BANKING & PROJECT FINANCE

BRRD

Under pressure

The rescue of two regional Italian lenders was carried out as a liquidation, not a resolution. It could undermine the credibility of EU rules on bank failures

The liquidation of Veneto Banca and Banca Popolare di Vicenza (the Venetian banks) in June 2017 ended a crisis that had been lingering since the failure of the banks' attempted initial public offering in July 2016.

The key features of the liquidation scheme include (i) a partial transfer of the businesses of the banks to Intesa San Paolo; (ii) the entry of the banks into insolvency pursuant to an ad hoc liquidation decree (the Italian Decree); and, (iii) a cash contribution of €4.785 billion ($5.7 billion) by the Italian state to Intesa to neutralise the impact of the acquisition on its regulatory capital and compensate it for restructuring costs.

This scheme was hailed as a success by EU and Italian authorities, as it preserves the continuity of services to customers and avoids destabilising the Veneto region, avoids a bail-in of senior creditors and depositors, and provides for the indemnification of holders of subordinated debt who are in fact retail depositors.

Two categories of stakeholders, however, did not fare as well. Shareholders and institutional subordinated debtholders remain in the existing banks (the so-called bad banks), with uncertain chances of recovery. And Italian taxpayers are bearing the full cost of the cash contributions to Intesa, with no possible upside. Indeed, by contrast with the Italian state's contribution to Monte dei Paschi di Siena, which took the form of a capital injection, its contribution to Intesa is a straightforward cash payment accounted for as income and intended not as an investment in the possible recovery of the banks' business but as a mere incentive for Intesa to acquire those businesses.

The very purpose of the Banking Union framework – and particularly the Bank Recovery and Resolution Directive (BRRD) and Single Resolution Mechanism Regulation (SRMR) – was to ensure that taxpayers would suffer the consequences of bank failures to the minimum extent possible and only as a last resort.

The liquidation of the Venetian banks results in the exact opposite: taxpayers suffer the largest burden, with no possible upside, and are in a worse position than shareholders, subordinated debtholders and senior creditors.

The question is whether this outcome was made possible by a

1 MINUTE READ

There is one key takeaway from the recent liquidation of two struggling regional banks in Italy. While the increasing level of bad loans is one concern, the main issue is that it has outlined the limitations of the EU's bank resolution framework.

It also opens a potential legal loophole when it comes to allowing individual member states to use their national insolvency rules to avoid applying bail-in rules, which came into effect in the mid-2010s in response to the financial crisis.

Veneto Banca and Banco Popolare di Vicenza's bailout raises concerns regarding the credibility of the BRRD framework, especially when it comes to ending the practice of taxpayer-funded bank cleanups.

loophole within the BRRD/SRMR framework, or resulted from a circumvention of that framework by the relevant authorities.

The BRRD/SRMR framework

Resolution v insolvency

The Venetian Banks are considered significant eurozone banks under the Banking Union framework, and are therefore subject to the direct supervision of the European Central Bank (ECB) and the resolution powers of the Single Resolution Board (SRB).

Under the SRMR, the SRB may place entities in resolution when the following conditions are met:

(a) The entity is failing or likely to fail.

(b) When it comes to timing and other relevant circumstances, there is no reasonable prospect that any alternative private sector measures, including supervisory action, would prevent its failure within a reasonable timeframe.

(c) A resolution action is necessary in the public interest, ie:

(A) It is necessary for the achievement of, and is proportionate to one or more resolution objectives: ((i) ensuring continuity of critical functions; (ii) avoiding significant adverse effects on financial stability, in particular by preventing contagion; (iii) protecting public funds by minimising reliance on extraordinary public financial support; (iv) protecting covered depositors; and, (v) protecting client funds and assets.

(B) Winding up of the entity under normal insolvency proceedings would not meet those objectives to the same extent.

The SRMR does not specify which actions the SRB must take if the first two conditions are met but the third condition is not (ie resolution is found unnecessary in the public interest). But it can be inferred from the BRRD/SRMR that, in such a case, the relevant institutions should be liquidated under normal insolvency proceedings pursuant to their national law. Indeed, a failing institution should in principle be liquidated under normal insolvency proceedings, which should always be considered before resolution tools are applied (recitals 45 and 46 BRRD).

Resolution actions, which can result in significant infringements of shareholders' and creditors' property rights, are the exception, and can only be taken if they achieve public interest objectives to a greater extent than normal insolvency proceedings, in particular by avoiding disruption of critical functions and preserving financial stability, thereby justifying such infringements (recitals 45 and 49 BRRD).

Public support in resolution

Since one of the main purposes of the BRRD/SRMR is to minimise the impact of bank failures on taxpayers, the framework contemplates only limited circumstances where public support can be provided to an institution that is failing or likely to fail: precautionary recapitalisation or government financial stabilisation tools (GFSTs), each subject to strict conditions.

Precautionary recapitalisation

An institution that requires public support is deemed to be failing or likely to fail for purposes of the BRRD/SRMR, except if the relevant public support satisfies the conditions of a precautionary recapitalisation, ie *inter alia:* (i) it is required to remedy a serious disturbance in the economy of a member state and preserve financial stability; (ii) it takes the form of a capital injection on terms that do not confer an advantage to the institution; (iii) it is granted to an institution that is solvent and is not used to cover existing or imminent losses; and, (iv) it is limited to injections necessary to address a capital shortfall established in European Banking Authority, ECB or national stress tests or asset quality reviews.

GFSTs

Member states are entitled to provide public support for the purpose of participating in the resolution of an institution through two types of GFSTs: public ownership tool or temporary public ownership tool. GFSTs can be provided only if (i) an extraordinary systemic situation arises; (ii) they are used as a last resort after all other resolution tools have been assessed and exploited to the maximum extent practicable; and, (iii) shareholders and creditors have been bailed in for an amount not less than eight percent of total liabilities including own funds of the institution.

The liquidation of the Venetian banks

Considering the above legal framework, only four solutions were compatible with the BRRD/SRMR.

- ***A precautionary recapitalisation (the Piraeus/MPS solution)***: The EU institutions determined that the Venetian banks were not eligible for this solution, on the basis that additional private support was required to avoid having the Italian state cover possible upcoming losses, and that such private support was not available.
- ***A resolution under the BRRD/SRMR - the application of resolution tools together with sale of assets to a private investor, without public support (the Banco Popular solution):*** This was not satisfactory, because Intesa required as a condition to acquiring the banks' businesses to be fully immunised from the impact of the acquisition on its core equity tier 1 (CET1) capital, as a result of which public support was required.
- ***A resolution under the BRRD/SRMR: the application of resolution tools together with sale of assets to a private investor, with public support in the form of GFSTs***: This solution would have required the bail-in of at least eight percent of the banks' equity and liabilities, ie because of the structure of their balance sheets, a bail-in of senior liabilities.
- ***Entry into normal insolvency proceedings under Italian law, provided***

EU and Italian authorities chose a fifth option: placement in what qualifies as resolution although labelled mandatory administrative liquidation, together with public support

that resolution of the banks was determined by the SRB to not be in the public interest.

On June 23 2017, the SRB confirmed the ECB's assessment according to which the Venetian banks were failing or likely to fail and noted that no private sector solutions were available. However, it declared that resolution was not in the public interest, on the basis that (i) the banking functions performed by the banks were not critical since provided to a limited number of third parties and capable of being replaced in an acceptable manner and within a reasonable timeframe; (ii) the failure of the banks would not be likely to result in significant adverse effects on financial stability due to low interconnectedness; and, (iii) normal Italian insolvency proceedings would achieve the resolution objectives to the same extent as resolution, notably insofar as they would ensure a comparable degree of protection for depositors, investors, other customers, clients' funds and assets. As a result, the SRB concluded that the banks would be liquidated under normal Italian insolvency proceedings.

On June 25, the Italian government adopted the Italian Decree, which introduces extraordinary and urgent measures in relation to the banks, subject to approval by the European Commission under the state aid regime including (i) the forced transfer, by the insolvency administrator, of the businesses of the banks (excluding subordinated debt and outstanding litigation claims) to a bidder to be identified in accordance with a competitive process; and, (ii) public support by the Italian state to such bidder in the amount of €4.785 billion as well as ancillary guarantees by the state in favour of the bidder and the banks for up to €11.2 billion.

The recitals of the Italian Decree state that:

'*The placement of [the Venetian banks] under insolvency proceedings without public support measures would lead to a destruction of value of their business, with significant losses for senior creditors, as well as a sudden interruption in the provision of credit to businesses and families, with significant adverse effects on the local economy, social fabric and employment.*'

As a result, there is 'extraordinary necessity and urgency to adopt measures allowing the orderly exit of [the Venetian Banks] from the market and avoiding a significant economic disturbance in the [Veneto region]'.

On June 25, the Commission confirmed that the Italian Decree was in line with EU state aid rules. Therefore, while on the face of it the SRB decision indicates that it appears to have chosen option four, EU and Italian authorities chose a fifth option: placement in what effectively qualifies as resolution although labelled mandatory administrative liquidation (*liquidazione coatta amministrativa*), together with public support (to the banks and Intesa), but without applying the required bail-in of senior creditors under the eight percent rule.

Public support to an entity in liquidation is, by the Commission's own standards, incompatible with state aid rules, given the BRRD/SRMR framework and the existence of the bail-in tool

Specifically, the Italian Decree shows that the banks did not in fact enter normal insolvency proceedings as contemplated by option four.

Normal insolvency proceedings

Firstly, it seems fairly obvious that the enactment of an ad hoc and *ex post facto* legislative decree that provides for public support (in the form of a €4.5 billion cash contribution by the state and an additional €11.2 billion in state guarantees) to facilitate the purchase of a failing bank's business does not qualify as normal insolvency proceedings.

Indeed, the notion of normal insolvency proceedings, as used in the BRRD/SRMR framework, refers to a scenario which is the most destabilising for the financial system and therefore implies the absence of any form of public support (recitals 45 and 49 BRRD). If public support were allowed in insolvency, insolvency would never be destabilising and thus resolution would never be required.

This interpretation is confirmed by the Commission's own 2013 Banking Communication, which, while it allows the provision of public support to an entity in liquidation, indicates that this type of public support qualifies as compatible aid only for as long as there is no resolution framework in place. It reads:

'*The Commission recognises that, due to the specificities of credit institutions and in the absence of mechanisms allowing for the resolution of credit institutions without threatening financial stability, it might not be feasible to liquidate a credit institution under ordinary insolvency proceedings. For that reason, State measures to support the liquidation of failing credit institutions may be considered as compatible aid.*'

Given the entry into force of the BRRD/SRMR in 2014 and of the bail-in tool in 2016, public support to an entity in liquidation is, by the Commission's own standards, incompatible with state aid.

More generally, the very purpose of the BRRD/SRMR is to minimise reliance on taxpayer funds by limiting the circumstances in which member states may provide support to failing banks, to achieve the overarching goal of the Banking Union framework, which is to avoid having bank failures degenerate into sovereign and therefore eurozone crises. Allowing member states to continue to provide public support that is prohibited or subject to prior bail-in of senior liabilities under the BRRD/SRMR to significant EU institutions, under national insolvency laws, not only undermines that objective but deprives the BRRD/SRMR from any useful effect.

Secondly, under the BRRD/SRMR, normal insolvency proceedings refer to the insolvency proceedings existing at the time of the placement in resolution. This is evidenced by the manner in which the no creditor worse off (NCWO) principle operates. This principle requires shareholders and creditors to receive, in resolution, 'at least as much as what they would have received if the institution under resolution had been wound up under normal insolvency proceedings at the time when the decision [of placement in resolution] was taken' (article 74 BRRD). If normal insolvency proceedings referred to insolvency proceedings that could be adopted *ex post facto* by national legislators rather than to insolvency proceedings existing at the time of resolution, shareholders and creditors would not benefit from any protection under the NCWO principle, which would be deprived from any practical effect. In addition, shareholders and creditors would not be in a position to make investment decisions as they would have no visibility as to what the default situation (ie treatment in insolvency) would be. The Italian Decree, which is an ad hoc scheme adopted after the SRB's decision, can therefore not qualify as normal insolvency proceedings for the purposes of the BRRD/SRMR.

Finally, the Italian Decree does not qualify as insolvency proceedings insofar as it is de facto a resolution regime. Indeed, it provides for the forced sale of specified assets and liabilities and the deactivation of ordinary protections such as shareholder and third-party consents, thereby replicating features of the sale of business and bridge institution tools provided in the BRRD/SRMR (which are expressly incorporated by reference in the Italian Decree). Such a forced sale is made to a specified buyer identified ex ante by the resolution authorities, as is the case pursuant to the sale of business tool. Indeed, while the Italian Decree does not name Intesa as the buyer but only refers to the 'competitive bidder,' the amount of the cash contributions set forth in the Italian Decree corresponds to the exact amount needed to immunise Intesa's CET1– and Intesa's own press release of June 21 stated that it was ready to purchase the Venetian banks' assets subject to the adoption of an appropriate legislative framework ensuring full CET1 immunisation. The recitals of the Italian Decree indicate that its objective is not to provide for the ordinary liquidation of the banks but the exact opposite, ie the adoption of extraordinary, urgent and ad hoc measures required to ensure the orderly resolution of the banks, which would be impossible under ordinary liquidation provisions.

Therefore, the only difference between the scheme introduced by the Italian Decree and resolution under the BRRD/SRMR is that the Italian Decree allows for public support in circumstances where it would have either been prohibited or necessitated the bail-in of senior liabilities under the BRRD/SRMR framework.

Public interest condition

The motivation of the SRB's June 25 decision, according to which resolution of the Venetian banks would not be in the public interest, casts further doubt as to its actual objectives since it directly contradicts the grounds put forward by the Italian government two days later to justify the adoption of extraordinary orderly resolution measures with respect to the banks under the Italian Decree (the need to maintain critical banking functions and to avoid adverse effect on financial stability). It also contains an internal contradiction as it states that:

'*Normal Italian insolvency proceedings would achieve the resolution objectives to the same extent as resolution*.'

Indeed, the expression 'normal Italian insolvency proceedings' in the above-mentioned sentence, refers either to (i) the ordinary Italian insolvency law in force at the time of its decision on June 23, in which case the adoption of the Italian Decree on June 25 was unnecessary, contradicts the SRB's intent and should have been censured rather than validated by the Commission; or to, (ii) the Italian Decree, in which case, as explained above, the SRB and the Commission are adopting an interpretation of the notion of normal insolvency proceedings incompatible with BRRD/SRMR.

In addition, while the SRB's decision mentions that the objective of protecting creditors, depositors and clients is achieved to the same extent as in resolution, it fails to mention the other resolution objectives. This includes, specifically, the objective of minimising taxpayer support, which is clearly not satisfied under the Italian Decree to the same extent as it would have been under the BRRD/SRMR.

By applying an ad hoc regime which is labelled as liquidation but de facto resolution – except that it allows the Italian state to provide public support in circumstances where it was impermissible pursuant to BRRD/SRMR – EU and Italian authorities appear to have misinterpreted the notion of 'normal insolvency proceedings'. They also seem to have misused their power to make a determination as to whether the public interest condition was satisfied.

While this outcome may have been more attuned to EU political and economic reality than the BRRD/SRMR framework and ultimately satisfactory from a financial stability perspective, it undermines both the BRRD/SRMR framework and the authorities in charge of implementing it. It also raises the question of whether it could be useful, with respect to legacy situations and possibly until the minimum requirements for own funds and eligible liabilities and total loss absorbing capacity framework is fully implemented, to introduce as part of BRRD2 reforms certain transitional provisions or exemptions that would allow EU authorities to effectively and transparently resolve failing banks without running afoul of the rules they themselves wrote and rendering the EU resolution framework unintelligible for investors.

By applying an ad hoc regime labelled as a liquidation but de facto a resolution, EU and Italian authorities have misinterpreted the notion of normal insolvency proceedings

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