

Banking crisis management in the European Resolution Framework: from “bail-out” to “bail-in”

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Abstract

The European Directive 2014/59 c.d. the BRRD - Bank Recovery and Resolution Directive, introduces harmonized rules for handling bank resolution and banking crises. This legislation gives the crisis management and crisis management authorities - the ECB and the national supervisory authorities - powers and tools to: *i.* Planning crisis management; *ii.* Intervening in time before the crisis; *iii.* Handle the resolution phase. The bail-in, translated with “internal rescue”, is a tool that should enable the supervisors to reduce the value of the shares and receivables due to the bank or to convert them into shares to absorb losses and recapitalize the bank sufficiently in order to restore adequate capitalization and maintain market confidence. This paper discusses the evidence of the rescue of four non-large Italian banks carried out at the end of 2015. It also points out that it would be necessary to use the new rules on resolutions that were considered too dangerous for creditors of the banks in question in 2016.

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1 Banking crises and resolution tools

The European Directive 2014/59 c.d. the BRRD - Bank Recovery and Resolution Directive, introduces harmonized rules for handling bank resolution and banking

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crises. This legislation gives the crisis management and crisis management authorities - the ECB and the national supervisory authorities - powers and tools to:

- i.* Planning crisis management;
- ii.* Intervening in time before the crisis;
- iii.* Handle the resolution phase.

As for the first point, during the normal banking phase, the relevant competent authorities will have to prepare the resolution plans identifying the actions to be taken in case of bank crises to facilitate the application of the resolution instruments. The supervisory authorities will have to approve the plans for rehabilitation prepared by the individual banks, indicating the measures they intend to adopt when signs of economic, financial and capital deterioration appear. As for the second point, they are among the so-called "early intervention" of the supervisory authorities, the prudential measures aimed at obtaining the temporary implementation of plans prepared by the banks and approved by the authority. In the most serious cases, the removal of the entire administrative body and senior management and, if that is not enough, the appointment of one or more temporary administrators. These are measures whose results should bring the bank back to normal or, if not, start it at the resolution.

a. As far as the third point is concerned, the resolution procedure may be adopted when there are certain conditions, such as:

to. bankruptcy or risk of bankruptcy, when the latter has significantly eliminated or reduced its capital as a result of losses;

b. The lack of alternative private measures, such as capital increases or oversight, to avoid bankruptcy in a timely manner;

c. The inadequacy of the bank's ordinary liquidation that would not safeguard the stability of the banking system, protect depositors and customers, ensure the continuity of production and distribution of financial services and, therefore, resolution is necessary in the public interest .

The resolution may provide that the competent authorities may:

a. Sell part of the bank's assets to a private buyer (bank or non-bank);

b. Relocating temporarily the assets and liabilities of the bank in crisis to an entity (so-called bridge bank) constituted and managed by the resolution authority to allow the bank to continue its activity in view of its subsequent sale to third parties;

c. Transfer bad debts to a vehicle (so-called bad bank) managing its liquidation in a timely manner;

d. Apply the so-called bail-in, ie devaluation of bank shares and credits, including by converting them into shares, to absorb losses and recapitalize the bank in crisis or a new entity that continues its essential functions.

State intervention in support of bail-out banks is only envisaged in extraordinary circumstances, especially as the crisis of a bank could have serious repercussions on the functioning of the financial system as a whole. Innovation would basically do this: eliminate or limit the burden on the public budgets of aid to national financial systems. Eurostat data indicates that, at the end of 2013, aid to national financial systems had increased public debt of nearly 250 billion euros in

Germany, almost 60 billion euros in Spain, 50 billion euros in Ireland and the Netherlands, 40 billion euros in Greece, 19 billion euros in Belgium and Austria, 18 billion euros in Portugal and 4 billion euros in Italy. The activation of public intervention, including the possibility of temporary nationalization, requires that the costs of the crisis be shared with shareholders and creditors by applying a bail-in of at least 8% of the total liabilities of banks.

2 From “bail-out” to “bail-in”

The bail-in, translated with “internal rescue”, is a tool that should enable the supervisors to reduce the value of the shares and receivables due to the bank or convert them into shares to absorb losses and recapitalize the bank sufficiently to restore adequate capitalization and maintain market confidence. The shareholders and creditors of the rescheduled bank would in no way be held liable for a loss greater than the one they would bear in the event of the liquidation of the bank in accordance with ordinary procedures.

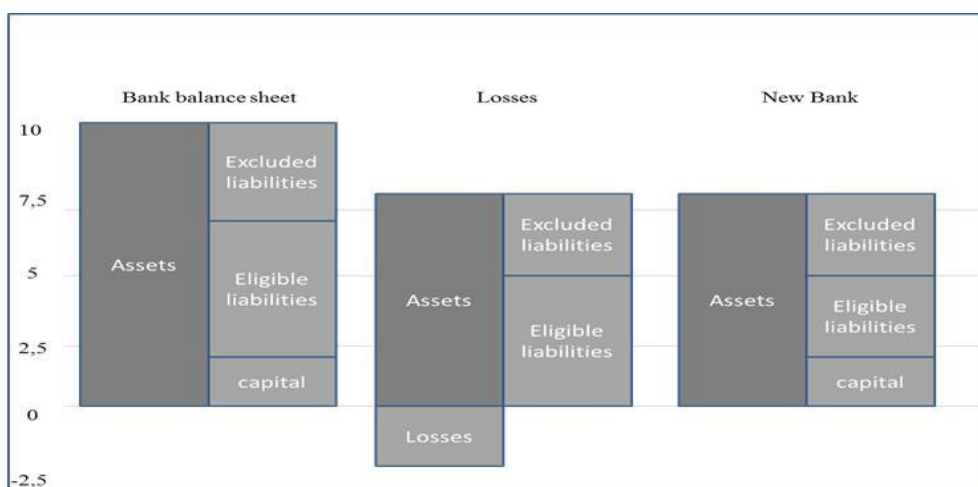


Figure 1: How bail-in works

In normal terms, the bank has on its capital side liabilities of bail-in liabilities and liabilities that can be different than bail-in (excluding liabilities), such as deposits secured by the depositary’s guarantee system. In the event of a default, as a result of losses, the bank's assets may be eliminated and its debts reduced. In the event of a resolution or a new bank, the authority has the bail-in which allows it to restore more or less all of the capital by converting part of the bank's debts to third parties. Through the bail-in the bank can then continue to operate and there is no cost to taxpayers, as the financial resources needed to stabilize the bank come from shareholders and creditors (Figure 1).

However, the following are excluded and cannot be either devalued or converted into shares:

- a. deposits secured by the national deposit guarantee system, up to a maximum of 100,000 euros per depositor;
- b. guaranteed bank liabilities, including secured bank bonds, liabilities deriving from derivative contracts to hedge credit risks and securities issued as collateral for the bonds, to the extent of the value of the assets held as collateral, and the liabilities to tax administration and social security institutions, if the related claims are favored by privilege or other legitimate cause of pre-emption;
- c. non-bank liabilities arising from the custody of customer assets or through a trust relationship such as securities deposited in a separate account and the contents of the security boxes;
- d. interbank liabilities with a duration of less than 7 days (excluding intragroup transactions);
- i. liabilities arising from participations in payment systems with a duration of less than 7 days;
- f. payables to employees, payables to suppliers and tax payers provided that they are privileged by bankruptcy law.

All other liabilities, not expressly excluded, fall within the bail-in which involves the involvement of shareholders and creditors according to a specific hierarchy:

- a. the shareholders;
- b. holders of other equity securities;
- c. the other subordinate creditors;
- d. unsecured creditors;
- e. depositors and small and medium-sized enterprises holding deposits for amounts over 100,000 euros;
- f. the deposit guarantee fund, which may contribute to the bail-in instead of the aforementioned depositors.

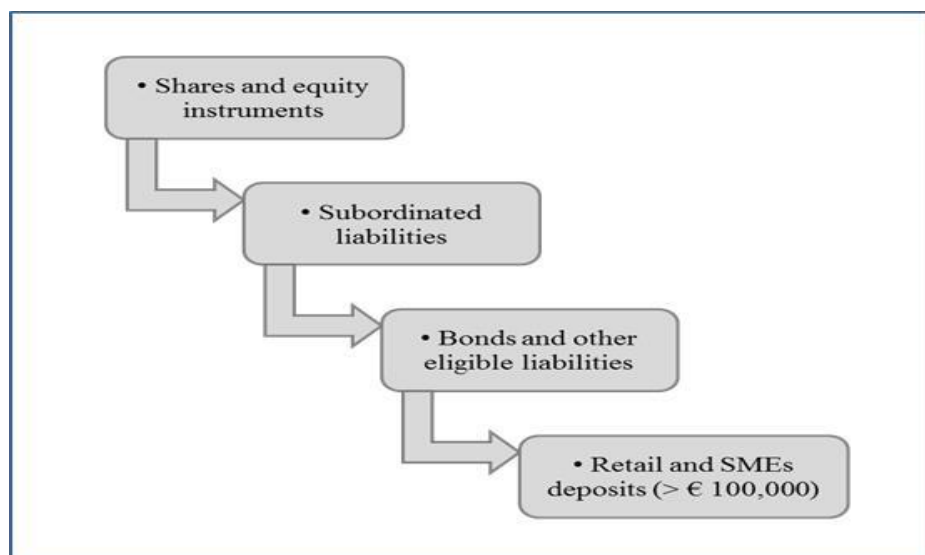


Figure 2: Bail-in procedure

In essence, logic assumes that the interests of those who invest in riskier financial instruments are sacrificed first and once the most risky categories of resources are exhausted, it goes to the next category, unless the authority decides to exclude certain categories of discretionary claims, in order to avoid contagion risk and thus preserve the stability of the system.

In addition, the law provides for the so-called “legal approach” to the bail-in, ie all these measures apply to instruments already in circulation and already in the hands of investors. Therefore, extreme caution and attention should be paid to customers who intend to subscribe to bank securities and at the same time require banks to reserve liabilities other than deposits, such as subordinated liabilities that bear losses immediately after the shares to more experienced investors. Banks will need to give timely communication to customers when placing new issue securities.

Deposits up to 100,000 euros are expressly excluded from the bail-in as protected by the Deposit Guarantee Fund. These are the sums deposited on the current account or in a savings deposit book or deposit certificates. This protection does not, however, concern other forms of savings, such as bank bonds.

Deposits of individuals and SMEs over 100,000 euros are subject to bail-in only if all the other instruments preceding the bankruptcy hierarchy were insufficient to cover the bank's losses and restore an adequate level of capitalization. However, such retail deposits over 100,000 euros may be excluded from the bail-in at the discretion of the authority in order to avoid the risk of contagion and to preserve the stability of the system provided that the bail-in has been applied at least 8 percent of total bank liabilities.

A Single Resolution Mechanism (SRM) has been set up for the management of the banking crisis in the euro area, which will be powered by the Single Resolution Fund (SRF), with contributions from banks in member countries.

The primary function of the SFR is to fund the application of the resolution measures, for example through the granting of loans or the issuance of guarantees. In exceptional circumstances and especially in order to avoid systemic risk of contagion, the fund may absorb losses by banks' creditors in crisis, within a few limits, of the total liabilities of the same, reducing the amount of bail-in.

If the application of all that is required is not sufficient to avoid the bankruptcy of the bank in crisis and if that bankruptcy is judged to be prejudicial to its systemic consequences, to conclude direct intervention of the State of the country where the bank operates if available could be used. This intervention would therefore be considered compatible with the State aid rules, which the European authorities have increasingly given importance to.

3 The solution to the crisis of the four Italian banks

The Italian Government and the Bank of Italy, working together in close collaboration, on 22 November 2015, took measures to resolve the critical situation of four banks under special administration: Banca Marche, Banca

Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara, and CariChieti. Banca Marche worked in the Marche region and in other areas of Central Italy: Umbria, Emilia Romagna, Lazio, Abruzzo and Molise via a network of 308 branches. The bank's operated by lending to SMEs and retail clients. The latest published figures at the end of 2012, showed Banca Marche had total assets of 22.7 billion of euros, net customer loans of 17.3 billion of euros and deposits of 7.2 billion of euros, causing the bank to be placed under special administration on 15 October 2013.

Banca Popolare dell'Etruria e del Lazio is to be found on the Italian stock exchange, operating principally in Tuscany and Central Italy. Its business focuses on lending to SMEs and retail clients and it has a network of 175 branches. The group had total assets of 12.3 billion of euros, net customer loans of 6.1 billion of euros and deposits of 6.4 billion of euros, according to published figures of 30 September 2014, causing the bank to be placed under special administration on 10 February 2015.

Cassa di Risparmio di Ferrara is a regional bank with 106 branches in the geographical area around Ferrara. The bank focused on lending to SMEs and private clients using funding mainly from retail customers. At the end of 2012 the bank had total assets of 6.9 billion of euros, net customer loans of 4.6 billion of euros and deposits of 3.4 billion of euros, according to published figures at the end of 2012, causing the bank to be placed under special administration on 27 May 2013.

Carichieti found in the Italian region of Abruzzo is a medium-sized regional bank with a focus with a traditional business focused on lending to SMEs and retail clients. At the end of 2013, according to published figures, the bank had total assets of 4.7 billion of euros, 2.1 billion of euros of net customer loans and deposits of 2.5 billion of euros, causing the bank to be placed under special administration on 5 September 2014.

This is a complex of small or medium-sized banks, which handle a total market share of about 1 percent in terms of deposits.

The solution that has been adopted has allowed banks to continue their activity and satisfactorily helped their recovery. The interest of the economy of the territories is the protection of public savings in the form of deposits, current accounts and ordinary bonds. The losses accumulated by the four banks, valued with prudent criteria, were absorbed by using risky financial instruments, ie subordinated shares and bonds, as provided by the European Directive BRRD.

Specifically, the solution adopted is articulated in the following steps, as described below. For each of the four banks, the "good" part of the balance sheet has been separated from the "bad" one.

In the "good" or bridge bank part, all assets other than bank loans were defined as doubtful realization loans, on the liability side it has deposits, current accounts and ordinary bonds. The Resolution Fund, provided for by European legislation and administered by the Bank of Italy Resolution Unit, also replenished the capital of approximately 9 per cent of the total risk-weighted assets. The good part has been

provisionally managed by extraordinary administrators with the main task of selling in the shortest time the assets on the market to the best bidder, with transparent procedures and then reimbursing the sale proceeds to the Resolution Fund. In the following Table are noted the data for each of the four good banks and the aggregate data. For each of the four banks which have the same name is added the adjective “new”.

A “bad bank”, without a bank license, takes possession of all bad debts remaining after the absorption of the losses by cancelling shares and subordinated bonds and, any extras, by a special contribution from the Resolution Fund. Banking debts were written off from the original value of 8.5 billion to 1.5 billion euros and were sold to specialists in the recovery of loans, or managed internally.

Below is the single bad bank data that collects the bad debts assets of the four original banks. See Table 1.

Table 1: Good banks, Bridge banks aggregate and the Single bad bank (billion euros, rounded)

	Nuova Banca delle Marche	Nuova Banca dell'Etruria e del Lazio	Nuova Cassa di Risparmio di Chieti	Nuova Cassa di Risparmio di Ferrara	Bridge banks - Aggregate	Single "bad bank" for all four
Assets						Assets
Loans, investments, etc. (no “bad debts”)	12.4	6.1	3.1	2.9	24.5	Bad loans 1.5
Claims on “bad bank” (guaranteed by Resolution Fund)	0.9	0.3	0.1	0.2	1.5	Cash 0.1
Cash	2.0	0.7	0.2	0.6	3.6	
Total	15.3	7.1	3.4	3.7	29.6	Total 1.6
Liabilities						Liabilities
Deposits, current accounts, bonds and other funding	14.3	6.7	3.3	3.5	27.8	Payables to bridge banks 1.5
Capital (underwritten by Resolution Fund)	1.0	0.4	0.1	0.2	1.8	Capital (underwritten by Resolution Fund) 0.1
Total	15.3	7.1	3.4	3.7	29.6	Total 1.6

As evidenced by the settlement process, the burden of rescue is first and foremost borne by the shareholders and holders of the subordinated bonds of the four banks, and thus ultimately on the entire banking system that feeds, with its ordinary and extraordinary contributions, the Resolution Fund. The State and therefore the taxpayers did not incur any costs.

The resolution fund contributed a total of about 3.6 billion euros to the settlement process, divided as follows: approximately 1.7 billion euros to cover the losses of the original banks and possibly recoverable at least in part; about 1.8 billion euros to recapitalize good and recoverable banks by selling them; about 140 million euros to be able to equip the bad bank of the minimum capital provided by the supervisory regulations to thus be able to operate on the market. The liquidity required by the resolution fund was anticipated by the three largest Italian banks, namely Banca Intesa Sanpaolo, Unicredit and UBI Banca, at market rates and with a maximum maturity of 18 months.

Ultimately, - the four original banks are configured as containers with losses and coverage and are immediately subject to administrative liquidation; - Good banks continue to pursue banking activities, having been cleansed from suffering and adequately recapitalized; - The bad bank stays alive for the time it takes to sell or realize the sufferings that have been transferred to it.

Following State aid rules and discussions with the EU Commission this solution emerged. It is immediately effective avoiding the prolonging of the paralysis of the four Italian banks in order to resolve the crisis.

4 The EU framework for resolution banking crisis and conclusion

The European regulator intends to adopt a model of minimum harmonization of the banking crisis management discipline, while giving the Member States the option to adopt different levels of protection compared to those provided for in the directive. Specifically, it is possible to adopt additional and / or stricter provisions of European legislation provided they do not conflict with the principles established by the directive itself (Article 1, paragraph 2 of the BRRD).

The Regulation n. 806 of 2014 of the European Parliament and of the Council established the Single Resolution Mechanism (SRM) for the centralized management of banking crises in the euro area with the aim of ensuring uniform supervision at the European level. The single resolution mechanism, a key element of the European Banking Union, is composed of the Resolution Authority of the countries of the Union - the Single Resolution Committee - and a Common Resolution Fund, financed by the banks included in the area of application of the discipline. For banks qualified as significant under the regulation, the Committee will decide the resolution programs for failing banks that will be implemented by the national resolution authorities, exercising the powers that the European

legislation and the national rules attribute to them. To avoid risks of contagion at the systemic level, the Single Resolution Fund can absorb 5% of the losses of creditors of banks in crisis, provided that the minimum bail-in rules of 8% of total liabilities have been applied and the principles set out in the Bank Recovery and Resolution Directive and the Single Resolution Mechanism Regulation. If all the mechanism illustrated was not sufficient to prevent the bank from collapsing and if this failure was considered to be detrimental to the systemic consequences, it will be possible to obtain an intervention from the country in which the bank operates. If necessary, this intervention would be considered compatible with state aid legislation. The European legislation, therefore, intends to share the burdens of the crises through the use of public funds in an area that exceeds the national dimension.

Of course the reaction by the public to the bail-in were not favorable. Admitting savings entrusted to banks, which in popular imagination have always been considered risk-free, could now be devalued, was not easy.

There was, first the evidence of the rescue of four non-large Italian banks carried out at the end of 2015, also evidence in order to avoid that in 2016 it would be necessary to use the new rules on resolutions that were considered too dangerous for creditors of the banks in question.

In the outlined context, a first conclusion considers the need for the ECB and the National Supervisory Authorities to ensure a stronger and coordinated banking supervisory system at European level, which is able to identify as soon as possible, any problems in the crisis of the banking system, and to initiate the assessments necessary for appropriate decisions. It is therefore essential for banks to be managed more efficiently and effectively. This can only be achieved by strengthening the role of guidance and control by the central structures of the countries in the Union. It follows that the aforementioned measures pursue the objective of encouraging greater stability in the banking sector so that savers are able to restore confidence in the financial and credit market.

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List of significant supervised Italian entities (Cut-off date for significance decisions: 5 December 2017)

	Country of establishment of the group entities	Grounds for significance
Banca Carige S.p.A. – Cassa di Risparmio di Genova e Imperia		Size (total assets EUR 30-50 bn)
Banca Cesare Ponti S.p.A.	Italy	
Banca del Monte di Lucca S.p.A.	Italy	
Banca Monte dei Paschi di Siena S.p.A.		Size (total assets EUR 150-300 bn)
Mps Leasing & Factoring S.p.A.	Italy	
Mps Capital Services Banca per le Imprese S.p.A.	Italy	
Wise Dialog Bank S.p.A.	Italy	
Banca Monte Paschi Belgio S.A.	Belgium	
Monte Paschi Banque S.A.	France	
Banco BPM S.p.A.		Size (total assets EUR 125-300 bn)
Aletti & C. Banca di Investimento Mobiliare S.p.A.	Italy	
Banca Akros S.p.A.	Italy	
Banca Popolare di Milano S.p.A.	Italy	
BPER Banca S.p.A.		Size (total assets EUR 50-75 bn)
Banco di Sardegna S.p.A.	Italy	
Banca di Sassari S.p.A.	Italy	
Cassa di Risparmio di Bra S.p.A.	Italy	
Cassa di Risparmio di Saluzzo S.p.A.	Italy	
Nuova Cassa di Risparmio di Ferrara S.P.A.	Italy	
Banca popolare dell'Emilia Romagna (Europe) International S.A.	Luxembourg	
Banca Popolare di Sondrio, Società Cooperativa per Azioni		Size (total assets EUR 30-50 bn)
Banca della Nuova Terra S.p.A.	Italy	
Barclays Bank plc		Size (total assets EUR 30-50 bn)
Credito Emiliano Holding S.p.A.		Size (total assets EUR 30-50 bn)
Credito Emiliano S.p.A.	Italy	

Banca Euromobiliare S.p.A.	Italy	
Credem International (Lux)	Luxembourg	
ICCREA Banca S.p.A. – Istituto Centrale del Credito Cooperativo		Size (total assets EUR 30-50 bn)
ICCREA Bancaimpresa S.p.A.	Italy	
Banca per lo Sviluppo della Cooperazione di Credito S.p.A.	Italy	
Intesa Sanpaolo S.p.A.		Size (total assets EUR 500-1,000 bn)
Banco di Napoli S.p.A.	Italy	
Intesa Sanpaolo Private Banking S.p.A.	Italy	
Banca IMI S.p.A.	Italy	
Banca Prossima S.p.A.	Italy	
Cassa dei Risparmi di Forlì e della Romagna S.p.A.	Italy	
Cassa di Risparmio di Firenze S.p.A.	Italy	
Cassa di Risparmio del Veneto S.p.A.	Italy	
Cassa di Risparmio del Friuli Venezia Giulia S.p.A.	Italy	
Cassa di Risparmio in Bologna S.p.A.	Italy	
Mediocredito Italiano S.p.A.	Italy	
Istituto per lo Sviluppo Economico dell'Italia Meridionale - (I.Sv.E.I.Mer.) – S.p.A.	Italy	
Cassa di Risparmio di Pistoia e della Lucchesia S.p.A.	Italy	
Fideuram – Intesa Sanpaolo Private Banking S.p.A.	Italy	
Intesa Sanpaolo Bank Ireland Plc	Ireland	
Allfunds Bank International, S.A.	Luxembourg	
Fideuram Bank (Luxembourg) S.A.	Luxembourg	
Intesa Sanpaolo Bank Luxembourg S.A.	Luxembourg	
Všeobecná úverová banka, a.s.	Slovakia	
Banka Intesa Sanpaolo d.d.	Slovenia	
Allfunds Bank, S.A.	Spain	
Banca 5 S.p.A.	Italy	
BANCA NUOVA S.P.A.	Italy	
Banca Apulia S.p.A.	Italy	
Mediobanca – Banca di Credito Finanziario S.p.A.		Size (total assets EUR 50-75 bn)

CheBanca! S.p.A.	Italy	
Compass Banca S.p.A.	Italy	
Mediobanca International (Luxembourg) S.A.	Luxembourg	
Banca Esperia S.p.A.	Italy	
UniCredit S.p.A.		Size (total assets EUR 500-1,000 bn)
Finecobank S.p.A.	Italy	
UniCredit Bank Austria AG	Austria	
Schoellerbank Aktiengesellschaft	Austria	
UniCredit Bank AG	Germany	
UniCredit Bank Ireland plc	Ireland	
UniCredit International Bank (Luxembourg) S.A.	Luxembourg	
UniCredit Luxembourg S.A.	Luxembourg	
UniCredit Banka Slovenija d.d.	Slovenia	
UniCredit Bank Czech Republic and Slovakia, a.s., pobočka zahraničnej banky	Slovakia (branch)	
Unione di Banche Italiane Società per Azioni		Size (total assets EUR 100-125 bn)
IW Bank S.p.A.	Italy	
Banca Adriatica S.p.A.	Italy	
Banca Tirrenica S.p.A.	Italy	
Banca Teatina S.p.A.	Italy	
Carilo - Cassa di Risparmio di Loreto Spa	Italy	
Banca Federico del Vecchio S.p.A.	Italy	
UBI Banca International S.A.	Luxembourg	