a wide array of rescue measures and resolution tools has been put in place by the competent authorities to deal with ailing or failed banks. Such measures have been tailored to the sizes, the types of businesses and the international projections of the target entities. In dealing with large and systemic banks, recourse to taxpayers' money has been inevitable; in other cases, market solutions have been successfully arranged; in others, mixed solutions have eventually been implemented.

Public intervention emerged as the sole realistic option when delays and difficulties in orchestrating private solutions made other remedies unfeasible, mainly because of their inconsistency with the need for a timely decision in such a fast burning scenario. In most cases, such delays were mainly because of a lower risk appetite throughout the market as well as to uncertainties about the values of assets and liabilities: opaque banks' balance sheets induced potential buyers to be extremely cautious and less willing to take unnecessary risks that could potentially jeopardise their own level of capital and liquidity.

A brief description of the banking troubles experienced in various countries is instructive. This helps explain the magnitude of the problems encountered in managing and resolving the crisis as well as the financing issues that Governments had to address in order to cover losses and to stabilise the financial system as a whole. Particularly complex techniques were applied in the case of the disruption of large financial institutions, and nationalisation, as a last resort tool, has also

been a concrete option in many jurisdictions, along with the perspective to put the bailed out banks back on the market once general conditions have improved.

Unlike the initial lack of information about the amount of public interventions, over time disclosure in this field increased, also helped by specific law provisions in the most affected countries. Many publications are now reporting data on the financial disbursements made by public authorities to bail out banks, but it is difficult to come to the real figures of the losses incurred by taxpayers because of the diversity of the instruments activated by Governments and central banks (capital injection, loans, guarantees and others) and because of the progressive reimbursement of such funds by borrowing banks. The long list of US programs is a good example of such a difficulty. According to recent estimates,[1] public intervention in the USA and Europe amounted initially to about 4,000 billion euros (of which 2,850 billion euros was in the form of guarantees), reduced to about 2,800 billion euros (including guarantees). In any case, such an amount reflects the very size of the financial support and not that of the incurred losses.

2. Banks' insolvencies in the USA.

The USA was the epicentre of the earthquake from which all the tremors that hit the entire financial world set off. In the course of 2007, in strict connection with the distress in the subprime mortgages market, the first banking crisis took place, followed by increased problems in autumn 2008 with a concentration of big banks under dire straits. As underlined, the crisis revealed a number of gaps in the U.S. crisis framework and preparations. As a consequence, all traditional and consolidated paradigms followed for banking crisis management and resolution had to be abandoned and unconventional tools had to be utilised for the stabilisation of the banking system. Extraordinary financial measures were adopted by the Treasury, the Federal Reserve and the Federal Deposit Insurance Corporation (FDIC) .[2]

In spring 2007, the first signs of the bursting of the US housing bubble started to appear with the failures of some non-banking institutions. The first crisis event occurred in April with the failure of **New Century Financial**, the second-largest subprime lender, followed by the collapse, in summer 2007, of two **Bear Stearns'** hedge funds. These were managed by Bear Stearns Asset Management (the High-Grade Structured Credit Fund and the High-Grade Structured Credit Enhanced Leveraged Fund), whose managers were arrested and prosecuted for fraud a year

---

[1] R&S Mediobanca, *Interventi pubblici a favore delle banche e degli istituti finanziari in Europa e negli Stati Uniti*, Aggiornamento al 15 novembre 2010.

[2] INTERNATIONAL MONETARY FUND, *United States: Publication of Financial Sector Assessment Program Documentation - Technical Note on Crisis Management Arrangements*, May 2010. Moreover, this document stated that "there was no clear responsibility for financial stability, either collectively or in individual agencies. Perhaps as a result, risk monitoring in an inter-agency forum and in individual agencies did not manage to recognize fully the build-up of risks within the U.S. system. Potential risks were missed or mis-calibrated, and correlations and interconnections between risks were not clearly identified".

later. In August, another mortgage lender, **American Home Mortgage**, went bankrupt.

In March 2008, **Bear Stearns** went bust, as a consequence of losses incurred in other hedge funds to which it was exposed and of severe liquidity problems, partially got through with an injection of $30 billion by the Federal Reserve. The bank was bailed out - over a week end - by selling its capital to JP Morgan Chase & Co. at a share price of $10 (corresponding to $1.2 billion; just some months before the share price was $170). As a condition imposed by JP Morgan for the purchase of the bank, in order to reduce the risks deriving from the uncertain amount of troubled assets, $30 billion of toxic assets were removed from Bear Stearns' balance sheet and transferred to a special vehicle under the US guarantee. This was the Maiden Lane LLC, a limited liability company (LLC) created by and financed by the Federal Reserve Bank of New York (FRBNY) with the purpose of managing those assets over time to maximise the repayment of credit extended to the LLC. The loan was based on a provision allowing the FED to make a loan, even to an investment firm, under "unusual and exigent circumstances".[3]

Given the size of the bank, this special solution - a private sector one, accompanied by a public guarantee - was justified with the aim of avoiding that the failure of a major financial institution could undermine the stability of the global financial system. Indeed, the insolvency of the bank could have given rise a potential fire sale of nearly $210 billion of Bear Stearns' mortgage-backed securities (MBS) and other bad assets, which could have caused further devaluation in assets of the same nature across the banking system. Anyway, losses for shareholders were huge and jobs cuts were relevant. The importance of the Bear Stearns bailout resides in the fact that it paved the way for an endless series of State supports to bank insolvencies, posing the theoretical and practical premises for what subsequently would have been considered the inevitable "too big to fail" approach.

Another significant banking crisis was that of **Countrywide Financial Corp.**, a bank engaged in residential mortgage banking and related activities. The size of the involvement of the bank in this sector is expressed by the fact that it had issued about 17% of all the mortgages in the United States. The bank was one of the main providers of subprime and Alt-A bonds created in 2006 and 2007 by Freddie Mac and Fannie Mae.[4] Problems at the bank started to emerge in August 2007, when Countrywide notified the Securities and Exchange Commission (SEC) of liquidity problems because of the decline in the secondary market for securitised mortgage obligations. It also announced its intent to draw

---

[3] Section 13(3) of the Federal Reserve Act provided for an array of exceptional crisis measures for lending to non-banks and operations to lend to individual non-banks, provided that lending was adequately secured. See INTERNATIONAL MONETARY FUND, *United States: Publication of Financial Sector Assessment Program Documentation - Technical Note on Crisis Management Arrangements*, May 2010.

[4] J. SHENN, *Fannie, Freddie Subprime Spree May Add to Bailout*, Bloomberg.com, 22 September 2009.

on the entire $11.5 billion credit line from a group of 40 banks. Rumours about the bank's bankruptcy induced many depositors to withdraw their bank accounts. As a consequence of this announcement, its shares lost about 75% of their peak value in the stock market.

A number of measures were adopted in order to allow the bank to overcome these difficulties: the FED lowered the discount rate to 0.5% and injected liquidity into the bank by accepting about $17.2 billion in repurchase agreements for MBS. Moreover, Countrywide Financial obtained $2 billion of new capital from Bank of America.

After a new drop in Countrywide stocks in November 2007 ($8.64 per share), on January 11 2008, Bank of America announced its intention to buy Countrywide for $4 billion in an all-stock transaction.[5] The price corresponded to a value of about $5½ per share ($4.43 before the Bank of America deal was announced).[6] On the basis of shareholders' and the Authorities' approval, on July 1 2008, Bank of America completed its purchase of Countrywide.[7] Bank of America had previously announced that the takeover of Countrywide would have resulted in the loss of 7,500 jobs over the next two years.

After these two relevant bailouts, the crisis of **Lehman Brothers** was a distinctive case because of its different treatment by authorities. Lehman was one of the most important US investment banks with strong liaisons with hedge funds. Indeed, the group, consisting of 2,985 legal entities operating all over the world, was complex and highly interconnected. Over the weekend of 13 e 14 September 2008 (the so-called "*week end that changed the world*"), when Lehman's crisis was evident, the supervisory authorities strove to find a bidder for a rescue without any State aid. Two hypotheses were on the negotiating table conducted at the FRBNY's offices with the top executives of two major US banks: Bank of America and Barclays. Both candidates failed to step up for different reasons. The first opted to buy **Merrill Lynch** for $50 billion, another of the biggest American banks suffering because of many billion of dollars of losses on subprime securities; the latter opted out of negotiations because the authorities refused to put a significant amount of "illiquid assets" of the failing bank into a bad bank, whose capital would have been underwritten by other entities. Authorities refused to adhere to such a scheme, already tested a decade

[5] In 1997, Countrywide had spun off Countrywide Mortgage Investment as an independent company called IndyMac Bank. It was he largest saving and loan association in the Los Angeles area and the seventh large mortgage originator in the US. The bank was placed into conservatorship by the FDIC on July 11, 2008 because of liquidity problems which arose after a week-long bank run. A bridge bank, IndyMac Federal Bank, FSB, was established under the control of the FDIC.

[6] It is worth to mention that from 2005 to 2007 the CEO of the bank had sold much of his CFC stock realizing $291.5 million in profits. A class action suit was filed on behalf of shareholders alleging securities violations. On June 4, 2009, the SEC charged former CEO with insider trading and securities fraud and former COO and CFO with securities fraud for failing to disclose Countrywide's lax lending standards in Countrywide's 2006 annual report.

[7] D. SMITH, *The age of instability. The Global Financial Crisis and What Comes Next,* Profile Books Ltd., 2010.

earlier in the Long-Term Capital Management bailout and, more recently, in the Bear Stearns case, deciding not to take the risk and to try to find other market solutions. Moreover, Barclays was asking a further guarantee for carrying on Lehman's trading business, which was supposed to entail higher unveiled risks that the buyer was not willing to take.

At the end of the day, both Lehman and the supervisors realised that there were no chances to save the bank and, on the next Monday, Lehman filed for Chapter 11 bankruptcy proceedings. This was the first time such a big bank had been involved in this kind of procedure, with repercussions on the overall financial system.

The Chapter 11 of Lehman Brothers and further measures adopted outside the US

On 15 September 2008, *Lehman Brothers Holding Inc.* filed to the competent Court of New York for the opening of the reorganisation proceeding provided for by Chapter 11 of US bankruptcy law. On 16 September, the same filing was made by its subsidiary LB 745 LLC. The other entities of the group were not submitted to the proceeding.

The law provides for that from the date of the filing the company is protected from creditors' legal actions (c.d. *automatic stay*); this allows the company the possibility to prepare and negotiate with creditors a restructuring plan for the reorganisation of the business or, alternatively, for its liquidation. The approval of the plan by creditors is needed.

The proceeding permits the continuation of the activity by the debtor (*debtor in possession*), under the supervision of the court and of the creditors' committed. The company cannot pay debts risen before the opening of the proceeding or carry out transactions exceeding the ordinary management, unless the authorisation of the court is granted.

In extraordinary circumstances (fraud, incapacity or irregularities in the management) a "*case trustee*", who takes over the power for the company's management, or an *examiner*, for the assessment of the firm's situation, may be appointed. Following such events, the authorities of other countries took measures against the subsidiaries of Lehman located in the respective jurisdictions. In particular:

– In the U.K., on 15 September 2008, the local subsidiaries of L.B. (L.B. International - Europe; *L.B. Ltd, L.B. Holdings PLC* and *L.B. UK RE Holdings Ltd.)* were placed under "administration" and the management was jointly entrusted to four partners of PricewaterhouseCoopers; the proceeding determined the protection from legal actions by third parties, specific actions excepted. The proceeding conferred to administrators broad management powers, in order to reorganise the company or to

ensure an orderly and efficient liquidation in the creditors' interests;

- in France, the Commission Bancarie adopted the provisional administration against the local banking branch (*Banque Lehman Brothers*) and the branch of the investment firm's Lehman Brothers International Europe (UK);
- in Japan, on 15 September, the Financial Services Authority (FSA) ordered the *L.B. Brothers Japan Inc.* to hold (ring fence) in Japan the same amount of assets and liabilities, net of those towards foreign creditors, and to act in a way not to prejudice investors' rights. Subsequently, the Japanese authorities ordered the suspension of activity, prohibiting the carrying out of transactions on financial instruments from 15 to 29 September, except to conclude contracts in progress. Finally, on 16 September, on the demand of *Lehman Brothers Japan Inc.* and *Lehman Brothers Holding Japan Inc.*, the Court of Tokyo disposed the reorganisation proceeding of the two companies (*civil rehabilitation*), prohibiting the payment of liabilities arisen until 15 September, specific transactions excepted;
- in Germany, on 15 September, the suspension of payments was adopted against the local banking subsidiary (*Lehman Brothers Bankhaus AG*); the *moratorium* also had effects on European branches, according to the provisions of the European Directive on reorganisation and winding-up of banks. In particular, the BaFin prohibited: i) making payments, transferring assets or disposing of them in other ways; and ii) accepting payments that were not aimed at reimbursing the bank's debts;
- in Korea, supervisory authorities prohibited the branches of the *L.B. International - Europe* and of *L.B. Bankhaus AG* from carrying out banking activity and transferring assets abroad.

The partial sales of the group's assets were carried out with Barclays and Nomura. In September 2008, Barclays plc announced that it had acquired a portion of Lehman for $1.35 billion, including most of Lehman's North American operations. Nomura Holdings, Japan's top brokerage firm, agreed to buy the Asian division of Lehman Brothers for $225 million and part of the European division for a nominal fee of $2; this price was so low because Nomura acquired only Lehman's employees in the regions, and not its stocks, bonds or other assets.

In parallel to the filing for Chapter 11, a package of measures was adopted by the central bank and 10 leading US banks to assure an orderly resolution of derivatives exposure against its counterparties.

The bankruptcy of Lehman Brothers spread panic in the global market causing a strong loss of confidence among investors and intermediaries. Losses for investors and creditors are likely to be huge when the bankruptcy procedures, still underway all over the world, are concluded.

A lot of questions have been raised by the Lehman Brothers' case, which have remained partially unanswered until now, in light of the fact that, in the same period, other banks and financial firms were bailed out, with a considerable amount of public money and severe consequences on public finances.[8] Moreover, from an institutional and legal point of view, the global scale of the conglomerate resulted in a number of problems concerning the treatment of cross-border insolvencies lacking a uniform and coordinated framework.

Indeed, as well as the Lehman insolvency, another financial institution, **AIG** (American International Group) was facing huge problems in CDS activity. AIG was an insurance company that was very active in CDS transactions, which consist of insuring third parties against borrowers defaulting on their debts. Its problems derived from the decline of the subprime and asset-backed securities (ABS) markets, whose prices fell with negative consequences on the firm, who had provided protection through CDS.[9]

AIG benefited from a loan facility from the FRBNY of $85 billion. This injection of capital was accompanied by a restructuring plan, which provided for the sale of assets and the focus of the financial institution on the "core" business (insurance and pension funds); consequently, speculative activities were abandoned.

On November 10 2008, the Federal Reserve and the Treasury announced a restructuring of the Government's financial support to AIG. As part of this restructuring, two new LLCs were created to take in AIG's toxic assets and to alleviate capital and liquidity pressures deriving from its securities lending program.

The first operation consisted of the extension of credit by the FRBNY to Maiden Lane II LLC, a company formed to purchase $20.5 billion in residential MBS from various AIG subsidiaries. The FRBNY lent Maiden Lane II LLC approximately $19.5 billion. The loan had a six-year term and accrued interest at one-month LIBOR plus 100 basis points. Monthly loan repayments commenced in January 2009.

With the second operation, the FRBNY financed a newly formed Maiden Lane LLC, purposely created to purchase $29.3 billion of collateralised debt obligations (CDOs) from certain counterparties of AIG, enabling AIG to terminate

---

[8] For an explanation of what happened during the week end to decide the destiny of Lehman Brothers, see D. SMITH, *The Age of instability*, 2010, cit.. Moreover, about Leeman's crisis and other banking crises that hit the US and what happened behind the scenes in the stormy autumn of 2008 to organise the banks' rescues, A.R. SORKIN, *Too Big To Fail. The Inside Story of How Wall Street and Washington Fought to Save the Financial System – and Themselves*, Penguin Group, 2009; McDONALD-ROBINSON, *A Colossal Failure of Common Sense: The Inside Story of the Collapse of Lehman Brothers*, Crown Business, New York, 2010.

[9] About the AIG crisis and the articulated interventions made by US authorities to bail-out the financial institution, see D.L. KOHN, *Testimony Before the Committee on Banking, Housing, and Urban Affairs*, U.S. Senate, Washington, D.C., March 5, 2009; A. WATKINS, *The AIG Bailout: Constraining the FED's Discretion*, AndreewWatkins.doc, October 2010.

the associated CDS. The FRBNY lent Maiden Lane III LLC approximately $24.3 billion. The loan had a six-year term and accrued at one-month LIBOR plus 100 basis points. AIG contributed $5 billion of equity to Maiden Lane III LLC (the first to absorb losses). AIG's equity interest accrues interest at one-month LIBOR plus 300 basis points. Monthly loan repayments commenced in March 2009.

In March 2009, the Federal Reserve and the Treasury announced another restructuring of the Government's assistance to AIG in order to facilitate the orderly completion of the company's global divestiture program. In December 2009, the Federal Reserve completed transactions under which the FRBNY received preferred interest in two special purpose vehicles formed to hold the outstanding common stock of AIG's largest foreign insurance subsidiaries, American International Assurance (AIA) and American Life Insurance. In exchange, the outstanding loan balance held by AIG under the line of credit was reduced by $25 billion.

Over time, the amount of financial resources injected into AIG by the FED and Treasury increased markedly (to $182.3 billion). The rescue of the institution raised questions about public resources being used in favour of a non-banking entity and the different treatment applied with respect to Lehman, which in the same days was left to fail. Criticism was also expressed that money given to AIG was *de facto* utilised to reimburse its counterparties represented by many investment banks, which otherwise would have suffered huge losses from the AIG bankruptcy.[10]

The insurance group's recovery plan is now at an advanced implementation phase and an agreement has been reached with the Government for the reimbursement of FED financing, withdrawing resources also from the Treasury's credit lines that were granted within the bailout plan, which have been converted into capital. The total State shareholding (92.1%) will be gradually sold on the market to private investors and, according to recent estimates, the Treasury will yield a $22 billion profit.

In September 2008, the rescue plan of **Fannie Mae (**Federal National Mortgage Association) **and Freddie Mac (**Federal Home Mortgage Corporation) also took place, with the nationalisation of the two entities. The two financial institutions had operated since 1968 as Government sponsored enterprises (GSEs). They were privately owned, but they were also financially protected by the support of the Federal Government[11] and this ingenerated a sort of confusion over their real nature.

---

[10] On this issue, T. BAXTER, *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, Testimony before the Committee on Government Oversight and Reform, U.S. House of Representatives, 27 January 2010, available on website http://www.newyorkfed.org/newsevents/speeches/2010/bax100127.html.

[11] These government protections included access to a line of credit through the U.S. Treasury, exemption from state and local income taxes and exemption from SEC oversight.

Fannie Mae was established for the purpose of providing local banks with federal money to finance home mortgages, attempting to raise levels of home ownership. Initially, Fannie Mae operated as a national savings and loan, allowing local banks to charge low interest rates on mortgages for the benefit of homebuyers. This led to the development of the so-called "secondary mortgage market"; in this market, companies such as Fannie Mae were able to borrow money from foreign investors at low interest rates because of the Government's financial support. The possibility to borrow at low rates allowed Fannie Mae to provide fixed interest rate mortgages with low down payments to homebuyers.

In 1968, the need to remove Fannie Mae from the US Federal budget led to its privatisation and the beginning of its activity as a GSE, generating profits for stockholders while enjoying the benefits of exemption from taxation and oversight as well as implied Government backing. In order to avoid the creation of a monopoly, a second GSE, Freddie Mac, was created in 1970. Consequently, Fannie Mae and Freddie Mac controlled about 90% of the nation's secondary mortgage market and experienced a period of unprecedented financial growth over the past few decades. The total assets of these two companies were 45% greater than the amount of the nation's largest bank assets. Moreover, their combined debt was equal to 46% of the national debt. Freddie Mac bought $158 billion (13%) of all the subprime and Alt-A bonds created in 2006 and 2007, and Fannie Mae bought another 5% of those instruments. The depreciation in home prices led to growing losses for the GSEs, which backed the majority of US mortgages. During summer 2008, the US Government attempted to ease market fears; in particular, the Treasury Department and Federal Reserve tried to bolster confidence, granting both corporations access to Federal Reserve low-interest loans (at similar rates as commercial banks) and removing the prohibition on the Treasury Department to purchase the GSEs' stocks.

Despite these efforts, by August 2008, the shares in both Fannie Mae and Freddie Mac lost more than 90% of their last 12 months' value. On 7 September 2008, the Federal Housing Finance Agency, the regulator of the two financial institutions, placed Fannie Mae and Freddie Mac under conservatorship, stating that there were no plans to liquidate the companies. The Federal Government also dismissed the firms' chief executive officers and boards of directors, and caused the issuance to the Treasury of new senior preferred stock and common stock warrants amounting to 79.9% of each GSE.

In addition to the Government conservatorship, several Government agencies took steps to increase liquidity within Fannie Mae and Freddie Mac. In particular: the Federal Reserve purchased $47 billion in GSE debt and $53 billion in GSE-held MBS; the Treasury Department purchased $14 billion in GSE stock and $71 billion in MBS; finally, the Federal Reserve provided for a primary credit rate for loans to the GSEs. Over time, other financial resources were injected into the two entities in order to keep them afloat. It is worth noting that the only amount of guarantees provided to them would amount to $1,450 billion.

According to updated estimates, the two entities have drawn $148 billion from the US Treasury because of the rapid increase in losses on loans underwritten during the housing boom. Possible further injections of capital could be necessary, considering the substantial unlimited guarantee offered by the Government to the two entities, depending on the evolution of scenarios regarding changes in house prices. Until now, the final cost of the rescue package is unknown. The Federal Housing Finance Agency recently affirmed that - upon certain conditions - the cost could be $221 billion, a figure that makes the rescue of Fannie Mae and Freddie Mac one of the most expensive among recent bailouts.

In the same month, another big financial institution, the **Washington Mutual**, a bank specialised in mortgage lending, had a brush with the subprime market and went bust. The crisis was primarily brought about by the losses incurred in mortgage activity, but subsequently it was aggravated by a *run* causing a $16.7 billion withdrawal. On September 25 2008, the Office of Thrift Supervision (OTS) placed Washington Mutual into the receivership of the FDIC.

The FDIC sold the assets, all deposit accounts and secured liabilities to JP Morgan, with the exemption of unsecured debt or equity positions, at a price of $1.9 billion. JP Morgan reopened the bank's offices the next day as JP Morgan Chase branches. The holding company, Washington Mutual Inc. was left with $33 billion assets, and $8 billion debt after being deprived of its banking subsidiary by the FDIC. The next day, on September 26, Washington Mutual Inc. filed for bankruptcy in Delaware, where it was incorporated.

Washington Mutual's closure and receivership is regarded as the largest bank failure in American financial history. Before the receivership action, it was the sixth-largest bank in the United States. The CEO of the bank had been fired by the board of directors.

Together with Washington Mutual, **Wachovia** was also in dire straits. On September 26, depositors withdrew money from their accounts in order to drop their balances below the $100,000 level insured by the FDIC, an event known as a "*silent run*".

Wachovia lost $5 billion in deposits that day (about 1% of the bank's total deposit). The Office of the Comptroller of the Currency (OCC) pressured Wachovia to put itself up for sale over the weekend, to avoid a rescue that would have had a severe drain on the FDIC's insurance because of its size.

Wells Fargo emerged as the ideal candidate to acquire Wachovia's banking operations, but it stepped back because of concerns over Wachovia's commercial loans. In the meantime, regulators feared that if customers pulled out more money, Wachovia would not have had enough liquidity to meet its obligations.

Hence, the FDIC declared Wachovia "systemically important" to the health of the economy, and thus it could not be let to fail. On September 28, the FDIC decided to sell Wachovia's banking operations to Citigroup in an "open

bank" transfer of ownership. Citigroup became the source of liquidity allowing Wachovia to continue to operate until the acquisition was completed.

In its announcement, the FDIC stressed that Wachovia did not fail and had not been placed into receivership. In addition, the FDIC granted Citigroup full coverage of any losses incurring in the Wachovia banking portfolio above $42 billion, in exchange of $12 billion in preferred stock and warrants.[12] Some criticism was raised about the amount of support needed by the FDIC and the magnitude of recapitalisation that was necessary to Citigroup to perform the operation. Even though Citigroup was providing the liquidity that allowed Wachovia to continue operating, Wells Fargo and Wachovia announced on October 3 2008 that they had agreed to merge, overcoming the Citigroup deal.

Wachovia preferred Wells Fargo as a partner, as it would be more convenient than the merger with Citigroup and kept all of its businesses intact.

On October 9 2008, Citigroup abandoned its attempt to purchase Wachovia's banking assets. On October 12, the Federal Reserve approved the acquisition of the bank by Wells Fargo without Government assistance. The whole operation was closed on December 31 2008.

The banking crises described above can give only a partial view of the size and complexity of the extraordinary measures and instruments activated by the US authorities – the Government, Federal Reserve, FDIC and other institutions - since the beginning of the financial crisis. These measures were necessary in order to contrast the new and multiple forms of banking weaknesses (quality of assets, liquidity, capitalisation, profitability).

The most important measure launched by the US Federal Administration to deal with the financial crisis was the **Troubled Asset Relief Program** (TARP), which aimed at purchasing a large amount of illiquid, risky MBS from the banking system. Modifying some aspects of the previous Paulson rescue plan proposed in September 2008, the program was signed into law by the US President on October 3 2008. It enacted the *Emergency Economic Stabilisation Act* of 2008 and other acts. It can be considered the largest component of the Government's measures adopted to address the subprime mortgage crisis.

The Troubled Asset Relief Program

The TARP allowed the Treasury to purchase or insure up to $700 billion of "troubled assets", defined as:

- residential or commercial mortgages and any securities, obligations or other instruments that are based on or related to such mortgages, that in each case was originated or issued on or before March 14 2008, the purchase of which is necessary to promote financial market stability; and

[12] FEDERAL DEPOSIT INSURANCE CORPORATION, Press Release, September 29, 2008.

- any other financial instrument, the purchase of which is necessary to promote financial market stability, but only upon transmittal of related decisions to the appropriate committees of Congress.

In particular, the program allowed the Treasury to purchase illiquid, difficult-to-value assets from banks and other financial institutions, including also collateralised debt obligations. The ultimate goal of the TARP was to improve the liquidity of these assets by purchasing them using secondary market mechanisms. In this way participating institutions were allowed to stabilise their balance sheets and avoid further losses.

As to the identification of the "financial institutions" included in the TARP, it was established that they should have been "established and regulated" under US laws and have "significant operations" in the US. These include U.S. banks, US branches of a foreign bank, US savings banks or credit unions, US broker-dealers, US insurance companies, US mutual funds or other US registered investment companies, tax-qualified US employee retirement plans and bank holding companies.

The Act required financial institutions selling assets to the TARP to issue equity, equity warrants or senior debt securities (for non-publicly listed companies) to the Treasury. In the case of warrants, the Treasury received warrants for non-voting shares, or agreed not to vote on the stock. This measure was designed to protect taxpayers by giving the Treasury the possibility of profiting through its new ownership stakes in these institutions. Ideally, if the financial institutions benefit from Government assistance and recover their former strength, the Government will also be able to profit from their recovery.

There was the clear expectation that once the trading of the transferred assets had resumed, their prices would have stabilised and ultimately increased in value, resulting in gains to both participating banks and the Treasury itself. There was also the belief that these assets were oversold, as only a small percentage of all mortgages were in default, while the relative fall in prices represented losses from a much higher default rate.

Another important goal of the TARP was to encourage banks to resume lending again at levels before the crisis, both to each other and to consumers and businesses. It was considered that if the TARP could stabilise bank capital ratios, it should theoretically allow them to increase lending instead of hoarding cash to cushion against future unforeseen losses from troubled assets. As banks gain increased lending confidence, the interbank lending interest rates (the rates at which the banks lend to each other on a short-term basis) should decrease, further facilitating lending.

The TARP operated as a "revolving purchase facility." The Treasury had a pre-defined spending limit, $250 billion at the start of the program, with which it would have purchased the assets and then either sold them or held them to collect the 'coupons'. The money received from the sales and coupons would

go back into the pool, facilitating the purchase of more assets. One way that TARP money was being spent was to support the “Making Homes Affordable” plan, which was implemented by the Treasury on March 4 2009, using TARP money. Because “at risk” mortgages were defined as “troubled assets” under the TARP, the Treasury had the power to implement the plan. The Treasury also bought preferred stock and warrants from hundreds of smaller banks, using the first $250 billion allotted to the program.

The Treasury required institutions wanting access to the program to meet specific conditions, including: i) ensuring that incentive compensation for senior executives did not encourage unnecessary and excessive risks that threaten the value of the financial institution; ii) required clawback of any bonus or incentive compensation paid to a senior executive based on statements of earnings, gains or other criteria that are later proven to be materially inaccurate; iii) prohibition on the financial institution from making any golden parachute payment to a senior executive based on the Internal Revenue Code provision; and iv) agreement not to deduct for tax purposes executive compensation in excess of $500,000 for each senior executive.

The Office of the Special Inspector General for the TARP was established by the Emergency Economic Stabilisation Act of 2008. Under this Act, the Special Inspector General had the responsibility to conduct, supervise and coordinate audits and investigations of the purchase, management and sale of assets under the TARP.

On March 23 2009, the US Treasury Secretary announced a new program, the Public-Private Investment Program (P-PIP) to buy toxic assets from banks' balance sheets. P-PIP had two primary programs:

- the *Legacy Loans Program*, whose objective was to buy residential loans from bank's balance sheets. The FDIC would have provided non-recourse loan guarantees for up to 85% of the purchase price of legacy loans. Private sector asset managers and the US Treasury would have provided the remaining assets;
- the *Legacy Securities Program*, with the aim to buy residual MBS that were originally rated AAA and commercial MBS and ABS rated AAA.

The funds would have come in equal parts from the US Treasury's TARP monies, private investors and from loans from the Federal Reserve's Term Asset Lending Facility.

Within the TARP and P-PIP programs many interventions have been made. They relate to banks of different sizes and complexities and in various forms. In addition, the biggest US banks were re-capitalised by the Government within the program (among them, Bank of America, JP Morgan Chase, Citigroup, Morgan Stanley, Wells Fargo & Co, Bank of New York Mellon and Goldman Sachs).

In October 2008, **Citigroup** received an injection of liquidity of $25 billion, together with eight other banks. In November 2008, it received another $20 billion cash and guarantees for $306 billion for toxic assets. Finally, in February 2009 the US Government entered into the capital of the bank through the conversion of $25 billion of privileged stocks in ordinary stocks, holding 34% of the bank's capital. In December 2009, the Treasury, the Federal Reserve and the FDIC agreed to terminate the Master Agreement dated January 15 2009 with Citigroup. In consideration for terminating the Master Agreement, the FRBNY received a $50 million termination fee from Citigroup. Outstanding expenses in connection with the Master Agreement and not yet reimbursed by Citigroup will continue to be reimbursable. Now the Treasury is gradually selling its bank's stocks on the market.

In January 2009, a package rescue was granted to **Bank of America,** giving it additional Government support for $20 billion (in addition to the $25 billion given in 2008 through the TARP) to help it cover losses resulting from its acquisition of Merrill Lynch. The total $45 billion in aid came mostly in the form of large capital investments, but in January, Bank of America agreed with the Government to limit losses from a $118 billion pool of troubled assets. The Treasury agreed to make those guarantees alongside the Fed and FDIC. But Bank of America backed out of the deal before it was finalised, eventually paying a total of $425 million in fees to the Treasury, Fed and FDIC. The Treasury received $276 million of that. In December, Bank of America returned the $45 billion to the Treasury.

A significant evolution of the TARP was its extension to other recipients, such as the automakers companies and their financing arms ($25 billion in loans through the Automotive Industry Financing Program, of which $21 billion was spent). In this framework, General Motors obtained $50 billion.

Many economists have been critical of this program, arguing that the non-recourse loans lead to a hidden subsidy in favour of asset managers, banks' shareholders and creditors.[13] Banking analysts have argued that banks were reluctant to sell bad assets at fair market values because that would have implied asset write-downs. Moreover, removing toxic assets would also have reduced the volatility of banks' stock prices. This lost volatility would have hurt the stock prices of distressed banks. Therefore, such banks would only have sold toxic assets at above market prices.

In this context, we must mention the role of the **FDIC**[14] in supporting the hundreds of banking crises in the USA in the period 2008-2010. The FDIC has been appointed *receiver* and has taken over many of these banks, including the largest ever failed bank in history, with huge costs for the scheme, whose resources are depleted. We have to consider that just for two decades, the FDIC's

[13] P. KRUGMAN, *Geithner plan arithmetic*, New York Times, March 23, 2009, available on http://krugman.blogs.nytimes.com/2009/03/23/geithner-plan-arithmetic/.

[14] FEDERAL DEPOSIT INSURANCE CORPORATION, *Failed Bank List since October 2000 to October 2010*, available on website http:www.fdic.gov/bank/individual/failed/banklist.html.

interventions were limited and the financial capacity of the fund was estimated to have exceeded the real need on the basis of the expected banking crises.

The strongest innovation in FDIC activity during the financial crisis was its involvement in the abovementioned *Legacy Loans Program*, a loan guarantee scheme to help banks reduce their toxic assets and thus create the conditions to raise new capital. In this context falls the promise of the FED to buy up to $500 billion worth of MBS guarantees by Fannie Mae and Freddie Mac and up to $100 billion worth of their direct debts. The use of the FDIC to realise this program has been strongly criticised.

As a consequence of these interventions, in October 2008 the FDIC established a *Restoration Plan* for the Deposit Insurance Fund aimed at returning its statutorily mandated minimum reserve ratio of 1.15% within five years. In February 2009, considering the extraordinary scope and size of these banking crises, the FDIC amended its Restoration Plan to extend the restoration period from five to seven years. In May 2009, Congress amended the statute governing the establishment and implementation of a restoration plan to allow the FDIC up to eight years to return the Deposit Insurance Fund reserve ratio to 1.15%.

Subsequently, the Dodd-Frank Wall Street Reform and Consumer Protection Act required the FDIC to set a reserve ratio of not less than 1.35% for any year. Dodd-Frank also required the FDIC to take ''such steps as may be necessary'' to increase the level of the Deposit Insurance Fund to 1.35% of estimated insured deposits by September 30, 2020. Under Dodd- Frank, the FDIC is required to offset the effect of requiring that the reserve ratio reach 1.35% by September 30 2020, rather than 1.15% by the end of 2016, on insured depository institutions with total consolidated assets of less than $10,000,000,000.

Another important measure taken by the US Government was the **Guarantee Program for Money Market Funds**.[15] On September 29 2008, the US Treasury announced the details of its Temporary Guarantee Program for Money Market Funds, which was funded by the FED to the tune of $540 billion in response to growing concerns about the health of the money market industry. Under the program, the Treasury guaranteed the share prices of eligible money market funds that applied to the program and paid a fee to participate. The program provides coverage to shareholders for amounts held in participating money market funds from September 19 2008. The guarantee is triggered if a fund's net asset value (NAV) falls below $0.995 per share, which is commonly referred to as "breaking the buck." Funds that broke the buck before September 19 2008 were not eligible for the program. Following an initial three-month term, the Secretary of the Treasury had the option to renew the program for an additional period up to September 18 2009. The program was funded through the Treasury's Exchange Stabilisation Fund, which had approximately $50 billion in assets.

---

[15] P. WEISS, *Treasury Department Temporary Guarantee Program for Money Market Mutual Funds*, October, 2008.

The **FED's** responses to the financial crisis were huge and took place in a variety of forms through unconventional instruments, with the purpose of easing the financial conditions of banks. A number of programs were implemented to support the liquidity of financial institutions. As a consequence, the Federal Reserve's balance sheet has changed significantly.

The emergency liquidity programs that the Federal Reserve set up provided secured and mostly short-term loans. Over time, these programs helped to alleviate the strains and to restore normal functioning in a number of key financial markets, supporting the flow of credit to businesses and households. The Federal Reserve also provided credit to several SIFIs. All extensions of credit were fully secured and these are in the process of being fully repaid. Finally, the Federal Reserve provided economic stimulus by lowering interest rates. Over the course of the crisis, the Federal Open Market Committee (FOMC) reduced its target for the federal funds rate to a range of 0 to 1/4 percent. With the federal funds rate at its effective lower bound, the FOMC provided further monetary policy stimulus through large-scale purchases of longer-term Treasury debt, federal agency debt and agency MBS. These asset purchases helped to lower longer-term interest rates and generally improved the conditions in private credit markets.

These programs can be divided into three categories.

The first set of tools, which are closely tied to the central bank's traditional role as the lender of last resort, consisted of the provision of short-term liquidity to banks and other depository institutions and other financial institutions. The traditional discount window, Term Auction Facility, Primary Dealer Credit Facility and Term Securities Lending Facility may be included in this category. Because bank funding markets are global the Federal Reserve also approved bilateral currency swap agreements with 14 foreign central banks. These swap arrangements assisted these central banks in their provision of dollar liquidity to banks in their jurisdictions.

A second set of tools involve the provision of liquidity directly to borrowers and investors in key credit markets. The Commercial Paper Funding Facility, Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility,[16] Money Market Investor Funding Facility and the Term ABS Loan Facility fall into this category.

As a third set of instruments, the Federal Reserve has expanded its traditional tool of open market operations to support the functioning of credit markets through the purchase of longer-term securities for its portfolio.

---

[16] B. DUYGAN-BUMP-P. M. PARKINSON-E. S. ROSENGREN-G. A. SUAREZ-P. S. WILLEN, *How Effective Were the Federal Reserve Emergency Liquidity Facilities? Evidence from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility*, Federal Reserve Bank of Boston, Working Paper No. QAU10-3, April 2010.

When the functioning of financial markets improved, many of the new programs were expired or closed. Unlike the treatment applied to the TARP no rules about executive compensation or dividend payments were applied to borrowers using Federal Reserve facilities.

The main question asked by commentators during the financial crisis was related to the final cost of public intervention, considering the lack of transparency in the use of public funds. Moreover, the peculiarity of this crisis has been the progressive extension of the use of public resources to non-banking financial institutions and non-financial institutions (automotive industry) given the concerns about the long economic recession.

Figures available on the TARP show that many banks and firms have been reimbursing over time the sums received by the Government, so that the final cost will be much lower compared with initial forecasts. Surprisingly, in many cases the Government is recovering its capitals and gaining profits because of the fees paid by recipients to get financial support; in other cases, losses have demonstrated to be lower than those expected.

Indeed, in respect to the original cost forecasts of about $356 billion, the estimated final expense for the US Government at October 2010 was about $30 billion, including expected interests from AIG. As underlined, this cost (1% of the GDP) will be significantly less than the taxpayers' cost of the savings and loan crisis of the late 1980s (3.2% of the GDP).[17] In addition, concerns about holding companies such as GM, AIG and Citigroup for several years are reducing, since these companies are buying back the Treasury's stake. Of the $245 billion invested in US banks, over $169 billion has been paid back, including $13.7 billion in dividends, interest and other income, along with $4 billion in warrant proceeds as of April 2010. In March 2010, GM also repaid more than $2 billion to the US and Canadian Governments and on April 21 GM announced the entire loan portion of the US and Canadian Governments' investments had been paid back in full, with interest, for a total of $8.1 billion.

However, a strong political backlash has occurred more recently in the US about the huge sums of money used by the Government to bail out large foreign banks, prompting concerns about a possible role of the FED as "*the central bank of the world*". Indeed, it has been reported that about 55% of the loans granted under the Term Auction Facility went to US branches of foreign banks. Another 5% went to US banks owned by foreign parents. German banks took about 15% of the total lending and UK banks about 12%.

---

[17] Information about the amounts of State's interventions within TARP and the reimbursements made by recipients are contained in

3. The banking crises in Europe.

In Europe the effects of the financial crisis were devastating. With the exception of some countries, most European banking systems were hit very severely, reporting many failures and insolvencies (UK, Germany, Ireland, Belgium, the Netherland, Iceland, Denmark, Switzerland). In some of these countries, the size of public intervention was relevant and the European authorities had to intervene, supplementing the already existing State aid rules allowing public support for rescuing and restructuring ailing firms "*to remedy a serious disturbance in the economy of a Member State*" (article 87, paragr. 3, lett. b) of the Treaty).[18] In particular, the European Commission accepted the possibility of a State intervention because of the seriousness of the financial crisis and of the threats to the stability of financial institutions and issued further guidelines in order to reduce the distorting effects of those interventions on financial institutions operating in the same Member State or in other Member States. For this purpose, three communications were issued with reference to the different State aid measures adopted during the financial crisis.[19] In some countries, the involvement of public finances was so relevant that national balance sheets went into trouble, requiring international support.

After the US, the **United Kingdom** may be considered the second biggest country affected by the financial crisis. Many banking crises occurred as a consequence of the same weaknesses affecting US financial institutions, but the problems were exacerbated by the lack of an effective crisis resolution system.[20] The amount of public money injected into banks was huge, and after the ongoing reimbursement by banks the public exposure also remains considerable.

The first crisis event occurred at **Northern Rock** in 2007, which will be remembered as the first example of a *bank run* in an advanced country over the past century, highlighting the shortcomings of a risky business model and of

---

[18] EUROPEAN COMMISSION, *Community guidelines in State aid for rescuing and restructuring firms in difficulty* (Official Journal of the European Union C 283/2 of 19 September 1997), updating previous guidelines of 1994 (Official Journal C 368 of 23 December 1994). Moreover, see *Community Guidelines in State aid for rescuing and restructuring firms in difficulty (<<R&R guidelines>>)*, Joint Case C 244, 1 October 2004, p. 2.

[19] EUROPEAN COMMISSION, *The application of State aid rules to measures taken in relation to financial institutions in the context of the current financial crisis*, 2008/C 270/02, Official Journal of the European Union, 25 October 2008; EUROPEAN COMMISSION, *The recapitalisation of financial institutions in the current financial crisis: limitations of aid to the minimum necessary and safeguards against undue distortions of competition*, 5 December 2008 (C2009/C 10/03); EUROPEAN COMMISSION, *Communication from the Commission on the treatment of impaired assets in the Community banking sector* (2009/C 72/01), published in the Official Journal of the European Union of 26 March 2009. About the EU framework on State aid in the banking sector, see S. GEBSKI, *Competition First? Application of State Aid Rules in the Banking Sector,* The Competition Law Review, Volume 6, December 2009. This work, other than a broad picture of the regulations and principles on State aid issues, illustrates the most important decisions taken by the Commission on banking crises during the last financial crisis.

[20] P. TUCKER, *The Debate on Financial System Resilience: Macroprudential Instruments*, Speech at Barclays Annual Lecture, London, 22 October 2009

an ineffective deposit insurance system.[21] The bank carried out activities based on heavy borrowing in the UK and international money markets, extending mortgages to customers by this funding, and then re-selling these mortgages on international capital markets, according to a model "originate to distribute".

When global demand from investors for securitised mortgages dropped in August 2007, Northern Rock became unable to repay loans from the wholesale money market with the money that should have been raised from securitisation.

On 14 September 2007, the bank sought and received a liquidity support facility from the Bank of England to replace funds it was unable to raise from the money market. The simple news that the Bank of England was extending emergency liquidity assistance (ELA) to Northern Rock panicked individual depositors, triggering a serious bank run.

After two unsuccessful bids to take over the bank, with the transfer order of 21 February 2008, Northern Rock was nationalised. A restructuring plan was prepared, including the transfer of mortgages to other banks and costs reduced by cutting staff. Reversing this plan, on 23 February 2009 Northern Rock announced that it would be offering £14 billion of new mortgages over the next two years. This new lending was partly funded by an increase in Government loans. The reason for this change was the intent of the British Government to increase the availability of credit to the economy.

As a consequence of the nationalisation, by the end of 2009 customers regained confidence in the bank. Anyway, Northern Rock shareholders received no compensation for the suffered losses.

With effect from 1 January 2010, Northern Rock was split into two parts: the first, the new Northern Rock, included the commercial banking activities; the second, called Northern Rock Asset Management, received other assets and liabilities, including a loan granted by the Government of £22.8 billion.

After Northern Rock, in September 2008 another banking nationalisation took place in the UK, **Bradford & Bingley.** After a competitive auction, Abbey National (a branch of the Banco Santander S.A.) intervened by buying the bank's 200 branches and its savings accounts of over £20 billion (transfer order n. 2546 of 2008). The transfer of the deposits to the intervening bank, aimed at assuring the continuity to retail customers services, was made possible thanks to the provision of liquidity from the Treasury and the *Financial Services Compensation Scheme* (the English Deposit Guarantee System).

---

[21] UK Deposit Insurance System at that time protected depositors up to £20.000, with a depositors coinsurance. Moreover, in that framework the DIS performed only "pay-box" functions", with no chances to be utilised for preventive purposes. On Northern Rock case see, R. EISENBEIS-G- KAUFMAN, *Lessons from the Demise of UK's Northern Rock and the U.S.'s Countrywide and Indymac*, in F. BRUNI-D.T. LLEWELLYN (eds), *The failure of Northern Rock - A Multidimensional Case Study*, SUERF Studies 2009/1/ Vienna.

The most relevant part of the bank business, about £50 billion, remained on the book of the bank, which assumed the new denomination of Rumco, and was nationalised through the transfer of the shares to the Treasury. The Government also granted a huge amount of guarantees to Rumco in favour of creditors.

With effect from 1st July 2010, Bradford & Bingley merged with Northern Rock Asset Management.

Very relevant was the crisis of **HBOS** (Halifax Bank of Scotland), a bank active in the retail sector and the first mortgage lender in the United Kingdom. On 17 September 2008, soon after Lehman Brothers collapsed, HBOS's share price fell dramatically, despite the FSA's assurances as to its liquidity and exposures. In the meantime, rumours had spread through the media, reporting that HBOS was in advanced takeover talks with Lloyds TSB. In order to avoid another Northern Rock case, the UK Government announced that the takeover should take place, even bypassing competition law.

On 18 September 2008, the terms of the offer by Lloyds TSB were announced and the deal was closed on 19 January 2009.

In order to restore market confidence and to help the stabilisation of the whole banking system, many general measures were adopted by the UK Government. On 8 October 2008, the British Government announced a bank rescue package totalling about £500 billion in loans and guarantees, as a strong response to the global financial crisis. Of this targeted amount, £200 billion was made available for short-term loans through the Bank of England's *Special Liquidity Scheme*, £50 billion was made available through the new *Bank Recapitalisation Fund* and £250 billion was temporarily underwritten by the Government, by means of a loan guarantee to any eligible lender between British banks. One of the main differences between the British package rescue and the US TARP was the specific amount of £50 billion dedicated to the purchase of shares in the banks, whereas the American package was primarily devoted to the purchase of MBS that American banks were unable to sell in the secondary securities market.

The Special Liquidity Scheme was introduced in April 2008 to improve the liquidity position of the banking system by allowing banks and building societies to swap temporarily their high quality MBS and other securities for UK Treasury Bills for up to three years. The scheme was designed to finance part of the illiquid assets on banks' balance sheets by exchanging them temporarily for more easily tradable assets. The drawdown period closed on 30 January 2009, but the scheme will remain in place for three years.

Through the Bank Recapitalisation Fund, the Government bought a combination of ordinary and preference shares in any affected banks; the amount of the stake to be bought in any bank was negotiated with the bank itself. The supported financial institution, other than having restrictions on executive pay and dividends to shareholders, had to offer reasonable credit to homeowners and small businesses. The total cost for Government should be paid by the dividends

from those shares and, from a long-term perspective, from the revenue provided by selling the shares at market conditions.

On 13 October 2008, the British Government announced that the Treasury would inject £37 billions of new capital into Royal Bank of Scotland (RBS), Lloyds TSB and HBOS to avert financial sector collapse.

The troubles of **RBS** proved to be singular, considering that the bank had pursued an expansion strategy, based on the acquisition of other banks located abroad in order to strengthen its international size. Indeed, on 22 April 2008 RBS announced its intention to raise £12 billions in new capital to cover a write-down of about £6 billion resulting from credit market positions and to fund the purchase of ABN AMRO. Then, on 13 October 2008, the British Government announced its willingness to subscribe a stake of up to 58% in the group, permitting the bank to strengthen its resources and to restructure its finances, while maintaining its support to the real economy.

The British Government stressed that it was not "standard public ownership" and that the banks would return to private investors as soon as possible. As a consequence of the mismanagement that necessitated this rescue the chief executive of the group resigned.

In January 2009, the British Government announced its intention to convert the RBS preference shares acquired in October 2008 into ordinary shares. This measure increased the State's holding in the bank from 58% to 70%. At the same time, RBS announced other losses of about £8 billions and write-downs of goodwill (primarily related to the takeover of ABN AMRO), of around £20 billions.

Another important measure adopted by the UK Government was the constitution of a special fund for interventions in the financial market, the *UK Financial Investments*, aimed to allow banks to guarantee the payback of any new issuance. Moreover, in February 2009 it set up an *Asset Protection Scheme*, a scheme for the protection of assets, as well as an *Asset Purchase Scheme*, a scheme for the acquisition of assets, which allowed the Bank of England to buy up to £50 billion of mortgage securities. To implement the Asset Protection Scheme, an executive agency of the UK Government, the Asset Protection Agency was created, as part of the Treasury.

In mid-February 2009, the UK Parliament passed a new banking law (*Banking Act*), which allowed the Government, in the case of necessity and for the purpose of supporting a bank, to use the financial resources of a *Consolidated Fund*.

In March 2009, the UK government took a controlling interest in Lloyds TSB under its Asset Protection Scheme.

In **Ireland,** the global financial crisis led a number of financial institutions to require support. In September 2008, for the purpose of protecting the financial

stability, the Irish government - without any agreement at the European level - decided to provide a blanket guarantee to all deposits of banks and building societies. Subsequently, State guarantees were extended to other bank liabilities (bonds, interbank deposits, commercial papers and also some kind of subordinated debts). On 1 October 2008, a *Credit Institutions Financial Support Bill* was presented to Parliament, empowering the Ministry of Finance to provide banks with loans, guarantees and swaps of assets and any other needed measure. Measures were applicable only to Irish banks and not to subsidiaries and branches of foreign banks operating in Ireland.

The first banking crisis occurred in January 2009 to **Anglo Irish Bank,** which was nationalised after a hidden loans scandal emerged in December 2008 and when it was clear that recapitalisation wouldn't be enough to save the bank. After then, it emerged that Anglo Irish counterfeited its account before nationalisation, using a "circular" transaction with another bank, the Permanent TSB, whose CEO resigned after this revelation.

The amount of financial resources injected into the bank was huge and increasing. In October 2010, this was estimated to be between 29.3 and 34 billion euros, much higher than the initial budget, because of the losses on the bad assets, especially mortgages, transferred to the bad bank specifically created for this purpose (*National Asset Management Agency*). This agency purchased risky loans by the banks and provided them with bonds they could swap for cash at the ECB.

According to recent information, the bank proposed to exchange, on a contractual basis, the subordinated bonds classified in Tier 2 capital, amounting to 2 billion, with public bonds with a maturity of one year at 20% of their nominal value (with a corresponding loss of 80%). It must be considered that before the announcement the market price of those bonds was very close to the price offered (25). An incentive was established for bondholders to accept the offer, consisting of the possibility that those refusing the exchange would get back a very low amount of cash. The reaction was negative from bondholders, but the measure proposed by Anglo Irish to its creditors was the expression of the impossibility to assure the full payment to all creditors, especially when the bonds were included in the notion of capital. Moreover, it reflected some international proposals for the participation of the private sector (unsecured and uninsured creditors) in the losses of banks' insolvencies (see chapter 3).

Besides Anglo Irish, a strong recapitalisation was carried out for two large banks, **Allied Irish Bank** and **Bank of Ireland**, with a bailout of about 3.5 billion euros for each bank. As a counterbalance for this Government support, the Minister for Finance had the power to appoint 25% of the directors of each bank, while the banks agreed to provide a 30% increase in mortgages for first time homebuyers and a 10% increase in loans to small and medium-sized enterprises. Moreover, senior bank executives salaries were frozen and no bonuses were admitted.

The final cost of Allied Irish was much higher than that initially expected. In December 2010, another 3.7 billion euros was injected by the Irish Government,

with the authorisation of the High Court, in favour of the bank, which "de facto" became State- owned (92,8%) after the divestment of some assets. This was the first application of the new law on bank rescues approved in Ireland, *the Credit Institutions Stabilisations Act*. The Act allows the Government to intervene in the capital of banks without the consent of shareholders, but with the authorisation of the High Court.

Finally, to the total cost of the crisis of the Irish banking system another 2.7 billion euros should be added related to the bailout of the **Nationwide Building Society.**

Ireland
From Banking to Sovereign Debt Crises

The crisis of the Irish banking system has turned into the Ireland crisis. Indeed, because of the interventions in the banking system the Irish public deficit is estimated to have reacheed the 32% of GDP, well in excess of the limit imposed by Maastricht rules. Moreover, the ratio debt/GDP has risen to 65.5%. So, severe measures must be adopted in the coming years to return public deficit to normality.

Concerns about the level of sovereign debt and the possible incapacity to roll it over at its contractual maturity has induced the State to make recourse to a joint EU/IMF 85 billion euros bailout plan, upon conditions related to the reduction of the State's balance sheet deficit, to the restructuring of the banking system and to the adoption of structural reforms for the recovery of the economy. The plan provides for the intervention of the European Financial Stability Fund (17.7 billion euros), of the European Financial Stability Mechanism (22.5 billion euro) and of the IMF (22.5 billion euros), with the remaining amount provided by Irish pension funds and other European countries. The new resources will be dedicated to the rescue of the Government (50 billion) and banks (35 billion). The recapitalisation plan of the banks aims at reaching the Core Tier 1 capital adequacy ratio at 12%, much higher than the level that is being agreed at an international level and, consequently, this will increase the Government stake in them, leading the holding in Bank of Ireland to 80% (from 36%) and in Allied Irish Bank to 100%.

In October 2010, the dependence of the Irish banking system on ECB liquidity support reached about 130 billion euros, corresponding to 25% of the total financing of the ECB to European banks. Relevant financing has been granted by the Irish Central Bank as well.

The activation of the IMF/European safety net for such a large amount of money raised the problem of a way out for the Irish banking crisis, since no enterprise in a market economy can survive by only relying on public support. A drastic retrenchment of the Irish banking sector seems to be inevitable, through the sale of assets - including loan portfolios and overseas

businesses - in order to cut back the industry to its core function of serving the local market.

The Government is now winding down the fully nationalised Anglo Irish Bank Corp. and the Irish Nationwide Building Society. Allied Irish is trying to sell its UK banking business and its holding in Central Europe, but at the moment still unsuccessfully. Similar shrinking operations are under consideration by the Bank of Ireland, such as the partnership with the UK Post Office. However, after the normalisation of the banking sector, more advanced strategies should be designed by the Irish Government, such as opening banks' capital to private foreign investors, even if it is unclear whether a real interest towards the Irish banking system by international investors really exists.

Among European countries **Germany** was one of the most seriously hit by the global financial crisis. Banking crises started to emerge in 2007, increased in 2008 and then resolved with public interventions. In particular, in order to re-establish confidence in the financial system and the regularity of transactions among financial institutions, the German Government approved a massive rescue package for the banking sector at the end of 2008. As a major measure, a special resolution fund belonging to the Federal Republic of Germany was created, the Financial Market Stabilisation Special Fund (*Sonderfonds Finanzmarktstabilisierung* (*SoFFin*), with available funds of 500 billion euros.[22] This was regulated by the Financial Market Stabilisation Fund Act, which established the main provisions for its functioning. The Act was complemented by a regulation enacted by the Federal Government on 20 October 2008.

Potential beneficiaries of the fund's interventions could be financial sector companies incorporated in Germany (credit institutions, investment firms, investment companies, insurance companies, pension funds, operators of stock or derivatives exchanges and certain financial holding companies), including German subsidiaries of foreign financial sector companies. Special purpose vehicles to which risks from financial sector companies could be transferred might also benefit from these stabilisation measures.

The fund can take three kind of measures: i) provide State guarantees for the refinancing of banks' liabilities up to 400 billion euros; ii) take holdings in financial institutions to increase their capital up to 80 billion euros; and, if necessary, iii) take risk positions (something like a "*bad bank*") for 20 billion euros. Each bank was allowed a maximum 10 billion euros for recapitalisation while the state could spend up to 5 billion euros per bank to assume risk positions. However, unlike the packages in the United States and in United Kingdom, in Germany State support could be granted only following banks' request.

---

[22] FRESHFIELDS BRUCKHAUS DERINGER, *Financial Market Stabilisation Act and Financial Market Stabilisation Fund Regulation come into force*, Briefing, October 2008.

The latter two measures can only be granted in cases in which guarantees would not be sufficient. The remuneration to the fund for all stabilisation measures must be adequate and in line with market conditions. The beneficiary financial sector enterprises are subject to requirements to ensure a sound and prudent business policy. In the case of a recapitalisation or an assumption of risk, these requirements include:

- the limitation of the remuneration for board members and managing directors (a total remuneration of more than 500,000 euros per year is, as a rule, considered excessive).
- the suspension of dividend distributions to shareholders other than the fund.

The first episode of a banking crisis was that of **IKB**, which suffered from a heavy involvement in the US subprime mortgage market. The bank, whose principal shareholder was the State-backed bank KfW (80% owned by the Federal Government and 20% by Lands), was rescued from bankruptcy in August 2007. At the root of the bank's problems, a major role was played by the significant change in the business model. In fact, IKB previously specialised in financing mid-sized companies, during the last decade, together with other regional banks (Landesbanken), tried to diversify its business to more risky international investments, including subprime securities that were not held directly but through the Rhineland Funding, an off balance sheet conduit registered in a tax haven country. The size of this conduit exceeded 10 billion euros in spring 2007, more than one fifth of the entire IKB balance sheet at the time. At the end of 2007, the abrupt drop in the value of subprime assets started to bring Rhineland down and, by contamination, IKB itself. Losses were estimated to be between 2.3 billion euros and 2.5 billion euros.

Part of IKB's junior debt belonged to local savings banks as well as to Landesbanken and other public institutions. This fact certainly explains the panic of the federal authorities, leading the president of BaFin to speak on 2 August 2007 of 'the worst banking crisis since 1931'.

Many questions arose when crisis burst, such as how could a small German bank with only 1,700 employees and a mere €1.4 billion in equity capital make such huge bets in the United States without being noticed. IKB bought 12.7 billion euros in special securities via Rhineland Funding that failed to show up on the bank's books. IKB could at least show that most of its special holdings had higher credit ratings. Indeed, rating agencies started to become more realistic and downgraded their ratings only when the market had gone south.

Public intervention was articulated and changed over the time. It consisted of a sequence of repeated equity injections, loans, guarantees and risky asset relief. Part of the rescue plan for IKB was for KfW to keep the bank solvent, in spite of IKB's mostly private ownership (KfW held only 38% of its equity at the time). Moreover, several attempts to find a private buyer failed. In October 2008 the EU Commission approved the State aid plan for IKB, imposing the selling of the holding of KfW in IKB. On 21 August, KfW sold its 91% equity stake in

IKB to the American private equity fund Lone Star for 137 million euros. After this divestment, at the end of 2008 and in 2009 the Government fund, the Soffin, further intervened granting guarantees for bonds issued by IKB.

The crisis of the IKB did not occur in isolation. Difficulties simultaneously affected other Landesbanken, such as **Sachsen LB** and **WestLB**, which ran into trouble at the beginning of 2008 with risky US ABS. In October 2008, **BayernLB** also went bust. As a consequence, these events blew the credibility of German financial supervision. According to some experts, problems originated in the poor coordination between authorities (central bank, BaFin and the Ministry of Finance).

The **WestLB** crisis occurred because of the “toxic assets” held by the bank’s Brightwater fund. The fund had $35 billion in structured debt spread across several special purpose vehicles. More than half of the funds managed by Brightwater were for foreign clients, and only a small proportion was made up of subprime loans. In March 2008, about 23 billion euros of bad assets were transferred to a special purpose vehicle - Phoenix Light SF Limited - created by the bank itself, backed by the Land of the North Rhine-Westphalia, two regional banks and other local entities. The Land also acquired equity positions in the bank. After the opening of a proceeding for State aid by the EU Commission, the bank was obliged to realise a restructuring plan and cut costs to obtain the Commission’s approval. Subsequently, other non-performing assets of 61.3 billion euros (along with the previous amount of 23 billion) were transferred to the bad bank provided for by the Financial Market Stabilisation Act, called Erste Abwicklunganstalt, in which the Soffin injected new capital, convertible into WestLB shares.

In August 2007, **Sachsen LB**, based in the State of Saxony, was supported by Sparkassen-Finanzgruppe, the German savings banks association, which granted a 17.3 nillion euros credit facility to a conduit that Sachsen LB had funded and managed. The conduit, called Ormond Quay, borrowed in the short-term commercial paper market and invested in longer-term structured credit instruments. This was supported by a credit line from Sachsen LB. The rescue was triggered when commercial paper investors refused to refinance Ormond Quay and Sachsen LB was unable to provide the credit facility it had pledged.

Outfitted with $16.75 billion at the end of 2006, Ormond Quay was slightly larger than was IKB’s Rhineland Funding. The official line from Saxony was that most of the debt held by the fund had excellent credit ratings.

Sachsen LB has been sold to Landesbank des Bundeslandes Baden-Wurttemberg. In the context of such an operation, the Saxony State granted a guarantee for 2.75 billion euros to a specific SIV, to which the bad assets of the bank have been transferred.

BayernLB was the first German bank to draw from the Soffin. An articulated intervention was designed by the Government to bail out the bank, through a package assured by the Bayern State and the Soffin for the recapitalisation of the bank and the guarantee of the new issuance of bonds. Moreover, Bayern

State guaranteed an ABS portfolio up to a maximum amount of 6 billion euros, guaranteed also by BayernLB up to 1.2 billion euros.

Besides the crises in the abovementioned Landesbanks, the crisis of the **Hypo Real Estate,** Germany's second largest commercial property lender, was also significant. It was saved through an injection of a huge amount of financial resources by the Government, the central bank, the Soffin and by leading banks.

Hypo Real Estate met financial difficulties during the liquidity crisis of September 2008, principally because of the heavy debt burden of its subsidiary, **Deutsche Pfandbriefbank** (Depfa). On 29 September 2008, the German Finance Ministry announced that a 35 billion euros credit line would be extended to Hypo Real Estate from a consortium of German banks. On 4 October 2008, the banking consortium involved pulled out, so a newly plan was agreed on 6 October, according to which a credit line of 50 billion euros was granted by German banks (15 billion) and by Government and Bundesbank (35 billion).

The Soffin, who granted guarantees to the bank, in February 2009 increased its total funding to 52 billion euros. Moreover, it underwrote an increase in the bank's capital for about 60 billion and, on 17 April 2009, launched an offer, consequently accepted by the shareholders, to take over Hypo Real Estate by buying shares that raised its equity stake to 90%. By the end of 2009, the complete nationalisation of the firm was decided. Furthermore, the Soffin recapitalised Depfa and granted guarantees in order to allow the subsidiary to issue bonds on the market. Finally, in September 2010 the non strategic-assets of the bank were transferred to a bad bank, FMS Wertmanagement, purposedly created by Hypo Real Estate.

In the course of the financial crisis, many other interventions were made by the Soffin in favour of the German banking system, in some cases in conjunction with other authorities, such as the central bank and the interested Land.[23] One of the most important measure was in favour of **Commerzbank**, which during the financial crisis merged with Dresdner Bank. The total injection of financial resources in the bank was 25 billion euros, 1.8 billion of which was new capital (25% of the capital), 8.2 billion was "silent capital", which would have been the first to be reimbursed once the bank was able to increase capital, and the remaining part (15 billion) in the form of guarantees for the issuance of new bonds.

After the financial crisis the German banking system is more public-owned than ever before. However, the restructuring and privatisation of Landesbanken, one of the structural problems, has not made significant steps forward.

Very peculiar is the history of the Icelandic banking system failure. As highlighted,[24] the **Iceland** is an optimal example of the way things may go

---

[23] HSC Nordbank, NordLB, LBBV, Sparkasse KolnBonn, Aareal Bank.

[24] J. STIGLITZ, *Freefall. America, Free Markets, and the Sinking of the World Economy*, 2010.

wrong when a small open economy decides to acritically adopt a model of heavy deregulation. The peculiarity of the banking system was that three large banks (Kaupthing, Glitnir Bank and Landsbanki) grew far more than the country's GDP (these banks raised deposits and invested in assets totalling about $176 billion, eleven times the GDP of the nation).[25] In other words, the banking system was allowed to growth also raising funds on international markets, in an uncontrolled way (the consolidated liabilities against foreign countries amounted to more than $100 billion compared with a national GDP of $14 billion). When problems started to emerge in the three banks, they were also allowed to raise retail deposits in the UK and Netherlands through special current accounts (*Icesave*), with high interest rates.

Kaupthing (with its KSF subsidiary in the UK), **Glitnir Bank** and **Landsbanki** failed and were nationalised in September 2008. The failure of the three banks was considered by the IMF to be the biggest in relation to the size of the economy.

The banks were too big for *home* authorities to supervise as well as to manage once in default. Moreover, national financial resources were not sufficient to save them. The case of Iceland is paradigmatic of the policy of total liberalisation, when small banks located in small countries are allowed to raise deposits in other countries, with the impossibility of the home country Government being able to inject financial resources to save them and protect depositors in host countries. This occurred in the UK and the Netherlands, where disputes arose as to who should have borne the burden of the foreign depositors' payout. With Iceland unable to step in, the UK and the Netherlands Governments had to reimburse depositors in their countries to the tune of $6 billion.

In August 2009, the Icelandic Parliament passed a law concerning the package prepared by the Government to rescue the banks. The plan was supported by a two-year loan of $2.1 billion from the IMF, together with pledges from Poland, the UK, the Netherlands and Germany, which would take its standby facility to more than $10 billion, corresponding to half of Iceland's GDP. Moreover, the law provided a State guarantee (with maturity in 2024) for the restitution to the UK and the Netherlands of $6 billion.[26] The law was subsequently changed to meet some requests from the UK and the Netherlands concerning the maturity of the guarantee.

The financial crisis has also significantly affected the **Benelux** countries (Belgium, the Netherlands, Luxembourg), characterised by defaults and consequent bailouts of very large banks, such as Fortis, Dexia, ABN AMRO and ING.

---

[25] W. H. BUITER – A. SIBERT, *The Iceland Banking Crisis and What to Do About It: The Lender of Last Resort Theory of Optimal Currency Areas*, Centre for Economic Policy Research (Cepr) Policy Insight 26, October, 2008, available on website address http:www.cepr.org/pubs/Policy Insights/policy Insight 26.pdf.

[26] M. SALTMARSH, *Iceland to repay nations for failed banks' deposits*, in "The New York Times", 29 August 2009, p. B2.

The rescue of **Fortis,** a banking, insurance and investment management conglomerate operating in the three countries, occurred in September 2008. Fortis was the largest Belgian financial conglomerate in early 2008; from mid-2008 onwards, the bank faced huge liquidity problems, which became wider and stronger following the acquisition of the Dutch bank ABN AMRO.

The Belgian and Dutch Governments first met on 27 September 2008 to discuss the rescue of Fortis. The following day the group was partially nationalised, with a capital injection of more than 11 billion euros by the three Benelux countries. Later, a mixed solution was adopted for the entire group.

In the Netherlands, the Government nationalised the domestic component, buying Fortis' Dutch bank, its insurance arm as well as the parts of ABN AMRO that Fortis had previously acquired. The remaining parts were sold to BNP Paribas.

In Belgium, the Government bought Fortis' Belgian bank (the largest component of the overall Fortis Group) and sold a 75% stake in it to BNP Paribas. BNP also bought Fortis' Belgian insurance operations and acquired a majority stake in Fortis' Luxembourg subsidiary. At the end of these complex transactions, the Belgian and Luxembourg Governments became minority shareholders with blocking power in exchange for shares in BNP Paribas.

As observers underlined, the resolution of the banking group took place along national lines in a protracted process that failed to preserve franchise value. Its completion was delayed for nearly six months between December 2008 and May 2009 after Belgian shareholders in Fortis succeeded in challenging the deal to sell most of the Belgian bank to BNP Paribas. The Belgian Court of Appeal found that shareholders were entitled to vote on the transaction in order for it to be valid under Belgian law. Shareholders voted against the transaction and subsequently approved it after having agreed to modifications.

Many lessons have been learned from the Fortis crisis. The first is setting the right trade-off among private shareholders' rights and the public interest for a swift and decisive bank resolution for safeguarding overall financial stability. The second is the prevailing relevance of national interests and the difficulties achieving a cross-border consensus, even among jurisdictions whose financial regulators have a long tradition of cooperation and whose legal frameworks are considerably harmonised.[27]

On 30 September 2008, **Dexia**, a Belgian-French bank specialised in lending, was bailed out by the Belgian, French and Luxembourg Governments, which announced a 6.4 billion euros deal to keep it as a going concern.

ING, a Dutch financial conglomerate, received a capital injection of about 10 billion euros from the Dutch Government on 19 October 2008, aimed at

[27] J. LIPSKY, *Towards an International Framework for Cross Border Resolution*, delivered at the ECB and its Watchers Conference XII Frankfurt, Germany, July 9, 2010.

increasing its core Tier 1 capital ratio to above 8%. The Government was granted with securities, veto rights on major operations and investments and the power to appoint two Government advisors to the supervisory board. At that time, ING management officially stated that the capital injection should not reduce the rights of existing shareholders.

On 21 December 2009, ING announced that it had completed its planned repurchase of 5 billion euros of the Core Tier 1 securities issued in November 2008 to the Dutch State and its 7.5 billion euros rights issue.

In **Switzerland,** the two leading banks, **UBS** and **Credit Swiss**, faced serious problems because of their involvement in US toxic assets. Given the systemic relevance of the two banks, the Government and the Swiss National Bank (SNB) provided a financial package of $14.1 billion to stabilise the Swiss banking system.

In particular, in October 2008 the Swiss Government provided a six billion Swiss franc convertible loan (mandatory convertible notes at an interest rate of 12.5%) to UBS in order to prevent the bank collapsing under more than $50 billion of write-downs on toxic assets. The Government's injection of funds into UBS represented approximately 9% of the bank's capital. Furthermore, the SNB created a special purpose vehicle to which illiquid securities and other assets of UBS up to an amount of $60 billion were transferred. In this way, the UBS balance sheet was relieved of the considerable risks related to these assets. The fund was capitalised with $6 billion of equity capital provided by UBS and $54 billion from the SNB. As collateral, the SNB got the ownership of the assets and the control of the fund entity, as well as the overwhelming share of the equity in the event of positive performance.

UBS made recourse to State capital after two earlier fundraisings. Its strategy, based on the dumping of "toxic" assets and the increase of capital, would have halted the outflow of funds from its core arms (wealth and asset management), affected by the withdrawals of Sfr49.3 billion and Sfr34.4 billion respectively in the previous three months.

The Swiss Government, for its part, did not regard its participation in UBS capital as a long-term commitment, being its intention, when market conditions permit, to sell it to private investors. In any case, the UBS bailout was the most extreme of a series of actions taken by the Swiss authorities to guarantee interbank lending and increase deposit protection, following similar measures adopted across Europe.

UBS was involved in tax violation in the USA. As a consequence of this investigation, some months after the public intervention, the FINMA (the new Swiss Financial Market Supervisory Authority) ordered UBS to disclose some bank client data to US tax officials to avert criminal charges against the bank, a first breach of Swiss bank secrecy rules that grew wider over the following months.

Credit Suisse, the second largest Swiss bank, raised $8.8 billion from "a small group of major global investors", including the Qatari authorities, which

already held a significant stake. The bank had previously written down $44 billion of bad assets. The assets transferred into a new fund included $31 billion related to the United States subprime and other markets that included MBS and securities backed by student loans.

The measures adopted by the Swiss Government were in contrast to the previous stance of standing apart from the wave of banking bailouts among European countries. But such was the size of the Swiss banking industry in relation to the overall economy that the Swiss might not have had the resources to bail out UBS or Credit Suisse if they had ran into deeper trouble.

Denmark also experienced a banking crisis, which affected the **Roskilde Bank,** a bank founded in 1884 and which in 1996 merged with Ringsted Sparkasse. On 24 August 2008, the bank ran into financial trouble and it was acquired by the National Bank, together with the Private Contingency for Settlement of needy banks, savings and cooperative banks because it was insolvent and could not find a buyer. This was the first time since 1928 that the Danish National Bank had taken over another bank.

The loss was first estimated between £3 and £6 billion, but rumours spread that the loss in the worst scenario could amount to 37 billion kroner. Its 33,000 shareholders also lost their money.

On 29 September 2008, Roskilde Bank signed an agreement for the sale of 21 branches, including nine branches to Nordea, seven branches to Spar Nord Bank and five branches to Arbejdernes Landsbank.

Italy, France and Spain have not experienced banking crises during the financial crisis, thanks to their more traditional business models based on retail banking. Nevertheless, they have still been affected by the general turmoil in terms of the drying up of liquidity and other disturbances in the financial system as well as from the credit crunch.

This is why, according to internationally agreed measures, nearly all the Governments decided to take action to stabilise the financial system and the economy through two kinds of initiatives, namely the provision of liquidity to the banking system and the recapitalisation of banks in order to restore confidence and provide the economy with a normal level of financing.

In particular, the Italian financial system proved to be solid, thanks to a rather prudent banking business model and a stricter regulation and supervision, as assessed by the FSB peer review.[28] Indeed, during the period

[28] FINANCIAL STABILITY BOARD, *Peer Review of Italy*, Peer Review Report, 20 January 2011. According to this assessment, "the Italian financial system showed much resilience to the recent global financial crisis, although it was affected by the knock-on effects on the economy. This resilience can be attributed to the traditional, relationship-oriented business model and stable retail funding base of Italian banks, as well as to the prudent regulatory and supervisory framework that promoted conservative mortgage lending practices and discouraged banks from participating in complex securitization activities and sponsoring structured investment vehicles. All major financial institutions remained profitable over this

2007-2009 only a few small banks were placed under special administration and compulsory liquidation proceedings (see chapter 5)[29], and in any case these were not connected with the factors that gave rise to the financial crisis, but rather to misconduct in banking activity. According to the framework agreed at the European level for the stabilisation of the banking system, in Italy two legislative decrees have been issued introducing the possibility of State intervention for increasing the banks' capital in order to support the productive system and stabilise the real economy:

1) the Legislative Decree 9 October 2008, n. 155 (*Urgent measures for guaranteeing the stability of the financial system and the continuity in the provision of credit to firms and consumers, in the current crisis situation of international financial markets*) provided for that, until 31 December 2009, the Ministry for the Economy and Finance could underwrite or guarantee an increase of capital approved by Italian banks or by the parent company of banking groups facing a situation of capital inadequacy ascertained by the Bank of Italy, in the framework of a program of stabilisation and strengthening of a bank for the duration of 36 months. Moreover, the Ministry for the Economy and Finance could provide the State guarantee for loans granted by the Bank of Italy to Italian banks and to Italian subsidiaries of foreign banks for the purpose of facing severe liquidity crises (ELA). Finally, as a complement to and in addition to the interventions of the depositor guarantee schemes provided for in Banking Law, the Ministry for the Economy and Finance was authorised to provide the State guarantee in favour of the depositors of Italian banks for a period of 36 months from the entry into force of this decree law;
2) the Legislative Decree 29 December 2008, n. 185 (Anti-Crisis Decree, containing *urgent measures for the support to families, work, employment and enterprise and for re-designing the national strategic framework in order to contrast the effect of the general crisis*). The decree empowered the Ministry for the Economy and Finance to underwrite financial instruments (special banking bonds), without voting rights, computable in the supervisory capital, issued by Italian banks fundamentally healthy whose stocks are negotiated in regulated markets. According to the law provisions, the Ministry could underwrite financial instruments provided that the operation was advantageous as a whole (according to the conditions provided for by the Ministry defining the contractual and economic characteristics of such instruments), took place at market conditions and was directed to pursue the objectives indicated by the law (the recapitalisation of the banking system and the financing of the economy).

period, and only few of them made use of the facilities provided by the government. The various stress tests recently carried out confirmed the ability of these institutions to withstand more adverse scenarios".

[29] BANK OF ITALY, Annual Report, May 2010.

No banks made recourse to the first category of State intervention, because no banks were undercapitalised, while only four banks issued the special financial instruments of the second category for a total amount of 4.1 billion euros.

The real problem which arose at the peak of the crisis was the drying up of liquidity in the financial system, brought about by a loss of confidence among financial institutions. A successful initiative was adopted by the Bank of Italy to foster a recovery in trading on the interbank circuits and a greater diversification of contract maturities: the Mercato Interbancario Collateralizzato (*collateralized interbank market).* The Bank of Italy, together with e-MID and the Italian Banking Association, created a mechanism to enable market participants to trade funds through a procedure that minimises counterparty and liquidity risks.

The Collateralised Interbank Market[30]

This is a special market segment in the e-MID trading platform, which ensures the complete anonymity of trades. Initially, the new market segment handled trades on maturities of one week and longer. Participating banks shared in covering the risk up to predetermined limits.

The new market segment would have been operational until 31 December 2009, but its activity continued beyond that date, with appropriate modifications.

In the new interbank market, the Bank of Italy: i) evaluated the collateral provided by banks; ii) verified that trades comply with established limits and conditions, and iii) ensured the prompt settlement of transactions in the event of default by a participant, subsequently recovering the amount from the collateral deposited.

The collateralised market was established for Italian banks, but it was then extended to EU credit institutions that satisfied the same requirements established for Italian participants, subject to an understanding with their home country authorities. For each banking group, only a single bank could participate, but it was nevertheless able to contribute collateral pertaining to other group's banks.

An advisory committee composed of the Bank of Italy, e-MID, the Association of Bank Treasurers and the Italian Banking Association examined any problems that arose in the functioning of the new market segment and assessed proposed changes to its characteristics.

---

[30] BANK OF ITALY, *Conditions of Guarantee for Contracts in Euro in the Anonymous collateralized E-MID market segment*, 15.6.2009, Available on Bank of Italy's website.

In **France** the financial crisis had its first manifestation in 2007, when BNP Paribas had to freeze three investment funds worth 2.76 billion euros ($3.7 billion) because it was unable to value their US mortgage-based assets.

After these events, no further problems affected the banking system. In accordance with the general plan agreed by Eurozone Member States, the French Government issued specific laws providing State guarantees (up to an amount of 360 billion euros) aimed at ensuring the injection of liquidity into the banking system and increasing banks' capital with the aim of supporting the development of credit to the economy (households, businesses and local communities' projects), while maintaining a high level of solvency.[31] The guarantees were also intended to cover Dexia's interbank transactions, in accordance with the terms established in the intergovernmental agreement signed in October 2008 with Belgium and Luxembourg. All these measures were in addition to the Government's commitment to subscribe banks' capital to stabilise financial institutions in troubles.

In application of these measures, in October 2008, the French Government created the SPPE (*Societè de Prise de Partecipation de l'Etat*), an entity fully owned by the State, with the purpose of subscribing subordinated debts and preference shares issued by financial institutions and that constitute core capital. The SPPE issuances benefited from the French State guarantee.

In fact, the SPPE injected 19.7 billion euros of liquidity into banks, of which 7 billion went to Bpce (popular and saving banks), 5.1 billion to BNP Paribas, 3.4 billion to Societè Generale, 3 billion to Crèdit Agricole and 1.2 billion to Crédit Mutuel. The remuneration of these financings was established at 8.2% with a maturity of between 2010 and 2013. However, the restitution by some banks of the financial resources has begun well in advance of this.

Even though **Spain** has not been directly affected by banking crises during the financial crisis, many concerns have been raised by the negative dynamics of the domestic real economy and by the increase of non-performing loans. As highlighted by the recent peer review conducted by the Financial Stability Board,[32] "the financial crisis had significant after-effects since it led to the bursting of Spain's real estate bubble that had built up prior to the crisis. In that context, the risks identified in the Financial Sector Assessment Program (FSAP)[33] relating to rapid credit growth in the housing sector and to the regulation, supervision and governance of savings banks ("cajas") materialised. The adoption by the Spanish authorities of tighter regulatory capital and loan loss provisioning requirements for banks' real estate exposures, as recommended by the FSAP, proved to be an insufficient buffer against the risks emanating from such activities"**.** Moreover,

[31] C. LAGARDE, *France's plan for ensuring the financing and restoring confidence*, October 13, 2008.

[32] FINANCIAL STABILITY BOARD, *The Peer Review of Spain*, Review Report, 27 January 2011.

[33] Financial Stability Assessment Programs conducted by the International Monetary Fund.

Spain has the highest unemployment rate all over Europe at 20% and a budget deficit of 9.3% of GDP.

In this context, the strengthening of the banking system is of primary importance, through structural changes in saving banks, which manage assets worth 1,300 billion euros, equal to 42% of the total banking system's assets. In May 2010, the sector of savings was subjected to a reorganisation and concentration process, reducing regional cajas from 45 to 17. For the financial support of these operations, the Government has constituted a resolution fund (*Fondo de Restructuracion Ordenada Bancaria* - FROB), which has injected 12 billion euros of public funds.

Supervisory authorities are now requiring cajas to reach a 8% Tier 1 minimum requirement and, for some of them, even higher (10%). Banks that fail to comply with these requisites are required to draw up a recapitalisation plan, including providing an injection of private capital and listing on the stock market. If banks fail to meet these objectives, the Spanish Government may effect a temporary nationalisation of the Cajas.

For this purpose, a new measure is being adopted by the Government in order to allow the FROB to directly intervene in the capital of the cajas, becoming their shareholders.

The estimated size of the Government financial support is from 30 to 100 billion euros, because of the growth in the "non performing" exposures of cajas to the real estate sector.

From this perspective, Caja Madrid, the country's second-largest savings bank, is negotiating a merger with five smaller banks of the same category hoping to benefit from Government financial support (99 billion euros bank rescue fund). The transaction would allow the smaller banks to retain some independence, benefiting in the meantime from a larger combined balance sheet and Government bailout money.

4. The lessons learned from the crisis.

After the financial crisis and its disruptive effects on banking systems, creditors and investors are now much more aware of the multiple factors causing distress in the global financial system and of the complex mechanisms that lead to it in the past. One of the key points to deal with is the high level of leverage of financial institutions, with a small proportion of capital related to asset sizes, which ends up being very risky. Moreover, overcoming the "*too big to fail*" theory, that justified State interventions as the last resort to avoid worse consequences on the economy, is a necessary step. Public support can no longer be re-called in the future, because it is no more acceptable that in normal times profits are private and in times of crisis losses are charged to the public balance sheets. This relevant source of moral hazard constitutes the premise for future crises. The

general rule should be that the banks and their shareholders and managers should bear the costs of the crisis.

From a perspective of prevention and effective crisis management we have to consider that large and complex financial institutions are not only "too big to fail", but also "*too big to be saved*", as proven in some countries whose balance sheets were smaller than those of their banks, with the consequence that public funds were not available to rescue them. Going to the "core" issue, from a supervisory point of view, we should be aware that these banks are also "*too big to be controlled and supervised*", both internally by competent controlling bodies and externally by supervisory authorities.

Policymakers are now addressing this problem and are looking for new mechanisms that may effectively resolve big banks. In this regard, a number of proposals are under discussion by many international bodies.

On one hand, drastic structural measures have been proposed, such as downsizing systemically-important financial institutions and reducing their scope and complexity. This is a radical approach, entailing the deglobalisation of financial institutions. It has been argued that if the legal and regulatory frameworks for dealing with financial institutions are national in scope, financial institutions themselves should be national in scope as well. However, it has been observed by many regulators that such an approach would increase significantly costs while reducing access to global capital just when the benefits of capital mobility have been clearly recognised, most notably in dynamic emerging economies.

In the same direction of structural reforms, the separation of commercial banks and investment banks has been proposed. In the US this implies the return to the Glass-Steagall Act in order to reduce the risks that banks raising deposits can take. This approach aims at defining what a financial institution can do. According to the "Volcker rule",[34] all depository institutions should be prevented from engaging in proprietary trading and from owning or sponsoring private equity funds or hedge funds. In this perspective, various configurations of "narrow bank" have been outlined.[35] From the same perspective, it has been underlined that "(E)ither those guarantees to retail depositors should be limited

---

[34] P. VOLCKER, *Statement before the Senate Committee on Banking, Housing and Urban Affairs of the United States,* Hearing on "*Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies*", 2 February 2010;

[35] J. KAY, *Narrow Banking. The reform of Banking Regulation*, CSFI Report, Centre for the Study of Financial Innovation, London, September 2009, according to which all money raised by banks as deposits could only be invested in safe assets; in this way insured deposit taking would be separated from lending. Therefore, it would be equivalent to a 100% reserve requirement on all deposits. This would not mean legal or structural separation on narrow banking from financial activities, but only that within each bank or banking group deposit-taking and portfolio investments are segregated functionally. So, deposit money can not be used for speculative capital market activities. Moreover, L. KOTLIKOFF, *Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking*, Wiley, 2010; For an analysis of the different definitions of narrow banking, see J. CARMASSI-E. LUCHETTI-S. MICOSSI, *Overcoming too-big-to-fail. A Regulatory Framework to Limit Moral Hazard and Free Riding in the Financial Sector*, in *Preventing and Managing Future Crises*, Edited by N. Forti, Bancaria Editrice.

to banks that make a narrower range of investments, or banks which pose greater risks to taxpayers and the economy in the event of failure should face higher capital requirements. Or we must develop resolution powers such that large and complex financial institutions can be wound down in an orderly manner. Or, perhaps, an element of all three".[36]

But there does not seem to be large consensus on the utility and opportunity of structural interventions in the banking system. Many regulators and industry representatives oppose this perspective, stating that such measures are not necessary and would not be a sufficient solution and that alternative ways can be found to achieve banking system stability without renouncing the benefits related to the diversification and innovation of financial activity.[37] Many considerations have been made in support of this approach, according to which banks should be set free to carry out their activities according to their strategies, since there is no clear evidence that a specific business model may constitute a source of crisis, since failures have involved both investment and commercial banks.

As a consequence of this different approach, other instruments have been envisaged to reform the banking system, aimed at indirectly reaching the desired structural effects in terms of downsizing and derisking. These have been identified in the reduction of a bank's leverage, through the introduction of a leverage ratio, together with more stringent micro regulation and supervision (capital, liquidity) and macro-prudential supervision.

Besides more stringent prudential rules and supervision, improvements in risk management and internal control systems are considered essential. For crisis prevention, banks should have in place plans and measures to orderly resolve distress, should it occur.

Moreover, the international financial crisis has proven the importance of effective crisis management both at the international and at the domestic level. On the domestic side a more convergent, structured and developed set of tools is on track, according to international standards. For instance, in many countries concrete initiatives to improve domestic regulation and crisis management frameworks have been taken, although progress is still to be made.

The international facet looks more problematic, as the lack of a harmonised legal framework in cross-border banking crisis management and resolution, especially for banking groups, is the main issue. The most conflicting aspect is that banks are global, while rules are national, and this implies severe consequences in terms of the lack of coordinated crisis management and the unequal treatment of stakeholders located in different countries. In such cases, authorities have two options: provide

---

[36] M. KING, Spech at the Lord Mayor's Banquet for Bankers and Merchants of the City of London at the Mansion House, 17 June 2009,

[37] A. TURNER, *What do banks do? Why do credit booms and busts occur and what can public policy do about it?*, in *The Future of Finance*, The LSE Report, available on website futureoffinance.org.uk.; J. CARMASSI-E.LUCHETTI-S. MICOSSI, *Overcoming too-big-to-fail. A Regulatory Framework to Limit Moral Hazard and Free Riding in the Financial Sector*, cit., p. 19.

public support to the institution or rely on an insolvency regime that is ill equipped to efficiently restructure financial institutions in an efficient and orderly manner. Recent experience has demonstrated that the more interconnected and integrated international financial institutions and groups have become, the more disruptive and value-destroying uncoordinated local resolution actions are likely to be.

Consequently, the following questions have been raised. Who makes the decisions on the management of banking crises? When should we intervene? Which instruments can be used?

The relevance of a harmonised framework is clear if one only considers the negative impact of the implementation of different procedures in each of the States where banks operate, the deriving conflicts and the overlap among legal systems with high costs, time wasting and contentions among creditors. The lack of common insolvency rules enhances the risk of the unfair treatment of creditors and makes it difficult even to obtain the necessary information to support their claims.

The experience of Lehman Brothers has been a useful stress test for this purpose, in that it has allowed us to understand "on field" the number and severity of problems that can arise in such scenarios.

This is as true for insolvency proceedings as it is for other crisis management and resolution instruments that authorities may trigger. In particular, legal systems may differ with regard to deposit protection schemes and State interventions rules, given also the lack of agreed *burden share* criteria among countries. So, policymakers have to decide who has to pay the costs of crises without drawing on public support. For this purpose, levies on banks and taxes on financial transactions intended to set up specific funds devoted to the resolution of the crises have been envisaged and somewhere even established.

5. Current international responses.

5.1 The global debate.

The objective of strengthening the international framework in banking crisis management and resolution is currently under analysis by the regulation setters in many international forums because the financial crisis has clearly demonstrated heavy shortcomings in domestic and international frameworks.

Filling such gaps is the main objective of future far-reaching reforms of the global financial system, involving the structures and institutional frameworks of regulation and supervision.

Recognising the need for a new framework and fixing its main guidelines does not imply having found a solution that works for all countries and stakeholders, because interests are different as well as the assessments and the consequent actions to be put in place. This is a key point, because responses should be global

on a uniform basis, otherwise the financial system could run into the same risks that gave rise to the turmoil.

Following the G20 meeting in Pittsburgh in September 2009, there is now international commitment that taxpayers' money should never again be used to cover bank losses.[38] To get such a result, a profound financial sector reform has been deemed necessary by the G20, based on four pillars: i) strong regulatory reform, based on a new regime for bank capital and liquidity; ii) effective supervision, with stronger rules and more effective powers to supervisors for the oversight and supervision of risks, including early intervention; iii) resolution, particularly addressing systemic institutions, for the purpose of reducing moral hazard and avoiding taxpayers bearing the burden; and iv) transparent international assessment and peer reviews with regard to tax havens, money laundering and terrorism financing and the adherence to prudential standards.

On mandate of the G20, the FSB is playing a key role in dealing with the main aspects of the financial regulation reform and focusing, in particular, on the crisis management of intermediaries with systemic relevance and with cross-border implications. It has focused on three essential factors that can hinder effective coordination among national authorities in the case of crisis: i) insufficient exchange of information; ii) differences in the mandates and competencies of national authorities; and iii) potential for conflicts of interests among national banking crisis resolutions.

The FSB's Principles for Cross-Border Cooperation on Crisis Management, published in April 2009, set out a framework for improved cooperation between authorities so as to minimise the risk of a disorderly bank collapse. The principles expressly provide for contingency plans to be prepared by banks for their own winding downs (*living wills*).

A comprehensive update on the progress of its work on global regulatory reform has recently been made by the FSB.[39] Here, we have a clear picture of the principles, recommendations and actions that should be taken over forthcoming years to strengthen the financial system and reduce systemic risks.

As to the policy oriented to reducing the moral hazard associated with those financial institutions that are too big, too interconnected or too complex to fail, the FSB has submitted to G20 leaders an interim report that sets out principles that national authorities should follow in developing a policy framework to reduce moral hazard risk associated with SIFIs. These principles will be transfused into policy recommendations.[40] Furthermore, the FSB has developed a report updating the G20 about the progress made in the implementation of its recommendations

---

[38] The G-20 Toronto Summit Declaration, June 26-27, 2010.

[39] M. DRAGHI, *Progress and issues on the global regulatory reform agenda*, Toronto, 24 June 2010.

[40] FINANCIAL STABILITY BOARD, *Reducing the moral hazard posed by systemically important financial institutions*, *FSB Recommendations and Time Lines*, October 2010.

for strengthening financial stability,[41] including stronger prudential standards (capital and liquidity) and measures to address SIFIs and resolutions.

Consistently with the work by the FSB, the Basel Committee on Banking Supervision has conducted an in-depth study on banking resolution and deposit insurance schemes, publishing two reports containing specific recommendations.

The report drafted by the "Cross-border Bank Resolution Group" has issued **10 high-level recommendations**[42] for strengthening the cross-border bank resolution framework. It reccomends: i) the introduction of effective national resolution powers; ii) the establishment of frameworks for a coordinated resolution of financial groups; iii) advance planning for the resolution or winding down of systemically important cross-border financial institutions; iv) the convergence of national resolution measures; v) a reduction in the complexity and interconnectedness of a group's structure and operations; vi) the development of procedures to facilitate mutual recognition of management and resolution proceeding and measures; vii) arrangements to ensure timely sharing of information; viii) to enable authorities to transfer contractual relationships; ix) to plan clear option to exit from public intervention; and x) to strengthen risk mitigation mechanisms. A specific recommendation regards the case in which national authorities believe that a group's structure is too complex to permit orderly and cost-effective resolution; in this case authorities should consider imposing regulatory incentives on those institutions, through capital or other prudential requirements, designed to encourage the simplification of the structure in a manner that facilitates effective resolution.

Furthermore, the Basel Committee and International Association of Deposit Insurers (IADI) have issued "core principles"[43] and a methodology for compliance assessment[44] in the field of deposit insurance. They are fairly high level in nature, and are not specific to some of the main important issues that are currently under discussion, especially at the EU level, such as coverage, funding mechanism and pay-out delays.

The IMF is also involved in this matter. It is producing two works on a "Framework for Cross-Border Resolution of Insolvent Financial Institutions". The first will examine legal and policy issues, while the second will set out recommendations for the resolution of these issues[45].

---

[41] FINANCIAL STABILITY BOARD, *Overview of Progress in the Implementation of the Recommendations for Strengthening Financial Stability*, Report of the Financial Stability Board to G20 Leaders, 18 June 2010.

[42] BASEL COMMITTEE ON BANKING SUPERVISION, *Report and Recommendations of the Cross-border Bank Resolution Group*, March 2010, available on the Bank for International Settlements website (www.bis.org).

[43] BASEL COMMITTEE ON BANKING SUPERVISION – INTERNATIONAL ASSOCIATION OF DEPOSIT INSURERS, *Core Principles for Effective Deposit Insurance Systems*, June 2009.

[44] BASEL COMMITTEE ON BANKING SUPERVISION, *Core Principles for effective deposit insurance systems. A proposed methodology for compliance assessment*, 28 May 2010, available on the BIS website (www.bis.org.).

[45] INTERNATIONAL MONETARY FUND, *Resolution of Cross-Border Banks. A Proposed Framework for Enhanced Coordination*, June 11, 2010. On this initiative, see J. LIPSKY, Towards an

5.2 European initiatives.

Following the analysis of the weaknesses of the current regulatory system, and taking advantage of the main findings of the international debate, a number of initiatives have been set out at the European level as well.[46]

Concrete steps forward towards a new and more structured institutional framework were made before the financial crisis. We recall particularly the *Memorandum of Understanding on Cross-Border Financial Stability*, entered into force in June 2008, introducing common principles for the management and resolution of systemic financial crises and new procedures to strengthen coordination. Consequently, *Domestic Standing Groups* have been created within each country, with the participation of Finance Ministries and all supervisory authorities involved in financial stability issues.[47] Other relevant bodies provided for by the Memorandum include *Cross-Border Stability Groups*, which are coordination groups among supervisory authorities, central banks and ministers of finance that aim to evaluate the systemic impact of crises on banking groups and financial markets between home and host authorities. These groups also provide mechanisms for the exchange of information and coordinate interventions. Moreover, they should establish ex-ante criteria for burden sharing, considering the specific features of the group itself.

In light of the financial crisis the organisational solutions and principles identified for the treatment of banking crises will no longer be sufficient. There is a clearly emerging need for a more articulated and advanced regulatory setting in terms of objectives, rules, authorities involved and instruments. It is also evident that a more advanced framework of banking crisis management cannot be pursued without a coherent development of the architecture of regulation and supervision.[48]

Based on the conclusions reached by De Larosiere Report,[49] this architecture has been realised. New arrangements have been adopted for strengthening macroeconomic supervision and micro-prudential supervision arrangements for cross-border banks. New authorities have been set-up in order to realise

---

International Framework for Cross Border Resolution, delivered at the ECB and its Watchers Conference XII Frankfurt, Germany, July 9, 2010. According to him, "the November G20 Leaders Summit in Seoul recognize the potential value of an international resolution mechanism. However, there is no prospect of an agreement on this issue anytime soon, and certainly not by the Summit. The reason for this isn't a lack of will or interest, but because creating an agreed resolution mechanism for cross-border institutions has no clear precedent and will involve difficult choices. Inevitably, this process will take time". It is worth to re-call also the previous work of INTERNATIONAL MONETARY FUND-WORLD BANK, *An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency*, April, 2009.

[46] S. FITZGERALD, *The Reform of Financial Supervision in Europe*, Institute of International and European Affairs, 2009.

[47] In Italy, the "Committee for the Safeguard of the Financial Stability", to which participate the Minister of Economy and Finance (chairman), the Governor of Bank of Italy, the Presidents of CONSOB (market authority) and ISVAP (insurance sector authority).

[48] M. CIHAK-E. NIER, *The Need for Special Resolution Regime for Financial Institutions: The Case of the European Union*, IMF Working Paper 09/200, International Monetary Fund, Washington D.C., 2009.

[49] Report of "The High-Level Group on Financial Supervision in the EU", Brussels, 25 February 2009.

closer cooperation in the regulation and supervision of cross-border financial institutions. In the new framework, day to day supervision will remain in national hands, consistent with the fiscal competence of Member States.

As to the new architectural design of supervision, after long discussions and negotiations among national bodies, the European Parliament has approved the constitution of two new bodies: the *European Systemic Risk Board (ESRB)* and the *European System of Financial Supervision (ESFS)*, which are responsible for macro-prudential and micro-prudential supervision, respectively. These reforms have for the first time attributed supervisory powers to European bodies in a way that could be considered to be an acceptable compromise with regard to the powers and functions of the new authorities. So, we can say that this is a midway point, and that the parliamentary decision created the premises for further development in the expected direction of the completely integrated European supervision of cross-border financial institutions.

The ESRB has the function of carrying out macro-prudential oversight, which represents the most innovative feature of the new institutional design. It will consist of three areas of intervention, namely risk analysis, early warning and action, even though it will not have any binding powers to impose measures on Member States. The ESRB will be composed of a general board (61 members) and a steering committee together with advisory technical and scientific committees, to which national central banks, supervisory authorities and community institutions will join. The ECB will provide technical and logistic support for the performance of ESRB functions.

The ESRB will identify the potential areas of risks and threats to financial stability and issue warnings on those aspects that need interventions by regulatory or supervisory authorities. It is also entitled to monitor the implementation of all necessary measures. This risk assessment activity will help coordination in order to reach a unitary vision of vulnerabilities at a single group level. Not having the ESRB direct enforcement powers, it will act through other European and national authorities. For this purpose, it is expected that the ESRB will cooperate closely with the European Supervisory Authorities (ESAs) in order to ensure that macro-prudential evaluations are reflected in micro-prudential supervision at individual institutional levels.

The ESFS is composed of three new authorities. Each of them is competent for a specific intermediation sector (banking, financial market and insurance). The authority for the banking sector is the European Banking Authority (EBA),[50] which is composed of the national banking supervision authorities. Since the

[50] The other two authorities are: the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities Authority (ESA). EIOPA has the function to support the stability of the financial system, transparency of markets and financial products as well as the protection of insurance policyholders, pension scheme members and beneficiaries. EIOPA is based in Frankfurt am Main, Germany. ESMA has its core responsibility in ensuring the integrity, transparency, efficiency and orderly functioning of securities markets, as well as enhancing investor protection. ESMA is based in Paris.

beginning, there has not been full agreement on EBA functions, because of different positions on some issues. For examples the UK's point of view on supervision was in favour of the maintenance of this function within national boundaries, so that only regulation could be performed at the EU level.

According to the framework approved, the EBA should carry out the following functions:

– realising a single *rulebook* and its enforcement, implying the development of technical standards, in order to overcome discrepancies in the interpretation and implementation of European legislation;
– ensuring the consistent application of the European rules, through harmonised supervisory practices and peer reviews by national authorities, including the power to investigate and make recommendations to national supervisors regarding the interpretation of EU legislation;
– strengthening the oversight of cross-border groups and participating in supervisory colleges;
– coordinating EU-wide stress tests to assess the resilience of financial institutions to adverse market developments;
– establishing a central European database aggregating all micro-prudential information; and
– ensuring a coordinated response in crisis situations, implying the power to take action in emergency situations to coordinate the responses of national supervisors. Where coordination is insufficient, the EBA will have the power to require national supervisors take specific actions, even though - from a UK point of view - not impinging on the fiscal responsibilities of Member States.

On such a basis, the problems posed by the financial crisis and the new examinations conducted led to support the need for a more coherent and systematic framework of the prevention, management and resolution of cross-border crises and systemic relevant intermediaries and financial groups.[51] From this perspective, it is worth recalling the communication of the Commission to the Parliament on "*An EU Framework for Cross-Border Crisis Management in the Banking Sector*"[52] and the communication from the Commission to the Parliament on "*Bank Resolution Funds*"[53] for financing resolutions of bank crises funded by banks.

---

[51] J.CARMASSI-E.LUCHETTI-S.MICOSSI (with contribution from D. GROS and K. LANNOO), *Overcome too-big-too-fail. A regulatory frame work to limit moral hazard and free riding in the financial sector*, Report by the Centre for European Policy Studies (CEPS)-Assonime Task Force on Bank Crisis Resolution, Brussels, 2010; UNICREDIT GROUP, Forum on Financial Cross-Border Groups, *Cross-Border banking in Europe: what regulation and supervision?*, Discussion Paper, N. 1, March 2009

[52] EUROPEAN COMMISSION, *An EU Framework for Cross-Border Crisis Management in the Banking Sector*, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the European Court of Justice and the European Central Bank, Brussels….., COM (2009) 561/4.

[53] EUROPEAN COMMISSION, *Bank Resolution Funds*, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central

The first communication stresses the importance of new common supervisory powers and tools to be used in a coordinated manner for early intervention purposes. As to resolution measures, the Commission recognises the lack of harmonisation within the EU, given the narrow scope of the Directive on the reorganisation and winding up of credit institutions (it provides for only the mutual recognition of proceedings for cross-border bank branches and not for subsidiaries), so prospecting a new EU resolution regime, including rules for preventing national authorities from ring fencing local assets. On the issue of insolvency law the Commission is seeking a compulsory framework for cooperation and information exchange between actors involved in proceedings concerning entities of a banking group, under the coordination of a "lead administrator". The second communication aims at introducing a new financial mechanism to finance the resolution of large and complex banks. Specific criteria have been identified to shape the new instrument in a way to affirm its complementary nature to crisis management measures.

The problems on the table look complex, because they imply a variety of aspects that need to be deeply examined, affecting the legal and institutional profiles of each national jurisdiction (company law, insolvency law, design of regulation and supervision, judicial power) and on the different ways to approach the problems. Evidently, it is not easy to reach a convergence and so, as an alternative to convergence, different solutions must be found.

EU authorities could consider going ahead with the new envisaged route on their own and this could be a reasonable option considering the constraints deriving from the objective of the single market. But, one of the most important lessons learned after the crisis is that financial systems are strictly interconnected, problems are global and solutions must therefore be global, otherwise competitive distortion among legal frameworks is inevitable. So, it would be reasonable to move in parallel with the initiatives of other international rule setters. However, if uncertainties prevail, the EU could follow the path that leads to a more globalised approach.

The initiatives underway seem to follow a decisive approach. Indeed, a specific Work Programme has been established by the European Commission, including the presentation of a legislative proposal. Essential guidelines on the actions to be taken in recovery and resolution issues have been outlined in a communication of the Commission on cross-border crisis management in October 2010.[54] It aims at refining some of the provisions contained in the previous communication and includes three classes of measures: preparatory and preventative measures, early supervisory intervention and resolution tools and

Bank, Brussels, 26.5.2010, COM (2010) 254 final.

[54] EUROPEAN COMMISSION, *An EU Framework for Crisis Management in the Financial Sector* Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee, the Committee of the Regions and the European Central Bank, Brussels, 20.10.2010, COM (2010) 578 final.

powers. It also establishes principles for the coordination of cross-border crisis management, focusing on the roles of European Supervisory Authorities.[55]

The EU is now consulting on the technical details of the proposed principles contained in the framework outlined in the October communication. Decisions should be taken based on the responses to the consultation and on an impact assessment of the different options for achieving the proposed policy objectives.[56]

Three steps have been outlined for the gradual harmonisation of different regimes. The first step should be the presentation of a legislative proposal for a harmonised scheme of crisis prevention and bank recovery and resolution. The second step should be a further harmonisation of bank insolvency regimes, with the aim of resolving and liquidating banks under the same substantive and procedural rules (by the end of 2012); the third step should be the creation of an integrated resolution regime, possibly based on a single European Resolution Regime (by 2014).

5.3 Current changes in institutional settings and financial regulations in various countries.

Although the attempt to reach international consensus on a reform of the financial system at international level is still underway, in many jurisdictions concrete initiatives have been taken to introduce legislative changes on supervision and crisis management. In some ways, a reverse approach is being followed whereas a more reasonable approach would imply reaching international consensus on those arrangements to be then transposed into national regulations.

In the US on July 21, 2010, President Obama signed the Dodd-Frank "Wall Street Reform and Consumer Protection Act" (the Act), which strengthens the regulation of banks and other financial institutions and creates a *Financial Stability Oversight Council*, entrusted with macro-prudential analysis and intervention tasks.

The enhanced regulation of financial institutions is contained in the *Financial Institution Stability Improvement Provisions*, which better standardise how financial institutions conduct their business and increase their reporting duties. The aforesaid provisions require more oversight of financial institutions, widen the number of financial institutions subject to oversight, including foreign banks

[55] Respect to this step-by-step approach followed by European Authorities, somebody claim a more integrated framework, including the creation of a European Resolution Authority (ERA).See J. LIMPSKY, *Towards an International Framework for Cross-Border Resolution*, July 2010, cit; G.G.H. GARCIA-R.M. LASTRA-M.J. NIETO, *Bankruptcy and reorganisation procedures for cross-border banks in the EU: Towards an integrated approach to the reform of the EU safety net*, Journal of Financial Regulation and Compliance, Vol. 17, N. 3, Emerald, Bingley, 2009.

[56] EU COMMISSION, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution*, DG Internal Market and Services, Working Document, January 2011.

and other financial firms not previously subject to any regulation, and require more capitalisation of financial institutions.

In short, the reform has introduced the following innovations:[57]

i) the creation of the *Financial Services Oversight Council* (FSOC), which has the task of: a) identifying risks to the financial stability of the US; b) promoting market discipline and information, notably by eliminating expectations that financial and non-financial organisations will be shielded from losses in the event of failures; and c) responding to emerging systemic threats to financial stability.

   Voting members of the FSOC are representatives of the major federal financial regulatory bodies and it is chaired by the Secretary of the Treasury. The President appoints an independent member with insurance expertise. In addition, State banking and insurance regulatory representatives can be non-voting members. The FSOC may advise Congress and recommend measures to enhance the efficiency, competitiveness and stability of US financial markets and reduce systemic risks. For the first time, the Federal Government is empowered of legislative authority to monitor insurance companies, traditionally regulated by various States.

   The FSOC is also competent on non-bank financial companies, including private equity funds and hedge funds. The Private Fund Investment Advisors Registration provisions of the Act require most hedge fund and private fund advisors to register with the SEC and implement compliance measures such as instituting a chief compliance officer, developing a written code of ethics and implementing policies to curb insider trading.

   Moreover, the FSOC is empowered to identify SIFIs, thereby bringing such companies under the FED' supervision.

   It is worth noting that the FSOC, in contrast to the EU approach, is involved to some extent into the micro-prudential area, with the authority, inter alia, to recommend heightened prudential standards to apply to certain activities and practices, regardless of whether institutions are systemically important or not. Under specific circumstances, the chairman of the FSOC may place financial institutions under special supervision, if they could endanger the financial stability of the US. Consistently, the council may play a direct role in the crisis resolution process of SIFIs.

ii) the reorganisation and strengthening of micro-prudential regulatory institutions. The reform has maintained the pluralism of the institutional set-up of regulatory institutions, while purposedly rationalizing and re-ordering their functions.

[57] V.V.ACHARYA-T.COOLEY-M. RICHARDSON (Edited by), *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, John Wiley and Sons, November 2010.

The *Federal Reserve Board* is tasked with the regulation and supervision of all banks, thrifts, bank holding companies and nonbank financial institutions with assets over $50 billion. It is also responsible for the supervision of SIFIs and financial market utilities (payment, clearing and settlement activities). It has increased powers to require "stress tests" on financial institutions and require large and complex financial institutions to develop and update liquidation plans, which must be periodically updated. It can also address the systemic risks and increase regulation of foreign banks.

The FDIC is responsible for the regulation and supervision of state banks/thrifts with assets under $50 billion, and it retains responsibility for the liquidation of most financial institutions, with the exception of SIFIs.

The *Office of the Comptroller of the Currency* (OCC) is responsible for the regulation and supervision on of national banks/thrifts with assets under $50 billion.

The *National Credit Union Administration* (NCUA) is responsible for the regulation and supervision of federal credit unions, while the *Securities Investor Protection Corporation* (SIPC) retains its functions concerning the liquidation procedures for broker-dealer companies.

The *Federal Insurance Office* (FIO) has been entitled to monitor all major aspects of the insurance industry and cooperate with other regulators.

The *Office of Thrifts Supervision* (OTS) has been abolished.

A framework for coordinating regulatory agencies is established.

iii) the strengthening of the regulatory framework. The capital rules have been strengthened with the general application of risk-based capital requirements and leverage capital requirements to all financial institutions (US insured depository institutions, US bank holding companies, US intermediate holding companies of foreign banking organisations, thrift holding companies and systemically important non-bank financial companies).

In particular, the Federal Reserve Board is directed to require financial holding companies to meet a 15:1 debt-to-equity leverage requirement. In addition, short-term borrowings by such a company can be limited and guaranteed debt can be limited to $500 billion. Sales of ABS will require creditors and syndicators to maintain a portion of the credit risk on the receivables sold. Many forms of capital, such as trust preferred certificates, will no longer be counted as capital.

Banks generally will be subject to regulatory restrictions on proprietary trading and on investing in hedge and private equity funds (up to 3% of their Tier 1 capital) as well as trading for hedging purposes (*The Volcker Rule*). Non-bank holding companies engaging in trading for their own account will be subject to greater capitalisation requirements.

Transparency and accountability in derivatives products have been improved through the compulsory clearing of most derivatives transactions

via regulated central counterparties clearing houses (CCPs). *The SEC and the Commodities Futures Trading Commission are to consult on the further regulation of derivatives instruments. As a consequence, additional reporting and collateral requirements may be imposed. In addition, any authority of the Federal Energy Regulatory Commission over energy related financial and other matters is not altered by the Act.*

New provisions have been issued on executive compensation and corporate governance. In particular, a non-binding shareholder vote is required for the executive compensation of a publicly traded financial institution. As to corporate governance, three areas have been regulated (the establishment of risk committee; additional disclosure on organisational structure; the SEC's authority to adopt proxy access).

The reform also ends the "shadow" banking system by regulating and raising standards for hedge funds. It requires hedge funds and private equity advisors to register with the SEC as investment advisors and provide the necessary information on their trades and portfolios to assess systemic risk. As to *Credit Rating Agencies*, increased internal controls, greater transparency of rating procedures and methodologies have been introduced, providing the SEC with greater enforcement and examination tools.

Regulations to implement the key Financial Institution Stability Improvements Provisions of the Act will be developed over a fairly lengthy period, reflecting varying effective dates for different provisions and allowing in many cases a transition period for affected institutions to meet the new requirements.

iv) Deposit insurance reform. The DIS has been changed in structural and operational aspects. *The FDIC will be able to seek the bankruptcy of an insured bank and its claims will have preference over unsecured claims. It can require more reports from banks and can receive warrants or other financial instruments from them.* Significant changes have been introduced with regard to management and pricing of the deposit insurance fund. The maximum deposit insurance amount increases to $250,000.

v) a new crisis management and resolution framework. Although liquidation procedures for most financial institutions and the role of the FDIC remain unchanged, the Act introduces new provisions for liquidations of SIFIs. For this purpose, the Orderly Liquidation Procedure (OLP) and the Orderly Liquidation Fund (OLF) have been created, under the Orderly Liquidation Authority (OLA).[58]

The fund will be managed by FDIC and used in case of the liquidation of SIFIs. It will be funded by risk-based assessment fees. The OLA provides

[58] For an analysis of the new regime, see V. V. ACHARYA-B. ADLER-M. RICHARDSON-N. ROUBINI, *Resolution Authority, in* V.V.ACHARYA-T.COOLEY-M. RICHARDSON (Edited by), *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, John Wiley and Sons, November 2010.

a primary role to the FSOC, which, as said, may intervene in resolution of SIFIs. The Council will require "living wills" to SIFIs and put them into receivership if the company is in (or is in danger of) default.[59]

In **Europe** institutional changes are also on course in almost all Member States, which are reforming their national supervisory structures and, in some cases, the supervisory models. An ECB review published in 2006 identified three main supervisory models:

a) the *sectoral model,* when each sector (banking, securities and insurance) is supervised by one authority;

b) the *twin peaks model,* when responsibilities are allocated on the basis of supervisory objectives, with prudential supervision and the conduct of business regulation attributed to two different authorities; and

c) the *single authority model,* when all supervisory functions are allocated to a single authority that covers both prudential supervision and investor protection.

An update of the review conducted by the ECB shows that innovations seem to go in the directions described in the following box:

The evolution of supervisory models in Europe[60]

According the recent ECB review, the tendencies of supervisory schemes in Europe can be outlined as follows:

i) a clear trend towards the consolidation of supervisory authorities. This evolution is shown by the reduction of countries with the sectoral model. It is currently present in six countries (Greece, Spain, Cyprus, Lithuania, Slovenia and Romania) and, with some variations, in Portugal, Bulgaria and Luxembourg. Greece is planning to adopt the integrated sectoral model (i.e. with the central bank supervising banks and insurance companies);

(ii) a larger involvement of central banks in supervisory activities, associated with the option of the "twin peaks" model. Three Member States (Belgium, Portugal and the United Kingdom) are adopting the "twin peaks" model and France has already adopted it, in addition to the Netherlands and Italy (in the latter some supervisory responsibilities are assigned according to the sectoral model). The enhanced involvement of central banks in supervisory activities is based essentially on the information-related

[59] The Dodd-Frank reform is completed with specific provisions concerning consumer protection. The Bureau of Consumer Financial Protection (BCFP) has been created as a new executive agency, tasked with regulation of consumer financial products and services. It is placed within the FED and will assume most of the consumer protection functions exercised by regulators under existing federal consumer protection laws.

[60] EUROPEAN CENTRAL BANK, *Recent developments in supervisory structures*, October 2010.

synergies between the central banking and the prudential supervisory function. This has proven particularly advantageous when the central bank was able to have direct access to information on individual financial institutions that was properly assessed and fully understood, given its operational supervisory involvement (while complying with the rules about the confidentiality of supervisory information);[61]

iii) the predominance of the single supervisory authority model (a central bank or an entity outside the central bank), which is still present in 15 countries. Recently Finland adopted this model. However, for the first time since 2000, some countries with a single authority outside the central bank are planning to change their supervisory models: this is the case for Belgium and the United Kingdom, which are planning to adopt a "twin peaks" model, and reform is under discussion in Germany. In each case the intention is to assign supervisory responsibilities to the central bank (in the case of the United Kingdom to a subsidiary of the Bank of England); and

iv) the implementation of macro-prudential supervision in national contexts, with the objective of strengthening the capacity to address systemic risk, either by establishing an ad hoc authority or by enhancing the powers of existing authorities. As evidenced, this tendency does not translate into a single model, since an optimal supervisory structure is difficult to detect. The ECB survey seems to support the idea that the involvement of the central bank in financial supervision is increasingly strengthened by the adoption of the "twin peaks" model.

Such recent developments as regards the institutional allocation of supervisory responsibilities seem to challenge the empirical findings of the academic literature, showing that the degree of consolidation of the supervisory structure tends to be inversely related to a central bank's involvement in supervision,[62] namely the more consolidated the supervisory structure, the lower the role of the central bank is. Three Member States (Czech Republic, Ireland and Slovakia) have now concentrated supervision over the whole financial sector within the central bank, and another country (Lithuania) is planning to move in a similar fashion.

In the **United Kingdom**, following the first banking crisis in the country, domestic bank resolution arrangements were modified in 2008 to introduce

[61] In 16 EU countries (Bulgaria, Czech Republic, Germany, Greece, Spain, Ireland, Italy, Cyprus, Lithuania, Luxembourg, Netherlands, Austria, Portugal, Romania, Slovenia and Slovakia) national central banks have responsibilities for financial supervision; in 6 EU countries (Belgium, Germany, Greece, Lithuania, Portugal and the United Kingdom) it is planned to vest the central bank (or a body connected to it) with new supervisory responsibility, in four cases covering the whole financial sector. In all the remaining countries, institutional arrangements are in place ensuring that the NCB is closely involved in financial supervision.

[62] D. MASCIANDARO, *Divide et Impera: Financial Supervision Unification and the Central Banking Fragmentation Effect*, in European Journal of Political Economy, 2007, pp. 285-315.

emergency legislation (Banking Act 2008)) for the nationalisation of Northern Rock and the treatment of Bradford & Bingley and Icelandic banks. Before 2008, the UK did not have a special regime for the resolution of banking crises.

The reforming process was completed in early 2009 with the issuing of the 2009 Banking Act. This legislative initiative aimed at remedying specific shortcomings with regard to public authorities' powers to intervene in crisis management and resolution. Its cornerstone was the amending of the remits of the Bank of England and the FSA in this field. The 2009 Banking Act attributed the Bank of England an explicit statutory objective to contribute to protecting and enhancing the stability of UK financial systems. It also established a new ***special resolution regime*** that gives the UK tripartite authorities powers to deal with failing banks and building societies with the aim of protecting depositors, the stability of UK financial systems and confidence in UK banking systems. It was used to resolve the Dunfermline Building Society issue.

Three different proceedings to deal with UK banks (deposit-taking institutions) in difficulties are provided: the Special Resolution Regime, the Bank Administration Procedure, and the Bank Insolvency Procedure.[63]

The *Special Resolution Regime* reinforces the powers of the Bank of England and HM Treasury for stabilisation purposes. These two authorities have been empowered by law to intervene in troubled banks with three options:

i) the Bank of England can transfer all or part of a bank (through a share or business sale) to a private purchaser, even though the bank is still balance sheet solvent. The sale may be carried out through a transfer of the bank's shares and other securities or some or all of its property rights and liabilities;

ii) the Bank of England can transfer all or part of the business (but not the shares) of a bank to a subsidiary wholly owned and managed by the Bank of England (bridge bank). This option can be pursued where an immediate private sector sale is not possible, and where a stable platform is needed to prepare for and effect the onward sale to a private sector purchaser;

iii) as a last option, the Treasury may transfer the shares of a bank to either a nominee of the Treasury or a company wholly owned by the Treasury (nationalisation).

Special provisions have been introduced in terms of safeguards for partial property transfers with the effect that certain assets and liabilities cannot be separated by a transfer. A distinction has been made between netting safeguard, security safeguard and capital markets safeguard.

The *Bank Administration Procedure* is used in the case of a partial transfer of assets and liabilities while a part of them remain with the "residual bank", which is placed under administration. The main purpose of the proceeding is: i)

[63] P. BRIERLY, *The UK Special Resolution Regime for failing banks in an international context*, Financial Stability Paper 5/2009, Bank of England, 2009.

to ensure the supply of services and facilities to enable the transferee to operate effectively and ii) to rescue the residual bank as a going concern or achieve a better result for its creditors as a whole than if it had been directly wound up.

The *Bank Insolvency Procedure* is used to provide for the orderly winding up of a failed bank. It is a special court-based liquidation, with the primary objective of ensuring the rapid reimbursement of depositors under the Financial Services Compensation Scheme or a transfer of insured deposit accounts to another financial institution. The Bank of England, FSA and Treasury are all entitled to ask the court for a bank insolvency order and for the appointment of a liquidator.

Other possible changes in the UK legislation include the application of the new special regime to non-deposit-taking investment banks as well. Under consideration are also the problems of how to strengthen the supervision of big banks and their preparedness to possible crisis (living wills) and the treatment of cross-border banking groups that are too big to save. Finally, it has been announced that a pre-funded scheme could be introduced for UK DIS.

Further innovations are currently under discussion for the strengthening of the UK's financial system through a new structure for UK financial regulation, aimed at "putting the stability of the financial system at the centre of the regulatory mission".[64] For this purpose, the UK Government issued in July 2010 a document containing the main aspects of financial regulation reform,[65] followed by another document, issued in February 2011, containing further details on the proposals to reform the framework of financial regulation (Osborne reforms).[66] They emphasise the weaknesses of the current 'tripartite' regulatory system - the Bank of England, the FSA and the Treasury – which failed in i) identifying the problems that were growing in the financial system; ii) taking steps to mitigate them before they led to significant instability in financial markets; and iii) dealing adequately with the crisis when it did break, especially during the first part of the crisis in the summer of 2007.

The current regulatory institutional setting in UK
The Tripartite system

The Bank of England is responsible for ensuring monetary and financial stability. It oversees the financial infrastructure, in particular payment systems, with the aim of reducing systemic risk.

The FSA has, since 1 December 2001, been the sole supervisor of the majority of the financial services sector, as provided by the Financial

[64] A. BAILEY, *The outlook for financial regulation in the UK*, Bank of England, Speech given on a regional visit on Edimburgh, 10 January 2011.

[65] HM TREASURY, *A new approach to financial regulation: judgement, focus and stability*, July 2010.

[66] HM TREASURY, *A new approach to financial regulation: building a stronger system*, 17 February 2001, followed by a new document in June: HM, *A new approach to financial regulation: the blueprint for reform*, 16 June 2011 (Ashrust London, June 2011).

Services and Markets Act (FSMA) of 2000, regulating most financial services markets, exchanges and firms. The FSA is an independent non-governmental body taking the form of a company limited by guarantee, entirely financed by the financial services industry. It is accountable to the Chancellor of the Exchequer (HM Treasury) and, through him/her, to Parliament. On 1 October 2009, the FSA also implemented a major reorganisation to a new operational structure designed to better align its internal operating model to its core activities of identifying and mitigating risk and carrying out supervision and enforcement.

The Treasury has the responsibility for maintaining the overall legal and institutional framework.

The three authorities have signed a Memorandum of Understanding that, *inter alia*, provides for the establishment of a *Standing Committee*. The Standing Committee meets monthly to discuss individual cases of significance and other developments relevant to financial stability. The Bank of England's Deputy Governor (responsible for financial stability issues) is a non-executive director on the FSA's Board, while the FSA's Chairman is a member of the Bank of England's Court of Directors. It also put the Bank of England's payment system oversight role on a statutory footing. The FSA cooperates with HM Treasury and the Bank of England in the field of financial stability. The Financial Services Act 2010 provided the FSA with a statutory objective to contribute to the protection and enhancement of the stability of the UK's financial system.

The major innovations of the new outlined regime will be:

i) the replacement of the existing tripartite regulatory system in financial stability issues, assigning all powers in this field to a single authority, the Bank of England. The Bank will have the responsibility for macro-prudential regulation, namely looking across the economy at macroeconomic and financial issues that may threaten stability and it will be given tools to address the risks it identifies. It will have the power to require the new Prudential Regulatory Authority to implement its decisions by taking regulatory action with respect to all firms;

ii) the creation of a *Financial Policy Committee* (FPC) within the Bank of England, with the responsibility for financial stability. The committee would have the functions of improving the system's resilience by addressing aggregate risks and cyclical imbalances that may rise from time to time. It will have the specific tasks of monitoring the system, taking action through other authorities, and communicating its analysis and actions;

iii) the constitution of a new *Prudential Regulatory Authority* (PRA) as a subsidiary of the Bank with the responsibility for micro-prudential regulation. The new authority should change the "light" approach of supervision adopted by the FSA, which proved to be ineffective during the financial

crisis,[67] in favour of a more intrusive one, focused more on the technical situations of financial institutions as well as their risks and business models. As underlined in the analysis accompanying the debate for the reform, “the FSA’s approach to micro-prudential regulation was flawed. In the run up to the financial crisis, financial supervision relied too much on ‘tick-box’ compliance with rules and directives at the expense of proper in-depth and strategic risk analysis. Effective prudential regulation of firms requires an approach based on understanding of their business models, and the ability to make judgements about the risks that firms’ activities pose to themselves and to the wider financial system as a whole”.[68]

The PRA will regulate banks and other deposit-takers, broker-dealers (or investment banks) and insurers. It will have the primary objective to promote the stable and prudent operation of the financial system through the effective regulation of financial firms, in a way that minimises the disruption caused by any failed firms. Among its diversified functions, the PRA will have the responsibility for making rules and approving institutions’ recovery and resolution plans, issues on which further reflections are on course for the possible integrations of PRA powers, such as for interventions in crisis management and the break-up of large groups to help with resolvability;

iv) in addition to the PRA, a new conduct of business regulator, the *Financial Conduct Authority* - FCA (called *Consumer Protection and Markets Authority* in the previous document) has been established, separate from the Bank. It will be responsible for consumer protection and the regulation of the conduct of all financial firms, including those regulated by the PRA.

In June 2010, an Independent Commission on Banking (Vickers Commission) has also been established by the Government in order to examine the structure of banking in the UK and consider how to promote financial stability and competition. The Commission has published an interim report in April 2011[69] and a final report in September 2011**.** The report contains an analysis of the weaknesses that characterise the UK financial system and a number of recommendations, based on a mix of capital and structural measures, to strengthen it. The key points of the Commission’s recommendations are:

i) that the most systemically important banks hold additional capital requirement (10%) to the Basel 3 minimum (7%), to make them better at absorbing losses and less likely to fail;

ii) ‘bail-in’ instead of bailout, so that private investors, not taxpayers, bear the losses if things do go wrong; and

---

[67] A. BRUMMER, *Unveiled at last: The New Face of UK Financial Regulation*, MailOnline, 17 May 2011.

[68] HM TRASURY, *A new approach to financial regulation: judgement, focus and stability*, July 2010.

[69] INDEPENDENT COMMISSION ON BANKING, *Interim Report. Consultation on Reform Options*, April 2011.

iii) a separation of retail business (*retail ring-fencing*) from global wholesale activities and investment banking, which should be carried out by separate banks. So, only ring-fenced banks should be able to take deposits from individuals and small businesses. The purpose is to isolate and to make retail banks safer, banning them from providing more risky services. The separation will avoid that possible losses deriving from riskier trading or investment activities put at risk depositors.

These recommendations should now be transposed into law and their implementation completed by the beginning of 2019, consistently with Basle 3 implementation's deadline, so that the banking sector will have a sufficient period of time to gradually change its balance sheet's structure.

Commission's proposals have not received unanimous consent in the UK for different reasons and a wide debate is still underway.

As to the new framework for crisis management introduced by the 2009 Banking Act, further changes may be needed to the Special Resolution Regime in light of the creation of these new authorities.

A separate legal framework has been established for crisis management and resolution of investment banks. On 8th February 2011, a new special proceeding applicable to insolvent investment banks came into force, the *Special Administration Regime* (SAR), introduced by "The Investment Bank Special Administration Regulations 2011". To overcome some of the shortcomings highlighted in the Lehman Brothers insolvency, the Regulations set out new objectives for special administration. These objectives are:

- to return client property as soon as reasonably practicable. This objective aims at overcoming difficulties encountered dealing with the return of property and money held for clients;
- to co-operate with the markets in resolving failed trades. This objective requires the administrator to work with market infrastructure bodies in applying their default rules and resolving unsettled trades or settlement instructions; and
- to either rescue the investment bank as a going concern or wind it up in the best interest of the creditors.

Other important innovations introduced by the Regulations are:

- administrators will be able to set a bar date for asset claims;
- the rules governing losses for shortfalls of client securities are clarified; and
- suppliers of key services are obliged to continue to supply them to the administrator.

For those institutions that, other than carrying out investment services, raise deposits from the public, Regulations provide for two new insolvency proceedings, implying some changes respect with respect to the SRA. They are:

i) Special Administration (Bank Insolvency), as an alternative to "bank insolvency procedure" set out in part 2 of the Banking Act. It modifies the SAR in order to give priority to the administrator to work with the Financial Services Compensation Scheme in connection with the transfer of deposits to another financial institution; and ii)

ii) Special Administration (Bank Administration). This is an alternative to "bank administration procedure ", as set out in Part 3 of the Banking Act, where part of the business of the deposit taking bank is sold to a commercial purchaser or transferred to a bridge bank. It modifies the SAR in order to give priority to the administrator to provide support to the purchaser.

This complex legal framework is characterised by overlapping provisions of Bankruptcy Law, Banking Law and investment banks Regulations. Clearly, it aims to respond to the need of designing rules that better fit with the different characteristics of financial institutions. Only the practical implementation will allow to verify the smooth functioning of the whole framework.

In **Ireland**, a new reform was adopted in July 2010, just seven years after the previous relevant innovations that changed the financial system's institutional framework. Indeed, in 2003 Ireland's central bank was restructured and became known as the Central Bank and Financial Services Authority of Ireland (CBFSAI). The Irish Financial Services Regulatory Authority (IFSRA) was established as an autonomous authority within the CBFSAI, responsible for the prudential supervision of the whole financial services sector with the exception of pension funds. The IFSRA cooperated closely with the CBFSAI in relation to the task of maintaining overall financial stability.[70]

The innovations introduced in July 2010 aimed at reintegrating financial regulation into a unitary Central Bank of Ireland with a unitary board – the Central Bank of Ireland Commission – replacing the Boards of the Bank and the IFSRA. This created new senior posts within the Bank in the form of the Head of Financial Regulation and the Head of Central Banking.

The legislation ensures that the independent role of the Governor under EU law and Eurosystem structure is preserved. The consumer information and education role, currently carried out within the Consumer Directorate in the Financial Regulator, will be reassigned to the National Consumer Agency.

In **Italy,** the institutional setting for regulation and supervision, tracing back to the 1993 and 1998 banking and financial reforms, remains unchanged.

[70] In this framework, the Governor of the CBFSAI had a number of specific powers: (i) he was to be consulted by the Financial Regulator and his agreement was required as regards any matter relating to the financial stability of the Irish state's financial system; (ii) he had the power to authorise a CBFSAI employee to investigate (including carrying out on-site inspections) licensed credit institutions, building societies, trustee savings banks, approved stock exchanges, authorised investment business firms and authorised collective investment schemes; and (iii) he could, with respect to his functions, have issued guidelines to the IFRSA as regards the policies and principles that the IFRSA was required to implement in performing the CBFSAI's functions.

The responsibility for the supervision and regulation of the financial sector lies with four different authorities: Banca d'Italia; the *Commissione nazionale per le società e la borsa* (Securities Commission, CONSOB), the *Istituto per la vigilanza sulle assicurazioni private e di interesse collettivo* (Insurance Supervisory Institute, ISVAP) and the *Commissione di vigilanza sui fondi pensione* (Pension Fund Supervisory Commission, COVIP).

The only innovation was introduced in March 2008, according to the guidelines approved at the European level for strengthening the domestic institutional setting for financial stability purposes (Domestic Standing Group). The Minister for Economic Affairs and Finance, the Governor of the Banca d'Italia and the Chairs of the CONSOB and the ISVAP signed a protocol on cooperation and information exchange that established the *Comitato per la salvaguardia della stabilità finanziaria* (Financial Stability Committee).

The Committee is chaired by the Minister of the Economy and Finance and is composed of the highest representatives of the signatories institutions; it is expected to meet at least twice a year or whenever systemic threat arises. The purpose of the Committee is to ensure, in accordance with the respective competences of the participating institutions, cooperation, information sharing and an exchange of views concerning financial stability and the prevention and management of systemic crisis, including those having potential cross-border effects.

The Italian banking legislation does not provide for bail in nor bail out tools for the treatment of systemic banks.

The **Belgian** Government has decided to reform the supervisory architecture of the financial sector in order to move towards the "twin peaks" model by integrating the prudential supervision of financial institutions into the central bank.

The current supervisory institutional setting in Belgium

Since January 2004, the Banking and Finance Commission and the Insurance Supervision Office have been merged to form the Banking, Finance and Insurance Commission (CBFA). The CBFA has the power to regulate and supervise credit institutions, investment firms, securities markets, securities settlement institutions (and assimilated entities) and clearing institutions, undertakings for collective investment, insurance companies, insurance brokers and pension funds.

The National Bank of Belgium (NBB) is entrusted with macro-prudential supervision. Cooperation between the two bodies is ensured, however, since three members of the NBB's management committee are also members of the CBFA's management committee. Moreover, as required by Belgian law, a framework for cooperation between the CBFA and the NBB has been established, namely the Financial Services Authority Supervisory Board (FSASB), which combines the supervisory boards and the Council of Regency

of the CBFA and the NBB, and the Financial Stability Committee (FSC), which combines the Boards of Directors of the two institutions.

The FSC examines all questions of mutual interest to the NBB and the CBFA, such as issues related to maintaining the stability of the Belgian financial system, interactions between prudential supervision and the control of systemic risks facing market infrastructures or the coordination of the response of the Belgian financial authorities to crisis situations (financial or operational) of a systemic nature. On the other hand, the FSASB arranges dialogue and consultation between the CBFA and the NBB. It is authorised to issue, at the request of the ministers concerned or on its own initiative, opinions on all of the questions relating to the way in which financial institutions and financial markets operate and are organised.

On 1 April 2011, the Royal Decree of 3 March 2011 entered into force. It implemented the so-called "twin Peaks" structure for the supervision of the financial sector, as introduced by the Belgian Law of 2 July 2010 (the "twin peaks law").

The "twin peaks" supervisory structure divides competences functionally between two supervisory financial authorities: the National Bank of Belgium (NBB) and the Financial Services and Markets Authority (FSMA), formerly known as the Banking, Finance and Insurance Commission.

Most of the micro-prudential powers of the FSMA have been transferred to the NBB.

As a result, the NBB has now become the principal prudential supervisor of the Belgian financial system at both macro and a micro-level. The main objective of the NBB is to ensure that financial institutions are properly organised and maintain appropriate levels of solvency, liquidity and profitability.

The FSMA remains the supervisor of financial markets, investment products and the rules of conduct that apply to financial institutions. It will also be given increased powers as regards consumer protection and the supervision of transparency.

The Committee for Systemic Risk and System-relevant Financial Institutions (SRSIC) - created on a transitional base to replace the FSC, with the function of supervising systemic risk and performing micro-prudential supervision of systemic financial institutions - has been abolished and its powers have been transferred to the NBB and the FSMA.

In **France,** the January 2010 reform[71] has significantly changed the institutional set-up established with the Financial Security Act of 1 August 2003. It has

[71] Ordonnance n. 2010-76 of 21 January 2010 *portant fusion des autorités d'agrément et de contrôle de la banque et de l'assurance*. The ACP has taken over the competences of the *Commission bancaire* on prudential *supervision*, of the *Comité des établissements de crédit et des entreprises d'investissement*, entitled of powers of authorisation to the different stages of constitution, development and restructuring of banks, and of the competences of the *Autorité de contrôle des*

reorganised and simplified the framework for financial supervision, instituting the *Autorité de contrôle prudentiel* (ACP), an independent administrative authority with licensing and supervisory functions on a bank's activity, insurance companies and payment institutions.

The ACP is not a legal entity. Its financial independence is guaranteed by the fact that it will be funded by all companies falling within its jurisdiction.[72] In order to take into account the specificities of each sector, the structure of the ACP has been designed to ensure that the issues specific to banking or insurance institutions are dealt with by specialised departments.

Besides the principal task of preserving the financial system's stability, the ACP is competent in the field of consumer protection, which previously was not expressly attributed to the originating authorities, with a specific mention of the supervision of the conduct of business for financial products.[73]

Moreover, the ACP has various powers in relation to banks facing financial difficulties. Among them, the most relevant are the suspension or compulsory resignation of one or several banks' managers, the appointment of an interim administrator (administrateur provisoire) to whom the administration, direction and representation of the bank are transferred (in this case, the ACP may also request in court a forced sale of the shares held by managers) and the withdrawal of licence. At the moment, French law does not provide for a bank restructuring regime specifically aimed at preventing systemic risk in the financial sector. However, the introduction of a bridge bank regulation is under consideration.

The reform has confirmed the role of the Autorité des Marché Financiers (AMF),[74] introduced with the 2003 Financial Security Act. This is an independent public authority, with legal personality and financial autonomy. The AMF assesses the fairness of the relationship between intermediaries and customers in the provision of investment services, information to investors and the regular functioning of the financial instruments market.

---

assurances et des mutuelles (ACAM), del *Comité des entreprises d'assurance*. These changes had been delegated by article 152 of the *Loi de modernisation de l'économie* n. 2008-776. The reform has introduced another authority, the CCLRF, which has replaced the *Comité de la réglementation bancaire et financières* (Banking and Financial Regulation Committee, CRBF) and the *Commission de la réglementation of the Conseil national des assurances* (Regulatory Commission of the National Insurance Council). CCLRF must be consulted on draft regulatory provisions and on draft legislative provisions in the fields of insurance, banking and investment firms (subject to the competence of the AMF).

[72] M.E.HERTZ – C. MERMET, *French reform of supervision of the financial system*, IFLR 1000, Bernard Hertz Bèjot, Paris.

[73] On this issue, the ACP supervises the compliance with « toute disposition législative et réglementaire ou des règles de bonne pratique de leur profession, constatées ou résultant de ses recommandations, ainsi qu'à l'adéquation des moyens et procédures qu'elles mettent en œuvre à cet effet».

[74] The Financial Security Act of 1 August 2003 established the *Autorité des marchés financiers* (AMF), which is an independent public body with legal personality and financial autonomy. It is responsible for the protection of savings and the smooth functioning of financial markets. In particular, the AMF monitors securities transactions and collective investment products in order to ensure compliance with the obligation of information disclosure to investors. A Banque de France representative appointed by the Bank's Governor is a member of the AMF's Board.

According to the reform, the ACP and AMF will cooperate for the purpose of "*promouvoir une élaboration commune de la politique de contrôle, une veille sur l'évolution des produits et une surveillance conjointe de la publicité*". For this purpose, the two authorities will establish a joint centre that will develop policy on inspections in this field, monitor product developments and jointly monitor product advertising. This joint centre will provide a single point of contact for consumer enquiries, while preserving the partition of responsibilities between the two authorities.

The spirit of the reform is to make the French supervision structure both stronger and simpler, reducing the number of authorities and allowing the new one to have a comprehensive view of the financial sector. This authority has a strong relationship with the central bank: such a link, already in place for banking supervision, will be thus extended to the supervision of the insurance sector. To ensure proper balance, the authority is chaired by the Governor of the Banque de France and has a vice-chair for insurance, who will serve as the first point of contact for the insurance industry. The authority's departments are managed by a general secretariat.

The French Parliament recently approved the Financial and Banking Regulation Law (*Loi de Régulation Bancaire et Financière)* of October 22 2010 containing other measures to strengthen the financial system. Among these, the creation of the Council of Financial Regulation and Systemic Risk.

Chaired by the Minister of Finance (or his or her representative), it will be composed of the Governor of the Banque de France, as President of the ACP, assisted by the Vice-President, the Presidents of the AMF and of the Accounting Standards Authority or their deputies. The Council will be entrusted with the following tasks: (i) to foster cooperation and the exchange of information between the institutions represented; (ii) to examine the French financial sector and market status report from a macro-prudential perspective, taking into account the opinions and recommendations of the ESRB; and (iii) to facilitate the cooperation and coordination of work in relation to international and European standards applicable to the financial sector, with the power to issue opinions or position statements when necessary. The Council will have no power to make decisions, but may advise the French Government on decisions.

The Governor of the *Banque de France* participates, together with the President of the AMF, in the *Collège des Autorités de contrôle des entreprises du secteur financier* (CACES), chaired by the Minister of the Economy, to which are advocated competences on cross-sectors issues with regard to the competences of single authorities.

In **Germany** the current regulatory institutional set-up is described in the following box.

The regulatory set-up in Germany

In the current framework, the *Bundesanstalt für Finanzdienstleistungsaufsicht* (BaFin) supervises banks, investment companies and insurance companies, with the objectives of assuring, on one hand, the stability and the proper functioning of the German financial market and, on the other, consumer and investor protection.

The Deutsche Bundesbank (BBk) is also involved in banking supervision, carrying out the ongoing monitoring of institutions (including on-site inspections and off-site examinations).

The BBk also performs audits and evaluates banking operations to check compliance with the regulatory capital requirements and the adequacy of risk management. Against this background, the establishment of the *Forum für Finanzmarktaufsicht* (Forum for Financial Market Supervision) aims at facilitating and enhancing efficient cooperation between the BBk and the BaFin. In particular, the Forum coordinates the actions of the BBk and of the BaFin, and provides advice on issues concerning integrated financial services supervision that are considered to be important for the stability of the financial system.

On 21 February 2008 the new Supervision Guidelines governing the cooperation of the BaFin and the BBk in the ongoing supervision of credit and financial services institutions were published. The BaFin carries out the surveillance of banks or investment companies in cooperation with the BBk.

As to the supervision of the insurance sector, the BaFin continues to provide surveillance of insurance companies operating across the borders of the federal states (*Länder*), whereas the regional authorities supervise either the insurance companies operating within the borders of each federal state or those that are economically less important.

In October 2009, the German Government announced its intention to concentrate the responsibility for banking, financial and insurance services supervision at the BBk in order to introduce a full integrated solvency supervision.[75]

A general reform of the financial system is underway aiming to revise the competencies and responsibilities of the central bank and the supervisory authority for the conduct of banking supervision. Innovations concerning banking crisis management are also relevant; they are based on the introduction of a special regime which will give supervisory authorities a wider range of instruments to intervene before banks become insolvent.

On 1 January 2011, the *Bank Restructuring Act* entered into force, which provides for new resolution tools, regarding: the increase of the powers of interventions for the BaFin prior to a crisis; ii) the Restructuring and Orderly

[75] K.C.ENGELEN, *Germany's Fight Over Bafin. The ramifications of a Bundesbank takeover*, International Economy, 2010.

Liquidation of Credit Institutions; iii) the establishment of a Restructuring Fund for Credit Institutions; and iv) the Extension of the Limitation Period of Corporate Law Management Liability.

In short, the main aspects of the reform can be described as follows:

i) **the increased powers of the Bafin.** The Bafin is tasked with a wide array of powers to intervene according to the seriousness and urgency of a bank's situation. These powers are strictly related to the supervisory functions. For this purpose, a distinction is made between an "expected" shortfall in regulatory capital or liquidity requirements, and the "actual" shortfall in these requirements.

   In case of expected shortfalls, the BaFin may order the improvement of capital and liquidity, including the presentation of a business plan. Moreover, it may impose the preparation of "living wills", that is a "risk reduction plan", including an exit from or the separation of certain parts of the firm's or group's business, as well as other measures to avoid insolvency.

   In case of actual shortfalls, the BaFin may prohibit or limit dividends or other distributions to shareholders, payments on variable compensation (bonuses) to managers, the granting of loans; it may also order the reduction of risks resulting from certain types of transactions or the use of certain systems and/or to prepare a restructuring plan;

ii) **the new special treatment of banking crises.** The Act introduces new pre-insolvency measures for credit institutions that are in deep waters through restructuring and reorganisation operations. Moreover, it introduces supervisory powers to transfer assets and liabilities held by a "systemic" bank to another bank or to a "bridge bank". All these measures are managed by the BaFin in cooperation with Germany's Federal Authority for Financial Markets Stabilisation (*Bundesanstaltt für Finanzmarktstabilisierung*, or FMSA).

   The new regime envisages three alternative measures for restructuring:

   a) **restructuring proceeding** (*Sanierungsverfahren*). This procedure is applicable on a voluntary basis, at the initiative of the bank itself, in the case of an expected shortfall below minimum capital or liquidity requirements. It implies that problems can be overcome by early intervention by the bank's management.

      The bank has to apply to initiate the proceeding to the BaFin, which has no direct power to intervene *ex officio*. The bank has to submit a proposal of a restructuring plan containing the restructuring measures and the appointment of a restructuring advisor. The role of the BaFin in this proceeding is relevant: it will assess the bank's situation and, if appropriate, it will apply to Regional Court of Appeal for the opening of the restructuring proceeding. The court will approve the opening of such a proceeding and appoint a proposed restructuring advisor, unless manifestly inappropriate. The restructuring advisor has the

task of overseeing the restructuring plan in close cooperation with the BaFin and can give instructions to the bank's management. Given its voluntary nature, the restructuring plan cannot interfere with third-party rights. The Regional Court, upon the proposal of the BaFin, can take further measures as necessary to protect the interests of creditors. It may replace members of the management, prohibit or limit dividends or other distributions, adjust compensation policy for the future or replace the necessary consents of the bank's supervisory body.

b) **reorganization proceeding** (*Reorganisationsverfahren*). In case restructuring measures cannot be implemented successfully, a bank may apply for the commencement of reorganisation procedures. The BaFin may apply for the opening of reorganisation proceeding with the Regional Court of Appeals if it determines, in consultation with the BBk, that i) the ongoing existence of the bank is endangered, in particular that the bank's own fund or liquidity have fallen below 90% of the minimum requirements or this is expected unless corrective action is taken, and that ii) systemic risk is deemed to exist if the risk of failure of the bank may negatively affect other undertakings in the financial sector, the financial markets or confidence of depositors and other market participants in the functioning of the financial system.[76]

The court opens the proceeding and appoints a proposed reorganisation advisor, unless manifestly inappropriate.

The bank must propose a reorganisation plan (*Reorganisationsplan*) and a reorganisation advisor to the BaFin. The plan has a legal structure similar to an insolvency plan under the German Insolvency Code (*Insolvenzordnung*). The reorganisation plan has to contain measures (e.g. capital or corporate measures, restructuring of a bank's obligations towards creditors, transfer of assets or business to another entity) for the reorganisation and liquidation of the bank, as well as limitations to the rights of shareholders or creditors ("bail in"), with the exception of the rights of employees, pensioners and claims protected by deposit protection/investors compensations schemes.

The plan may reduce principal amounts or interest, extend maturities or change other terms and conditions of debts. It can provide for a debt-equity swap with the consent of affected creditors and may exclude pre-emptive rights of existing shareholders (i.e. lead to dilution). In any case, the plan can include any type of corporate restructuring (spin-off, merger, sale of assets, change of statutes).

---

[76] To this end the following factors should be taken into account: i) nature and size of liabilities of the bank to other regulated firms and other undertakings in the financial sector; ii) size of deposits; iii) nature, size and composition of risks incurred by the bank and relevant market conditions; iv) interconnectedness with other participants on the financial markets; v) conditions of the financial markets, in particular expected consequences of a failure of the bank.

The reorganisation plan has to be approved by each class of creditors if their rights are affected. Creditors' votes are expressed in a meeting. The approval requires simple majority of creditors and nominal amounts of claims represented at the meeting.

The plan is deemed approved despite rejection by one or more classes of creditors ("cram down") if the majority of creditors classes has approved. The rejecting creditors will likely not be worse off with the plan than without, and all creditors share fairly in the value of the restructuring. A shareholder vote may be necessary, but without halting the approval of the plan, if it has been approved by the majority of creditors and it is necessary to avoid material negative effects for other undertakings in the financial sector.

The plan must be confirmed by the Regional Court of Appeal. It takes effects *erga omnes*. The reorganisation advisor oversees the implementation of the plan.

The powers of the BaFin to take over other actions under the Banking Act throughout the proceedings remain unaffected;

c) **transfer order** (*Übertragungsanordnung*). The last step consists of the power of the BaFin to take measures necessary for the stabilisation of a credit institution which should get into trouble even without the consent of the concerned institution. This may happen if the owners are not willing or able to provide the bank with the funds necessary for its restructuring and the existence of the bank is endangered and this in turn may endanger the stability of the financial system. In these cases, if other measures are not available to remedy the situation, the BaFin, in consultation with BBk, may issue a "transfer order", forcing the bank to transfer all or part of its assets and liabilities to a private bank or to a special public entity, a "bridge bank" established by the Restructuring Fund.

   Germany considers a transfer order as a "reorganisation measure" according to the Directive 2001/24/EC on the reorganisation and winding up of credit institutions.

   The transfer order can be issued only if the acquiring bank has declared its consent. As further preconditions for the transfer order, the assuming entity must have its seat in Germany, have two trustworthy and qualified managers and have sufficient capital. The transfer order is effective from the day the endangered bank and the assuming entity are notified. Obviously, transfer requires a preliminary valuation of the transferred business. If business has a positive value, the transferring bank will receive an equivalent value in equity from the acquiring bank. If the transferred business has a negative value, the acquiring bank can receive financial support from the Restructuring Fund.

Special provisions are covered by law to safeguard contracts underway when a transfer order is issued. For example, contracts cannot be terminated unless justified by specific conditions. Liabilities secured by financial collateral can only be transferred together. The same applies to assets and liabilities that are part of a netting arrangement or part of a payment or securities settlement system under the Finality Directive.

The acquiring bank is jointly liable for the non-transferred liabilities, but only up to the amount that creditors would have received if the transfer had not occurred. In this case it is likely that the Restructuring Fund guarantee the acquiring bank for the amount that it could be called to pay.

The Restructuring Act provides the BaFin with extensive rights against the transferring bank (withdraw of license, rights in respect of shares obtained in the acquiring bank) and the acquiring bank (in order to safeguard the transferred assets or business units, if the acquiring bank needs further restructuring);

iii) **the Restructuring Fund.** Another important innovation of the Restructuring Act is the introduction of a special Restructuring Fund for Credit Institutions (*Gesetz zur Errichtung eines Restrukturierungsfonds für Kreditinstitute*), which can be used to finance all the measures provided for by the law. It is administered by the Financial Markets Stabilisation Authority (FMSA).

The Fund has the purpose to provide assistance to failing systemic credit institutions. To this end it can: i) create bridge banks or acquire participations in banks acquiring assets from failing banks; ii) issue guarantees for bonds issued by acquiring banks, up to 20 times of its accumulated contributions from banks, but not more than 100 billion euros; or iii) recapitalise acquiring banks.

The restructuring fund has funds of 70 billion euros. It is financed through a bank levy (*Bankenabgabe*), comprising annual and special contributions to be paid by German credit institutions licensed under the German Banking Act. If accumulated funds are insufficient, the Federal Ministry of Finance is authorised to borrow up to 20 billion euros to finance the Fund. The specific annual contributions are calculated in relation to the systemic risk of the bank's failure, but discussions are still underway with regard to the question of which entities should be subject to the bank levy (i.e. should investment forms and insurance companies also contribute to the funding) and how the basis of calculating the bank levy should be structured. In any case, these annual contributions are calculated based on figures from the bank's most recent financial statements, in particular the subscription of relevant liabilities (*beitragsrelevenate Passiva*) and the nominal value of the bank's off-balance sheet derivatives transactions. As stated in the Restructuring Act, even if the bank does not make a profit, it must pay a minimum contribution as a percentage of the regular contribution;

iv) **the extension of the Limitation Period of Corporate Law Management Liability.** The initiation of restructuring proceedings or reorganisation proceedings or the adoption of a transfer order may trigger the contractual termination rights of the counterparties of the bank, especially for financial transactions such as derivatives, securities lending and repurchase transactions that are concluded under standardised master agreements.

To this regard, the Restructuring Act provides for the limitation of the rights of counterparties to terminate contractual relationships with banks that enter into reorganisation proceedings or that receive a transfer order from the BaFin. However, such limitations do not apply within the restructuring proceedings.

In detail, contractual relationships with a bank under reorganisation proceedings are subject to a temporary suspension of termination rights.[77] They may not be terminated at all following a transfer order. This measure has been officially motivated with the consideration that the suspension of the termination rights is an effective means to prevent the termination of contracts that are essential for the continuation of the business activity of the bank.

Finally, the Restructuring Act introduces an extension of the limitation period for liability claims against management and board members (*Vorstände* and *Aufsichsträte*) of Germany-based banks from five years to a maximum of 10 years.

Currently in **Spain,** three different bodies perform supervisory functions according to the sectoral model.

The supervisory institutional set-up in Spain

The Banco de España (BdE) is responsible for the prudential supervision of all credit institutions, with the objective of safeguarding the stability of the system. The Comisión Nacional del Mercado de Valores (National Securities Market Commission, CNMV) is responsible for supervising the Spanish stock markets and the intermediaries operating in them; it aims to ensure market transparency and investor protection. The Directorate-General Insurance and Pension Funds, within the Ministry of Economic Affairs and Finance, is responsible for supervising private insurance and reinsurance, insurance intermediation, capitalisation and pension funds.

Legislation provides for cooperation agreements between the three supervisors. In 2004 an agreement was signed between the BdE and the Director-General Insurance and Pension Funds.

[77] Contracts may not be terminated starting from the day on which the proceedings are applied for until the next following business day. Moreover, the effectiveness of other termination events (such as non-payment, change of control or breach-of-representation provisions) occurring during this period shall be postponed until its expiration.

In 2006, a cooperation agreement on financial stability and for the prevention and management of crises with potentially systemic effects was signed by the Ministry of Economic Affairs and Finance and the three supervisory authorities. This agreement established the Comité de Estabilidad Financiera (Financial Stability Committee) composed of high-level members from the Ministry and each authority that discuss financial stability, regulation and implementation of the cooperation agreements.

In 2009, a new bilateral agreement was signed between the BdE and the CNMV, updating the former agreement of 2004, in order to improve the coordination, efficiency and technical harmonisation of the supervision of financial institutions and markets.

A new legislation (Royal Decree Law 2/2011) came into force on11 March 2011, increasing capital requirements for financial institutions and allowing the FROB, the Fund for Orderly Bank Restructuring, to make temporary capital injections in favour of those institutions that would be assessed as being non compliant with the new capital requirements.

The new law aims at increasing the level and quality of capital, according to Basel 3 standards.

The FROB, initially designed to manage the restructuring process and to assist capital strengthening, will support the higher capitalisation required by new forms of financial support, such as the possibility for FROB to acquire a stake and to remain as a shareholder for a maximum of five years. Until now, no provisions have been issued to strengthen going concern bank restructuring, such as bridge bank or bail in tool.

CHAPTER 3

TOWARDS A NEW FRAMEWORK FOR CRISIS MANAGEMENT AND RESOLUTION

1. Fixing the components of a new framework.

The design and implementation of a new model for banking crisis management requires a clear understanding and a holistic approach looking at the many pieces that compose the complex mosaic of the banking activity in a broader context, made of market dynamics and institutional settings, with particular reference to company and insolvency legislations. The complexity of the topic requires us to address in a coherent way all the issues that are typically involved in a banking crisis.

To this end, even though some simplifications are unavoidable, we can outline the following aspects whose consideration is essential for the design of a new model:

i) which principles and objectives apply for crisis management?

ii) what are the "target" financial intermediaries and, particularly, what are the size, complexity and domestic or international extension of their business?

iii) which model of crisis management?

iv) how to manage international banks and banking groups?

v) who pays the costs of the crisis?

2. Which principles and objectives?

The first objective in banking crisis management is **the preservation of financial stability.** This relies on the ability of the authorities responsible for supervision and crisis management to early detect problems of systemic relevance affecting single banks or a group of institutions. The protection of financial stability may require the use of instruments aimed at isolating the problems where they arise and avoiding contagion effects on other institutions or on the market as a whole.

A pre-requisite for financial stability is the preservation of public and market **confidence** in the banking system. Confidence is the essence, the foundation, of a financial system; should it fall, as during the last financial crisis, a *bank run* may occur with consequent domino effects affecting the whole system. Restoring trust is the primary objective to pursue for central banks and supervisors, by any available instrument.

When crisis phenomena occur, the **protection of depositors** is of fundamental relevance, given the role of deposits in the banking sector. Furthermore, it is of

utmost importance, depending also on the size and complexity of the banking institutions involved, to ensure the **continuity of essential banking services**, especially the provision of credit to the economy and the participation to the payment and settlement system. So, a disorderly disruption in banking activity should always be avoided.

The preservation of these values should be combined with other objectives that are essential for a good and effective functioning of a financial system. An overly protective approach, indeed, may create market distortions and encourage risky behaviour by bank managers. In handling banking crises **market discipline** should be preserved, so that shareholders and managers should be the first to pay the cost of the crisis with appropriate measures and sanctions. Then, if other instruments are not available, the burden should be borne by uninsured depositors and other creditors, who should be made responsible for their allocation choices. In any case, no assurance of public sector support should be taken for granted by the market in order to stimulate safe and prudent behaviours by all stakeholders and reduce or mitigate **moral hazard**.

3. Which target intermediaries?

Firstly, it is important to define the classes of financial intermediaries to deal with, because differences in the nature of financial activities lead to different objectives, rules and instruments applicable in the treatment of the crises. We will refer here to banks and banking groups, even though the solutions identified may be extended and adapted to other financial intermediaries, such as investment firms and credit firms, and tailored to different types of banks (i.e. commercial vs. investment banks).

For this purpose, three categories of banks can be identified:

– **small and medium-size domestic banks**. This area of intervention falls under the interest of each jurisdiction, but it is not of minor importance from an international perspective, and thus requires a harmonisation of rules and instruments for the treatment of banking crises. We cannot say that crises in small and medium-sized banks deserve less attention by authorities. Small banks are important in domestic economies and entail interests that deserve protection. Here, the role of deposit insurance is essential in protecting depositors or in facilitating other operations such as the transfer of insured deposits to another bank together with all or part of the assets or the transfer of all assets and liabilities;

– **big national banks**, which have systemic implications within each jurisdiction. Further measures and instruments should be provided for to deal with these institutions, which involve a wider range of interests, variable according to the size and complexity of the bank. Problems in such category of banks may affect other components of the financial system and compromise the overall stability.

The preservation of the business continuity and the minimisation of the disruptive effects on the economy require diversified approaches from supervision and crisis management. Clear rules on the coverage of the losses deriving from the crisis must be established. The role of deposit insurance remains essential for the protection of insured depositors, but it is not sufficient to safeguard other relevant interests. So, it is essential to decide whether to charge the cost to uninsured depositors and other creditors or to make recourse to a resolution fund financed by the banks. The objective of the reform should be to avoid, in principle, public support because the size of the bank and the consideration of the broad interests involved (too big to fail) cannot justify a heavy burden for taxpayers, as occurred during the last financial crisis.

Nonetheless, should the potential capacity of private resources not be sufficient to deal with financial crises of systemic size, with many intermediaries involved, it cannot be excluded that some State support becomes necessary. In this case, policymakers should design a consistent regulation aimed at establishing appropriate conditions for financial support in order to avoid or minimise moral hazard and preserve market discipline;

– **international banks**, that is SIFIs operating in foreign countries through branches or subsidiaries (banking group). Here problems are of paramount relevance and much more must be done, because there are no rules and instruments for a coordinated treatment of the different components of an international bank, especially sharing the costs of crises. These issues emerge both in reorganisation and liquidation procedures.[1]

The insolvency of Lehman Brothers represents the most significant example of this. As already seen (see chapter 2), when Lehman filed for bankruptcy protection in the United States, it had operations around the globe involving dozens of different group entities. In addition to the main proceedings opened in the United States and in the United Kingdom, insolvency proceedings were opened and special administrators were appointed in numerous other jurisdictions where Lehman operated, with little or no coordination. This is also an example of the negative effects that could derive from competing proceedings in the cross-border liquidation of a financial group. The separate insolvency proceedings and the complex intra-group structure of Lehman prevented the return of segregated client money deposited by Lehman's UK-based broker dealer in the German subsidiary under moratorium.

As a result, there is a need for a global approach leading to a coherent system of banking crises management, in which all interconnected elements can be dealt with by a single authority in a unitary view, which could facilitate a clear and timely understanding of the problems and a prompt activation of useful instruments. But, this model of a centralised and unitary management of banking

[1] V.V.ACHARYA-M.RICHARDSON-N.ROUBINI, *What If a Large, Complex Financial Institution Fails?,* Mimeo, NYU Stern School of Business.

crises, while simple from a theoretical point of view, presents many obstacles and difficulties in practice.

4. Which model of banking crisis management and resolution?

The first element to consider when issuing a crisis management regulation is to clearly establish its boundaries, i.e., if the importance of strengthening preventive measures and early intervention – as evidenced during the recent crisis – allows to extend crisis management beyond the proper insolvency. To accept this idea means entering into an area that interferes with banking supervision. This is the reason why in most countries crisis management is attribuited to supervisory authorities.

It also suggests to set up a **special banking crisis management and resolution regime** dealing with a wide spectrum of problem situations.

According to this outlined framework, we can identify four essential phases featuring the management of banking crises, corresponding to the increasing levels of severity of the problems involved. They are:

- crisis prevention;
- early intervention;
- crisis management and resolution;
- liquidation.

4.1 Crisis prevention.

As said before, prevention is better than cure when it comes to minimise the costs for private and public finances (as the old proverb says, *a stitch in time saves nine*). As underlined by the European Commission "*a framework focused on prevention can be expected to diminish the probability and severity of bank failure, and more efficient procedures leading to earlier intervention and effective resolution measures should reduce the cost of any measures taken and mitigate the implicit guarantees associated with institutions deemed 'too big to fail"*.[2]

Thus, crisis prevention can be considered the "core" function of banking supervision, especially of the future framework. Its ultimate goal is a more intrusive monitoring of banks, especially of those with systemic relevance, that, although sound from a micro-prudential point of view, are likely to be subject to disturbances by internal and external factors, within markets that are global

[2] EUROPEAN COMMISSION, *Bank Resolution Funds*, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, Brussells, 26.5.2010.

and more interconnected, as the financial crisis has demonstrated. So, there is no "*one size fits all*" approach, given the differences in size, structural complexity and business connotation of the banks.

In light of the financial crisis this is the field in which the major improvements are needed in order to prevent severe disturbances in the future. Indeed, we cannot ignore the fact that shortcomings in regulation and supervision, especially in those countries where crises phenomena originated, constituted one of the main causes of it. Furthermore, the possibility to arrange an orderly resolution of a bank, should a failure occur, depends on the availability of an effective preventive scheme and on the capacity to implement it by banks and supervisors.

In essence, a new scheme of crisis prevention should be designed in a way that allows a bank to be prepared to overcome negative situations and the supervisory authority to intervene appropriately from the very beginning of the crisis. This means that the scope and the mandate of supervision should be adequately reinforced through a more stringent application of off-site and on-site examinations for a better evaluation of risks together with a more pervasive set of instruments for intervention and a more effective application.

At the European level, the framework for strengthening crisis prevention has recently been improved with amendments to the Capital Requirements Directive.[3] In particular, one of the main issues is the institution of colleges of supervisors (article 131a) with the objective of facilitating the supervisory tasks referred to in articles 129 and 130(1) concerning emergency situations. In particular, the new provision entails the planning and coordination of supervisory activities in going concern, preparation for emergency situations, including adverse developments in credit institutions or financial markets, adoption of the exceptional measures referred to in article 132(3)(b), preparation of joint assessments, implementation of contingency plans and communication to the public.

These measures supplement those provided for by article 136 of Directive 2006/48, which allows competent authorities to "require any credit institution that does not meet the requirements of this Directive to take the necessary actions or steps at an early stage to address the situation", including the power: i) to oblige banks to hold own funds in excess of the minimum level laid down by the regulation; ii) to require the reinforcement of the arrangements, processes, mechanisms and strategies implemented to comply with articles 22 and 123; iii) to require banks to apply a specific provisioning policy or treatment of assets in terms of own funds requirements; iv) to restrict or limit the business, operations or network of credit institutions; and v) to require the reduction of the risk inherent in the activities, products and systems of banks. Furthermore,

---

[3] Directive 2009/111/EC of the European Parliament and of the Council of 16 September 2009 amending Directive 2006/48/EC, 2006/49/EC and 2007/64/EC as regards banks affiliated to central institutions, certain own funds items, large exposures, supervisory arrangements and crisis management.

specific own funds requirements in excess of the minimum may be imposed in certain circumstances".

Other improvements are underway – according to proposals coming from the FSB and the Basel Committee – to strengthen prudential regulation and supervision in order to overcome shortcomings and to strengthen bank resilience in stressed market conditions.

In the effort of detecting different classes of risk for the financial sector, the new framework has moved in a twofold direction, namely macro-prudential and micro-prudential supervision, with different areas and instruments of analysis, but with the joint objective to strengthen financial stability.

4.1.1 Macro-prudential supervision

Macro-prudential supervision has the function to timely detect areas of systemic risks and potential threats to financial stability, to require appropriate corrective measures by competent authorities and to monitor the implementation of them.[4] This function tends to clearly distinguish itself from micro-prudential supervision and gives a more prominent role to central banks, but at the same time works in strict cooperation with micro-supervision.

The foundation of such approach considers that micro-prudential supervision is important for the stability of individual intermediaries, but is not sufficient to ensure systemic stability, given the large size of banks and the strict interrelations between them and the markets, with the consequent risks of propagation of the crisis at a systemic level, as the financial crisis well demonstrated.

Micro-prudential tools (capital and liquidity requirements, loan-to-value ratios) may be calibrated to serve macro-prudential goals as well, but possible conflicts may arise. This is the case, as observed,[5] when during an economic downturn "*the macro-prudential regulator would want to run down the equity buffer built up during good times in order to avoid a credit crunch, while the micro-prudential regulator, concerned with preserving the safety and soundness of individual institutions, might be reluctant to let that happen*".

As a consequence, interaction between macro-prudential and micro-prudential policymakers is of utmost importance. Complementarities between the two approaches should be enhanced through continuous exchanges of information and coordination.

---

[4] On this issue, BANK OF ENGLAND, *The role of macroprudential policy: A discussion paper*, Novermber 2009; C. BORIO, Implementing a macroprudential framework: Blending boldness and realism, Keynote address for the BIS-HKMA research conference on "Financial Stability: Towards a Macroprudential Approach, Hong Kong SAR, 5-6 July 2010; S. HANSON-A. KASHYAP-J. STEIN, *A macroprudential approach to financial regulation*, Journal of Economic Perspectives.

[5] I. VISCO, *Key issues for the success of macroprudential policies*, Policy Panel on the Macroprudential Policy Framework, BoK-BIS Conference, Seoul, 18 January 2011.

4.1.2 Micro-prudential supervision.

After the strong debate of the past two years, new rules have been released for a substantial strengthening of the existing regulatory framework for banks. The new rules ("Basel 3") do represent an evolution on the Basel 2 framework, with the purpose of addressing risk profiles that had not been well captured before the financial crisis and of enhancing defences in terms of more capital and improved risk management and organisational capacity.

The new framework is based on the following measures:[6]

i) **new definition of capital.** This aims to introduce a more rigorous and harmonised notion of regulatory capital, based on instruments of the highest quality. The new notion reinforces the loss-absorbing capacity of capital instruments, overcoming the weaknesses and the complexity of the old definition, which included many different elements without a clear understanding of which of them were really available for the coverage of losses. The new notion will therefore limit the use of hybrid instruments and focus on the role of "core" capital, the common equity, composed of ordinary shares and retained earnings. This is the predominant part of the Tier 1 capital, a concept that will continue to exist in the new definition, along with other instruments of "high quality", so that total Tier 1 capital will have a loss-absorbing capacity on a "going concern" basis.

   Tier 2 capital will be composed essentially of subordinated debt and will have a loss-absorbing capacity on a "gone concern" basis.

   Tier 3 capital, which in the Basel 2 framework was used to cover market risk, will be eliminated and deductions from capital will be harmonised.

ii) **enhanced coverage of risk.** One of the main lessons learned from the crisis has been the need to strengthen the coverage of risk in the capital framework. As already underlined, many failures were identified in the Basel 2 framework to capture major on- and off-balance sheet risks, as well as derivatives related exposures. For this purpose, more stringent requirements have been proposed for: trading book exposures, by introducing a stressed value-at-risk requirement and also extending the existing incremental risk default capital charge to cover migration risk; securitisation positions, with higher risk weights for "re-securitisation" and short-term securitisation liquidity facilities; and counterparty credit risk on over the counter (OTC) derivatives, repos and securities financing activities. As regard counterparty risk, the treatment of exposures to central counterparties is still under discussion at this stage.

---

[6] BASEL COMMITTEE ON BANKING SUPERVISION, *A global regulatory framework for more resilient banks and banking systems*, 16 December 2010. On these issue, S. WALTER, *Basel III and Financial Stability*, Speech at the 5th Biennal Conference on Risk Management and Supervision, Financial Stability Institute, Bank for International Settlements, Basel, 3-4 November 2010; J. CARUANA, *Basel III. Towards a safer financial system*, Speech at the 3th Santander International Banking Conference, Madrid, 15 September 2010.

These changes are expected to increase significantly the average trading book capital requirements and, consequently, will make proprietary trading less attractive and indirectly achieve some degree of separation between banking and proprietary trading activities. According to a quantitative impact study carried out by the Basel Committee, the new rules would require banks to hold capital on trading book assets about four times as much as that required by Basel 2.

Furthermore, the Basel Committee is conducting a general review of the trading book, which is targeted for completion by 2012.

iii) **new capital ratios, including macro-prudential buffers**. In addition to the increased quality of capital and risk coverage, the new framework provides for a recalibration of the capital ratio in order to improve its loss-absorbing capacity not only in normal times, but also in times of economic stress.

For this purpose, banks will be required to hold common equity capital of 4.5% of risk-weighted assets, well above the 2% indirectly required under the current regulation. Tier 1 capital requirements, which include common equity and other qualified financial instruments, will increase from 4% to 6%. In addition, banks will be asked to hold a *capital conservation buffer* of 2.5% of risk-weighted assets. This buffer will be held in common equity capital. Consequently, the total common equity requirement will increase to 7% and the Tier 1 capital ratio to 8.5%, while the total capital ratio will reach 10.5%.

The role of the capital conservation buffer is very important, in that it aims to address some of the problems that materialised during the financial crisis. The objective is to ensure that banks maintain a buffer of capital that can be used to absorb losses during periods of financial and economic stress. It means that banks should build capital during phases of economic growth and be forced to use this buffer when the economy contracts. As observed, this new component of capital will change completely the configuration and notion of capital, since it introduces a macro-prudential objective into the capital requirement, which is "*not only a firm-specific risk-based framework, it is also a system-wide, systemic risk-based framework*".[7]

The effectiveness of the new capital regulation will be reinforced through the provision according to which when the buffer is utilised to absorb losses, banks should restrict discretionary payments such as dividends to shareholders and bonuses to managers until the capital buffer will be reconstituted by raising capital in the market.

Finally, another important element of the capital requirement from the macro-prudential perspective is the introduction of a *countercyclical buffer***.** This aims to prevent the amplification of cyclicality in the banking sector caused

[7] H. HANNOUN, *The Basel III Capital Framework: a decisive breakthrough*, Speech held at BOJ-BIS Level Seminar on Financial Regulatory Reform: Implication for Asia and the Pacific, Hong Kong SAR, 22 November 2010.

by excessive credit growth. More precisely, its purpose is to avoid that after a period of sustained credit growth, when an asset price bubble bursts or the economy enters a downturn, causing a deterioration in assets quality, banks could tighten their credit to the economy, thereby exacerbating the problems of the real economy. So, the countercyclical buffer would not only protect the banking sector from losses deriving from periods of excessive credit growth, but also ensure the availability of credit to the economy during times of stress.

This buffer would be considered as an extension of the conservation buffer and would be established within a range of 0-2.5% of common equity or other fully loss-absorbing capital. It would also be implemented by each jurisdiction according to national circumstances. As a consequence, for any given country, this buffer would only be in effect when there is excessive credit growth resulting in a system-wide build-up of risk. For banks operating in different jurisdictions, the buffer would be an average of the buffers applied in each of the jurisdictions in which the bank has credit exposures.

Calibration of the Capital Framework

Capital requirements and buffers (all numbers in percent)

	Common Equity Tier 1	Tier 1 Capital	Total Capital
Minimum	4.5	6.0	8.0
Conservation buffer	2.5		
Minimum plus conservation buffer	7.0	8.5	10.5
Countercyclical buffer range*	0 – 2.5		

Consistently with this forward-looking approach, the Basel Committee is promoting stronger provisioning practices through three related initiatives: i) changing the accounting standards (IAS 39.6) towards an expected loss approach, which could capture actual losses more transparently and is also less pro-cyclical than is the current "incurred loss" approach. In this direction is moving the International Accounting Standards Board (IASB), with the objective of improving the usefulness and relevance of financial reporting for stakeholders, including prudential regulators; ii) updating the supervisory guidance of the Board in line with the move to such an expected losses approach. Such guidance will assist supervisors in promoting strong provisioning practices under the new approach; and iii) addressing incentives to stronger provisioning in the regulatory capital framework.

iv) **leverage ratio**. The new capital requirements are supplemented by a non-risk-based leverage ratio that will serve as a backstop to the risk-based measures described above. On one hand, it aims to avoid the uncontrolled growth of a bank's assets in the expansive phases of the economic cycle relative to the amount of capital, reducing in this way the level of leverage in a bank's balance sheet. On the other hand, it reduces the deleveraging dynamics in periods of stress. From another point of view, the leverage ratio defuses the multiplier effect of losses when things go wrong. To this aim a minimum Tier 1 leverage ratio of 3% is set during the parallel run period. Based on the results of the parallel run period, any final adjustments would be carried out in the first half of 2017 with a view to migrating to a Pillar 1 treatment on 1 January 2018 following an appropriate review and calibration.

v) **liquidity requirements**. As an important innovation of the new framework, a global liquidity standard will supplement the capital regulation for the purpose of overcoming one of the main causes of the recent financial crisis. In the Basel 2 framework the management of liquidity risk fell under the scope of Pillar 2, which required banks to manage and monitor this kind of risk in an appropriate way, through governance, risk management and internal control instruments (qualitative profiles), but it did not impose binding quantitative rules. According to the new Basel Committee proposal,[8] banks should meet two new quantitative liquidity requirements: a short-term requirement, the *Liquidity Coverage Ratio* (LCR), and a long-term requirement, the *Net Stable Funding Ratio* (NSFR).

These two regulatory standards are aimed at achieving two separate but complementary objectives. The LCR objective is to promote the short-term resiliency of the liquidity risk profile of institutions. The NSFR objective is to promote resiliency over longer-term time horizons.

The LCR aims at ensuring that banks have sufficient high quality liquid resources to survive an acute stress scenario lasting for one month. It identifies the amount of unencumbered, high quality liquid assets (assets that can be easily and immediately converted into cash at little or no loss of value) an institution holds that can be used to offset the net cash outflows it would encounter under an acute short-term stress scenario specified by supervisors. The scenario entails both institution-specific and systemic shocks.[9]

---

[8] BASEL COMMITTEE OF BANKING SUPERVISION, *Basel III: International framework for liquidity risk measurement, standards and monitoring*, December 2010.

[9] The scenario entails: i) the run-off of a proportion of retail deposits; ii) a partial loss of unsecured wholesale funding capacity; iii) a partial loss of secured, short-term financing with certain collateral and counterparties; iv) additional contractual outflows that would arise from a downgrade in the bank's public credit rating by up to and including three notches, including collateral posting requirements; v) increases in market volatilities that impact the quality of collateral or potential future exposure of derivative positions and thus require larger collateral haircuts or additional collateral, or lead to other liquidity needs; vi) unscheduled draws on committed but unused credit and liquidity facilities that the bank has provided to its clients; and vii) the potential need for the bank to buy back debt or honour non-contractual obligations in the interest of mitigating reputational risk.

In quantitative terms, the LCR is defined as:

$$\frac{\text{Stock of high-quality liquid assets}}{\text{Total net cash outflows over the next 30 calendar days}} > 100\%$$

The NSFR aims at maintaining a more robust structural liquidity profile, by creating additional incentives for banks to fund their balance sheets and off-balance sheet exposures and capital market activities with more stable sources of funding on an ongoing structural basis (covered bonds, securitisation in simple forms, and other instruments). In practice, the ratio requires a minimum amount of funding that is expected to be stable over a one-year horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures.

In quantitative terms, the NSFR is defined as:

$$\frac{\text{Available amount of stable funding}}{\text{Required amount of stable funding}} > 100\%$$

In addition to quantitative requirements, *qualitative elements* are of fundamental importance for appropriate liquidity risk management. In this regard, the Basel Committee has provided specific guidance on the risk management and supervision of funding liquidity risk, in terms of appropriate policies of governance and more rigorous systems, procedures and internal controls to manage liquidity risk in stressed scenarios (use of liquidity stress test and contingency plans, based on idiosyncratic and market-wide events).[10] The guidance stresses the role of the corporate bodies in issuing policies and strategies for the management of liquidity risk.

Similarly to other Basel 3 standards, the two liquidity rules will enter into force gradually, after a monitoring period: 2015 for the LCR and 2018 for the NSFR.

vi) new Pillar 2 and Pillar 3 requirements. Another important action is the enhancement of supervision, risk management and disclosure. In this direction, the Pillar 2 supervisory review process was strengthened by the Basel Committee in July 2009.[11] Further improvements will be introduced in some areas such as corporate governance, risk appetite, risk aggregation and stress testing.[12] Moreover, more comprehensive Pillar 3 transparency requirements will be established for more complex capital market activities.

---

[10] BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for Sound Liquidity Risk Management and Supervision*, 2008, Available at www.bis.org/publ/bcbs144.htm. On this issue also European Directive 2009/111/CE of 16 September 2009, amending the Directive 2006/48/CE, 2006/49/CE and 2007/64/CE, which introduces the obligation to define strategies and processes for the liquidity risk management and to prepare contingency plans.

[11] BASEL COMMITTEE ON BANKING SUPERVISION, *Enhancements to the Basel II framework*, July 2009, available at www.bis.org/publ/bcbs157.htm.

[12] About the weaknesses in risk management practices identified during the crisis see SENIOR SUPERVISORS GROUP, *Risk Management Lessons from the Global Banking Crisis of 2008*, October 2009. According to the Group, progress in developing a risk appetite framework and IT infrastructures to aggregate risks data more accurately have been made in the banking systems, but further work is needed to

With reference to the whole Basel 3 framework, concerns have also been expressed about the burden on banks of the new rules in term of excessive increases of capital and liquidity requirements. Moreover, negative effects have been envisaged on the growth of the credit supply to the economy. So, it has been asked that all measures concerning the Basel 3 framework are phased in over the medium term so as not to hinder the recovery process. For different reasons, expectations about the introduction of *grandfathering clauses* that extend the previous rules for a transitional period have been expressed. Recognising the proposals put forward by financial institutions and market operators, international policymakers introduced transitional arrangements for the implementation of these new standards in order to help the banking sector meet higher capital standards through reasonable earnings retention and capital increases, while still supporting lending to the economy.

4.1.3 Other measures.

Consistent with the new prudential framework, other measures are going to be finalised in order to remove further weaknesses highlighted by the crisis:

a) **additional requirements for Systemically Important Financial Institutions (SIFIs).** For larger and more systemically important banks the new standards established by the Basel 3 regulations could prove insufficient. A specific policy framework is being designed by the FSB and the Basel Committee to address the systemic and moral hazard risks posed by these institutions, which for their size, complexity and interconnectedness could cause significant disruptions to the financial system and the economy [13] (see Chapter 5, par. 4.1.).

   According to the proposals put forward, a combination of capital and liquidity surcharges, together with tighter exposure limits, should be applied to these institutions, acting as a sort of "*tax on size*", because expected losses that their failure would produce could have system-wide dimensions.

   In other words, in terms of capital requirements, SIFIs should have a loss-absorbing capacity above the minimum standard established by the Basel 3 framework, as a result of a higher share of their balance sheet being funded by capital and other instruments that increase the resilience of the institutions as going concerns. For this purpose, a quantitative requirement could be applied to contingent capital instruments and other "bail in" instruments, which could bear losses at the point of

---

strengthen these practices, which revealed as particularly weak during the crisis (SENIOR SUPERVISORS GROUP, *Observations on Developments in Risk Appetite Frameworks and IT Infrastructure*, December 23, 2010).

[13] FINANCIAL STABILITY BOARD, *Reducing the moral hazard posed by systemically important financial institutions. FSB Recommendations and Time Lines*, 20 October 2010.

Phase-in arrangements

(shading indicates transiction periods - all dates are as of 1 January)

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Leverage Ratio	Supervisory monitoring		Parallel run 1 Jan 2013 - 1 Jan 2017 Disclosure starts 1 Jan 2015					Migration to Pillar 1	
Minimum Common Equity Capital Ratio			3.5%	4.0%	4.5%	4.5%	4.5%	4.5%	4.5%
Capital Conservation Buffer						0.625%	1.25%	1.875%	2.50%
Minimum Common Equity plus capital conservation buffer			3.5%	4.0%	4.5%	5.125%	5.75%	6.375%	7..0%
Phase-in of deductions from CET1 (including amount exeesing the limit for DTAs, MSRs and financials)				20%	40%	60%	80%	100%	100%
Minimum Tier 1 Capital			4.5%	5.5%	6.0%	6.0%	6.0%	6.0%	6.0%
Minimum Total Capital			8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
Minimum Total Capital plus conservation buffer			8.0%	8.0%	8.0%	8.625%	9.25%	9.875%	10.5%
Capital instruments that no longer qualify as non-core Tier 1 capital or Tier 2 capital			Phased out over 10 year horizon beginning 2013						

	2011	2012	2013	2014	2015	2016	2017	2018	As of 1 January 2019
Liquidity coverage ratio	Observation period begins				Introduce minimum standard				
Net stable funding ratio	Observation period begins							Introduce minimum standard	

non-viability, enabling in this way a creditor recapitalisation within resolution (on this issue see paragraph 4.3.1).

Moreover, SIFIs should be subject to a strengthened supervisory system based on more effective risk assessment and enforcement. To this end, national supervisors should have clear mandates, powers, standards and resources, according to the Recommendations made by the FSB that will be introduced in the next review of the Basel Committee's "Core Principles".[14]

Finally, work is underway to design a new regime for an orderly resolution of SIFIs, aimed at preserving the essential financial and economic functions of the bank without exposing the taxpayer to the risk of loss, which should be born by shareholders and unsecured and uninsured creditors. For this purpose all jurisdictions should undertake legal reforms to introduce a resolution regime, a resolution authority and provisions concerning cooperation with other foreign resolution authorities for cross-border financial institutions.

b) **compensation to managers.** Remuneration practices have been widely identified as a major contributory factor to the crisis, in that the mechanisms on which they were based, linked to short-term profits, gave perverse incentives to excessive risk-taking. The main objective is, therefore, that the authorities could effectively assess the remuneration practices applied by banks, verifying that compensation is correlated with the relevant risks and their respective time horizons or, in other words, that remuneration is aligned with long-term value creation and that it does not lead to excessive risk-taking. Specific recommendations have been issued on this topic by the FSB, concerning the structure of compensation and risk alignment, the governance of compensation (stakeholder involvement and the establishment of a remuneration committee), disclosure and supervisory oversight.[15] Consistent with the FSB principles, specific provisions have been issued by the EU[16] that require "express obligation for credit institutions and investment firms to establish and maintain, for categories of staff whose professional activities have a material impact on their risk profile, remuneration policies and practices that are consistent with effective risk management". For this purpose, article 136 of the CRD has been amended to introduce

---

[14] FINANCIAL STABILITY BOARD, *Intensity and Effectiveness of SIFI Supervision. Recommendations for enhanced supervision*, prepared by the FSB in consultation with IMF, " November 2010.

[15] FINANCIAL STABILITY BOARD, *Principles for Sound Compensation Practices*, 2 April 2009; FINANCIAL STABILITY BOARD, *Principles for Sound Compensation Practices. Implementation Standard*, 25 September 2009; Moreover, FINANCIAL STABILITY BOARD, *Thematic Review on Compensation, Peer Review Report*, March 2010.

[16] EUROPEAN COMMISSION, DIRECTIVE 2010/76/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 24 November 2010 amending Directives 2006/48/EC and 2006/49/EC as regards capital requirements for the trading book and for re-securitisations, and the supervisory review of remuneration policies.

the power for supervisory authorities to require "credit institutions to limit variable remuneration as a percentage of total net revenues when it is inconsistent with the maintenance of a sound capital base".

c) **the enlargement of the boundaries of regulation and supervision**. The reform of the banking system in the shape that is resulting from the international debate and the legislative and regulatory initiatives does not exhaust the extension of the measures necessary to deal with all the weaknesses that emerged from the financial crisis. In particular, responses should be given to the demand for the regulation and supervision of many financial products and structures (non-banking intermediaries) that are not subject to any jurisdiction, which played a relevant role in determining and amplifying the systemic risk (the *shadow banking system*). The first problem here is to identify an appropriate definition of the "shadow banking system" to avoid that some of those structures and instruments can escape from controls. The second issue is to determine which regulation and supervision to apply to them to avoid distortions in competition among market operators, leaving in such a way the leaks in the regulatory apparatus that characterised the financial crisis.

One of the main issues is the regulation and oversight of entities managing alternative investment funds, such as **hedge funds** and **private equity**, for which a large consensus for the harmonisation of rules has been reached at an international level. Works are on course on this matter by the International Organisation of Securities Commissions (IOSCO) and the FSB. The latter has recently issued a document for public consultation,[17] which clarified the meaning of the "shadow banking system", defining it as "a system of credit intermediation that involves entities and activities outside the regular banking system, and raises i) systemic risk concerns, in particular by maturity/liquidity transformation, leverage and flawed credit risk transfer, and/or ii) regulatory arbitrage concerns".

Moreover, the document envisages four categories of regulatory approach, currently under consideration: a) indirect regulation, considering banks' interactions with shadow banking entities in order to reduce the spillover of risks into the regular banking system; b) direct regulation of shadow banking entities; c) regulation of shadow banking activities instead of regulating shadow banking entities, in order to address risks affecting particular instruments, markets or activities; and d) macro-prudential measures, namely a series of policy measures to address systemic risk in the shadow banking system more broadly (e.g. regulatory measures for mitigating pro-cyclicality or policies to strengthen market infrastructure to lower contagion risks).

At the EU level, on November 11 2010, the European Parliament adopted the EU Directive establishing a harmonised framework on

[17] FINANCIAL STABILITY BOARD, *Shadow banking: scoping the issues*, 12 April 2011.

Alternative Investment Fund Managers (AIFMs)[18] for monitoring and supervising the risks they pose to their investors, counterparties, other market participants and financial stability.

The Directive allows AIFMs to provide services throughout the EU single market, subject to compliance with strict requirements. It will also cover real estate funds, commodity funds and all other funds that are not covered by the Directive on collective investment funds.

To operate in the EU, fund managers should be authorised by the competent authority of their home Member States. Upon receiving this authorisation, they will be able to market funds established in the EU to professional investors in any Member State. AIFMs should also satisfy the competent authority of the robustness of their internal systems concerning risk management, disclose on a regular basis the principal markets and instruments in which they trade and explain their main exposures and concentration of risks.

Moreover, AIFMs should provide investors with a clear description of their investment policies, including information on the types of assets and the uses of leverage. Competent authorities would have the power to set limits to leverage in order to ensure the stability of the financial system. AIFMs are required to disclose aggregate leverage and the main sources of leverage, and competent authorities would be required to share relevant information with other competent authorities.

Specific requirements should be requested for AIFMs to acquire controlling stakes in companies, in particular the disclosure of information to other shareholders and to the representatives of the employees of the acquired company. However, it does not extend such requirements to the acquisition of small and medium-sized enterprises (SMEs) to avoid affecting start-ups or venture capital.

An optional exemption is provided for smaller funds. In particular, funds with managed assets below 100 million euros if they use leverage and with assets below 500 million euros if they do not. Smaller funds would however be subject to minimum registration and reporting requirements.

Another important aspect under consideration for regulation regards the supervision of **credit rating agencies** (CRAs), which had a reinforcing effect on the financial crisis. The FSB has forwarded proposals on the ways to reduce the relevance of ratings issued by agencies for regulatory purposes.[19] In the same direction are moving Basel Committee proposals,

---

[18] EUROPEAN COMMISSION, Directive of the European Parliament and of the Council on Alternative Investment Fund Managers and amending Directives 2004/39/EC and 2009….., Brussels, 30.4.2009, COM (2009) 207 final.

[19] FINANCIAL STABILITY BOARD, *Principles for Reducing Reliance on CRA Ratings*, 27 October 2010.

which will include measures requiring banks to perform their own internal assessment of externally rated securitisation exposures, the elimination of certain "cliff effects" arising from guarantees and credit derivatives (within the credit risk mitigation practices) and the incorporation of key elements of the IOSCO Code of Conduct Fundamentals for Credit Rating Agencies into the Committee's eligibility criteria for the use of external ratings in the capital framework. The Committee is also conducting a more fundamental review of the securitisation framework, including its reliance on external ratings.

At the EU level, a specific regulation has been issued[20] in order to put in place a common regulatory regime for the issuance of credit ratings. As stated in the regulation, the new approach aims at enhancing "the integrity, transparency, responsibility, good governance and reliability of credit rating activities, contributing to the quality of credit ratings issued in the Community, thereby contributing to the smooth functioning of the internal market while achieving a high level of consumer and investor protection. It lays down conditions for the issuing of credit ratings and rules on the organisation and conduct of credit rating agencies to promote their independence and the avoidance of conflicts of interest".

The new regime moves in a twofold direction: the centralisation of supervision at the European level and the increase in the transparency of the entities requesting ratings so that all agencies have access to the same information.

Under these rules all CRAs that would like their credit ratings to be used in the EU need to apply for registration to the Committee of European Securities Regulators (CESR). The risks of conflicts of interest affecting ratings are addressed by the provision that CRAs cannot also offer consultancy services. Moreover, CRAs are required to be more transparent, disclosing the methodology, internal models and key rating assumptions they use to issue their ratings. This should allow investors to better perform their due diligence. Finally, financial institutions that issue structured finance instruments should provide all other interested CRAs with access to the information they give to their own CRAs, in order to enable them to issue unsolicited ratings.

Regulation 1060/2009 has recently been amended by another regulation,[21] which enables the new European supervisory authority, the European Securities and Markets Authority (ESMA) to supervise CRAs

---

[20] REGULATION (EC) N° 1060/2009 OF THE PARLIAMENT AND OF THE COUNCIL of 16 September 2009 on credit rating agencies, Official Journal of the European Union, 17.11.2009, L 302/1.

[21] REGULATION (EU) No 513/2011 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 11 May 2011 amending Regulation (EC) No 1060/2009 on credit rating agencies, Official Journal of the European Union, 31.5.2011, L 145/30.

registered in the EU. It would have the powers to request information, make investigations and perform on-site inspections.

The exchange of information among authorities is a key element of the new legal framework. For this purpose, the ESMA, competent authorities and sectoral competent authorities should supply each other with the information required for the purposes of carrying out their duties.

Moreover, the ESMA may transmit to central banks, the European System of Central Banks and the ECB, to the ESRB and to other public authorities responsible for overseeing payment and settlement systems confidential information necessary for the performance of their tasks. Similarly, such authorities should communicate to the ESMA information that it may need in order to carry out its duties under the regulation.

d) the regulation of the OTC derivatives market. According to international debate, the regulation of derivatives should aim to make this market more similar to an exchange-traded market, with a central clearing counterparty (CCP) for each transaction, acting as a buyer in every sale of a financial instrument and as a seller in every purchase. The CCP's main purpose is to manage the risk that could arise if one counterparty is not able to make the required payments when they are due. The CCP should impose higher collateral requirements to mitigate the risk of the default of participants. A specific regulation of the derivatives market, short selling, and CDS has been introduced in the USA (Dodd-Frank Law).

A proposal on the regulation of OTC derivatives has recently been presented by the European Commission[22]. Its main points can be summarised as follows: i) the introduction of the obligation to clear OTC derivatives contracts through a CCP) ii) the improvement of transparency through the reporting of derivatives contracts traded by a financial or non-financial firm with large positions to trade repositories (central data centre), accessible also to supervisory authorities; and iii) the standardisation of products, as a condition for a better identification and risk implication of them (counterparty credit risk and operational risk). Moreover, the proposal aims at strengthening the powers of market supervisory authorities at a national and at a European (i.e. ESMA) level. The latter will play a key role in terms of the identification of contracts that will be subject to the clearing obligation, of responsibility for the surveillance of trade repositories and of the issuance of technical standards for the application of the regulation. In case of excessive potential of risk the ESMA could intervene to prohibit exchanges.

[22] EUROPEAN COMMISSION, *Proposal for a Regulation on OTC Derivatives, central counterparties and trade repositories* – COM/2010/0484 final.

A key issue that remains is the need to better understand how to intensify the supervision of CCPs: the risk that they will progressively attract a huge portion of systemic risk, without an adequate supervisory umbrella behind them.

Reflections are underway on this issue in order to assess the possibility of a direct access of the CCP to central banks' liquidity. Moreover, competition should be fostered by allowing investors to choose which CCP to use and by creating interconnections (interoperability) between CCPs.

4.1.4 Strengthening internal and supervisory controls of banks.

In this more articulated and comprehensive prudential framework, based on more stringent capital and liquidity requirements, the supervisory authority should have powers to implement intensified supervision with a modular exercise of on-site and off-site examinations against the different types and sizes of financial institutions (principle of *proportionality*) and to take more focused preventive intervention. In particular, larger banks should expect a more intense supervision than before and should be prepared at any moment to deal with a distressed situation that could take place both for internal problems and as a consequence of bad market conditions. An appropriate design and implementation of corporate governance, organisational structure and operational processes as well as internal control system and procedures, plays a key role in detecting weaknesses and identifying effective remedial action. Strengthening self-control is the essence of the new framework, because no external control can be more effective than a good internal one.

While supervisory controls are based on external data and information provided by banks (with consequent limits linked to their truthfulness and timeliness) and the scope of investigations is often limited, internal controls have many strengths. If properly implemented, internal controls may be more focused and incisive. They are carried out on a continuum basis, based on a strong commitment of the top management, shared throughout the organisation, and aimed at the improvement of the organisational and governance set-up. Risk management and internal auditing are the "core" of the new internal control system and essential elements of the good governance of banks, which should continuously have the capacity to detect, assess and manage all kinds of risks. Stricter capital and internal control requirements should be the two fundamental elements to effectively oversee risks.

In this picture of more stringent supervision, risk assessment should be made not only considering normal times but also under stress scenarios. The carrying out of **stress tests** is considered essential to evaluate the resilience of a bank to adverse market conditions. These exercises are not new, as they are already covered by the Pillar II requirements within the Basel 2 framework. In this context, stress tests are the quantitative and qualitative techniques through which

banks evaluate their vulnerability with respect to events that are exceptional but plausible. They consist of assessing the effect on the bank's risks of specific events (*sensitivity analysis*) or of the joint movement of a set of economic and financial variables using adverse scenarios hypotheses (*scenario analysis*). The choice of risk factors is relevant, because they have to be appropriately linked to the bank's business; the construction of scenarios is also important, because it could be too severe or too benign, with consequent implications in terms of risk management; lastly, due consideration should be given to the correlation effects between different risk factors.

Under the Basel 2 regulation, banks are required to carry out stress tests to better evaluate their exposure to risks, the related mitigation and control systems and, if necessary, the adequacy of their internal capital. The latter is a challenging issue, because regulation does not necessarily provide for the use of new capital to cover the exposure to risks deriving from stress tests, but it also covers other measures to reduce or mitigate the risk.

What is new about stress tests after the financial crisis? The innovation should be that stress tests become an ordinary tool of bank management and banking supervision, especially for large and complex financial institutions. Supervisory authorities should have the power to impose a stress testing program on the bank, also agreeing in advance the risk factors and the severity of them in the ”worst case” scenario to be used for the exercise; moreover, the consequences of the outcomes of the tests should be clear “ex ante”. The critical issue is the action to take when a capital shortage emerges from the exercise. In this case, the question is whether banks are obliged to increase capital given that under Basel 2 the test is not binding, but banks are requested - within their internal assessments of capital adequacy (ICAAP) - to illustrate to supervisory authorities how they intend to address this shortage going forward; measures may be different. Another important issue regards the degree of the disclosure of the results of stress tests, considering that while in general they may contribute to increasing transparency about the bank's situation, in some circumstances the major disclosure may have a negative impact on the market, so that appropriate safeguards should be ex ante established.

Another important component of a crisis prevention framework is the preparation by banks, especially by large and complex financial institutions, of specific **contingency plans.** Such arrangements are put in place by banks to increase their preparedness to deal with adverse conditions, so that they can recover from weaknesses that affect the technical profiles of the bank (recovery plans) or, even, realise an orderly resolution of the bank in the event that it should fail (resolution plans). This is a sort of preventive planning of crisis resolution. Contingency plans should be prepared and kept updated under the supervision of supervisory authorities.

This is the application of the so-called "*living will*" approach,[23] which requires banks – at least the most complex ones – to set up or improve the internal organisation to be prepared to deal with negative events. It requires banks have available at any time details about their structures and operations in order to be prepared to assess the different resolution options in a timely manner in accordance with the authorities' strategies. These should include all information about the most complex operations, such as netting and derivatives contracts. Living wills might involve significant simplifications of the group's structure by separating business lines or activities that cut across legal entities, including drawing a clear line between deposit-taking and other banking operations in order to facilitate their selling to third parties. This could be of utmost importance when a crisis occurs, because information and preparation on each well-separated business area are essential to organise a transfer to third parties in a timely and effective way. If banks are not able to demonstrate they made such an exercise, authorities may require banks to reorganise and simplify their corporate structures.

For cross-border institutions, contingency plans should be prepared under the oversight of colleges of supervisors, within which a key role should be played by the consolidating supervisors. For cross-border banking groups, specific provisions are currently covered by article 129 (and also 42) of the CRD,[24] according to which, *inter alia* "the competent authority responsible for the exercise of supervision of a consolidated basis of EU parent credit institutions and credit institutions controlled by EU parent financial holding companies shall carry out the following tasks: (a) coordination of the gathering and dissemination of relevant or essential information in going concern and emergency situations; and (b) planning and coordination of supervisory activities in going concern as well as in emergency situations, including in relation to the activities in article 124, in cooperation with the competent authorities involved". In the new framework, article 129 should be integrated with the introduction of provisions regarding more specific contingency plans.

These contingency plans should take the twofold form of a "recovery liquidity plan" and a "recovery capital plan", aimed at maintaining the bank as a *going concern*. They should set out how the bank would respond to stressed

---

[23] On this issue, C. GOODHARTH, *How should we regulate bank capital and financial products? What role for "living wills"*, in The Future of Finance, The LSE Report, 2010; T.F. HUERTAS, *Living Wills: How can the Concept be Implemented*, remarks before the Conference "Cross-Border Issues in Resolving Systemically Important Financial Institutions", at Wharton School of Management, University of Pennsylvania, February, 12, 2010; SHEARMAN & STERLING, *Financial Institutions Recovery and Resolution Plans*, Client Publication, March 26,2010; E. AVGOULEAS-C. GOODARTH-D. SCHOENMAKER, *Living Will as a Catalyst for Action*, February 2010. The FSB is working on this issue, upon a mandate of the G20. The objective is that the top 25 banks and dealers with cross-border activity will produce recovery and resolution plans, in connection with their supervisory authorities. The exercises should be done within existing supervisory colleges, extended to other competent authorities (resolution authorities, central banks).

[24] DIRECTIVE 2006/48/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions (recast), Official Journal of the European Union, L 177/1, 30.6.2006.

situations and the concrete actions the management of the bank would take to overcome them, with a clear identification of the decision-making process and the execution of the plan. The timeframe for the execution of the plan is also essential.

The *recovery liquidity plan* consists essentially of a funding plan, helping banks deal with liquidity distress. The plan should include all information, readily available, about liquidity holdings (treasury bonds, bond issued by other banks and any kind of marketable assets) as well as the availability of collaterals for ordinary and emergency liquidity facilities by central banks.

The *recovery capital plan* is aimed at "derisking" the banking group in order to maintain it as a going concern. Derisking means that banks are prepared to lay risk off their balance sheets, thereby winding down or liquidating part of their portfolios as well as selling all or part of their business lines and possible intra-group transactions for emergency situations. Alternatively, banks should include in their recovery plans the possibility to raise capital from private investors in the form of *contingent capital.*[25] This should not be the kind of hybrid capital issued by banks only for supervisory purposes, being convertible into capital only if a bank is placed into liquidation; it should be debt convertible in ordinary loss-absorbing equity when a bank is hit by distress. In fact, the envisaged instruments are different from the hybrid securities that are widespread in the market today, which cannot be used for recovery purposes. The plan should contain clear indications about the amount of contingency capital and the types of investors who will underwrite it. In some way, this would represent a form of protection provided by the private sector to issuing banks[26] in its own interest, because distresses in the banking system could impair other asset classes, as the recent financial crisis demonstrated. The question is whether and under which conditions a market for contingent capital could work.

Furthermore, banks should have a *resolution plan*, aimed at ensuring that arrangements are in place to ensure that if the bank is failing or is likely to fail, it could be rapidly and orderly resolved or liquidated and "put to rest, but with essential economic functions maintained somehow".[27] This plan may have different shapes, according to specific situations. For example, in some cases it might be relatively simple to liquidate the bank, with retail depositors receiving compensation from the DIS; in other cases, it could be advisable or more appropriate to sell the deposits to another bank together with all or part of

---

[25] On this issue, P. TUCKER, *The crisis management menu*, Intervention at SUERF, CEPS and Belgian Financial Forum Conference: *Crisis Management at the Cross-Road*, Brussels, 16 November 2009; M. KING, "Speech by Mervyn King, Governor" to Scottish Business Organisations, Edinburgh, October 2009; G. DE MARTINO-M. LIBERTUCCI-M. MARANGONI-M. QUAGLIARIELLO, *Countercyclical contingent capital (CCC): possible use and ideal design*, Questioni di Economia e Finanza (Occasional Papers), Banca d'Italia, Number 71, September 2010.

[26] P. TUCKER, *The crisis management menu*, Speech at the SUERF, CEPS and Belgian Financial Forum Conference on "*Crisis Management at the Cross-road*, 16 November 2009.

[27] P. TUCKER, *The debate on financial system resilience: macroprudential instruments*, Barclays Annual Lecture, London, 22 October 2009.

the assets or, to sell only good assets with deposits while bad or unsellable assets remain in the hands of the liquidator.

This reinforced supervision should be accompanied by preventative powers, which can be applied if the resolution authorities identify some impediments to the orderly resolution of the bank. In other words, supervisory authorities should assess whether the proposed arrangements are credible, realistic and effective to restore the viability of the bank or to realise an orderly winding-down of its activities. If supervisory authorities are not satisfied of the bank's contingency plan, they should intervene by requiring it to change the plan, incorporating changes in business operations and corporate structure to facilitate the implementation of the plan.

More specifically, according the EU Commission's proposal, supervisory authorities should have the power to: i) limit the maximum individual and aggregate exposures of a financial institution to a client or a group of connected clients, expressed as a percentage of its regulatory capital; ii) impose more frequent or specific reporting to credit institutions; iii) limit the growth of certain activities of a credit institution by constraining leverage ratios; iv) require a reduction in the refinancing risk in credit institutions' funding structures, through a lengthening of maturities; v) require changes to legal or operational structures; vi) review of remuneration policies to align them with sound risk management; and vii) require to issue additional convertible capital instruments in excess to the minimum.

4.2 Early intervention.

Here, we are in a situation where a bank is facing problems that, if not addressed in a timely and effective way, could affect the whole financial situation over time. The objective is to intervene at an early stage, when weaknesses emerge, preventing them from deteriorating and ensuring the recovery of the bank.

The most critical issue of an early intervention system is to identify the appropriate *triggers* for interventions, namely to decide *when* to intervene when a bank is still solvent and problems are deemed reversible and solvable by the banks itself. So, a right balance between the need for timely intervention and the intermediaries' autonomy principle should be pursued, taking into account that actions taken by authorities be proportionate to the nature and size of the problems and calibrated to restore compliance with prudential requirements.

The debate between automatic and discretionary rules for intervention is still open, because there are no clear elements in favour of one or the other scheme. Automatic rules mean a system of mandatory early corrective actions by supervisors when banks under their surveillance show that their capital has fallen below a certain threshold or they are affected by liquidity difficulties. The literature has long supported the mandated corrective action scheme underlying

its key role in containing moral hazard created by the existence of a DIS and in protecting the DIS itself. Moreover, mandated early action is essential in inhibiting regulatory forbearance, an approach often used by supervisory authorities in the past to resolve banking difficulties in a longer timeframe and with less intrusive instruments.[28]

The US *Prompt Corrective Action* (PCA), operating since 1991, is a useful reference model.[29] In the course of the debate for the institutional reform of regulation at the EU level, a proposal for the introduction of a system of mandated corrective action in Europe has been made[30] and, more recently, the attribution of such power to the EBA has been proposed.[31]

But, the debate on this scheme has lost part of its relevance, since today the early corrective action system is in place in most countries, even though in a less rigorous and automatic way. This is because a certain degree of discretion and flexibility could be more appropriate for supervisory authorities, while under the the U.S. PCA corrective measures are left, to some extent, to the discretion of the authorities.

In every supervisory system, schemes are in place to provide for correspondence between the assessment of the bank's situation and the severity of intervention. The approach is that as the situation worsens interventions become stronger and more intrusive. Whatever the supervisory model, supervisory authorities should have powers and responsibilities to intervene timely and effectively and, when various authorities are involved in the decision-making process, coordination is essential.

For this purpose, it is essential that supervisory authorities use an appropriate *risk assessment methodology* in order to ascertain the real scope of the crisis and

---

[28] G.J. BENSTON-G.G. KAUFMAN, *Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Option*, Monograph Series in Finance and Economics, 1988-1, New York, NY:NYU Press, 1988; T.H.L. BECK, *The incentive-compatible design of deposit insurance and bank failure resolution – Concepts and country studies*, in D.G. MAYES-A. LUIKSILA (eds), *Who pays for bank insolvency?*, Basingstoke, Hampshire: Palgrave Macmillan, 2004.

[29] The P.C.A. is regulated by U.S. Code, Title 12, Chapter 16, Section 1831o, Prompt corrective action, (a) (1). It is based on five capital thresholds for insured depository institutions: well capitalised, adequately capitalised, undercapitalised, significantly undercapitalise and critically undercapitalised. The capitalisation ratios are calculated both on risk-adjusted and unadjusted-basis. Corrective measures includes a broad range of requirements and restrictions (suspension of dividend payments, restriction of asset growth, compulsory recapitalisation and, when a bank is critically undercapitalised, authorities are obliged to close it, and this happens when the bank has not entirely lost its capital).

[30] ESFRC (European Shadow Financial Regulatory Committee), *Dealing with problem banks in Europe*, Statement No. 1, 22 June 1998; ESFRC, *Reforming Banking Supervision in Europe*, Statement No. 23, 21 November 2005; M.J. NIETO- L. WALL, *Preconditions for a Successful Implementation of Supervisors' Prompt Corrective Action: Is there a Case for a Banking Standard In the European Union?*, Working Paper 2006-27, Federal Reserve Bank of Atlanta, December 2006. After the financial crisis, J. CARMASSI-E. LUCHETTI-S. MICOSSI, *Overcoming too-big-to-fail. A regulatory framework to limit moral hazard and free riding in the financial sector*, Report by CEPS-Assonime Task Force on Bank Crisis Resolution, 2010.

[31] UNICREDIT GROUP, *Cross-border banking in Europe: what regulation and supervision?*, Forum on Financial cross-border groups, 2009.

its viability. Supervisory authorities should have in place an appropriate set of quantitative indicators to be complemented by a qualitative assessment. As a result, an effective trigger for interventions should be established not only as a direct consequence of quantitative indicators, but also as the outcome of an overall assessment coming from these quantitative and qualitative evaluations. It would also be appropriate that harmonised technical standards be developed at an international level for risk assessment.

From this perspective, the provisions outlined in the European framework currently under examination seem to be acceptable, according to which supervisors should be granted the powers of early intervention not only where banks fail to meet the requirements of the CRD, but also where they *are likely* to fail to meet the requirements of the CRD. This means that supervisory powers could be activated not only in case of the actual breach of the CRD, but also in case of potential infringements of capital requirements, in order to reinforce the timeliness of interventions. Moreover, the CRD includes either quantitative or qualitative factors, such as risk management, corporate governance or internal control systems.

For this purpose, an extension of the powers provided for by article 136 is necessary for early intervention purposes. This require banks to reach self-solutions, depending on the stage of the crisis and the capacity of the shareholders/management to resolve it, while externally imposed solutions may become necessary in the case of more severe problems and/or if the shareholders/management are not equipped with the financial resources or managerial skills necessary to solve them.

The new framework should include a wide range of powers, such as requiring banks:

i) to take action to raise capital, with some derogation to the Company Law Directives. For this purpose, two options have been outlined: i) the general meeting could *ex ante* decide on a shortened convocation period to convene itself to decide on an increase of capital in an emergency situation; and ii) the general meeting could ex ante mandate the management body of a bank to take a decision on the increase of capital in an emergency situation. This mandate should specify the term of the mandate and the maximum amount of the capital increase;

ii) to restrict or limit the business, operations or network of banks, including the divestment of the riskiest activities;

iii) to use net profit to strengthen their capital bases. This implies the power to require the restriction or prohibition of any kind of distribution to shareholders, including payments to hybrid instrument holders;

iv) to request intra-group financial support according to a voluntary agreement reached at group level;

v) to replace one or more board members or managing directors or require their dismissals;

vi) to impose additional or more frequent reporting requirements, including reporting on capital and liquidity positions.

All these measures may be relevant not only individually or on a standalone basis, but also as components of a package of interventions, **a recovery plan**, which is essential for the treatment of a distressed bank and its restoration or reorganisation. The plan could comprise all measures needed to reorganise the bank (in terms of capital injection, ownership change, management replacement, review of the activities, risk management structure and internal control system). The plan may also include the negotiation of the restructuring of debt with some or all of its creditors.

Banks should be prepared upon the request of supervisory authorities to prepare the plan, including all measures to restore their financial situations, subject to the approval of supervisory authorities. The plan should be implemented in a reasonable timeframe, according to the problems of the banks and the nature and complexity of the measures identified, under the control of the supervisors.

Another effective tool for early intervention is the power, already existing in some countries (such as in Italy), to replace the whole board and control body of the bank with special administrators appointed for a limited period of time to take over and manage the bank and to prepare and implement a recovery plan.

This may happen in specific circumstances where the bank is in distressed situations and its management is unable or unwilling to take all necessary measures to restore the financial situation. Special administrators should have the powers of the directors to manage the bank.

A key issue here is the scope of the special managers' powers, in the sense that the interaction with the shareholders' rights should be specified. Undoubtedly the consideration of general interests involved in the treatment of banking crises may justify some kind of compression, to a reasonable extent, of shareholders' rights, in cases explicitly provided for by law. But, the problem is to identify what is the extent that may be considered reasonable. Is it acceptable that shareholders' rights are infringed to the extent that all powers relating to the resolution of the bank are assigned to special administrators, so that they could decide extraordinary operations, such as mergers, acquisitions, increases of capital or the transfer of the enterprise or of all or part of its assets and liabilities? Or do special administrators have to convene a general meeting of the shareholders to make such decisions?

Different configurations of the procedure can be realised, with different official powers for special managers. The Italian consolidated framework in such matters offers a good example of the second, more balanced and less intrusive model. Obviously, the more the intervention with special administration is anticipated at an early stage (depending on the definition of the triggers for

intervention), the less the first model can be justified. A sort of trade-off in fact exists between the initial requirements for special administration and the extent of the infringement of shareholders' rights. In any case, if the first model is chosen, ways to compensate the shareholders affected by the expropriation measures should be put in place.

A less intrusive tool in this respect could be the appointment of a special manager who assists the existing management in the running of the bank and in the design and implementation of a recovery plan. In this case, however, the definition of triggers for supervisory intervention is a delicate issue.

Such arrangements should be part of the supervisory review provided for by article 124 of the CRD, according to which supervisory authorities must review the arrangements, strategies, processes and mechanisms implemented by banks for capital requirement obligations and evaluate the risks to which banks are exposed. Based on this review, they have to assess if the capital of the bank ensures a sound management and coverage of their risks. For the purpose of crisis management, article 124 should be appropriately integrated.

When liquidity problems arise in viable institutions, a central bank support is an indispensable source of funding against a wide range of collateral, even though a last resort one, because banks have to make recourse to other available market sources. This is a critical issue, because the possibility to fund from the discount window provided by central banks can constitute a disincentive for prudent liquidity management by banks in the normal course of business. In this direction, it is important that central banks apply rigorous criteria for granting financial resources, avoiding taking risks by requiring marketable assets as collateral and applying adequate haircuts. In terms of risk, the effects of financing through secured loans or outright purchases is also different. Furthermore, some kind of penalisation should be applied to the terms under which liquidity insurance is granted.

In the Eurozone, granting ELA to banks falls into the main responsibilities of national central banks.[32] The scopes of these facilities were well specified by the Governing Council in 2007,[33] according to which it constitutes a central bank function if: i) the counterparty requiring ELA is temporarily illiquid but solvent; ii) the collateral provided is adequate; and iii) systemic risk is at stake, as subsequently clarified, being ELA an instrument for safeguarding financial stability. If the counterpart "is likely to be insolvent" or the collateral is inadequate, the intervention falls outside the scope of the central bank's functions and constitutes a Government's task.

In the granting of ELA, national central banks are subject to reporting obligations. They have to report to the Executive Board of the ECB each relevant

---

[32] EUROPEAN CENTRAL BANK, *Council Agreement on ELA*, SEC/GOVC/16/99/16,14 April 1999.

[33] EUROPEAN CENTRAL BANK, *EU Arrangement for the provision of emergency liquidity assistance*, SEC/GovC/07/5/09a. Final – SEC/GebC/07/1/10a.final, 5 April 2007.

facility. The latter will inform the Governing Council, which can prohibit the granting of the facility if it interferes with monetary policy. When the operation is carried out, national central banks have to keep the ECB periodically informed on its ongoing performance.

A crucial issue in ELA transactions is the selection and evaluation of instruments that could be offered as collateral. Since no constraints are provided for by central banks, a priority rule should be fixed in the selection of eligible instruments, even though any type of asset on the bank's balance sheet could be used as collateral in principle. In this context, it is of paramount importance to know in advance the necessary elements for the evaluation of collateral and the application of haircuts.

Given the importance, highlighted by the recent financial crisis, of the market as a source of liquidity for the financial system, it has been pointed out that central banks should be available to provide liquidity to the market, acting as a *Market Maker of Last Resort*.[34]

4.3 Crisis management and resolution.

Here, we consider the case of *failing* or *likely to fail* banks, namely situations in which banks are unable to solve problems by themselves and resolutions tools and powers by authorities are needed. The resolution of a bank means that an external intervention is necessary, normally provided by another bank; external financial resources - private or public - may also be necessary to support the operation.

The key issue is to assess when the bank is failing or is likely to fail. This assessment has to do essentially with the capital of the bank, in situations where it can be all or in part absorbed by losses. Another relevant profile is liquidity, when the bank is unable or likely to be unable to meet its obligations in the normal course of business. An appropriate definition is essential because it identifies the trigger conditions for resolution, namely when resolution tools and powers can be activated. It should not be identified with a situation in which a bank is balance sheet-insolvent in order to allow resolution operations to take place with the minor use of funds. In any case, precise quantitative thresholds should not be identified, since qualitative triggers may also be opportune, even though referring to capital and liquidity.

In defining the triggers for resolution, moreover, balanced solutions should be reached, because the use of tools and powers for resolution may interfere with the property rights of shareholders and creditors. So, neither too early nor too late trigger events should be established. For this purpose, various options are under

---

[34] P. TUCKER, *The Reportoire of Official Sector Interventions in the Financial System: Last Resort, Market-Making, and Capital*, Speech at the 2009 International Conference Financial System and Monetary Policy Implementation, Bank of Japan, 27-28 May, 2009.

consideration at the European level:[35] i) if the bank has incurred or is likely to incur in losses that will deplete its capital, or the assets are or are likely to be less than its liabilities, or the bank is or is likely to be unable to pay its obligations in the normal course of business; ii) if the bank can no longer fulfil, or is likely to fail to fulfil, the financial condition for authorisation; or iii) if the bank no longer possesses, or is likely to fail to possess, sufficient Tier 1 instruments to meet the requirements of article 75 of the CRD (minimum capital requirement). Furthermore, two supplementary conditions are being examined, such as that no other measures can be activated to restore the bank's situation and its return to viability in a reasonable timeframe and that the application of resolution tools is necessary in the public interest.

Once evaluated that the bank is failing or is likely to fail, competent authorities have to decide whether to liquidate the bank under insolvency proceeding or apply crisis management and resolution tools. In this case, the decision should be taken about the maintenance of the bank as a legal entity (i.e. keeping the bank as a *going concern* through a restructuring process) or the use of resolution tools in order to orderly resolve it on a *gone concern basis* (that is, an orderly liquidation of the bank, which no longer exists as a legal entity).

This is a challenging issue, since authorities are required to assess the wide range of interests involved in the crisis and decide accordingly the route to take. The choice depends on the size and complexity of the bank and on the objectives to be followed for resolution, in terms of continuity of essential financial services, avoidance of domino effects that could endanger financial stability, protection of public funds and of insured depositors.

In the going concern solution, the bank is bailed out if there are concrete chances to re-establish ordinary conditions in banking activity in a reasonable timeframe. The firm still has a present value, namely a concrete goodwill. By means of these interventions, the bank will be able to play a future role in the market, at acceptable costs and with positive results (almost surely). "Acceptable costs" mean according to an economic evaluation, made in accordance with the principles of private investors.

In the gone concern solutions, restructuring measures are not feasible. The bank has no market value and it must be resolved or liquidated in an orderly way, avoiding to the greatest possible extent disruptive effects on third parties.

In both cases, the entrepreneur (shareholders and top management) has to suffer the consequences of distress in terms of losses of capital, replacement and criminal sanctions, should they have committed any crime, according to the market rules.

---

[35] EUROPEAN COMMISSION, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution, DG Internal Market*, Working Document, 2010.

As a general principle, going concern solutions should be pursued in connection with private solutions, in that it seems reasonable to keep the legal autonomy of the bank if only private money is used; whereas, if public money is put into the bank for its resolution, a gone concern solution must be more appropriate. But, the dividing line between the two approaches is unclear, especially in the resolution of complex financial institutions, where the two approaches may live together when applied to different entities of the conglomerate. Furthermore, we have to evaluate how to use deposit insurance funds or resolution funds, which are private in nature (being funded by banks), but are considered to be public funds under the State aid framework. Finally, moral hazard and market competition issues have to be considered when deciding to maintain a bank on a going concern basis, especially when public funds are used.

As far as the tools for intervention are concerned, the attempt to create a link between available tools and solutions (going concern or gone concern) could be unconvincing, and probably not useful, because a certain instrument can be indifferently used for one or the other solution.

One thing is taken for granted. In the crisis management process the involvement of the authorities is deeper, and the room for autonomous action by management is narrow or even nonexistent. If there is a danger that a bank could fail, competent authorities have to take over the bank for crisis management or resolution purposes as soon as possible. Furthermore, the triggers for intervention should be established in a very wide way in order to include the assessment of prospective situations.

Here, we enter a delicate field, because there are different ways to manage the crisis. National institutional set-ups and experiences are different and after the financial crisis many countries have changed their crisis management regimes. In addition, those countries that in the past entrusted this task to the courts have now decided to adopt a *special crisis management and resolution regime*, which entrusts crisis management to an administrative authority in order to speed up the process and better pursue public policy objectives.

Competent authorities can activate various proceedings for crisis resolution depending on the legal framework designed in each country. We may have, according to different cases, a special administration that can suspend all payments in exceptional circumstances (moratorium) or a receivership (corresponding to liquidation, applied for resolution). In general, in failing banks, shareholders' rights could be expropriated and other derogations from Company Law Directives may be necessary. This basic level of special crisis management regime could be insufficient for large and complex financial institutions, which have a relevant component of their balance sheets composed of trading portfolios, especially derivatives contracts. Therefore, other measures could be designed to orderly wind down such complex trading positions.

4.3.1 Going concern solutions.

As for going concern solutions, the instruments available could be the issuance of new capital, the merger with another bank or the transfer of some activities to another credit institution. Their application should be part of a restoration plan prepared by the special administrator and implemented under the control of the authorities. This should include all forms of external support granted by private funds (such as deposit insurance schemes and other forms of external support).

The recent debate has led to the consideration of other extraordinary instruments that can be usefully activated for bailing out large and complex financial institutions without recourse to public funds, something that has been configured as a *super-special resolution regime* (super-SSR)[36] and now is being incorporated within EU crisis management proposals.

These measures originate from the consideration that during the crisis all uninsured creditors were bailed out, while "those who finance the system in good times need to have incentive to price the risks".[37] This consists of writing down (haircut) all or part of the unsecured debt of a failing bank - without the declaration of insolvency and even to avoid it and the consequent closure of the bank - in order to re-establish the normal capital position of the bank according to prudential regulation standards or to the tighter standards considered appropriate by the authorities and allow the bank to continue as a going concern. The reduction of liabilities could be accompanied by the conversion of the written down debts in equity in order to assign all or part of the capital of the restored bank to creditors, as a way to compensate them for the write down of their claims and also for changing, wholly or partially, the ownership of the bank, when this is considered of strategic importance for the future good governance of the bank.

The instrument can be activated when other resolution tools are unavailable or insufficient to achieve the resolution objectives. In any case, it cannot be used in isolation, but should be accompanied by other restructuring tools (transfer of bad assets, replacement of management and so on) in order to ensure the return of the bank to viability. Substantially, it consists of the recapitalisation of the bank by its sophisticated creditors rather than by public funds. Obviously, it can be structured in different ways, such as allowing the injection of new capital by third parties, according to the design of the new corporate governance of the bank contained in the restructuring plan, which should provide all the measures needed to reorganise the business of the bank, including the sale of non-core activities. The construction that forms the basis of this proposal is that the haircut of creditors' claims replicates outside a formal insolvency proceeding

---

[36] P. TUCKER, *Resolution of large and complex financial institution – the big issue*, European Commission Conference "*Building a Crisis Management Framework for the Internal Market"*, 19 March 2010.

[37] P. TUCKER, *The crisis management menu*, Intervention at SUERF, CEPS and Belgian Financial Forum Conference: *Crisis Management at the Cross-Road*, Brussels, 16 November 2009.

the same effects of insolvency, which normally gives rise to creditors' claims for write downs as a result of losses in assets recovery. The rule should be applied according to the ranking of creditors within the legal framework of the insolvency proceedings, so that subordinated debt is subject to haircut first and then the other creditors according to the ranking of their claims.

The new envisaged mechanism can be applied in different juridical terms, contractual or statutory, with different implications and effects.[38]

The *contractual approach* consists of a clause included in a bond contract, according to which the bond owner will not be repaid in full and its unsecured claim will be converted into capital following a trigger event and at a conversion rate established in the contract. This instrument should be strictly linked to the proposal under consideration by international standard setters (FSB, BCBS, EU Commission) for a new banking regulatory framework requiring banks to issue a specified proportion of debt instruments convertible into equity (*contingent capital*) under the trigger of a threshold that kicks in before a bank becomes insolvent.[39]

The *statutory approach* implies that the haircut of unsecured debt and its conversion into equity are decided by the competent authority, which should have the administrative powers to do so when a bank meets the trigger conditions for entry into resolution, regardless of a specific contractual provision.

In order to make this instrument flexible, resolution authorities - in addition to the power to write off equity and write down and convert subordinated debt - may be given the power, on a discretionary basis, to write down and convert into equity all senior debt deemed necessary to ensure the bank is returned to solvency (*comprehensive approach*). An alternative approach would be the power for resolution authorities to require banks to issue a fixed amount of "bail in" debt (*targeted approach*).[40]

The contractual option does not seem to raise major problems from a legal point of view, since the conditions for haircutting debts and the triggers for conversion are formalised in a private contract. Here, the problem is represented by the implications in terms of the cost and availability of funding, which could require specific rules to incentivise the use of convertible debt instruments by investors and intermediaries, who will demand higher remuneration to compensate for major risk. Some questions arise from this option: can banks raise

---

[38] C. PAZARBASIOGLU-J. ZHOU-V.LE LESLE'-M. MOORE, *Contingent Capital: Economic Rationale and Design Feature*, IMF Staff Discussion Note, January 25, 2011; M. MOORE, *Contingent Capital and Statutory Bail-in Within a Crisis Prevention/Crisis Resolution Framework*, Speech held at the Workshop "*How promising are contingent capital instruments and bail-ins to strengthen financial stability?*, Brussels: Bruegel, 11 February 2011.

[39] M. KING, Speech to Scottis Business Organisation, Edimburgh, 20 October 2009; G. DE MARTINO-M. LIBERTUCCI-M. MARANGONI-M. QUAGLIARIELLO, *Countercyclical contingent capital (CCC): possible use and ideal design*, Questioni di Economia e Finanza (Occasional Papers), Banca d'Italia, Number 71, September 2010.

[40] EUROPEAN COMMISSION, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution, DG Internal Market*, Working Document, 2010, p. 89.

contingent capital from private investors? Should banks be obliged to underwrite each other's contingent capital?

A more complex and challenging issue seems to be the statutory model, which requires the in-depth analysis of the various legal implications that it can raise. On one hand, it should be considered that the envisaged measure is effective, because every crisis can be resolved in a timely manner with the haircut of debts and the conversion of them into capital. On the other hand, administrative authorities are given strong powers to resolve the crisis in a way that implies the non-fulfilment of the failing bank's obligations, undermining the essential aspects of private and bankruptcy law and the core aspects of the functioning of the financial system. In essence, this solution institutionalises the principle that creditors shoulder the costs of the failures of large banks rather than taxpayers.

The main question is whether a supervisory authority or another crisis management administrative authority can be given the power to authoritatively decide to haircut the debt or convert it into capital. Can creditors' rights be affected by an administrative decision?

From a general point of view, it is conceivable that such a solution is justified by the consideration of the systemic relevance of the bank and the need to avoid major disturbances to the bank's stakeholders and the entire financial system. Nevertheless, one should ask if a general public interest can be invoked to sacrifice private interests supported by civil law and, in some countries, by constitutional law.

In particular, since a haircut may result in interference with the property rights of bonds, the legal basis of this option deserves appropriate reflections, in order to avoid that the legal certainty of the entire resolution package put in place to restore the bank be challenged before the courts. This may constitute a disincentive to using the instrument.

From an economic point of view, a haircut applied *ex-ante* is more advantageous for creditors than that applied *ex-post* in the course of insolvency proceedings, as normally happens. However, it could be argued that in the case of official liquidation, specific rules apply with respect to creditors' rights. In ordinary bankruptcy proceedings, this solution is possible with the consent of creditors and the court's approval, even though it is time consuming and not necessarily consistent with the need for rapid resolution.

Furthermore, because this solution is carried out on a going concern basis, the whole operation could favour shareholders after the restructuring process. So, specific mechanisms should be identified: i) the first step should be the reduction or the annulment of the capital to cover the losses; ii) then, the conversion of debts into capital should follow in order to allow creditors to recover their claims from the future business management (their recovery will be incorporated in the future value of the bank); and iii) for the haircut, it is necessary to identify some kind of compensation for creditors subject to the haircut, namely the return to

them of any major recovered amount with respect to the initial devaluations or write downs of assets.

So, a properly designed framework for the use of administrative powers is essential, in terms of:

i) a clear definition of the categories of banks covered by the mechanism of haircuts. The question is whether to apply such a measure only to systemic banks, with the exclusion of small and medium-sized banks;

ii) the triggers for the application of the measure;

iii) the kinds of debt instruments subject to write down (for example, unsecured and uninsured debts, with exclusion of retail deposits and perhaps interbank credits and secured debt, including covered bonds), with the problem that in cross-border crises the rules concerning the priority ranking of creditors are not harmonised. Further reflections need to be made for certain kinds of instruments, such as swaps, repos, derivatives and other short-term debt.

iv) the determination of the amount of the write down, depending on the estimated losses in the short timeframe normally available for such decision; and

v) the forms of compensation for haircut creditors. In theory, the maximum amount of the haircut should be equivalent to the losses that unsecured creditors would be charged (ex-post) in the case of liquidation under insolvency proceedings. In cases where creditors are left worse off than in insolvency-specific mechanisms compensation should be required. In some cases, the conversion of debt into equity may represent a form of compensation.

These are all topics of extreme importance, which require due consideration of the possible contagion effects on investors and other financial institutions that hold the bonds subject to haircut. Finally, the possible negative effect of the existence of the administrative power to the haircut should be evaluated, since creditors could be induced to withdraw their claims at the first signs of a bank's difficulty, thereby exacerbating the problems of the bank.

4.3.2 Gone concern solutions.

As to the tools available for gone concern solutions – that is when a bank has no chance of returning to profitable business – we may consider the following instruments for an orderly resolution:

i) **the sale of all or part of a bank's business** (rights, assets and liabilities) to another financial institution without the consent of shareholders. The transfer should be carried out in a transparent way and through competitive means in order to maximise the value of the transferred business;

ii) **the institution of a "*bridge bank*"** by authorities responsible for crisis resolution, to which all or part of the assets and liabilities of the failing bank are transferred. This is a temporary bank, wholly owned by one or more public authorities, which manages the business for a certain period of time with a view to arranging a permanent solution. A key issue is the appointment of the directors and managers for the management of the bridge bank in the transitional period as a commercial enterprise;

    Another important issue is the treatment of the shareholders and creditors of the affected bank, which should not have any right over the bridge bank, but only on the residual value realised from the sale of the bridge bank after the payment of all other creditors and expenses connected to the crisis management. As a consequence of the transfer of the "core" business, the residual bank should be wound up and all losses connected to it should be charged to shareholders and uninsured creditors.

iii) **the bad bank/good bank separation**, which consists of the separation of performing assets from non-performing or difficult to value assets, transferring the latter to a special vehicle (*bad bank*) in order to cleanse the balance sheet of the troubled bank. In this case the evaluation of assets is a critical issue, depending on the entity (private or public) that finances the operation. Moreover, if the transfer of assets is accompanied by a partial transfer of liabilities, the principle of the equal treatment of creditors (*par condicio creditorum*) should be preserved.

The application of resolution tools implies the adoption by authorities of resolution powers to transfer shares or business to another bank, to write off or cancel shares, to write down or convert debt or to replace management or impose a temporary moratorium on the payment of claims.

The effectiveness of these measures requires that authorities are able to exercise their powers irrespective of any restrictions on (or requirement for the consent of) the transfer of the rights, assets and liabilities that might otherwise apply. Moreover, they should be able to provide for continuity arrangements, such as i) the continuity of contracts entered into by the transferor, so that the transferee assumes the rights and liabilities of the transferor relating to the business that has been transferred and is substituted for the transferor in all contractual documents; and ii) the substitution of the transferee for the transferor in any legal proceedings relating to the transferred business.

As to the interference of resolution tools and powers with the rights of shareholders and creditors,[41] the legal framework should provide for some forms of compensation and adequate mechanisms to determine the right amount of compensation. To this end, a general principle outlined at the EU level is that "compensation should ensure that creditors do not receive less favourable

---

[41] On this issue, see E. HUPKES, *Special Bank Resolution and shareholders' rights: balancing competing interests*, Journal of Financial Regulation and Compliance, Vol. 17, No. 3, Emerald, Bingley, 2009.

treatment as a result of the application of the resolution tool or use of resolution power than they would have received if the resolution tool or power had not been used and the entire credit institution had, at the point when the resolution tools were applied, instead entered insolvency under the applicable national law".[42] This principle is correct and it could also be more advantageous in some circumstances from a substantial point of view, but it is not the same for affected third parties from a legal point of view, given the different proceedings followed for the determination of the compensation value in respect to insolvency proceedings.

In this framework, specific rules should be issued to allow certain restrictions on the rights and contracts of the bank under resolution so that the resolution authority may dispose of the time necessary to arrange and effect the transfer. This is the case for a temporary suspension of all close out rights of any party under a netting arrangement or a temporary suspension of any payment or delivery obligations related to contracts to which a bank is a party. Problems here are related to: i) the extent of the obligations and contracts that could fall under the suspension, with the problem of the treatment of eligible deposits (which could also be affected by the suspension); ii) the duration of the suspension, which could be restricted just to a few days; iii) the clear determination of the starting date and the expiry date of the suspension (the "*dies a quo*" and the "*dies ad quem*" of the suspension period); and iv) the disclosure to the public of the suspension.

Specific issues arise in the case of partial property transfer, namely when not all assets, liabilities and rights have been transferred to the transferee and some creditors' claims remain with the transferor's bank and when the authority could modify or cancel the terms of contracts. In these cases appropriate safeguards should be provided for in favour of creditors and counterparties that are affected by the transfer to prevent the resolution authority from "*cherry picking*" transfers, which could negatively affect some counterparties. Such safeguards should apply, in particular, to security arrangements, title transfer financial collateral arrangements, set off arrangements, netting arrangements and structured finance arrangements. Moreover, as a consequence of such resolution measures (the transfer, modification and cancellation of contracts), the specific provisions of the Settlement Finality Directive (Directive 98/26/EC) for trading, clearing and settlement systems should be kept under consideration.

Compensations and safeguards are essential components of a resolution framework, which protect the infringement of the rights of different stakeholders outside the rules and procedures normally provided for in insolvency proceedings, where a central role is played by judges and courts. That is why another binding element of the resolution framework should be the accountability of the resolution authorities. This could recognise the right for those persons affected by resolution tools and powers to apply to the court for the judicial review of decisions taken

[42] EUROPEAN COMMISSION, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution*, cit., p. 63.

by administrative authorities. To what extent the court could review or reverse wrongful decisions or actions taken by resolution authorities and which remedies could be adopted is a delicate and open issue.

4.4 The liquidation.

This is the last option available. It can be adopted when other resolution measures cannot be pursued, in that it implies the assemblage of all assets and their conversion into cash, which will then be distributed to creditors according to the rules provided for by the bankruptcy law or other equivalent insolvency law applicable to banks.

In this case, the bank ceases to exist as a legal entity and all relationships with counterparties terminate and the organisational structure is dismantled. Depositors are protected by DIS interventions.

The powers of administrative authorities in a winding up process are (should be) relevant in order to ensure the minimisation of costs for creditors and other stakeholders. In countries where the liquidation of banks falls within the competence of the courts, administrative authorities should have significant powers in the phase of the opening of the proceedings. They should at least have the power to petition the court for winding up the bank and they should be consulted before the decision is taken.

The role of the administrative authority is also essential in the phase of the liquidation process, because this could take place in many forms. Indeed, alternative ways of liquidations could be activated with the purpose of safeguarding the provision of some financial services and contracts through the sale "en bloc" of them to other interested financial institutions.

An important issue concerning winding up is its application to banking groups, which often lacks of a specific discipline at national level, with consequent problems for creditors and other involved parties. Major problems arise when the liquidation has to be applied at international level, both to banks and to banking groups, given the substantial differences existing among national insolvency laws. This is a sensitive field, because it is strictly linked to other areas of national laws, such as property, contracts and commercial law and priority. So, the problem is how to harmonise these different regimes in a concrete and realistic way.

5. Cross-border issue for internationally active banks.

5.1 A single crisis management *rule-book* for European banks?

Effectively handling cross-border banking crises is a complex issue. International banks typically have systemic relevance; however, they are

"international" in business but "national" in jurisdiction (in terms of applicable law and regulations). So, the crucial problem is how to deal with these intermediaries or banking groups that are "single entities" from an economic point of view and are subject to different rules applicable in each jurisdiction in which they operate through branches or subsidiaries. In the normal activity of the group this issue is reflected in sharing competences between the home and host authorities, according to the provisions of memoranda of understandings (MOU) stipulated among them. But, when things go bad and the bank is failing, the problem becomes of paramount importance, because crisis management authorities need to handle complex institutions in a coordinated way and according to a uniform approach.

Here, there is a wide range of interests to address, with many jurisdictions and authorities involved, which tend to apply their own rules and instruments. There could be the risk that transfers of assets between the different entities of the group in different countries take place, with possible damage for some components in favour of others, which could remain without compensation in an uncertain legal framework.

Unlike supervision, where a harmonised set of rules is being defined at the European level, a *single rule-book* for crisis management is more difficult to design. Insolvency laws and resolution tools are different across single jurisdictions and a reasonable balance needs to be pursued in order to transfer sovereignty from the national to the European level without the significant sacrifice of each country's autonomy, even though this is unavoidable. For this purpose, international authorities are identifying new principles, setting out a common toolkit and a framework for a clear allocation of powers and responsibilities among the authorities and countries involved in the management of the crises. One of the main issues is to decide who has to take the leadership in arranging and implementing the resolution plan. The need to solve a problem strictly connected with the peculiarity of these financial institutions has been well underlined: they are "global" in the normal course of business, but become "national" when they go bankrupt, because it is necessary to apply national rules for resolution or insolvency, or to make recourse to national taxpayers to pay the cost.

The strengthening of the coordination in the management of a cross-border crisis among the authorities involved is essential (who decides). Another "core" element is to define instruments for the resolution that can be activated at the group's level, the only approach that can minimise the costs for the stakeholders located in different countries. However, what might seem to be the best solution is not always the simplest to pursue. National traditions and approaches are deeply rooted in each jurisdiction. After all, given the complexity of the issues involved and the little experience in handling this sort of crises, we cannot say there is an optimal reference model.

Many countries are in favour of a solution that requires cross-border financial institutions to operate in host countries through subsidiaries rather than branches, in order to enable the ring-fencing of local assets and a more focused supervisory

control by the host. Others - among which is the European Commission – follow a radically different approach, according to which the entire group should be considered as a whole and ring fencing should be prevented (obviously with the appropriate safeguards in the case of the transfer of assets within the group).

5.2 Which model for cross-border banking insolvency?

In theory, two extreme approaches in managing the insolvencies are possible: i) the *universal resolution* approach (single entity resolution); and ii) the *territorial resolution* approach (or *ring fencing* approach).

The first model, the *universal resolution approach*, aims at resolving the insolvency of the cross-border banking group by applying the laws and rules of the parent bank country; these rules are applicable to all components of the group including those established in other jurisdictions. There are different ways to apply this model. One could be a "strong" coordination of the proceedings opened with regard to each legal entity located in the different countries, with a primary role of the procedure of the parent bank; another one could be to realise a "*pooling of assets*" of the different entities of the group, considering them as a single economic entity. This approach would require a shared legal framework at an international level, probably in the form of an international treaty regulating the legal instruments to resolve cross-border banking crises and criteria for sharing the burden of the crisis between the different countries involved.

This approach characterises the Directives concerning the banks and the insurance companies, with some mitigations. It ensures certainty with regard to the applicable law and the insolvency proceedings, which regulate crises in banks with branches in multiple Member States.

The second model, the *territorial resolution approach*, is based on the application of separate procedures to each entity of the banking group in the respective jurisdictions of establishment, which implies the entrustment of the management and resolution of the crisis to the national authorities of the countries involved. This approach considers that a potential conflict of interests exists between home and host authorities, because of the different resolution regimes and host authorities' reluctance to lose their sovereignty in the management of the crisis.

It aims at protecting national stakeholders by ring fencing the assets that belong to local entities. According to this scheme, each national jurisdiction applies its own domestic legislation and governs insolvency proceedings for the components and the assets of the entity located in its own jurisdiction.

The territorial model implies that national authorities try to protect the stakeholders of local entities not only during a resolution process, but also during the "on going supervision", through specific regulatory and supervisory

measures, such as the requirements for assets retention and limitations to intra-group transactions, including asset transfer (*supervisory ring fencing*).

This is applied, for example, in Italian Bankruptcy Law, which provides for the declaration of the insolvency of a firm that has its head office abroad, even if it has gone bankrupt in another jurisdiction; no coordination with other proceedings opened in other countries is provided for.

The matter is complex on its own; depending on whether we choose the first or second model, there are different implications in terms of the changes in each national legal framework, including the rules related to corporate and bankruptcy law and the criteria regarding the burden sharing among the countries involved in the crisis. The choice between the two approaches is no simple task, because each of them has specific strengths and weaknesses. After the financial crisis, we should be especially aware that no optimal model exists.

There is no doubt that the ideal approach could be the first one, as it tends to treat a banking group as a single entity and the management and coordination of the crisis is conducted by the authorities of the parent bank. This solution would require the definition of a multilateral treaty to oblige countries to participate in a coordinated international resolution process, possibly under the jurisdiction of an international tribunal or resolution authority. But, this cannot be considered a feasible option at this time, because few countries could agree to lose part of their national sovereignty in this field. However, it cannot be excluded that in the more integrated area of the European Union this could be a realisable model.

A more realistic approach, at least in the short-term, would be to choose the second model, which is currently in use worldwide, and improve it with appropriate measures. Indeed, we cannot underestimate that for global financial institutions it is in some way unrealistic, and perhaps ineffective, to rely on the home supervisory authority to control on a consolidated basis the entire group. Moreover, the recent crisis has shown that these intermediaries are too big to be internally controlled by the same parent company. This was the case of the Icelandic crisis, where financial institutions had become "too big" for the home jurisdiction to provide effective consolidated supervision or to take the necessary crisis management and resolution actions. As underlined by the Basel Committee, "cross-border expansion can create its own risks of unmanaged growth in the absence of effective supervision by home authorities"[43]. The case of Icelandic banks revealed also how national resources can be limited in relation to the financial costs of the crisis. As a consequence, when a crisis is looming, the behaviours of the different entities could not be well coordinated and some "coordination" failures may provoke distortions and damages for some entities of the group. So, it should be carefully evaluated the opportunity to set up a multilateral supervision of banking groups, with a stricter coordination by the lead

[43] BASEL COMMITTEE ON BANKING SUPERVISION, *Report and Recommendations of the Cross-border Bank Resolution Group*, Bank for International Settlements, March 2010.

supervisor, considering the effectiveness that could derive from the contribution of host authorities.[44]

From this more realistic perspective, a member of "intermediate" approaches have been envisaged. One of these solutions may consist in the resolution of a financial institution by the country in which the institution is headquartered. Host authorities could defer and cooperate with the resolution brought by the home country authorities, under certain conditions. This could entail separate insolvency proceedings being managed by host countries, but remitting the proceeds to the home country resolution. This approach, however, would also require some harmonisation of rules on national resolution regimes and the treatment of creditors. This combines the positive aspect of the central coordination of the crisis by the supervisory authority of the parent bank with the significant role of host authorities.

This approach is provided for by EU Regulation on insolvency, which does not apply to financial institutions. We may have the opening of a principal proceeding in the home country and the possibility of the host country opening a secondary proceeding when there is at least one branch in this country. This secondary proceeding has effects and jurisdiction on the assets related to this branch, outside the principal proceeding. After the reimbursement of the creditors of the secondary proceeding, only the remaining part will be conferred to the principal proceeding.

Cross-border issues are relevant in all phases, from crisis prevention and early intervention to crisis management, resolution and liquidation, because a coordinated action between the competent authorities of different countries is essential both in supervision and in crisis management. The problem here, especially at the European level, is to identify a right balance between decentralised controls (national supervisory authorities, colleges of supervisors) and centralised control (EBA). The role of colleges of supervisors is increasing at the European level after their formalisation in legislation, but their activation is now on course also at a global level, as requested by the FSB. The constitution of "resolution groups" should be a further step, since for group-wide restructuring binding agreements should be reached between home and host authorities. This

---

[44] J. LIMPSKY, *Towards an International Framework for Cross Border Resolution*, delivered at the ECB and its Watchers Conference XII Frankfurt, Germany, July 9, 2010. According the Author, "We would envisage establishing an international framework under which countries would agree to cooperate with each other if certain conditions are met. The establishment of such a framework may involve changes to legislation at the national level that would enable such cooperation to take place. The framework would consist of four principal elements: i) countries would amend their domestic legislation to permit their own authorities to cooperate in an international resolution whenever they view such cooperation as being consistent with the interests of creditors and financial stability; ii) participating countries would adhere to "core coordination standards" that ensure that their national supervisory and insolvency frameworks are sufficiently robust; they would agree on the criteria and parameters that would guide the burden sharing process among the members of the coordination framework; iv) finally, they would agree on procedures for coordinating resolution measures across borders, including the cross-border recognition of measures taken in other countries".

could be the right forum to define rules for deferring powers to the home authority and burden sharing agreements.

The complexity of the issue will require very important political decisions, considering that different approaches are to be used to deal with them. Choices depend on many factors, especially on the objectives pursued, ranging from the management *strictu sensu* of the crisis (the decision-making process) to the definition of the *burden sharing* rules between the countries involved.[45]

In Europe, cross-border issues imply the extension to banking groups of the Directive on the reorganization and winding-up of credit institutions (directive 2001/24/EC of 4 April 2001), in the context of more harmonized corporate and bankruptcy legislations. For example, when an insolvency proceeding is applied to a parent bank, its rules should affect all the branches and subsidiaries located in other European countries. The project is complex and ambitious, because it touches many sensitive aspects of national jurisdictions. That is why it entails a very high level political decision.

A possible alternative solution to a harmonisation directive could be the creation of a 28' regime on crisis management and resolution, which would be applicable to banks and banking groups operating across borders. This framework - already applied to the European Company - would have the advantage of designing a complete and uniform procedure for cross-border banks, which would also identify clear competences for the intervention, direction and control of the proceeding, without requiring relevant changes at a national level.

5.3 The EU group resolution: who is in charge of managing the crisis?

The starting point for the EU authorities is that it is difficult to design an integrated resolution model for cross-border banking groups in the absence of a harmonised insolvency regime and a single European supervisory authority for those entities.[46]

On this basis, the strategic option, which is being outlined at the EU level in the new crisis management framework, is the definition of a common set of resolution tools and powers available for resolution authorities in order to facilitate coordinated actions in the case of the failure of a cross-border banking group. Without harmonisation, cooperation and coordination are the key aspects of the envisaged approach.

The organisational mechanism necessary for this cooperation and coordination is the creation of **resolution colleges** for group entities, which

[45] C.A.E. GOODHART-D.SCHOENMAKER, *Fiscal Burden Sharing in Cross-Border Banking Crises*, International Journal of Central Banking, Vol. 5, No.1, 2009.

[46] EUROPEAN COMMISSION, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution*, cit., p. 75.

mirrors the same model of supervisory colleges. The college should be chaired by the resolution authority responsible for the EU parent bank (the group-level resolution authority), which should be responsible for crisis planning and the preparation of resolutions plans, possibly including burden sharing.

The **group-level resolution authority** should have the power to decide in the cases of group failure the appropriateness of the group resolution schemes in cooperation with the other resolution authorities involved, which would be responsible for the implementation at a national level of the group resolution scheme against the individual legal entities.

Work to define common principles and the approach for an effective resolution at a global level is currently underway within the FSB and G20 with the aim of providing for the constitution of resolution groups for internationally active groups. Thus, at this broader level, it is also crucial to identify a common resolution framework, based on a harmonised set of tools and authorities' powers, within a cooperative and coordinated context.

5.4 The critical issue of intra-group asset transferability.

One of the most critical issues in crisis management is the possibility of transferring assets among different entities of a group as a mean to overcome liquidity problems. This issue is present in domestic legislation regulating intra-group transactions, but it takes a specific relevance in cross-border situations, where different legal frameworks may hinder effective crisis management.

Some national legislations restrict intra-group asset transfers, based on the principle of corporate legal personality. In these countries, ring fencing assets is a normal practice for the protection of creditors and the minority shareholders of each entity. Only a few national legal systems give relevance to the concept of "group interest", which consider the indirect interest that each entity of the group has in the wellness of the group as a whole. The problem here is that rules differ country by country and no legal certainty is ensured to the parties involved.

In the normal course of business, the transfer of assets between the various components of the group would be an ordinary transaction within the overall financial strategy of the group, which is considered as a single enterprise. Intra-group financial support may take place in a variety of forms (loans, guarantees, provision of collateral, injection of new capital). The delicacy of this topic resides in the conflict that can materialise between the consideration of the group as a whole (group interest) and the legal and financial autonomy of each entity. This is especially true when the internal movement of financial resources may result in an enrichment of some companies (the beneficiary of the assets) at the detriment of other entities (the transferor of the assets), whose creditors and shareholders may be affected if things go bad.

In distressed situations, some things are in some ways different. Conflicts between the consideration of "group interest" and individual interest are stronger, because the transfer of assets by the transferor is riskier than it would be in normal conditions. In these cases, the definition of whether and under which conditions the transfer of assets may take place within the various components of the banking group is of crucial importance. Many questions arise about who can grant financial support, the possible responsibility of the management, the financial terms of the support, the possible consequences of the transferee's default and the role of the supervisor.

A preliminary distinction could be based on the conditions of intra-group assets transfers, depending on whether they are made on commercial terms ("arms length") or not.

The first category (transactions on commercial terms), in general, consists of ordinary transactions within the group, but if the supported entity faces liquidity stress the transaction could prove riskier. So, in these cases it is not easy to assess what "commercial terms" should mean, because it should be proven that other counterparties would be available to enter into the same transaction at the same conditions (in terms of type of transaction, asset classes transferred, conditions for transfers, evaluation of assets, collateral, etc). This is the reason why some countries establish restrictions to intra-group asset transfers even though they are based on commercial terms.

As a consequence, a possible change in European legislation – in light of the new crisis management framework – should remove the obstacles to "arms length" intra-group transactions, introducing specific conditions, such as the preliminary shareholders agreement (with appropriate speeding up procedures) in order to allow managers to operate with confidence and to limit legal challenges that minority shareholders and creditors may bring against them.

The second category of asset transfers (transactions not on commercial terms) is more critical, since it more clearly evidences that transactions are made in support of a component of the group in order to prevent that the crisis of one entity could determine the failure of other entities or the entire group. Transactions of this kind are more justifiable than those of the previous category, in light of the "group interest", based on the concept of solidarity between the different components of the group. The problem here is that the concept of "group interest" is not provided for in many national company laws and is not recognised in insolvency laws.

A possible regulation of this kind of financial support is more challenging, because conditions for granting support should be more stringent in terms of the need to preserve the financial strength of the transferor and its continuing capacity to meet prudential requirements. Jurisprudence in some European countries[47] has identified some conditions that could usefully constitute the basis

[47] One of the jurisprudential cases is that of Rozenblum case law, French Cass. Crim, 4 February 1985.

for further analysis on a possible discipline, fixing the right balance between the need for financial stability of the entire group (group interest) and the interests of the single companies, which remain in any way autonomous pursuing their own interest (especially creditors and minority shareholders).

This jurisprudence has stated that: i) transactions should take place within a policy (agreement) elaborated by the group as a whole; ii) financial support should cover some return to the company providing the assistance and that the balance of the mutual obligations is preserved; and iii) financial assistance should not exceed the capacity of the company that supports the burden. These principles imply that mutual support cannot take place on a unilateral basis, but rather that there is a certain "quid pro quo" between entities in order to avoid that one partner is always on the losing side. Moreover, it means that support should not be given in a context of insolvency or without guarantees if it exceeds the capacity of the creditors.

In general, financial support may be granted only if there is a reasonable prospect that it will be able to make the beneficiary entity overcome the difficulties and that the financial stability of the group as a whole is preserved. Moreover, it should only be granted if the transferor complies with the prudential requirements and if reasonable certainty exists that the loan will be reimbursed by the entity receiving the support.

So, intra-group asset transfer during a crisis situation is a delicate issue. Specific safeguards should be established in the agreement for the protection of minority shareholders and creditors of the transferor, such as:

a) approval by shareholders' meeting, which authorises the management body to provide financial support;

b) procedures and criteria for the evaluation of the assets;

c) technical conditions of the transferor and the transferee;

d) revocation rules if the transferor goes bankrupt, namely the power of the liquidator of the transferor to have "claw back" action to recover the transferred assets against the transferee.

e) in the case of transferee's insolvency, the provision of priority rules for the transferor on the "estate" of the transferee with respect to other (unsecured) creditors.

f) disclosure of information regarding the agreement.

A specific involvement of supervisory authorities should be provided for, with the specification of their powers, such as the authorisation of the agreement, especially in cross-border transactions. Consequently, the supervisor of the transferor could have the power to prohibit or restrict financial support when the transfer of assets threatens the liquidity or solvency of the transferor or financial stability.

At the EU level this topic should be disciplined within the framework of the CRD (article 129), with a prominent role for the consolidating supervisor

within the college of supervisors in order to reach a common decision in a short timeframe. Moreover, a specific role could be recognised to the EBA, as a mediator in the case of disagreement among the members of the college.

On these aspects, the specific provisions of the Italian Civil Code and banking law regulating banking groups could be a useful term of reference. In both normative sources, there is no ban on intra-group transactions, so that in some way the consideration of the "group interest" may assume juridical relevance, upon certain conditions in terms of responsibility and disclosure requirements. The responsibility principle is provided for by article 2497 of the Civil Code, according to which the companies exercising direction and coordination activity on other companies, when acting in their own interests or of other entities in violation of the principles of correct management, are directly responsible towards shareholders and creditors of those companies. Responsibility towards shareholders could derive from prejudices caused to the profitability and the value of the holding company, while responsibility towards creditors could be connected with any damage caused to the integrity of the capital of the controlled company. However, responsibility can be avoided when the damage could be compensated for by the overall successful result of the direction and coordination activity or eliminated as a result of specific operations. Shareholders and creditors can act against the company exercising direction and coordination activity only if they have not been satisfied by the company subject to the direction and coordination activity.

Disclosure requirements are also relevant. Article 2497-bis of the Civil Code provides for the communication to the Register of the Enterprises of the company exercising direction and coordination powers and of the companies subject to those powers; this information must also be given in all the acts and correspondence of the company. Moreover, administrators must indicate all relationships with the company exercising the direction and coordination activity as well as the effects of this activity on the annual balance sheet results.

Another important provision on this issue is contained in article 99 of the Banking Law, which provides for, in the case of the insolvency of the company damaged by the activity of direction and coordination, a special revocation regime (the so-called aggravated revocation) for damaging operations conducted before the liquidation of the bank.

If there has been a judicial finding of insolvency, the liquidators are responsible for bringing the claw back actions (referred to in article 67 of the Bankruptcy Law) with respect to other companies belonging to the group. Such actions may be brought for the acts specified in article 67, subparagraphs 1), 2) and 3) of the Bankruptcy Law, which were effected in the five years prior to the compulsory liquidation decree (anomalous transactions) and for the acts specified in subparagraph 4) and in the second paragraph of this article (normal transactions), which were effected in the three years prior to the order. So, for these transactions the "suspect period" is longer than it is in an ordinary regime for

commercial insolvency, where it ranges from six months or one year, depending on the nature of the operations.

6. Sharing the burden of the crises (who pays the costs?).

Another crucial issue is who has to pay the cost of the crisis or, similarly, who will be charged for the losses deriving from the crisis. As discussed, the purpose of the new framework is to prevent the crisis from occurring, by strengthening preventive measures by banks and supervisory authorities. But, no measure can guarantee that banking crises will not occur. In this case, an early intervention by authorities with the tools outlined above can turn out to be effective at finding out adequate solutions involving private parties' initiatives.

But when a bank becomes insolvent, namely when its liabilities are larger than the value of its assets, shareholders might not be able to solve the crisis by themselves. In these cases, the critical issue is to identify who can inject the *Capital of Last Resort* into the bank, in other words which category of stakeholders eventually has to pay the bill.

The first rule is that the cost of the crisis should be paid by the stakeholders of the bank itself. As said before, shareholders should, in principle, bear the losses originated by bad management and this could lead to the annulment of capital. If losses are higher than its capital, a second rule/step could be that losses are charged to investors in subordinated debts and hybrid instruments issued by the bank, according to the contractual rules, because these are "like capital" instruments. The third rule/step is that uninsured depositors and other creditors bear the losses, along the lines of the proposal of *haircuts* and conversion into equity described above, as they can be somehow considered responsible for choosing the bank to which they entrusted their savings.

The third step could be different, in the sense that after the annulment of capital, exceeding losses, as opposed to uninsured depositors and other creditors, could be covered by external funds such as a *resolution fund* set up by the banks themselves to be activated jointly with other resolution measures. In this case, the coverage of losses is ensured not by the stakeholders of the problem bank, but by the banking system as a whole. This is the application of the "*polluter pays*" principle, taken from environmental policy, according to which those responsible for causing the crisis pay all costs.

The ultimate step is public intervention. However, this option should be avoided for many reasons, including the unsustainability of public finances and *moral hazard* concerns. Moreover, in international crises, if public intervention is unavoidable, clear *ex-ante* guidelines on *burden sharing* criteria should be established.

6.1 The role of deposit guarantee schemes (DGSs).

Within crisis management and resolution policy, a key role should still be played by deposit insurance schemes. The lesson learned from the financial crisis - especially from the failure of Northern Rock failure – is that "no bank, whether sound or ailing, holds enough liquid funds to redeem all or a significant share of its deposits on the spot. This is why banks are susceptible to the risk of bank runs if depositors believe that their deposits are unsafe and try to withdraw them all at the same time. This can seriously affect the whole economy".[48]

In the Northern Rock case, the existence of a DGS could not prevent a bank run from occurring, since depositors considered the level of protection granted by the UK compensation scheme (20,000 euros) too low.

6.1.1. The first step of the reform.

A clear need for a reform of deposit insurance schemes emerged. In Europe, Directive 2009/14/EC of 11 March 2009[49] was introduced to remedy certain critical aspects of the previous Directive 94/19/EC, for converging deposit-guarantee schemes. In order to maintain depositor confidence and attain greater stability in the financial system, the previous level of coverage of 20,000 euros was increased to 50,000 euros and subsequently to 100,000 euros, "unless a Commission impact assessment, submitted to the European Parliament and the Council by 31 December 2009, concludes that such an increase and such harmonisation are inappropriate and are not financially viable for all Member States in order to ensure consumer protection and financial stability in the Community and to avoid distortions of competition between Member States". Another relevant change in the new framework was the abandonment of the possibility to have the coinsurance principle in place, so that depositors could be paid up to the insured amount without bearing losses.

In particular, it has been evaluated that a higher level of coverage can contribute to improve depositor confidence (and market confidence) in situations of instability. From this perspective, the recent financial crisis highlighted the role that DGSs may play not only in terms of the protection of depositors, but also in terms of the mitigation of market stress in acute crisis situations.

Another important innovation of the Directive is the acceleration of the terms of reimbursement to depositors. The payout delay, currently between three months and nine months, was reduced to 20 working days from the date on which

---

[48] EUROPEAN COMMISSION, Impact Assessment, Commission Staff Working Document, *Accompanying document to the* Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes (recast), Brussels, SEC(2010) 834/2.

[49] DIRECTIVE 2009/14/EC OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 11 March 2009 amending Directive 94/19/EC on deposit-guarantee schemes as regards the coverage level and the payout delay.

the competent authorities make their determination or a judicial authority makes a ruling concerning the unavailability of deposits. That time limit includes the collection and transmission of the data on depositors and deposits, which are necessary for the verification of claims. That period can be extended only under exceptional circumstances and after approval by the competent authorities.

Furthermore, in cases where the payout is triggered by a determination of the competent authorities, the decision period of 21 days currently provided for should be reduced to five working days.

It is also provided for that two years after the entry into force of the Directive, the Commission should submit to the European Parliament and to the Council a report on the effectiveness of the payout procedures assessing whether a further reduction in the delay to 10 working days would be appropriate. Only in exceptional circumstances can a deposit guarantee scheme apply to the competent authorities for an extension of the time limit, which in any case cannot exceed 10 working days. Furthermore, Article 12 of the Directive requires the Commission to submit to the Council and to the European Parliament a report on the possible further harmonisation of European guarantee schemes, including the benefits and costs of the possible introduction of a Community-wide deposit guarantee scheme.

The harmonisation of these two main aspects of the deposit insurance at the European level - the increase in coverage and the speeding up of the reimbursement – has contributed to a substantial improvement in the regulation in this field. But shortcomings and significant differences among countries remain, in terms of subjective and objective protection (kind of depositors, eligible instruments, levels of coverage), financial obligations imposed on banks, the financial strength of systems and disclosure towards depositors.

In general, many questions have been raised about the role and functioning of the DGS. It has been definitely proven - as a result of the previous theoretical debate - that this instrument cannot be used to deal with systemic phenomena, which in fact have been handled with recourse to public money. A deposit guarantee system should maintain its key function of protecting depositors of small and medium-sized banks, but cannot resolve big banks or systemic crises. So, its role in the resolution of large and complex financial institutions should be established.

In the US, for example, the financial crisis - in addition to the collapse of major investment banks, resolved via extraordinary public interventions - brought about the demise of hundreds of small banks, which were supported by the FDIC, according to its consolidated capacity to step in and operate as a *receiver* (transfer of insured deposits, A&L transfer and so on).

6.1.2 The second step of the reform.

There are many ways to further improve the DGS. Choices that should be made by policymakers depend on the overall design of crisis management and

resolution that will be established at a domestic and at an international level. The debate on the possibility of the further harmonisation of deposit insurance schemes is at an advanced stage at the European level. An effort has been made to identify the essential components of a good design of a DGS, based on "best practices" followed worldwide. Among these, the most important issues are funding and funding mechanisms (*ex-ante* or *ex-post* mechanisms), contribution criteria (risk-based premiums), the function of DGS in the resolution of large and complex financial institutions and the role of the State.

These are key questions and, after the international crisis, unless we want undue distortions in DGS intervention in cross-border bank insolvencies, there should not be room for national responses. In fact, a uniform set of rules and standards averts the unequal treatment of depositors in different countries and discrepancies in the utilisation of DGS in the support of other resolution measures on the transfer of deposits or of assets and liabilities to other banks, reducing the effectiveness of crisis management.

From this point of view, 18 "core principles" jointly issued by the Basel Committee and the International Association of Deposit Insurers (IADI) in June 2009[50] certainly go in the right direction, on the basis of the inputs given by the FSB in 2008.[51] They represent a new general framework for policymakers in designing or improving a deposit insurance scheme. The principles aim at establishing broad guidelines for the main aspects of DGS,[52] whose application should make a DIS more effective, in any way leaving countries free to introduce supplementary measures in order to take into account specific national circumstances. In order to facilitate the implementation of these core principles, specific explanations and supporting guidance have been given for each principle. Furthermore, the joint report stresses the importance of the following preconditions for an effective DGS: the ongoing assessment of the economy and banking system; sound governance of agencies comprising the financial system safety net; strong prudential regulation and supervision; and well-developed legal framework (business law, including corporate, bankruptcy, contract, consumer protection and private property law) and accounting and disclosure regime.

Subsequently, a further step forward has been made towards the effective implementation of the core principles, establishing an appropriate methodology for the assessment of a country's compliance with the principles, based on "essential" and "additional" criteria for each principle.[53] They may be used in

---

[50] BASEL COMMITTEE ON BANKING SUPERVISION - INTERNATIONAL ASSOCIATION OF DEPOSIT INSURERS, *Core Principles for Effective Deposit Insurance Systems,* June 2009.

[51] FINANCIAL STABILITY FORUM, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, April 2008.

[52] The document categorises the 18 principles into 10 broad groups: objectives, mandates and powers, governance, relationships with other safety net participants and cross-border issues, membership and coverage, funding, public awareness, legal issues, failure resolution, reimbursing depositors and recoveries adaptable to different countries settings and structures.

[53] BASEL COMMITTEE ON BANKING SUPERVISION, *Core principles for effective deposit insurance systems. A proposed methodology for assessment*, 28 May 2010. The methodology has been

self-assessment by deposit insurers, in the IMF and World Bank assessments in the context of the Financial Sector Assessment Program (FSAP), in the external review by third parties and in peer reviews (for example, those conducted by the regional committees of the IADI).

The elaboration of a methodology for assessment purposes certainly confers to the core principles a feature of being less voluntary than we would expect from "soft law" rules as they are, because they constitute a benchmark for the evaluation of the effectiveness of each country's DGS by international bodies. But, we cannot underestimate that these core principles are very "broad" in many important aspects, with the risk that some problems encountered during the financial crisis remain unresolved and that we will continue to go on with substantial differences in "core" issues. This is a typical feature of international "soft law", which tries only to identify a common feature for different countries' institutional and legal settings.

There is a high expectation for a move towards a more concrete and harmonised model of DGS, including efficient and effective solutions to many critical aspects of its functioning, especially those deriving from more complex banking institutions and market conditions. This is crucial, especially at the European level, where the integration of the banking system is stronger and differences may have a wider impact.

On the basis of the discussions and proposals made by the FSB and the Basel Committee, the EU Commission recently put forward a proposal[54] to amend the 1994 Directive in order "to boost consumer protection and confidence in financial services", including investment firms. The purpose is to improve the protection of depositors and retail investors. Moreover, the Commission has launched a public consultation on options to improve the protection of insurance policyholders, including the possibility of setting up insurance guarantee schemes in all Member States.

According to the Commission's statements, the main elements of the Directive's proposal for banks are:

i) the simplification and harmonisation of the scope of coverage and arrangements for payout;

ii) the further reduction of the time limit for paying out depositors and better access for DGS to information about their participating banks;

iii) sound and credible DGSs that are sufficiently financed, since concerns have been expressed that existing DGSs are not well funded;

defined with the collaboration of IADI, the European Forum of Deposit Insurers (EFDI), the European Commission, the International Monetary Fund and the World Bank.

[54] EUROPEAN COMMISSION, *Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes* (recast), {COM(2010) 369}{SEC(2010) 834}{SEC(2010) 835}, Brussells, 12.7.2010.

iv) new ways of funding, with a mixed approach (*ex-ante* and *ex-post*), including mutual borrowing between DGSs.

i) As to **coverage and payout,** the new discipline aims at harmonising and simplifying the subjective and objective requirements for eligibility to protection. The concept of depositors has also been clarified, so that most discretionary exclusions have become mandatory, in particular the exclusion of authorities and financial institutions of any kind. It has been specified that deposits in non-EU currencies are covered under the law and so are the deposits of all non-financial companies.

Deposits are now more precisely defined. It has been specified that only fully repayable instruments can be deemed deposits, with the exclusion of structured products, certificates or bonds. The purpose here is clearly to prevent DGSs from taking unpredictable risks with investment products.

The level of coverage reached 100,000 euros by the end of 2010. It has been estimated that this level of protection implies that 95% of depositors in the EU will get all their savings back if their bank fails.

Very innovative is the provision according to which all DGSs must now be supervised on an ongoing basis and they must perform regular stress tests of their systems.

Payout has been further accelerated, so that depositors will now be reimbursed within seven days without submitting an application. To make this possible, the managers of DGSs will have to be informed early about problems at banks by supervisory authorities, and in particular if a bank failure becomes likely. Banks will have to specify in their books whether deposits are protected or not. Moreover, DGSs and banks must exchange information on depositors, domestically and across borders, unfettered by confidentiality requirements. Credit institutions must also be in a position to provide the aggregated deposits of a depositor ('single customer view') at any time. As a consequence of these provisions, more transparency is needed between DGSs, banks and supervisors.

ii) As for **transparency**, further disclosure is required between banks and depositors about the coverage and functioning of their schemes, which should be based on a clearer and simpler standard template, and on their account statements. To this end, before making a deposit, depositors must now countersign an information sheet that contains all relevant information about the coverage of the deposit by the DGS. Depositors must be informed accordingly about the statements of account. Advertising on deposit products must be limited to factual references to coverage by the DGS in order to avoid using the DGS as a marketing argument.

As specified, the regular disclosure of specific information by DGSs (*ex-ante* funds, *ex-post* capacity, results of regular stress testing) ensures

transparency and credibility, leading to enhanced financial stability at negligible costs.

iii) The **financing system** should be more articulated, based on a mixed *ex-ante/ex-post* mechanism; the purpose is to ensure that DGS funding is proportionate to the scheme's potential liabilities, through a four-step approach.[55]

First, on the assumption that a solid *ex-ante* financing provides for a solid reserve, it has been established that DGSs must hold 1.5% of eligible deposits on hand after a transition period of 10 years ('target level').

Second, if financial resources turn out to be insufficient in the event of a bank failure, the existing fund can be supplemented by additional *ex-post* contributions by banks of up to 0.5% of eligible deposits.[56] Consequently, *ex-ante* funds will account for 75% of DGS financing and *ex-post* contributions for 25 %.

Third, if funding is found to be insufficient, a "mutual borrowing" is established, according to which a DIS can borrow a limited amount from other EU schemes, which, altogether, can lend to the DGS up to 0.5% of its eligible deposits, proportionately to the amount of eligible deposits in each country. This loan must be repaid within five years and new contributions to the DGS must be raised to reimburse the loan. To secure repayment, lending DGSs have the right to subrogate to the claims of depositors against the failed credit institution and these claims will rank first in the liquidation proceeding of the credit institution.

Fourth, as a last resort, alternative funding arrangements can be provided, based on contributions by banks calculated in a way that they will be adjusted to the risks posed by individual banks. These arrangements must comply with the monetary financing prohibition laid down in article 123 of Treaty on the Functioning of the European Union (TFEU).

Only after 10 years, will this four-step mechanism become operational. In order to adapt the target level to schemes' potential liabilities, it will be recalibrated based on covered deposits (i.e. taking into account the coverage level), but without diminishing the level of protection.

Functions of DGS. DGS funds should principally be used for paying out depositors (pay-box functions), but they can also be used for bank resolution purposes in accordance with State aid rules. However, this possibility is subject

---

[55] About the envisaged level of the DGS' funding, see EUROPEAN COMMISSION, *Impact Assessment,* Commission Staff Working Document, Accompanying document to the Proposal for a Directive of the European Parliament and of the Council on Deposit Guarantee Schemes (recast), Brussels, SEC(2010) 834/2.

[56] It is provided for that if making this payment jeopardises a bank, it may be exempted by the competaent authorities on an individual basis.

to the least-cost criterion, in the sense that the amount useful for the resolution package is limited to the amount that would have been necessary to pay out covered deposits. The purpose of this provision is to avoid the depletion of funds for the benefit of a bank's uninsured creditors. Consistently, considering that bank resolution and payout have different purposes, DGS funds should be ring fenced when the target level is build up, ensuring that the primary function of DGSs, i.e. deposit payout, is not impeded.

Another innovative provision of the proposed reform is **risk-based contributions** to DGSs. Credit institutions should contribute to DGSs according to their risk profiles. In principle, contributions consist of both non-risk and risk-based elements. The latter will be calculated on the basis of several indicators reflecting the risk profiles of each credit institution, which could be those commonly used in supervisory activity to evaluate the financial soundness of credit institutions: capital adequacy, asset quality, profitability and liquidity. The use of such indicators is facilitated by the circumstance that they are available under existing reporting obligations.

Some flexibility is adopted by the Directive to take into account existing differences between banking sectors in Member States. It provides for a set of *core indicators* (mandatory for all Member States) and another set of *supplementary indicators* (optional for Member States). The core indicators reflect the most important profiles of the bank's situation (such as capital adequacy, asset quality, profitability and liquidity) and account for 75%; supplementary indicators account for 25%. This approach to calculating risk-based contributions relies on the Commission reports of 2008 and 2009 and also reflects current approaches in some Member States.[57]

In general, the Directive requires that the total amount of contributions collected by DGSs should first be determined in line with the target level for DGS funds; then the amount should be apportioned among DGS member banks according to their risk profiles. Consequently, the Directive provides incentives for sound risk management and discourages risky behaviour by clearly differentiating the levels of contribution paid by the least and most risky banks (from 75% to 200% of the standard amount, respectively).

As to the non-risk element, the contribution base is the amount of *eligible deposits*, as is currently the case in most Member States. However, over time, *covered deposits* (i.e. eligible deposits not exceeding the coverage level) will become the contribution base in all Member States because they better reflect the risk to which DGSs are exposed. A full harmonisation of the calculation of risk-based contributions should be achieved in a later stage.

Mutual guarantee schemes. The proposal confirms the recognition of mutual guarantee schemes, which protect depositors by protecting the credit

---

[57] JRC (Joint Research Centre, European Commission), *Possible models for risk-based contributions to EU Deposit Guarantee Schemes*, June, 2009.

institution itself. Since all banks must join a DGS, mutual guarantee schemes can either be recognised as DGSs and in this case must meet the requirements set out in Directive 2006/48/EC for institutional protection scheme (article 80, paragr. 8)[58] in order to ensure consistency in EU law. Alternatively, mutual schemes and DGSs can be set up separately. In the latter case, a dual membership of a bank to both schemes and the additional safeguard role of mutual schemes can be taken into account when the contributions to the DGS are set.

Cross-border cooperation is a very important provision of the Directive for facilitating the payout process in cross-border situations. The host country DGS acts as a single point of contact for depositors at branches in another Member State. This includes not only communication with depositors in that country (acting as a 'post box') but also paying out on behalf of the home country DGS (acting as a 'paying agent'). Agreements between DGSs will facilitate this function.

Schemes have to exchange relevant information with each other. Mutual agreements will facilitate this. Banks reorganising themselves in a way that causes their membership of one DGS to cease and entails the membership in another DGS will be reimbursed their last contribution so that they can use these funds to pay for the first contribution to the new DGS.

A specific role should be played by the EBA, which collects information on deposits, conducts peer review analyses, confirms whether a DGS can borrow from other DGSs and settles disagreements between DGSs.

Some considerations on the new Directive on DGSs may be thus expressed. The first and general one is that the design and the implementation of such an important tool cannot be realised outside of a proper crisis management framework, especially with regard to its mandate.

The proposal also explicitly provides for the preventive intervention of DGSs to avoid bank failure. As it has been underlined,[59] "there are still technical issues to be addressed, since the current proposal lacks reference to the least-

---

[58] According to this provision, a risk weight of 0 % can be assigned to the exposures to counterparties which are members of the same institutional protection scheme as the lending credit institution, provided that some conditions are met. Among these: i) the credit institution and the counterparty have entered into a contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy in case it becomes necessary; ii) the arrangements ensure that the institutional protection scheme will be able to grant support necessary under its commitment from funds readily available to it; iii) (d) the institutional protection scheme disposes of suitable and uniformly stipulated systems for the monitoring and classification of risk with corresponding possibilities to take influence; those systems shall suitably monitor defaulted exposures; iv) the institutional protection scheme conducts its own risk review which is communicated to the individual members; v) the multiple use of elements eligible for the calculation of own funds ('multiple gearing') as well as any inappropriate creation of own funds between the members of the institutional protection scheme shall be eliminated; vi) the institutional protection scheme shall be based on a broad membership of credit institutions of a predominantly homogeneous business profile; and vii) the adequacy of the systems is approved and monitored at regular intervals by the competent authorities.

[59] A. M. TARANTOLA, *Strengthening financial stability. The contribution of deposit insurance*, Rome, 2010.

cost criteria and authorisation processes. Nevertheless, the recognition of DGS as preventive actors in helping to avert worst crisis scenarios is welcomed. It could provide the necessary impulse for implementing this feature in EU countries where DGSs currently lack such role".

Another issue regards the constitution of a pan-European DGS. Many remarks have supported the importance of such a new instrument, in terms of significant savings in administrative costs (estimated at about 40 million euros per year), the better management of bank failures (because the impact of a bank failure on a large scheme would be smaller than it would be on an individual Member State DGS) and incentives for a pooled solution in the interests of all depositors, regardless of nationality. However, "owing to the complex legal issues arising from differences in national legal frameworks and the absence, at the moment, of an integrated European supervisory and crisis management framework, this idea is still a longer-term project".[60]

Another important innovation in the EU crisis management framework is the set-up of **a new compensation scheme for investment services,** aimed at modifying the current Investor Compensation Scheme Directive (97/9/EC), which provides for the protection of investors who use investment services in cases where an investment firm is unable to return assets belonging to an investor. In Europe, there are now 39 investor compensation schemes operating in 27 European Member States.

The Commission proposal provides for a faster compensation if an investment firm fails to return the investor's assets due to fraud, administrative malpractice or operational errors; the level of compensation has been increased from 20,000 to € 50,000 euros. Disclosure to investors has been significantly improved by providing that investors will receive better information on the functioning of schemes.

As underlined by the Commission, under the new Directive not only will European investors have better protection for their savings, but they will also be able to choose the best savings product in any EU country without worrying about differences in protection. There will also be advantages for banks from the new framework since they can offer investment products throughout the EU without being hampered by differences in the protection offered to investors.

6.2 Bank Resolution Funds.

Although DGSs aim to protect depositors, other financial resources may be necessary to implement the resolution measures outlined above as an alternative to the liquidation of the bank. They may be activated to support both going concern and gone concern solutions. Within the debate underway at an international level,

---

[60] A. M. TARANTOLA, *Strengthening financial stability. The contribution of deposit insurance*, Rome, 2010.

the EU Commission has recently proposed the constitution in each Member State of ex ante resolution funds, funded by levies on banks, to use in connection with the resolution tools and in accordance with the objectives and principles governing resolution. They are intended "to facilitate the resolution of failing banks in ways which avoid contagion, allow the bank to be wound down in an orderly manner and in a timeframe which avoids the "fire sale" of assets ("principle de prevoyance")".[61] As specified, this instrument aims at implementing the principle affirmed by the G20 meeting in Pittsburgh in September 2009, namely taxpayers' money should never again be used to cover bank losses and that the burden of crises should fall on private shoulders. The resolution funds constitute an integral part of the toolkit included in the new EU crisis management framework. The main issues are:

i) how to finance resolution funds and the size of them;

ii) the scope of the funds, namely the purposes to which they are addressed; and

iii) the governance of the funds (who has to decide on the use of them).

The **financing** of Bank Resolution Funds should be designed in a way that two objectives can be pursued: i) the amount of money reflects the likelihood and the cost of a resolution; and ii) the creation of incentives for appropriate behaviour, mitigating the risk of resolution.

As to the **size of the resources** (*target size*) that should be available for a good functioning of the Fund, the solution depends on the purpose that we want to attribute to the Funds and the target banks to whom they are dedicated.

Three options have been envisaged at the EU level to commensurate the Fund and the contributing system, each of them reflecting the different capacity to express the riskiness of banks: the banks' assets, the banks' liabilities and the profit and bonuses. The solution is not easy to identify, because each of them has pros and cons.[62] The prevailing parameter seems to be the "*eligible liabilities*", intended as the liabilities of contributing institutions net of Tier 1 capital and covered deposits, as defined under the DGS Directive.

---

[61] EUROPEAN COMMISSION, *Bank Resolution Funds*, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, Brussels, 26.5.2010, COM (2010) 254 final.

[62] According to the Commission, banks' assets are good indicators of their risk. Indeed, they could well reflect the potential likelihood of a bank failure and the need to resolve the bank. Indirectly assets could represent an indicator of the amount which might need to be spent. However, as pointed out, banks' assets are already subject to risk weighted prudential capital requirements. Imposing a levy based on assets could therefore constitute an additional capital requirement and would have to be considered carefully in the context of the wider reforms to capital standards currently underway. Banks' liabilities could be the most appropriate indicators of the amounts that might be needed when facing the need to resolve a bank. Costs of bank resolution are most likely to arise from the need to support certain liabilities. However, it has been underlined that banks' liabilities could be a less effective proxy for the degree of risk. Profits and bonuses can be an indicator of a bank's size and more reflective of the 'polluter pays' principle. However they may not be closely correlated to the amount of resolution financing a bank might require or the probability of its failure.

This issue is delicate and it may have many implications; so, it has to be examined carefully before decisions are taken. In any case, it requires a coordinated approach unless we want to bear the risk of competitive distortions between national banking markets. As specified by the Commission, resolution funds are not intended to achieve the size experimented during the financial crisis, because the new "crisis management framework must ensure that any losses in the context of a bank failure are first and foremost borne by shareholders, holders of subordinated debt and unsecured creditors, before resolution funds can be available".

However, despite the need for a common approach, at least at the European level, some countries (e.g. Germany, Sweden, Spain) have already decided to introduce levies on banks for the express purpose of establishing dedicated funds[63], but with different purposes and financial implications.

A decision on this point requires a detailed quantitative analysis and a comprehensive impact assessment**,** taking into account the wider set of reforms underway on levies and bank capital. The cost profile of all these measures should be calibrated in order to avoid stifling the economic recovery and the cost of credit to the real economy. This could happen if increased costs for banks related to resolution funds are transferred to bank customers in the form of higher charges.

Strictly linked to the funding is the issue of **the scope of the resolution funds**. It is important to define when the funds have to intervene, restricting the area to those situations in which supervisory authorities determine that the institution is not recoverable and resolution measures are needed. So, the funds should not be used when banks are placed into liquidation under normal insolvency proceedings, namely when DISs are called to reimburse depositors.

According to this picture, resolution funds may be used for: i) financing a bridge bank (with the resolution authority taking over the bank) to allow for the continuation of the activity of an insolvent institution. This could imply, for example, providing bridge financing and/or guarantees; ii) financing a total or partial transfer of assets and/or liabilities from the ailing entity to another financial institution. Costs could involve a guarantee of the assets (e.g. loss sharing with a potential acquirer of bad assets) and/or financing or guaranteeing the transfer of liabilities for a period of time in order to maintain market confidence and avert the risk of a run by creditors; iii) financing a good bank/bad bank split; or iv) covering administrative costs, legal and advisory fees, as well as the need to preserve certain vital functions of the banks, such as payments systems.

---

[63] In Sweden, the fund is targeted to reach 2.5 per cent of GDP in 15 years. It will be built up on the basis of a stability fee paid by banks and other credit institutions, amounting to 0.036 percent per year levied on certain parts of the institution's liabilities (excluding equity capital and some junior debt securities). The IMF has indicated that on the basis of past experiences of crises, approximately 2-4 percent of GDP should suffice for the provisioning of resolution funds (this corresponds to the direct costs of ongoing banking crisis), depending on the relative importance of the financial sector.

Lastly, **the governance** of Bank Resolution Funds deserves careful consideration, because the size of a fund could be significant in most economies. The debate on this point is open, because there are tendencies towards the allocation of contributions from banks to the State balance sheet and their use for the reduction of huge public deficits, including the injection of relevant public resources to bailout banks. But, a solution of this kind could put forward again recourse to public funds if new crises occur, while dedicated funds would render clearer and effective the destinations of the financial resources set aside for the coverage of resolution costs, as the Commission proposal has stated.

Accepting this point of view leads to the conclusion that bank resolution funds should be entrusted to those authorities responsible for the resolution of banks, acting independently from Government. Further reflections are necessary on the governance issue, because many questions arise about the management of the funds collected and their usage, especially in cross-border resolutions. Here, specific rules should be defined about the decision-making process on the sharing of costs between the different countries' resolution funds, with the involvement of colleges of the authorities in charge for resolution and the new EBA.

On the basis of the proposed features of Bank Resolution Funds, a number of questions have been posed with regard to: i) moral hazard concerns; ii) the possibility of creating a single pan-European Resolution Fund; and iii) the relationship between the Bank Resolution Fund and the DGSs.

On the first issue, many think that the set-up of an *ex-ante* fund could institutionalise moral hazard and encourage banks to hold riskier assets in their portfolios. On this point, a specific focus should be made, because the implications in terms of moral hazard cannot represent a convincing reason to oppose the constitution of resolution funds. Indeed, after the financial crisis and the huge involvement of public purses in bailing out banks, moral hazard is not a problem concretely referable to bank resolution funds, because it can be raised only with reference to State intervention, not to privately funded resolution measures. Furthermore, a certain degree of moral hazard is unavoidable in the financial system, because it is ingrained in the existence of the regulation and supervision of the banking system and to a crisis management and resolution framework aimed at protecting certain categories of creditors and investors and the stability of the financial system. The only way to eliminate moral hazard would be to let banks fail, but the costs for stakeholders and disruptive effects on the financial system and real economies make this not desirable.

In the current situation, moral hazard is certainly well rooted, since there are expectations that the State will bail out failing banks, while the new system is aimed at avoiding this problem through appropriate mechanisms and clear and known in advance rules. According to the principles that are at the foundation of the proposal, "*the use of the funds would bring no benefits to risk takers whose risks have turned bad - as they would be the first in line to take any losses*" (shareholders and creditors), but they would rather contribute to an orderly

failure of the banks, preserving market discipline and reducing moral hazard, in accordance with EU State aid rules.

The possibility of creating a **single pan EU resolution fund** has also been raised. The benefits of such a solution are evident,[64] but it has been considered that at this stage there are no conditions for such a decision, given the current absence of a centralised banking supervision and crisis management framework. As a consequence, a balanced solution is the creation, as a first step, of an EU approach based on "*a harmonised network of national funds linked to a set of coordinated national crisis management arrangements*", with the purpose of creating an EU Resolution Fund in the longer term, in a context of a European supervisory and crisis management framework.

Finally, as far as the **relationship between resolution funds and DISs** are concerned, the existence of different purposes has to be underlined. DISs aim to reimoburse depositors up to the guaranteed amount, while resolution funds ensure that the bank can be wound up and cover different costs, related to the resolution of the bank in one of the forms mentioned above.

Moreover, a consistent approach should be followed between the assessment risk criteria used by DGSs and Bank Resolution Funds and those used for prudential requirements, since the underlying purposes might not justify significantly different methodologies.

Finally, it is useful to underline that in many countries deposit insurance schemes already perform "risk minimisers" as well as "pay-box" functions, for example by funding the transfer of deposits from the failing entity. But, some limitations should be provided in order to use deposit guarantee funds for resolution purposes only up to the amount that would have been necessary to pay out covered deposits. Costs beyond this limit should be borne by resolution funds.

6.3 The tax on financial transactions (the "Tobin tax").

As specified by the Commission, the purpose of Resolution Funds is very different from the alternative recently put forward to pay part of the costs of the recent financial crisis through a levy on financial transactions, something comparable to the Tobin tax, which was proposed in 1972 on foreign exchange trades in order to reduce market volatility. The measures envisaged aim to recoup the public funds used during the financial crisis to stabilise the banking system or

[64] On this regard, many aspects have been underlined, such us increasing risk diversification; delivering economies of scale; reducing the amount that would be subject to burden sharing; providing the right incentives for cooperation; speeding up decision-making; and guaranteeing a level playing field. It would also better reflect the pan EU nature of banking markets, in particular for cross border banking groups.

to tackle excessive risk-taking or speculation. They may be regarded as a useful complement to the preventive funds.[65]

The project is still under consideration. Recently, it has been underlined that the rationale for imposing special taxation on banks is three-fold: i) to recoup the costs of past bailouts and interventions; ii) to compensate for the subsidy received by banks by virtue of possible future bailouts and being too big to fail; and iii) to create incentives to change funding structures and perhaps against becoming too big to fail.[66] Many supporters of this project (including many social organisations) aim to finalise the special taxation on banks to more general objectives, claiming that tax revenues should finance social and environmental policies in developed countries and contribute to financial cooperation for the development of poor countries in the world. The amount of the tax should range between 0.01% and 0.1% of each transaction.

It has been estimated that a tax of 0.05% of each transaction on financial instruments in the EU could raise revenues of between $163 and $400 billion per year, while at world level the revenues could be between $400 e $946 billion per year. Thus, such a negligible percentage on each financial transaction could allow Governments to collect huge amounts of resources to fund important social, environmental and international cooperation policies.

As pointed out, the project would be successful if an agreement between at least the major 20 countries in the world could be reached about its implementation and the distribution of the resulting revenues among countries. But, such an agreement is difficult to reach, since different stances emerged: the US and UK oppose such a plan, while other countries (Italy, France and Germany) are in favour if the tax could be of a generalised application.

Many doubts have been raised about the desirability and feasibility of the project, especially when considering that taxes on financial transactions could lead to the transfer of contracts and settlements to off-shore centres not subject to the same imposition.

6.4 The proposal for a private European Fund (Mr. Profumo's proposal).[67]

---

[65] Specific proposals were made by the IMF on a special taxation on the banking sector: i) a *Financial Stability Contribution* (FSC) linked to a credible and effective resolution mechanism. FSC would be based on a levy to pay for the fiscal cost of any future government support to the financial sector. This could either accumulate in a fund to facilitate the resolution of weak institutions or be paid into general revenue. The FSC would be paid by all financial institutions, initially levied at a flat rate (varying though by type of financial institutions) but refined thereafter to reflect individual institutions' riskiness and contributions to systemic risk -such as those related to size, interconnectedness and substitutability - and variations in overall risk over time; ii) a "*Financial Activities Tax"* (FAT) levied on the sum of the profits and remuneration of financial institutions, and paid to general revenue. See, INTERNATIONAL MONETARY FUND, *A fair and substantial contribution by the financial sector. Final Report for the G-20*, June 2010.

[66] D.T. LLEWELLYN, *Post crisis regulatory strategy: where is Pillar 4?*, Bancaria Editrice, n. 6, 2011.

[67] A. PROFUMO, *Una soluzione più efficace della supertassa*, Il Sole 24 Ore, 13 luglio 2010.

Along the line of creating a private mechanism to finance banking crises without recourse to public funds, a proposal has recently been made based on the constitution of a European *Recovery Fund* amounting to 20 billion euros, funded by voluntary contributions by the 20 largest European banks. The envisaged amount could be set aside for a period of five years. The objective of the fund would be to prevent or minimise possible liquidity crises, as occurred during the financial crisis when banks found difficulties in raising funds on the market despite the availability of adequate collateral. These situations were overcome thanks to special financial support from central banks; but, as the recent crisis showed, instruments available to central banks - the provision of short- term liquidity against collateral - are not sufficient to prevent systemic crises. Thus, situations in which instruments provide banks with medium-term financing could be necessary when markets are blocked.

According to the proposal,[68] the Fund would provide guarantees to allow weak banks to issue medium to long-term debt (secured bonds) for a multiple of the amount of the Fund's support. This guarantee would be additional to the collateral given by the issuing banks. The Fund would take a risk of "first loss" up to a predetermined percentage of the debt in order to meet investors' preferences and facilitate issuance on the market. In this way, a "fire sale" of a bank's assets could be avoided, giving stakeholders the time to find a solution to the crisis.

The constitution of the Fund could be a concrete response to the obstacles that banks can encounter in accessing the capital market during a liquidity crisis, namely it could overcome the lack of coordination among investors in financing a bank in difficulty and the uncertainty on counterparty risk. The existence of the additional guarantee provided for by the Fund would favour coordination among investors, while uncertainty would be overcome by the intervention of authorities, which would play a key role in the performance of the Fund's activity.

Indeed, the Fund could intervene only in cases where supervisory authorities evaluate that a bank needs to be supported in funding and that the crisis is reversible, giving in this way a clear signal to the market. As clarified, dealing with banks of systemic relevance, the Fund should work in the context of the new European framework for supervision and crisis management.

The outlined features of the Fund should, therefore, express the institutional objective of the new instrument, namely that the Fund neither aims to rescue insolvent banks nor act as an alternative tool to cover losses from banking crises. The purpose of the Fund should be to avoid that a liquidity shortage deriving from troubles in the capital market could jeopardise banks that are solvent and profitable. That is why the Fund should intervene at an early stage of the crisis by giving banks access to medium-term financing.

---

[68] C. LAMANDA, *A proposal on European Crisis Management*, in *Preventing and Managing Future Crises*, Bancaria Editrice, 2010.

According to the features of the new instrument, there is no foundation to the proposal that national DISs could flow into the Recovery Fund as though the objectives of the two instruments were identical. But, this possibility does not seem to be coherent, given that the characteristics envisaged for the Fund are different from those of a DIS. Indeed, the Fund's function is not to reimburse depositors or to cover losses related to resolution measures, but to provide liquidity, at least as an *ex-ante* decision. Another difference is that the provision of liquidity would take place under market conditions, rather than under the conditions required to resolve a failing bank. In this sense, the Fund is not a "resolution fund" as in many circumstances a DIS can be.

Furthermore, if the Fund involves only the top 20 banks in Europe, the possible confluence of a DIS in the Fund for those banks could result in a significant depletion of the resources of the DIS, so jeopardising its capacity to perform its main functions.

From this perspective, the DIS should keep its own objective to protect depositors in the case of the liquidation of a bank. A partial operational convergence between the two Funds could exist in countries where DISs perform not only pay-box functions but also preventive interventions, such as the provision of liquidity to banks in difficulty for avoiding insolvency, upon the condition of the least-cost criterion with respect to liquidation.

In conclusion, given the different functions of the two funds, the mechanisms and functioning of the Recovery Fund could be designed to make it complementary to the DIS within a well-defined and consistent framework. Finally, what interactions could exist with Bank Resolution Funds should be clarified. Complementary functions between the three funds could be established in order to structure a system of financial intervention that is able to adapt to the different features of the banking crises and to different resolution measures. A possible set-up could be that DISs aim to reimburse depositors in the case of liquidation or to transfer insured deposits to another bank (with or without assets). The Bank Resolution Fund aims to implement the resolution measures identified above, after the clarification about its use in going concern or gone concern solutions. Then, Profumo's Fund could be activated in the case of illiquidity, allowing banks the possibility to fund themselves on the market with the help of the guarantee granted by the Fund and for a multiple amount of it.

6.5 Public intervention.

This is the last resort solution, which can be activated when other measures are not available or are insufficient to reach the general objectives established by authorities. After the financial crisis the existence of room for public intervention was largely questioned. Considering the huge burden that public finances have

borne to bail out the financial system all over the world, there is a large consensus among policymakers and regulators that in the future taxpayer's involvement in banking crises should be avoided, because it is no longer acceptable that business upsides are private while downsides are public.

So, the strategic issue of the design of the new framework is how to ensure the *Capital of Last Resort provision*[69] for the restructuring of insolvent banks. Private sector solutions such as those mentioned above should be the norm, appropriately disciplined based on clear and predefined application criteria. But, even the most effective regulation and supervision cannot avoid crises from occurring, and public finance could be called on to bail out severe distresses that endanger financial stability at a domestic and an international level, especially when wholesale creditors cannot be charged with losses in connection with "*domino effect*" considerations. The problem here is how to arrange this intervention and how to share the burden among different countries for cross-border intermediaries, because it is not possible or advisable to establish *ex-ante* principles for public intervention and specific criteria. A case-by-case approach is inevitable if we do not want to give market and institutions certainties about State intervention.

When we talk about public intervention, we cannot help but mention the ELA that central banks can grant to financial institutions facing liquidity distress, if the technical situation of the recipient bank should deteriorate. This possibility has widened with the extension over time of the range of financial instruments acceptable as collateral, up to the so-called "toxic" or "not marketable" assets, which may put at risk central bank financing, leading it to take "capital risk" that is outside the scope of the central banks functions.

Considering the huge amount of these assets present in the balance sheets of central banks, which has recently been extended to include sovereign bonds issued by States in distress, one should ask how much capital is at risk in the central banks' balance sheet and whether they ultimately have taken over the burden of losses. If things go in this way, the intervention of central banks is taking the form of a bailout. This area deserves further reflection by policymakers and central banks and it should be appropriately considered in the new framework for banking crisis management.

---

[69] P. TUCKER, *The crisis management menu*, cit.

CHAPTER 4

THE MANAGEMENT OF BANKING CRISES IN ITALY. THE CONSOLIDATED SPECIAL REGIME

1. A general picture of the Italian special framework.

1.1 Main characteristics of the supervisory and crisis management system.

In evaluating the adequacy of a crisis management system at the national level, we should consider its capacity to deal with the different features of a bank's distresses (illiquidity, unprofitability, undercapitalisation, governance and organisational shortcomings) and their degrees of severity in an effective and timely way. This assessment requires an analysis of the main components of the regulation, supervision and crisis management model, including the role and powers of the competent authorities (central bank, supervisory authority, Government, special resolution authority), the range of the instruments available, the design of the official proceedings for the reorganisation, resolution and liquidation of banks, the existence and appropriateness of a deposit insurance system and its interrelation with the other tools of the whole safety net.

Handling a banking crisis requires a close interaction among different authorities involved in the decision-making process. A clear distinction of the respective remits as well as coordination rules, with specific regard to the exchange of information in the appropriate and timely manner, are essential for the successful management of such complex situations. Regardless of the legislative frameworks and of the distribuition of powers among authorities, we may say that some instruments are aimed at requiring the bank's management to take corrective action in order to remedy to the weaknesses detected, while others are more intrusive. Among the latter is the appointment of special administrators or liquidators that - under a stricter supervision of the competent authorities - take over the bank management for reorganisation, resolution or winding up.

Italian Banking Law (legislative decree 385 of 1 September 1993) is well in line with this general model, based on a special crisis management and resolutions regime. It provides for a well-articulated "toolkit" to be activated in the case of a bank's difficulties. Many of the instruments available can be traced back to the 1936 Banking Law, which has revealed still effective in the developed financial environment over recent decades.[1]

[1] L. CERENZA-E. GALANTI, *Italy*, in M.GIOVAGNOLI-G.HEINRICH (edited by), *International Bank Insolvency. A Central Bank Perspective*, Kluver Law International, London, 1999.

The Italian supervisory model

The supervisory scheme in place in Italy is inspired by the "twin peaks" model. The Banca d'Italia is entrusted with prudential supervision over credit institutions, investment firms and all other financial intermediaries, whereas the CONSOB regulates the transparency and conduct of investment services. Moreover, the CONSOB supervises the securities markets, the disclosure and completeness of information made available by issuers, market abuse and insider trading. However, the Banca d'Italia is responsible for supervising those markets that are relevant from a monetary point of view, such as the wholesale market for Government securities and the interbank deposits market, with the aim of ensuring the overall efficiency of the market and the orderly conduct of trading. In addition, the Banca d'Italia, in agreement with the CONSOB, regulates and supervises the post-trading infrastructure.

Insurance companies are under the supervision of the ISVAP, with the objective of guaranteeing both the stability and transparency of insurance companies; whereas pension funds are monitored by the COVIP.

As envisaged by the law, cooperation between financial supervisory authorities is ensured by the appropriate means of coordination and information exchange. In the interests of having a complete overview of the Italian supervisory framework, the *Comitato interministeriale per il credito e il risparmio* (Inter-ministerial Committee for Credit and Savings, CICR) should also be mentioned. The CICR is a collective body composed of different ministers competent in economic and financial issues, and chaired by the Minister of the Economy and Finance; the Governor of the Banca d'Italia also attends its meetings. The CICR is responsible for issuing broad guidelines on prudential supervision in the area of credit activities and the protection of savings; it can take decisions on certain specific matters within its scope of competence.

In 2008, the *Comitato per la salvaguardia della stabilità finanziaria* (Financial Stability Committee) was established for cooperation and information sharing on relevant topics concerning financial stability. The Committee is chaired by the Minister of the Economy and Finance and composed of the Governor of the Banca d'Italia and the Chairs of the CONSOB and the ISVAP.

The management of banking crises in Italy centres on **the role of the supervisory authority**, whose functions are assigned by the Banking Law to the Bank of Italy. In this framework, crisis management and resolution tasks are part of the supervisory activity. This includes preventative (early intervention and subsequent corrective action) and crisis management and resolution tools. The latter implies a wide range of powers, such as the initiation, direction and coordination of formal crisis proceedings, the approval of deposit insurance schemes' interventions and the activation of public measures in exceptional circumstances.

In the Italian framework, the treatment of banking criseis contributes to the pursuit of the specific purposes of banking supervision, set up by article 5 of the Banking Law. This includes the sound and prudent management of the intermediaries subject to supervision, the overall stability, efficiency and competitiveness of the financial system and the compliance with provisions concerning credit.

The concentration of powers in the Bank of Italy's hands has proven to be effective, especially in cases of particular complexity as to the sizes and kinds of business. The performance, at the same time, of *lender of last resort* functions may also help overcome liquidity problems. Where necessary, the ELA can also be activated. All these areas of intervention are managed in strict coordination with the ECB. In this sense, the Italian framework is in line with the European tendency towards the increasing involvement of central banks in macro and micro-prudential supervision.

More specifically, the management of banking crises configures an **administrative model,** providing a wide range of tools, from preventative measures and early interventions to two special crisis procedures for crisis management and resolution: **special administration** and **compulsory administrative liquidation.** The most important functions related to these two proceedings - the direction, coordination and control – are performed by the Bank of Italy and not by the courts, such as for commercial enterprises under Bankruptcy Law.

Measures adopted by the Bank of Italy as a resolution authority are subject to judicial review. Nearly in all cases submitted to the Court, rulings have been favourable to the Bank of Italy.

The rationale for this institutional set-up is well founded. In fact:

i) the stability and efficiency of the financial system are common objectives both for crisis management and supervisory activity;

ii) moreover, the Bank of Italy has an information advantage that allows it to make early diagnoses and prescribe effective remedies. The supervisory authority, through off-site and on-site examinations, is able to detect in advance the existence of a pathological condition, to evaluate the real characteristics of the crisis and to modulate appropriate interventions to resolve the problems in the most efficient way, and to take into consideration all the various stakeholders and minimise cost.

   In most cases, mergers and aquisitions with other banks are arranged. Therefore, having a profound knowledge of the market is a primary factor and the Bank of Italy plays a significant role in this field;

iii) finally, special crisis procedures lay at the end of a wide array of instruments tailored for different crisis situations that can affect banks and other financial intermediaries.

1.2 The preventative nature of intervention tools.

The area of crisis prevention refers essentially to the Bank of Italy's powers of intervention, provided for by the Banking Law, which are the "core" of its supervisory activity. They apply when weaknesses are detected by the Bank of Italy through off-site and on-site examinations regarding the governance and the financial conditions of the bank, with the assumption that problems can be solved through *remedial action* taken autonomously by the bank's management.

1.2.1 The supervisory approach.

Some preliminary features of this Italian supervisory activity should be underlined to better understand how preventive action is carried out and how effective it can be. It is worth recalling that, according to advanced international standards, supervisory activity is conducted in a structured and formalised way, based on predetermined principles, objectives, methodologies and evaluation processes. It is performed according to the following approaches:

i) *consolidated*, to detect the intermediaries' overall risks and safeguards, regardless of their actual organisational and corporate structure;

ii) "*risk-based*", targeted at assessing all relevant risks and the corresponding organisational safeguards through the application of standard analysis schemes to intermediaries operating in the same fields of activity, even when they are entered in different registers;

iii) *proportional*, directed at grading controls in proportion to the intermediaries' sizes, systemic relevance and specific problems.

The proportionality principle means that, with a view to the cost containment for intermediaries, the obligations imposed on supervised entities are also graded according to their characteristics, size and complexity. To this end, systemic impact of the crisis and nature of the weakness are taken into special consideration.

In order to apply to the *proportionality principle*, intermediaries are divided into five macro-categories:

1. Intermediaries having a significant international presence;

2. Nationwide systemically-relevant intermediaries: entities – including those controlled by foreign-based intermediaries – with total assets of no less than 20 billion euros and, conventionally, other intermediaries, other than those referred to in point 1, which are allowed to use internal risk measurement systems to calculate capital requirements (intermediaries with "authorised systems");

3. Medium-sized to large intermediaries: entities - not falling within macro-categories 1 and 2 - characterized by at least one of the following conditions:

- total assets between 3.5 and 20 billion euros (banks and intermediaries regulated by article 106 of the Banking Law);
- assets under management exceeding 10 billion euro (intermediaries mainly involved in asset management);
- annual turnover – dealing for own account or for the account of a third party – exceeding 150 billion euros (intermediaries mainly involved in dealing for own account or for the account of a third party);

4. Minor intermediaries: entities characterised by at least one of the following conditions:
   - total assets of 3.5 billion euros or less (banks, mainly mutual banks and special financial intermediaries);
   - assets under management of 10 billion euros or less (intermediaries mainly active in asset management);
   - annual turnover – dealing for own account or the account of a third party – of 150 billion euros or less (intermediaries mostly involved in dealing for own account or for the account of a third party);
5. Entities subject to specific regulations.

The Italian supervisory methodology[2]

The central point of supervisory activity is the *Supervisory Review and Evaluation Process* (SREP), according to the standards defined in the Basel 2 framework. This aims to check whether intermediaries have the appropriate capital and organisational safeguards vis-à-vis the risks they take, ensuring an overall operational balance. The proportionality principle is the basis of the SREP in terms of both intensity and frequency of assessments.

The SREP comprises a set of actions that evaluates the current and future situations of intermediaries. For this purpose, a methodological and operational integration as well as a useful interaction between off-site controls and inspections are key factors for the effective and efficient pursuance of supervisory purposes. The coordinated use of analysis and evaluation instruments can adequately exploit the information gathered and the results obtained in order to avoid the duplication of activities, to rationalise the use of resources, to make the analysis quicker and to ensure unity to the supervisory process. In the presence of significant deficiencies and/or anomalies, the SREP leads to the adoption of appropriate corrective measures.

The SREP is structured into two phases: evaluation cycle (periodic) and correction/follow-up (contingent).

---

[2] BANK OF ITALY, *Guide to Supervisory Activity*, Circular 269 of 7 May 2008, available on website www.bancaditalia.it/vigilanza/disclosure/review/part-1.pdf.

The **evaluation cycle** consists of three steps: a) planning; b) control and analysis; c) evaluation.

Planning aims to identify the scope of evaluation: risk profiles, business lines, legal entities to be assessed; the instruments to be used: off-site assessments, meetings with corporate officers, on-site inspections; the time references for the "evaluation cycle" and the timing of the analysis to be performed.

The *control and analysis* activities include:

i) checking compliance with the regulations concerning: prudential rules and operational limits; financial statements; and disclosure requirements;

ii) the analysis of the intermediary's situation with regard to the ICAAP (internal capital assessment process) for calculating the total capital the intermediary deems adequate to cover its risks;

iii) the exposure to all relevant risks and the corresponding organisational safeguards, by means of the RAS (risk assessment system). This system assesses risk exposures and the adequacy of the pertinent controls, as well as the organisational, capital and economic safeguards, in order to be able to form an overall opinion. The RAS describes a structured survey procedure in which off-site and on-site controls are performed in an integrated way, with the aim to adopt the most appropriate instruments to attain the desired results;

iv) checking the maintenance of the requirements for authorisation to use the internal risk measurement systems for calculating capital requirements.

Evaluation consists of attributing scores to the risk areas and cross-cutting profiles (profit and capital adequacy) covered by the RAS, and then calculating the total score of the intermediary. In practice, risk exposure, profit and capital adequacy are assessed based on analysis schemes, which are mainly fuelled by prudential returns and generate an "automatic" score; this can be adjusted by analysts using the "integrative schemes".

Analysis schemes are uniformly applied, in both off-site and on-site controls, where risk exposures are recalculated only if adjustments emerging from on-site verifications require a modification of the judgment. Organisational evaluations are based on an interpretation process of "qualitative" factors.

The RAS results are the basis for subsequent supervisory actions; these are very different, ranging from an ordinary oversight action to corrective measures, in extreme cases of an extraordinary nature. Such actions might be directed to specific/cross-cutting risk profiles or to the general situation of the intermediary.

Correction/follow-up phase is a result of the evaluation cycle and consists of the determination of the corrective measures, where necessary, tailored in accordance with the types and severity of the anomalies found. Supervisory

measures are consistent with the results of the analysis of risks and of the intermediary's overall situation (principle of correspondence between evaluation and action), as well as the level of awareness and reliability of corporate officers.

In the follow-up phase, progress in the implementation of the plan defined by the intermediary to meet the requests of the supervisor is monitored, taking into account the intermediary's operational specialisations and its general situation.

An important innovation introduced in supervision, long before the emergence of the financial crisis, is the **macro-prudential analysis**. The sound and prudent management of individual entities and the stability of the financial system are complementary objectives. The problems of one intermediary may influence other entities through the markets, determining macroeconomic effects. Meanwhile, the difficulties of large undertakings or key intermediaries in payment and settlement systems may spread to other entities, with contamination effects and macroeconomic consequences; aggregated shocks of a real and/or financial nature may also have repercussions on the whole system or individual intermediaries.

The macro-prudential analysis has preventive purposes, aiming to find vulnerabilities in the financial system that might take on systemic proportions and affect industrial activity. This is also characterised by certain specificities:

a) focus on the financial system as a whole;

b) intense supervision of systemically-relevant intermediaries and on those highly specialised, which are more exposed to the typical systemic risks of their business segments;

c) analysis of the exposure to macroeconomic risks, also taking their dynamism into account;

d) analysis of the mechanisms of risk amplification determined by adverse collective behaviour.

Macro-prudential analysis and micro-prudential controls are part of an interactive approach structured into several steps:

i) individuation of risks and structural vulnerabilities that in the case of adverse plausible circumstances may affect the financial system as a whole or specific segments of it;

ii) identification of shock transmission mechanisms, distinguishing between areas where shocks have immediate effects and areas where they spread at a later stage because of interactions between the real and financial economy or among financial market operators;

iii) prior assessment of vulnerabilities in terms of event probability and possible impact, also by means of stress tests;

iv) verification of the permanence of risk factors among intermediaries and/ or in the reference markets (e.g. by means of specific/targeted inspections or off-site controls);

v) evaluation of the possible systemic relevance of risk factors that emerged during the above-mentioned analysis;

vi) planning of supervisory actions to mitigate the potential impact of the vulnerabilities found (e.g. through recommendations to the system).

The described evaluations and interventions are implemented by the integration of supervision into a macro-prudential approach, following a path “from macro to micro” (from issues systemically relevant to their effects on intermediaries) and “from micro to macro” (from individual behaviours to phenomena of potential systemic relevance).

The set of instruments available for supervisory purposes is completed with **stress testing**. This is a tool used in macro-prudential analysis to get a prospective assessment of the system’s soundness and of possible vulnerabilities to shocks on one or more risk factors. Together with market information, the stress tests targeted to the financial system as a whole assist in strengthening the effectiveness of the control activity and directing the supervisory action to the prevention of prospective risks.

1.2.2 Corrective action.

As for corrective action, the Banking Law provides the Bank of Italy with a wide range of instruments. According to article 53 of the Banking Law, the Bank of Italy may:

a) convene the directors, members of the board of auditors and managers of a bank to examine its situation;

b) order the convening of the governing bodies of a bank, set the agenda for the meeting and propose the adoption of certain decisions on the problems identified. These can vary according the bank’s situations, including the replacement of board members and auditors not in line with *fit and proper* rule, reorganisation of sectors of activity, requalification of business, reduction in costs, increase in capital, interruption in dividends payments and merger with another institution when problems are not resolvable with the maintenance of the same proprietary and structural set-up;

c) directly convene the governing bodies of a bank where the competent bodies have not complied with an order issued under sub-paragraph b);

d) adopt specific measures for individual banks concerning all the matters included in prudential regulation, where the situation so requires (application of a capital requirement higher than the regulatory minimum; restrictions on

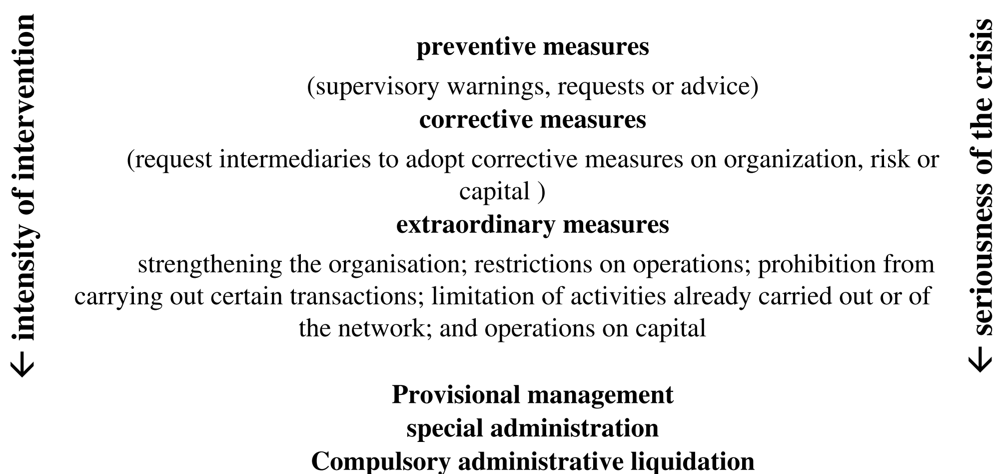
operations or the structure of their networks; prohibitions on carrying out certain transactions, including corporate operations; prohibitions on distributing profits or other elements of capital, as well as on payment of interests on financial instruments included in the supervisory capital.[3]

Furthermore, according to article 78 of the Banking Law, the Bank of Italy may prohibit banks authorised in Italy from undertaking new transactions or order the closure of branches for the violation of laws, regulations or by-laws governing their activities, for management irregularities or, in the case of branches of non-EC banks, for an insufficiency of funds. The same measures are applicable to branches of European banks, after informing the competent supervisory authorities (article 79).

As said, these situations do not necessarily express a situation of a banking crisis as defined above, but banks' weaknesses that need corrective actions, because without remedial interventions problems could exacerbate and turn into a crisis. The forms of intervention depend on the severity of the weaknesses, according to the described *proportional approach*. Well-defined correspondence between the two, in the sense that activable measures are proportionate to the real nature and size of the problems, while not in an automatic way, as in the "*prompt corrective action*" used in some countries, such as in the USA.

Automatism and discretion are the opposite ends, but the most effective solutions often lay in the middle. In any case, discretion is not absolute, because the range of interventions is strictly linked to a technical evaluation of the bank's situation according to the principles and methodologies set out by supervisory authorities, so that consistency between assessment and interventions according to the severity of the crisis is achieved.

THE GRADUATION OF THE FORMS OF INTERVENTION



[3] The provision related to the prohibition of distribution of interest has been introduced by the legislative decree 30 December 2010, n. 239, which has implemented the Directive 2009/111/EC amending Directive 2006/48/EC (with the introduction of article 63a in the banking law).

Special administration and compulsory administrative liquidation are the two procedures provided for by the Banking Law for handling banking crises. They could be considered to be as the legal instrument for dealing with a variety of situations, such as early intervention, crisis management and resolution. From the point of view of the financial sector, they are classed as 'extreme' tools, specifically to tackle situations of extreme seriousness. However, compared with the ordinary instruments of Bankruptcy Law, their preventative functions emerge clearly.

Special administration and compulsory administrative liquidation have the same legal definition of the trigger requirements for their activation. The difference between the two resides in the seriousness of the situation. The purposes are also different: the first is essentially aimed at the reorganisation or recovery of the banks; the second aims to wind down the bank's business; but also in this case resolution tools are used to minimise the disruptive effects of the liquidation and to protect depositors.

1.3 Crisis management: general principles.

The pre-definition of the principles – namely the "values" of crisis management – is essential for the treatment of banking crises and the activation of the relative instruments. These are well identified in the Italian framework, even though not always expressly mentioned in laws and regulations. They are valid for any kind of banks and assume an increasing importance according to the sizes, complexity of structures and the business functions performed by intermediaries.

One of the main goal in the choice of the instruments of intervention is the ***protection of the business***, because it is of primary importance to avoid or minimise the disruptive effects of the crisis on depositors and other stakeholders or, from another point of view, to preserve the financial services provided to the economy. So, the preferred outcome, whatever the legal solution, is to assure continuity in the business through M&A transactions, P&A transactions or other similar solutions.

Another principle of general application in crisis management and resolution is to ***preserve market discipline***, without charging taxpayers with the costs of the crisis. This implies that the first step is to charge losses to shareholders and afterwards to call them to recapitalise the bank or, if not possible, to arrange a deal whith another private bank (priority to *private sector solutions*) at market conditions. An important element of these transactions is the adoption of competitive criteria in the selection of the "intervening bank" in the crisis.

Strictly connected with the market discipline issue is reducing ***moral hazard***. This problem could rise when external support is essential for a bank's resolution, for example in the case of DIS intervention.

To reach these goals a set of general rules is in place. The first element from this perspective is that the cost of the DIS is charged to banks, so that there is a strong incentive for their good management of banks and reciprocal monitoring. A second element is that interventions of DIS are mandatory only for compulsory liquidations, while other kinds of interventions are discretionary and subject to the "*least-coast*" criterion. Furthermore, the protection assured to depositors is not full, so that a depositors' control of the management of banks remains; finally, a *risk premium system* for banks' contributions to deposit insurance schemes is another essential factor for reducing riskiness of the bank.

Another key aspect to face moral hazard is the provision of administrative sanctions applicable by authorities against corporate officers for the infringement of law and regulation; moreover, legal actions towards the same corporate officers can be taken for damages incurred to shareholders and creditors as a consequence of mismanagement.

Finally, it is worth citing the discretionary nature of previous public intervention by the Bank of Italy. The *constructive ambiguity* principle was applied so that there was no assurance that in the case of a big bank failure public intervention should have taken place. Specific restrictive rules were applicable. In practice, this happened in only in a few cases of general interest.

1.4 An overview of special proceedings.

The two special proceedings of special administration and compulsory administrative liquidation can be activated by the authorities in a wide range of situations, which are not necessarily insolvency. According to the scheme provided for by the Banking Law, the Bank of Italy may intervene (through the appointment of special administrators or liquidators) in case, for instance, of unsafe and unsound conducts; fraud and illegal behaviour; violations of laws; or non-compliance with prudential regulations. The Authorities rarely know the exact nature and seriousness of the problem. Thus, the specific mandate of the special administrator is to fully assess them and find the best solution.

Special administration, in effect, consists of the appointment by the Bank of Italy of one or more special administrators, who replace the troubled bank's management. They take over the running of the company and perform all the functions of the dissolved administrative bodies of the bank.

The purposes of the procedure are indicated by law, namely to ascertain the condition of the bank, to eliminate irregularities and to promote solutions for safeguarding depositors.

Compulsory administrative liquidation is a procedure equivalent to the failure of a commercial business. It may be activated, if so required, in the case of insolvency or in other situations provided for by the Banking Law. It implies

the revocation of the banking license. The proceeding is managed by one or more liquidators appointed by the Bank of Italy, implying the removal of the firm from the market. The liquidators proceed with the realisation of the bank's assets in order to pay creditors under the rules governing general insolvency proceedings or bank-specific insolvency rules.

The evolution of Italian legislation has led to the extension of the banking model to other financial institutions, such as investment firms (SIM), fund management companies (S.G.R.), open-ended investment companies (SICAV) and some more relevant financial intermediaries regulated by article 106 of the Banking Law.

The use of these two proceedings depends on the resolution policy. The Italian approach - like the majority of countries - aims at seeking solutions that preserve or maximise the value of the firm and protect its productive organisation and customer relationships.

This strategy is implemented in the two procedures through specific resolution techniques.

In special administration, the solutions could include recapitalisation by shareholders within a reorganisation plan, the reallocation of ownership or the merger with financially solid banks capable of reinstating sound and prudent management. The search for a solution is facilitated by the continuation of the firm's regular activities. The suspension of payments is resorted to only in exceptional circumstances.

In compulsory administrative liquidation, the main goal is to collect and sell the assets of the bank and to distribute the proceeds to creditors. This is a way to solve banking crises when other resolution measures are not available or have been tried unsuccessfully. The main characteristic of the liquidation is the extinction of the bank as a legal entity, but this does not necessarily imply the winding up of the business.

In fact, the opening of liquidation proceedings may lead to the realisation of assets and payment to creditors in different ways. In other words, different techniques to conduct the liquidation may be followed, depending on the specific situation of the bank and on the possible effects on the third parties involved. These techniques are:

– liquidation assets by assets (fire solution/piecemeal liquidation);
– sale "en bloc" of assets (bulk sale);
– securitisation of assets;
– transfer of assets and liabilities to another bank (P&A transactions);
– transfer of insured deposits to another bank, usually accompanied by the transfer of assets for a corresponding amount.

The sale “as a whole” of the business to another intermediary avoids the dissolution of pre-existing legal relationships, so that liquidators may continue the business of the undertaking, under the direction and the control of the Bank of Italy. This operation allows liquidators to preserve the value of the assets, reduce costs and limit the repercussions of the failure. Normally, the acquiring bank pays a goodwill to the liquidator for the business taken over and this goodwill can be sufficient “to fill the hole” between assets and liabilities.

Given this approach, the P&A transaction is to be considered not exclusive of “restructuring and resolution measures”, but it can be used within the liquidation process too. In Italy, the transfer of assets and liabilities is the favourite and the most used technique to liquidate the bank without disruptive effects.

This explains why, the transfer of A&L is not an alternative to liquidation, but a way of liquidation. In this sense, the P&A transaction should be considered as a “bank restructuring and resolution” measure and as a “banking liquidation” approach.

It is worth noting that recently the Banking Law was reviewed to provide for and better regulate the **voluntary liquidation** of a bank, previously only disciplined by the civil law. This is a voluntary decision taken by the shareholders or management to exit from the market. It implies the renouncement to the banking license. According to new provisions of the Banking Law, banks are required to promptly inform the Bank of Italy of the occurrence of a cause for the dissolution of the company. The Bank of Italy verifies the existence of the conditions to carry out the liquidation procedure in a regular manner.

This goal is normally reached through the transfer of assets and liabilities to another bank in order to avoid the interruption of banking activity. In such cases, the bouk will be solvent and the liquidator will meet its obligations.

An important provision of law is that, when the procedure for the ordinary liquidation of a bank is not carried out in a regular and expeditious manner, the Bank of Italy may order the replacement of the liquidators and of the members of the oversight bodies, without causing any change in the liquidation procedure.

1.5 The discipline of banking group crises.

Italian Banking Law provides for a specific discipline for banking group crises. In some circumstances, special administration and compulsory administrative liquidation are applicable both to the parent bank or parent financial firm and to the banks and financial firms belonging to banking groups.

Although each single company has its own legal identity and autonomy, the economic, financial and operational relationships among group companies require a unity of management or, at least, coordination among officials even in the case of liquidation. So, a single special administrator or liquidator can be appointed

for all companies of the group. The power of the appointed administrator or liquidator to replace the management of the group's companies not placed under special proceedings, in order to achieve the best coordination of the whole group, is also effective.

1.6. Deposit insurance schemes.

The framework for the treatment of banking crises is completed by two deposit guarantee schemes, which can intervene in the case of the liquidation of a bank for the reimbursement of depositors and, in other ways, on a voluntary basis for the resolution of insolvent banks.

Deposit insurance in Italy has a very long history; it was introduced far before the European directive that made it mandatory at the European level. The higher coverage level in respect to the minimum required by EU regulations has contributed to maintaining depositors' confidence in the reliability of the banking system even if *rumours* affect a specific bank. No *bank runs* have been reported in Italy until now and the activation of special resolution measures have allowed a rapid transfer of an ailing bank or of its assets and liabilities to another bank, without charging depositors and other creditors with the costs of the crises.

When necessary, in rare cases of extraordinary general interest in the '90s, public support in the form of central bank intervention has been activated, according to the EU State aid rules. These were the cases of Banco di Napoli and Sicilcassa (see chapter 6).

2. Special administration

2.1 The main features of the proceeding.

The special administration is covered by articles 70-78 of the Banking Law. This can be considered as the proceeding through which public authorities (the Bank of Italy and Minister of the Economy and Finance), in specific cases provided for by law, intervene for the substitution of the management and controlling bodies of the bank in order to re-establish the safe and prudent management of the bank itself and to reorganise it in the pursuit of general interests connected with banking activity. As a consequence of the dissolution of governing bodies, the management of the bank is entrusted to officials appointed by the Bank of Italy with a mandate to return it to normal conditions. If this goal is not achievable, other solutions will be sought for the protection – to the maximum extent possible – of the bank's stakeholders.

It is immediately evident that this "replacement effect" can be considered as the first, and the most important, featuring element of the proceeding. Given also the wide circumstances in which the special proceeding can be activated,

it assumes an effective “precautionary” nature, preventing the situation from worsening as a consequence of irregular or imprudent management.

The special administration lasts for one year, unless the Minister decree establishes a shorter period or the Bank of Italy authorises early closure. In exceptional cases, the procedure may be extended for a period of up to six months. The Bank of Italy may extend the time limit of the procedure by up to two months, even if it has been extended for six months as said before, for acts related to the closure of the procedure, provided the manner of their performance has already been approved by the Bank of Italy (technical extension).

2.2 Starting requirements.

The effectiveness of the proceeding and its precautionary nature depend essentially on the wide scope of the starting requirements (*trigger events*), both quantitative and qualitative. These are:

– serious administrative irregularities or serious violations of laws, regulations or by-laws governing the bank’s activity;
– forecast of serious capital losses; and
– reasoned request by the administrative bodies or the extraordinary general meeting.

More precisely, serious administrative irregularities recur when governing bodies prove unfit to conduct banking business in accordance with the principles of sound and prudent management. Intervention is put in place at a early stage before the economic situation deteriorates so to prevent the situation from worsening. The time factor is of utmost importance, since the sooner the intervention is made, the greater the possibilities of solving the crisis are.

As experience teaches us, a crisis can come from extra-economic factors, fraudulent and misleading behaviour or criminal use of the banking activity. All these factors demand compulsory measures by supervisory authorities to be adopted before market sanctions begin to hit the bank. In this context, it is worth underlining the breadth of the provision of law, which allows plenty of space to the authorities’ evaluation and discretion. Since the law does not indicate exactly when the irregularities become “serious”, supervisory authorities are left with the task of doing so.

Despite the lack of specific law provisions, the concept of *serious irregularities* is quite clear and consolidated in practice, where a wide range of circumstances have been assumed by authorities to support the opening of the procedure, such as:

– deviation from the principles of sound and prudent management, especially in credit allocation, which is still the “core” business of the banking activity.

In general, it may happen in the case of excessive risk-taking in the banking business;

- compromising the bank's autonomy: external influences that erode the independence and integrity of the management;
- impossibility for collegial bodies to perform their functions because of internal conflicts;
- unreliability of the environment in which it operates and of the account books; and
- criminal prosecution against the management of the bank.

The requirements concerning *capital losses*, even prospective ones, denote the primary importance of capital adequacy for banks, namely the minimum start-up capital, the solvency requirements and other supervisory rules linked to the amount of capital.

The third juridical condition for the opening of the proceeding (the request by the bank itself) is simpler for the authorities, in that it means the governing bodies of the bank itself are aware of the problem and decide to pass the buck.

2.3 The effects.

The main effects deriving from the opening of the proceeding is the dissolution of the administrative and auditing bodies of the bank and their replacement with *special administrators* and an *oversight committee*. Furthermore, the functions of the general meetings and other similar governing bodies are suspended by effect of the special administration.

During the proceeding, the business goes on as usual under the management of the special administrators. This means that the bank continues to be managed as a "*going concern*" and this facilitates the search for an efficient and effective solution for its stakeholders.

Only in exceptional circumstances the special administrators, in order to protect the interests of creditors, may suspend the payments of the bank's liabilities of whatever kind and the restitution to customers of financial instruments connected with investment services. This measure can be adopted after consulting the oversight committee and subject to the authorisation by the Bank of Italy, which may issue directions for its implementation. The suspension of payments can last up to one month, which may be extended in the same manner for an additional two months.

During the suspension period forced executions or actions to perfect security interests involving the bank's properties or customers' securities may not be initiated or prosecuted. Furthermore, mortgages may not be registered on the bank's immovable property nor may any other rights of preference on the bank's

movable property be acquired, except in the case of enforceable court orders issued prior to the beginning of the suspension period.

Another important statement of the law is that the suspension of payments does not constitute insolvency, according to the notion given by Bankruptcy law.

Other effects of the proceeding may be connected with legal consequences for the administrative body, the auditing body and the managing director, in that the law enables the special administrator to ask an Italian Law Court for the juridical punishment of the bank's previous corporate officers.

2.4 Aims of the procedure and tasks of the special administrators.

Another important provision of the Banking Law is related to the functions and the powers of the special administration's bodies. According to article 72 of the Banking Law, the special administrators perform administrative functions and exercise the administrative powers of the bank. The oversight committee exercises control functions and gives opinions to the special administrators in the cases provided for by law or following the direction of the Bank of Italy.

The tasks of the special administrators can be split into three categories:

– i) to ascertain the bank's situation;

– ii) to eliminate irregularities; and

– iii) to promote solutions that are in the interests of the depositors.

The task of ascertaining the bank's situation implies the assessment of the actual technical and organisational conditions of the bank under the most important profiles (liquidity, capital adequacy, profitability, administrative and accounting procedures, internal control mechanisms). This is a very important function, because without a clear and complete picture of the bank's situation it would be impossible to evaluate the real nature of the crisis, its reversibility and the chances for reorganisation or other solutions.

The second task is eliminating irregularities in administration. This activity involves the regularisation of the management of the bank through the removal of existing pathological situations that gave rise to the crisis. In a wide configuration, it includes all initiatives aimed at healing the shortcomings in all organisational, internal control and operational procedures. This contributes to the requalification of the bank's most important sectors, thereby creating conditions for safe and prudent management.

Finally, there is the task to propose and promote the solutions of the crisis in the interests of depositors. This is the "core" of the special administrators' functions, performed in strict coordination with the Bank of Italy, which has the power to approve every solution and authorises, if needed, the convening of the shareholders' meeting.

On the basis of their findings, the special administrators have to take action for the reorganisation of the bank, provided that the bank *is able* to carry on its business on its own or ultimately using shake-up measures (restructuring, increase of capital, replacement of management, etc.). Otherwise, if the bank *is not able* to carry on its business autonomously, a different solution has to be found, such as combination with another bank or compulsory administrative liquidation.

Special provisions are granted by law to the special administrators and to their acts. Should the decisions of the special administrators be challenged, the court cannot suspend the execution of those subject to authorisation or that in any case implement measures of the Bank of Italy. In the performance of their functions the special administrators are public officers. However, civil actions against them and members of the oversight committee for acts performed in the conduct of their official duties can be brought subject to the authorisation of the Bank of Italy.

The Bank of Italy, by way of instructions to the special administrators or to members of the oversight committee, may establish special safeguards and limitations on the management of the bank. The members of the special bodies are personally responsible for failing to observe the directions of the Bank of Italy; third parties without knowledge of the Bank's directions are not be prejudiced, however.

Legal action for liability against members of the dissolved administrative and control bodies and the general manager, as well as action against the person appointed to control or audit the accounts, can be brought by the special administrators after consulting the oversight committee, subject to authorisation by the Bank of Italy. The bodies that succeed the special administrators will carry on the legal actions and report on their progress to the Bank of Italy.

In the interest of the procedure, the special administrators, having consulted the oversight committee and subject to authorisation by the Bank of Italy, may replace the person appointed to control the accounts for the duration of the procedure.

2.5 Procedural steps.

The first step of the proceeding is the proposal of the Bank of Italy to the Minister of the Economy and Finance for the submission of the bank to special administration, which implies a previous ascertainment of the existence of the requirements provided for by law, illustrated and motivated in the proposal itself. This may take place through off-site or on-site investigations.

Based on the Bank of Italy's proposal, the Minister of the Economy and Finance issues a decree for the placement of the bank under special administration. Within fifteen days of the date of the Minister decree, the Bank of Italy issues an order appointing:

a) one or more special administrators; and

b) an oversight committee composed of three to five members, which appoints its own chairman by majority vote.

The Bank of Italy, pending the instalment of these special bodies, may appoint one of its own officers as *provisional administrator*, who has the same powers as do special administrators. The Bank of Italy may remove or replace the special administrators and the members of the oversight committee.

After their appointment, the special administrators take over the bank and run it with the powers provided for by law. They carry out the functions of investigations, regularisations and identification of crisis solutions that may alternatively consist of:

i) the restitution of the bank to ordinary administration, after the implementation of a reorganisation plan, which implies the appointment of a new board of directors and a new board of auditors by general meeting;

ii) the acquisition of control (majority equity stake) by another bank or other parties by the acquisition of shares or subscription in the case of an increase in capital;

iii) merger with another bank; or

iv) voluntary or compulsory administrative liquidation.

When a solution has been found, the special administrators have to convene the shareholders' meeting for the subsequent deliberations on the measures proposed by them. Indeed, decisions related to the implementation of these extraordinary operations remain in the remit of the shareholders' meeting. This means that shareholders' rights cannot be infringed during the special administration. The agenda of the shareholders' meeting is established exclusively by the special administrators and cannot be modified.

After implementing the measures for the reorganisation, the merger or other resolution measures approved by the shareholders (or the liquidation of the bank), their mandate is concluded and they put in place all initiatives for the formal conclusion of the proceeding. In this case, the special administrators, before ceasing their functions, have to provide for the reconstitution of the bank's ordinary governing bodies.

The emoluments owing to the special administrators and members of the oversight committee for the performance of their mandate are determined by the Bank of Italy and charged to the bank subjected to the procedure.

2.6 Powers of the Bank of Italy.

Other than the functions connected with the opening of the proceedings (proposal of the special administration and appointment of the two special

bodies), the Bank of Italy performs a key role in the direction and coordination of the proceeding.

In this connection, the Bank of Italy:

i) oversees the special bodies' management and the development of the procedure;

ii) issues instructions to the special bodies in order to establish special safeguards or limitation on the management of the bank;

iii) authorises important decisions of the special bodies (legal action, etc.);

iv) authorises the convening of the shareholders' meeting for decisions related to the solution of the crisis and the conclusion of the proceeding; and

v) approves the financial statements drawn up by the special bodies at the end of the proceeding.

2.7 The conclusion of the special administration.

At the end of the procedure the special administrators and the oversight committee prepare separate reports and send them to the Bank of Italy.

The closure of the accounting period in progress at the start of special administration is delayed for legal purposes until the end of the procedure. The special administrators draw up financial statements for approval by the Bank of Italy within four months of the closure of the procedure. The accounting period to which these financial statements refer constitutes a single tax period.

Within one month of approval by the Bank of Italy, the bodies that succeed the special administrators will file the relevant income tax return in accordance with the tax laws in force at the time.

2.8 A tool for "emergency" situations: provisional management.

Article 76 of the Banking Law provides for a specific tool for urgent interventions: *provisional management*. Without prejudicing what is established by the discipline of special administration, in presence of the same starting requirements, the Bank of Italy may provide for one or more administrators to take on the administrative powers of the bank. Provisional management may not last for more than two months. During such time, the functions of the administrative and control bodies are suspended. The officers of the Bank of Italy may be appointed as administrators. In the performance of their functions the administrators are public officers.

Many of the provisions dictated by law for the regulation of the special administration are also applicable to provisional administrators, if compatible.

Provisional management is an effective instrument for urgent interventions. It allows the Bank of Italy to take over a failing institution through a simpler proceeding than that requested for special administration. In fact, it does not require the involvement of the Minister of the Economy and Finance in the opening of the proceeding.

In other words, prompt intervention allows the Bank of Italy the possibility to assess the situation of the bank in a short period of time and to gain time for a more structured intervention. In this period, if the bank is facing liquidity problems, the suspension of payment can be adopted. Normally, this short proceeding is followed by the special administration. So, at the end of its mandate, the provisional administrator hands over the bank to the special administrators.

2.9 The regimes of non-EC banks branches.

The special administration also applies to branches of non-EC banks. In this case, special provisions are covered by the Banking Law. Article 77 provides for that in the case of the special administration of branches of non-EC banks established in Italy, the special administrators and the oversight committee could assume the powers of the administrative and control bodies of the parent bank.

The Bank of Italy notifies the supervisory authorities of Member States hosting branches of non-EC banks of the start of the special administration procedure. The notification comes before the start of the procedure, where possible, or immediately thereafter.

Special Administrations			
2001-2010			
Starting requirements		**Solutions**	
article 70, par. 1 lett. a) and b)	28	Mergers	8
article 70, par. 1 lett. a)	20	Control transfer	1
article 70, par. 1 lett. b) and c)	2	Return to ordinary governing bodies	16
		compulsory administrative liquidation	8
		Voluntary liquidation	4
		Ongoing	13
Total	**50**	**Total**	**50**
1991-2000			
Starting requirements		**Solutions**	
article 70, par. 1 lett. a) and b)	51	Mergers	29
article 70, par. 1 lett. a)	15	Return to ordinary governing bodies	15
article 70, par. 1 lett. a), b) and c)	1	Compulsory administrative liquidation	22
article 70, par. 1 lett. c)	2	Voluntary liquidation	3
Total	**69**	Total	**69**

article 70, par. 1 lett. a): serious administrative irregularities or serious violations of laws
article 70, par. 1 lett. b): serious expected capital losses
article 70, par. 1 lett. c): the liquidation has been request by the administrative bodies or the extraordinary general meeting

3. Compulsory administrative liquidation

3.1 The objectives and main features of the proceeding.

Compulsory administrative liquidation is the proceeding that the Banking Law (articles 80-95) provides for the winding up of a bank. In the Italian framework this is the "last resort" solution applicable when other solutions cannot be reached.

Once the liquidation has been declared, the bank ceases to exist as a legal entity and the purposes of the proceeding are the assessment of the liabilities of the bank, the liquidation of the assets and the payment of depositors and other creditors, taking into account the priority in the ranking of different classes of creditors.

The proceeding has the same functions as the bankruptcy proceeding provided for by the Bankruptcy Law, with some differences related to the administrative nature of the compulsory liquidation in respect to the judicial nature of the bankruptcy. Indeed, for matters not expressly provided for in the Banking Law, the provisions of the Bankruptcy Law apply insofar as they are compatible.[4]

3.2 Starting requirements.

As for triggers, the legal discipline of the compulsory liquidation largely coincides with the special administration, although there are differences in the severity of the respective situations. These are:

– exceptionally serious administrative management irregularities or exceptionally serious violations of laws, regulations or by-laws governing the bank's activity;

– forecast of exceptionally serious losses of capital;

– reasoned request by the administrative bodies or by the extraordinary general meeting of the bank; and

– declaration of insolvency by the Law Court.

Unlike the special administration, an autonomous trigger for compulsory liquidation is the declaration of insolvency by the court. Its definition derives from article 5 of the Bankruptcy Law, according to which insolvency is "when one is no longer able to regularly meet his obligations. The state of insolvency manifests itself through non-fulfilments or other exterior events which show that debtor is no longer able to regularly meet his obligations". Despite the reference to the general notion, the configuration and interpretation of insolvency in the banking sector are particular. Case law gives great importance to the particular nature of the bank's insolvency, emphasising patrimonial deficit over specific non-fulfilments of obligations. The concept implies an irreversible crisis,

[4] V. TUSINI COTTAFAVI, *La liquidazione coatta amministrativa*, in G. BOCCUZZI, *La crisi dell'impresa bancaria. Profili economici e giuridici*, Milano 1998.

namely the impossibility of continuing to fulfil regularly one's obligations. For this evaluation, the importance of supervisors' inspections and liquidators' assessments, whose credibility derives from the reliability of the bodies that state them, has been stressed.

The judicial finding of insolvency may precede the opening of compulsory administrative liquidation upon request by one or more creditors or upon petition of the public prosecutor. Generally, however, it follows the liquidation because it originates from the petition of the liquidators.

Another peculiarity is that insolvency may be declared by the court after consulting the Bank of Italy. This is important because from the declaration of insolvency the opening of the compulsory liquidation proceeding is mandatory.

3.3 The opening of the proceeding and its effects.

3.3.1 The administrative steps for the opening of the proceeding.

The proceeding for the opening of compulsory liquidation is the same as for the special administration:

i) the first step is the proposal of the Bank of Italy to the Minister of the Economy and Finance, containing the motivations for the submission of the bank to compulsory liquidation;

ii) the second step is the decree of the Minister of the Economy and Finance, which revokes the banking licence and apply compulsory administrative liquidation, even where special administration or the liquidation under the ordinary rules are in effect.

   The decree of the Minister of the Economy and Finance and the proposal of the Bank of Italy are notified by the liquidators to interested parties upon request, but not before their installation.

iii) the third step is the order of the Bank of Italy appointing the bodies responsible for the procedure: one or more liquidators and an oversight committee composed of between three and five members, which appoints its own chairman by majority vote.

   The Bank of Italy may remove or replace the liquidators and members of the oversight committee. The emoluments owing to the liquidators and the members of the oversight committee are determined by the Bank of Italy in accordance with the criteria it establishes and are charged to the liquidation.

3.3.2 The effects.

The opening of the proceeding determines specific effects, which can be classified into different categories. These are:

i) **effects on corporate bodies**. From the date the decree is issued, banking activity is interrupted and the functions of the administrative and control bodies, general meetings and every other governing body of the bank cease. Moreover, the liquidators may ask an Italian Law Court for the juridical punishment of the bank's corporate officers;

ii) **effects on the bank**. From the date of the installation of the liquidating bodies, and in any case from the third day following the date of adoption of the compulsory administrative liquidation decree, the payment of liabilities of whatever kind and the restitution of third parties' assets are suspended.

    Other effects on the bank are those typically related to bankruptcy, aimed at creating the "estate" in the interest of creditors (articles 42, 44, 45 and 66 of the Bankruptcy Law);

iii) **effects on creditors.** This category includes the rules concerning the "concursus creditorum" (under which credits or rights must be ascertained in compliance with law), and those aimed at protecting the "estate" from individual actions (automatic stay). The latter consists of the prohibition of bringing or prosecuting actions against the bank in liquidation, with the exception of some circumstances specifically provided for by law (articles 87, 88 and 89 and par. 3 of article 92). Moreover, no forced executions or actions to perfect security interests in the bank's properties can be initiated or prosecuted on any grounds. For civil actions of any kind deriving from the liquidation, the only competent court is where the bank has its registered office.

iv) **effects on pre-existing relationships and contracts.** These are regulated by articles 72-83bis of the Bankruptcy Law, according to which the liquidators have the power to suspend contracts not enforced or not fully enforced at the date of the decree of the compulsory liquidation. In other cases, contracts may be continued or interrupted;

v) **effects on acts conducted to the detriment of creditors**. If judicial insolvency has been declared for the bank in liquidation, revocation actions can be brought by the liquidators to increase the bank's "estate" in favour of creditors. Moreover, the declaration of insolvency makes it possible to apply sanctions against the bank's managers for bankruptcy crimes.

3.4 Power and functioning of liquidating bodies.

The liquidators legally represent the bank, perform all actions pertaining to it and carry out the operations of the liquidation. In the performance of their functions the liquidators are public officers. The oversight committee assists the liquidators in the performance of their functions, supervises their actions and gives opinions on specific cases provided for by law or following the directions of the Bank of Italy.

3.4.1 The assessment of the bank's liabilities.

This is an important task entrusted by law to the liquidator. It consists of filing the list of admitted creditors, the amount of the claims allowed for each, indicating the existence and order of the rights of preference as well as the list of persons holding property rights with respect to assets and financial instruments in the bank's possession (the *statement of liabilities*). This function is divided into an administrative phase and a judiciary phase. In the first phase the liquidator prepares the statement of liabilities. In the judiciary phase objections to the statement of liabilities may be presented by interested parties.

The administrative phase is regulated by article 86 of the Banking Law. Within one month from their appointment the liquidators must notify each creditor, by registered letter, of the amounts payable to each as they appear in the accounting records and documents of the bank. The notice must be understood to be given subject to the reservation of the right to contest creditors' claims. Similar notices must be sent to persons appearing to hold property rights with respect to assets and financial instruments in the bank's possession connected with investment services and to customers entitled to the restitution of such financial instruments. The Bank of Italy may establish additional forms of disclosure.

Within 15 days of the receipt of the registered letter, the creditors and holders of rights may present their claims to the liquidators accompanied by supporting documentation. Moreover, the law attributes to creditors and the holders of property rights, who have not received the said notice, the right to request the recognition of their claims within 60 days from the publication of the liquidation decree.

At the end of this process the liquidators present to the Bank of Italy, after consulting the superseded directors of the bank, the statement of liabilities, namely the list of admitted creditors and the amounts of the claims allowed for each, indicating the existence and order of the rights of preference, as well as the lists of the holders of rights and of the persons whose requests for claims have been denied. Customers entitled to the restitution of financial instruments connected with investment services are entered in a special separate section of the statement of liabilities. Furthermore, the liquidators file the lists of preferred creditors and holders of rights, as well as of the persons belonging to the same categories whose requests for allowance of their claims has been denied, with the clerk of the court of the place where the bank has its registered office for inspection by those having entitlement.

The judicial phase is covered by articles 87-89 of the Banking Law. Persons whose claims have not been allowed in whole or in part may present objections to the statement of liabilities. Objections can be presented by filing with the clerk of the court a petition to the president of the court of the place where the bank has its registered office (article 87).

Appeals by the parties or the liquidators from the judgment of the court may be filed within 15 days of the date of the notification of the judgment. The

limitation period for filing petitions for cassation will be reduced by half and run from the date of notification of the appellate judgment (article 88).

After filing the statement of liabilities and until such time as all allotments and restitutions have been completed, creditors and the holders of rights who have not received notice and who have not been included in the statement of liabilities may seek to enforce their rights in accordance with specific provisions of the law (late petition). Such persons can sustain the expenses caused by the delay in filing the petition unless they are not responsible for the delay (article 89).

3.4.2 The liquidation of assets.

The liquidators have all the powers necessary to realise the bank's assets. The liquidators, with the favourable opinion of the oversight committee and subject to authorisation by the Bank of Italy, may transfer assets and liabilities, the business or parts of the business, as well as assets and legal relationships identifiable *en bloc* to a third party, normally a bank. Transfers may be effected at any stage of the procedure, including prior to the filing of the statement of liabilities; the transferee is responsible only for liabilities appearing in the statement of liabilities.

According to this provision, liquidation may occur in different ways and techniques depending on the specific situation of the bank and the effects on third parties. These techniques are:

– liquidation assets by assets (*piecemeal liquidation*);
– sale "en bloc" of assets (*bulk sale*);
– securitisation of assets;
– transfer of assets and liabilities to another bank (P&A transaction). Sometimes, the transfer does not regard all assets and liabilities, but only a part of them, upon the condition of the respect of equal treatment of creditors' rules. This is a way to realise a bad bank/good bank scheme, in the sense that good assets are transferred to another (existing) bank or to a bank purposely created, while the bad assets remain in the hands of liquidators, who realise them for the allotment to creditors; and
– transfer of insured deposits to another bank, usually accompanied by the transfer of assets for a corresponding amount.

The transfer of assets and liabilities is preferred and it is the most used technique to liquidate the bank without disruptive effects. This is why a P&A transaction is not an alternative to liquidation, but a means of liquidation. Hence, the P&A should be considered in both the "bank restructuring and resolution" and the "banking liquidation" solutions.

The assignment of all assets and liabilities to another bank is the preferable solution for many reasons: i) higher selling-price (the value of a going concern is normally higher than the value of net capital. This difference is usually paid by

the transferee to the liquidation as goodwill); ii) maintenance of credit relations with solvent debtors and, in particular, with productive enterprises, which would suffer from a sudden cut-off of financing by the bank; iii) best protection of depositors' interests (assignment of business, continuity of contracts and transactions connected to deposits); iv) protection of enterprise value; and v) minimisation of depositors' protection schemes.

The alternative way of liquidation, the individual selling of assets and distribution of liquidated assets by allotment to depositors and other creditors may have negative effects for creditors and other stakeholders in terms of:

- lower selling price of a bank's assets;
- cut-off of financing of enterprise and interruption of contracts;
- break-up of the business unit;
- wasting of enterprise value; and
- possible intervention of depositors' protection scheme.

Where necessary and to assure the best realisation of the bank's assets, the liquidators, subject to authorisation by the Bank of Italy, may continue the business in accordance with the cautionary recommendations of the oversight committee. This is decided at the installation of the liquidating bodies within three days of the date of the adoption of the compulsory administrative liquidation decree, and it excludes the dissolution of pre-existing legal relationships.

For paying allotments to persons having entitlement, the liquidators may also contract loans, undertake other kinds of borrowing operations and offer the bank's assets as security, in accordance with the directions and cautionary recommendations of the oversight committee and subject to authorisation by the Bank of Italy.

3.4.3 Payments to creditors and the restitution and allotment of assets.

The liquidators restitute assets as well as financial instruments connected with investment services and allot the bank's liquidated assets in the order established by article 111 of the Bankruptcy Law (priority rules). Emoluments and refunds due to the bodies responsible for the special administration procedure and to the administrators of the provisional management that preceded the compulsory administrative liquidation, if any, are treated as equivalent to expenses pre-deductible, which are payable first in the ranking of priority established by the Bankruptcy Law.

Special provisions are stated where the separation of the bank's assets from those of customers entered in the special section of the statement of liabilities is respected but the separation by customer of the assets of such customers is not respected or the financial instruments are not sufficient to effect all the restitutions. In these cases, the liquidators, where possible, effect restitutions *pro rata* according to the rights on the basis of which each customer has been admitted to the special

section of the statement of liabilities or liquidate the financial instruments belonging to customers and allot the proceeds on the same pro rata basis.

Customers entered in the special section of the statement of liabilities participate with unsecured creditors, in full where the separation of the bank's assets from those of customers is not respected, and for the part of their rights not satisfied in the cases where financial instruments are insufficient.

The liquidators, after consulting the oversight committee and subject to authorisation by the Bank of Italy, may make partial allotments and restitutions to all the persons having entitlement or to certain categories of such persons, even before all the assets have been realised and all liabilities assessed. The allotments and restitutions must not jeopardize the possibility of the final assignment of the quotas and assets due to all the persons having entitlement.

In effecting allotments and restitutions, where there are claims of creditors or other interested parties whose admission to the statement of liabilities has not been decided, the liquidators set aside the amounts and the financial instruments corresponding to the allotments and restitutions not effected to such persons for distribution or restitution to them in the event of recognition of their rights or, failing such recognition, for release to the persons having entitlement. In these cases, the liquidators, with the favourable opinion of the oversight committee and subject to authorisation by the Bank of Italy, may acquire suitable guarantees in substitution of the amounts set aside.

Claims and requests presented after the expiry of the limitation periods established by law (late petitions), are eligible to participate only in subsequent allotments and restitutions, if any, and to the extent allowed by the liquidators, or, after the filing of the statement of liabilities, by the judge deciding on objections presented under article 87, par. 1. Persons who file late proof of claim under article 89 participate only in such allotments and restitutions as may be effected after the filing of the petition. In these cases, property rights and rights of preference shall be enforceable where the assets to which they refer have not been divested.

3.5 The powers of the Bank of Italy.

The Bank of Italy has a central function in the carrying out of the proceeding, playing the same role of the courts in bankruptcy proceeding. These key functions are:

– ascertainment of the existence of the requirements of compulsory liquidation and proposal to the Minister of the Economy;
– appointment, removal or replacement of the liquidators and members of the oversight committee;
– issuing of directives concerning the implementation of the liquidation and prescription of its authorisation or preliminary consultation with the oversight committee for some categories of operations or actions. The members of

the liquidating bodies are personally responsible for the failure to observe the directives of the Bank of Italy; third parties without knowledge of the Bank's directives cannot be prejudiced;

– authorisation of some important decisions of the liquidating bodies, such as legal actions for liability against members of the dissolved administrative and control bodies and the general manager, actions against the person appointed to control or audit the accounts and actions against the company or other entity exercising management and coordination functions;
– receiving and examining the annual report on the bank's accounts and assets and liabilities as well as on the progress of the liquidation by the liquidators and the oversight committee. The Bank of Italy establishes also the procedures and time limits for the periodic reports to creditors on the progress of the liquidation.

3.6 Composition with creditors.

At any stage of the compulsory liquidation, the liquidators, after obtaining the opinion of the oversight committee, or of the bank itself and that of the liquidating bodies, may propose a composition with creditors to the court of the place where the undertaking has its registered office. The proposed composition must be authorised by the Bank of Italy.

The agreement must indicate the percentage to be offered to unsecured creditors, the time of payment and any guarantees. The obligation to pay the quotas indicated in the composition may be assumed by third parties with the total or partial release of the debtor's bank. In such case, actions by the creditors for the execution of the composition may be brought only against the assignees within the limits of their respective quotas.

The proposed transaction and the opinion of the liquidating bodies are filed with the clerk of the court. The Bank of Italy may establish other forms of publication. Within 30 days of the filing interested parties may present objections by filing a petition with the clerk of the court, notice of which is given to the liquidator. The court decides on the proposed composition, taking account of the objections and of the opinion rendered by the Bank of Italy. The judgment is made public by way of filing with the clerk of the court and by other means established by the court.

The liquidators, assisted by the oversight committee, supervise the implementation of the composition in accordance with the directives of the Bank of Italy. Once the composition has been implemented, the liquidators convene the shareholders' meeting of the bank to adopt a resolution modifying the corporate purpose in relation to the revocation of the authorisation to engage in banking. Where the modification of the corporate purpose is not effected, the liquidators have to take the measures necessary for the deletion of the company and the deposit of the statutory company books provided for by the provisions of the Civil Code on the dissolution and liquidation of corporations.

3.7 The conclusion of the proceeding.

Once the assets have been realised and before the last allotment to the creditors or the last restitution to customers, the liquidators present to the Bank of Italy the closing statement of the accounts of the liquidation and the statement of the source and application of funds and the allotment plan, accompanied by their own report and a report by the oversight committee. The Bank of Italy authorises the filing of the documents with the clerk of the court.

The liquidation constitutes a single accounting period, including for tax purposes; within one month of the filing, the liquidators present the income tax return for the period in accordance with the tax laws in force at the time. The filing is made public by way of a notice in the Gazzetta Ufficiale della Repubblica Italiana. The Bank of Italy may establish additional forms of publication.

Within 20 days of publication in the Gazzetta Ufficiale della Repubblica Italiana interested parties may initiate legal actions by filing a petition with the court. Once the limitation period referred to has expired without the initiation of legal actions or once such actions have been decided by an enforceable judgment, the liquidators may proceed with the final allotment or restitution.

Amounts and instruments that cannot be distributed are deposited in the manner established by the Bank of Italy for subsequent distribution to persons having entitlement. The provisions of the Civil Code on the liquidation of corporations concerning the deletion of the company and the deposit of the statutory company books applies. The fact that petitions and judgements are pending, including the judgement on the state of insolvency, cannot preclude the performance of the final duties described above and the closure of the compulsory administrative liquidation procedure. Such closures are subject to the setting aside of amounts or the acquisition of guarantees in order to ensure stakeholders' rights.

Compulsory Administrative Liquidation			
2001-2010			
Starting requirements		**Solutions**	
Article 80, par. 1 and 2)	10	Transfers of assets and liability	11
Article 80, par. 1	2	Depositors pay-out	1
Total	**12**	Total	**12**
1991-2000			
Starting requirements		**Solutions**	
Article 80, par. 1 and 2)	16	Transfers of assets and liability	33
Article 80, par. 1	16	Depositors pay-out	**1**
Article 80, par. 2	2		
Total	**34**	**Total**	**34**

article 80, par. 1: exceptionally serious administrative irregularities or violations of laws or capital losses
article 80, par. 2: request by the administrative bodies, the extraordinary general meeting, the special administrators or the liquidators

4. The discipline of banking group crisis

4.1 The banking group: definition and general discipline.

Before outlining the discipline of a banking group crisis management, some general remarks on the notion and regulation of the banking group is necessary to better understand the peculiar rules of crisis management. The objective of the discipline is to consider the group as a single entity from a supervisory and crisis management perspective, without neglecting at the same time the consideration of the legal personality and autonomy of each component of the group.

The first issue to consider is the specific provision concerning the composition of the group. Article 60 of the Banking Law provides for two alternative configurations:

i) an Italian parent bank and the banking, financial and instrumental companies it controls; or

ii) an Italian parent financial company and the banking, financial and instrumental companies it controls, where such companies include at least one bank and the banking and financial companies are of decisive importance, as established by the Bank of Italy's regulation.

The definition of control is contained in the Civil Code (article 2359, pars. 2 and 3) as integrated by article 23, par. 2 of the Banking Law, which specifies that a situation of control exists in the presence of contracts or provisions of the bylaws that establish or effectively entail the power to exercise management and coordination functions on other companies. It also includes some situations in which control is deemed to exist in the form of dominant influence.

A register of banking groups is kept by the Bank of Italy. For this purpose, the parent undertaking is to notify the Bank of Italy of the existence of the banking group and of any changes in its composition.

The Bank of Italy may verify the existence of a banking group and enter it into the register, or may establish a composition of the group different from that notified by the parent undertaking.

Companies belonging to the group must indicate in their documents and correspondence that they are included in the register. Regulations concerning the keeping and updating of the register are issued by the Bank of Italy.

The parent undertaking is the Italian bank or the financial company that has its registered office in Italy which controls the various entities of the banking group and which is not, in turn, controlled by another Italian bank or by another financial company that has its registered office in Italy which can be considered a parent undertaking.

The parent undertaking is subject to the same supervisory controls of banks. With respect to other companies belonging to the group and the owners of holdings in such companies, the Bank of Italy has the powers to require the names of the owners of holdings based on the register of members, notifications received or other information available. The Bank of Italy may also require the directors of companies and entities that own holdings in a bank to provide the names of the persons that control such companies and entities. Moreover, the Bank of Italy verifies that the by-laws of the parent undertaking are not in conflict with the sound and prudent management of the group.

The parent undertaking, in carrying out its activity of management and coordination, must issue rules to the components of the group for the implementation of the instructions issued by the Bank of Italy in the interests of the stability of the group. The directors of the companies belonging to the group must supply all figures and information needed for the issue of such rules and cooperate in complying with the provisions on consolidated supervision.

4.2 Consolidated supervision.

4.2.1 The banking and financial institutions included within the scope of consolidated supervision.

The banking group is subject to the regulation and supervision of the Bank of Italy on a consolidated basis. However, the boundary of the consolidated supervision is wider than that of the banking group; indeed, article 65 of the Banking Law provides for that the Bank of Italy carries out the supervision on a consolidated basis with respect to the following persons:

a) companies belonging to a banking group;

b) banking, financial and instrumental companies owned for at least the 20 per cent of capital by companies belonging to a banking group or by an individual bank;

c) banking, financial and instrumental companies not included in a banking group but controlled by a natural or legal person who controls a banking group or an individual bank;

d) companies that control at least one bank;

e) companies other than banking, financial and instrumental companies where they are controlled by an individual bank or where companies belonging to a banking group or companies referred to in lett. d) hold, jointly or otherwise, a controlling interest.

The scope and performance of consolidated supervision are regulated by law, according to the same model applicable to individual banks.

Specific reporting requirements are provided for the banking group. Article 66 of Banking Law provides for that, for the purpose of carrying out the supervision on a consolidated basis, the Bank of Italy may require financial institutions to transmit reports, figures and any other relevant information on a periodic basis. The Bank of Italy establishes the manner and time limits for the transmission of the reports, figures and information. For this purpose companies referred to in article 65 shall provide the parent undertaking or individual bank with the reports, figures and information needed to carry out consolidated supervision.

Furthermore, the Bank of Italy has regulatory functions and powers. It issues instructions to the parent undertaking concerning the banking group as a whole or its components with regard to:

a) capital adequacy;

b) the limitation of risk in its various forms;

c) permissible holdings;

d) administrative and accounting procedures and internal control mechanisms; and

e) disclosure concerning regulatory matters.

The Bank of Italy may also issue instructions to one or more components of the banking group.

Finally, the Bank of Italy may carry out inspections of financial institutions included in a banking group and require them to exhibit the documents and records it deems necessary. The inspections of companies other than banking, financial and instrumental companies may be for the exclusive purpose of verifying the accuracy of figures and information provided for the consolidation.

4.2.2 Cross-border cooperation between authorities: the provision of the colleges of supervisors.

As a consequence of innovations in the EU supervisory framework (Directive 2009/111/EC), significant changes have recently been introduced in the Banking Law as regards the cooperation between authorities, including giving formal recognition to colleges of supervisors. Article 69 has been modified to provide that the Bank of Italy, for the purpose of supervising banking groups operating in more than one country, may establish, including by way of agreements with the supervisory authorities of other Member States, forms of cooperation and coordination, constitute colleges of supervisors and participate in colleges constituted by other authorities.

The effect of these agreements is that the Bank of Italy may also exercise the supervision on a consolidated basis over:

a) financial companies that have their registered offices in another Member State that control an Italian parent undertaking or individual bank;

b) banking, financial and instrumental companies controlled by persons referred to in subparagraph a); and

c) banking, financial and instrumental companies whose capital, at least 20%, is held, jointly or otherwise, by persons referred to in subparagraphs a) and b).

During this process, if the Bank of Italy identifies an emergency situation that potentially jeopardises the liquidity and stability of the financial system of Italy or another Member State in which the banking group operates, it should promptly alert the Ministry of the Economy and Finance and, in the case of a group that also operates in other Member States, the competent monetary authorities.

The same provisions also apply in the exercise of the supervision of individual banks operating with branches that have systemic relevance in host European countries. Moreover, credit authorities, in cases of crisis or tensions in financial markets, can take into account the effects of their own decisions on the stability of the financial system of other interested countries.

4.3 The management of banking group crisis.

4.3.1 General remarks.

Within the general discipline of the banking group, the treatment of the crisis represents the area in which a bent for the overcoming of the plurality of companies is more tangible, in favour of the consideration of the group as a whole. That is why crisis situations concerning companies belonging to the group, in some circumstances, may be relevant for the bank or financial parent company, justifying its placement under special administration or compulsory administrative liquidation, independent of its specific situation.

The special discipline of banking group crisis management constitutes a parallel normative *corpus* with respect to the individual bank crisis management, with peculiarities connected to the specific aspects of the banking group. The peculiarities reside in the need to ensure a coordinated and unitary management of the conglomerate, through strengthening internal coordination mechanisms and intensifying the powers of the special administrators or liquidators of the parent company with respect to subsidiaries and the enrichment of public informative sources on the group's situation.[5] The discipline of these coordination mechanisms is very articulated.

---

[5] M. BIANCO-M.MARCUCCI, *Groups and groups' bankruptcy discipline in Italy,* in BANK OF ITALY, *Insolvency and Cross-border Groups. Uncitral Recommendations for a European Perspective?*, Legal Research, No 69, February 2011; R. CERCONE, *Le procedure per la crisi dei gruppi bancari*, in G. BOCCUZZI, *La crisi dell'impresa bancaria. Profili economici e giuridici*, 1998, p. 358.

Beyond these peculiarities, the principle of the patrimonial autonomy of each company remains steady and, consequently, so does the exclusive responsibility of each of them towards their creditors. This is because the phenomenon of "group insolvency" and the subsequent confusion of assets are unknown to the Italian legal framework, so that the unitary consideration of the group does not result in a juridical subjectivity of the group itself.

4.3.2 The special administration of the parent undertaking.

The parent undertaking, in addition to the cases provided for in article 70 (serious irregularities or losses), may be placed in special administration where:

a) there has been serious non-compliance in the performance of the activity of management and coordination of the banking group; or

b) in the case of "widespread crisis", namely when a company belonging to the banking group has been subjected to bankruptcy proceedings or other similar proceedings and the financial or operational equilibrium of the group could be seriously affected.

The special administration of the parent undertaking may last for one year from the decree of the Minister of the Economy and Finance unless the decree itself establishes a shorter period or the Bank of Italy authorises its early closure. In exceptional cases the procedure may be extended for up to one year.

The special administrators, after consulting the oversight committee and subject to authorisation by the Bank of Italy, may remove or replace some or all of the directors of the companies belonging to the group to make necessary changes in management policy. The new directors will remain in office until the end of special administration of the parent undertaking at the latest. Removed directors are entitled only to an indemnity equal to the ordinary compensation due to them for the remainder of their appointment and not exceeding in any case a period of six months.

The special administrators may request a judicial finding of the insolvency of the companies belonging to the group. They may also request the companies belonging to the group provide figures, information and any other elements that may be useful in the performance of their duties.

To overcome financial difficulties, the special administrators may order the suspension of payments, the limitation periods of which could be tripled with respect to the ordinary duration provided for by article 74 in the case of an individual bank's special administration.

4.3.3 The compulsory administrative liquidation of the parent undertaking.

The parent company may be placed into compulsory administrative liquidation, in addition to the cases referred to in article 80 (exceptionally serious

irregularities and losses), where non-compliance in the performance of the activity of management and coordination of the banking group are exceptionally serious.

The liquidators report on the state of the accounts and the progress of the liquidation, accompanied by information on the implementation of the procedures to which other companies belonging to the group have been subjected and any actions that may have been taken to protect depositors. This report is accompanied by a report from the oversight committee.

The Bank of Italy may provide for the filing of the report to be published by way of special notices.

Similar to the special administration, the liquidators may also request a judicial finding of the insolvency of the companies belonging to the group; they may also request the companies belonging to the group provide figures, information and any other elements that may be useful in the performance of their duties.

Where there has been a judicial finding of insolvency in the parent company, the liquidators are responsible for bringing the revocation actions referred to in article 67 of the Bankruptcy Law with respect to other companies belonging to the group (intra-group revocations). Such actions may be brought for the anomalous transactions that harmed creditors in the five years prior to the compulsory liquidation decree and for the "normal" acts effected in the three years prior to the order, if the liquidator proves that the counterpart of such operations knew the state of the insolvency of the parent company.

4.3.4 The special administration and compulsory liquidation of group entities.

The special administration. Where the parent undertaking is subjected to special administration or compulsory administrative liquidation, the provisions of special administration may apply to companies belonging to the group. A request to the Bank of Italy for special administration may also be made by the special administrators or the liquidators of the parent undertaking.

Where a company belonging to the group is subjected to a reorganisation proceeding or an official receiver has been appointed by court order in accordance with the provisions of the Civil Code governing the reporting of serious management irregularities to the court, such procedures are converted into special administration. The competent court, upon request or on its own authority, may declare that the company is subjected to special administration and order the transfer of the record to the Bank of Italy. The bodies of the terminated procedure and those of the special administration are then promptly handed over to the company. The effects of acts legally completed are not prejudiced.

Where the companies belonging to the group to be subjected to special administration are subject to supervision, the order should be adopted after consulting the competent supervisory authority, which in an emergency may be given a time limit within which to formulate its opinion.

The duration of special administration is independent of that of the procedure to which the parent undertaking has been subjected.

To overcoming financial difficulties, the special administrators, acting in agreement with the special administrators or the liquidators of the parent undertaking, may order the suspension of payments, the limitation periods of which could be tripled.

Compulsory administrative liquidation. Where the parent undertaking is subjected to special administration or compulsory administrative liquidation, the provisions of compulsory liquidation apply to the group companies that a court has declared to be insolvent. A request for compulsory liquidation may also be made to the Bank of Italy by the special administrators or the liquidators of the parent undertaking.

Where companies belonging to the group are subjected to bankruptcy proceedings, compulsory liquidation or other insolvency proceedings, such procedures should be converted into compulsory liquidation governed by the Banking Law. Without prejudice to the prior findings of insolvency, the competent court, upon request or on its own authority, may declare that the company is subjected to compulsory liquidation and order the transfer of the record to the Bank of Italy. The bodies of the terminated procedure and those of the liquidation must promptly hand over the company. The effects of acts legally completed are not prejudiced.

4.4 Procedures applicable to individual companies.

Where the parent undertaking has not been subjected to special administration or compulsory administrative liquidation, the companies belonging to the group are subjected to the procedures established by the laws applicable to them. Notice of such orders are given immediately to the Bank of Italy by the issuing administrative or judicial authorities. The administrative or judicial authorities overseeing the procedures inform the Bank of Italy of any circumstances that emerge during the procedures that may be relevant for the purposes of the supervision of the banking group.

4.5 The coordinated management of the proceedings.

The same persons may be appointed to more than one of the bodies responsible for the special administration or compulsory administrative liquidation of companies belonging to the same group "where this is considered likely to facilitate the procedures".

A special administrator or liquidator who by virtue of being a special administrator or liquidator of another company belonging to the group has an interest conflicting with that of the company in a particular transaction must

disclose such interest to any other special administrators or liquidators, the oversight committee and the Bank of Italy.

In the event of omission, members of the oversight committee with knowledge of the conflict should give such notice. The oversight committee may establish special safeguards and formulate guidelines with respect to the transaction, for the non- observance of which the special administrators or the liquidators are personally responsible. Without prejudice to its power to remove or replace members of the bodies responsible for the procedures, the Bank of Italy may issue directives or, where appropriate, appoint a special administrator or liquidator to carry out particular actions.

4.6 Jurisdictional competences.

Where the parent undertaking is subjected to special administration or compulsory administrative liquidation, the competent court for revocation actions and for all controversies between companies belonging to the group should be the court in whose jurisdiction the parent undertaking has its registered office. Where the parent undertaking is subjected to special administration or compulsory administrative liquidation, the competent court for appeals from administrative measures concerning or connected with the procedures of the special administration or compulsory administrative liquidation of the parent undertaking and group companies should be the Regional Administrative Court in Rome.

4.7 Groups and companies not entered in the register.

The provisions concerning the banking group crisis proceedings are applied according to a substantive and not formal criterion. Indeed, article 105 provides for that the discipline of banking group crisis also applies to groups and companies that, even though they are not entered in the register of banking groups, meet the conditions for entry therein.

5. Deposit insurance schemes

5.1 The origin and evolution of the deposit guarantee schemes in Italy.

In Italy, DISs play an important role in managing and resolving banking crises. They are a relevant component of the *safety net*, supplementing the supervision and the lending-of-last-resort functions performed by the Bank of Italy. With the objective of protecting depositors from bank insolvency, they concur to restore the confidence in the banking system, avoiding that situations of crises affecting single intermediaries could spread to other intermediaries giving rise to systemic crises.

In Italy two deposit guarantee systems were created on a voluntary basis in the 1970s and 1980s. In 1978, the Italian Mutual Banks (*banche di credito*

cooperativo) created a Central Fund of Guarantee for Mutual Banks (*Fondo Centrale di Garanzia delle Casse Rurali ed Artigiane*), disciplined by an internal regulation. This Fund aimed to provide to mutual banks in temporary difficulty the financial resources necessary to restore normal conditions and to intervene, even in case of the liquidation of banks, in depositors' interests and in safeguarding the image of that category of banks.

In 1986 the Italian banking system set up the "Fondo Interbancario di Tutela dei Depositi", with the participation on a voluntary basis of all Italian banks.

The history of the two systems is an integral part of the transformation process of the Italian banking system. The two DISs were created in an economic and institutional context featured by the strong presence of the State in the Italian economy, including being a majority shareholder in banks. At that time, the market structure started to become more competitive because of its opening to foreign markets and intermediaries; the national legal system was evolving on the spur of European regulation, favouring market changes and new intermediaries' strategies. In this context, more and more oriented to market logic, the need for private solutions to banking insolvencies was strongly felt.

Until then, in fact, banking crises had been resolved through public interventions measures adopted under the regulation provided for by the Treasury Minister Decree of 27 September 1974 (see chapter 6).

The two voluntary schemes were an expression of the capacity of the Italian banking system to autonomously resolve crises that could inevitably occur in the banking market and to free the public balance sheet from improper burdens. From this perspective, the two funds constituted a form of self-regulation of the Italian banking system. Indeed, the creation of a mechanism of self-protection from insolvencies was the most coherent answer of Italian banks to the increasing autonomy that the Banking Law was progressively recognising to banks in the definition of strategic options, organisational structure, operational areas and territorial articulation.

The statute and by-law regulating the organisation and functioning of the two schemes entrusted the Bank of Italy with a wide range of powers related to the main aspects of the funds' activity, especially the power to authorise interventions to support troubled banks, because of the strict link between the funds' activity and its role in crisis resolution. That gave the private discipline of deposit insurance system public relevance.

The relationship between public and private intervention was clearly defined. The only guarantee for savers was represented by the coverage provided by the two private funds under the extension and limitation provided for by their statutes, while the public support was devoted to the crises of major scope and size, involving general interests and triggered only under a decision taken by the relevant authorities. This principle was stated in the deliberation of the Interministerial Committee of Credit

and Saving of 23 December 1986,[6] specifying that the introduction of a private instrument of guarantee did not prejudice the need for a public tool of interventions in extraordinary cases of relevant general interest.

5.2 The new regulation following European Legislation.

After the implementation of EU Directive 94/19/EC the two funds underwent some changes. The most important of which consisted of the mandatory membership (as a prerequisite to conducting banking activity), as stated by the Italian Banking Law.

In accordance with the new European framework, the two Italian DISs had to modify their internal regulations. So, we have now:

i) the "*Fondo Interbancario di Tutela dei Depositi - F.I.T.D*" (Interbank Deposit Protection Fund), whose members are all banks configured as joint-stock corporations as well as cooperative banks. In December 2010 there were 280 participating banks, of which nine were extra-EU banks and two EU banks.

ii) the "*Fondo di Garanzia dei Depositanti del Credito Cooperativo* (Mutual Banks Depositors Protection Fund), whose members include 516 mutual banks.

The Banking Law governs the most essential aspects of deposit insurance schemes: member institutions, the nature of the insurance system, their interventions, the powers of the Bank of Italy and the procedures for excluding banks from the schemes. Other regulation of the matter is provided for by statute and by-law of the two DISs.

The most important rules stated by the Banking Law are the following.

i) **bank membership and legal nature of DISs.** Article 96 provides for that all banks are required to be members of a deposit insurance scheme established and recognised in Italy (mandatory membership).

   Italian branches of banks based in other EU countries may join an Italian system to supplement the coverage provided by the country of origin (*topping up* rule), while membership is compulsory for the branches of non-EU banks in Italy unless they are members of an equivalent foreign scheme.

   As to the institutional set-up, the two Italian DISs are private law consortia among banks and are administered by representatives of the members. The schemes' corporate structure are similar to those of other corporate enterprises, comprising:

   – the General Meeting;

[6] The benefit consisted of the deduction from the aggregate subject to binding reserve of a percentage of 50% of the total commitments.

- the Board;
- the Executive Committee; and
- the Boards of Auditors.

They do not perform supervisory functions nor can they oblige banks to adopt measures in case of difficulties. Their functions are performed in strict coordination with the Bank of Italy.

ii) **the level of coverage.** Until the full harmonisation process, Italian deposit insurance schemes granted a very high coverage level to depositors. The limit of reimbursement was 103,291 euro per depositor. This choice was for two reasons, namely to protect small depositors (unaware depositors) and to contribute to the stability of the financial system. The protection "per depositor" and not "per deposit" meant that if a depositor had more than one deposit or account at a failed bank, these deposits or accounts would be consolidated and repaid up to the limit provided for by law.

Recently, Italian legislation has been amended with the legislative decree 49/2011 for the implementation of the new rules introduced by European Directive 2009/14/EC.[7] The article 96-bis of the Banking Law provide for a limit of coverage of 100,000 euros for each depositor. The Bank of Italy will update such a limit to align it to further changes that could be introduced by the European Commission to adequate it to the inflation rate.

As to the object of the guarantee, the reimbursement regard claims relative to repayable funds acquired by banks in the form of deposits or other forms and to bankers' drafts or other similar credit instruments.

Some categories of bank's liabilities are excluded from protection. They are:

- bearer deposits and other repayable bearer funds;
- bonds and claims arising from acceptances, promissory notes and securities transactions;
- the bank's share capital, reserves and other elements of capital;
- financial instruments regulated by the Civil Code;
- deposits arising from transactions for which there has been a conviction for crimes referred to in articles 648-bis a 648-ter of the Penal Code;
- deposits from central Government departments, regions, provinces and municipalities and other local public authorities;
- deposits from banks, financial companies, insurance companies, collective investment undertakings, other companies of the same banking group; electronic money institutions;

[7] Legislative decree 24 march 2011, n. 49. Implementation of the Directive 2009/14/EC, amending the Directive 1994/19/EC, concerning the deposit insurance systems as to the coverage level and the terms of reimbursement (11G0090). GU n. 93 of 22.4.2011.

– deposits from members of the governing and senior managers of the bank or of the banking group's parent undertaking;

– deposits from owners of significant holdings in the bank; and

– deposits for which depositors has, on an individual basis, obtained from the bank rates and conditions which concurred to aggravate the financial situation of the bank.

The total amount of deposits protected by the *FITD* is 448 billions euros, corresponding to 70,1% of total deposits, while the amount of deposits protected by the *Mutual Banks Depositors Protection Fund* is 27 billion euros.

The level of protection provided by the FITD (Billion euros - June 2009)	
Eligible deposits	588.8
Reimbursable funds (<=103.000 euros)	447.6
Ratio of protected deposits	70.1%
Non-insured funding	581.9
Reimbursable funds/total funding	**35.3%**

iii) **interventions.** Primarily, the DISs step in to protect depositors in cases of the liquidation of a failed bank. In particular, the reimbursement of depositors is mandatory in the event of the compulsory administrative liquidation of a bank.

For branches of EC banks in Italy that are members of an Italian guarantee scheme on a supplementary basis (*topping up*), payments are made where the guarantee scheme of the home Member State has intervened.

The time for reimbursement has also been articulated: DISs are obliged to make payments, up to an amount equivalent to 20,000 euros, within three months of the date of the decree of compulsory administrative liquidation. This limit may be extended by the Bank of Italy in exceptional circumstances or special cases for a period not exceeding a total of nine months. The Bank of Italy will adjust periodically that limit to take into account the inflation rate according to the decisions taken at Community level.

The legislative decree 49/2011, implementing European Directive 2009/14, has now provided for that the reimbursement of depositors is carried out within 20 working days from the date in which the effects of the compulsory liquidation are produced. This term may be prolonged by the Bank of Italy, in exceptional circumstances for a period not more than 10 working days.

As a consequence of the reimbursement, DISs succeed to the rights of depositors in respect of the bank in compulsory administrative liquidation within the limits of the payments made and, within such limits, have priority to receive allotments from the liquidation with respect to depositors that have

received such payments. As evident, this provision responds to the equity principle and to the purpose of minimising the costs of deposit insurance schemes. In fact, in cases where allotments from the liquidation are higher than is the amount reimbursed by the fund, it aims at making it possible that the fund wholly recover the sums reimbursed, with only the exceeding part returned to depositors.

However, as an alternative to depositors' pay outs, the law provides for a different kind of intervention governed by the statutes and by-law of the schemes, namely the support to a transfer of assets and liabilities to another intermediary, where paying part of the shortfall is less costly than is a deposit pay-out and liquidation of assets. Such support tends to be preferred because ordinarily the goodwill recognised by the bank taking over the assets and liabilities makes assisting the transfer less costly than does repaying depositors.

From a more general point of view, A&L transfer to another bank is a way to preserve continuity in the business activities carried out by banks, which is important from a financial stability perspective, allowing at the same time those responsible for the crisis to be subject to insolvency rules and liable for misconduct.

The schemes may also intervene in the support of banks under special administration to prevent the worsening of the situation, reduce temporary liquidity problems and facilitate M&A. This is done by granting loans, providing guarantees and acquiring equity interests.

The Insurance Fund for Mutual Banks can intervene even when a procedure has not been formally initiated in order to support a turnaround plan or facilitate M&A by a healthier institution.

iv) **interaction with the Bank of Italy.**[8] As stated before, the activities of the Italian DISs are strictly interrelated with the functions and powers of the Bank of Italy, which has a central role in the management of banking crises.

The powers of the Bank of Italy with regard to deposit insurance schemes can be split into two categories, concerning their *genetic/structural profiles* and their *functioning*.

The first category includes: i) the power of the recognition of guarantee schemes, in order to make sure they meet the standards of European regulation as incorporated into Italian law; ii) the approval of schemes' by-laws and amendments thereto, in order to make sure the schemes are not structured in a way that will cause an unbalanced distribution of insolvency risks within the banking system, which could increase rather than mitigate instability; and iii) the verification of the equivalence of the non-EU schemes that ensure the Italian branches of non-European banks, in comparison with

[8] G. BOCCUZZI, *Interrelationships between deposit insurers and supervisory authorities in the Italian and International experience*, Fondo Interbancario di Tutela dei Depositi, Working Papers, n. 9, February 2005.

the protection offered by Italian deposit insurers: these banks, in fact, are excluded from EU law by which foreign branches are covered by the home State's deposit insurance schemes.

As to the second category, the functioning of insurance schemes, the Bank of Italy has the power to coordinate their activity with banking crisis procedures and its supervisory activity. This stems from the initiatory, supervisory role that it plays in the management of banking crises, where the need for coordination is more pressing.

Banking Law clearly defines the role of the supervisor and of deposit insurers in the management of banking crises. Crisis-handling procedures (special administration and compulsory administrative liquidation) are initiated by the Minister of the Economy and Finance at the proposal of the Bank of Italy, which is responsible for the technical appraisal. The supervisory authority appoints officials responsible for the crisis management, issues instructions and oversees all procedures. Meanwhile, deposit insurers have the specific task of protecting depositors and have no say in decisions about supervision and crisis management.

Because the Bank of Italy has to give its authorisation for interventions by DISs, if the deposit insurer intervenes, the prior coordination between the two will prevent the actions of one from posing an obstacle to the other. In crisis management, in fact, cooperation grows more intense to ensure that intervention is swift and appropriate to the nature of the crisis. It is rare in Italy for depositors to be reimbursed; far more frequently, alternative solutions are devised by which another bank acquires the assets and liabilities of the one being wound up, with the financial support of the insurers covering part of the deficit. The effort to find market solutions – best offers, that is, determined via auction or other means – helps reduce the cost for the insurance schemes.

In these cases, of course, good coordination is especially important given the intervening bank's involvement in negotiating the solution to the crisis. The sharing of information about the troubled bank's finances becomes more complex than usual, since crisis management officials are required to keep its situation transparent for both the intervening bank (who has to evaluate the extent of its financial commitment) and the insurers (who have to decide whether it is more effective to reimburse depositors or to provide for other forms of intervention).

Furthermore, the Bank of Italy regulates the deposit reimbursement procedures, and the banks are required to give information to the public regarding the schemes to which they belong and the coverage/exclusion of the various kinds of deposits.

A stable information flow between the Bank of Italy and the deposit insurance schemes is especially crucial here. The Banking Law expressly provides for such information sharing, without prejudice to confidentiality. The deposit

insurers and their personnel have been reminded that criminal charges apply if they fail to respect the professional secrecy of the information received.

Under specific *memoranda of understanding*, the Bank of Italy provides deposit insurers with quaterly information on the business profile gathered from its files. The insurers are also informed promptly of the initiation of crisis management procedures.

The Bank of Italy is kept abreast of initiatives and debates taking place on the subject of deposit insurance, thanks to stable institutional relationships and to the attendance, without voting rights, of a delegate at the meeting of the Fund's board.

Finally, another important power of the Bank of Italy deserves to be outlined in connection with the possibility that a bank could be excluded from the guarantee scheme, given the interaction of this circumstance with its supervisory role.

According to the law, a bank may be excluded from guarantee schemes in the event of exceptionally serious failure to comply with the obligations arising from membership.

Subject to approval by the Bank of Italy, guarantee schemes must notify a bank of its failure to comply and grant a time limit of one year to fulfil its obligations. Once such limitation period, which may be extended by up to another year, has expired without the bank complying, guarantee schemes will, subject to authorisation by the Bank of Italy, give notice to the bank of its exclusion.

Funds raised up to the date of receipt of the notice of exclusion are covered by the guarantee. The excluded bank will promptly inform depositors of such notice in the manner specified by the Bank of Italy. The exclusion of the bank from the DIS implies that the Bank of Italy revokes the banking authorisation to the bank upon the cessation of participation in guarantee schemes; the possibility of ordering compulsory administrative liquidation pursuant to article 80 is unaffected. The exclusion procedure may not be initiated or continued in respect of banks subject to special administration.

v) **funding.** The funding of the system for the pursuit of their purposes is provided by participating banks. It is arranged on an *"ex-post basis":* resources are requested to member banks only in the case of interventions (*"call scheme*").

Member banks' commitment ranges between 0.4% and 0.8% of reimbursable funds.

The "contribution quotas" are based on a proportional quota of insured deposits (*contribution base*). A regressive mechanism is applied (*regressive quotas*) along with a correction mechanism, based on some balance sheet indicators and the connected risk profiles (*risk-based premiums*).

5.3 The operational aspects of Italian deposit insurance schemes.

Italian DISs carry out the essential function of the reimbursement of depositors in the case of compulsory administrative liquidation (*pay box* functions), as provided for by the European Directive. But it is worth underlining that this kind of intervention has not been much utilised. In fact, as shown by the table below, it has been used only in one case in 1990 for the reimbursement of depositors of a very small bank and at a very low final cost.

The favourite form of intervention, instead, has been the support given by the scheme to the transfer of the assets and liabilities of a liquidated bank to other banks, filling partially the gap between the two.

The other form of intervention - financial support to banks under special administration – has also been adopted in one case, under the condition of *least cost criterion* respect to the pay-outs to depositors.

The most relevant intervention of the FITD has been in support of Sicilcassa, a southern bank placed into compulsory liquidation at a cost of 516 million euros. The peculiarity of this case is that the cost of the FITD intervention was only a part of the total cost paid to make it possible to transfer assets and liabilities to the intervening bank, the Banco di Sicilia. The remaining part was provided by public intervention, through the financial support given by the Bank of Italy under the special financing provided by Ministerial Decree of 27.9.1974. This mixed resolution scheme, based on private and public resources, was only applied in this case, because of the heavy impact of the final cost of the private scheme (see par. 6.3).

It is interesting to note that the cost of banking crises for the FITD from its constitution is quite low. It amounts to little more than 1 billion euros over the past two decades. It is also remarkable that the last intervention dates back to 1997 and that since then no interventions have been made by the DIS.

FITD (Interbank Deposit Protection Fund) Interventions
From 1988 to 2010

Type of intervention	**Number of banks**	**Final cost** (euros/millions)
Support to banks under special administration	2	355
Reimbursement of depositors	1	0,5
Transfer of assets and liabilities	5	696,5
Total	**8**	**1,052**

The intervention mechanisms of the Mutual Bank Fund are essentially the same. As already said, an additional form of intervention by the DIS of Mutual Banks is provided, realisable out from a special administration proceeding, subject to the presentation of a reorganisation plan from the beneficiary bank.

FGDCC (Guarantee Fund for Depositors of the Cooperative Credit) Interventions

From 1997 to 2010

Type of intervention	Number of banks	Cash	Guarantees
Reimbursement of depositors	2	5,4	
Transfer of assets and liabilities of banks under Compulsory administrative liquidation	9	17,4	
Support to banks under special administration	18	20	98,3
Interventions outside formal proceedings	22	22,7	99,5
Total	**51**	**65,5**	**197,8**

The enforcement mechanism of the two deposit insurance schemes is viewed favourably by the credit authorities and by the banking system as a whole for the relevant outcomes, in terms of the protection assured to depositors, the contribution it has given to the reorganisation of banks in crises and the low costs of intervention. In the case of FGDCC, disbursements are a minor component of interventions, in that 197,8 million euros, out of a total cost of 263,3 million euros, are represented by guarantees.

Once again, one of the main strengths of the FGDCC has been its strict integration with the Bank of Italy, to whom, as said before, the Banking Law entrusts specific powers in the opening and direction of the two proceedings for the management of banking crises.

Other innovations are underway within the organisation of Mutual Banks. The governing bodies of the system have recently taken other measures to strengthen instruments for the prevention and resolution of crises.

In July 2004, it constituted - on a voluntary basis - another fund for the guarantee of bondholders. This fund has been operational since the 1 January 2005.

Furthermore, another guarantee scheme for the protection of the liquidity and solvency of Mutual Banks is in the pipeline. This initiative is in line with the capital requirements Directive (article 80, par. 8 of Directive 2006/48/EC), which recognises the crossed guarantee systems among banks (the *Institution Protection Schemes*) and, in the presence of such systems, permits that the mutual exposures among participating banks be considered free risk and weighted zero for capital requirements purpose.

6 Public intervention in Italy

6.1 Public intervention tool.

Before the establishment of private deposit guarantee systems, and even after, in the event of the failures of banks with systemic relevance, depositor

protection has been assured by public intervention in the form of a special loan granted by the Bank of Italy, in accordance with the Decree of Treasury of 27 September 1974.

The decree empowered the Bank of Italy to grant special advances, at the rate of 1%, for up to 24 months, to banks that, taking over the deposits of other banks in compulsory administrative liquidation, had to cover the consequent losses in their exposures, because they were uncollectible in whole or in part. The funds were used to buy Treasury bonds from the Bank of Italy, which were then deposited as collateral for the advance.

The restoration mechanism was represented by the profit deriving from the *spread* between the interest rate paid on the special advances and the yield obtained on Treasury bonds. Specific operational mechanisms were applied to avoid effects on the monetary basis.

As an alternative to the coverage of losses connected with the assumption of a bank's deposits, the instrument was also activated to cover the losses deriving from the transfer of assets and liabilities of the insolvent bank to another bank to indirectly protect its depositors and safeguard the continuity of essential functions and services.

Such financial assistance was subject to conditions. First, compulsory administrative liquidation should have been initiated. Second, according to a Government resolution, the Bank of Italy's intervention should be limited to "exceptional cases of significant general interest" (Resolution of 23 December 1986 of the Interministerial Committee for Credit and Saving, issued when the Interbank Deposit Protection Fund was set up). The resolution specified that after the introduction of the private DIS, it should represent the only instrument for the resolution of banking crises of a certain relevance, while previously it was also activated to resolve small banks' crises. Indeed, after the said resolution, the special central bank's advances were granted in the 90's only in two cases of bank collapse because their significant size and relevance for the economy would have put at stake the overall stability.

It is important to underline who was the final bearer of the cost of public intervention. Indeed, the special mechanism based on central bank's advances, charged the losses directly to the Bank of Italy's balance sheet, resulting in a reduction of annual central bank profits. But, the losses were indirectly charged to the Treasury accounts, in terms of a reduction of the State's taxes and dividend revenues on the annual accounts of the Bank of Italy.

The rationale for public intervention has been well represented in supervisory authority statements,[9] identified in "the need to preserve the primary role of banking firms to serve the economy, upon condition that intervention is accompanied by restructuring plans entrusted to skilled managers, so that the

---

[9] A. FAZIO, *Concluding Remarks for 1995*, Bank of Italy, Annual Report, Rome, 31 May, 1996.

perspective of reorganisation of the bank call for private capital and allows the following placement of the bank itself on the market". Reorganisation measures aim at removing structurally unbalanced factors, such as the reduction of operational costs.

6.2 Guidelines for public intervention.

Worldwide experience in the management of banking crises, even before the recent financial crisis, was that Governments intervened to protect depositors, sometimes at considerable costs. The use of public funds was generally accepted in cases of systemic risks in order to forestall the denial of credit to a large number of customers in particularly sensitive markets or regions.

One of the main concerns in the use of public funds was to prevent, as far as possible, the moral hazard that could arise from the certainty of a State intervention. In Italy, many conditions and requirements were provided for in order to reduce the moral hazard connected with public interventions:

i) there was no certainty about State intervention and *ex-ante* criteria were not established. So, a case-by-case approach was followed, at the discretion of public authorities, in order to maintain a sort of *constructive ambiguity*;

ii) an extremely important principle governing public intervention was that when promoting a solution, free market mechanisms had to be followed;

iii) the survival of the business should not impede the punishment of the bank's corporate officers. With compulsory administrative liquidation, the fate of the bank and its depositors is separate from that of its shareholders (who lose their investments) and its administrators and managers (who are subject to the sanctions provided for by the law). In this connection, the special administrator or the liquidator are entrusted with:
   - promoting the legal action for liability against members of the dissolved bodies of the bank;
   - giving notice to the judicial authority of the events that are likely to have a criminal nature;
   - presenting the petition for the declaration of insolvency by the court; and
   - preparing the report on the reasons for bankruptcy according to article 33 in the Bankruptcy Law;

iv) State aid for solving banking crises should not be exonerated from antitrust rules, established to protect market competition. Accordingly, in the European Union, public intervention for solving banking crises is subject to the rules for the State aid, which are applicable to all firms; and

v) for a State-owned bank, after the implementation of the resolution plan, the public intervention should result in its privatisation.

6.3 The two cases of public intervention in the '90s.

In the context of the crisis affecting the Italian economy, especially the southern economy, a large number of small banks went under distress in the '90s. They were handled with the application of ordinary instruments and according to private market solutions.

Only two cases of medium-sized to large banks crises occurred in southern Italy. They were public banks and, in some way, their weaknesses reflected the poor management typical of banks falling into the political sphere.

In these cases, ordinary instruments were not actionable. Without external financial support, a private solution could have not been possible. So, an assisted solution took place to support the intervention of other banks. The result of the restructuring of the two banks was the privatisation.

The various forms of public interventions carried out in the period 1990-1996 had an impact on 1996 State balance sheet of 0.5% of GDP, much lower than the figures in other countries (saving and loans association's rescue in the US amounted to 3.3% of 1990 GDP; in Finland, bank rescue interventions absorbed 9.3% of 1995 GDP; in France, 1.5% of 1996 GDP was spent on Credit Lyonnais).

A brief description of these two cases is important in order to understand the specific problems posed by bigger banks and how extraordinary and articulated have been the solutions found.

6.3.1 The case of Sicilcassa.

The structural and operational features of the bank. Sicilcassa was a regional public sector Italian bank that had its registered office in Palermo, the chief town of Sicily, a region in the southern part of Italy. It had 241 branches, mostly located in Sicily, and 3,740 employees. The capital belonged to a Foundation (77%)[10] and to the *Regione Siciliana* (23%).

The bank was well rooted in the local financial market together with the Banco di Sicilia, one of the oldest Italian banks. Both were leaders in the Sicilian banking market.

---

[10] The Foundations were banks owned by the Italian Treasury and Local Authorities. According to Law n. 218 of 1990 (the "Amato Law"), the Foundations transferred their banking business to banking limited companies created for that purpose. The Foundations, in this way, no longer engaged directly in banking activity. Instead, they acquired the entire stocks in the transferee banking limited companies. The Foundations were authorised to manage their own banking holdings and to pursue social aims in the fields of public interest. These transformations allowed - in the following years - the privatisation of the banking firms held by the Foundations. The latter lost their controlling stake in the banks, by selling off to private investors.

The weaknesses of the bank and the inception of the crisis. The bank had been under special observation by the Bank of Italy for some time owing to financial, economic, organisational and managerial weaknesses. Many supervisory interventions at the bank took place in the early '90s, when an on-site inspection brought to light that Sicilcassa had developed lending without monitoring credit risks fairly. As a result, the bank had a poor quality of credit, with a high percentage of non-performing loans. This, together with high operating costs, caused problems in terms of profitability and capital adequacy. Consequently, the Bank of Italy urged the bank to tackle these problems and imposed a "specific" 10% *solvency ratio* (i.e. capital adequacy ratio) instead of 8%.

In the subsequent years, the Bank of Italy requested again that Sicilcassa embark on a course of reorganisation that would lead to restoring soundness and invited it to seek a banking partner of high standing in order to realise an aggregation. In 1995, as a consequence of judicial enquiries involving the governing bodies of the bank, there was a complete change of the board of directors. The new mangers tried to redress the situation.

The Bank of Italy carried out a new on-site inspection at the end of 1995. The results were unfavourable. It revealed that external and internal causes had brought the bank to financial, economic and managerial distress, with serious risks for its stability. In particular:

- the credit risk management was completely ineffective and the granting of credit was inefficient in all its phases; 16% of the bank's loans supported five big regional industrial conglomerates operating in the construction business, where the economic and financial condition was seriously worsening; moreover, in some cases, assets of those conglomerates were frozen by the judicial authorities;
- non-performing loans were about 52% of the total amount of the bank's loans (3,176 million euros against 6,077 million euros) and the losses on these impaired assets were about 1,047 million euros;
- the bank's business was dependent on relationships with various public sector entities, both on the credit and on the liabilities side (loans of 360 million euros, of which expected losses were 40 million euros);
- day-to-day business was characterised by wide-scale wrongdoing; and
- company organisation was ineffective and inconsistent and the internal control system was unable to discover internal irregularities.

The situation of the bank was worsened by a downturn in the local economy and, to some extent, by increasing competition from local and national banks. As a consequence, the situation of the bank was characterised by negative profitability and serious undercapitalisation. The bank could not resolve these problems on its own.

Given the situation, the Bank of Italy proposed to the Minister of the Economy a decree for the special administration of the bank for serious administrative

irregularities, serious violations of laws, regulations or bylaws governing the bank's activity and serious capital losses.

The decree was issued on the 7 March 1996. Two special administrators and an oversight committee of three members were appointed by the Bank of Italy. The special administrators carried out an assessment of the bank's situation and removed irregularities. The analysis of the bank's assets brought to light further credit losses, in excess of capital of about 979 million euros.

Coverage in the local press contributed to the loss of confidence by the bank's customers. Hence, the bank's liquidity was further endangered. The situation was extremely critical.

The special administrators embarked on a strategy for the survival of the bank through a reorganisation plan, which included capital injection by the bank's public shareholders.

The resolution plan. During special administration, the special administrators began the implementation of a corporate adjustment plan and identified the necessary conditions for the bank's survival, which included an adequate supply of new capital and the entry of a partner of high standing, which could implement far-reaching restructuring measures.

Nevertheless, the recapitalisation proposed by the bank's shareholders was judged to be insufficient and leading Italian banks, contacted by the special administrators, did not show an interest in intervening. The impasse made it necessary to order compulsory liquidation, which made it possible to adopt the measures envisaged by the laws governing depositor protection and to draft a plan to end the crisis.

A great part of its assets together with almost all its liabilities was transferred to the Banco di Sicilia, together with the whole firm (branches, personnel, contracts, etc.). Bad loans of relevant amounts were kept by the liquidators of Sicilcassa.

The negative gap between the assets and liabilities purchased by the Banco di Sicilia was compensated by: i) the intervention provided by the Deposit Protection Fund (1 ITL trillion); ii) and the public resources provided by the Bank of Italy, by means of the special advances established by the Ministerial Decree of 27.9.74.

Banco di Sicilia was interested in a process of reorganisation and technical enforcement in order to ensure the full success of the merger with the assets and liabilities of Sicilcassa.

To strengthen the economic and financial solidity of Banco di Sicilia, interventions for the recapitalisation of the bank were made. The *Mediocredito Centrale* (an Italian bank operating in the mid-to-long term loans sector) injected

1 ITL trillion in capital and the Treasury contributed to it with its holding in IRFIS (another Italian bank specialised in the mid-to-long term sector).

The crisis solution plan for Sicilcassa led to the reorganisation of the Sicilian banking system and the creation of a large credit institution operating in southern Italy. The privatisation of the group was completed at the beginning of 2000.

EU approval in application of State aid rules. With reference to the various support measures provided for by the restructuring plan in favour of Banco di Sicilia and Sicilcassa and the inherent elements of State aid according to article 87, par. 1 of the Treaty, the EU Commission opened the procedure provided for by article 88, par. 2 of the Treaty. In particular, under EU examination were: i) the support of the Interbank Fund for Deposit Protection for the coverage of Sicilcassa's losses; ii) the granting by the Bank of Italy to Banco di Sicilia of special advances covered by the Ministry Decree of 27.9.1974; iii) the increase in Banco di Sicilia's capital reserved to Mediocredito Centrale; and iv) the contribution of capital by the Treasury with its holding in IRFIS.

Following the examination of the information provided by the Italian authorities, the EU Commission established that the contribution of the FITD in the liquidation of Sicilcassa for the coverage of the deficit between assets and liabilities transferred to Banco di Sicilia did not constituted State aid according to article 87, par. 1, of the Treaty. The decision was motivated by the consideration that the FITD was composed of a majority of private banks.

As to the special advances granted by the Bank of Italy for the compensation of losses and the other interventions in the capital of Banco di Sicilia, the EU Commission stated that they constituted State aids, but they were compatible with the common market and the EEA Agreement pursuant article 87, par. 3, lett. c) of the Treaty and article 61, par. 3, lett. c) of the EEA Agreement in consideration of the restructuring measures adopted by the bank and the conditions posed by the Commission itself.[11]

6.3.2 The case of the Banco di Napoli (BN) group.

The structure and operational features of BN. BN was a State-owned banking group. The capital of the holding company was held by:

- the Foundation (48.1%, representing 71.2% of voting rights);
- the Treasury (9.2% and 13.5%);
- private shareholders (10.3% and 15.3%); and

[11] EUROPEAN COMMISSION, Commission Decision of 10 November 1999 conditionally approving the aid granted by Italy to the public banks Banco di Sicilia and Sicilcassa (2000/600/EC), Official Journal of the European Communities, L 256/21, 10.10.2000.

– the remaining capital (32.4%) took the form of savings' shares, without voting rights, quoted on the Italian stock market.

The BN group was composed of a holding company (Banco di Napoli SpA), a sub-holding company, 11 companies controlled directly, two companies controlled indirectly and 16 other major direct or indirect holdings.

At the end of 1994, it was present throughout Italy, with 810 branches, of which 684 were located in the south, where it was the leader in the banking market, and 126 in the central and northern parts of Italy. It was also present abroad, with main subsidiaries in France, Luxembourg, Germany, the UK, Spain, the US and Hong Kong. BN ranked seventh in Italy in terms of total balance sheet, with a capital/debt ratio (9.3%) above the minimum of 8% but with low profitability (return on equity ratio of 3.8%).

The group's activities covered various areas of financial intermediation and credit, movable and immovable property activities, factoring, leasing, management of trust funds and unit trusts, merchant banking and insurance.

The inception of the crisis. BN incurred particularly severe losses in 1994 and 1995 of ITL 1.147 billion (0.6 billion euros) and ITL 3.155 billion (1.6 billion euros) respectively, which virtually wiped out its assets and made it impossible to comply with the prudential ratios. The reasons for such extensive losses were, among others, the following:

– the intense policy of expansion, launched at the early '90s, focusing on its network of branches and on loans to the large industrial groups of northern Italy and small and medium-sized enterprises in the south, at a time when the economy had already entered a recession;
– the difficulties experienced by debtors, together with unsuitable credit selection methods and inadequate risk control procedures, led to serious losses on loans;
– BN's public status delayed its adjustment to an increasingly competitive environment and the adoption of the measures necessary to increase its technical efficiency and its organisation;
– staff expenditure continued to be particularly high, exceeding the national average; commitments for future retirement payments were not sustainable;
– acquisition and asset management policy were haphazard, as it was not based on criteria of profitability, while the risks faced by firms in which it had invested were being insufficiently monitored by the head of the group;
– the corporate governance, especially the internal control mechanisms, proved inadequate.

Some controlled companies were affected by strong uncertainty about the quality of assets and business perspectives. In particular, a controlled bank, incorporated under Luxembourg law (*BNI*), might have been a source of potential losses for the group, owing to potential credit risks. An Italian-controlled bank, specialised in long-term loans to southern firms (*ISVEIMER*), was compromised by the high level of credit losses and inefficiency in the business management. Many branches, mainly located in the North, presented low profitability.

In 1995, BN's situation deteriorated, chiefly because of an increase in loan defaults. Non-performing loans were suspected of incorporating losses other than those already assessed. This was difficult to calculate.

The increasing proportion of non-performing assets put pressure on the imbalance between remunerative assets (earnings) and the burden of liabilities (charges), compelling BN to have continual recourse to the inter-bank deposits market. This increased the cost of resources and diminished its profitability further.

In 1996, the situation was worsening: in the first quarter alone, BN realised operating losses of 150 million euros. The trend was expected to be confirmed in the following quarters.

Moreover, BN was suffering from severe financing difficulties. A liquidity crisis was resolved by means of a debenture loan of 1.2 billion euros granted in January 1996 by Cassa Depositi e Prestiti (a State-owned financial institution) and private banks.

The resolution plan. In March 1996, an urgent decree law of the Italian Government - subsequently ratified by Law 588 of 19 November 1996 - provided a basket of specific measures to solve the crisis, through the reform, restructuring and privatisation of BN.[12]

The law authorised:

– the Treasury to inject capital 1 billion euros into BN;

– the intervention of Bank of Italy to cover the losses arising from the restructuring process (by means of the special advances provided for by the Treasury Decree of 27 September 1974). In other words, the Bank of Italy would cover the losses arising from the liquidation of the ISVEIMER and the recovery of BN's non performing assets, after they had been transferred by BN to the SGA (Società per la Gestione delle Attività Ltd.), a specific asset management company (bad bank).

---

[12] N. DE IANNI, *Banco di Napoli spa. 1991-2002: un decennio difficile*, Rubettino Università, 2007; G. MINERVINI, *La crisi del Banco di Napoli e gli interventi della Fondazione. Alcuni documenti*, in Dieci anni dell'Istituto Banco di Napoli. Fondazione. 1991-2001, Napoli, 2002.

The Treasury's recapitalisation was subject to a number of conditions imposed as a guarantee of the commercial nature of the State intervention. The main conditions were:

- the Treasury intervention had to be accompanied by: i) funds from one or several banks and other institutional investors; ii) an undertaking that it would have participated in the bidding procedure for the controlling interest in the BN (amounting to 60% of the capital);
- BN equity had to be adjusted based on the losses assessed on 31 March 1996;
- BN had to adopt an appropriate restructuring plan to restore capital adequacy and profitability and define new strategic lines. The plan had to be drawn up with the assistance of an expert appointed by the Treasury; approved by the Bank of Italy; and be consistent with EU law on State aid; and
- trade union agreements had to reduce labour costs, by levelling the unit cost, including social security costs, to the average for the banking sector. The early retirement of employees could be resorted to.

All measures provided by law were successfully implemented. In addition, the restoration plan required branch network restructuring. Northern Italy branches were sold and foreign branches were closed. BN directors and auditors were replaced.

Bank of Italy coverage was activated for losses arising from the voluntary liquidation of ISVEIMER and the recovery of the SGA assets.

The voluntary liquidation of ISVEIMER. In April 1996, ISVEIMER entered into voluntary liquidation. In the course of the winding up, the liquidators were able to reimburse ISVEIMER's creditors on the due dates thanks to the liquidity provided by BN. The intervention of the Bank of Italy compensated BN for the losses incurred as a result of the loans granted to ISVEIMER. For this purpose, two special advances were granted by the Bank of Italy in 1997, as provided for by article 3 of Law 588 of 19 November 1996 under the procedure established in the Ministerial Decree of 27 September 1974.

The intention was to fully protect the interests of ISVEIMER's creditors to prevent the undesirable effects for financial markets in view of the extent of the involvement of foreign financial institutions in ISVEIMER.

The liquidation process was very quick because of the ability of the liquidating bodies to rapidly and effectively sell the most valuable assets on domestic and international markets and repay liabilities. In the meantime, they extinguished staff pension obligations and put in place employee severance measures. In 2000, the realisation of the liquidation's assets was practically concluded, including the transfer of the remaining non-performing loans to SGA, in order to concentrate on the recovery of the BN deteriorated assets .

The SGA operation. On 1 January 1997 the SGA, a special vehicle, was set-up by the authorities to manage and recover the huge amount of the BN's bad assets. The purpose was to free BN's balance sheet of non-performing loans to facilitate its restructuring and viability.

The SGA: the successful story of a "bad bank"

The strategic choice made by Italian authorities was the maximisation of the recoveries of bad assets in order to minimise the use of public resources to cover the losses. For this purpose, greater attention was given to the design of the corporate governance of the SGA and the creation of an efficient and effective structure for the management and recovery of bad loans. The complexity of the mission was also linked to the objective to maximise the outcomes while at the same time trying to avoid disruptive effects on the economy.

The appointment of a highly skilled management was a crucial decision for the performance of the company. The composition of the management and control bodies was established according to professional, independence and integrity criteria.

The SGA acquired the non-performing assets for 6,426 million euros from BN (loan defaults, doubtful loans in excess of 51,000 euros, claims restructured or in the process of being restructured, holdings). The assets were acquired at a net book value on 30 June 1996 (the gross value of transferred assets was € 8.3 billion). The largest holding transferred was that in BNI.

The vehicle was financed by a loan granted by BN equal to the value of the assets transferred. So, the transaction generated an interest-bearing credit of BN towards SGA. The credit would have been repaid by the SGA with proceeds from the asset recovery.

Any losses suffered by BN on that credit would have been covered by the Bank of Italy intervention, through the special advances provided for by the Ministerial Decree of 27.9.1974. The transaction was based on the principle that BN should have neither benefited nor incurred losses in relation to its position vis-a-vis SGA.

The purpose of the SGA operation was to avoid the risk of future losses for BN on transferred assets and thus facilitate its early sale. Although in principle the book value on 30 June 1996 reflected the estimated value of the transferred assets, this could not have excluded the risk of future losses.

SGA had sole responsibility for asset recovery. To avoid conflicts of interest in the management of the assets, specific measures were provided: i) SGA stock was in the possession of BN, but voting rights were transferred to the Treasury; ii) the SGA board of directors and auditors were not related to

BN and were appointed with the approval of the Bank of Italy; iii) SGA was under the special supervision of the Bank of Italy.

A specific hive-off structure was set up under the general management of BN, which was separate from the rest of BN in order to serve SGA in the asset recovery. The relationships between SGA and BN was governed by the principle of "BN proposes and SGA decides". Administrative and accounting separation between BN and SGA was guaranteed by the adoption of a specific accounting system separate from BN internal accounting system.

SGA experience was positive. The recovery of credit was relevant: by 2010 the revenues amounted to 5,492 million euros, corresponding to 82% of the initial amount of loans acquired. Other recoverable loans still existing on the balance sheet of SGA will further increase total revenues, thus reducing the costs of public finance.

The privatisation of BN. In 1997, at the end of a competitive auction, BN's controlling stake (60%) was acquired by a joint company owned by an Italian bank (49%) and an insurance company (51%). The new shareholders provided a recapitalisation of BN. Later, the Treasury sold the remaining stake and recovered a part of the capital injected into BN.

The EU approval in application of State aid rules. In relation to the restructuring plan of BN, the EU Commission commenced the procedure provided for by article 93, par. 2, of the Treaty. Among others, the main aspects under EU examination were: i) the capital increase by the State; and ii) the granting of special advances by Banca d'Italia under the decree of 27.9.1974 to offset the losses incurred by SGA.

These transactions were declared compatible with the common market and with the EEA Agreement under article 92, par. 3, lett. c) of the EC Treaty and article 61, par. 3, lett. c) of the EEA Agreement. The aid was authorised upon specific conditions implying the sale or the closure of a certain number of domestic and foreign branches and other aspects established by the Commission.

On the contrary, the advances granted by Banca d'Italia for the winding up of Isveimer were not considered State aid to the BN insofar as the financial resources in question were utilised in accordance with criteria acceptable to a private investor and with some conditions established by the Commission.[13]

6.4 Current framework.

[13] EUROPEAN COMMISSION, *Commission Decision of 29 July 1998 giving conditional approval to the aid granted by Italy to Banco di Napoli* (1999/288/EC), Official Journal of the European Communities, L 116/36, 4.5.1999.

After these two interventions, the special mechanism provided for by the Treasury decree of 27.9.1974 (entailing Bank of Italy's special advances) has no longer been activated, since no relevant banking crises occurred in Italy in the following years. In any case, even though a formal revocation of this measure has not been adopted, over time two aspects made this instrument not concretely available for the coverage of losses deriving from banking crises.

The first critical aspect was of technical nature, related to the compensation mechanism in itself. Compared with the '70s and '80s, in the second part of the '90s and 2000s the spread between the rate of special advances (1%) and the public bonds in which they were invested continuously reduced, so that huge amounts of advances were necessary to produce differential profits for the coverage of losses.

The second critical aspect was related to the nature of the Bank of Italy's instrument, so that it could have been considered outside the scope of central bank operations. According to ECB rules, central banks cannot intervene to cover the losses of banks' insolvencies, being this, when deemed necessary, a task of the State. As a consequence, if a central bank substitutes itself to the State in bailing out banks, this operation is forbidden by article 101 of Treaty (now article 123), which prohibits the monetary financing of the State.[14]

Therefore, currently there is no pre-established specific instrument for public intervention in Italy.

---

[14] Article 123 of the Treaty on the functioning of the European Union (ex Article 101 TEC). 1. Overdraft facilities or any other type of credit facility with the European Central Bank or with the central banks of the Member States (hereinafter referred to as 'national central banks') in favour of Union institutions, bodies, offices or agencies, central governments, regional, local or other public authorities, other bodies governed by public law, or public undertakings of Member States shall be prohibited, as shall the purchase directly from them by the European Central Bank or national central banks of debt instruments. 2. Paragraph 1 shall not apply to publicly owned credit institutions which, in the context of the supply of reserves by central banks, shall be given the same treatment by national central banks and the European Central Bank as private credit institutions.

CHAPTER 5

WHERE ARE WE GOING?

1. Where are we now?

In the previous chapters I outlined a general picture of the multiple aspects of the financial crisis: the main factors, the mechanisms of its spreading among the markets and market participants and the effects produced on the financial systems and the real economies worldwide. It can be divided into three distinct phases, each one with different effects in the various EU countries:[1] i) the financial crisis originated in the U.S. subprime market, and its contagious effects spread especially in the EU, whose investors were holding many of those "toxic" financial instruments marketed through the "shadow banking system"; ii) the strong economic recession in 2009, whose effects are still hitting many countries; and iii) the deterioration of public finances in Greece in 2010, followed by similar situations in other EU countries, with serious repercussions on sovereign debt.

I looked at the crises involving financial institutions in several countries, at their origins, figures and remedies adopted to manage and resolve them. Distinctive features and commonalities have been highlighted. Particularly, it has been emphasized the fact that approaches based on bail out and use of public money are no longer sustainable.

The description of these crisis events has been functional to a better understanding of the debate on how to prevent such disruptive phenomena from occurring in the future. As said, many recipes have been forwarded from various (interested) parties, sometimes with conflicting views. Policymakers have been called to an exceptional and difficult task; they worked intensively to reach a consensus on a reform of the financial system, in its international and national dimension, defining a wide set of measures in two critical areas whose shortfalls clearly emerged during the crisis: prudential regulation and crisis management of financial institutions.

The strengthening of prudential regulation aims at creating incentives for prudent behaviour of intermediaries reducing the probability of bank failures. Since no guarantee exists that bank failures could not happen in the future, financial institutions and authorities have to be better prepared to effectively deal with them, so that a well articulated framework for crisis management and resolution is essential, minimising the costs for stakeholders. These two pillars of the reform may be considered inseparable.[2]

---

[1] F. SACCOMANNI, *L'Unione Europea di fronte alla crisi globale: le implicazioni per le banche, la finanza e la politica economica*, Speech at the EU Berliner Gesprache, Bundesministerium der Finanzen, Berlin, 8 February 2011.

[2] For an interesting contribution to the debate on the regulatory reform, see D.T. LLEWELLYN, *Post crisis regulatory strategy: where is Pillar 4?*, Bancaria Editrice, n. 6, 2011.

Three years after the beginning of the financial crisis, it is time to take stock of what has been done and what still has to be done to create the conditions for removing the causes of the crisis and setting up the right measures aimed at re-establishing conditions for a sounder banking system.

The financial crisis has taught us many lessons, unveiling the need for a review of economic theories and regulation policies. Eventually, we may now take advantage of this experience to get a better knowledge of market failures and of the role of the States and regulators to tackle them by preventative and follow-up actions. We are aware that institutional and regulatory responses are generally late. Regulation normally follows, not always prevents, crisis phenomena. Among other factors, concur to this the theoretical approach based on the capacity of market forces to give off their innovative energies and self-correcting action or, anyway, the capacity of authorities to deal with them with the available tool-kit.

We well know now that the market globalisation and the contagion effects across countries and segments of finance require global responses; measures must be concerted at the international level, in that no single country may effectively deal with such complex and wide phenomena.

Undoubtedly, the measures orchestrated by Governments and central banks worldwide in the course of the crisis turned out to be effective.[3] Since the beginning of the crisis, the coordinated action taken at the global level has addressed the regulatory and market "failures" that emerged; major disruptive effects were avoided and public interventions created the conditions for financial markets to keep on working and posed the basis for structural reforms. As a consequence, substantial improvements have been achieved in terms of financial conditions, profitability and capitalisation. But, despite these positive outcomes, many questions remained unanswered. Are these improvements in the financial sector enduring? Have we definitely come out of the crisis?

As to the banking sector, concerns are related to the high level of credit risk, which could increase further as a consequence of the economic recession that has characterised the major economies over the past three years. The expected scenarios are not positive because of moderate economic growth and modest international trade. Moreover, in some countries, the exposure of domestic banks to risky sovereign debt (belonging to those countries affected by an unsustainable level of the debt/GDP ratio) as well as the high level of unemployment raise serious concerns about potential instability.

Unlike past years, banks can no longer rely on sustained profits because of reductions in trading revenues and net interest income, and concerns have been expressed on the capabilities of banks to refinance themselves given the large amount of debt roll over that EU banks will have to deal with in the coming months.

---

[3] I. VISCO, *Rebalancing Trade and Capital Flows*, Panel at Global Economic Symposium, Istambul, 27-29 September 2010.

Difficulties in bank funding could be increased by public-sector financing needs, especially in countries with large fiscal imbalances.[4] The explosive mix between sovereign debt and banking sector fragility is still one of the main concerns for European countries.

As highlighted, "in past months, we saw budgetary pressures having dramatic spill-over effects on bank funding in some countries; at the same time, signs of instability in the banking sector had negative repercussions on sovereign issuers".[5] Indeed, we are experiencing a process in which banking debts have transformed into States debts and banking crises have turned out to be public finance crises. This is particularly evident in some countries (Ireland, Iceland), while in others this process has run reversely, since States' balance sheet imbalances have given rise to problems for the banks that invested in public bonds (Greece). All these events have clearly posed the problem of the economic governance in Europe, prompting new public balance sheet discipline, based on more stringent rules for debts and balance sheet deficits (in terms of GDP) to be complied with by European countries.[6]

Despite the clear understanding about what happened during the financial crisis and the implementation of global action, the complexity and magnitude of the crisis made it extremely difficult to reach a common view on recipes for the future. Although at the inception of the turmoil consensus between Governments and policymakers was reached on the action to put in place to stabilise the global financial system and economy, different views have emerged about the steps to be taken for the reform of the financial system.

Concerns have been expressed worldwide that things could go in the wrong direction, because when the threats to the financial system have receded following the measures adopted, differences have emerged about the general objectives of structural and regulatory reforms at their detailed measurement. To some extent, this is a normal process, because managing the present is quite different from designing the future; gaps between the technical evaluations and the political wills to realise changes could also be very deep. These are the results of the tendency of each country to preserve its own institutional settings and national powers in sensitive issues and to have different starting levels of regulation in respect to the models emerging from the international debate.

Conflicting interests also express different visions and consequent solutions. On one hand, the financial industry is favourable to light regulation, a sort of fine-tuning of the old rules and set-ups without changing the pillars on which the

---

[4] About the sovereign debt crisis and its management in European countries, C.A.P. BRAGA-G.A. VINCELETTE (edited by), *Sovereign debt and the financial crisis: will this time be different?,* The World Bank, 2010.

[5] L. BINI SMAGHI, *The financial and fiscal crisis: a euro area perspective*, Le Circle, Brussels, 18 June 2010.

[6] I. VISCO, *The European Economic Governance: Reform and implications*, Speech held at Università dell'Aquila on 8 March 2011 for the twentieth anniversary of the Faculty of Economics.

structure of the financial system (which led to the financial crisis) was based. On the other hand, most of the economists, policymakers and regulators pursue the objective of introducing relevant changes in regulation and supervision and also in the institutional settings of supervision.

Now, three years after Lehman Brothers collapse, which caused the storm in the international financial system, with the political support of the G20 and the coordination of the FSB, a package of measures seems to be taking shape. Therefore, we are entering a phase in which regulation, supervision and crisis management are being changed significantly. It is generally recognised that these changes should be designed and implemented according to a unified and coherent approach, because the three components are strictly linked.

But, reforms are not proceeding at the same speed. Although a consensus has been reached on a set of changes in prudential regulation, on other more complex issues discussions are still underway.

European countries seem to be moving in a more expeditious way, according to the program of interventions announced by the European Commission, which provides for new measures for prudential supervision, crisis management, deposit insurance systems and resolution funds.

One could expect the first step to be the reshape of the international framework, followed by adjustments in national legislations, in order to draw up new systems featured by inherent consistency in terms of strategy, objectives and instruments. But nobody can imagine the introduction of a single model, because institutional settings are different among countries. As a consequence, the current approach aims at leaving room for the consideration of national peculiarities. Changes could be relevant, however, especially in those countries that did not benefit of a special crisis management and resolution regime before the financial crisis.

The risk of an uncoordinated action is high. Indeed, many countries are introducing reforms in their financial systems in anticipation of the decisions being discussed in many international bodies. This reversed process may present the concrete risk of incoherent developments, hampering the definition of shared and harmonised global solutions. This is of paramount importance, because regulatory arbitrage could remain between jurisdictions inducing preference for businesses or kinds of entities subject to looser legislation.

2. The need for clear principles and rules for the future.

From the experience of the financial crisis, central banks, supervisors and crisis management authorities have learned how to deal such destabilising events. Instruments in the field have been very articulated. Much has also been learned about what not to do. The key and unambiguous point is that public support for banks is no longer available. This is a clear message to economic

operators, so that all stakeholders have a clear picture of the consequences of their behaviours.

But this does not mean that public authorities should leave things go as they would without any public intervention. Public action is somewhat unavoidable, since the coordinating role of authorities and the activation of special instruments and powers are of utmost importance.

The first objective should be to prevent an illness rather than to recover from it. For this purpose, the main objective is to identify rules and instruments to prevent financial institutions from becoming too big, or too interconnected, or too systemically important to fail, with negative effects in terms of moral hazard and competition.[7] Many solutions could be followed. In particular, policymakers have two main alternatives: i) to intervene directly with structural measures against large and systemic banks (downsizing, separation of commercial banks from investment banks, different configurations of narrow banks); or ii) to accept the existence of large and complex financial institutions and strengthen the regulation and supervision of them in order to minimise the risk of their failure. However, if this option should be preferred, banks would be made to fail in an orderly way, minimising the disruptive effect on the financial system and on the economy.

As mentioned in chapter 3, the option for structural changes has been strongly opposed so far, both for theoretical reasons and practical difficulties for the implementation in the short-term. However, we cannot ignore that many countries are going in this direction. Indeed, forms of structural measures have been introduced in the US with the Dodd-Frank reform and also in U.K. this issue is an option after the recommendations of the Vickers Commission's Report.

Anyway, the most likely way forward seems to be the strengthening of the old prudential instruments and the introduction of innovative ones to effectively deal with large and complex banks and banking groups for the prevention and management of crises. The strategy pursued is, therefore, aimed at indirectly influencing banks' structure and sizes because if banks fail to meet prudential requirements, they will be obliged to downsize their activities and to derisk if they are unable to raise new capital. The reduction of costs and dividends to shareholders could be essential for pursuing these objectives.

Prevention measures are based essentially on the redesign of the capital framework in order to restore proper financial incentives and discourage over-investment in risky activities, in this way correcting all the drawbacks manifested during the financial crisis. According to the proposed framework, capital should be of higher quality, according to harmonised rules, and better correlated to the risk. A complementary measure is the introduction of a leverage ratio in order to reduce the indebtedness level of intermediaries. New liquidity requirements

---

[7] R. MASERA, *Taking the moral hazard out of banking: the next fundamental step in financial reform*, working paper, University G. Marconi, April 2011.

have also been designed, implying a larger buffer of highly liquid assets and a lengthening of funding profiles and other instruments. These measures go under the name of the Basel 3 prudential requirements.

The strengthening of requirements for banks will be accompanied by the capture within the boundary of regulation and supervision of risks posed by the shadow banking system or by particularly complex financial instruments. The role of OTC derivatives and credit risk agencies will also be addressed with new rules. As a result of this comprehensive reform, banks should be less risky and more focused on their traditional functions of intermediaries and advisors. Conclusively, as it has been stressed during the crisis, "the financial system that will emerge from this crisis will be one that operates with less debt and more capital, should be immune to the set of perverse incentives that are at the root of the crisis, and should be such that the risks are better assessed and identified. In the end, while avoiding over-regulation that would stifle innovation, the reform process will re-draw the balance between market discipline and regulation".[8]

The route that has led to the redesign of the financial regulation has been impassable; many obstacles have been overcome. In particular, concerns expressed by industry about the possible negative effects of the capital and liquidity requirements on banks (in terms of the huge amount of new capital required) and on the economy (in terms of output), have pushed regulators to soften the new rules and to implement them gradually, in order to give banks and the economy enough time to fully recover from the current difficulties. This request has been granted by policymakers, considering the huge amount of new capital that the new rules will require. It has been evaluated that if the reform had entirely come into force at the end of 2009, the banks of G20 countries would have had a need of recapitalisation for about 600 billion euros, assuming an objective of common equity of 7%.

Standards setters claim that the stronger requirements on capital and liquidity will have a long-term net positive impact on the economy. In this regard, an assessment by the FSB and Basel Committee on long-term economic impact showed that the new capital requirements will have a relatively modest impact on growth.[9]

---

[8] M. DRAGHI, *How to Restore Financial Stability*, Bundesbank Lecture, 16 September 2008.

[9] FINANCIAL STABILITY BOARD - BASEL COMMITTE OF BANKING SUPERVISION, *Assessing the Macroeconomic Impact of the Transition to Stronger Capital and Liquidity Requirements*, Macroeconomic Assessment Group, Final Report, December 2010. On this issue, P.ANGELINI, L.CLERC, V.CURDIA, L.GAMBACORTA, A.GERALI, A.LOCARNO, R.MOTTO, W.ROEGER, S.VAN DEN HEUVEL, J.VLCEK, *Basilea III: effetti di lungo periodo su crescita economica e fluttuazioni cicliche*, Banca d'Italia, Questioni di Economia e Finanza, n. 87, 2001. For an analysis of the effects of the new Basel 3 framework on the Italian economy, A. LOCARNO, *L'impatto di Basilea III sull'economia italiana*, Banca d'Italia, Questioni di Economia e Finanza, n. 88, 2011, according to which the for each percentage point increase in the capital ratio the level of GDP would reduce up the a maximum of 0.33%, corresponding to a reduction of the annual growth rate of 0.04% (without considering non-spread effects) and 0.05% (including non-spread effects).

The impact of the new capital requirements

According to the FSB and Basel Committee assessment, "GDP is projected to fall by 0.22 percentage points below its baseline level in the 35th quarter after the start of implementation, followed by a recovery of growth towards baseline. This implies that annual growth rates will be reduced by 0.03 percentage points for 35 quarters, followed by a period during which annual growth will be 0.03 percentage points higher. These estimates assume that banks act so as to bring the global common equity capital ratio to a level that would meet the agreed minimum and the capital conservation buffer, according to the eight-year transition path set by supervisors. If banks choose to implement the new requirements ahead of the schedule set out by supervisors, the impact on the overall level of GDP will be somewhat greater and compressed into a shorter time period, resulting in a greater impact on growth rates. These effects would also be accentuated to the degree that banks choose to hold an additional voluntary equity capital buffer above the new standards".

Some authors have estimated that the frequency of crises ranges from 3.6% to 5.2% per year, with an average of around 4.5%. An analysis by the Basel Committee[10] evaluated that the application of the new capital and liquidity requirements (common equity ratio of 7% and NSFR of one) would reduce the probability of crises to 3.3%. An increase in the capital ratio from 7% to 8%, with no change in liquid assets, reduces the probability of a banking crisis to 3%.

The same analysis showed that for each percentage point reduction of the annual probability of a financial crisis it is possible to have an expected annual benefit between 0.2% and 0.6 per cent of GDP.

3. How will the new "prudential" measures be judged? Will the outlined solutions be effective?

During the drafting of the reform, many questions have been raised about the effectiveness of the proposed measures to solve the problems posed by the financial crisis and their ability to avoid future systemic crises.[11] Criticism has been expressed in various directions, as it is normal when situations to be remedied are so complex and the range of interests so wide.

Certainly, nobody can believe that the new rules may have thaumaturgical capacities in avoiding new financial troubles, since we do not know which

[10] BASEL COMMITTEE OF BANKING SUPERVISION, *An Assessment on Long-Term economic impact of stronger capital and liquidity requirements*, August 2010;

[11] For an analysis of the new prudential regulation on the banking system, see McKINSEY&COMPANY, *Basel III and European Banking: its impact, how banks might respond, and the challenges of implementation*, EMEA Banking, November 2010.

factors could drive the next crisis or the new bubbles in the financial system. Moreover, we do not know what level of capital and liquidity can ensure the desired degree of stability. Undoubtedly, the challenge for the future is to invest much more in risk management and internal controls, which include the forecasting of possible scenarios that could affect banks' businesses and technical profiles (stress tests).

The proposed package of prudential measures has been properly designed and the drawbacks that came out during the crisis have been sorted out. So, we can trust that this new framework will offer appropriate incentives to financial institutions to adequately manage they own risks.

Notwithstanding, criticism still remain. Some analysts have claimed that the measures are too light,[12] since the new quantitative requirements are lower than what they could have been and that the transitional period for their enforcement is too long, with the concern that in the meanwhile a new crisis could occur. According to this view, the new rules have been seen as a relief by bankers, because most global banks seem to have already sufficiently thick capital cushions to easily comply with the new capital requirements. So, the new framework will not be as tough as it could have been, with the concern that it will not be able to cope with another similar downturn. In addition, banks not complying with the new rules will have a long period of time to build up their capital cushions, with the possibility to resort to different techniques, such as sales of assets and spinoffs.

This stance may count on supporters also among regulators and central bankers, who consider the Basel 3 framework insufficient to safeguard financial stability, deeming that the capital of banks should be increased much over the level established by the new prudential schemes. The outlined hypotheses of structural interventions have not been abandoned and the discussions about the separation between retail and investment banking continue, especially in UK.

On the opposite side, different positions have been conveyed by the industry, which considers the Basel 3 rules burdensome. Moreover, concerns have been expressed at the international level about the negative feedback of Basel 3 on the real economy and on the ability of the banking system to finance small and medium-sized enterprises.

After all, what we can be sure of is that further hesitations could be counterproductive and create the ground for future crises. As firmly recently underlined,[13] "(I)t is now essential to ensure the complete implementation of the new rules, as scheduled and in all the different jurisdictions. The United States and

---

[12] M. WOLF, *Basel: the mouse that did not roar*, Financial Times, September 15, 2010. According to the Author, the Basel Committee has given birth to a little mouse, because the amount of capital required by the new regulation is much inferior to the levels that market would require if investors should not take for granted that governments must bail-out banks and protect creditors, as experience has shown.

[13] M. DRAGHI, *Concluding Remarks 2010*, Bank of Italy, Ordinary Meeting of Shareholders, 31 May 2011.

Europe have a key responsibility. National interests must not prevail, otherwise the credibility of the reform and financial stability itself will be undermined. Intermediaries cannot call for shared rules to ensure a level playing field and at the same time seek competitive advantages through their less strict application at national level".

4. What else can we do?

Other than the implementation of the new prudential rules, many problems remain to be addressed in the reforming process. The most important is undoubtedly the "*too big to fail*" issue.

Moreover, it is necessary to increase the transparency and reduce the risks generated by the *shadow banking system*, a grey area between the regulated and unregulated sectors. As underlined,[14] in tracing the new boundary of regulation, new rules should be designed for those unregulated entities "that engage in credit intermediation with maturity transformation that are currently unregulated and are therefore subject to liquidity risks. The extension of the perimeter should follow the principle that similar activities and risks must be subject to the same rules". Although policymakers seem to have reached a general consensus on the need for a tighter regulation to address the problem, different views still remain when it comes to fixing instruments and rules.

Finally, a great number of projects and proposals to regulate derivatives and credit rating agencies have been advanced so far, but the implementation of new forms of supervision on these products and entities is still to be finalised.

Eventually, the lack of a common "toolkit" that became manifest during the last financial crisis and the negative effects that it produced on banks' stakeholders, require setting up a new crisis management and resolution framework as a priority for international policymakers.[15]

4.1. The "too big to fail" issue. Which rules?

What was made clear after the financial crisis is that no more bailouts will be effected at taxpayers' expenses. This is not only related to moral hazard issues, but also to the consideration that Governments can not afford any more the cost of systemic crises. We may say that there is no more a public provider of capital of last resort to save banks.

---

[14] M. DRAGHI, *Concluding Remarks 2010*, Bank of Italy, Ordinary Meeting of Shareholders, 31 May 2011. Moreover, *S. WALTER, Basel III: Stronger Banks and a More Resilient Financial System, Conference on Basel III,* Financial Stability Institute, Basel, 6 April 2011.

[15] In support of the refinement/reconsideration of some areas of the new framework, R. MASERA, *The Basel III Regulatory Framework: A Review*, Paper presented at the Conference on "*La crisi finanziaria e la gestione dei rischi negli intermediari finanziari*, Centro Studi I Cappuccini, San Miniato, 13 May 2011.

As said, the problem of SIFIs is now even more relevant than before the crisis, because banking crises have been resolved through mergers with and acquisitions by other banks, so that banks are now bigger and more systemically important, and therefore more complex and interconnected than ever. As recently underlined by Mervin King,[16] "We allowed a [banking] system to build up which contained the seeds of its own destruction. We've not yet solved the 'too big to fail' or, as I prefer to call it, the 'too important to fail' problem," Moreover, "The concept of being too important to fail should have no place in a market economy".

Neither easy answers nor a single solution is likely to be found to this problem, as demonstrated by the fact that a common solution has not been found yet. Furthermore, while objectives seem converging, different stances exist on the instruments to be used. On the other side, harmonised solutions are inevitable with regard to preventative measures and crisis management instruments to clarify how to deal with insolvency and who has to pay the costs. Heterogeneous solutions are likely to introduce uncertainties, increase competitive distortions and moral hazard.

This is an issue on which international regulators are clearly focused. The FSB is addressing the cross-border negative externalities posed by systemically important banks through "a combination of a capital surcharge, contingent convertible bonds and mechanisms to "bail in" the creditors of large and complex financial institutions".[17] As a preparatory tool, the largest banks will be required to write their "living wills" explaining how to break them up in times of crisis or reorganise themselves into simpler structures. In order to effectively intervene and perform such solutions, supervisors and resolution authorities should be entitled with stronger powers.

4.1.1. SIFIs.

Many questions have been raised on the treatment of SIFIs, particularly whether or not the envisaged regulatory, preparatory and resolution responses represent adequate solutions. So, the question is: are we sure that these solutions are the right ones and that they will work?

A large consensus seems to have been reached on the measures outlined by the FSB for the containment of moral hazard related to the activity of SIFIs, in that they realise significant improvements for a better management of the "too big to fail" issue. As underlined, in the solutions identified, they aim to be neutral in respect of the existing international legal and institutional framework. However, when considering specific countries, some of those solutions could be unfeasible or they may even generate undesired effects. But other measures have been

[16] M. KING, Interview with the Daily Telegraph, 4 March 2011.

[17] M. DRAGHI, *Next steps on the road to financial stability*, Financial Times, 17 September 2010.

outlined elsewhere, such as the introduction of a special tax as a contribution for the systemic risk they pose to the financial sector.

It is worth underlying that as a result of the ongoing international debate, SIFIs do not constitute a single category. A distinction has been made between SIFIs and global-SIFIs (G-SIFIs). SIFIs are entities whose disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity. G-SIFI's are those very big in size whose distress or failure would cause adverse economic consequences across a range of countries.[18]

The policy framework has been outlined in the following ways:[19]

i) with reference to SIFIs (global and national), it includes requirements for a higher loss- absorbing capacity (with application only to G-SIFIs initially); an effective resolution system; a more intensive supervision; robust core financial market infrastructures to reduce contagion risk; and supplementary prudential regulations by national authorities;

ii) as to G-SIFIs, home jurisdictions will provide additional measures, including: the coordinated assessment of risks within international supervisory colleges; mandatory recovery and resolution plans; and firm-specific cooperation agreements for cross-border resolution through crisis management groups. The monitoring of the implementation of such measures will be carried out by a Peer Review Council (PRC), composed of senior members of the relevant national authorities with a jurisdiction on G-SIFIs.

4.1.2 Prudential requirements for SIFIs.

Specific policy measures for G-SIFIs were agreed by the Group of Governors and Heads of Supervision (GHOS) at its June 2011 meeting,[20] including a methodology for assessing systemic importance, the additional required capital and the arrangements by which they will be phased in. The GHOS submitted these proposals to the FSB, which is coordinating the overall set of measures to reduce the moral hazard posed by global SIFIs.

---

[18] FINANCIAL STABILITY BOARD, *Reducing the moral hazard posed by systemically important financial institutions*, FSB Recommendations and Time Lines, 20 October 2010.

[19] FINANCIAL STABILITY BOARD, *Reducing the moral hazard posed by systemically important financial institutions*, FSB Recommendations and Time Lines, 20 October 2010; M. DRAGHI, *Statement to the IMF*, International Monetary and Financial Committee, Twenty-Third Meeting, Washington DC, 16 April 2011**;** FIN POL (Financial Service Commission English Blog – FINancial POLicies in Korea*, Overall Systemically Important Financial Institutions (discussed at g20)*, 12 May 2011.

[20] Measures for global systemically important banks agreed by the Group of Governors and Heads of Supervision, 25 June 2011. The Group of Central Bank Governors and Heads of Supervision is the governing body of the Basel Committee and is comprised of central bank governors and (non-central bank) heads of supervision from member countries.

The measures outlined by the GHOS and endorsed by the FSB have now been transposed into a consultative document by the Basel Committee, identifying the response to the first regulatory issue posed by G-SIFIs, namely to reduce the probability of failure of G-SIFIs by increasing their going concern loss absorbency, while the improvement of a global recovery and resolution framework (which is the second broad objective) should be achieved through additional proposals by the FSB and BCBS on R&R and bail in.[21]

The BCBS has developed an assessment methodology for G-SIB (Global Systemically Important Banks) that, if so classified, will be subject to additional requirements in terms of common equity Tier 1 capital. The assessment methodology for G-SIBs is centered on an indicator-based measurement approach (through quantitative and qualitative indicators), aimed at considering the impact that a failure of a bank might have on the global financial system and the wider economy. It comprises five broad categories: size, interconnectedness, lack of substitutability, global (cross-jurisdictional) activity and complexity.

As a result of the adoption of the proposed methodology, G-SIBs will be allocated into different groups (buckets), based on the score produced by the indicator-based measurement approach. Each bucket of G-SIBs will be subject to different level of additional loss absorbency requirements ("bucketing approach").

According to the BCBS proposal, the magnitude of additional loss absorbency requirements will range from 1% to 2.5%, depending on a bank's systemic importance. To provide a disincentive for banks facing the highest charge to increase materially their global systemic importance in the future, an additional 1% surcharge would be applied in such circumstances.

The higher loss absorbency requirements will be introduced in parallel with the Basel 3 capital conservation and countercyclical buffers between 1 January 2016 and year end 2018, becoming fully effective on 1 January 2019.

The decision to require institutions to hold common equity Tier 1 in order to meet additional loss absorbency requirements looks ambitious. It reflects the objective to increase the resilience of banks as going concern. For this purpose, the recourse to other instruments that only absorb losses at the point of non-viability (i.e. when a bank is unable to fund on the private market) has been considered inappropriate. The objective, therefore, is to use those instruments that convert into common equity while the bank remains a going concern (well in advance of the point of non-viability). As underlined, the GHOS and BCBS will continue to review contingent capital and support its use to meet higher national loss absorbency requirements than the global minimum, as high-trigger contingent capital could help absorb losses on a going concern basis.

---

[21] BASEL COMMITTEE ON BANKING SUPERVISION, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*, Consultative document, July 2011.

Market participants have expressed concerns about the outlined measures in terms of additional capital requirements. In particular, they have advocated a more cautious approach to avoid the risk of over-regulation on G-SIBs and the cumulative impact of the extensive regulatory changes that are already underway.[22]

At September 2011 meeting, the Basel Committee agreed to finalise the assessment methodology for global systemically important banks (G-SIBs) based on a review of the comment letters received on its July 2011 consultative document. As already said, the rationale for adopting additional policy measures for G-SIBs is based on the "negative externalities" created by systemically important banks which do not fully address current regulatory policies. No single solution but a multipronged approach has been envisaged to reduce the probability of failure and the extent or impact of failure of G-SIBs. The measures adopted by the Committee address the objectives of requiring additional going-concern loss absorbency for G-SIBs, complementing the measures adopted by the FSB to establish robust national resolution and recovery regimes, and improving cross-border harmonisation and coordination. However, even with improved resolution capacity, the failure of the largest and most complex international banks will continue to pose disproportionate risks to the global economy [23]

4.1.3 Living wills. Something new under the sun?

A wide debate on contingency plans (living wills) is underway, with specific regard to their preventative nature and attitude to simplification and derisking. Indeed, if a bank's legal and operational structure is too complex for an orderly resolution, authorities should have the power to streamline it.

The main idea is that if banks are too big, too complex or too interconnected, they should be prepared to intervene if things go bad. For this purpose, it is essential to detect in advance possible legal, organisational and operational obstacles that could hinder the implementation of the necessary interventions for crisis management and resolution.

The idea in itself is simple, because it requires banks to be prepared, when in life, to deal with the difficulties they could encounter in adverse conditions. As underlined, "*(I)n some ways, living wills are analogous to contingency planning for public emergencies that arise when a hurricane, earthquake or other natural disaster strikes. Even though human choices are the underlying causes of financial panics, financial panics are also like natural disasters because they have occurred*

---

[22] GLOBAL FINANCIAL MARKET ASSOCIATION (GFMA), *Discussion Note on SIFI Loss Absorbency Submitted to the FSB Standing Committee on Supervisory and Regulatory Cooperation*, 16 May 2011.

[23] BASEL COMMITTEE ON BANKING SUPERVISION, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*, November 2011 (see on Internet BIS Website: http://www.bis.org/publ/bcbs207.htm).

repeatedly, suddenly, unpredictably and destructively throughout the history of financial markets".[24] From this point of view, there is nothing new under the sun, in that this should be a normal exercise in the bank management. In other words, this requires banks to be able to know their own financial, organisational and operational situations in order to be ready to make all interventions necessary. Specific corporate governance rules and internal control systems should be in place to continuously monitoring the situation. Responsibility on these issues falls on bank's governing bodies.

The innovation here is that supervisory authorities should have the power to intervene, requiring banks to take all necessary measures for recovery and resolution. As a consequence, if a bank is not able to make all the necessary adjustments, supervisory authorities should directly intervene to impose structural and operational changes. In these cases, structural changes become mandatory.

Many considerations have been made about the strengths and weaknesses of the new instrument. If a large consensus has been reached about the goal and from a theoretical point of view, in practise it could become "too complex to work". Undoubtedly, a sort of pessimism on the effectiveness of this measure is justified if one only takes into account the experience of the last financial crisis and the incapacity of authorities to manage such complex financial institutions.

Indeed, we cannot underestimate the methodological and practical difficulties that the exercise could present for banks and supervisory authorities. First, it requires the configuration of different crisis scenarios, implying both going concern (for recovery plans) and gone concern prospects (for resolution plans). After the design of a certain scenario, banks should outline a list of specific initiatives that could be taken in different crisis situations, as well as the concrete actions to be taken and the decision-making processes to realise, along with the relative timeframes. For this purpose, beyond any other legal constraint, models of group governance and organization have to be taken into account as they may represent an obstacle to carrying out derisking processes or resolution interventions to ensure the continuity of essential functions and the availability of deposits.

Among these elements, an essential role is played by the group's articulations, the actual design of business lines and the operational schemes employed for the most complex transactions, such as those in derivatives and structured products, which mostly impact on the level of interconnection. It should be taken into account the arrangements of information systems and the operational links among the different components of the group, in terms of reciprocal guarantees and service contracts.

All these aspects can explain the reason why financial institutions are very reluctant to develop "living wills", especially when it comes to sensitive business and strategic profiles, which could create conflicts between the different

---

[24] D. POLK & WARDWELL LLP-MCKINSEY & CO, *Credible Living Wills: The First Generations*, April 25, 2011.

components of the group and the authorities of different countries. This is connected with the possibility that from the joint examination of contingency plans between banking groups and the supervisory authorities of different countries where they are located could emerge aspects of excessive complexity, so as to preclude effective crisis management.

Apart from these difficulties, it seems that the practical implementation of contingency plans raises two aspects of ambiguity:

i) the first is related to the possibility of supervisors requiring a bank to simplify the group's structure. It is evident that such a power could give the same authorities the prerogatives to shape the market, which was a typical feature of the "structural" supervisory model, an out-of-date model, in that it was incompatible with the autonomy of banks to choose their own structural and organisational models and with the functioning of the European market; and

ii) the second is connected with the curious trade-off that could emerge between effectiveness in prevention and in the management phases of the crisis. This relates to the evaluation of fundamental elements of intra-group integration and interconnection, with regard, in particular, to the management of liquidity, risk management and control systems and the functioning of IT and accounting systems among the different components of the group. These elements can ensure, at an early stage, a major capacity of the group to prevent and resolve autonomously their difficulties. On the contrary, under a crisis scenario, the same elements may hinder the timeliness of the derisking processes (through the sale of specific components or business lines) or the performance of resolution measures (e.g. through the succeeding of other operators in the management of essential functions or the transfer of assets and liabilities to a special purpose vehicle according to the good bank/bad bank model). We can also refer to an integrated Treasury management among different components of the group, which allows, in an ongoing phase, a better circulation of liquidity between the different entities of the group, but that can lead – in the case of crisis - to ring fencing measures, aimed at the segregation of assets in favour of domestic creditors. Or, finally, to an IT system strongly integrated which, on one hand, may ensure early warnings at a consolidated level, while impeding, on the other hand, the possibility to elaborate on tailored scenarios for the different countries in which the group operates.

All these aspects should be in-depth analysed before issuing a regulation that could reveal ineffective or hardly to be implemented. In alternative, we could think of options based on a mandatory downsizing of the too big banks or other structural rules to be imposed by supervisors. In this way the problem of the too big, too complex or too interconnected to fail would be resolved at the root.

4.1.4 The resolution measures. Who pays the costs?

The preventative measures examined above are extremely important because they aim to reduce the likelihood of insolvency. As said, other relevant issues

remain to be addressed, such as improvements in the global recovery and resolution framework, in order to reduce the extent or the impact of failure of G-SIBs. On this issue, as announced, a specific package of policy measures is also being proposed[25]. The crisis management and resolution reforms imply the capacity of a national framework to resolve the crisis without disruptions to the financial system or taxpayers losses, namely the capacity to realise "going concern" capital and liability restructuring as well as "gone concern" restructuring and wind down measures. National legislations need to be amended to give the competent authorities the powers and instruments to resolve large and complex financial institutions.

The focus is on the mechanisms aimed at avoiding State interventions through the participation of creditors in banks' losses. The new framework will be based on financial instruments issued by banks, to be automatically activated when a trigger point has been reached (contingent capital), rather than by holding common equity. Moreover, should such credit institutions be subjected to a formal special resolution regime, a "bail in" arrangement should take place, entailing haircuts or debt-equity swaps.

Consequently, new principles and a new institutional architecture at an international level are necessary for improving supervision and the crisis management capabilities when different countries are involved in a crisis. Reforming the financial system is not an easy task, because national stances are always considered as a priority on this sensitive issue. I have already recalled the complex process that characterised the introduction of the European Directive on the reorganisation and winding up of credit institutions. But, after the weaknesses showed during the crisis, any further uncertainty could be guilty of an oversight.

The main principle of a new framework should be the participation of private creditors in the recovery of failing banks in order to avoid the use of public funds for their bailouts. In this direction, the proposals made by international rule-setters for the use of contingency capital and bail in instruments, as described above, are undoubtedly effective because they imply the conversion of debt instruments in capital when the bank is in trouble. But, as seen, further work is needed. These instruments should be clearly identified from legal and supervisory points of view, unless we want to introduce elements of opacity and ambiguity into the notion of capital just when the regulation of capital aims at increasing its quality.

Moreover, concerns have also been expressed by the industry on the possibility that the issuing of such instruments could not be absorbed by the market. This could tend to substitute unsecured debt with collateralised debt, expressly excluded from the application of the write down. So, a contingent capital-based solution (the contractual approach) has gained consensus in respect of the bail in approach, as the first option is likely to be less distorting than the second one, hitting categories of investors who are more aware of the specific risks they have taken.

---

[25] FINANCIAL STABILITY BOARD, Press release of the meeting in Paris, 18 July 2011.

By contrast, this kind of solution does not exclude the possibility that specific private funds may be constituted for supporting resolution measures. On this projects, many proposals have been put forward, especially at the European level. The need for interactions between Bank Resolution Funds[26] and DISs has clearly emerged. The search for synergies between the two instruments is essential or, alternatively, a merger into a single legal entity could be considered. Moreover, the possible complementary role of the fund proposed by Mr. Profumo for granting liquidity support to troubled but viable banks should be evaluated. The three funds seem to refer to different situations and applications, so that a combination of them cannot be excluded. A crucial issue for the effectiveness of these instruments is the provision of a priority ranking for other unsecured creditors in the case of insolvency.

But, again, there does not seem to be consensus on this issue. A resolution fund is especially opposed by market participants, who look at the additional mandatory contribution for crisis resolution as the wrong approach to the problem. This is because it does not adequately take into consideration the level of taxation in the various States and the differences between those banking sectors not affected by the crisis and not supported by public funds and those that have benefited from taxpayers' money. Moreover, they fear a competitive distortion if such a levy is not globally adopted.[27]

4.1.5 Coordination vs. integration at the EU level.

As said, the treatment of cross-border banking group crises is a critical issue. The progressive convergence of national instruments for crisis management and the strengthening of coordination mechanisms may certainly ease orderly interventions in the case of crises. But, such coordination mechanisms can not ensure by themselves an integrated system of crisis management, which is likely to be - at least at the EU level - the most efficient solution to minimise the total cost for stakeholders. Indeed, we cannot underestimate that in the last financial crisis the heavy limits of the coordination and cooperation-based approach emerged clearly. Solutions based on ring fencing in favour of local creditors prevailed. In a few cases, a way out solution was found through a difficult and costly break-up of financial institutions that were strongly integrated along national boundaries, as in the case of Fortis, mainly because of the absence of pre-agreed schemes of burden sharing among interested parties.

Well aware of these aspects, the European architectural reform assigns to the EBA a specific role for the coordination of cross-border crises, not only with tasks of mediation and decision in emergency situations. Less clear is the role

---

[26] R. MASERA-G. MAZZONI, *A proposal for a Special Resolution Fund (SRF) for SIFIs (Systemically Important Financial Institutions) financed through risk-sensitive fees. A market based measure of systemic risk*, University G. Marconi, Working Paper, 2011.

[27] G. SABATINI, *The management of bank crisis in the new European supervisory architecture*, Siena, April 1-2, 2011.

of the EBA in the cases of bank resolution, mainly because such situations may involve authorities not performing supervisory functions.

So, in the medium-term the possibility of reaching a more integrated European set-up should be explored in order to achieve a more efficient crisis management of cross-border financial institutions. For this purpose, the introduction of a banking group crisis discipline should have priority, recognising group interests and providing a clear legal framework for a fair and equal treatment of creditors and the alignment of responsibility between home and host authorities. A second step could be the creation of a European authority for the crisis management of cross-border intermediaries, supported by a European Resolution Fund. Obviously, this is a matter of high institutional profile, which requires a strong political commitment. But, the last financial crisis has taught us that there should be no room for hesitation unless we want to repeat the same mistakes.

5. The institutional setting of the special resolution regime.

The institutional design of crisis management and resolution is another key aspect to consider in the reform of the financial system. Excluding the possibility of the primary involvement of judicial authorities in crisis proceedings, it should be established to which administrative authority confer the resolution powers and, particularly, the entitlement to adopt resolution tools. This problem has both a national and an international dimension.

Harmonised solutions are hardly achievable given the different institutional solutions adopted in each country with regard to the authorities responsible for banking crises resolution: supervisory authority, central bank, deposit insurance system, Ministry of Finance or specific resolution authority. As a consequence, the choice in this field should be left to national discretion, allowing Member States to retain existing arrangements. In some countries, resolution functions could be shared by different authorities, with the consequent necessity of a clear definition of responsibilities and powers and of an effective and efficient coordination of functions. Legislation should attribute clear responsibilities to assess whether triggers for resolution are satisfied, wich resolution tools to apply and how to manage the resolution process.

One critical aspect to consider is the opportunity of separation between supervisory and resolution functions, in some countries entrusted to different authorities to minimize the risk of supervisory forbearance. Where both functions are carried out by the same authorities, a specific separation between the two functions should be established.

Leaving these choices to national discretion could lead inevitably to coordination problems with foreign authorities responsible for cross-border banking crises. It has been argued that the solutions outlined at the EU level could not be effective, as they provide for simple coordination mechanisms, while an integrated European banking system requires a single authority equipped with

appropriate powers of intervention. One solution envisaged to this problem could be the creation of a "group-level resolution authority", which could be the resolution authority of the Member State where the consolidating supervisor is located, according to article 4/48 of the Directive 2006/48/EC. A possible role of the EBA in this field has been questioned, especially the role of resolving disagreements between resolution authorities (mediation role), given the fact that the EBA is composed of representatives from supervisory authorities; specific organisational and operational procedures must be established to avoid mixtures of potentially conflicting functions.

Another critical aspect of the new resolution framework is the legal instruments through which resolution mechanisms can be carried out. As said, a single rulebook for crisis resolution is difficult to draw, because models are very different among countries. In the US, the resolution authority has the power to take control of a bank and to directly exercise all the powers of its shareholders and management. Another model followed in many countries (such as in Italy) is based on the appointment by the resolution authority of an administrator to the failing bank, who takes the control of the banks and performs all resolution functions. Other solutions can also be followed, for example, the application of resolution tools through executive orders or decrees, according to national administrative competences and procedures. Even though, at first sight, the US receivership model seems to be more effective, being it based on the implementation of resolution tools directly by authorities, the legal implications it may have in various countries are numerous. Given these differences, a single solution is hard to be achieved, so the international framework should follow a realistic approach, limiting itself to establishing objectives and instruments of resolution and leaving the definition of the legal mechanisms to national powers.

6. Possible innovations in the Italian framework.

The Italian financial system will be part of this innovative process even though, as said at the beginning of this work, the Italian banking system has not been directly affected by a banking crisis during the financial turmoil. The system has proven sounder and more resilient than others more directly hit by the crisis. More traditional business models and more prudent management policies have helped Italian banks to substantially avoid the turmoil. Indeed, complex structured products were not significantly present in their balance sheets. Moreover, Italian banks' leverage is on average lower than other European banks. At June 2010, for the first 10 Italian banks, the leverage ratio was on average 18.4, with respect to a value of 30 for other European banks.[28] In this context, a relevant role has been played by the cooperative banks and mutual banks, whose business model has allowed them to maintain the financial support to small and medium-sized enterprises during the crisis.

---

[28] R&S Mediobanca, *Major International Banks: Financial Aggregates*, 9th edition of annual statistical survey of leading international banks, 2011.

A concurrent, but not minor feature has been the effectiveness of banking regulation and supervision.[29] Here, it is worth enlightening the strict application of prudential regulation by the Italian authorities over recent decades such as, for example, the stricter rules concerning the computability of hybrid financial instruments in Tier 1 supervisory capital or the more cautious treatment of the businesses at the origin of the financial crisis. Within Basel 2, the Italian regulation and supervision framework takes into account the variety in sizes and complexity of banks and banking groups, providing for an array of different rules. The principle of proportionality is effectively applied, by sorting out intermediaries into five macro-categories to conduct the SREP: intermediaries with relevant international presence; intermediaries with domestic systemic relevance; medium-sized to large intermediaries; small intermediaries; and intermediaries subject to particular regulations. For each category of banks a tailored approach to supervision is followed, which is mainly focused on preventive action and corrective measures in order to tackle the troubles at a very early stage.

Finally, as to the Italian framework for crisis management, as already said, despite its age it is one of the most modern special resolution regime all over the world. It has proven fundamental for its flexibility in instruments and enforcement techniques. The same perception of its effectiveness has been sufficient to prevent bank run so far. Losses for depositors and uninsured creditors have been avoided, taking into account market and competition rules. Even in the two cases in mid '90s, where public intervention turned out to be necessary, banks were sold to private entities and costs for taxpayers were not incurred.

After the financial crisis, under the new international regulation, stricter rules, more stringent supervision and new crisis management and resolution tools will be required for systemic financial institutions. Authorities will be equipped with new tools and powers of intervention and, as a consequence, also the Italian legal framework will need some adjustments.

The area of crisis prevention pertaining to prudential regulation and supervision falls within the Bank of Italy's remit. In this field some legislative and administrative reforms have already been issued in order to implement the CRD II framework. An articulated and stringent regulation has been also issued with reference to the policies and practices of remuneration and incentives in banks (in line with the CRD III). As to the other preventive tools that will be provided for by the new framework, the Banking Law entrusts the Bank of Italy with all powers concerning reporting requirements, off-side and on-site examinations and corrective interventions.

Contingency plans (living wills) and stress tests also fall under the provisions of the existing legislation. So, it is the Bank of Italy, in its regulatory functions, that sets the appropriate rules according to the international provisions. Some legislative changes, however, could be necessary to supplement the Bank of

---

[29] M. DRAGHI, Address by the Governor of the Bank of Italy at the Annual Meeting of the Italian Banking Association, Rome, 15 July 2010.

Italy's powers, such as entitling the supervisor to impose change to the banks' structures and organisations to allow an orderly resolution.

As to early intervention, Italian law provisions are largely in line with the proposal outlined at the EU level.[30] Some supplementary measures, however, seem to be necessary. This is, for example, the case for "removal", namely the power of the supervisory authority to replace one or more board members or managing directors or to require their dismissals in cases where they are liable for misconduct. This could be a measure that selectively affects the bank's governance, avoiding to use the more intrusive instrument of the special administration when not necessary. The Bank of Italy has not actually the power to remove single directors.

On the contrary, the appointment of a special manager - a specific measure provided for in the EU proposal for early intervention - is an instrument well rooted in the Italian special crisis management regime. As already seen, broad requirements (triggers) are requested for the opening of the proceeding, including severe irregularities and violations of law. An alignment of the legal provision with the rules under discussion at EU level might be necessary (the use of special administration when an institution fails to meet the requirements of the CRD and is not willing or able to draw up or implement a specific recovery plan).

As to crisis management and resolution, special administration and compulsory administrative liquidation are the two fundamental components of the special crisis management and resolution regime in force in Italy. Their design and concrete implementation practices enable the supervisory authority to manage different kinds of bank crises.

Special administration allows the Bank of Italy, in its supervisory functions, to intervene also at an early stage of a bank's difficulties, since it can be activated in the case of irregularities before they give rise to losses. In the case of large and complex financial institutions and banking groups this procedure can also be necessary to better assess a bank's situation and to prepare and implement a recovery plan. For this purpose, it is of prominent importance that the procedure implies the removal of all directors and the suspension of the shareholders meeting. Therefore, special administrators can conduct, in an independent way and without any kind of interference, the assessment of the real situation of the bank, the removal of irregularities and the finding of the best arrangements for the resolution of banks or banking groups. For more complex conglomerates mixed solutions can also be realised in order to restructure viable entities and to liquidate those not consistent with future business activity.

From this perspective of going concern, with the consent of the shareholders, all solutions can be realised, such as P&A transactions, mergers or even more

---

[30] As said, articles 53 and 67 of Banking Law have recently been supplemented in order to include the specific measures the Bank of Italy may take against banks and banking groups that are facing difficulties. Article 69 has been changed to provide for the constitution of the colleges of supervisors and for actions to be taken in cases of emergency regarding the liquidity and stability of the Italian and of another Member State's financial system.

extraordinary solutions, such as bad/bank-good bank splitting or the creation of bridge banks.

One peculiarity of the procedure is that shareholders' rights cannot be infringed. So, the approval of capital owners is necessary. In case of opposition by shareholders to the special administrators' proposals for overcoming the crisis, depending on the seriousness of the situation, compulsory administrative liquidation can be activated. In this case, as an alternative to a piecemeal liquidation, the transfer of assets and liabilities to another bank, bad bank/ good bank or bridge bank schemes are possible way-outs lacking the consent of shareholders, because under liquidation the same functions of the shareholders' meeting come to a cease.

So, the use of the two procedures, in isolation or combination, is possible, especially with a banking group whose entities (banks and other intermediaries) are in different situations. The "administrative" nature of the proceedings and their management by supervisors are undoubtedly advantages.

We cannot exclude, however, that some room for improvements still exists. Many questions have been raised about the adequacy of the Italian crisis management regime in respect of the evolution of the international framework. Undoubtedly, one of the strengths of the system is the use of special administration for early intervention, when mismanagement or violations of rules can undermine the future stability of the bank. This preventive measure, as the experience has clearly shown, may not always be effective, because in some markets and for particular categories of banks, it can exacerbate the financial situation of the bank. This is because of the possible negative reactions of counterparties (depositors' withdrawals, interruption of liquidity support) and difficulties in finding appropriate market solutions for the acquisition of the bank or its businesses.

Another possibility of intervention could be the provision of a lighter special administration, based on the appointment by the supervisory authority of a "shadow" administrator, with the function of monitoring and approving the main firm's decisions, without replacing the ordinary management (as in special administration).

The widening of the toolkit for the management of weak banks is consistent with the objective of making common instruments available in different countries, both to ensure the equivalent capacity of intervention at a national level and to coordinate the management of cross-border crises.

The Commission's proposal for instrument harmonisation at the European level is an attempt to make common tools available in various countries, thus allowing a flexible application. Some critical aspects of the proposal refer to the introduction of "new" resolution measures based on schemes and tools not belonging to the Italian ways of managing banking crises, which are essentially based on the transfer of assets and liabilities within the context of the compulsory administrative liquidation.

Indeed, Commission's proposals seem to prefigure, especially for banks having systemic relevance, the direct empowerment of the authorities to take control of the failing bank and to put in place resolution measures. This power is not currently provided for by the Italian Banking Law. Undoubtedly, the new instruments could significantly strengthen the ability of supervisory authorities to better manage banking crises with systemic relevance.

However, such changes to the Italian law require further analysis especially under a legal point of view. Issues of consistency with our constitutional framework should be kept under consideration given the infringement of third parties' rights that the new powers and instruments could imply. Therefore, the problem is to what extent such wide and discretionary powers should be assigned to the Bank of Italy, in its role of supervisory authority (or attributed to other resolution authorities), and what "check and balances" should be introduced to safeguard and compensate affected third parties. Evidently, the wider the powers of administrative authorities are, the more the legal risks that may arise.

The reference, here, is to those resolution tools implying a constraint to shareholders' and creditors' rights, such as bail in transactions, mandatory transfers of shares, and assets and liabilities - if this is the case - to bad banks or to bridge banks to be established under the control of the resolution authority.

Bail in operations are very peculiar, implying the power to charge some categories of creditors with losses in order to allow ailing banks to rapidly recover their solvency conditions, avoiding the disruptive effects of liquidation on other stakeholders and on the same creditors as a whole.

The current Italian framework does not enable authorities to haircut non-insured creditors claims and to convert debts into capital. Particularly, neither the Bank of Italy nor the special administrators and liquidators can carry out these transactions autonomously, unless an agreement between creditors and the failing bank (or its special bodies) has been reached. But, an agreement is in such cases hardly feasible in practice due to the great number of creditors involved; thus, a different mechanism must be find out on the basis of a new legislative measure.

Such an instrument is currently in force in other proceedings provided for by the bankruptcy law for commercial firms, but this requires the majority of creditors' approval and an endorsement by a court for the purpose of making such agreements "*erga omnes*" effective.

So, this is a very sensitive issue. The principle of the "equitable treatment of creditors", one of the pillars of the Italian insolvency framework, should be considered. It is very different to apply a haircut before insolvency proceedings or after it, when the protection of creditors is differently regarded. In the former case, the going concern solution should be looked into carefully, both as a contractual option and as an authority-led one. Anyway, if the supervisory authority decides to apply haircuts or a debt/equity swap, appropriate legal conditions should be identified as well as "checks and balances" such as compensation mechanisms

for creditors if things should go better than ex-ante evaluations and expectations. This is a field where room for litigation is wide.

In the latter case, which is a gone concern context (i.e. liquidation), with shareholders and unsecured and uninsured creditors haircut and managers wiped out, the whole bank's situation is clearer and all resolutions measures, including public intervention, may be applied in an easier way.

The recent reform of Italian Bankruptcy Law has benefited from many schemes taken from the banking crisis management model. Can it now offer useful insights into the banking model? The main issue is the agreement with creditors (restructuring of debt), which is a specific topic of reorganisation proceedings. Another important topic is the priority rule (pre-deduction) for the financing granted by creditors to firms under reorganisation proceedings. Finally, it might be considered the extension to the banking sector of the bankruptcy rule that, under article 67, grants special protection from claw back actions to third parties somehow involved in a firm's reorganisation. This may prove a useful tool, even outside of a formal crisis management proceeding, to help the bank exit the crisis.

As a consequence, statutory bail in should be applied under strict and predetermined conditions, in terms of triggers for intervention, such as: i) risk of a systemic instability; ii) likelihood of major losses for creditors in case of liquidation (*no creditor worse off* principle); iii) compliance with the priority rules applicable in case of insolvency (equity and subordinated debt should be haircut first); iv) clear definition of the classes of creditors to be hit; and v) the provision of adequate forms of compensation for creditors affected.

Contractual bail in poses less problems of legal compatibilities as banks have already been issuing contingent capital that may cover losses under certain circumstances. In any case, clear rules for the application of the two instruments (statutory or contractual bail in) should be established by law.

Similar considerations may be made for a partial transfer of the liabilities of a failing bank to a third party, which could infringe the principle of "equal treatment of creditors" with reference to non-transferred creditors. In such a case, a clear and objective pre-determination of the conditions and criteria for the treatment of creditors is essential.

As to the bridge bank, the Bank of Italy should be entitled to set up such an entity, to which temporarily transfer assets and liabilities of a failing bank. But, the problem here is to define who puts the capital and manage the bank. A solution to the first question could be offered by the institution of a resolution fund (in the terms examined in chapter 3), while the management of the entity should be appointed by the Bank of Italy (likewise special administrators) or by the Resolution Fund in stricter coordination with the Bank of Italy. Managers should have an high skilled profile, be independent from the board of the bank, perform their functions under the strategic lines defined by the Bank of Italy and the Resolution Fund. The bridge bank should be sold on the market at the end of the transitional period and the revenues should be returned to the resolution fund.

Moreover, the law should entrust the Bank of Italy with the power to establish bad banks to which transfer non performing or difficulty-to-evaluate assets in order to facilitate the resolution process. As already said for bridge banks, the financing of the transferred assets and the bank management are the most critical issues for bad banks as well.

As evident, such resolution measures imply the recourse to a resolution fund. This is one of the most challenging issues, requiring a political decision on how to finance it, among the various options that can be followed and taking into account the solutions identified at the international level to ensure the necessary convergence. Italian law could establish a new fund or entrust this function to the DIS, which already carries out some resolution functions in the current framework. The solution of an autonomous fund could be preferred for the fact that DIS is tailored to small and medium-sized banks, while a resolution fund could be more appropriate for large and systemic banks. The problem is to establish to what extent the banking system, which currently support the DIS, can be charged with further levies to provide financial resources to the fund.

This point seems to be the most critical as the outlined proposals at the international level seem far from reaching a convergent solution. Many countries are adopting their own solutions with the creation of national "resolution funds". The questions to be answered are: can this approach be effective in case of another systemic crisis? Why not to implement a global solution or at least one at European level?

As to the DIS, we can say that the Italian system is largely compliant with the model outlined by the Core Principles of the Basel Committee. Operational experience has been very positive in that DISs have not only performed *pay-box* functions, but also intervened in restructuring and resolution plans in order to minimise the negative effects of distressed banks on different categories of stakeholders (*risk-minimiser* functions).

The turbulence that affected financial markets and intermediaries has shown the importance of the DIS for the preservation of confidence in banking systems. The increase in the coverage recently introduced at European level is an indirect recognition of the validity of the choices made by the Italian legislator in the '90s when it introduced a higher level of protection compared with the "minimum" established by the 94/19/EC Directive. Since then, the Italian view has been in the direction of the stability of deposit insurance than protecting consumers.

Some critical aspects of the Italian schemes, however, could require some changes in DIS regulation in light of the project of the new, more harmonised EU Directive. These may regard: i) the adequacy of financial resources available for interventions, since 0,4% of reimbursable funds might be insufficient in large crises; ii) the object of the protection, with the possible inclusion of new products and services as a consequence of financial innovations; iii) the funding mechanism, with a possible change from the *ex-post* system to an *ex-ante* one, in order to overcome the pro-cyclicality effect that derives from the *ex-post*

scheme, which could require banks to finance the fund's interventions just when contributing banks may encounter difficulties in profitability and liquidity. The same mechanism implies, moreover, that the recipient bank in trouble will not contribute to the system; and iv) the relationships with the supervisory authority, in terms of major coordination and exchange of information.

Further reflections are necessary on many topics concerning deposit insurance, especially for large and complex banking institutions that operate cross-border through branches and subsidiaries. A new approach should characterise the role of DISs within the domestic and international safety net instruments on financial stability. In particular, the role of DISs should be clarified with regard to systemic crises and to the related problem of burden sharing. Indeed, if it is recognised that DISs play a central role in the management of the crises of small and medium-sized financial institutions, more in-depth analysis should be made about their involvement in large banks crises, which should, in principle, be outside the scope of their interventions. Answers on this issue will depend on the resolution measures applied to these institutions: will they be left fail or will the DIS be called to reimburse insured depositors? Or will they be resolved with restructuring processes, so that the DIS may contribute, along with other instruments, to fill the capital deficit? The interaction and definition of clear boundaries with Bank Resolution Funds or other similar schemes should in any case be established.

Apart from the discipline of resolution measures, some adjustments might be necessary in the banking group crisis regulation should new provisions be introduced at EU level, with regard coordination mechanisms with foreign resolution authorities, since harmonised proceedings hardly take place at the moment. The introduction of the new "colleges of resolution authorities" could require new provisions in Italian Banking Law for allowing the exchange of information and coordination with other non-supervisory authorities.

7. Which model is coming out of this process? From the Bankruptcy Law to the Banking Law.

The financial crisis has ultimately concluded the debate over the option between the judicial or the administrative model of crisis management proceedings. The scheme emerging from the solutions outlined in international proposals not only confirms the preference for an administrative scheme, but heads towards strengthening the latter. This leads to the conclusion that the authorities might require banks to simplify their structures as a result of contingency recovery and resolution plans, or impose creditors write down or convert them into capital (bail in transactions).

So, as a consequence of this new framework, we would expect a more pervasive role of administrative authorities in the future, whatever they are (supervisory authority, central bank or specific resolution authority), so that the gap between the tendency of commercial firm's law towards the private autonomy and that of banking firm's law towards authoritative intervention widens.

Another feature of this new setting could be the strengthening of the discretionary powers of supervisory and resolution authorities. This is a peculiar trend, because before the crisis we were going just in the opposite direction of reducing discretion in favour of strengthening general rules.

The implementation of these new principles and rules could require changes in the institutional architecture of crisis management at national level. This is a complex issue, because it could require the reconsideration of the safety-net in many countries. In particular, the problem is to establish which authority should be entitled with crisis management functions (central bank, supervisory authority, special crisis management authority, Finance Minister). The crisis has shown that when systemic risk is involved, the role of Finance Ministries increases.

As said, solutions may be different and depend, in each country, on many factors, some of them even of historical nature. Certainly, there is no one ideal model and we may hardly implement a single solution for all European countries.

8. Concluding remarks. What kind of financial system will come into effect after the crisis?

Experience has shown that banking crises depend on many factors that are internal and external to banks. Often both factors concur. Among internal causes, crisis events may be a consequence of fraud and misbehaviours. The recent crisis somehow confirmed these characteristics. We can agree with that opinion,[31] according to which a sort of "moral deficit" or "moral decay" was at the root of the financial crisis, which is referable not necessarily to fraudulent events that occurred in many banking crises, but particularly to the whole configuration of the business model or to the management strategies of financial institutions. This led to the creation of complex financial instruments and to the incongruous growth of short-term profits in favour of shareholders and variable remunerations of managers. In the same direction, against the speculative approach of banks' management, it has been stated[32] that banks should take a longer-term approach to their businesses rather than simply trying to "maximise profits next week" and that traditional manufacturing industries have a more "moral" way of operating compared with financial institutions.

Since each financial crisis allows us to learn a lesson, we should reflect at this point not only on the amendment of regulation in order to avoid crisis events in the future, but also on understanding more clearly what kind of financial system we want in the future. If we think of a system capable of efficiently and effectively meeting the needs of the citizens and of the real economies, we must pay due consideration to both private and social benefits of market participants.

---

[31] J. STIGLITZ, *Freefall. America, Free Markets, and the Sinking of the World Economy,* W.W. Norton & Co., 2010.

[32] M. KING, *Mervyn King blasts banks for exploiting customers*, Guardian.co.uk, 5 March 2011.

From this perspective, it is worth underlying that beyond the rules, the role of human behaviours is very important in guaranteeing the correct functioning of the economic system. No statement may be more eloquent than the one made by the Senator Chris Dodd when submitting the regulatory reform to the US Parliament: "We can't legislate wisdom or passion. We can't legislate competency. All we can do is create the structures and hope that good people will be appointed who will attract other good people".

In the same direction, it has been recently underlined that,[33] "one of the lessons of the crisis is that the profit's objectives must be realised in a long-term vision, having regard to the robustness of the balance sheet and to the preservation of the economic capital over time. So, the best defence of stability is the pursuing of a sustainable and responsible enterprise growth, which takes into account the needs of all the actors involved. The productive process must develop having regard not only to the remuneration of shareholders, but also to the needs of employees, of clients, of citizens (that should not be called to pay for banking insolvencies). The value creation for shareholders is important, but in the long-term it is not realisable without considering the welfare of all people involved in the productive process. In this perspective, finance is not an end to itself, but an instrument serving the growth, based on behaviours marked by correctness and prudence".

A new value system for banks and other financial institutions looks necessary, with a general rethinking of their roles within the entire financial system. In this sense, banks' corporate governance structures may play an essential role, provided that new ethical principles are included in corporate missions.

To this regard, the public consultation for a Green Paper on the reform of corporate governance - launched by the European Commission - is welcome since its objective is to ensure that "the interests of consumers and other stakeholders are better taken into account, businesses are managed in a more sustainable way and bankruptcy risks are reduced in the longer term".[34] This issue is of paramount importance, especially for cross-border, large and complex financial institutions, whose management and control have proven particularly challenging. The financial crisis showed many corporate governance failures, including insufficient board oversight on senior management, inadequate risk management and unduly complex or opaque bank organisational structures and activities.

One of the main reflections should regard the real functioning of the mechanisms of internal consultation and of control on the management resolutions and choices in order to ensure an appropriate level of information and discussion within the boards and between these and other bodies. The recent international debate and recommendations have been stressing the importance

---

[33] A.M. TARANTOLA, *Verso una nuova regolamentazione finanziaria*, Speech at the "Scuola di Alta Formazione dell'I.P.E. – Inaugural Conference of the Master in Advanced Finance, Naples, 21 January 2011 (the English version is mine).

[34] EUROPEAN COMMISSION, Green Paper, *Corporate Governance in financial Institution and remuneration policies*, Brussels, 2.6.2010, COM (2010) 284 Final.

of non-executive and independent administrators in order to ensure the safe and prudent management of banks. But empirical analysis has demonstrated that the presence of such figures did not significantly affect the capacity of banks to withstand the financial crisis.

The Basel Committee recommendations[35] have stressed the importance of corporate values and codes of conduct. In particular, for the effective functioning of the board, it is important that their members achieve an adequate level of knowledge of the banks' riskiest activities in a way to carry out a primary role in approving and monitoring risk strategies. We can say that competence, professionalism and experience, as well as personal quality and integrity, are essential attributes for board members, so that we should change from "fit and proper" to "fit for the job".

In this framework, the board should actively carry out its extensive duties and responsibilities, including its business and risk strategy, organisation, financial soundness and governance. It should also ensure an effective oversight of senior management. The board and senior management should know, understand and guide the bank's overall corporate structure, ensuring that the structure (and the entities that form the structure) is justified and does not involve undue or inappropriate complexity. Senior management, and the board as appropriate, should understand the purpose of any structures that impede transparency, be aware of the special risks that such structures may pose and seek to mitigate them.

Risk management is a fundamental function in banks. The Basel Committee's principles affirm that under the direction of the board, senior management should ensure that the bank's activities are consistent with the business's strategy, risk tolerance/appetite and policies approved by the board. A bank should have an independent risk management function (including a chief risk officer or equivalent) with sufficient authority, stature, independence, resources and access to the board.

Under risk-oriented management, banks should reconsider their internal incentive systems, dismissing remuneration practices when excessively oriented to short-term objectives. For this purpose, banks should fully implement the FSB's *Principles for Sound Compensation Practices* and accompanying *Implementation Standards* or the national regulations that are consistent with the FSB's principles and standards, which emphasise the most correct and risk-oriented compensation rules. The Italian regulator has quickly moved in this direction, issuing severe rules and guidelines for good corporate governance and introducing rigorous remuneration policies within the banking system, even

---

[35] BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for enhancing corporate governance*, Consultative Document, March 2010, which supplement previous principles and guidance. See *Enhancing Corporate Governance for Banking Organisations*, Basel Committee on Banking Supervision, September 1999 and February 2006, available at www.bis.org/publ/bcbs122.htm. See also, OECD, *OECD Principles of Corporate Governance*, revised April 2004, originally issued in June 1999, available at www.oecd.org/dataoecd/32/18/31557724.pdf and the recent update of the OECD principles, OECD, *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles, 2010,* available at www.oecd.org/dataoecd/53/62/44679170.pdf.

though unsound compensation practices have not been relevant in the Italian banking system. This reflects a specific regulatory initiative aimed at: i) aligning compensation policies to sound risk management; ii) introducing disincentives to excessive risk-taking; and iii) giving the a concrete sign of the regulatory pressure on the financial sector to address deficiencies in such practices.

At a higher level, a new strategy and mission should be clearly stated in financial institutions, namely the observance of ethics and social responsibility. But, we should ask ourselves: what is ethics in finance after the financial crisis? Has it changed its meaning and content in respect of what we knew before the financial crisis? In my opinion, ethics can no longer be referred to the relationship between banks and customers, as if only customers' interests should deserve protection. This value should assume a new meaning today in light of the disastrous effects produced by the financial crisis over a wide range of stakeholders.

Managers' behaviours should consider the negative direct and indirect effects (externalities) that finance can produce on market participants, in terms of the cost of services, economic activity and employment, as the financial crisis has demonstrated. We should simply consider the effects determined by subprime mortgages on homeowners in terms of the loss of properties and on investors who acquired those complex structured products from which many losses derived. According to this view, a financial system should be regarded as a mean to a goal rather that as a goal in itself. If the financial system makes undue profits, this may lead to imbalances in the overall economy, especially in lending to small and medium-sized enterprises.[36] We share the idea that what we need now is a new form of capitalism, especially of financial capitalism, with new rules and institutions capable of making the financial markets work better and coherently with the general interests.[37]

Ethics and social responsibility are preconditions for the recovery of confidence in the financial system, which was dramatically lost during the financial crisis. But, as underlined two years ago in the concluding remarks of the Governor of the Bank of Italy, this may take place "not by means of artifices but with the patient, laborious effort to understand what has happened and what future scenarios are possible; and with the consequent action".[38]

Now, more than three years since the beginning of the most severe and disruptive crisis since 1929, we must ask ourselves whether the initiatives taken so far are restoring confidence. The question is whether the system is heading in the right direction given the continuous development of speculative business by the biggest international banks and the return to previous compensation practices in the financial sector.

---

[36] J. STIGLITZ, *Firefall. America. Free Market, and the Sinking of the World Economy*, 2010.

[37] M. ONADO, *I nodi al pettine. La crisi finanziaria e le regole non scritte*, Laterza, 2011.

[38] M. DRAGHI, *Concluding Remarks*, Annual Report for 2008, May 2009.

Moreover, problems seem not to be confined to the banking system. When I started to write this book, regulators and central banks were designing an exit strategy from the public support to the financial system. Now, we are facing a new turbulence, a sovereign debt crisis, which not necessarily is a consequence of the banking sector bailouts. This is a storm that does not seem to come to an end and whose origin stems from a strict intertwinement between sovereign Governments' risk and financial institutions that invest a large percentage of their assets in government bonds.

In other words, at the time the international community was trying to work out banking crises without public support, a new catastrophe occurred with States on the edge of insolvency. Just think about the of Greece risk of default and the difficulties actually encountered by other countries (including the US) in managing their sovereign debt. In this situation, whatever is the amount of financial resources available for rescue purposes, it would not in any case be sufficient to cope with a sovereign debt crisis. Thus, we may say that the kind of problems posed by this renewed market turbulence is not different from the one faced during the first banking crisis.

A Sovereign State default is an accident to avoid at any cost, just as it was for banks, because of the overwhelming effects on global financial system and real economies. For this purpose, current difficulties of sovereign States have been de-escalated and considered as "selective default", which is when a debtor is able to meet only specific classes of obligations or to pay back a specific group of undertakings. The questions again are what form of restructuring should be applied and who pays the costs?

New forms of solidarity among countries are now taking shape. Specific measures have been introduced at the European level to refinance public debt (European Financial Stability Fund, European Stability Mechanism) in order to avoid the feared spill-over effects. In essence, we are extending to sovereign debt the same analytical schemes proposed for bank resolution in order to avoid the negative effects of default on bondholders. But, it is still unclear to what extent these instruments may be applied and whether or not private creditors should contribute to the restructuring process. In any case, it is something that nobody had ever imagined.

What is clear now is that such complex situations must be addressed with adequate instruments.

When we talk about the recent financial crisis, we are inclined to regard it as a natural disaster, i.e. earthquake, hurricane, tsunami, storm, just to highlight the strength of phenomena and their disruptive effects. But the comparison should not go beyond this. Indeed, we can do nothing - or just a little - against natural disasters, because they are out of our control.

For economy and finance it is quite different, because they are based on events that are under human control; they are in our hands; at least in the sense that we can understand and try to oversee and manage them with appropriate measures.

The point is that, although problems and possible remedies are well known, not the same is for the decisions that have to be taken by relevant authorities, because after a crisis nothing can be left as it was before.

Drastic measures are required, which could be very costly for all the players involved: savers, investors, banks, taxpayers and citizens in general. This is the foundation for issuing new rules for economic entities - firms, financial institutions, States – especially aimed to control leverage, for its attitude to produce high profits in good times and huge losses in adversity. Such reforms require a strong political will, both at the international and national level, and no further hesitations, which – given the magnitude of the crisis - may exacerbate the situation, giving markets the perception of a lack of determination to move towards the right direction of a change.

One of the key points is the *principle of responsibility*, which - in its two facets - should drive this complex and delicate phase of the reforming process.

The first is that each actor must do its part, especially governments and financial industry.

Governments should strengthen their balance sheet position, through clear, effective, and rigorous action plans providing structural measures, while in the same time taking into account targets of economic growth, which are essential to overcome the enduring recession in most countries. The recent disorders taught us that market discipline does exist both for private and public entities. Private firms would be sanctioned by the bankruptcy regime, with all its consequences for shareholders and managers in terms of financial and personal responsibilities. Public entities are subject to a political responsibility, which generally emerge only in the long-term. But, what has been made clear is that when such difficulties come out (in terms of perception of risk and consequent rise of the government bonds interest rates) their negative effects on economies and public finances may be of great magnitude. As a consequence, policymakers should follow more rigorous discipline of public balance sheets, introducing stricter rules and restraints to their debt, as it should be for private firms and banks.

The banking sector should rebuild its resilience to shocks, reinforcing its financial position, through higher levels of capital and more balanced liquidity requirements, while in a longer term, banks should change their business strategies as well as their internal processes to prevent further crises.

But, regulators must also do their own shares, taking decisions aimed at modifying the regulation of financial activities and institutions. We are aware that no prudential rule can avoid new disasters to the financial system and the real economy, because it represents only a piece of the complex mosaic that should be designed and implemented. Nevertheless, rules currently under discussion are of utmost importance, especially if at the end of the day they will result in a selective way, giving the right incentives to sound practices and sanctioning unfair conduct of business. They are important also for the positive message

they convey to the market with regard to the firm determination of authorities to reorder their action and push the supervised entities to eliminate excesses.

Open questions in regulation (Basle 3, the treatment of SIFIs and the resolution of banks) must be rapidly addressed with a resolute action. Moreover, strict coordination among jurisdictions is essential to achieve a uniform application of the regulation, avoiding situations such as those occurred under the Basle 2 framework, which has not been implemented by many countries, such as the USA. It is important to restore confidence in a real change of the financial system, supported by the awareness that from now on stronger values will assist the economic enterprise, including a new balance between private and social objectives.

The second facet of the principle of responsibility is that once ascertained personal and political responsibilities at any level, no one of the actors involved in financial disorders should take part in the reorganisation and restructuring process. In a broader sense, it should be more deeply looked into the cultural background that brought about the financial crisis. To this regard, in the current situation it seems extremely appropriate to borrow an assertion of Albert Einstein according to which "(T)he problems that exist in the world today cannot be solved by the level of thinking that created them". Many consider that much could be done in this direction and probably, market operators and citizens have not yet perceived a real sign of change. And this is one of the main sources of the moral hazard.

We should not only consider the "crisis" as a negative event, but as a convenient opportunity for change. Going back to the Greek etymology of the word, the crisis may represent a moment of reflection, evaluation, improvement, and a source of a new chance. But, the transition from the crisis to the change requires the ability of each of the actors involved to shoulder one's responsibility to take the proper decisions and to give the right solution to the problems. To do this, new approaches should be developed to find a new balance at a higher level of wellness.

Actually, if only a real discontinuity with the past is accomplished and a new basis for a fair and sound model of finance is set up, we may say that the high costs, the efforts and sacrifices made have not been in vain, because we have laid the foundations for new behaviours, with the hope that problems of such severity and extent will never happen again in the future.

BIBLIOGRAPHY

V.V.ACHARYA-M.RICHARDSON-N.ROUBINI, *What if a large, complex financial institution fails?*, Mimeo, NYU Stern School of Business.

V.V.ACHARYA-T.COOLEY-M. RICHARDSON (Edited by), *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, John Wiley and Sons, November 2010.

V. V. ACHARYA-B. ADLER-M. RICHARDSON-N. ROUBINI, *Resolution Authority,* V.V.ACHARYA-T.COOLEY-M. RICHARDSON (Edited by), *Regulating Wall Street: The Dodd-Frank Act and the New Architecture of Global Finance*, John Wiley and Sons, November 2010.

V.V. ACHARYA-M. RICHARDSON (Edited by), *Restoring Financial Stability: How to Repair a Failed System*, John Wiley & Sons, 2009, NYU Stern School of Business.

ANGELIDES COMMISSION, the *Financial Crisis Inquiry Commission* established in May 2009 by the Fraud Enforcement and Recovery Act (FERA).

P.ANGELINI, L.CLERC, V.CURDIA, L.GAMBACORTA, A.GERALI, A.LOCARNO, R.MOTTO, W.ROEGER, S.VAN DEN HEUVEL, J.VLCEK, *Basilea III: effetti di lungo periodo su crescita economica e fluttuazioni cicliche*, Banca d'Italia, Questioni di Economia e Finanza, n. 87, 2001.

E. AVGOULEAS-C. GOODARTH-D. SCHOENMAKER, *Living Will as a Catalyst for Action*, February 2010.

BANK FOR INTERNATIONAL SETTLEMENT, Contact Group on the Legal and Institutional Underpinnings of the International Financial System, *Insolvency Arrangements and Contracts Enforceability*, 2002, available on www.bancaditalia.it.

BANK OF ITALY, *Guide to Supervisory Activity*, Circular 269 of 7 May 2008, available on website www.bancaditalia.it/vigilanza/disclosure/review/part-1.pdf.

BANK OF ITALY, *Insolvency and Cross-border Groups. Uncitral Recommendations for a European Perspective?*, Legal Research, No 69, February 2011.

BANK OF ENGLAND, *The role of macroprudential policy: A discussion paper*, November, 2009.

J.R. BARTH-R.D. BRUMBAUGH Jr-J.A. WILCOX, *The repeal of Glass-Steagall and the Advent of Broad Banking*, Economic and Policy Analysis Working Paper 2000- 5, April 2000.

BASEL COMMITTE ON BANKING SUPERVISION, *Supervisory Guidance on Dealing With Weak Banks,* March 2002.

BASEL COMMITTEE ON BANKING SUPERVISION, *Report and Recommendations of the Cross-border Bank Resolution Group*, March 2010, available on the Bank for International Settlements website (www.bis.org).

BASEL COMMITTEE ON BANKING SUPERVISION – INTERNATIONAL ASSOCIATION OF DEPOSIT INSURERS, *Core Principles for Effective Deposit Insurance Systems*, June 2009, available on …

BASEL COMMITTEE ON BANKING SUPERVISION, *Core Principles for effective deposit insurance systems. A proposed methodology for compliance assessment*, 28 May 2010, available on the BIS website (www.bis.org.).

BASEL COMMITTEE OF BANKING SUPERVISION, *International framework for liquidity risk measurement, standards and monitoring*, Consultative Document, December 2009.

BASEL COMMITTEE ON BANKING SUPERVISION, *A global regulatory framework for more resilient banks and banking systems*, 16 December 2010.

BASEL COMMITTEE OF BANKING SUPERVISION, *Basel III: International framework for liquidity risk measurement, standards and monitoring*, December 2010.

BASEL COMMITTEE ON BAKING SUPERVISION, *Principles for enhancing corporate governance*, Consultative Document, March 2010.

BASEL COMMITTEE ON BANKING SUPERVISION, *Enhancing Corporate Governance for Banking Organisations*, September 1999 and February 2006, available at www.bis.org/publ/bcbs122.htm.

BASEL COMMITTEE ON BANKING SUPERVISION, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*, Consultative document, July 2011.

BASEL COMMITTEE ON BANKING SUPERVISION, *Global systemically important banks: Assessment methodology and the additional loss absorbency requirement*, November 2011 (see on Internet BIS Website: http://www.bis.org/publ/bcbs207.htm).

T. BAXTER, *Factors Affecting Efforts to Limit Payments to AIG Counterparties*, Testimony before the Committee on Government Oversight and Reform, U.S. House of Representatives, 27 January 2010, available on website http://www.newyorkfed.org/newsevents/speeches/2010/bax100127.html.

ANDREW BAILEY, *The out look for financial regulation in the UK*, Bank of England, Speech given on a regionbal visit on Edimburgh, 10 January 2011.

T.H.L. BECK, *The incentive-compatible design of deposit insurance and bank failure resolution – Concepts and country studies*, in D.G. MAYES-A. LUIKSILA (eds), *Who pays for bank insolvency?*, Basingstoke, Hampshire: Palgrave Macmillan, 2004.

G. BENSTON, *The separation of Commercial and Investment Banking: The Glass-Steagall Act Revisited and Reconsidered*, New York, Oxford University Press, 1989.

G.J. BENSTON-G.G. KAUFMAN, *Risk and Solvency Regulation of Depository Institutions: Past Policies and Current Option*, Monograph Series in Finance and Economics, 1988-1, New York, NY:NYU Press, 1988; L. BINI SMAGHI, *The financial and fiscal crisis: a euro area perspective*, Le Cercle, Brussels, 18 June 2010.

M. BIANCO-M.MARCUCCI, *Groups and groups' bankruptcy discipline in Italy,* in BANK OF ITALY, *Insolvency and Cross-border Groups. Uncitral Recommendations for a European Perspective?*, Legal Research, No 69, February 2011.

G. BOCCUZZI, *La crisi dell'impresa bancaria. Profili economici e giuridici*, Giuffrè, Milano, 1998.

G. BOCCUZZI, *Direttiva comunitaria in materia di risanamento e liquidazione degli enti creditizi. Commento ai Titoli I, II, III, IV (art. 28, 29 e 33),* in G. ALPA-F. CAPRIGLIONE (a cura di), *Diritto Bancario Comunitario*, UTET, Torino, 2002.

G. BOCCUZZI, *Interrelationships between deposit insurers and supervisory authorities in the Italian and International experience*, Fondo Interbancario di Tutela dei Depositi, Working Papers, n. 9, February 2005.

G. BOCCUZZI, *Rischi e Garanzie nella Regolazione Finanziaria*, Cacucci Editore, Bari, 2006.

E. FERNANDEZ-BOLLO-C. ARNAUD, Défaillance des établissements de crèdit, in Rev. Droit banc. et financ., 2000, pp. 369 ss..

C. BORIO, *Implementing a macroprudential framework: Blending boldness and realism*, keynote address for the BIS-HKMA research conference on "*Financial Stability: Towards a Macroprudential Approach*", Hong Kong SAR, 5-6 July 2010.

P. BRIERLY, *The UK Special Resolution Regime for failing banks in an international context*, Financial Stability Paper 5/2009, Bank of England, 2009.

M. BRUNNERMEIER-L.H. PEDERSEN, *Market Liquidity and Funding Liquidity*, Review of Financial Studies, 22(6), 2008, pp. 2201-2238.

W. H. BUITER – A. SIBERT, *The Iceland Banking Crisis and What to Do About It: The Lender of Last Resort Theory of Optimal Currency Areas*, Centre for Economic Policy Research (Cepr) Policy Insight 26, October, 2008, available on website address http:www.cepr.org/pubs/ Policy Insights/policy Insight 26.pdf.

A. CAMPBELL, *Issues in Cross-Border Bank Insolvency: The European Community Directive on the Reorganization and Winding-Up of Credit Institutions*, in www.imf.org/external/ np/leg/sem/2002/cdmfl/eng/campb.pdf.

F. CANNATA-M. QUAGLIARIELLO, *The role of Basel II in the Subprime Financial Crisis: Guilty or Not Guilty?*, CAREFIN Working Paper, Università Bocconi, N. 3, 2009.

J. CARMASSI-E. LUCHETTI-S. MICOSSI (with contribution from D. GROS and K. LANNOO), *Overcome too-big-too-fail. A regulatory frame work to limit moral hazard and free riding in the financial sector*, Report by the Centre for European Policy Studies (CEPS)-Assonime Task Force on Bank Crisis Resolution, Brussels, 2010.

J. CARUANA, *Basel III. Towards a safer financial system*, Speech at the 3th Santander International Banking Conference, Madrid, 15 September 2010.

R. CERCONE, *Le procedure per la crisi dei gruppi bancari*, in G. BOCCUZZI, *La crisi dell'impresa bancaria. Profili economici e giuridici*, 1998, p. 358.

R. CERCONE, *Direttiva comunitaria in materia di risanamento e liquidazione degli enti creditizi. Le eccezioni all'applicazione della lex concursus (titolo IV, artt. 20-27-30-32)*, in G. ALPA-F. CAPRIGLIONE (a cura di), *Diritto Bancario Comunitario*, UTET, Torino, 2002.

L. CERENZA-E. GALANTI, *Italy*, in M. GIOVAGNOLI-G.HEINRICH (edited by), *International Bank Insolvency. A Central Bank Perspective*, Kluver Law International, London, 1999.

M. CIHAK-E. NIER, *The Need for Special Resolution Regime for Financial Institutions: The Case of the European Union*, IMF Working Paper 09/200, International Monetary Fund, Washington D.C., 2009.

R. CONT-A. MOUSSA-A. MINCA-E. BASTO, *Too Interconnected to Fail: Contagion and Systemic Risk in Financial Networks*, Lecture presented at the IMF, Washington D.C., May 2009.

A. DE ALDISIO, *Banking crises management: an overview of the international debate*, Fondo Interbancario di Tutela dei Depositi, Working Paper n. 7, September 2003.

J.P. DEGUEE, *The Winding up Directive Finally Establishes Uniform Private International Law for Banking Insolvency Proceedings*, in European Business Review, 2004, 1, pp. 99 ss..

N. DE IANNI, *Banco di Napoli spa. 1991-2002: un decennio difficile*, Rubettino Università, 2007.

G. DE MARTINO-M. LIBERTUCCI-M. MARANGONI-M. QUAGLIARIELLO, *Countercyclical contingent capital (CCC): possible use and ideal design*, Questioni di Economia e Finanza (Occasional Papers), Banca d'Italia, Number 71, September 2010.

M. DRAGHI, *Progress and issue on the global regulatory reform agenda*, Toronto, 24 June 2010.

M. DRAGHI, Address by the Governor of the Bank of Italy at the Annual Meeting of the Italian Banking Association, Rome, 15 July 2010.

M. DRAGHI, *Statement to the IMF*, International Monetary and Financial Committee, Twenty-Third Meeting, Washington DC, 16 April 2011.

M. DRAGHI, *Modernisation of the Global Financial Architecture: Global Financial Stability*, Remarks to the Committee on Economic and Monetary Affairs European Parliament, 17 March 2010.

M. DRAGHI, *Financial Stability in the global environment? Learning the lessons from the market crisis*, Keynote Speech at IOSCO's Annual Conference, June 10 2009.

M. DRAGHI, *Challenges to Financial Stability and the Proposals of the Financial Stability Board*, 12th Conference of the ECB-CFS Research Network "*Learning from the Crisis: Financial Stability, Macroeconomic Policy and International Institutions*", *hosted by the Einaudi Institute for Economics and Finance.*

M. DRAGHI, *How to Restore Financial Stability*, Bundesbank Lecture, 16 September 2008.

M. DRAGHI, *Next steps on the road to financial stability*, Financial Times, 17 September 2010.

M. DRAGHI, Opening address at the Bank of Italy Conference "*The Mezzogiorno and economic policy in Italy*", Rome, 1 October 2010.

M. DRAGHI, *Concluding Remarks 2010*, Bank of Italy, Ordinary Meeting of Shareholders, 31 May 2011.

B. DUYGAN-BUMP-P. M. PARKINSON-E. S. ROSENGREN-G. A. SUAREZ-P. S. WILLEN, *How Effective Were the Federal Reserve Emergency Liquidity Facilities? Evidence from the Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility*, Federal Reserve Bank of Boston, Working Paper No. QAU10-3, April 2010.

R. EISENBEIS-G- KAUFMAN, *Lessons from the Demise of UK's Northern Rock and the U.S.'s Countrywide and Indymac*, in F. BRUNI-D.T. LLEWELLYN (eds), *The failure of Northern Rock - A Multidimensional Case Study*, SUERF Studies 2009/1/ Vienna.

K.C.ENGELEN, *Germany's Fight Over Bafin. The ramifications of a Bundesbank takeover*, International Economy, 2010.

EUROPEAN CENTRAL BANK, *Council Agreement on ELA*, SEC/GOVC/16/99/16,14 April 1999.

EUROPEAN CENTRAL BANK, *EU Arrangement for the provision of emergency liquidity assistance*, SEC/GovC/07/5/09a. Final – SEC/GebC/07/1/10a.final, 5 April 2007.

EUROPEAN CENTRAL BANK, *Recent developments in supervisory structures*, October 2010.

EUROPEAN COMMISSION, *Community Guidelines in State aid for rscuing and restructuring firms in difficulty ("R & R guidelines")*, Joint Cases C 244, 1 October 2004, p. 2.

EUROPEAN COMMISSION, *The application of State aid rules to measures taken in relation to financial institutions in the context of current financial crisis*, 2008/C 270/02, Official Journal of the European Union, 25 October 2008.

EUROPEAN COMMISSION, *The recapitalisation of financial institutions in the current financial crisis: limitation of aid to the minimum necessary and safeguards against undue distortions of competition*, 5 December 2008 (2009/C 10/03).

EUROPEAN COMMISSION, *Communication from the Commission on the treatment of impaired assets in the Community banking sector*, 2009/C 72/01, Official Journal of the European Union, 26 March 2009.

EUROPEAN COMMISSION, *An EU Framework for Cross-Border Crisis Management in the Banking Sector*, Communication from the Commission to the European Parliament, the Council, the European Economic and SociaL Committee, the European Court of Justice and the European Central Bank, Brussel….., COM (2009) 561/4.

EUROPEAN COMMISSION, *Bank Resolution Funds*, Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the European Central Bank, Brussels, 26.5.2010, COM (2010) 254 final.

EUROPEAN COMMISSION, Green Paper, *Corporate Governance in Financial Institutions and Remuneration Policies*, COM (2010) 284 Final, Brussels, 2 June 2010.

EUROPEAN COMMISSION, *Technical Details of a Possible EU Framework for Bank Recovery and Resolution*, DG Internal Market and Services, Working Document, January 2011.

ESFRC (European Shadow Financial Regulatory Committee), *Dealing with problem banks in Europe*, Statement No. 1, 22 June 1998.

ESFRC, *Reforming Banking Supervision in Europe*, Statement No. 23, 21 November 2005.

Federal Deposit Insurance Corporation, *Managing the Crisis: The FDIC and RTC Experience 1980-1994*, Washington DC, August 1998.

A. FAZIO, *Concluding Remarks for 1995*, Bank of Italy, Annual Report, Rome, 31 May, 1996.

Federal Deposit Insurance Corporation, *Resolutions Handbook: Methods For Resolving Troubled Financial Institutions In The United States*, Washington DC, 1998.

FEDERAL DEPOSIT INSURANCE CORPORATION, *Failed Bank List since October 2000 to October 2010*, available on website http:www.fdic.gov/bank/individual/failed/banklist.html.

FINANCIAL SERVICES AUTHORITY, *The Turner Review. A regulatory response to the global banking crisis*, March 2009.

FINANCIAL SERVICES AUTHORITY, *A regulatory response to the global banking crisis*, Discussion Paper, DP09/2, March 2009.

FINANCIAL STABILITY BOARD, *Reducing the moral hazard posed by systemically important financial institutions*, Interim Report to G20 Leaders, 18 June 2010.

FINANCIAL STABILITY BOARD, *Overview of Progress in the Implementation of the Recommendations for Stengthening Financial Stability*, Report of the Financial Stability Board to G20 Leaders, 18 June 2010.

FINANCIAL STABILITY BOARD, *The Peer Review of Spain.*

S. FITZGERALD, *The Reform of Financial Supervision in Europe*, Institute of International and European Affairs, 2009.

E. GALANTI, *The new EC Law on Bank Crisis*, International Insolvency Review, 2002, Issue 1, 49.

J.K. GALBRAITH, *A Short History of Euphoria*, Penguin Books, 1994.

S. GEBSKI, *Competition First? Application of State Aid Rules in the Banking Sector,* The Competition Law Review, Volume 6, December 2009.

G.G.H. GARCIA-R.M. LASTRA-M.J. NIETO, *Bankruptcy and reorganisation procedures for cross-border banks in the EU: Towards an integrated approach to the reform of the EU safety net*, Journal of Financial Regulation and Compliance, Vol. 17, N. 3, Emerald, Bingley, 2009.

M. GOODFRIEND, *Central Banking in the Credit Turmoil: An Assessment of Federal Reserve Practice*, Carnegie Mellon University And National Bureau of Economic Research, August 30, 2010.

C. GOODHARTH, *How should we regulate bank capital and financial products? What role for "living wills"*, in The Future of Finance, The LSE Report, 2010.

C.A.E. GOODHART-D.SCHOENMAKER, *Fiscal Burden Sharing in Cross-Border Banking Crises*, International Journal of Central Banking, Vol. 5, No.1, 2009.

H. HANNOUN, *The Basel III Capital Framework: a decisive breakthrough*, Speech held at BOJ-BIS Level Seminar on Financial Regulatory Reform: Implication for Asia and the Pacific, Hong Kong SAR, 22 November 2010.

S. HANSON-A. KASHYAP-J.STEIN, *A macroprudential approach to financial regulation*, Journal of Economic Perspectives, 2010.

M.E.HERTZ – C. MERMET, *French reform of supervision of the financial system*, IFLR 1000, Bernard Hertz Bèjot, Paris.

HM TREASURY, *A new approach to financial regulation: judgement, focus and stability*, July 2010.

HM TREASURY, *A new approach to financial regulation: building a stronger system*, 17 February 2001.

HM, *A new approach to financial regulation: the blueprint for reform*, 16 June 2011.

T.F. HUERTAS, *Living Wills: How can the Concept be Implemented,* remarks before the Conference "Cross-Border Issues in Resolving Systemically Important Financial Institutions", at Wharton School of Management, University of Pennsylvania, February, 12, 2010.

E. HUPKES, *Insolvency - why a special regime for banks, in Current Developments in monetary and financial law*, Vol. 3, IMF, 2003.

E. HUPKES, *Special Bank Resolution and shareholders' rights: balancing competing interests*, Journal of Financial Regulation and Compliance, Vol. 17, No. 3, Emerald, Bingley, 2009.

INTERNATIONAL MONETARY FUND, *Resolution of Cross-Border Banks. A Proposed Framework for Enhanced Coordination*, June 11, 2010.

INTERNATIONAL MONETARY FUND, *Financial Sector Taxation. The IMF's Report to the G-20 and Background Material*, Edited by Stijn Claessens, Michael Keen, Ceyla Pazarbasioglu, September 2010.

INTERNATIONAL MONETARY FUND-WORLD BANK, *An Overview of the Legal, Institutional, and Regulatory Framework for Bank Insolvency*, April, 2009.

J. KAY, *Narrow Banking. The reform of Banking Regulation*, CSFI Report, Centre for the Study of Financial Innovation, London, September 2009.

M. KING, Speech held at the Lord Mayor's Banquet for Bankers and Merchants of the City of Lonson at the Mansion House, available on the website http://www.bankofengland.co.uk./publications/speechs/2009/speech394.pdf.

M. KING A., "Speech by Mervyn King, Governor" to Scottish Business Organisations, Edinburgh, October 2009.

M. KING, *Mervyn King blasts banks for exploiting customers*, Guardian.co.uk, 5 March 2011.

D.L. KOHN, Testimony Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, Washington, D.C., March 5, 2009.

L. KOTLIKOFF, *Jimmy Stewart is Dead: Ending the World's Ongoing Financial Plague with Limited Purpose Banking*, Wiley, 2010.

P. KRUGMAN, *Geithner plan arithmetic*, New York Times, March 23, 2009, available on http://krugman.blogs.nytimes.com/2009/03/23/geithner-plan-arithmetic/.

C.P. KINDLEMBERGER-R.ALIBER, *Manias, Panics, and Crashes. A History of Financial Crises*, Hoboken, NJ: John Wiley & Sons, 2005.

JRC reports at http://ec.europa.eu/internal_market/bank/docs/guarantee/risk-based-report_en.pdf and http://ec.europa.eu/internal_market/bank/docs/guarantee/2009_06_risk-based-report_en.pdf.

C. LAGARDE, *France's plan for ensuring the financing and restoring confidence*, October 13, 2008.

C. LAMANDA, *A proposal on European Crisis Management*, in *Preventing and managing future crises. New Regulation, Resolution Funds and Deposit Insurance as tool for European banking groups*, Bancaria Editrice, 2010.

R. LEVINE, *Finance and Growth: Theory and Evidence*, Handbook of Economic Growth, 2004.

D.T. LLEWELLYN, *Post crisis regulatory strategy: where is Pillar 4?*, Bancaria Editrice, n. 6, 2011.

J. LIPSKY, *Towards an International Framework for Cross Border Resolution*, delivered at the ECB and its Watchers Conference XII Frankfurt, Germany, July 9, 2010.

A. LOCARNO, *L'impatto di Basilea III sull'economia italiana*, Banca d'Italia, Questioni di Economia e Finanza, n. 88, 2011.

D. MASCIANDARO, *Divide et Impera: Financial Supervision Unification and the Central Banking Fragmentation Effect*, in European Journal of Political Economy, 2007, pp. 285-315.

R. MASERA, *The great financial crisis. Economics, Regulation and Risk*, Bancaria Editrice, 2009.

R. MASERA, *The Basel III Regulatory Framework: A Review*, Paper presented at the Conference on "La crisi finanziaria e la gestione dei rischi negli intermediari finanziari, Centro Studi I Cappuccini, San Miniato, 13 May 2011.

R. MASERA, *Taking the moral hazard out of banking: the next fundamental step in financial reform*, working paper, University G. Marconi, April 2011.

R. MASERA-G. MAZZONI, *A proposal for a Special Resolution Fund (SRF) for SIFIs (Systemically Important Financial Institutions) financed through risk-sensitive fees. A market based measure of systemic risk*, University G. Marconi, Working Paper, 2011.

McDONALD-ROBINSON, *A Colossal Failure of Common Sense: The Inside Story of the Collapse of Lehman Brothers*, Crown Business, New York, 2010.

McKINSEY&COMPANY, *Basel III and European Banking: its impact, how banks might respond, and the challenges of implementation*, EMEA Banking, November 2010.

G. MINERVINI, *La crisi del Banco di Napoli e gli interventi della Fondazione. Alcuni documenti*, in Dieci anni dell'Istituto Banco di Napoli. Fondazione. 1991-2001, Napoli, 2002.

F.MODIGLIANI-M. MILLER, M., *The cost of Capital, Corporation Finance and the Theory of Investment*, *American Economic Review*, 1958.

MODIGLIANI-M. MILLER, *Corporate Income taxes and the cost of capital: a correction*, *American Economic Review*, 1963.

M. MOORE, *Contingent Capital and Statutory Bail-in Within a Crisis Prevention/Crisis Resolution Framework*, Speech held at the Workshop "*How promising are contingent capital instruments and bail-ins to strengthen financial stability?*, Brussels: Bruegel, 11 February 2011.

M.J. NIETO-L. WALL, *Preconditions for a Successful Implementation of Supervisors' Prompt Corrective Action: Is there a Case for a Banking Standard In the European Union?*, Working Paper 2006-27, Federal Reserve Bank of Atlanta, December 2006.

OECD, *OECD Principles of Corporate Governance*, revised April 2004, originally issued June 1999, available at www.oecd.org/dataoecd/32/18/31557724.pdf.

OECD principles, OECD, *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles, 2010,* available at www.oecd.org/dataoecd/53/62/44679170.pdf.

M. ONADO, *I nodi al pettine. La crisi finanziaria e le regole non scritte*, Laterza, 2011 (2009?).

L. PANZANI, *L'insolvenza dei gruppi di società*, Università di Buenos Aires, II Congreso International de Derecho Comercial y de los Negocios, Buenos Aires, 1-4 June 2009.

C. PAZARBASIOGLU-J. ZHOU-V.LE LESLE'-M. MOORE, *Contingent Capital: Economic Rationale and Design Feature*, IMF Staff Discussion Note, January 25, 2011.

M. PELLEGRINI, *Direttiva comunitaria in materia di risanamento e liquidazione degli enti creditizi. Introduzione al Titolo IV (artt. 20-27-30-32)*, in G. ALPA-F. CAPRIGLIONE (a cura di), *Diritto Bancario Comunitario*, UTET, Torino, 2002.

R.J. PHILLIPS-A. ROSELLI, *Narrow banking: a Proposal to Avoid the Next Taxpayer Bailout of the Financial System*, in ApertaContrada. Riflessioni su Società, Diritto, Economia, avalaible on website www.apertacontrada.it, 2009.

D. POLK & WARDWELL LLP-MCKINSEY & CO, *Credible Living Wills: The First Generations*, April 25, 2011.

R. A. POSNER, *The Crisis of Capitalist Democracy*, Harvard University Press, 2010.

A. PROFUMO, *Una soluzione più efficace della supertassa*, Il Sole 24 Ore, 13 luglio 2010.

N. ROUBINI, The rising risk of a systemic financial meltdown: the twelve steps to financial disaster, RGE Monitor, February 5, 2008.

N. ROUBINI-S. MIHM, *Crises Economics. A crash course in the Future of Finance*, Penguin Audiobooks, 2010.

G. SABATINI, *The management of bank crisis in the new European supervisory architecture*, Siena, April 1-2, 2011.

F. SACCOMANNI, *L'Unione Europea di fronte alla crisi globale: le implicazioni per le banche, la finanza e la politica economica*, Speech at the EU Berliner Gesprache, Bundesministerium der Finanzen, Berlin, 8 February 2011.

P. SAVONA, *C.P. Kindleberger. I Momenti d'oro dell'economia*, Collana a cura di P. Savona, Luiss University Press, 2009.

SHEARMAN & STERLING, *Financial Institutions Recovery and Resolution Plans*, Client Publication, May 26, 2010.

J. SHENN, *Fannie, Freddie Subprime Spree May Add to Bailout*, Bloomberg.com, 22 September 2009.

D. SMITH, *The age of instability. The Global Financial Crisis and What Comes Next. The Global Financial Crisis and What Comes Next,* Profile Books Ltd, 2010.

M. SALTMARSH, *Iceland to repay nations for failed banks' deposits*, in "The New York Times", 29 August 2009, p. B2.

SENIOR SUPERVISORS GROUP, *Risk Management Lessons from the Global Banking Crisis of 2008*, October 2009.

R. SHILLER, *Irrational Exuberance*, Princeton University Press, Second Edition, 2005.

R. SHILLER, *The Subprime Solution: How Today's Global Financial Crisis Happened, and What to Do about it*, Princeton University Press, 2008.

A. R. SORKIN, *Too Big To Fail. The Inside Story of How Wall Street and Washington Fought to Save the Financial System*, Penguin Group, 2009.

J. STIGLITZ, *Freefall. America, Free Markets, and the Sinking of the World Economy,* W.W. Norton & Co., 2010.

L. A. STOUT, Risk, *Speculation, and OTC Derivatives: An Inaugural Essay for Convivium*, in Accounting, Economics, and Law, A Convivium, Volume 1, Issue 1, 2011.

N.N. TALEB, *Robustezza e fragilità. Che fare? Il Cigno Nero tre anni dopo*, Il Saggiatore, 2010.

N.N. TALEB, *The black Swan: The impact of the Highly Improbabile*, Random House, 2007.

A. M. TARANTOLA, *Strengthening financial stability. The contribution of deposit insurance*, Rome, 2010.

A.M. TARANTOLA, *Verso una nuova regolamentazione finanziaria*, Speech at the "Scuola di Alta Formazione dell'I.P.E. – Inaugurale Conference of the Master in Advanced Finance, Neaples, 21 January 2011.

P. TUCKER, *The Reportoire of Official Sector Interventions in the Financial System: Last Resort, Market-Making, and Capital*, Speech at the 2009 International Conference Financial System and Monetary Policy Implementation, Bank of Japan, 27-28 May, 2009.

P. TUCKER, *The crisis management menu*, Intervention at SUERF, CEPS and Belgian Financial Forum Conference: *Crisis Management at the Cross-Road*, Brussels, 16 November 2009.

P. TUCKER, *The debate on financial system resilience: macroprudential instruments*, Speech at Barclays Annual Lecture, London, 22 October 2009.

P. TUCKER, *Shadow banking, capital markets and financial stability*, Remarks at a BGC Partner Seminar, London, 21 January 2010.

P. TUCKER, *Resolution of large and complex financial institution – the big issue*, European Commission Conference "Building a Crisis Management Framework for the Internal Market", 19 March 2010.

A. TURNER, *What banks do? Why do credit booms and busts occur and what can public policy do about it?*, in *The Future of Finance*, The London School of Economics and Political Science, 2010, available on futureoffinance.org.uh.

V. TUSINI COTTAFAVI, *La liquidazione coatta amministrativa*, in G. BOCCUZZI, *La crisi dell'impresa bancaria. Profili economici e giuridici*, Giuffrè, Milano, 1999.

UNCITRAL, *Model Law on Cross-Border Insolvency with Guide to Enactment*, United Nations Publications, New York, 1999.

UNCITRAL, *Legislative Guide on Insolvency Law*, United Nations Publications, Vienna, 2005.

UNCITRAL, *Legislative Guide on Secured Transaction. Terminology and recommendations*, United Nations Publications, Vienna, 2009.

UNCITRAL, *Practice Guide on Cross-Border Insolvency Cooperation*, July 2009. Available on http:/www.uncitral.org/uncitral/index.html.

UNICREDIT GROUP, Forum on Financial Cross-Border Groups, *Cross-Border banking in Europe: what regulation and supervision?*, Discussion Paper, N. 1, March 2009.

I. VISCO, *Rebalancing Trade and Capital Flows*, Panel at Global Economic Symposium, Istambul, 27-29 September 2010.

I. VISCO, *Key issues for the success of macroprudential policies*, Speech at the Policy Panel on the Macroprudential Policy Framework, BoK-BIS Conference, Seoul, 18 January 2011.

I. VISCO, *La governance economica europea: riforma e implicazioni*, Speech held at Università dell'Aquila on 8 March 2011 for the ventennale of the Faculty of Economics.

P. VOLCKER, *Statement before the Senate Committee on Banking, Housing and Urban Affairs of the United States,* Hearing on "*Prohibiting Certain High-Risk Investment Activities by Banks and Bank Holding Companies*", 2 February 2010.

S.B. WADHWANI, *What mix of monetary policy and regulation is best for stabilising the economy?*, in The *Future of Finance*, 2010.

S. WALTER, *Basel III and Financial Stability*, Speech at the 5th Biennal Conference on Risk Management and Supervision, Financial Stability Institute, Bank for International Settlements, Basel, 3-4 November 2010.

S. WALTER, *Basel III: Stronger Banks and a More Resilient Financial System, Conference on Basel III,* Financial Stability Institute, Basel, 6 April 2011.

A. WATKINS, *The AIG Bailout: Constraining the FED's Discretion*, AndreewWatkins. doc, October 2010.

P. WEISS, *Treasury Department Temporary Guarantee Program for Money Market Mutual Funds*, October, 2008.

M. WOLF, *Basel: the mouse that did not roar*, Financial Times, September 15, 2010.

QUADERNI PUBBLICATI

n. 1 – Francesco Capriglione, *Evoluzione tecnica e disciplina giuridica dell'intermediazione finanziaria,* ottobre 1985 (esaurito).

n. 2 – Francesco Carbonetti, *Moneta,* dicembre 1985.

n. 3 – Pietro De Vecchis, *L'istituto di emissione,* febbraio 1986 (esaurito).

n. 4 – Giuseppe Carriero, *Governo del credito e Regioni a statuto speciale: il quadro istituzionale,* aprile 1986.

n. 5 – Giorgio Oppo, *Una svolta dei titoli di massa (il progetto Monte Titoli),* aprile 1986.

n. 6 – Luigi Desiderio, *Le norme di recepimento della Direttiva comunitaria n. 780/77 in materia creditizia,* maggio 1986 (esaurito).

n. 7 – Giorgio Sangiorgio - Francesco Capriglione, *La legge bancaria: evoluzione normativa e orientamenti esegetici,* giugno 1986.

n. 8 – Vincenzo Mezzacapo, *L'attività bancaria nell'ambito dei movimenti di capitali nella CEE,* giugno 1986 (esaurito).

n. 9 – Francesco Capriglione, *Le gestioni bancarie di patrimoni mobiliari,* luglio 1986.

n. 10 – Francesco Carbonetti, *I cinquant'anni della legge bancaria,* settembre 1986.

n. 11 – *La legge bancaria,* ottobre 1986.

n. 12 – Carmine Lamanda, *L'evoluzione della disciplina del controllo sul sistema creditizio dalla legge bancaria ad oggi,* dicembre 1986 (esaurito).

n. 13 – Giovanni Imperatrice, *L'accertamento dell'illecito amministrativo nel diritto valutario e nel diritto tributario,* marzo 1987.

n. 14 – Giorgio Sangiorgio, *Profilo istituzionale della disciplina pubblicistica del credito,* maggio 1987.

n. 15 – Francesco Capriglione, (a cura di) *La disciplina comunitaria del credito al consumo,* luglio 1987.

n. 16 – Carlo Taglienti, *Il credito documentario: nozione, fondamento, problematica,* settembre 1987.

n. 17 – Pietro De Vecchis, *Aspetti legali delle crisi bancarie in Italia,* gennaio 1988.

n. 18 – Vincenzo Mezzacapo, *Il mercato secondario organizzato dei titoli emessi o garantiti dallo Stato,* agosto 1988.

n. 19 – Francesco Carbonetti, *Il controllo della Banca d'Italia sulle emissioni di titoli atipici,* ottobre 1988.

n. 20 – Francesco Capriglione, *Le polizze di credito commerciale,* dicembre 1988.

n. 21 – Francesco Capriglione, *La responsabilità penale del banchiere: evoluzione giurisprudenziale e prospettive di riforma,* dicembre 1989 (esaurito).

n. 22 – Marcello Condemi, *Le sanzioni amministrative bancarie e la giurisprudenza della Corte d'Appello di Roma,* aprile 1991.

n. 23 – Marco Mancini - Marino Perassi, *I trasferimenti elettronici di fondi,* maggio 1991.

n. 24 – Enrico Galanti, *L*a crisi degli enti creditizi nella giurisprudenza: la liquidazione coatta amministrativa, giugno 1991.

n. 25 – Francesco Capriglione, *Note introduttive alla disciplina delle s.i.m. e dell'organizzazione dei mercati finanziari,* giugno 1991.

n. 26 – AA.VV., *La ristrutturazione della banca pubblica e la disciplina del gruppo creditizio,* gennaio 1992.

n. 27 – Giorgio Sangiorgio, *Le Autorità creditizie e i loro poteri,* marzo 1992.

n. 28 – Francesco Capriglione, *Il recepimento della seconda direttiva Cee in materia bancaria. Prime riflessioni,* febbraio 1993.

n. 29 – *Il Sistema dei pagamenti. Atti del Convegno giuridico* (Perugia S.A.Di.Ba., 23-24 ottobre 1992), settembre 1993.

n. 30 – Olina Capolino, *L'amministrazione straordinaria delle banche nella giurisprudenza,* ottobre 1993.

n. 31 – P. Ferro-Luzzi - P. G. Marchetti, *Riflessioni sul gruppo creditizio,* dicembre 1993.

n. 32 – *Testo Unico delle leggi in materia bancaria e creditizia,* marzo 1994.

n. 33 – *Testo Unico delle leggi in materia bancaria e creditizia. The 1993 Banking Law,* marzo 1994.

n. 34 – Giuseppe Carriero, *Struttura ed obiettivi della legge sui fondi immobiliari chiusi,* novembre 1994.

n. 35 – Lucio Cerenza, *Profilo giuridico del sistema dei pagamenti in Italia,* febbraio 1995.

n. 36 – Giovanni Castaldi, *Il riassetto della disciplina bancaria: principali aspetti innovativi,* marzo 1995.

n. 37 – Vincenzo Pontolillo, *L'evoluzione della disciplina dell'attività di emissione di valori mobiliari,* giugno 1995.

n. 38 – O. Capolino - G. Carriero - P. De Vecchis - M. Perassi, *Contributi allo studio del Testo Unico delle leggi in materia bancaria e creditizia,* dicembre 1995.

n. 39 – Francesco Capriglione, *Cooperazione di credito e Testo Unico bancario,* dicembre 1995.

n. 40 – Marino Perassi, *L'attività delle banche in "securities" e la disciplina dei contratti-derivati in Giappone,* aprile 1996.

n. 41 – Enrico Galanti, *Norme delle autorità indipendenti e regolamento del mercato: alcune riflessioni,* novembre 1996.

n. 42 – M. Perassi - R. D'Ambrosio - G. Carriero - O. Capolino - M. Condemi, *Studi in materia bancaria e finanziaria,* novembre 1996.

n. 43 – Convegno *Per un diritto della concorrenza* (Perugia, giugno 1996), dicembre 1996.

n. 44 – *Crisi d'impresa, procedure concorsuali e ruolo delle banche,* marzo 1997.

n. 45 – Donatella La Licata, *La cessione di rapporti giuridici "individuabili in blocco" nell'art. 58 del T.U. bancario,* aprile 1997.

n. 46 – Paolo Ciocca - Antonella Magliocco - Matilde Carla Panzeri, *Il trattamento fiscale dei rischi sui crediti,* aprile 1997.

n. 47 – P. De Vecchis - G.L. Carriero - O. Capolino, M. Mancini, R. D'Ambrosio, *Studi in materia bancaria e finanziaria 1996,* settembre 1997.

n. 48 – Giuseppe Carriero, *Il credito al consumo,* ottobre 1998.

n. 49 – *Fondamento, implicazioni e limiti dell'intervento regolamentare nei rapporti tra intermediari finanziari e clientela*, marzo 1999.

n. 50 – A. Magliocco - D. Pitaro - G. Ricotti - A. Sanelli, *Tassazione del risparmio gestito e integrazione finanziaria europea*, settembre 1999.

n. 51 – ENRICO GALANTI, *Garanzia non possessoria e controllo della crisi di impresa: la* floating charge *e l'*administrative receivership*,* gennaio 2000.

n. 52 – *Bankruptcy Legislation in Belgium, Italy and the Netherlands*, (Brussels, 7 July 2000), giugno 2001.

n. 53 – VINCENZO TROIANO, *Gli Istituti di moneta elettronica,* luglio 2001.

n. 54 – STEFANO CAPPIELLO, *Prospettive di riforma del diritto di recesso dalle società di capitali: fondamento e limiti dell'autonomia statutaria,* luglio 2001.

n. 55 – BRUNA SZEGO, *Il* venture capital *come strumento per lo sviluppo delle piccole e medie imprese: un'analisi di adeguatezza dell'ordinamento italiano,* giugno 2002.

n. 56 – AA.VV., *Diritto Societario e Competitività in Italia e in Germania*, luglio 2003.

n. 57 – GIANMARIA MARANO, *I patrimoni destinati in una prospettiva di analisi giuseconomica*, giugno 2004.

n. 58 – ENRICO GALANTI E MARIO MARANGONI, *La disciplina italiana dei* Covered Bond, giugno 2007.

n. 59 – MARCO MANCINI, VINCENZA PROFETA E NICOLA DE GIORGI, *La Centrale d'Allarme Interbancaria nella disciplina sanzionatoria dell'assegno*, settembre 2007.

n. 60 – MARCELLO CONDEMI E FRANCESCO DE PASQUALE, *Lineamenti della disciplina internazionale di prevenzione e contrasto del riciclaggio e del finanziamento del terrorismo*, febbraio 2008.

n. 61 – BRUNA SZEGO, *Le impugnazioni in Italia: perchè le riforme non hanno funzionato?*, luglio 2008.

n. 62 – RENZO COSTI E FRANCESCO VELLA, *Banche, governo societario e funzione di vigilanza*, settembre 2008.

n. 63 – MARCO MANCINI E MARINO PERASSI, *Il nuovo quadro normativo comunitario dei servizi di pagamento. Prime riflessioni*, dicembre 2008.

n. 64 – ENRICO GALANTI, *Discrezionalità delle autorità indipendenti e controllo giudiziale*, giugno 2009.

n. 65 – DAVID PITARO, *Le disposizioni italiane di contrasto all'elusione fiscale internazionale*, luglio 2009.

n. 66 – CRISTINA GIORGIANTONIO, *Le riforme del processo civile italiano tra* adversarial system *e* case management, settembre 2009.

n. 66en – CRISTINA GIORGIANTONIO, *Civil procedure reforms in Italy: concentration principle, adversarial system or case management?*, september 2009.

n. 67 – OLINA CAPOLINO E RAFFAELE D'AMBROSIO, *La tutela penale dell'attività di Vigilanza*, ottobre 2009.

n. 68 – GIUSEPPE BOCCUZZI, *I sistemi alternativi di risoluzione delle controversie nel settore bancario e finanziario: un'analisi comparata*, settembre 2010.

n. 69 – AA.VV., *Insolvency and Cross-border Groups. UNCITRAL Recommendations for a European Perspective?*, febbraio 2011.

n. 70 – BRUNO DE CAROLIS, *L'Arbitro bancario finanziariocome strumento di tutela della trasparenza*, giugno 2011.

I Quaderni sono disponibili su Internet all'indirizzo www.bancaditalia.it, a partire dal n° 47.

Printed by the
Printing and Publishing Division of the
Bank of Italy, Rome, December 2011