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**BAIL IN AND NEW RULES FOR THE MANAGEMENT OF BANKING
CRISES: THE CASE STUDY OF THE FOUR ITALIAN BANKS**

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Abstract

La crisi finanziaria del 2007, cominciata negli Stati Uniti, si è propagata velocemente nel resto del mondo diventando ben presto una crisi globale. La crisi si è diffusa rapidamente anche in Europa dove il settore economico e finanziario è stato messo a dura prova. Dalle conseguenze drammatiche della crisi è nato il progetto dell'Unione Bancaria Europea, completamento dell'Unione Monetaria Europea. Questo progetto di unione bancaria è complesso e ambizioso e si propone di riportare stabilità nel settore bancario e finanziario europeo e di promuovere una maggiore integrazione tra i paesi dell'area dell'Euro. Gli strumenti attraverso i quali questo progetto persegue i suoi obiettivi sono tre: il Meccanismo di Vigilanza Unico, il Meccanismo di Risoluzione Unico e lo Schema Europeo di Assicurazione dei Depositi. Oggetto della presente analisi è il Meccanismo di Risoluzione Unico e in particolar modo la Direttiva Europea "Bank Recovery and Resolution Directive" (BRRD) n. 59 del 15 Maggio 2014 che ne costituisce la disciplina legislativa. Grazie all'introduzione del Meccanismo di Risoluzione Unico e della Direttiva BRRD la gestione delle crisi bancarie a livello europeo è cambiata radicalmente. Prima dell'Unione Bancaria Europea le crisi bancarie erano gestite in modo disomogeneo tra i paesi europei e la loro gestione prevedeva sostanzialmente due soluzioni: la liquidazione o il salvataggio pubblico tramite aiuti di Stato. In seguito, nel contesto dell'Unione Bancaria Europea, con il recepimento della Direttiva BRRD, sono state introdotte una serie di misure volte a garantire una gestione unitaria delle crisi bancarie. La principale novità è l'introduzione della procedura di risoluzione finalizzata a risanare le banche in crisi e a garantirne il normale funzionamento. Lo strumento che maggiormente racchiude l'essenza della procedura di risoluzione è il "bail in", applicabile alle banche aderenti all'Unione Bancaria Europea dal 1 Gennaio 2016. Il "bail in" prevede che, in caso di dissesto bancario, vi sia il coinvolgimento finanziario di azionisti, obbligazionisti e correntisti della banca stessa secondo una precisa gerarchia, e quindi che sia attuata una modalità di salvataggio bancario interno nettamente contrapposta alla precedente modalità di "bail out" basata su aiuti di Stato. Un esempio concreto di applicazione delle nuove regole europee è rappresentato dal salvataggio delle quattro banche italiane: Banca Marche, CariFerrara, CariChieti e Banca Etruria. Queste banche, dopo un periodo di amministrazione straordinaria, sono state poste in risoluzione il 22 Novembre del 2015 e salvate tramite le disposizioni del Decreto "Salva Banche" n. 183 del 22 Novembre 2015. Grazie agli strumenti di risoluzione previsti dal Decreto, in accordo con la normativa europea, il fallimento bancario è stato evitato e le banche sono state risanate, garantendo posti di lavoro e attività bancarie essenziali nei loro territori di collocazione. Il salvataggio dei quattro istituti di

credito è avvenuto senza la diretta applicazione dello strumento del “*bail in*”, non ancora entrato in vigore al momento del salvataggio, ma seguendo comunque il principio di condivisione degli oneri, il cosiddetto “*burden sharing*”, sui cui esso si basa. Nonostante l’epilogo sia complessivamente positivo, il caso di studio delle quattro banche Italiane non dimostra una corretta e fedele applicazione delle Direttiva Europea BRRD.

Introduction

After the economic and financial crisis of 2007, the banking crises have become a recurrent phenomenon in the global banking scenario. For this reason, the banking crises have been the subject of research of many authors. In particular, the objective of these researches was the identification and the analysis of causes, effects, common features and possible solutions of banking crises. The results of these analyses have shown that the banking crises can be of different nature according to their causes and of different seriousness according to their consequences. However, the main feature emerged, which characterizes the recent banking crises, is their systematic nature. More precisely, a banking crisis is defined systemic when the failure of a single banking institution leads, through a domino effect, to the failure of other institutions of the banking system, undermining, in this way, the financial stability. Therefore, at this regard, it is important to identify solutions and tools to manage and solve the banking crises in order to avoid serious conditions of instability for the financial and economic system. The management of banking crises is exactly the central topic of this paper. More specifically, the aim of this thesis is the analysis of the change in the management of the banking crises after the introduction of new European rules on this subject. In particular, at the base of this change, there is the institution of the European Banking Union, an ambitious and complex project, born after the economic and financial crisis of 2007 with the aim to restore the financial stability and to increase the European integration. Hence, thanks to the creation of the European Banking Union and especially to the Single Resolution Mechanism, which is its second pillar, the management of banking crises in Europe is radically changed. The evolution path of this change is analyzed in detail in the three chapters of this thesis. Before looking at the precise structure of this thesis, it is important to specify that, the topic of banking crises is dealt at a European level with a particular focus on the Italian banking system.

The starting point of the first chapter is represented by some general introductory notes about banks, banking businesses and banking risks. This preliminary analysis constitutes the first step for the understanding of the concept of banking crisis. As regards the banking crises, they are analyzed in terms of definitions, interpretations, causes, consequences and possible solutions. The topic of solutions mainly concerns the implementation of insolvency proceedings as extraordinary administration and compulsory administrative liquidation and highlights an uneven European management of banking crises. Then, the scenario of banking crises changes completely thanks to the institution of the European Banking Union. More precisely, the

European Banking Union, through the pillar of the Single Resolution Mechanism, introduces new rules for the orderly management of banking crises.

The second chapter is entirely dedicated to the new regime of banking crises management represented by the resolution procedure and its tools. In particular, in the second chapter is analyzed the content of the Bank Recovery and Resolution Directive No.59 of 2014 (BRRD Directive), which constitutes the legal basis of the resolution procedure. In the first part of the second chapter, the attention is focused on the main innovative elements provided by the European Directive. Then, the focus is shifted on the necessary conditions expressed by the BRRD Directive for the application of the resolution procedure. Moreover, it is provided a detailed analysis of the accounting data, contained in bank financial statements, which trigger the resolution procedure. At this regard, the main capital ratios and the ratios that account for the presence of non-performing loans, which, in turn, represent one of the main causes of banking distress have been analyzed. The final part of the central chapter deals with the functioning of bail in, the most important and significant resolution tool.

Lastly, the third and concluding chapter deals with the case study of the banking rescue of the four Italian banks occurred in the framework of the BRRD Directive. This case study shows, step by step, the issue of the banking rescue of Banca Marche, CariFerrara, CariChieti, and Banca Etruria following the methodology of investigation proposed in the previous chapter. In conclusion, the case study of the four Italian banks can be a significant but not entirely concrete example of application of the European resolution procedure in the Italian banking system.

CHAPTER ONE

Banking crises before and after the European Banking Union creation.

1.1 Introductory notes about banks, banking businesses and banking risks.

A bank is a company that deals with credit and monetary regulations by exercising brokerage business and financial activities. Therefore, a bank is a complex enterprise that performs a multiplicity of functions. Among the various functions performed by a bank, it is necessary to mention:

- Credit function: bank intermediation between who provides capital and who requires capital.
- Monetary function: creation of a bank money that makes possible the exchanges. In addition, a bank, through its operations, contributes to the achievement of monetary policy objectives.
- Business support function: use of financial measures that allow a bank to drive the enterprises in development, expansion and innovation processes.
- Service function: various services offered to the customers by a bank. Examples of services offered are securities trading, foreign currency exchange, issuance of credit instruments and custody of values in safety deposit boxes.
- Economic and social function: bank through its operations and its susceptibility to investment stimulates the economic development.

A bank to perform, as well as possible, its functions must pay attention to achieve three objectives that are necessary for its management:

- Liquidity conditions: necessary conditions in which a bank must operate in order to ensure claims and payments.
- Solvency conditions: the status of the bank's solvency is the ability to maintain the value of assets more than the value of liabilities.
- Positive financial result: a bank, like other companies, must register a positive financial result to carry out its operations.

Because of the multiplicity of functions and activities, a bank results very complex and for this reason is subject to many risks. Before analyzing the types of risk that a bank must face, it is useful to understand the definition of risk and the correlation between banking risks and banking crises. In general, the risk is the possibility that an unexpected or expected event affects the economy and the financial market. In particular, for a bank, there are many risks to consider. Some of these risks are similar to those faced by companies while others are typical of banking business.

Now, it is proposed a classification of banking risks by analyzing risks one by one. In details, the banking risks are:

- **Credit risk:** traditionally, it is the possibility that a bank suffers a loss due to the insolvency of its debtors. In order to avoid losses due to the insolvency of borrowers, a bank, before granting loans, must check the creditworthiness of its borrowers. The creditworthiness is the economic and financial reliability of a subject that looks for a loan. The estimation and the valuation of the creditworthiness of a customer bank is based on specific criteria and it is entrusted to appropriate rating agencies. The role of rating agencies is to assign a valuation to the financial solidity of a bank customer. The rating classification sets the levels of creditworthiness through a detailed analysis based on the presence of financial and capital resources, income flows, repayment capacity, debts and outstandings. Thanks to this classification, a bank is able to know the creditworthiness of its customers and to select the subjects to whom grant loans without incurring in unexpected losses. In line with this theme, it can be useful to mention the Mortgage Credit Directive 2014/17/EU¹ of 4 February 2014. The focus of this directive are the credit agreements for consumers relating to residential properties. The European Parliament and the European Council, through the implementation of this directive, aimed to a transparent set of rules in the mortgage market after the financial crisis of 2007 triggered by subprime mortgages. In detail, the Mortgage Credit Directive provides pre-contractual information to consumers, ensures a correct and transparent behavior of credit intermediaries and finally it evaluates the financial solidity of consumers. Moreover, there is a specific reference to the valuation of creditworthiness on Article 18 of Title VI of the Mortgage Credit Directive. The starting point of this article is the correct valuation of the creditworthiness of consumers before the conclusion of contracts. Indeed, it is very important to consider the ability of a consumer to fulfill the contractual obligations in order to avoid losses. This brief digression is interesting because highlights how the creditworthiness of a subject is important in each contractual relation in which the subject are banks, credit

¹ The full text of the Directive 2014/17/EU is available on www.eur-lex.eu

intermediaries and their customers. In this case, the reference to the topic of creditworthiness is essential to explain why a bank may not grant loans to all and how a correct valuation can reduce the credit risk and can protect a bank from the connected losses. Now, going deeper with the analysis of credit risk, it is also important to include in this category other credit risk specifications. Indeed, the default risk, the downgrading risk, the recovery risk, the exposure risk, the concentration risk and the spread risk belong to the category of credit risk. The default risk, also called, insolvency risk is referred to the probability of default of a bank customer. Then, the downgrading risk is a decrease of the creditworthiness and the recovery risk is the amount of loss given default. Moreover, the exposure risk indicates how much a bank is exposed to losses in the event of default of borrowers. Another credit risk is the concentration risk that is connected to the degree of loan's diversification. The last credit risk is the risk of changes in the debtor's spread required by the market. A final consideration, regarding the credit risk, is about the importance to find an estimation of this type of risk. It is very difficult to measure the credit risk in the banking system but the risk assessment activity is able to evaluate the risk through sophisticated macroeconomic and probabilistic models.

- **Market risk:** this is the second main risk for a bank and it arises from changes in the market variables. According to the type of variable, different types of market risk can be identified. The market variables are: exchange and interest rate, market shares, market products and market volatility. Each type of variable gives rise to a type of market risk. Indeed, for example, from the exchange rate variable results the exchange risk. The latter risk regards the risk due to the use of bank instruments denominated in various currencies. Also for the market risk, as for the credit risk, it is important to evaluate the risk through a correct measure. In this case, the measure is represented by the performances of past prices that are useful to forecast the future trend.
- **Operational risk:** the operational risk is closely connected with the banking business and according to Basel II is defined as: "The risk of loss resulting from inadequate or failed internal processes, human resources and internal systems or external events"². Therefore, human resources, informatics systems, processes and external events are the risk factors identified by the Basel Committee³ as determinants of the operational risk. From human resources, may arise events such as: frauds, rule violations and other issue related to the incompetence of the staff that leads to the operational risk. Regarding the informatics

² BASEL COMMITTEE ON BANKING SUPERVISION, June 2004, International Convergence of Capital Measurement and Capital Standards, Bank for International Settlement.

³ BASEL COMMITTEE ON BANKING SUPERVISION, October 2015, A brief history of the Basel Committee, Bank for International Settlement.

systems, as a second factor of the operational risk, the reference is to the technological aspects as failures or virus in the computer system and losses of data. The risk factor linked with processes is the risk that can arise in a bank's internal processes. For example, risk of accounting errors and risk in the calculation of taxes that a bank must pay. The last risk factor regards all the external events that are not controllable by the bank as natural disasters or political changes. A particular feature of the operational risk is its inevitability due to the close link with the banking business. For this reason, the evaluation and the measurement should take place through a system able to detect and estimate the events that cause losses to a bank. In this regard, the Basel II⁴ agreement deals with the identification of minimum capital requirements⁵ in order to cover the losses caused by this risk.

- Interest rate risk: a bank is exposed naturally to the risk of interest rate. This type of risk can have positive or negative effect for a bank and its banking business. Clearly, the nature of the effect depends on the interest rate variations and on the management of risk itself. If the effect is positive, the bank profitability will increase. Instead, on the other side, if the effect is negative, the asset value of a bank could be compromised. Therefore, the objective is to control the adverse movements and volatility of interest rate through an efficient risk management system.
- Liquidity risk: the inability of a bank to fulfill its payments within the contractual time limits represents the liquidity risk. Furthermore, the definition of liquidity risk can be analyzed taking into account two different aspects of liquidity. According to the financial institutions, a bank has a sufficient liquidity when it is able to pay its obligations. From this definition of liquidity results the concept of funding liquidity risk. Basically, this risk is the inability of a bank to fulfill its payment but without compromising its financial and operational situation. Then, according to the financial market, the liquidity is the possibility to sell a financial instrument without modifying too much the market price. For this reason, the concept of market liquidity risk is introduced. This last type of liquidity risk refers to the bank losses due to the use of liquid assets in situation of liquidity crises. The management of the liquidity risk is a very sensitive issue mainly after the events of the economic and financial crisis of 2007. Indeed, the crisis has highlighted the weakness of the banking system in liquidity management during a period of adverse economic conditions. After this period of economic

⁴ BASEL COMMITTEE ON BANKING SUPERVISION, June 2006, International Convergence of Capital Measurement and Capital Standard, Bank for International Settlement, (a revised framework).

⁵ The first pillar of Basel II agreement, in order to cover the unexpected losses, due to operational, credit and market risk provides the calculation of minimum capital requirements. BASEL COMMITTEE ON BANKING SUPERVISION, June 2006, International Convergence of Capital Measurement and Capital Standards, Bank for International Settlement, (revised framework), page 12.

and financial trouble, the Basel Committee in its third pillar has modified and strengthened the management of bank liquidity. In this regard, the Committee has published the document “Principles for Sound Liquidity Risk Management and Supervision”⁶ in order to regulate liquidity. Furthermore, the Basel Committee has changed the minimum capital requirements for liquidity in order to increase the bank resilience⁷ during long or short period of economic and financial stress.

- Other risks: the types of risks analyzed, until this moment, are the most important and the most common banking risks. However, given the complexity of banking system, other risks have to be considered. Among the various types of risks, it is necessary to mention the reputational risk and the systemic risk. In order to understand the reputational risk, it must be stressed the real meaning of reputation in the banking environment. The reputation is the confidential and trusting relationship, built over time, between a bank, its shareholders, its investors and its customers. Hence, for a bank the reputation represents the key ingredient for its operations and the reputational risk is defined as: “The potential that negative publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation or revenue reductions”⁸. When the reputation of a bank decreases also the banking profits decrease and, as a natural consequence, a bank begins to suffer losses. The reasons why a bank loses its reputation may be due to economic and financial events or situations of internal organization of the bank itself. Since a loss of reputation and a negative image lead to considerable difficulties for a bank, the institutions that deal with banking supervision focus their attention not only on a qualitative analysis but also on quantitative analysis of the problem. The purpose is to identify, in time, the causes that may lead to a decrease of reputation in order to limit the bank losses. In the end, a particular focus is on the systemic risk. Recently, as a result of the last crisis events, the systemic risk is increasingly feared. Therefore, it is necessary to explain the definition of this risk and its peculiarity. The systemic risk depends on a crisis of a single bank that subsequently affects the whole banking system. It is called systemic risk because the crisis of a single bank, through a domino effect, becomes the crisis of the entire system. Regarding its definition, according to the Report of consolidation in financial sector, the systemic financial

⁶ «The Sound Principles provide detailed guidance on the risk management and supervision of funding liquidity risk and should help promote better risk management in this critical area, but only if there is full implementation by banks and supervisors”. BASEL COMMITTEE ON BANKING SUPERVISION, January 2013, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, Bank for International Settlement.

⁷ For the concept of bank resiliency, see BASEL COMMITTEE ON BANKING SUPERVISION BANK, December 2010, Basel III: A global regulatory framework for more resilient banks and banking systems, Bank for International Settlement.

⁸ FEDERAL RESERVE SYSTEM’S, November 2006, Commercial Bank Examination Manual, section 1000.1.

risk is: “The risk that an event will trigger a loss of economic value or confidence in, and attendant increases in uncertainty about, a substantial portion of the financial system that is serious enough to quite probably have significant adverse effects on the real economy. Systemic risk events can be sudden and unexpected, or the likelihood of their occurrence can build up through time in the absence of appropriate policy responses. The adverse real economic effects from systemic problems are generally seen as arising from disruptions to the payment system, to credit flows, and from the destruction of asset values. Two related assumptions underlie this definition. First, economic shocks may become systemic because of the existence of negative externalities associated with severe disruptions in the financial system. If there were no spillover effects, or negative externalities, there would be, arguably, no role for public policy. In all but the most highly concentrated financial systems, systemic risk is normally associated with a contagious loss of value or confidence that spreads to parts of the financial system well beyond the original location of the precipitating shock. In a very highly concentrated financial system, on the other hand, the collapse of a single firm or market may be sufficient to qualify as a systemic event. Second, systemic financial events must be very likely to induce undesirable real effects, such as substantial reductions in output and employment, in the absence of appropriate policy responses”⁹. The causes of systemic risk are numerous and difficult to detect, but the most common are the rigidity of the banking system and the interconnection between banks belonging to the same system. The systemic risk has, like its starting point, the crisis of insolvency of a bank and therefore, is itself due to other banking crises. For this reason, a detailed analysis and evaluation is needed. The systemic risk issue is the focus of attention of banking supervisors and European directives. Indeed, according to the third pillar of Basel Committee¹⁰, the capital solidity and the capital reserves of a bank must be guaranteed in order to meet the financial and economic difficulties and in order to ensure that the failure of a bank does not become the failure of the entire system.

After a brief explanation about bank and its business, the types of banking risk have been introduced essentially for their link with banking crises. Indeed, it is important to recognize and identify various banking risks because some of them are considered causes of banking crises. In the following paragraphs, we will discuss in details about banking crises, their causes, and their effects and, with particular attention, about their management before and after the institution of the European Banking Union.

⁹ GROUP OF TEN, January 2001, Report of consolidation in financial sector,. This report is available on the websites of the IMF, the BIS and the OECD.

¹⁰ The focus of Basel III agreement is on the minimum capital requirements in order to ensure the capital solidity.

1.2 General overview of banking crises before the European Banking Union creation.

1.2.1 Definitions of banking crises.

The aim of the following paragraph is to define the banking crises through a careful analysis of causes, historical and economic context and effects on real economy.

First, it is necessary to assign to the banking crises a clear and complete definition. For this purpose, it may be useful to mention some of the banking crises definitions found in the literature. According to Calomiris and Gorton (1991), two important banking theorists, the banking crises have the characteristic of a financial panic situation. They define the financial panic in this way: “A financial panic occurs when bank debt holders at all or many banks in the banking system suddenly demand that banks convert their debt claims into cash to such an extent that the banks suspend convertibility of their debt into cash”¹¹.

After this definition, Caprio and Klingebiel (1996), proposed a different way of understanding the banking crises. As a result of their study, the banking crises have been associated with the concept of financial distress. They refer to financial distress as follow: “When a significant fraction of the banking sector is insolvent but remains open”¹².

After some years, Leaven and Valencia (2008), other two important authors of banking crises dataset, proposed the definition of systemic banking crises. Building on their approach it can be said that:” In a systemic banking crisis, a country’s corporate and financial sectors experience a large number of defaults and financial institutions and corporations face great difficulties repaying contracts on time”¹³.

In general, a banking crisis is defined as a financial distress or a situation of serious imbalance bank due to a trigger event. Despite this general interpretation is hard to find a single definition of banking crises in both past and modern literature of banking authors. The inability to find a single definition derives from the fact that in any definition, after referring to a general situation of imbalance bank, follows a different and incomplete list of the causes of banking crises. Indeed, in each definition, the cause of banking crises is attributed to several reasons. This

¹¹ CALOMIRIS C.W.-GORTON G., 1990, The Origins of Banking Panics: Models, Facts, and Bank Regulation, Rodney L. White Center for Financial Research.

¹² CAPRIO G., KLINGEBIEL D., 1996, Bank insolvencies: Cross Country Experience, Working Paper No. 1620, World Bank Policy Research.

¹³ VALENCIA F., LAEVEN L., September 1, 2008, Systemic Banking Crises: A New Database, International Monetary Fund.

happens because there are different ways of understanding the banking crises and different contexts in which they take place.

1.2.2 Interpretations and causes of banking crises.

At this point, it is necessary to understand what a banking crisis really is and what the triggers are. In general, the two main causes usually attributed to a banking crisis are the liquidity crisis and the insolvency crisis. The liquidity problems that a bank must face are linked to the bank run by depositors and to the refusal by the creditor of a bank to renew loans. As regards the insolvency crisis, a bank becomes insolvent when the clients are unable to pay the loans received or when the value of financial investments decrease. In addition to these two common causes, the banking crises are based on the risks, listed above, which are proper of the banking business. Although the causes of banking crises are more or less common to all banks, it is possible to attribute to each type of banking crisis its specific causes. Indeed, the concept of banking crisis gives scope for different interpretations. A banking crisis can be a crisis of individual credit institution, a systemic crisis of the entire banking system, a banking crisis before or after a financial crisis and a banking crisis at the same time of a currency crisis. For example, if the banking crisis affects only a credit institution, the reasons are probably the following: errors of management and administration, poor risk management system, excessive leverage connected to the assets erosion, inability to meet obligation and lack of liquidity. If, instead, the condition of financial distress of a single bank is transferred to the entire banking system, it is a question of systemic crisis. The causes of this type of banking crisis are due to interconnection, asymmetric information and competition among banks of the same system. For example if a bank is in a liquidity or insolvency crisis, this situation spreads very quickly infecting not only the whole banking system, but also the production system of companies.

Another way to interpret the banking crises is in light of a financial crises. For this purpose, it is appropriate to remember the role of banks in the financial crisis of 1929 and in the most recent financial crisis of 2007¹⁴. The starting point of the analysis is the financial crisis of 1929¹⁵. In this crisis, banks did not have the lead role but they were the means by which the crisis expanded. Nevertheless, banks played, in any case, a significant role in the crisis of those years and now it is explained why. In that period, about five thousand of banks failed because of their reckless behavior in the financial and credit market. Indeed, the banks granted loans to all

¹⁴ DE CARLI P., Aprile 2008, Crisi finanziaria ripensiamo il ruolo delle banche.

¹⁵ GALBRAITH J.K., October 2009, The great crash 1929, Peng Business.

companies considering to finance them through the money deposited by account or through the speculative activity of the securities purchase. The problem arose when, due to the devaluation of the securities, the banks were unable to recover loans and to return money to clients. This is the reason why many banks faced crises and failed. The failure of banks was followed by a worsening of the conditions of the companies, which consequently led to a worsening of the economy. This brief analysis is useful to highlight the role of banks as a vehicle of transmission of the crisis and to understand how a banking crisis can influence a financial crisis.

Now the focus is shifted on the crisis of 2007¹⁶ in order to see, about the link between banking and financial crisis, the difference with the previous one. In this case, the banking crisis and the financial crisis derive from the behavior of the banks and in particular from operations for the securitization of subprime mortgages¹⁷. Therefore, the crisis appears linked to the behavior of the banks, to their decision to make securitization as a normal banking activity of funding, to their inability to control the system and to their dependence on the securities issued by associated companies. This crisis, caused by the carelessness of banks to grant loans to people with uncertain incomes and unable to repay debts, is defined the largest and the most serious financial crisis of recent years. Moreover, this crisis is also known as a banking crisis because, at that time, many of the largest banking giants, small banks and financial institutions collapsed due to liquidity crisis and losses resulting from subprime mortgages. Among all the bank failures, the failure of Lehman Brothers in 2008¹⁸ must be remembered because it marks an important phase of the crisis. In conclusion, as can be noted, the role played by banks in 1929 and 2007 is different. Indeed, the banks prove to be, in the first scenario, the vehicle of the crisis transmission and, in the second scenario, the trigger factor. Despite this, thanks to the excursus on the two most important crisis of the last years, the close relationship between banks, banking crisis and financial crisis is demonstrated.

The last interpretation about banking crisis is connected to twin crisis¹⁹. The twin crisis consist in a banking crisis that is simultaneous to a currency crisis. A particular feature of twin crisis is the existence of a bidirectional relationship between the banking and currency crisis. Indeed, a change in the exchange rate system can have an effect on the banking system and vice versa. For

¹⁶ FINANCIAL CRISIS INQUIRY COMMISSION, January 2011, The Financial Crisis Inquiry Report, Final report of the national commission on the causes of the financial and economic crisis in the United States, Official Government Edition.

¹⁷ The securitization process is available on JOBST A., September 2008, What is securitization?, Financial and Development magazine of IMF, Vol 45, No 3.

¹⁸ ZINGALES L., October 2008, Causes and Effects of the Lehman Brothers Bankruptcy.

¹⁹ «Twin crises refer to the association of banking crises and balance-of-payments crises, and the vice versa». JÜRGEN VON HAGEN - TAI-KUANG HO, April 2003, Twin Crises, A Reexamination of Empirical Links, University of Bonn.

example, an increase in the exchange rate due to the speculative activity can lead to a deterioration of bank's asset and consequently to a banking crisis. Instead, interventions designed to ensure banking stability might lead to a depreciation of the exchange rate and to a currency crisis. After the explanation of the causes, the analysis continues with the explanation of the consequences and effects of the banking crises.

1.2.3 Consequences and effects of banking crises.

After a careful analysis of the causes, it is time to focus on the consequences and effects of banking crises. The starting point of this section is to ask what really happens to banks, people involved in banking business and economy after a banking crisis. Find an answer to the first part of the question, about the consequences for banks after a crisis, is quite easy. Indeed, for a bank, after a crisis, there are not many alternatives to consider. The possible alternatives are: a bank survives the crisis, a bank fails definitively, and a bank is saved from bankruptcy. Although it is difficult to believe that a bank can really fail, most of the time a banking crisis leads to failure. In situations of financial distress, not only small banks can fail but also the large banking giants that are considered "Too big to fail". The expression "Too big to fail"²⁰ is also used today to recall the large banking giants in size and importance that in the crisis of 2007 failed. Among the names of banking giants failed, we should mention Lehman Brothers that represents the largest bank failure in American history. Lehman Brothers exposed itself a lot in the subprime mortgages sector and this was the cause of its downfall. Subprime mortgages were the cause of significant losses as well as the cause of a large number of toxic securities derived from the securitization of mortgages. For these reasons, it was impossible to save, through a state aid or through an acquisition by another society, the Lehman Brothers. Other American banks, but not only American, fell into the hands of state administration or other banks and financial companies acquired them. Indeed, sometimes there is the possibility to save banks from bankruptcy but the situation is every time different according to intensity of banking crisis developed. Anyway, bankruptcy and methods of bank rescue will be examined in details in the next paragraphs.

Now going back to the analysis, regarding the people involved in banking business, the consequences are various. The people involved in banking business can be shareholders, depositors, creditors and debtors. Therefore, after a banking crisis, the shareholders lose the participation fees, the depositors lose savings, the creditors could not be refunded and the debtors

²⁰ For the interpretations and the meaning of "Too big to fail" see KAUFMAN G.G., June 2013, Too big to fail in banking: What does it mean?, Special Paper 222 , LSE financial markets group special paper series.

must face the problem of searching new funding resources. If we also consider the bank employees, they lose job and consequently increase the number of unemployed workers.

Then, about the effects on the economy, it must be pointed out the central role of banking crises in the economy. For this reason, when a banking crisis occurs, a range of economic negative repercussions follows. For example, if a bank has not liquidity to invest in businesses, a company has not enough capital for its activity. Consequently, without resources and fundings, the commercial activity becomes unsustainable. Therefore, the company fails to perform its normal activities, starts to suffer losses and dismisses the staff increasing the phenomenon of unemployment. In the majority of cases, the companies close their activity and in this way, the production sector results compromised. Lastly, a decrease in performance of the productive sector leads to a decrease of GDP and economic growth.

Another important effect of banking crisis is the link with financial crisis. Indeed, because of a banking crisis, a financial crisis can arise and, as already said, the banks are considered the vehicle of transmission of the crisis from the banking sector to the financial and economic one. This is a general overview about the banking crisis effects but the effects can be more specific according to the seriousness and the historical context in which the crisis takes place.

However, a final note about the impact of the effects must be made. The effects of a banking crisis have surely a negative impact for the economy and for the people involved because each crisis is interpreted as a negative event. However, even a negative event, like a banking crisis, can bring a positive effect. The positive side of the banking crisis is the opportunity to renew the banking system, eliminate the weaknesses and increase the strengths. Indeed, it is precisely in the moment of distress that arise the best solutions for banking crises. In the following paragraph, the attention is focused on banking crises solutions.

1.2.4 Solutions of banking crises.

Over the last two decades, due to the financial crisis, banking crises increased and became more serious. As previously discussed, banking crises may produce adverse effects but unfortunately, despite the analysis of the common causes and factors, it is not possible to predict them with certainty. For this reason, the focus is on what the solutions for management of banking crises are. Therefore, the purpose of this paragraph is to examine the possible scenarios and solutions after a banking crisis. This analysis remembers again that after a banking crisis many banks fail while other are saved. The starting point of this discussion are some considerations about the bank failure and then the focus shifts on procedures and mechanisms to rescue banks. First of all, the attention to the failure of a bank is very high because the economic consequences can be very

dangerous. For this reason, it is necessary to explain what a failure of a bank means and what a bank represents for the economy. The analysis starts from the consideration that a bank is not a simple company with particular credit function but it is considered a special entity.

Now, it is interesting to understand the specialty of a bank and consequently why the failure of a bank can not be compared with the failure of a company. A bank is considered special because has a central role in the economy that contributes to the stability and the growth of the economic system. In particular, a bank has the ability to transmute deposit into loan and investment²¹. In this way, through the household deposit, the companies and the production activities are financed and the continuity of the economic business cycle is guaranteed. The fact that a bank is special for the activities that carries out means that even its regulation is special.

Before analyzing the special regulation about the banking crises, there are some considerations about bank failure to point out. Most of the empirical studies about banking failures define the failure when a financial institution either has received external support or was directly closed²². In general, after a banking crisis, the majority of banks are in a situation of financial distress and they are forced to declare bankruptcy. Mainly, as a result of a declaration of bank failure, there are two alternatives: liquidation of the bank and closure of its activity or recapitalization of the bank through external aid. In the recent years, many banks, especially the banks that are considered “Too big to fail”, were saved thanks to external aid and this mechanism is called bail out. The bail out solution consists in the use of monetary liquidity belonging to the state or to the central banks in order to finance and avoid the bankruptcy of many banks and credit institutions in financial distress. This mechanism has certainly saved many banks but its cost is very high. Indeed, it is sufficient to say that, between 2008 and 2014, the governments spent about € 800 billion²³ that represent the 8% of the GDP of the European Union. Moreover, this solution to the problem of banking crises creates, in turn, the problem of moral hazard. In this case, the moral hazard is referred to the bank willingness to take risk situations with the presumption of being helped by the government or by the central bank as a lender of last resort. The bail out solution is applied in Europe, at the discretion to the government of each state, in order to save banks after crises. This solution is referred to the period preceding the birth of European Banking Union and afterwards, we will see the different approach and solution to banking crises in light of European Banking Union. The bail out tool and alternatively the liquidation procedure are used, generally,

²¹ «The ability to transmute deposit into loan and investment». The source of this expression is GARDENER T., 2013, Why banks are special, Chartered Banker, The voice of financial professionalism.

²² For the definition of failure see ARENA M., July 2003, Bank fundamentals, Bank failures and market discipline: an empirical analysis for Latin America and East Asia during the nineties, Bank of Canada Working Paper 2005-19, page 10.

²³ Information provided by “Il Sole 24 ore” edition of February 13, 2016, page 4.

in Europe for the management of banking crises and bank failures, but now the focus is on bank failures and banking crises regulation in Italy.

The Italian legislation about failure is very complete and specific because distinguishes procedures for companies and banks. In that way, it is possible to make a distinction between the discipline of company failure and the special discipline of bank failure. The distinction between company failure and bank failure is clear because the two different subjects are disciplined by two different regulations. As a matter of fact, the company failure is regulated by the Italian Bankruptcy Law based on the Royal Decree No.267/1942 of 16 March 1942²⁴ (updated version of 2016) and the bank failure by the “Testo Unico Bancario” called hereinafter “TUB” based on the Royal Decree No.385/1993 of 1 September 1993²⁵ (updated version of 2010). According to the Italian Legislation, the failure procedure is specific for company failures and other special procedures are applied to bank failures. In Italy, as in Europe, exists the possibility to save banks through the mechanism of bail out or there is the alternative of liquidation that in Italy assumes particular features and it is called compulsory administrative liquidation. In addition to the compulsory administrative liquidation, the TUB provide another specific insolvency procedure for banks called extraordinary administration.

Now the attention is focused on the two best practices for the management of banking crises:

- Extraordinary administration

The extraordinary administration is a useful tool to restore banks from crises. The functioning and the regulation of this procedure are sufficiently dealt in the TUB (IV Title Articles 70-77)²⁶. According to the Article 70 of TUB, the Bank of Italy has the power to order the dissolution of the control authorities of banks, as board of directors and board of auditors, in

²⁴ The Italian Bankruptcy Law is based on the Royal Decree 267/1942 of 16 March 1942. Today this law is the results of reforms and it is available in the updated version of 2016. The content of the Italian bankruptcy law are insolvency proceedings as failure, agreement with creditors, extraordinary administration and compulsory administrative liquidation.

²⁵ TUB means “Testo Unico Bancario”. It is addressed to banking businesses and people involved in banking activities. It is composed by nine sections, following the subsequent order:

- TITLE I - Credit authorities
- TITLE II - Banks
- TITLE III - Supervision
- TITLE IV - Discipline Crisis
- TITLE V - Who is involved in the financial sector
- TITLE VI - Transparency of Conditions
- TITLE VII - Other controls
- TITLE VIII - Sanctions
- TITLE IX - Transitional and Final Provisions

It is available, in the updated version of 2016, on www.bancaditalia.it

²⁶ In the IV tile of TUB, the Articles from 70 to 77 are entirely dedicated to the subject of extraordinary administration. BANCA D’ITALIA, Testo Unico Bancario, Legislative Decree 385/1993, updated version Legislative Decree 72/2016.

some specific cases: serious legislative statutory or administrative irregularities in banking activity, heavy losses on assets and dissolution by a reasoned request of the extraordinary bodies. Concerning the procedure of extraordinary administration and the authorities responsible for it, the Article 71 of TUB provides that, through a decree, the Bank of Italy may dissolve the organs of a bank in the cases in which arise the conditions listed in the previous Article. The Bank of Italy appoints the authorities responsible for this procedure and at any time may revoke or replace them. The authorities that deal with extraordinary administration during the procedure are one or more special commissioners or a supervisory committee composed by three or five members. Then, the Article 72 of TUB specifies that these authorities have the function of examining the situation of the bank subject to this procedure, of removing irregularities and of proposing useful solutions. The special commissioners and the supervisory committee are required to prepare specific reports on their activity and to communicate the results to the Bank of Italy. In the end, is in the responsibility of the Bank of Italy the approval of the administration's closing balance sheet and the communication of the closure of the special administration period of the bank. The procedure generally concludes with the recovery of the economic situation and with the return to the bank of its authorities. Usually the extraordinary management of the bank has a term of one year, but sometimes, at the discretion of the Bank of Italy, can be anticipated or extended for a period not exceeding six months. Furthermore, a particular situation is proposed in the Article 76 of TUB. The content of this Article concerns a situation, called provisional management, in which there are the conditions of extraordinary administration, but there are also reasons of extreme urgency. In this particular case, the Bank of Italy proposes the suspension of the control authorities of the bank and not the dismissal as in the extraordinary administration. The maximum term of this procedure is two months. Finally, in the Articles 78 and 79 of TUB, it is expected the closure of bank branches if there are the extraordinary administration requirements.

- Compulsory administrative liquidation

Before talking about the application of compulsory administrative liquidation, another type of insolvency proceedings, it is necessary to make some clarifications. First of all, it can be useful to compare this procedure with the others in order to understand similarities and differences. This procedure, indeed, is considered to be similar to the institution of failure but at the same time it differs in some aspects. The first difference regards the subjects to which this procedure is applied. Indeed, this procedure can be applied to companies, as an alternative to failure, and then is applied to banks, the subject of the analysis, as a specific procedure. In particular, in the case of the companies, the similarities between these procedures regard the

fact that they have the same liquidation purpose and for this reason, the use of one precludes the use of the other. Then, they differ from each other also in the authority that manages them and in the conditions on which they are based. Instead, the difference between the compulsory administrative liquidation and the extraordinary administration, considering both applicable to banks, concerns the nature and the purpose of the procedures. Indeed, the compulsory administrative liquidation has a liquidating purpose, which leads to the extinction of the institution, and the extraordinary administration has a conservative purpose, which consists in the restoration of the bank's estate. Another difference exists between the compulsory administrative liquidation and the voluntary liquidation of banks. The voluntary liquidation is a particular liquidation procedure applied to banks and regulated in the Article 97 of TUB²⁷ and consists in the liquidation of the banking activities in order to pay the liabilities. The authority responsible for it is the Bank of Italy that has the duty to approve and oversee the correct execution of this procedure. This procedure can be transformed in compulsory administrative liquidation if there are the conditions to apply it. Despite the initial conditions and the precise process of execution the most relevant difference between this type of liquidation is the fact that in the compulsory administrative liquidation is defended the public interest connected to the businesses to which this procedure is applied and in the voluntary liquidation is defended the interest of creditors.

Now can be examined in detail the conditions, the stages and the effects of compulsory administrative liquidation. This procedure regard the management of all enterprises under public control and in particular, in our case, of banks. The Articles 80-95 of TUB²⁸ regulate its execution and indicate the conditions for the application of procedure. The conditions are similar to the conditions of extraordinary administration but they are characterized by an exceptional seriousness. In particular, the reason that represents the objective condition for the application of the procedure, regulated by the Article 82 of TUB and the bankruptcy law, is the assessment of the state of insolvency. The protagonists of the procedure are the liquidator commissioners, the supervisory committee and the Bank of Italy. The Bank of Italy and the Minister of Economy initiate the procedure after the selection of liquidators and supervisory committee. After being aware of the documentation and accounting records of the bank, the liquidators communicate to the creditors the amount that they should receive. This stage of the procedure is called assessment of liabilities and it takes place one month after the

²⁷ The Article 97 of the IV title of TUB explains the voluntary liquidation. BANCA D'ITALIA, Testo Unico Bancario, Legislative Decree 385/1993, updated version Legislative Decree 72/2016.

²⁸ In the IV title of TUB, the Articles from 80 to 95 are entirely dedicated to compulsory administrative liquidation. BANCA D'ITALIA, Testo Unico Bancario, Legislative Decree 385/1993, updated version Legislative Decree 72/2016.

appointment of the liquidators. If the creditors do not received the amount, they are required to notify within 60 days after the procedure. Instead, if after the communication of the liquidators they want to make some complaints, the creditors are required to notify within 15 days after the communication received. Then, after 90 days, the state of liabilities must be prepared and delivered to the Bank of Italy and to the law court. Only when the state of liabilities is published on Gazzetta Ufficiale della Repubblica Italiana²⁹ it is considered approved and the creditor excluded from the procedure has the possibility of recourse within 15 days after the publication. If there are not complaints, the liquidators can proceed the liquidation of assets between creditors. According to the supervisory committee and the Bank of Italy, the liquidators can sell assets and liabilities, business units, legal relationships and the entire company. The procedure results completed and the liquidators prepare a budget and a final report on the entire procedure. As discussed at the beginning of paragraph, the failure and the compulsory administrative liquidation are very similar because they share the same purpose and the same stages of the procedures. Despite this, the discipline of failure required by the bankruptcy law is not applicable to banks and the compulsory administrative liquidation results the most specific and used procedure to resolve banking distress.

In this part of the chapter, the focus of the analysis is on the solution of banking crises before the creation of the European Banking Union and in particular on the functioning of the two special procedures applied to bank failures and banks in financial distress after a banking crisis. In general, it can be said that the two insolvency proceedings, explained above, work well but they have limits. The first limit consists in the fact that both procedures are implemented only if exist the specific conditions set by the TUB in their respective Articles. Furthermore, we can say that these procedures are applied to banks only if they are in a declared state of insolvency. In addition, another limit of the extraordinary administration and of the compulsory administrative liquidation, regards their implementation to an advanced state of banking crisis. Another weakness of these procedure concerns the length of time, sometimes too long, of their application.

For all these reason, there is the necessity to introduce new rules on banking crises and this happens with the institution of the European Banking Union and through the transposition of the Bank Recovery and Resolution Directive, called hereinafter “BRRD Directive”³⁰. The introduction of new rules on banking crises is necessary to unify and order the European rules

²⁹ Gazzetta Ufficiale della Repubblica Italiana is a collection of the Italian rules. It is available on the website www.gazzettaufficiale.it

³⁰ «BRRD» is the acronym for «Bank Recovery and Resolution Directive». It is the Directive 2014/59/EU of 15 May 2014. It establishes a recovery and resolution framework for EU credit institutions and investment firms.

about the management of banking crises. The most important news regard the introduction of the resolution procedure³¹ alternatively to the liquidation procedures. The liquidation can still be applied but the precedence will be given to the resolution and its instruments. Thanks to the introduction of resolution, the limits of the previous procedures will be eliminated and especially there will be greater attention to the initial phase of the bank crisis. Indeed, the resolution will be applied from the start of the banking crisis and not only in the state of insolvency of credit institutions. In this way, there will be more prevention and the adverse effect of banking crises will be limited from the beginning.

In the next part, it will be analyze the changes in the management of banking crises through the implementation of the European Banking Union and the transposition of BRRD Directive. The analysis will be focused on the resolution, its purposes and its instruments.

³¹« Resolution occurs at the point when the authorities determine that a bank is failing or likely to fail, that there is no other private sector intervention that can restore the institution back to viability within a short timeframe and that normal insolvency proceedings would cause financial instability. 'Resolution' means the restructuring of a bank by a resolution authority, through the use of resolution tools, to ensure the continuity of its critical functions, preservation of financial stability and restoration of the viability of all or part of that institution, while the remaining parts are put into normal insolvency proceedings». This definition of resolution is available on the website of European Commission at the section EU Bank Recovery and Resolution Directive (BRRD): Frequently Asked Questions, April 2014.

1.3 European Banking Union: change in the management of banking crises.

1.3.1 From the financial crisis to the need of financial stability.

The cause of the financial crisis, started in the United States in 2007, is attributed to subprime mortgages. Subprime mortgages are loans required to banks from the mid-1990s in the United States by many people, especially families with low and uncertain income. As everybody know, now as it was then, it is necessary to provide a guarantee in order to obtain a mortgage. The guarantee can be a stable income or for example the ownership of a house. Clearly, the people with low and uncertain income were not able to offer a guarantee to banks for the subscription of a mortgage. Despite this fact, the banks released subprime mortgages to people without the certainty of being repaid by them. The reasons that drove the banks in granting subprime mortgages were, for examples, the housing bubble and the securitization. The housing bubble is favored by the increase of house prices and low interest rates, which led the families to spend more and to require mortgages. Due to these conditions, banks were encouraged to grant mortgages and in case of non-payment of the mortgages, they sold the house at a higher price of the mortgage. The other reason that led to the mortgage lending is the securitization. The securitization is a mechanism by which banks resold the subprime mortgages with the associated risk to other financial institutions. In this way a bank resulted free of risk and was able to sell other subprime mortgages to other institutions. In particular, in the case of non-payment by subjects who received mortgages, a bank can sold the house at a higher price obtaining a gain for itself and for the people who required mortgages. Then a bank had to remove the credit with the people to whom it had granted the mortgage. This was possible thanks to the institution of special purpose vehicles (SPV). The special purpose vehicles were societies by which the bank was freed from the credits connected to subprime mortgages in exchange for securities of the SPV. Then, in order to avoid losses and decrease risks, a bank sold the titles of the SPV in the financial market. These titles were the collateralized debt obligations (CDO). Their value depended on the value of subprime mortgages and they were considered safe securities because they are composed by many mortgages. Later, were created other titles called credit default swaps (CDS). The credit default swaps were contracts under which the holder of a credit agreed to pay a fixed periodic amount, in favor of the counterparty, which, in turn, assumed the credit risk in the event of the occurrence of a default event and uncertain future. The value of CDS depended on the value of CDO and on the value of subprime mortgages connected with them.

The CDO and CDS were classified by the rating agencies as safe titles but in reality, they were very risky titles. For the feature of security, many financial institutions bought them and this led to the diffusion of the risk in the world. Until now, the primary causes of the financial crisis in the United States are explained, but from this moment, will be analyzed the diffusion of the crisis in the world.

After some years, something went wrong and the mechanism of securitization stopped. This happened because there was an increase of interest rates, an increase of the house prices and subsequently a decrease of house prices. Substantially, the housing bubble burst. This situation led to insolvency of borrowers, to losses for both banks and special purpose vehicles and to the devaluation of the titles as CDO and CDS. The titles submitted by the special purpose vehicles were the vehicle of transmission of the crisis from United States to the world. The losses referred to the titles, connected in turn with subprime mortgages, led banks to reflect on the amount of losses due to the toxic titles. Due to these losses occurred a liquidity crisis. Indeed, banks in a liquidity crisis were unable to repay creditors and the special investment vehicles. Furthermore, they could not ask loans to other banks because there was a lack of trust among banks. The only possibility, that a bank had, to continue its activity is the sale of their bonds and the reduction of the credit destined to families and companies. Although this, many bank and credit institution failed. In particular, must be remembered the failure of Lehman Brothers in 2008. This crisis was not only financial but also economic because the contagion spread across the real economy. There were devastating financial and economic consequences and for this reason there was the need of a restored financial stability.

1.3.2 From the need of financial stability to the project of European Banking Union.

The financial and economic crisis of 2007, due to the bubble of subprime mortgages, spread quickly from US to Europe. This crisis led to insolvency situations of many European banks and credit institutions. Some of these institutions failed while others were saved by government interventions. Precisely, for this last reason, between 2009 and 2011, the countries of the Euro area faced a sovereign debt crisis. In particular, the sovereign debt crisis is considered a consequence of the vicious circle between state and banks. The existence of a vicious circle between banks and state derives from the close relationship between states and banks based on the help that they offer each other in case of financial difficulties or in case of banking crises. Then, as a result of sovereign debt crisis, many countries recorded financial imbalance and in the most vulnerable countries, significant reductions in the growth rate and contractions in gross

domestic product occurred. The cause of this situation can be attributed to the lack of clear rules about the management of banking crisis and about the role of responsibility in saving banks assigned to the states or to the central banks. Another significant reason is associated to a weak and uncoordinated banking supervision system entrusted to the national banks. The most frequent problem, derived exactly from this last reason, concerns the different decisions and behaviors applied by the governments or by the national banks of each country to solve banking crisis and other financial imbalances. All these facts, inevitably, give rise to effects as financial and economic difficulties, disintegration of the banking sector and fragmentation of the market. Therefore, thanks to the financial and sovereign debt crisis and to the resulting problems and weaknesses of the system, the project of European Banking Union takes shape.

The creation of European Banking Union represents the appropriate answer to the crisis and a useful instrument to prevent future crises. It represents also the need to restore and ensure the financial and economic stability and the European integration damaged by the financial crisis and by the existence of a vicious circle between banks and states. Furthermore, the European Banking Union constitutes and represents, after the Economic and Monetary Union (EMU)³², the more realistic project for the European integration. Indeed, the European Banking Union is meant as a unitary system with the aim of solving banking crises in a unified manner, of breaking the vicious circle between banks and states, of restoring financial stability and with the particular objective of promoting the integration between European countries. In the next paragraphs, it will be possible to understand better the European Banking Union through the analysis of its objectives, key elements and instruments.

1.3.3 European Banking Union: institution and objectives.

The aim of this paragraph is to analyze the steps and the reasons that leads to the European Banking Union through the definition of its structure and objectives. As previously discussed, the European Banking Union arises in a difficult context marked by the financial crisis. The primary objective of the European Banking Union is to restore the financial stability and the European integration.

In order to understand the need of an institution, as European Banking Union, and the need of integration it is necessary to step back. Indeed, the first step towards the European integration coincides with the period from 1990 to 1999, which corresponds to the institution of the

³² Economic and Monetary Union is a project of European integration. The stages of its implementation are available on www.ecb.europa.eu, www.bancaditalia.it and www.europarl.europa.eu.

Economic and Monetary Union (EMU). The creation of this institution is based on the decision of European Commission to promote the free movement of capitals and to establish a single authority and monetary policy for the Euro area. The objective of EMU is to create cohesion and convergence between the states that constitute it. Despite this fact, it can be said that the EMU has proved to be unable to realize completely its objectives. Indeed, imbalances and discrepancies were the results of the EMU. For this reason, due to the financial crisis and sovereign debt crisis, the European Commission realized the necessity to consolidate the relationships between the states of the Euro area and to solve the banking problems. In order to meet such requirements, the European Commission proposed the institution of a European Banking Union.

The concept of European Banking Union was presented for the first time by Barroso³³, the president of European Commission in that period, during a regular meeting of European Council on 23 May 2012. Then the European Council on 28 and 29 June 2012 determined with certainty the importance of implementing structural reforms in order to stabilize the financial, economic and banking situation. The most relevant reform concerning the European integration and the management of banking problems is the institution of the European Banking Union. The European integration and banking resolution, assigned to the European Banking Union, are not new objectives because there are objectives already proposed and unreached by other systems. In particular, the resolution and supervision of banking problems, before the institution of the European Banking Union, was in the responsibility of the European System of Financial Supervisors (ESFS)³⁴. This is a system of financial and banking supervision composed by three European Supervisory Authorities (ESAs)³⁵, the Economic Systemic Risk Board (ESRB)³⁶ and national authorities. The three ESAs, responsible for the micro-prudential supervision, are the European Banking Authority (EBA)³⁷, the European Securities and Markets Authority (ESMA)³⁸ and the European Insurance and Occupational Pensions Authority (EIOPA)³⁹. Instead,

³³ BARROSO J.M.D., July 2012, Speech by President Barroso at the European Parliament Plenary Debate on the European Council 28-29 June, Plenary session of the European Parliament/Strasbourg.

³⁴ The ESFS was created in 2009 after the crisis of 2007 in order to ensure the financial supervision in the EU. Its goal is to ensure micro and macro prudential supervision of the EU system.

³⁵ The three European Supervisory Authorities (ESAs) are: the European Banking Authority, the European Securities and Markets Authority and the European Insurance and Occupational Pension Authority.

³⁶ The Economic Systemic Risk Board was funded after the financial crisis in order to prevent the systemic risk. The ESRB entered into force thanks to the Regulation (EU) 1092/2010. More information is available on www.esrb.europa.eu.

³⁷ The European Bank Authority ensures effective and consistent micro-prudential supervision across the European banking sector. It was funded on 1 January 2011 as part of ESFS. More information is available on www.eba.europa.eu.

³⁸ The European Securities and Market Authority ensures effective and consistent micro-prudential supervision across the European banking sector. It was funded on 1 January 2011 as part of ESFS. More information is available on www.esma.europa.eu.

the ESRB is responsible for the macro-prudential supervision in the EU system and its goal is to identify and to prevent the systemic risk. Through the establishment of the European Banking Union, the ESFS system loses its central role of supervision because this role will be in the responsibility of the ECB and of the authorities of the Single Supervisory Mechanism. Then, regarding the European integration, it represents the primary objective of EMU but it results incomplete and for this reason assigned to the European Banking Union. Indeed, the institution of the European Banking Union constitutes the element that completes the project of the European Monetary Union. Despite these two main objectives, the European Banking Union has many others goals to achieve. In summary the goals to achieve are: financial stability; stable and unified banking sector; uniform rules on supervision and banking resolution; correct management of banking risks; breaking of the link between states and banks; stabilization of the internal market; integration between the states and final realization of the EMU. The project of Banking Union is broad, ambitious and not achievable in short time. It can be considered broad and ambitious because involves the countries of the Euro area and the Member States of EU in the achievement of the objectives mentioned above. Furthermore, it is also a complicated project because it is composed by different pillars developed gradually and with different implementation times. The pillars that belong to the European Banking Union are used for achieving the objectives and are substantially three: Single Supervisory Mechanism (SSM), Single Resolution Mechanism (SRM) and European Deposit Insurance Scheme (EDIS). Although the concept of Banking Union is outlined for the first time in 2012, the real application of its instrument, after the publication of the associated directive, starts later with the execution of the first pillars in 2014 and the others subsequently. The development and evolution of the European Banking Union are due to the solidity of its legal basis. Indeed, in order to manage and ensure the effectiveness of a system, sophisticated as the European Banking Union, it is necessary to lean on a unitary system of rules. The Single Rulebook⁴⁰ represents the regulatory framework on which the functioning of the European Banking Union is based and it has the scope to eliminate the differences in legislations between the states. The content of the Single Rulebook comprises legal acts that all the financial institutions of EU must respect. More specifically, the Single Rulebook includes measures concerning the minimum capital requirements for banks, protection of depositors and management of banking crises. Clearly, in

³⁹ The European Insurance and Occupational Pensions Authority contributes to the high-quality common regulatory and supervisory standard and practices. It was funded on 1 January 2011 as part of ESFS. More information is available on www.eiopa.europa.eu.

⁴⁰ «The term Single Rulebook was coined in 2009 by the European Council in order to refer to the aim of a unified regulatory framework for the EU financial sector that would complete the single market in financial services». This definition is available on the section “Regulation and policy” of the website www.eba.europa.eu

the Single Rulebook, there are many legal acts, but the most important acts regard the regulation of the issues mentioned above and related to the three pillars. For this reason, the legal bases of the European Banking Union contained in the Single Rulebook are:

- Directive 2013/36/EU (CDR IV)⁴¹ and Regulation 575/2013 (CRR)⁴² on minimal capital requirements: the directive CDR IV stabilizes the reserves of capital required to detain by each bank, the remunerations of bankers and the transparency of the banking activities. Instead, the Regulation CRR provides to each bank the minimal capital requirements to cover losses, liquidity requirements and containments of financial leverage
- Directive 2014/49/EU of 16 April 2014⁴³ on deposit guarantee schemes. The directive regards the institution of deposit guarantee in each state in order to protect and repay the depositor in case of banking failure. Thanks to these deposit schemes, it is possible to avoid the bank runs and preserve the financial stability.
- Directive BRRD 2014/59/EU of 15 May 2014⁴⁴ on management and resolution of banking crises. This directive offers to each bank rules and instruments in order to prevent and manage banking crises in an efficient way reducing its financial and economic impact. In particular, this directive will be the central argument of the second chapter because, thanks to it, we can analyze the difference in solving banking crises with respect to the methods used before the European Banking Union.
- Regulation 2014/806/EU of 15 July 2014⁴⁵ on resolution of banking crises. In particular this document provides the institution of a Single Resolution Funds to sustain the resolution procedures of credit institutions.

1.3.4 The first pillar of European Banking Union and the role of European Central Bank in banking supervision.

The Single Supervisory mechanism is the first pillar of the European Banking Union and represents the first significant step of its implementation. This pillar is very important because deals with the issue of supervision in banking sector. Hence, before analyzing the first pillar and its application, it is necessary to make a digression on banking supervision.

⁴¹ The full text of the Directive 2013/36/EU is available on the website www.eur-lex.europa.eu

⁴² The full text of the Regulation 575/2013 is available on the website www.eur-lex.europa.eu

⁴³ The full text of the Directive 2014/49/EU is available on the website www.eur-lex.europa.eu

⁴⁴ The full text of the Directive 2014/59/EU is available on the website www.eur-lex.europa.eu

⁴⁵ The full text of the Regulation 2014/806/EU is available on the website www.eur-lex.europa.eu .

In general, the banking supervision is defined as a preventive control on the banking system, exercised by competent authorities, in order to guarantee the stability and the efficiency in the system. The radical change in banking supervision, which marks the transition from multiple supervisors to only one, can be attributed to the birth of European Banking Union and to its first pillar of Single Supervisory Mechanism. Before looking at the functioning of this pillar, it is interesting to analyze the regulation and implementation of banking supervisory in the previous years.

After the crisis of 1929, the institution of the Basel Committee on banking supervision in 1974 represents an important step for the regulation of the banking supervisory at global level. Indeed, this Committee, composed by the central banks of the most industrialized countries of the world has the objective to regulate and ensure the financial stability. The main task of the Basel Committee is the definition of harmonized rules for the banking supervision with specific agreements. The first agreement, called Basel I, regards the soundness of the bank's assets and financial position with the introduction of the mandatory minimal capital requirement for all banks and with a particular focus on banking risks. Then, the Basel II, in order to complete the previous agreement, is focused on: the redefinition of minimum capital requirements in order to cover banking risks, the prudential control in order to verify capital adequacy and the market discipline in order to know with transparency the real conditions and banking risks. In the end, according with our analysis on banking supervision, the most interesting agreement is the Basel III. The reason that leads from Basel II to Basel III must be attributed to the financial crisis of 2007. The Basel III represents a set of unified rules on banking supervision with the clear objective to stabilize the financial and banking situation after the crisis. The set of rules regards protective measures for banks and credit institutions and regards more specific capital requirements, introduction of minimum liquidity requirements and introduction of a maximum level of leverage ratio. The measure introduced can be divided in micro prudential and macro prudential. The first order of measures regards the single financial distress of a bank. Then, the macro prudential measures involve all the banking system and the systemic crises that can affect it. The implementation of Basel III, due to its complexity, was not immediate. Indeed, in 2013 there was a partial implementation and only in 2019 the will be the entire implementation. The Basel III assumes importance in the explanation of the first pillar of European Banking Union because both these two agreements are contemporary and born in the same financial contest of the crisis of 2007. Although the Basel III is a global agreement, it constitutes a point of reference for the European Single Supervisory Mechanism. Now, after the explanation of Basel agreements, it is necessary to explain the objectives and the functioning of the Single Supervisory Mechanism. The Single Supervisory Mechanism is based on the Directive CRD IV

(2013/36/EU) and on the Regulation CRR (575/2013) but it is also governed by the Regulation 2013/1024/EU⁴⁶ and the Regulation 2014/468/EU⁴⁷. The main objectives of this mechanism, as a consequence of the economic and financial crisis of 2007, are the security and solidity of the European banking system, the European integration, the financial stability and a coherent supervision on the banks of the Euro area. In addition, also other banks outside the Euro area can be submitted to this mechanism if they decide to enter in it. This system is in operation from the beginning of December 2014 and contributes to change the management and the regulation on banking supervision. Indeed, it marks the transition of the responsibility on banking supervision from national supervision authorities to the European Central Bank (ECB). In this regard, there is a clarification to make: the European banks are controlled by the ECB not in the same way. This means that some banks are controlled in a direct way and others in an indirect way and now we explain the reason of this difference. The banks supervised by the direct control of the ECB are the more significant European banks. In general are considered more significant the banks with larger size and greater economic importance. The more significant banks are defined by the ECB and by the Single Supervisor Mechanism according to precise parameters:

SIZE	the total value of its assets exceeds € 30 billion
ECONOMIC IMPORTANCE	for the specific country or the EU economy as a whole
CROSS-BORDER ACTIVITIES	the total value of its assets exceeds € 5 billion and the ratio of its cross-border assets/liabilities in more than one other participating Member State to its total assets/liabilities is above 20%
DIRECT PUBLIC FINANCIAL ASSISTANCE	it has requested or received funding from the European Stability Mechanism or the European Financial Stability Facility

Table 1: Requirements of significant banks. Source: "What makes a bank significant?". Available at <https://www.bankingsupervision.europa.eu/banking/list/criteria/html/index.en.html>

Moreover, in order to define the more significant banks, the ECB uses an evaluation system called comprehensive assessment.

The comprehensive assessment is a detailed evaluation based on three complementary pillars: risk analysis, asset quality review and stress test. The risk analysis is both qualitative and quantitative with the objective to evaluate the vulnerability of the banks to the risk. Then, the assets quality review consists in the control of banking assets in order to ensure the capital

⁴⁶ Regulation 2013/1024/EU about the power of supervision assigned to European Central Bank. It is available on the website www.eur-lex.europa.eu

⁴⁷ Regulation 2014/468/EU about the cooperation between national authorities and European Central Bank in the Single Supervisory Mechanism framework. It is available on the website www.eur-lex.europa.eu

solidity in case of risks. In the end the stress test, based on asset quality review, are useful to verify the resiliency of banks to shocks through a simulation of a financial and economic worsening. The results of stress tests are fundamental to understand the solidity and the soundness of banks in order to decide the rules of supervision to apply. The stress tests identify the banks that must be subject to the direct supervision of the ECB. Since the stress tests are conducted periodically, the number of banks considered significant always changes. For example, after the stress tests conducted in 2014, the number of significant banks was one hundred and thirty. All the other banks considered less significant at the time of the stress test are subjected to indirect supervision of the ECB. This means that the national authorities in accordance with the rules of the ECB control them. However, it must remember that, each bank, after a stress test, can be significant and controlled directly by the ECB. Now, the focus is on the role of the ECB as single supervisor and its powers.

The powers, which only the ECB exercises, as single supervisor are: prudential evaluations, granting and revocation of banking licenses, purchase and sale of participations in credit institutions, respect of European rules and solid capital requirements in order to face risks. There are also particular situations as for example stress test, recovery plans and many others, in which both the ECB and national authorities exercise supervisory power. Then, there are activities, which are only of competence of national authorities such as the control on payment and the protection of consumers. The ECB in the EU has a crucial role not only for the activity of supervision, recently assigned, but also for its proper activity of monetary policy. For this reason, there were many hesitations in attributing also the role of supervision on banking sector to the ECB. Despite this fact, the ECB proves to be able to manage both the monetary and supervision functions. Indeed, the ECB in order to better exercise its function of supervision has adapted its body creating a particular Supervisory Board. This committee, supported by a Governing Council, plans and performs the functions of supervision of the ECB. A president, a vice president, four agents of the ECB and one agent for each national authority compose the Supervisory Board. In conclusion, only one year after, the Single Supervisory Mechanism has proved to be real, efficient and able to realize the harmonization of the European supervision as required by the European Banking Union.

1.3.5 The second and the third pillar of European Banking Union

The second pillar of the European Banking Union is the Single Resolution Mechanism and finds its legal basis on the European Regulation 2014/806/EU and on the BRRD Directive 2014/59/EU. This pillar regards the application of unified set of rules in order to ensure an

ordered management of banking crises in the Euro area. The principal objective of this mechanism are the stability of the banking sector, the elimination of the fragmentation of the internal financial market and the reduction of systemic banking crises and bank runs. About its structure, it is composed by the Single Resolution Board, the National Resolution Authorities and by the Single Resolution Fund. The Single Resolution Board, elected by the Council of European Union, is responsible of planning and decision about the resolution of all banks belonging to the European Union. Its decisional process consists in an executive assembly in which all decisions on resolution and on the use of the Single Resolution Fund are taken. Then, there are the National Resolution Authorities, which are responsible for the application of resolution procedure and collaborate with the Single Resolution Board. The third element of the Single Resolution Mechanism is the Single Resolution Fund, a special instrument used to solve the banking crises in extreme situations. The Single Resolution Fund is based on the European Regulation 2014/86/EU is used only in accordance with the rules provided by the BRRD Directive. This fund is used when there are no other solutions to solve banking crises or when the options used have not worked. As regards the resources from which the Single Resolution Fund is constituted, they are represented by the resources of the National Fund merged from 2016 in the Single Resolution Funds. More in detail, the Single Resolution Fund is composed by national compartments of the Member States that have signed an agreement in order to do this. According to the “Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund” of 2014, “The mutualisation the use of paid-in funds occurs in the following manner:

- During the first year of the transitional period, recourse shall be had to all the financial means available within the said compartments;
- During the second and third year of the transitional period, recourse shall be had to the 60 % and 40 % respectively of financial means available within the said compartments;
- During the subsequent years of the transitional period, the availability of the financial means in the compartments corresponding to these relevant Contracting Parties shall decrease annually by 6 ⅔ percentage points”⁴⁸.

Furthermore, in a period of eight years from 2016 to 2023, called transition period, the Single Resolution Fund should reach at least the target level of 1% of the covered deposits in the European Banking Union. The estimated amount to reach is about € 55 billion. In particular, the

⁴⁸ COUNCIL OF THE EUROPEAN UNION, May 2014, Agreement on the transfer and mutualisation of contributions to the Single Resolution Fund, page 24.

amount that each bank is required to deposit into the Single Resolution Fund depends on the dimension of the banks and it is comprised between € 1,000 and € 50,000.

At this point, it is interesting to explain the functioning of the Single Resolution Mechanism. The process starts when the ECB communicates to the Single Resolution Board the financial distress of a bank. At this point, the Single Resolution Board evaluates if there are the conditions of resolution or if the bank must be liquidated. If the conditions of resolution are present, the Single Resolution Board stabilizes the resolution program, which involves the use of resolution tools. The program becomes effective after 24 hours from the approval of the Single Resolution Board. During the subsequent 12 hours, the European Commission can approve or not the program. If the European Commission does not approve the program, the Single Resolution Board, in other 12 hours, has the power to object to the resolution of a credit institution and if there is the objection, the credit institution is subject to liquidation. The intermediary between the Single Resolution Board and the banks are the national authorities with resolution competences.

After the Single Supervisory Mechanism and the Single Resolution Mechanism, arose, in 2015, the European Deposit Incentive Scheme (EDIS), the third pillar of the European Banking Union. This pillar is cost neutral for the banking sector, weighted for the level of risk and it is based on the Deposit Scheme Guarantee (DGS)⁴⁹, provided by the Directive 2014/49/EU. The primary objective of is to create a single fund, financed by the banking contributions, in order to protect the depositors in case of financial distress and to avoid bank runs in insolvency situation. The EDIS will be entirely realized within 2024.

1.3.6 Final considerations about the project of European Banking Union.

The analysis of the fundamental pillars of European Banking Union is conducted and now it is time to make some reflections. The European Banking Union is considered an ambitious project with the purpose of financial stability and European integration. The implementation of the European Banking Union is not easy and for this reason, some points of the pillars and especially the last pillar are waiting to be applied. This project represents also an important change in the banking sector and in the European system and for this reason is characterized by some critical points. The first critical point regards the correctness of attributing to the ECB the role of single supervisory. In particular the doubt arises from the fact that the ECB also control the monetary policy and this can lead to conflicts of interests. Moreover, a critical point regards the list of

⁴⁹ The Deposit Scheme Guarantee is a system created in each state member in order to refund the depositors if their bank is in a financial distress. Information about DGS is available on www.consilium.europa.eu

subjects of supervision assigned to the ECB, to the national authorities or to both. Another critical point regards the distinction between the activity of supervision and the activity of resolution. Furthermore, there is not a clear distinction between the authorities designed for the supervision and the authorities responsible of resolution. Indeed, just think that the ECB has a role of greater importance in both functions. These are only some evident critical points but clearly there are many others in a complicated and board organization as the European Banking Union. The way for the implementation and correct operation of the European Banking Union is long and difficult and only the sharing of common objectives can lead over time to great results. The wish is that the desire of European integration delates the political and institutional conflicts in order to create an effective and solid European Banking Union. The European Banking Union is subject to many changes but its evolution is not the core of this paper. In the view of our analysis of banking crises and resolution tools, the European Banking Union represents only the background.

CHAPTER TWO

The new regime of banking crises management: the resolution and the key tool of bail in.

2.1 The institutional and legal framework of resolution: the Bank Recovery and Resolution Directive (BRRD).

2.1.1 The highlights of the BRRD Directive.

This first paragraph is an introduction to the resolution, the new European regime of banking crises management. Before going into the details of the resolution mechanism, it is useful to analyze the reasons that led to this new regime and the context in which the resolution procedure developed.

As previously discussed, the consequences of the economic and financial crisis of 2007 were severe and the financial stability of the European countries was compromised. Exactly for this reason, in the European countries, the need of financial stability, economic balance, harmonization of rules and European integration merged in the creation of the European Banking Union. According to these needs, the banking union architecture was organized in some fundamental pillars.

The first step to meet these needs is represented by the Single Supervisory Mechanism, the first pillar of the European Banking Union. The institution of a single supervisor and the creation of a solid supervisory mechanism are essential elements for the achievement of the European objectives.

Nevertheless, to complete the project of European integration, must be introduced a procedure to solve the banking crises in a unified manner. Indeed, in 2013, the European Commission

proposed the creation of a Single Resolution Mechanism⁵⁰, in order to complete the Single Supervisory Mechanism and to ensure uniform rules in management of banking crises.

Thus, new European rules about the resolution of banking crises were introduced in order to reduce the negative effect of banking crises on the economic and financial system. The new set of rules has two main objectives: the introduction of new tools, common to all European countries, for the orderly management of banking crises and the limitation of state intervention in financing troubled banks. Subsequently, the European Parliament adopted and applied the Single Resolution Mechanism to the countries belonging to the European Banking Union and to the countries submitted to the Single Supervisory Mechanism. The functioning of the Single Resolution Mechanism and the implementation of the resolution procedure are based on the European Directive 2014/59/EU called hereinafter “BRRD Directive”⁵¹. This Directive, after the events of the crisis of 2007, represents the turning point in the management of banking crises. Indeed, the BRRD Directive establishes a recovery and resolution framework for credit institutions and investment firms. As we previously analyzed, this Directive was introduced to harmonize rules on banking crisis since the European countries have proved to be free of measures and uniform laws on this subject. The BRRD Directive entered into force on 1 January 2015 except for rules about bail in, a tool of resolution, which entered into force on 1 January 2016.

Now, it is time to find out the key points of the BRRD Directive. This European Directive is broad and structured in different important points. After some introductory notes about the European context and a brief analysis of the underlying reasons for this change in the management of banking crises, the Directive enters into the heart of its arguments. The most important innovations, proposed and introduced thanks to the BRRD Directive, regard the aspect of the prevention of banking crises, the need for early interventions and finally the mechanism of resolution to save banks when the crisis is in an advanced state. In this context, the argument of prevention of banking crises and resolution of banks, is referred respectively to recovery plans and to instruments to save banks in efficient way. Hence, recovery plans and resolution’s tools, concepts already mentioned in the name of this Directive, represent the central topic of the European Directive and at this point of the analysis, it is necessary to understand what they are and how they are explained in the BRRD Directive.

⁵⁰ EUROPEAN COMMISSION, July 2013, Proposal for a REGULATION OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Bank Resolution Fund and amending Regulation (EU) No 1093/2010 of the European Parliament and of the Council. The full document is available on the website www.eur-lex.europa.eu

⁵¹ The full text of the BRRD Directive is available on the website www.eur-lex.europa.eu .

In particular, the Articles 5 and 6, belonging to the second section of the Title II of BRRD Directive, provide the definition and the assessment of recovery plans.

According to the Article 5 of Title II of BRRD Directive, the Member States ensure that: “Each institution draws up and maintains a recovery plan providing for measures to be taken by the institution to restore its financial position following a significant deterioration of its financial situation”⁵².

Instead, the valuation of the appropriateness of recovery plans, according to the Article 6 of Title II of BRRD Directive, is carried out by competent authorities through the analysis of “The institution’s capital and funding structure to the level of complexity of the organizational structure and the risk profile of the institution”⁵³. In particular, regarding the recovery plans, the European Banking Authority (EBA), established guidelines on possible scenarios of economic and financial distress that the recovery plans must be able to manage⁵⁴. In practice, the aim is to verify the adequacy of recovery plans in the event of the occurrence of a systemic event, a specific event or a combination of the two events. A systemic event can be a situation of macroeconomic recession or a severe lack of liquidity that involves the entire financial system and the real economy. Instead, the occurrence of a specific event is referred to an instability situation of a single credit institution. In some cases, a recovery plan must be able to provide coverage in the event of the occurrence of a combination of the two events explained above.

Then, according to the European Delegated Regulation 1075/2016⁵⁵, supplementary to the BRRD Directive, there is an additional specification of the contents and minimum requirements of recovery plans to take into account. Specifically, the section II (Articles 3-15) of this Regulation analyzes the content of recovery plans. The fundamental elements that compose a recovery plan are information about governance and people responsible for the preparation and updating of the recovery plan sections, strategic analysis of the business entity to which the plan is applied and description of recovery options.

Moreover, risk assessment, plan feasibility, assessment of business continuity and other preparatory measures are necessary elements for the application of the recovery plan. In

⁵² Article 5 “Recovery Plans”, Section 2 “Recovery Planning”, Title II, BRRD Directive 2014/59/EU.

⁵³ Article 6 “Assessment of recovery plans”, Section 2 “Recovery Planning”, Title II, BRRD Directive 2014/59/EU.

⁵⁴ EUROPEAN BANKING AUTHORITY, July 2014, Guidelines on the range of scenarios to be used in recovery plans. The full text is available on the website www.eba.europa.eu

⁵⁵ EUROPEAN COMMISSION, Commission Delegated Regulation (EU) 2016/1075 of 23 March 2016 supplementing Directive 2014/59/EU of the European Parliament and of the Council with regard to regulatory technical standards specifying the content of recovery plans, resolution plans and group resolution plans, the minimum criteria that the competent authority is to assess as regards recovery plans and group recovery plans, the conditions for group financial support, the requirements for independent valuers, the contractual recognition of write-down and conversion powers, the procedures and contents of notification requirements and of notice of suspension and the operational functioning of the resolution colleges. The full text is available on the website www.eur-lex.europa.eu

addition, the section III (Articles 16-21) deals with the valuation of recovery plans in order to verify if the plans are correct, clear, complete and in line with the requirements of the BRRD Directive. In the end, the final valuation of recovery plans is in the responsibility of resolution authorities in order to identify actions that may hinder, if necessary, the resolution procedure. In addition to the recovery plans, all banks, according to the BRRD Directive, are obliged to also prepare resolution plans in order to manage insolvency situations.

The BRRD Directive in the section II (Art 10-14) of the Title II disciplines the resolution plans. In particular, the Directive specifies that the resolution plans must be prepared during the ordinary life of a bank and annually updated considering the structural and organizational changes of a bank. In the resolution plans must be contained the actions to take and tools to use in a timely manner in the event of bank distress in order to ensure the fundamental banking activities.

The authorities who have the task of drawing up these plans are the resolution authority and the supervisory authority. Moreover, the BRRD Directive in Title III (Art 27-30) assigns, to the supervisory authorities, tools of early intervention in the event that the preventive measures are not sufficient. Through the early interventions, according to the Article 27 of BRRD Directive, it is possible to apply the measures provided in recovery plans or to substitute incompetent administrators. If the measures provided by the Article 27 are not enough, according to the Article 28 of the directive, the entire management can be removed and a temporary administrator is appointed. The functions of the temporary administrator are explained in the Article 29 of the section dedicated to early interventions. The temporary administrator is appointed by the supervisory authorities in order to substitute the management and to stabilize the financial conditions of a bank.

After talking about preventive measures and early interventions, it is time to introduce the resolution. The introduction of resolution procedure represents an important point in the management of banking crises. Before defining and explaining resolution and its tools, it is interesting to remember again the reasons that lead to its introduction and implementation. As previously discussed, the purpose of the procedure of resolution is the harmonization of the European rules on banking crises. Indeed, after the financial crisis of 2007, the European countries have proved to be unable to deal with a systemic crisis and to be free of a specific and efficient discipline about banking crises. Hence, the resolution procedure represents a unified solution to the problem because the resolution authorities apply it at European level. The reason that leads to this procedure is not only the need of a new and orderly management of banking crises but it is also the necessity to propose a valid tool as an alternative to the previous inefficient tools. Thus, this procedure is implemented as an alternative to the bank bail out in

order to reduce the use of public money. Indeed, as it will be seen later, thanks to the bail in tool, an important resolution's tool, the banking rescue from external becomes internal. Contrary to the bail out, in the case of bail in, shareholders, bondholders and depositors of the bank itself support the banking rescue. Moreover, this procedure is proposed as an alternative to the liquidation procedure. In particular, in Italy it is proposed as an alternative to the insolvency proceeding of compulsory administrative liquidation. Although the resolution represents the new procedure to be applied in banking crises, the liquidation can still be applied in order to manage the non-systemic banking crises.

Now, the analysis goes into detail of the procedure starting from its definition. The resolution is defined as the set of tools to be applied to banks in financial distress in order to ensure the continuity of the banking businesses. In the BRRD Directive, a huge scope is devoted to resolution and its tools.

Indeed, after recovery and resolution plans, a broad section (Title IV of BRRD Directive) is entirely dedicated to the objectives, general principles, requirements and tools of resolution. In this regard, the Article 31 belonging to the Title IV of the BRRD Directive lists the continuity of essential banking functions, the reduction of negative effects on financial stability, the customer protection and the safeguarding of public funds as the primary objectives of the resolution. Subsequently, the Article 32 of the BRRD Directive specifies when it is necessary to apply the resolution. In general, a bank is subject to resolution when exists, as an objective assumption, an effective condition or a potential risk of financial distress. More precisely a bank is considered to be in financial distress when occur situations in which the bank's liabilities exceed assets or situations in which the bank is not able to repay debts. Then, in the Article 34 is contained a list of general principles which govern the resolution. Among the principles, must be absolutely mentioned some principles: the principle according to which the weight loss must be supported by shareholders followed by creditors, the principle of equality between the creditors of the same class and the principle of no creditor worse off must. The last listed principle, stabilized by the Article 34 of BRRD Directive, states that no creditor receives from the resolution process less than he would receive by applying the previous insolvency proceedings. Going on with the analysis of BRRD Directive, there is a part of this directive entirely dedicated to resolution's tools. After a brief introduction and explanation of these tools in the Article 37, follows a series of Articles (Art 38-43) that explain tool by tool. In particular, the first resolution tool, analyzed in the Articles 38, is the sale of the business. It consists in the sale of a part of the business to a private buyer according to the procedural requirements specified in the Article 39. Another resolution tool, explained in the Article 40 is the bridge bank. The resolution authorities, in order to ensure the continuity of the essential banking functions, can transfer the actions, the rights, the

assets and the liabilities to the bridge bank with the ultimate aim of completing a sale at market conditions. More precisely, in the Article 41 are contained specific requirements for the good functioning of the bridge bank that the resolution authorities must respect. The analysis of the resolution's tools continues with the introduction, in the Article 42, of the assets separation tool. This tool regard the institution of a specific vehicle called bad bank. The aim of the bad bank is the sale of liabilities and of impaired assets that the resolution authorities have transferred from an entity in resolution or from the bridge bank to the bad bank.

The last tool, but probably the most important and the more discussed, is the tool of bail in. The resolution authorities, as specified in the Article 43 of the Directive, use this tool for the recapitalization of an entity or for the conversion into capital instrument of certain liabilities. The bail in is a very complex tool and for this reason in the BRRD Directive, there are many Articles entirely dedicated to its application, its functioning and its minimum requirements. Moreover, this tool represents the real change in the management of banking crises and therefore deserves a particular attention. For this reasons, the analysis about bail in and its implementation will be detailed in the following paragraphs.

Moreover, after the explanation of resolution tools and the entire section about bail in, the BRRD Directive focuses on the resolution powers. Before speaking about the resolution powers, it is necessary to make some clarifications about the resolution authorities. In the context of the Single Resolution Mechanism, the functions and the powers of resolution are entrusted to the Single Resolution Board (SRB) and to the National Resolution Authority (NRA). In particular, the SRB is a European board, which has the aim to make decisions about the resolution plans and the best actions in order to start and complete the procedure. Instead, the NRA is composed by the national resolution authority of each country and has complementary functions to those of the SRB. Indeed, in addition to the participation in SRB, trough national representatives, the national authorities of NRA are responsible for the concrete actuation of resolution's tools. For example, in the specific case of Italy, the Bank of Italy represents the resolution authority.

Hence, returning to the resolution powers, these are assigned to each national resolution authority. Among the resolution powers, assigned to the resolution authorities by the Article 63 of the BRRD Directive some general powers must be remembered. The most important powers that the resolution authorities exercise are the power to demand information in order to start the resolution procedure, the power to transfer titles issued by the entity in resolution and the power to yield to another entity the rights, the assets and the liabilities of the entity subject to resolution. In addition to these, which are just some of the powers held by the resolution authorities, there are other powers defined in the following articles of the directive in order to ensure a correct functioning and application of the resolution procedure.

Then, some article of the BRRD Directive are dedicated to the protection of shareholders and creditors since the application of the instrument of bail in provides their intervention to save the entity in distress. Summing up the content of this paragraph, the conclusion is that the BRRD Directive represents the guidelines for facing orderly and efficiently banking crises in the European countries. Despite the complexity of the BRRD Directive, in this analysis, the focus is mainly on the key points essential for the general understanding of the resolution procedure and the innovations related to it.

2.1.2 The transposition of the BRRD Directive in Italy.

At this point of the analysis, it is interesting to understand how the European Directive BRRD has been implemented in our country. In Italy, the BRRD Directive was implemented on 16 November 2015, the date of transposition of the two legislative decrees and the date of their publication in Gazzetta Ufficiale della Repubblica Italiana. The deadline for the transposition of the BRRD Directive has been fixed and notified to the European governments through the law of the European Delegation 114 of 9 July 2015⁵⁶. Hence, in Italy, compared to other European countries, the transposition of the BRRD Directive occurred late and after the European deadline fixed on 31 December 2014. For this reason, through a letter dated 28 May 2015, the European Commission has initiated the infringement procedure 2015/0066⁵⁷ against Italy due to the delay in transposing the BRRD Directive. In the end, the dispositions of the BRRD Directive have been applied since 1 January 2015 except for the provisions of bail in that have been applied since 1 January 2015. The two legislative decrees on which the transposition of the BRRD Directive is based are:

- **Legislative Decree No.180/2015⁵⁸**: this decree transposes the dispositions of the BRRD Directive about the resolution through its eight Titles:
 - Title I: General Provisions contain all the definitions necessary to understand the concept explained in the decree. Then, after the list of definition, it is also defined the scope of application of the present decree.
 - Title II: Authorities. This Title examines the role of the Bank of Italy as national resolution authority and the role of the Minister of Economy and Finance. The purpose of the Bank of Italy, following the approval of the Minister of Economy and Finance, is

⁵⁶ The full text is available on the website www.gazzettaufficiale.it

⁵⁷ SENATO DELLA REPUBBLICA, 2015, Attuazione della direttiva 2014/59/UE (Risoluzione crisi enti creditizi), Atto del Governo 209.

⁵⁸ The full text, published in Gazzetta Ufficiale n.267, is available on the website www.gazzettaufficiale.it

to apply a specific program of resolution to the entity in financial distress. Moreover, in order to manage the procedure of resolution, a specific unit for the resolution and crisis management was created inside the Bank of Italy. This unit exercises not only the resolution's powers but also the power of compulsory administrative liquidation.

- Title III: Preparatory Measures concern with individual or group resolution plans. Moreover, are also considered the conditions of resolvability of an entity.
 - Title IV: Resolution and other crisis management procedures regard the assumptions, the objectives and the principles for the application of resolution or other procedures. Then, follows a series of articles about the implementation of the resolution procedures and the functioning of bail in instrument. In the final part of the Title, the powers of resolution assigned to the resolution authorities are dealt.
 - Title V: Resolution Funds are set up at the Bank of Italy to meet the objectives of the resolution. Moreover, they are also explained the uses of resolution funds and the ordinary and the extraordinary contributions from which they are fed.
 - Title VI: Safeguarding and juridical protection regard the protection of the contractual agreement between the counterparts and the protection of the shareholders and the creditors involved in the bail in procedure.
 - Title VII: Administrative sanctions are applied to the entity or to the personnel of the entity when the rules are not respected. Then the Bank of Italy refers to the European Banking Authority the sanctions applied.
 - Title VIII: Final provisions are some clarifications about different issues as derogations, contents of resolution plans and entry into force of the decree.
- **Legislative Decree No.181/2015⁵⁹**: this decree is also called “Decreto Modifiche” because it modifies the Legislative Decree No.385/1993⁶⁰, which represents the “Testo Unico Bancario” (TUB) and the Legislative Decree No.58/1998⁶¹, which represent instead the “Testo Unico della Finanza” (TUF). As regards its structure, the Legislative Decree No.181/2015 is organized in the following way:
 - **Article 1**: the Article 1 of the present decree contains all the changes to the Legislative Decree No.385/1993. In particular, the changes made to the TUB are:
 - The introduction of resolution plans, early interventions and group financial support.
 - The extraordinary administration's alignment with the European regulation.

⁵⁹ The full text, published in Gazzetta Ufficiale n.267, is available on the website www.gazzettaufficiale.it

⁶⁰ The full text in the uploaded version of 2016 is available on the website www.bancaditalia.it

⁶¹ The full text is available on the website www.consob.it

- The adjustment of compulsory administrative liquidation to the new regulatory framework of BRRD.
- **Article 2:** the Article 2 of the present decree contains all the changes to the Legislative Decree No.58/1998. In particular, the changes made to the TUF regard:
 - The resolution of brokerage companies which in Italy are called “Società di intermediazione mobiliare” (SIM).
 - The introduction of administrative sanctions in case of resolution.
- **Article 3:** the Article 3 of the present decree regards its entry into force. Indeed the Article 3 specifies that:” This Legislative Decree shall enter into force on the day of its publication in the Gazzetta Ufficiale”⁶². Clearly, there are some exceptions for some articles.
- **Article 4:** the Article 4 of the present decree regards the financial provisions. This Article provides that: “The implementation of this decree does not have to derive new or increased burdens charged to public finance”⁶³.

In general, it is possible to say that the two Legislative Decrees respect and report exactly the provisions of the BRRD Directive except the cases⁶⁴ in which the Italian Legislative Decree No.181/2015 exceeds the provisions of the European Directive. An example of this situation regards the clause of the depositor preference. This clause is expressed in its original form in the Article 108 of BRRD Directive and it is repeated in its expanded form in the Italian Legislative Decree No.181/2015. According to this clause, the BRRD Directive stabilizes that there exist a preference for the credits of depositors in respect to the credits unsecured. More precisely, the principle of depositor preference provides that the deposits up to € 100,000, that are excluded from bail in, are privileged and also the deposits of physical persons and small businesses over the threshold of € 100,000 are considered quite safe by the Ministry of Economy and Finance. Clearly, this last category of credits boasts of a higher level of protection in respect of the ordinary credits without any types of guarantee. Instead, as regard the extended clause of depositor preference, the Italian Legislative Decree No.181/2015 adds to the clause other deposits. In particular, thanks to the extended depositor preference, in the pecking order of the deposits are also privileged the corporate deposits and the interbank deposits without guarantee respect to other unsecured credits. The introduction of the extended depositor preference has the

⁶² Article 3 “Entry into force” of the Legislative Decree 181/2015.

⁶³ Article 4 “Financial Provisions” of Legislative Decree 181/2015.

⁶⁴ The examples of situations in which the Italian Legislative Decree 181/2015 exceeds the rules provided by European Directive BRRD are: the depositor preference and the group of financial support. MAMONE M.G., DI FALCO C, L’attuazione della BRRD in Italia, in Riv. dir. banc., dirittobancario.it, 2015.

objective to ensure transparency in the pecking order of the bail in. Moreover, this clause establishes that the deposits are not subject to the bail in in the same way of non-guarantee banking claims. This extended version of the depositor preference should be proposed at European level in order to manage the instrument of bail in in the event that occurs the crisis of a cross-border group. The entry into force of this clause in our system is scheduled for 1 January 2019. Another case, in which the Italian Legislative Decree exceeds the provisions of the BRRD Directive, is the group of financial support. In this regard, the Italian Legislative Decree No.181/2015, states that the group of financial support agreements, once signed, are not subject to any kind of revocation.

The aim of this paragraph is a detailed analysis of the two Italian Legislative Decrees responsible for the introduction and the application of the European Directive BRRD in the Italian regulatory framework. In order to transpose effectively the BRRD Directive, it was necessary to issue, as previously discussed, two Legislative Decrees. The two Legislative Decrees, although they are different in content, they can be considered complementary to each other because they both dealt with the contents of the BRRD Directive. In particular, in the case of transposition of BRRD in Italy, it was necessary the introduction of the two Legislative Decree because they satisfy different functions. Indeed, the Legislative Decree No. 180/2015 brings the news of the Directive BRRD in the Italian context and the Legislative Decree No.181/2015 modifies the Italian TUB and TUF, in order to incorporate better the new regime of rules.

2.2 The detection of the conditions that trigger the resolution procedure through the analysis of the bank financial statements.

Until this moment, the analysis addressed in a superficial way the topic of the resolution. In other words, they were examined only the reasons that led to this new procedure, without going into the detail of its functioning. Now, before doing so, it is interesting as well as important to analyze the bank financial statements with the aim of identifying items and values that trigger the resolution procedure. The starting point of this type of investigation is the analysis of the bank financial statements.

2.2.1 Introductory notes on bank financial statements.

Before beginning the analysis of the bank financial statements, it is important to specify why this type of analysis is conducted. The reason lies in the fact that, through the study of the documents that make up the bank financial statements, it is possible to obtain information necessary to calculate some specific ratios that, in turn, are useful to understand the soundness of the banks and if there are the conditions that trigger the resolution procedure. At this point, it can be introduced the topic of bank financial statements. The banks, as the other companies, are required to submit the annual financial statement in order to allow the evaluation of their performances. Obviously, the bank financial statement is different from the company's financial statement. This difference is due to the fact that, in general, the financial statement of an entity reflects its specific activities. Hence, since the banks and the companies do not perform the same activities, it is normal to face two different financial statements. In addition, also among the bank financial statements may be differences depending on the specific type of activity that each bank performs. In general, it can be said that the bank financial statement presents particular features due to the bank's specialty. Before explaining the differences between banks and companies in the editing of financial statement, it can be useful to understand what these two types of financial statement have in common. So now, it is time to analyze the common principles for preparing the financial statements. Before the introduction of the principles on which the financial statements are based, it is necessary to recall what the bank financial statement is and what its functions are. The bank financial statement is substantially an accounting document that contains true and reliable information about the patrimonial, financial and economic situation of a bank. The utility of this document is to provide information on the bank's soundness to all subjects interested in its activities. To give an example, among the subjects interested in the performances

of the banks there are the shareholders, the depositors, the bank customers, the government, the tax authorities and other banks. At this point, it is fundamental to highlight the principles that the bank financial statement must observe in order to satisfy its function. The principles on which the editing of the financial statement are based are the same principles that constitute the basis for the editing of the company's financial statement. As regards the Italian legal system, the principle for the editing of the financial statement are contained in the Article 2423 of the Civil Code. Hence, according to this article, the two essential principles on which the financial statement must be based are the clarity and the true and accurate representation. The clarity represents one of the necessary elements that the administrator must follow during the preparation of the financial statement. In addition, this principle must be observed and applied in the evaluation of assets, liabilities and in the entire general structure of the document. Then, the true and accurate representation is referred to the need that the financial statement shows a situation very close to the reality. Clearly, a true and accurate representation also implies the ability of the administrators to respect the accounting and valuation rules established by law and to apply diligently the valuation techniques. The other accounting principles fixed by the Article 2423 bis of the Civil Code are:

- *Continuity*: the accounting evaluations must be conducted in the prospective of the continuity over time of the business.
- *Prudence*: the aspect of prudence regards the particular attention in the determination of the income.
- *Competence*: the concept of competence regards the attribution of the costs and of the revenues to the right accounting period.
- *Separation*: if in a financial statement item are aggregated elements of a different nature, there is the necessary to separate their evaluation.
- *Constancy*: the constancy is referred to the necessity to maintain over time the same criteria of evaluation in order to facilitate the comparison of the financial statement year to year.

Now, it is time to point out the differences between the financial statements of banks and the financial statement of companies. The substantial differences regard a specific reference legislation of the bank financial statement and its specific organizational structure. The banks financial statements, like all the banking discipline, are supported by a particular set of rules. The first important step in order to know the process of drawing up the banks financial statement in

Italy is represented by the Regulation of the European Community 1606/2002⁶⁵ thanks to which, starting from 2005, the entities belonging to the European Community are obliged to draw up the financial statement according to the IAS/IFRS international accounting standard. In particular, the Italian banks have transposed this rule through the Legislative Decree No.38/2005. Moreover, the Circular 262/2005⁶⁶, in the updated version of 2015, and other documents of the Bank of Italy state that the bank financial statements have to adopt the international accounting principles IAS/IFRS. The institution and the enactment of the international accounting standard were entrusted to the International Accounting Standard Board (IASB). The introduction of these standards is very interesting because bring news in the world of the international accounting. The principles innovations regard the comparability of the accounting data, the measurement of the data at fair value, new criteria of recognition and derecognition of accounting data and new accounting methods. As regards the set of rules on which the company's financial statement are based, it is possible to say that they are similar to the rules of banks financial statements because they are also based on IAS/IFRS international accounting standards but they are different in the sense that they are not regulated by a specific discipline like bank financial statements. In order to continue the analysis of the peculiarities but also of the differences between the bank financial statements and the company's financial statement, it is necessary to find out the structure of the bank financial statement. The Circular 262/2005 (updated version of 2013) of the Bank of Italy sets the parts that compose the financial statement of banks. Hence, a bank financial statement is composed by:

- **Balance Sheet:** this document is composed of items and sub items that represent the operative and accounting calculus of the financial statement. More precisely, the balance sheet reports the assets and the liabilities divided in an ordered scheme following precise liquidation criteria. The Circular of the Bank of Italy 262/2005 provides the scheme in opposite sections of the balance sheet. According to this scheme, the assets are on the left side and on the right side of the scheme, there are liabilities and the net equity. As regards the banking assets, they comprise all the active items of a bank listed for easiness of liquidation. In the balance sheet of the banks, unlike the balance sheet of companies, the most common assets are the financial assets and the credits. This happens because the banks respect to other companies perform activities of credit intermediation. Instead, the other companies mainly perform material and industrial activities and for this reason in their assets section of balance sheet there are

⁶⁵ EUROPEAN PARLIAMENT AND COUNCIL OF THE EUROPEAN UNION, July 2002, REGULATION (EC) No.1606/2002 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL on the application of international accounting standard. The full text is available on the website www.eur-lex.europa.eu

⁶⁶BANCA D'ITALIA, Dicembre 2005, Bilancio bancario: schemi e regole di compilazione. The full text is available in the updated version on the website www.bancaditalia.it

material and immaterial assets in line with their manufacturing activity. On the other side, there are the bank liabilities. These are funding sources listed following the criteria of collectability. Among the liabilities with a decreasing level of collectability must be mentioned debts to banks, debts to customers, outstanding securities, tax liabilities and so on. In the end, as the last item, there is the net equity, which represents the difference between the assets and the liabilities.

- **Income Statement:** this document summarizes the economic result of the accounting period considered. More precisely, in order to show this result, the income statement compares the costs and the revenues of the accounting period selected. The Circular of the Bank of Italy 262/2005 proposes the scheme of the income statement as well as the scheme of the balance sheet. According to this scheme, starting from the analysis of the revenues from which the operating costs are subtracted, the profit or the loss for the period is obtained. It is important to underline what the origin of the banking revenues is and what the banking costs are. First, the banking revenues derive from services offered to customer, securities trading and from the difference between active and passive interests. Instead, the banking costs are administrative expenses.
- **Notes to the financial statement:** this document is of great importance for the reading and the interpretation of the two previous accounting documents. Indeed, the purpose of the notes to the financial statement is to facilitate the understanding of the items reported in the balance sheet and in the income statement. In the particular case of the bank financial statement, the notes to the financial statement have another important and specific function. In the bank financial statement, unlike in the company's financial statement, there is a section that contains information about the credit quality. More in detail, this section is dedicated to the non-performing loans (NPL) divided into several subcategories. The analysis of the percentage of the non-performing loans on total loans represents, especially in recent years, an important and interesting measure of bank solidity. According to this measure, a bank is considered solid and sound if the percentage of non-performing loans is low. In the end, the notes to financial statement also contain information about the coefficients of capital adequacy and the coefficients of banking supervision.
- **Management Report:** in this document are contained comments and notes, expressed by the administrators of the bank, about the results achieved and problems encountered in operational and financial management. In particular, there are also information about the macroeconomic scenarios in which the banking strategies took place. In addition, this document integrate the notes to the financial statement with more conversational information about the items of balance sheet and income statement.

- **Changes in equity statement:** the aim of this document is to report the variations of the net equity. These variations underline the profits or the losses generated by the banking activities.
- **Cash flow statement:** this document is useful to analyze and calculate the financial flows during the accounting period.

The description of the documents belonging to the structure of the bank's financial statement is interesting in order to see the structural differences between the financial statement of banks and companies. At structural level, the company's financial statement and the bank financial statement are composed by the same documents but clearly, the items contained in each document are different because linked with the proper activity of the entity. For example, as regards the balance sheet of banks and the balance sheet of companies, the most important difference is the result of the accounting document. Indeed, for the banks, the result is represented by the total of the assets and for the companies is the turnover. Also in the income statement, there are considerable differences between the two financial statements. A significant difference regards the variations of the net equity caused, in the case of banks, by interests and financial activities and, in the case of companies by the volume of production. The long digression about the general elements and the structure of the bank financial statement is necessary in order to introduce the analysis of the performances of the banks.

2.2.2 Analysis of bank financial statements.

The analysis of bank financial statement is based on the reclassification of the balance sheet and on the reclassification of the income statement. The reclassification of these accounting documents is useful to evaluate the performances and the management of the banking activities. First, the reclassification of the balance sheet consists in the division of the assets and liabilities in particular categories. The assets but also the liabilities are divided in three categories:

Interest-bearing assets: loans to banks, loans to customers and participations.	Bearing liabilities: debts to banks, debts to customers, outstanding securities and financial liabilities.
Non-interest bearing assets: non-financial credits, cash and non-interest-bearing deposits.	Non-bearing liabilities: fiscal liabilities and provisions for liabilities and charges.
Non-financial assets: material assets, immaterial assets, fiscal assets and other assets.	Net equity: capital, reserves and profit or loss.

Table 2: The categories of assets and liabilities in the balance sheet reclassified.

Now, the focus shifts on the reclassification of the income statement. Before analyzing the reclassified items, it is important to underline the criterion according to which this occurs. The criterion consists in highlighting the different management areas that contributed to the creation of costs and revenues. The reclassification is proposed through the analysis of the income statement margins:

- **Interest margin**→ interest income - interest expenses. It is the result of the banking credit intermediation.
- **Intermediation margin**→ interest margin + net commissions ± income and expense. It can be interpreted as the total revenues of the banks.
- **Operating result**→ intermediation margin – operating costs. This result represent the revenues obtained by the banks thanks to their specific activities.
- **Income before taxes**→ operating result – adjustments to loans ± other income and expense.
- **Net income**→ income before taxes – taxes. The net income represents the earnings of the banks.

At this point, thanks to the reclassification of these two accounting documents, it is possible to identify some important financial ratios. The ratios obtained from the information contained in reclassified financial statements and they respond to different needs of analysis. Indeed, the ratios can be analyzed in order to acquire information about different aspects of the banking business. For example, if there is the need to evaluate the profitability of a bank, it is useful to consider the profitability ratios as *Return On Equity* (Net Income/Shareholder's equity), *Return On Investment* (Operating Income/Invested Capital), and *Return On Assets* (Net Income/Total Assets). If instead, the focus of the analysis is on the efficiency of the bank performances, the most interesting ratio to be analyzed is the *Cost Income*. More precisely, this index is calculated as the ratio between the operating costs and the intermediation margin and it represents a measure of the efficiency of operational management. After explaining the importance of the interpretation of financial statement information and the generic function of the ratios, it is time to go on with the analysis. The primary purpose of this analysis is the evaluation of bank solidity through specific indicators. Before going into detail of the parameters that show the bank solidity, it is necessary to make a clarification on bank solidity. Evaluating the solidity of a bank means evaluating if a bank is able to face, in general, financial difficulties or, in the worst cases, financial crisis. As discussed in the previous chapters, if a bank is not sufficiently solid, if a financial crisis occurs, in the majority of cases it collapses and definitively fails. Consequently, thanks to the new rules of banking crisis, if a bank is in a situation of financial difficulties, can be helped through the application of the resolution mechanism. Hence, the evaluation of bank solidity is fundamental in order to see, according to the conditions of the bank, if the resolution

mechanism triggers. The analysis of the indicators that show the necessity of the resolution mechanism will be detailed in the following paragraph.

2.2.3 Analysis of the parameters of bank solidity in the perspective of the application of the resolution procedure.

The starting point of this analysis is the elaboration of the information contained in the bank financial statement. Thanks to such information, it is possible to obtain specific parameters for the evaluation of bank solidity. The study on bank solidity assumes great importance in the new European regulatory framework about banking crises, in which the resolution mechanism is the main protagonist. Hence, the primary purpose of this paragraph is to provide the measures of bank solidity. Furthermore, it is important to understand how the National Resolution Authorities use these measures for their evaluations. The National Authorities responsible for the implementation of the resolution procedure, after the assessment of the general conditions in which the banks are, examine some technical parameters to see if there are the circumstances to apply the resolution. In particular, the conditions are provided by the values of the specific parameters. Concretely, the National Resolution Authorities evaluate the level of significance of each parameter. If the parameter meets the range of values in which it must be included, the parameter indicates that the bank is solid under the profile analyzed. If instead, the parameter is not included or is below the range of values, the bank is not solid and it becomes necessary to apply some resolution tools. Now, it is time to point out the parameters to which the National Resolution Authorities look to check the bank solidity. Before introducing the first parameter, which assesses the capital solidity of all the credit institutions, it can be useful to open a small parenthesis on bank capital. According to the requirements of the Basel Committee, before the introduction of Basel III, the bank capital can be divided in three components:

- Tier 1 Capital: it represents the basic capital or the core capital of each banks and it is composed by paid-up capital, reserves, undistributed earnings and a small percentage of hybrid instruments⁶⁷.
- Tier 2 Capital: it represents the supplementary capital and it is made up of undisclosed reserves, revaluation reserves, general provision, hybrid instruments and subordinated term debts.

⁶⁷ The hybrid instruments are borderline titles between equity and debts.

- Tier 3 Capital: it is composed by the capital instruments not included in the above categories as short-term subordinated debts.

Based on these definitions, the commonly accepted parameter to evaluate the bank capital solidity is the Core Tier 1 Ratio (Tier 1- hybrid instruments/Risk Weighted Assets%). More precisely, this ratio shows how many resources of basic capital, excluded the hybrid instruments, are necessary to carry out the lending activity and to face the related risks. Subsequently, thanks to the introduction of Basel III Agreement, a further subdivision of bank capital is proposed. This subdivision regards precisely the Tier 1 Capital. Indeed, according to the new standard, the Tier 1 Capital is composed by two distinct elements: Common Equity Tier 1 and Additional Tier 1 Capital⁶⁸. The Common Equity Tier 1 is the sum of the capital instruments of primary quality with the highest absorption capacity of the losses and on the other hand, the Additional Tier 1 Capital is the sum of new hybrid capital instruments with the feature of flexibility, perpetuity and increased loss absorption capacity⁶⁹. From these components, two new capital ratios are derived. The Common Equity Tier 1 Ratio takes the place of the Core Tier 1 Capital Ratio and represents the portion of the banking basic capital without considering the hybrid instruments that, in turn, are collected in Additional Tier 1 Capital and are taken into account in the Tier 1 Capital Ratio (Tier 1+ hybrid instruments/Risk Weighted Assets%). For this reason, the Common Equity Tier 1 Ratio represents the main indicator of primary quality of capital, which shows how many resources of primary capital quality are necessary to grant the lending activity and the associated risks. Hence, the best commonly accepted parameter to look at in order to assess the capital solidity of a bank is the *Common Equity Tier 1* (CET 1).

CET1 Ratio	→	Common Equity Tier 1/Risk Weighted Assets %
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Looking at the formula shown above, are noticed the two basic components of this ratio. The numerator of this ratio is only the capital of primary quality of each credit institutions. Instead, as regards the denominator, the Risk Weighted Assets (RWA) composes it. The RWA is the total amount of the assets weighted for risk. More precisely, to each asset is attributed a weighting coefficient which takes into account the level of risk of the assets and represents the percentage of assets covered directly by the bank capital. At this point, making the sum of the assets, multiplied by their weighting coefficient, the parameter of the Risk Weight Assets is obtained.

⁶⁸ BASEL COMMITTEE ON BANKING SUPERVISION, December 2010, Basel III: A global regulatory framework for more resilient banks and banking systems, Bank for International Settlement, pages 13-15.

⁶⁹ LO PO' L.A., I nuovi strumenti ibridi di capitale tra implicazioni regolamentari e questioni di diritto societario, in Riv. dir. banc., dirittobancario.it, 18, 2014.

Moreover, the RWA is important for the calculation of the capital that the banks are required to hold in order to satisfy the Basel capital requirements.

Now, returning to the CET 1, in synthesis it represents the percentage of risky assets covered by the bank basic capital. In particular, if the value of the CET 1 is higher, it means that a bank is able to face greater losses than a bank that shows a low value of CET 1. As regards the values assumed by the CET 1, it is important to specify that the European Central Bank, as single banking supervisor, sets the target values of this parameter. More specifically, the European Central Bank according to others European authorities ruled that the value of CET 1 for the all credit institutions of the Euro area must not be less than 8%. Clearly, this is only a general line, because the value of CET 1 varies not only according to the Member State in which the credit institution is located, but also varies from credit institution to credit institution. Indeed, the European Central Bank has the task to assign to each European credit institutions its specific CET 1. The mechanism through which the European Central Bank attribute the CET 1 to the credit institutions is the SREP test (Supervisory Review Evaluation Process). This type of test consists in the evaluation of the result reached by a bank about its ability to manage risks and its ability to meet capital requirements. In particular, the SREP test is based on the business model, the risk management, the capital risk and the liquidity risk of a bank. The European banks are subjected annually to the SREP test. After the test, each bank receives specific and individual guidelines to follow during the year. Among the guidelines, the banks also receive the annually target value of CET 1 to reach. In the case of Italian banks, the European Central Bank has determined that the target value of CET 1 must not be less than 10, 5%. The CET 1 represents the most common solidity indicator used by the banks but alone it is not enough. Therefore, it is time to introduce another useful parameter in order to evaluate the capital solidity.

Total Capital Ratio	→	Tier 1+ Tier 2/Risk Weighted Assets
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The Total Capital Ratio⁷⁰ is another parameter that shows the bank capital solidity. The Tier Capital 1, which represents the basic capital of each banks, plus the Tier Capital 2, which stands for the supplementary bank capital, give the numerator of this ratio. The denominator, as in the CET 1, is represented by the Risk Weighted Assets. Hence, the Total Capital Ratio is the percentage that express the ratio between the total capital and the assets weighted for the risk.

⁷⁰ BASEL COMMITTEE ON BANKING SUPERVISION, June 2010, Basel III: A global regulatory framework for more resilient banks and banking systems, Bank for International Settlements.

According to the European standards, the value of the Total Capital Ratio must be greater or equal to 10%.

Another parameter that must be considered, jointly to the two previous, is the Leverage Ratio.

Leverage Ratio	→	Capital Measure/Exposure Measure %
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Before speaking about the Leverage Ratio following the disposal of the Basel Committee⁷¹, it is necessary to say something about the general concept of financial leverage. The financial leverage is the ratio between the basic capital of a bank and the total amount of its assets. The principal problem, connected to the financial leverage, is the so called “leverage effect”. Indeed, the problem arises when the value of the bank’s assets exceeds the value of the basic capital. This means that the level of the banking debts is too high and the basic capital is unable to repay it. If this happens, the bank must face a serious risk of insolvency. Hence, the Basel III agreement introduced the Leverage Ratio not only to reduce the bank indebtedness but also to integrate the previous capital requirements indicators. The introduction of this ratio, according to the Basel Committee, represents an indicator of the bank adequacy to meet its long-term financial obligations and a way to contain the financial leverage. The reduction of the financial leverage is particularly important because, during the financial crisis, it has reached an excessive level and so has proved to be one of the principal cause of the crisis. Moreover, the Leverage Ratio also represents a way, non risk-based, in order to improve the system of capital requirements. The formula proposed above shows the way by which measure the Leverage Ratio. The numerator is the Capital Measure, which in reality is nothing more than the Tier 1 Capital. As regards, instead, the denominator, the Exposure Measure represents it. Different types of exposures as on-balance sheet exposures, derivative exposures, securities financing transaction exposures and off-balance sheet items contribute to the composition of the bank’s total exposure. According to the general dispositions of the Basel III Agreement, the minimum threshold of the Leverage Ratio is set at 3%. However, the Basel Committee will continue to monitor constantly in order to check if the threshold of the Leverage Ratio is correct for each banking business model. In particular, the European Banking Authority recommended to all European banks to introduce the 3% Leverage Ratio in order to lead more stable their institutions and to reduce the risk of taking much debt. In some cases, according to the different business model or to the general conditions of each bank, the Leverage Ratio may be higher than the

⁷¹ BASEL COMMITTEE ON BANKING SUPERVISION, January 2014, Basel III leverage ratio framework and disclosure requirements, Bank for International Settlements.

proposed threshold and if it happens this means that, the level of liabilities covered by capital is low. In the end, regarding the banks and the others credit institutions, they will be required to communicate their Leverage Ratio. This requirement of disclosure of the Leverage Ratio took effect from January 2015 thanks to the entry into force of the European Regulation CRR No.575 of 2013⁷², called hereinafter “Regulation CRR”. Moreover, the imposition of the requirement of financial leverage will be applicable from 2018, if the European Parliament and the European Commission reach an agreement on this topic.

Another important aspect in order to assess the reliability of a bank is the liquidity. As discussed in the previous chapter, a correct management of banking liquidity is an essential element for the functioning of the banking business. The necessity of the liquidity analysis became apparent especially after the difficulties faced by the banking system during the financial crisis of 2007. Indeed, the banks faced frequent bank runs and sales of assets at very low prices because in that period there was a need of immediate liquidity. For this reason, the Basel Committee in order to ensure the financial stability of the banking system published in 2008 a document about the principles of liquidity⁷³ and fixed two parameters for the banking liquidity evaluation. The first liquidity parameter is the Liquidity Coverage Ratio (LCR)⁷⁴.

$$\text{LCR: Stock of HQLA/ Total net cash outflows over the next 30 calendar days \%}$$

Through this parameter, the Basel Committee aims to enhance the bank resiliency about the short-term liquidity. More in detail, the LCR represents the necessity of the presence of high quality liquid assets in order to meet the obligation in a stressed scenario of 30 calendar days. Essentially, this is what the formula represents, in summary form, through the numerator and the denominator. At this point, it is necessary to make some clarification about the numerator and the denominator. The numerator is composed by the stock of High Quality Liquid Assets (HQLA). The stock of HQLA, according to Basel III, stands for assets that should be liquid in market during a time of stress. Then, in order to be considered liquid assets of high quality, they must have specific characteristics.

Moreover, the Basel III classifies the characteristics of liquid assets in two categories, as shown in the table below:

⁷² The full text is available on the website www.eu-lex.europa.eu
⁷³ BASEL COMMITTEE ON BANKING SUPERVISION, September 2008, Principles for Sound Liquidity Risk Management and Supervision, Bank for International Settlements.
⁷⁴BASEL COMMITTEE ON BANKING SUPERVISION, January 2013, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, Bank for International Settlements.

Fundamental characteristics	Market-related characteristics
Low Risk	Active markets
Ease and certainty of valuation	Sizable markets
Low correlation with risky assets	Low volatility
Listed on a developed and recognized exchange	Flight to quality

Table :3 Characteristics of liquid assets. Source: www.bis.org

As regards instead the denominator, it is the total net cash outflows defined by the Basel III as: “The total expected cash outflows minus total expected cash inflows in the specified stress scenario for the subsequent 30 calendar days”⁷⁵. In particular, the total of cash inflows is the 75% of the expected cash outflows. The official form of the parameter was introduced in 2013 and the LCR entered into force in 2015. Moreover, in order to check the reference values assumed by this parameter, it is necessary to examine the Article 460 of the⁷⁶. According to the transitory disposition of the Regulation CRR, the thresholds are so fixed: 60% of LCR from 2015, 70% of LCR from 2016, 80% of LCR from 2017, 100% of LCR from 2018. In addition, according to the Article 412 of Regulation CRR⁷⁷, the maximum threshold reachable is at and no more than 100%.

Now, the attention is shifted to the second liquidity indicator introduced by Basel III.

NSFR: Available amount of stable funding/ Required amount of stable funding %

The acronym NSFR stands for Net Stable Funding Ratio⁷⁸. This indicator shares with the Liquidity Coverage Ratio the objective of making the banking sector more resilient. However, in the specific case of NSFR, the strengthening of the banking resilience is tested in a stress period of one year. Indeed, the role of NSFR is to keep in balance the assets and the liabilities of the financial statement in the time span of one year. The first component of this ratio, placed at the numerator is the available amount of stable funding. This amount represents the portion of

⁷⁵ BASEL COMMITTEE ON BANKING SUPERVISION, January 2013, Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools, Bank for International Settlements.

⁷⁶ Article 460 “Liquidity”, Section 9, Title III “Eligibility requirements for special use of tools or methodologies” of Regulation CRR 2013/575/EU.

⁷⁷ Article 412 “Requirements on the liquidity coverage”, Section 6, Title I “Definition and Requirements on the liquidity coverage ratio” of Regulation CRR 2013/575/EU.

⁷⁸ BASEL COMMITTEE ON BANKING SUPERVISION, October 2014, Basel III: the net stable funding ratio, Bank for International Settlements.

capital and liabilities considered reliable during a period of one year. The calculation of the amount of stable funding is given by the sum of each element of this category multiplied by its ASF (Available Stable Funding) factor. Instead, as regards the denominator, it is represented by the required amount of stable funding. This amount is measured taking into account the liquidity risk profile of assets and the off-balance sheet exposures of an institution. The required amount of stable funding is calculated as the sum of each assets or off-balance sheet exposures multiplied by their specific RSF (Required Stable Funding) factor. In the tables below are shown respectively the elements of the available amount of stable funding with their ASF factors and the elements of the required amount of stable funding with their RSF factors.

ASF factor %	Components of available amount of stable funding
100%	Total Capital (Tier 1 Capital + Tier 2 Capital). Other preferred shares and capital instruments with maturity of one or more than one year. Other liabilities with maturity of one or more than one year.
85%	Stable non-maturity deposits and term deposits with residual maturity of less than one year.
70%	Less stable non-maturity deposits and term deposits with residual maturity of less than one year.
50%	Operational deposits and unsecured wholesale funding with maturity less than one year
0%	Other liabilities not included in above categories.

Table 4: Composition of the numerator of the NSFR. Source: Basel III: the net stable funding ratio available on the website www.bis.org

RSF factor%	Components of requires amount of stable funding
0%	Coins, banknotes, and all central bank reserves.
0%	Securities with maturity less than one year.
0%	Non renewable loans to financial with maturity less than one year.
5%	Marketable securities with maturity more than one year.
10%	Committed credits and liquidity facilities.
20%	Covered bonds with rating AA and maturity more than one year.
50%	Loans to banks with residual maturities six months or more and less than one year. HQLA for a period of six months or more and less than one year.
85%	Retail loans with maturity less than one year.
100%	All other assets not included in the above categories.

Table 5: Composition of the numerator of the NSFR. Source: Basel III: the net stable funding ratio available on the website www.bis.org

In conclusion, despite the specific and complete directive of Basel Committee about the implementation of this indicator, the entry into force of NRSF is scheduled for 2018 and its reference value is fixed at 100%.

At this point, the analysis of the indicators that trigger the resolution mechanism goes on with the introduction of an important ratio that takes into account the presence in bank financial statements of non-performing loans (NPL). Before introducing the ratio, which quantify the presence of NPL, it is necessary to explain what the origin of NPL is and what they really are. As regards the origin of NPL, it is possible to say that it is embedded in the credit function of the banks. Indeed, one of the most relevant banking activity is the granting of loans to families and companies. This activity, although it is a source of profits, thanks to the interests that the bank applies to these loans, it also represents a source of risk. The risk consists in the possibility that the debtors are not be able to repay to the banks the amount of loans within the deadline. If it happens, the loans are classified as non-performing. In particular, according to the European supervisory standards, a loan is defined non-performing if after 90 days from the deadline the debtor has not yet repaid it. Situations of debtor's insolvency happen very often and for this reason, the number of NPL increases. The problem arises exactly when the number of NPL becomes excessive. The high level of NPL can have serious consequences both in terms of banking profitability and in terms of new lending activities. If, due to the excessive presence of NPL, a bank is not able to guarantee loans to companies, in turn the companies are not be able to sustain investments and job's increase. In addition, if this situation involves many banks, the growth of the economic system is compromised and the economic crisis occurs. This situation calls to mind exactly what happened in the United States with the subprime mortgages in 2007. Indeed, also in that case, the American banks granted loans for the purchase of houses to poor people that, afterwards, proved to be not able to repay the amount of loans to the banks.

Now, coming back to the actual situation, it is possible to note that the presence of high levels of NPL and of problems linked to them constitutes the current scenario of the European banking system. In summary, high levels of NPL can be very dangerous for the soundness and the financial stability of banks. As a matter of fact, an excessive presence of NPL represents one of the most common and serious causes of banking crises. Hence, when an analysis on the bank solidity is conducted, one of the first things to do is to look at the amount of NPL. If the presence of NPL is high, there are the conditions to apply the resolution procedure. At this regard, it is useful to evaluate singly the presence of NPL and then the amount of NPL compared to the total amount of loans. Firstly, it is possible to calculate the percentage of NPL summing all types of NPL.

Indeed, there are different categories of NPL recently introduced by the classification of the European Banking Authority (EBA). The purpose of the EBA is to provide a single classification of NPL for the entire European banking system in order to make easier the comparison among the Member States. The EBA has reached its goal through the elaboration of the Implementing Technical Standard (ITS)⁷⁹ about NPL subsequently applied in the European banking system by the Regulation of the European Commission No.227 of 2015⁸⁰.

Before looking at the classification, it is also important to understand the new definition of these loans proposed by the EBA. According to the EBA standards, the concept of non-performing loans is defined better by the term “non-performing exposures” (NPE). At this regard, are considered non-performing exposures the exposures that satisfy even one of the following conditions⁸¹:1) exposure past due for more than 90 continuous and not cumulative days; 2) ascertained inability of the debtor to meet its obligation without the realization of a collateral.

At this point, as regards the classification, the non-performing exposures are divided in bad loans, unlikely to pay exposures, past due exposures and forbore exposures. The bad loans are characterized by the uncertainty of the repayment due to the insolvency of the debtor. The unlikely to pay exposures are classified “unlikely to pay” because the intermediaries consider impossible that, the debtors must be able to repay them without the liquidation of the collateral. Instead, the past due exposures are loans for which the payment deadline expired by more than 90 days and not more than 180 days. Finally, there are the forbore exposures, the last category recently introduced by the EBA. This type of credits are called “forborne” because forbearance measures are applied to them. According to the definition of the EBA, the forbearance measures are concessions that the creditor grant to the debtors in financial difficulties, which prevent them from fulfilling their obligations. More in detail, the concessions include modifications of the previous terms and contractual conditions and the partial or total refinancing of the credit agreement. In addition, the EBA specifies that the forbore exposures can be divided in non-performing forbore exposures if the debtor is in a situation of deterioration and in performing forbore exposures if the debtor is in financial difficulties. Moreover, there is the possibility that a non-performing forbore exposure, after three years of belonging to this category, becomes a performing exposure and, after two more years, becomes an exposure “in bonis”. The EBA, in

⁷⁹ EUROPEAN BANKING AUTHORITY, July 2014, Draft Implementing Technical Standards on Supervisory reporting on forbearance and non-performing exposures under article 99(4) of Regulation (EU) No 575/2013.

⁸⁰The full text of Regulation of the European Commission No. 227 of 2015 is available on the website www.eur-lex.europa.eu

⁸¹ CALLEGARO F., I nuovi Implementing Technical Standard dell'EBA in materia di forbearance measure e forbore exposure, in Riv. dir. banc., dirittobancario.it, 19, 2014.

order to monitor and evaluate the evolution of the forborne exposures, has set technical standards that the National Supervisory Authorities are required to follow.

After the definition and classification of non-performing exposures, should be specified that, during this analysis, the general term “non-performing loans” is preferred to the recent term “non-performing exposure” because in many accounting and technical document the reference is made only to the term “non-performing loans”. Now, it is interesting to calculate the effective amount of the NPL on the total amount of loans. The ratio between NPL and the total amount of loans is expressed below:

NPL Ratio	→	NPL/Total gross loans %
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The NPL Ratio shows the percentage of NPL on the total amount of loans. In particular, it is very interesting in order to express an opinion about the credit quality of a bank. The NPL Ratio is considered normal when the value is between 10% and 12% and it is considered dangerous when the value exceed the 15%. Thanks to this indicator, it is possible to have an idea about the amount of NPL recorded in the bank financial statements. In particular, looking at the actual scenario of the European banking system, it can be undoubtedly said that the level of NPL is very high. Needless to say that, the banks should have conducted an analysis about the creditworthiness of the debtors before granting loans. This, almost surely, could have been a way to contain the levels of NPL.

Now it is late and, at this point, it is important to understand what a bank can do in order to face and reduce the excessive presence of NPL. Among the ways that the banks can use to reduce the amount of NPL, there is the renegotiation of the contractual conditions in order to give more times to debtors to repay loans. Other solutions are represented by the possibility to sell parts of the non-performing loans to investors with the risk of losses or by the possibility to create a bad bank for the disposal of NPL. Although these solutions are not always easy to implement, the first thing that the banks must do when loans become non-performing is the adjustment of their value in bank financial statement. Clearly, the adjustment value varies from loan to loan because it depends on the possibilities of recovery of the loan and on the guarantees applied to the loan.

The indicator that can show this operation is the NPL Coverage Ratio.

NPL Coverage Ratio	→	Loans- Reserve balance/Total Amount of NPL %
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The NPL Coverage Ratio represents a significant measure of the bank solidity because it shows the bank’s ability to absorb losses from non-performing loans. The average value of NPL Coverage Ratio, according to the European standards, amounts to 40-60%. Sometimes, the value of the NPL Coverage Ratio can be lower than the target value and this is due to the guarantees applied to the loans. In this case, there is no need to allocate many reserves because the guarantees provide a greater certainty to recover the loans. On one hand, the reserves solve in part the problem of the higher value of NPL and on the other hand, they not only limit the concession of new loans but also consume the banking capital with the risk of a future need of a capital increase. At this regard, another indicator that deals with banking capital and NPL enters in the framework of the evaluation of the bank solidity. This indicator is the Texas Ratio.

Texas Ratio	→	$\frac{\text{NPL}}{\text{Bank's tangible capital equity} + \text{Loans}}$
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Gerald Cassidy and other analysts of RBC Capital Markets⁸² developed the Texas Ratio in order to measure and evaluate the credit problems of many Texan banks in 1980. In that period the cause of the failure of about 400 credits institution was a crisis of the property sector. For this reason, in the original version of the Texas Ratio, the numerator was composed by the sum of NPL and of property assets detained by banks. Subsequently, this indicator in a version modified and consistent with the most current banking conditions was introduced in Europe and only recently in Italy. The actual version of Texas Ratio is proposed by the formula above and shows the relation between the amount of NPL (the numerator) and the amount of liquid cash and money reserves retained for time of crisis (the denominator). This measure is very important because it is useful to understand whether and for how long the bank is able to sustain the NPL using its own resources. This condition is expressed in number by the value that assumes the Texas Ratio. Hence, looking at the numbers, if the value of the Texas Ratio is less than 100, it means that the bank is solid and able to face the problem of NPL with its own capital. Instead, if the Texas Ratio assumes values grater then 100, it means that the bank is likely to fail because it is not able to sustain the burden of the NPL with its own resources and needs of a capital increase.

The topic of NPL is difficult to argue in a complete way because, given its complexity and its importance for the actual banking sector, it is subject of many studies, which offer different solutions in order to reduce their amount. In this regard, as it has already been said before, the

⁸² RBC Capital Markets is a global investment bank.

problem of an excessive amount of NPL is considered a problem at European level and for this reason, it is necessary to find a solution at European level. Therefore, an important and recent step, in the direction of a European solution, is represented by a document of the ECB published in 2016 and entitled “Draft guidance to banks on non-performing loans”⁸³.

In this document, the ECB provides specific guidelines for the management of NPL to all banks subjects to its supervision. According to the ECB, the first thing that the banks must do is to establish a management strategy of NPL. In particular, the management strategy must be efficient, concrete and especially focused on the internal and external conditions in which the banks operate. The ECB specifies that it is important to consider as internal conditions the strengths and weaknesses of the banks and as the external conditions the market and the operative environment in which the banks are placed. Moreover, in order to make the management strategy more efficient, the ECB requires banks to set short, medium and long term objectives about the sustainable thresholds of NPL. Clearly, the objective is to reduce as much as possible the amount of NPL. In addition, the ECB suggests to banks that they should create in their operative structure a specific unit to manage and monitor the disposal of NPL. Another recommendation of the ECB is addressed to the bank directors. Indeed, the ECB recommends attention and timeliness in communicating strategies to be adopted and in the periodic monitoring of NPL. The guidelines of ECB represent only a way to make things clear about the treatment of NPL in the European banking sector but as regards the solutions, they are different in each country according to the recorded amount of NPL and to the general conditions of the economy. In conclusion, after the analysis of NPL, it can be said that the analysis of the bank solidity through the information provided by the bank financial statement is done.

Before concluding this topic, it is necessary to remember that the evaluation of bank solidity is a very difficult process. The principal difficulty consists in making a comprehensive assessment, which takes account of all the aspects of the banking business. In order to do this, the analysts, the shareholders and the other people interested in the bank solidity must calculate the different parameters according to the different aspect of bank solidity that they want to analyze. It is necessary to remember that although each single parameter shows reliable values and represents a valid measure of bank solidity, it is, if considered singularly, not sufficient for a complete evaluation. Indeed, it often happens that the same bank registers some parameters that argue in favor of solidity and others that sustain the contrary thesis. In alternative, making a comparison among different banks, may it happen that different banks show the same indicators but,

⁸³ The full text is available on the website www.bankingsupervision.europa.eu and on the website www.ecb.europa.eu

although this, they do not get the same judgment of solidity. Therefore, in order to obtain an objective final evaluation about bank solidity must not be considered only the parameter values but it is also necessary to take account of business models and general soundness conditions of the banks.

2.3 Necessary conditions for the application of the resolution procedure and its main tools.

The analysis of the financial statement ratios, which triggers the resolution procedure, highlights, through the information available on financial statements, some specific situations in which the resolution must be applied. However, there are other basic conditions necessary for the application of the resolution procedure. Before analyzing these conditions, a brief reminder of the framework in which the resolution takes place can be useful.

The resolution procedure belongs to the new European rules of banking crisis management introduced thanks to the project of the European Banking Union. In particular, the resolution procedure is set in the context of the Single Resolution Mechanism, the second pillar of the European Banking Union based on the European Directive BRRD. The Single Resolution Mechanism represents the new way to manage orderly the banking crises after the financial crisis and the banking failures of 2007. This mechanism is composed, as already discussed, by the Single Resolution Board, the National Resolution Authorities and the Single Resolution Fund. These three elements have the objective to help banks in the overcoming of the crisis thanks to three stages. The first stage consists in the preparation and implementation of recovery and resolution plans in order to face promptly the banking crises. The second stage regards a series of early interventions that must be applied when the banks are in financial difficulties, very close to the insolvency. Finally, the third stage coincides with the resolution procedure. The implementation of a resolution procedure consists in starting a process of restructuring aimed at the continuity of the core banking activities, at the reduction of the negative impact on the financial system, at the reduction of the costs sustained by the contributors and at the limitation of the state intervention. The National Resolution Authorities are responsible for the implementation of resolution and they start this procedure only after the check of the presence of certain basic conditions. Hence, the necessary basic conditions for the implementation of the resolution procedure are:

- The ascertainment of a situation of banking distress and, more specifically, of a situation in which the bank is failing or likely to fail.
- The certainty that private interventions, as capital increases, are unnecessary to avoid in the short term the banking collapse.
- The certainty of the ineffectiveness and of the inadequacy of the liquidation procedure in preserving financial stability, in protecting customers and in ensuring the essential banking functions.

At this point, after the analysis of the basic conditions under which the resolution procedure is implemented, it is time to examine the main resolution tools.

The National Resolution Authorities have the possibility to decide which tool is best to apply according to the general situation of the bank to resolve.

The tools, fully operative from 1 January 2016, that the National Resolution Authorities have at their disposal are:

- *The sale of the business*⁸⁴: this first tool consists in the sale of the entire or of a part of the business to a private buyer.
- *The institution of a bridge bank*⁸⁵: this second tool consists in the institution by the National Resolution Authorities of an entity, called bridge bank, in which flows the assets and the liabilities of the bank in financial distress with the aim to ensure the functioning of the main banking operations and with the ultimate objective of sale in the market. The bridge bank must be a partial or a total public company instituted by the National Resolution Authorities through a mandate of two years, which can also be extended. This new bank is considered a bridge because it is the vehicle through which the assets and the liabilities are transferred from the bank in resolution to a new buyer. Finally, the National Resolution Authorities consider the activities of the bridge bank ended when situations like these occur: the merger with another bank, the acquisition of the majority of the capital of the bridge bank by a third party and the acquisition of assets and liabilities by another subject.
- *The institution of a bad bank*⁸⁶: this third tool consists in the institution of an entity called bad bank. The bad bank is a vehicle in which flow the toxic assets of the diseased bank. The objective of the bad bank is the liquidation or the recovery of the non-performing loans.
- *The bail in*⁸⁷: this last tool consists in the reduction of the value of actions and loans or in their conversion into shares to absorb losses and recapitalize the bank. This tool represents the main innovation in the European scenario of the banking crises because it represents the alternative to the bail out. Indeed, thanks to the introduction of the bail in, the banking rescue no longer occurs through the central bank money or through the state money but occurs through the money of the bank itself.

⁸⁴ Article 38 “The sale of business tool”, Section 2, Chapter IV “Resolution Tools”, Title IV “Resolution” of the BRRD Directive 2014/59/EU.

⁸⁵ Article 40 “Bridge institution tool”, Section 3, Chapter IV “Resolution Tools”, Title IV “Resolution” of the BRRD Directive 2014/59/EU.

⁸⁶ Article 42 “Asset Separation Tool”, Section 4, Chapter IV “Resolution Tools”, and Title IV “Resolution” of the BRRD Directive 2014/59 /EU.

⁸⁷ Article 43 “The bail in tool”, Section 5, Chapter IV “Resolution Tools”, Title IV “Resolution” of the BRRD Directive 2014/59/EU.

The resolution tools, described above, are applied at the discretion of the National Resolution Authorities but they are all aimed at restricting the state intervention in banking rescues. Indeed, thanks to these tools the state is called to intervene only when the situation of banking distress is so serious to compromise the financial stability of the entire system. Moreover, as regards the application of the resolution tools, the European Banking Authority published in 2015 three sets of guidelines⁸⁸ about the implementation of resolution tools in banking sector in order to facilitate the National Resolution Authorities in taking their resolution decisions. In particular, the first two guidelines are about the sale of business tool and the assets separation tool while the third is about the necessary services that the resolution authorities may require from the institution under resolution.

⁸⁸ EUROPEAN BANKING AUTHORITY, Final Draft Guidelines, on factual circumstances amounting to a material threat to financial stability and on the elements related to the effectiveness of the sale of business tool under Article 39(4) of Directive 2014/59/EU, May 2015.

EUROPEAN BANKING AUTHORITY, Final Draft Guidelines, on the determination of when the liquidation of assets or liabilities under normal insolvency proceedings could have an adverse effect on one or more financial markets under Article 42(14) of Directive 2014/59/EU, May 2015.

EUROPEAN BANKING AUTHORITY, Final Draft Guidelines, on the minimum list of services or facilities that are necessary to enable a recipient to operate a business transferred to it under Article 65(5) of Directive 2014/59/EU, May 2015. These guidelines are available on the website www.eba.europa.eu

2.4 Bail in as a key resolution tool.

The regulation framework in which the bail in is included is the European Directive BRRD No.59 of 15 May 2014 about resolution procedures. The bail in tool, applicable to all the banks in the European Banking Union since 1 January 2016, represents the most relevant tool among all the resolution tools. In particular, the bail in is considered a key resolution tool because it is the only tool that captures the essence of the resolution procedure and it is also the only tool that represents the change proposed by the new European rules. Now, it is time to get to the heart of the argument through a detailed analysis of the bail in and its functioning.

2.4.1 What is the bail in?

The term bail in means precisely “internal rescue” and for this reason it is opposed to the term bail out that instead means “external rescue”. Before the introduction of the bail in tool and clearly before the introduction of the resolution procedure, the banks in crisis were saved by the state intervention and more precisely through the money paid by the taxpayers. The mechanism, just mentioned, is the bail out. Now, instead, the tool of bail in has taken the place of bail out in the European scenario of banking rescues. The reasons why the bail in has assumed a such important role are the need to restore stability in the financial system, to reduce the state intervention and the connected problem of moral hazard and to ensure the continuity of the essential function of the banks. Therefore, the bail in represents the innovative tool that the Resolution Authorities, if there are the necessary conditions to start the resolution procedure, can use in order to save the bank in strong financial distress. More precisely, the bail in is a mechanism by which the shares decrease in value and some credits also decrease in value or they are converted into shares in order to absorb the banking losses or to recapitalize the bank ensuring, thus, an unchanged level of market confidence. In this context, the responsibility of the banking rescue is internal to the bank itself and it is up to shareholders, some categories of creditors or bondholders and depositors. At this point, it is important to highlight the principle under which the mechanism of bail in is based. The principle according to which the shareholders, first, and then the creditors and the depositors are called to intervene, in the case of banking default, is the “*no creditor worse off*”. This principle states that the shareholder and the creditors, involved in the banking rescue, will not suffer losses greater than those that they could suffer in the event of bank liquidation under ordinary procedures. Moreover, as regards the general principle under which the mechanism of bail in works and which, in turn, consists in the contribution of the bank itself to its rescue, it is possible to say that it does not represent a news

in absolute sense. Indeed, before the introduction of bail in, this principle was applied in the burden sharing process. According to the burden sharing, in case of banking distress, before the state intervention, the shareholders and the creditors took part of the banking rescue through the reduction in value of their share and subordinated bonds or through the conversion of the latter in shares. This procedure seems to be similar to bail in but it differs from the bail in procedure because, contrary to the burden sharing, in the bail in procedure exists a specific pecking order to regulate the contributions of the various subjects. Despite the fact that the bail in is the protagonist of the European banking scenario, the burden sharing procedure can be still applied to the solvent banks that fail the stress tests.

2.4.2 Minimum requirements for the implementation of bail in.

Before explaining the functioning of bail in, it is necessary to point out some basic conditions required for the implementation of this tool. Certainly, the basic condition under which the bail in is applied is the condition of financial distress of a bank. This condition is necessary but not sufficient because there are some specific requirements that must be satisfied in order to apply concretely the bail in. More precisely, there are two specific requirements to which the Resolution Authorities must look to verify if there is the possibility to apply the bail in. The two requirements, in question, are the Minimum Requirement for own funds and Eligible Liabilities (MREL) and the Total Loss Absorbing Capacity (TLAC).

As regards the first requirement, the Article 45 of the BRRD Directive provides its definition and application. Hence, the Article 45 of the BRRD Directive states that “Member States shall ensure that institutions meet, at all times, a minimum requirement for own funds and eligible liabilities. The minimum requirement shall be calculated as the amount of own funds and eligible liabilities expressed as a percentage of the total liabilities and own funds of the institution”⁸⁹. The objective of MREL consists in ensuring the good functioning of the bail in tool through the increase of the liabilities with high capacity of absorption. According to the definition, the MREL is based not only on the amount of own funds but also on the amount of eligible liabilities. In particular, the eligible liabilities that must be considered for the computation of MREL are similar to the liabilities involved in the bail in mechanism but they follow specific criteria of eligibility. The

⁸⁹ Article 45 “Application of the minimum requirement”, Subsection 2, Chapter IV “Resolution Tools”, Title IV “Resolution” of the BRRD Directive 2014/59/EU.

Article 45 of the BRRD Directive states that the eligibility criteria for the liabilities follow these conditions⁹⁰:

- The instrument is issued and fully paid up;
- The liability is not owed to, secured by or guaranteed by the institution itself;
- The purchase of the instrument was not funded directly or indirectly by the institution the liability has a remaining maturity of at least one year;
- The liability does not arise from a derivative;
- The liability does not arise from a deposit which benefits from preference in the national insolvency hierarchy.

The BRRD Directive is useful in the analysis of MREL because highlight the conceptual aspects of this requirements.

Now, however, it is also interesting to analyze the operational side of MREL. At this regard, the European Banking Authority published in 2015 the “Draft Regulatory Technical Standard”⁹¹ on criteria for determining the minimum requirement for own funds and eligible liabilities under BRRD Directive. Thanks to this document, the European Banking Authority determines the formula for the calculation of MREL taking into account the criteria that compose it. An important thing to note is that this ratio can be calculated for each entity of the European Banking Union and verified by the Single Resolution Board, at European level, and, at national level, by the National Resolution Authorities. Despite this fact, it is not possible to make a comparison between the values because, as it determined by the BRRD Directive and confirmed by the European Banking Authority, there is not a common minimum MREL. Although a target value for the MREL does not exist, it is important to calculate it not only for the reasons explained above but also for the understanding of the criteria that case-by-case compose this ratio for all the credit institutions in the European Banking Union.

Therefore, before showing the formula through which the MREL is computed, it can be useful to analyze the following criteria⁹²:

- *Loss Absorption Amount*: it is the amount necessary to cover losses looking at the current balance sheet situation of a credit institution. It is composed by the regulatory capital requirements, the buffer requirements and the Pillar 2⁹³ capital requirements.

⁹⁰ See note 89.

⁹¹ EUROPEAN BANKING AUTHORITY, July 2015, Draft Regulatory Technical Standards on criteria for determining the minimum requirement for own funds and eligible liabilities under Directive 2014/59/EU. This document is available on www.eba.europa.eu

⁹².For the criteria of MREL calibration: MIŠKOVÁ MARTINA, ORSZÁGHOVÁ LUCIA, March 2015, MREL: Gone Concern Loss Absorbing Capacity.

- *Recapitalization amount*: it is the amount that a credit institution needs post resolution in order to meet the capital and fund requirements necessary to continue the business.
- *Exclusion from bail in*: the calibration of MREL does not consider as eligible liabilities the liabilities excluded from bail in. The eligible liabilities included in MREL are similar to the liabilities included in the bail in mechanism.
- *Business model, funding model and risk profile*: the SREP tests provides information about business and funding model, risk profile and governance of each credit institutions that can be useful in the calibration of the MREL.
- *Deposit Guarantee Scheme Contribution*: the resolution authority ensures that MREL is set at a sufficient level to ensure that the estimated contribution would be lower than 50% of the target level of the DGS.
- *Size and systemic risk*: the Draft Regulatory Technical Standards introduced 8% of total liabilities as a MREL floor for systemic institutions, in order to ensure that they would have an access to the resolution financing arrangements.

After the analysis of the criteria that compose the MREL, it is time to point out the MREL formula:

$\text{MREL} = \text{Loss Absorption Amount} + \text{Recapitalization amount} - (\text{DGS adjustments})^{*}\%$ <p style="text-align: center;">* Only if the banks are small.</p>

Now, the attention is focused on the Total Loss Absorbing Capacity (TLAC). The TLAC is nothing more than another minimum capital requirement, as MREL, that the most relevant global banks are required to detain in order to apply the resolution tools in case of banking insolvency. More precisely, this requirement is referred to the loss absorption capacity of the based on the presence of a certain amount of liabilities eligible to the bail in tool in case of banking resolution. This requirement share the same objective of MREL but differs form it for many aspects. For this reason, it is interesting to carry out the analysis of TLAC and its characteristic making a comparison with the MREL requirement. The Financial Stability Board thanks to the publication of the document “Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution”⁹⁴ introduced the TLAC in the scenario of banking resolution. Until now, it seems that the TLAC and the MREL are similar, thanks to the fact that they share the same objective. Instead, there are many differences between these two requirements. The first difference regards

⁹³ The “Pillar 2 Capital Requirements” are the Basel III additional capital requirements, applied case by case to each individual bank.

⁹⁴ FINANCIAL STABILITY BOARD, November 2015, Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution.

their scope of application. Indeed, while the MREL is applied in all the financial and credit institutions of the European Union, the TLAC finds its application in all the Global Systematically Important Banks (G-SIBs)⁹⁵. It means that, this requirement can not be applied in all European bank but only in the most relevant European banks. Going on with the analysis, another difference between the two requirements regards the approaches that they follow. On one hand, the European Banking Authority supported by the BRRD Directive, follows a bank specific approach based on the Pillar 2 requirements⁹⁶ in the formulation of the MREL and, on the other hand, the Financial Stability Board follows an approach based on the minimum requirements of the Pillar 1⁹⁷ in the computation of the TLAC. Moreover, a further difference regards the existence of a minimum target level for the two requirements and the timing of their entry into force. As regards the MREL, a precise target value does not exist but it is applied by 1 January 2016. Instead, the minimum target level of TLAC exists and, according to the standards of the Financial Stability Board, must reach the 16% of the risk-weighted assets (RWA) or the 6% of the leverage ratio exposure (LRE) by 1 January 2019 and the threshold of 18% of RWA and the 6, 75% of LRE by 1 January 2022. In addition, another difference between TLAC and MREL regards the liabilities and the financial instrument considered eligible for their computation. Firstly, as regards the liabilities of the MREL, they are considered eligible according to the criteria, listed above, established by the BRRD Directive. Instead, the eligibility criteria for the instruments, which compose the TLAC, are established by the Financial Stability Boards and comprises the following conditions⁹⁸:

- The instruments are fully paid up and are not guaranteed;
- The instruments are not subject to compensation or other rights which may affect the capacity to absorb losses in the resolution;
- The instruments have a remaining maturity of at least one year, or are perpetual;
- The instruments can not be redeemed prior to maturity;
- The purchase of the instruments is not funded directly or indirectly by resolution or its related party, unless otherwise provided by the competent authority.

These instruments intervene to cover losses before the other instruments and for ensuring the resolution procedure of the GSIBs they must be contractual subordinated to the excluded liabilities, subordinated to the excluded liabilities following the order stabilized by laws and

⁹⁵ “G-SIBs” stands for Global Systematically Important Banks. The list of the most relevant banks in the is published annually by the Financial Stability Board according to the results of the stress tests

⁹⁶ See note 93.

⁹⁷ “The Pillar 1 Minimum Requirements” are the Basel III minimum capital requirements mandatory for all banks.

⁹⁸ For the eligibility criteria of the TLAC instruments: FINANCIAL STABILITY BOARD, November 2015, Principles on Loss-absorbing and Recapitalization Capacity of G-SIBs in Resolution.

structural subordinated to the excluded liabilities according to the structure of the bank that issues them. In conclusion, are considered excluded from TLAC the liabilities arising from derivatives, the liabilities not arising from contracts, the debts instruments linked with derivatives , the short-term deposits and the liabilities excluded by law from the bail in.

Making a comparison between the two requirements, the MREL seems to be more concrete and easier to apply than the TLAC. This final consideration is probably due to the fact that the TLAC is reserved only to the most relevant banks, according to the ECB Supervision, and it is not yet applied.

2.4.3 The general functioning of the bail in tool.

After the analysis of the minimum requirements for the bail in implementation, it is necessary to explain how the bail in works. The objective of this paragraph is the understanding of the general functioning of the bail in tool and in order to do this, it can be useful to analyze the graph below.

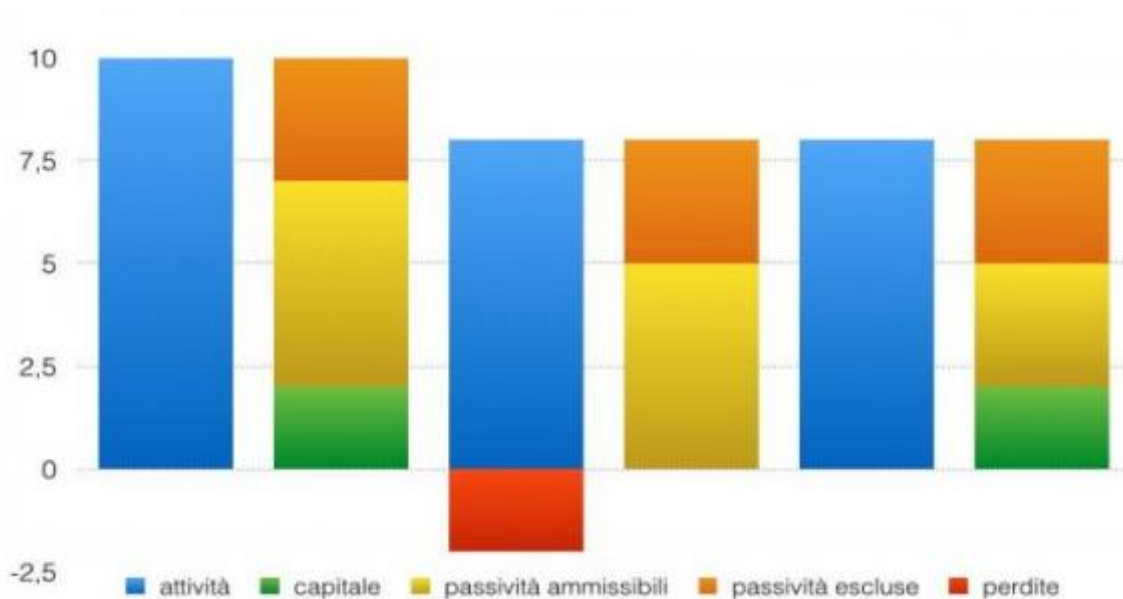


Figure 1: The functioning of bail in. Source: www.bancaditalia.it

The picture above shows a simple way, proposed by the Bank of Italy, to explain the bail in. In detail, the graph shows a bank in three different conditions through the analysis of its assets and liabilities. The two first columns on the left side of the graph represents the assets and the liabilities of a bank in *normal conditions*. In particular, the blue column represents the assets and the second column shows: in green the own capital of the bank; in yellow the liabilities eligible for the bail in and in orange the liabilities excluded from bail in.

Then, the two central columns correspond to a situation of *banking distress*. The bank is in a situation of distress due to losses probably connected to the excessive amount of non-performing loans. In this phase, the amount of losses (the red area in the first central column) reduces the amount of assets (the blue area in the first central column). As regards the second central column, it shows, in yellow, the liabilities eligible for the bail in and, in orange, the liabilities excluded from bail in. An important thing to note, in the second central column, is the lack of the green area that represents the bank capital. In this case, the bank capital is reduced in order to cover losses and to restore the situation in balance. This situation shows the necessity of an intervention and represents the basic situations in which the bail in is applied.

Now, shifting the focus on the last two columns on the right side of the graph, it is possible to see and analyze the last situation that represents the *new bank*. This last case represents the final situation after the implementation of bail in.

After the explanation of the general functioning, it is possible to note that the resolution procedure and the bail in tool lead to a reconstruction of the bank capital, previously reduced to absorb losses, thanks to the conversion of the liabilities eligible for bail in into shares. Hence, the bail in, intervening in a situation of banking distress, gives to the bank the possibility to continue the providing of its essential financial services. As regards a more complete explanation of the bail in tool, in the following paragraph there will be a detailed analysis of the subjects and of the liabilities involved or not involved in this mechanism.

2.4.4 Detailed analysis of the bail in tool: the loss-sharing criteria and liabilities included or excluded from the application of bail in.

From 1 January 2016, the bail in tool provides that, in case of banking distress, shareholders, creditors, bondholders and some depositors contribute to the banking rescue. The shareholders, the creditors, the bondholders and some depositors contribute to the banking rescues following a precise hierarchy of loss-sharing provided by the Directive BRRD. Before listing in which order the subjects, mentioned above, are called to intervene, it is necessary to underline the principle on which the hierarchy of loss-sharing is based. According to this principle, people who invest in riskier and more profitable financial instruments are the first subjects called to sustain losses through the reduction in value of their shares and credits or through the conversion of credits in shares. More precisely, only after the exhaustion of the resources belonging to the first risky category, it is possible to shift to the second category and so on. Hence, the pecking order of the subjects involved in the bail in mechanism is:

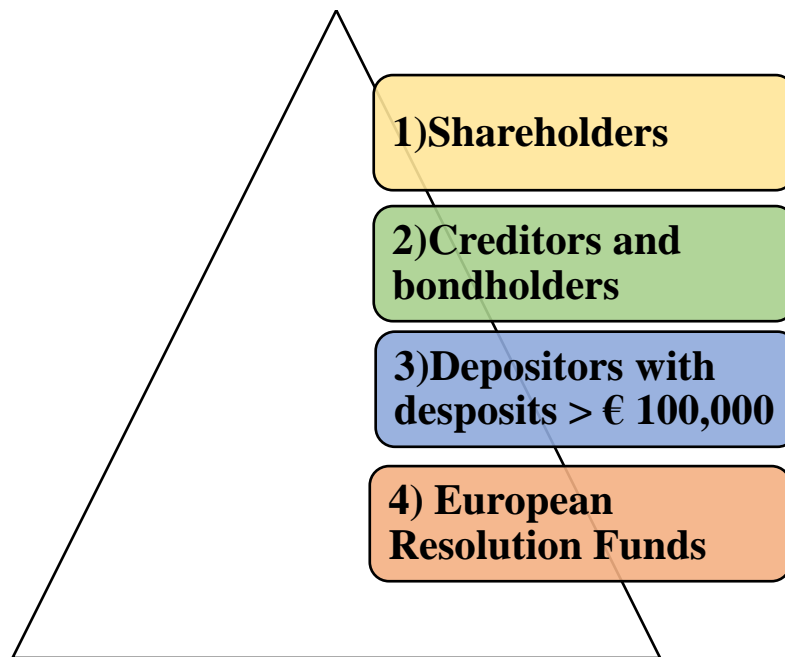


Figure 2: Subjects involved in bail in mechanism.

- The *shareholders* are the subjects to which the highest level of priority is assigned. Indeed, they are called immediately to contribute reducing or setting to zero the value of their shares or capital instruments.
- The *creditors* or the *people that hold banking bonds* are called to intervene in a second time when the resources of the category before are over. The creditors according to the type of bonds that they hold, from the more risky to the less risky, take part to the process of loss absorption and bank recapitalization through the reduction in value or the conversion in shares of their credits. At this point, it is necessary to make a clarification about the types of bonds issued by banks in order to understand what category of bonds are involved in the bail in mechanism. More precisely, at this regard, it is useful to look at the classification of bonds issued by banks according to their level of risk that, in turn, is associated to their level of return. The risk classification of bonds provides three types of bonds: covered, senior and subordinated. First of all, it is necessary to specify that the covered bond are explicitly excluded from bail in mechanism while the other two categories, mentioned above, are included. Moreover, although the senior and subordinated bonds are both included in bail in mechanism, they differ in term of risk and return and for this reason the investors who hold them are subjected to a different order of intervention. The first subjects called to intervene in case of bail in, clearly only after the shareholders, are the holders of subordinated bonds because their investments correspond to a high level of risk associated to a high opportunity of return. Summing up, the people invest in subordinated bonds issued by the banks in exchange of higher returns but, since the subordinated bonds take part of the banking capital,

they face the risk to lose the value of these instrument, which can be set to zero in case of bail in. More precisely, exist four different types of subordinated bonds: Tier 1, Upper Tier 2, Lower Tier 2 and Tier 3. These bonds differs in risk of insolvency(100% for all types), risk to defer a coupon rate(only Tier 1 and Upper Tier 2), risk to lose a coupon rate(only Tier 1), existence of a final maturity(only Lower Tier 2 and Tier 3) and risk of capital deduction (only Tier 1). Then, immediately below the intervention of holders of subordinated bonds, the holders of senior bonds are called to intervene and the value of their bonds is set to zero or drastically reduced. The reason why the senior bonds are involved in the bail in mechanism after the subordinated bonds is due to the fact that these investments offer a low level of return to which obviously is associated a low level of risk.

- The *depositors* like single individuals or small and medium enterprises are involved in the bail in mechanism if they hold deposits > € 100,000.
- The *European Resolution Found* occurs to cover the losses that should have been paid by other depositors, who however are considered protected end excluded from bail in. Moreover, the necessary requirement for this intervention is the previous payment of the 8% of the total bank liabilities by the shareholders, the creditors and the depositors with amount greater than € 100,000. In particular, this happens thanks to the intervention of the European Resolution Fund, which contributes to the bail in for a maximum of 5%.

Now, after the analysis of the subject involved in the bail in mechanism, it is time to point out the liabilities included and excluded from bail in. As it regards the liabilities included in the bail in mechanism, they clearly correspond to those hold by the subjects listed above. Thus summarizing, the principal liabilities involved in bail in are:

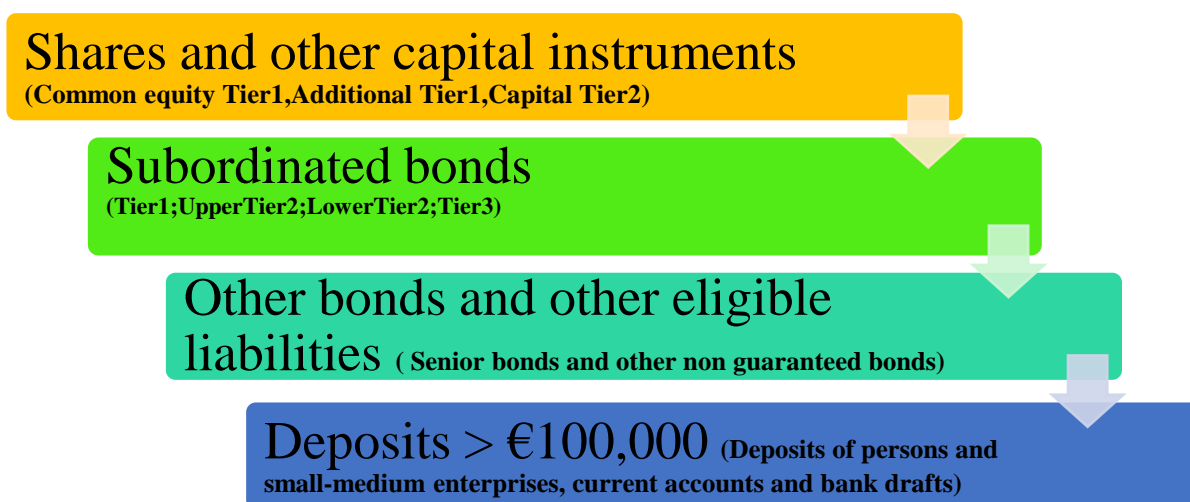


Figure 3: Liabilities involved in bail in.

In addition to the tools subjected to the bail in, it is also necessary to analyze the tool excluded from the bail in mechanism. Therefore, are completed excluded from bail in the following banking liabilities:

- The deposits with an amount \leq € 100,000. These deposits are protected by the Deposit Guarantee Fund;
- The guaranteed liabilities, including covered bonds and other guaranteed instruments;
- The safe deposit boxes or the securities held in a special account;
- The interbank liabilities (excluding intercompany transactions) with an original duration less than 7 days;
- The liabilities arising from participation in payment systems with a residual maturity of less than seven days;
- The debts to employees, the trade debts and the fiscal debts privileged by the bankruptcy law.

As regards all the other banking liabilities not explicitly excluded from the bail in, they can be subjected to the bail in mechanism. In particular, the European Commission has the responsibility to exclude other liabilities if they are considered risky for the financial stability of the system, if they extend the time of the execution of the procedure and if they worsen the situations of other creditors.

2.4.5 How to protect depositors from the mechanism of bail in?

Before giving some advices on how to protect depositors from bail in, it is necessary to note that they are already, in some way, protected by this mechanism. As previously discussed, not all the depositors are involved in bail in mechanism. Indeed, the depositors that detain current accounts, personal savings account books and deposits certificates with amounts less than € 100,000 are excluded from bail in mechanism and protected by the Deposit Guarantee Fund. As regards all the other depositors with amounts greater than € 100,000, they are involved in the bail in mechanism only if the instruments of the previous and more risky category are not sufficient to cover the losses. This means that the depositors are exposed to a lower risk because their instruments are the last category used in case of bail in according to the pecking order of bail in-able instruments⁹⁹. In addition, for a greater level of protection, the depositors are required to observe some precautions. In particular, the depositors must pay attention to open current accounts in banks. First and foremost, the depositors must pay attention if they are holders of

⁹⁹ Clause of extended depositor preference provided by Article 108 of BRRD Directive.

jointly current accounts. Indeed, also these current accounts can be subjected to bail in if the amounts of each depositors exceed the threshold of € 100,000. Moreover, the depositors, holders of many current accounts in the same bank, considering the fact current accounts are added together and protected only for the total maximum amount of € 100,000, are encouraged to diversify. In conclusion, the general advices for the depositors and the investors is:

- Detention of deposits < € 100,000.
- Investments in instruments excluded from bail in.
- Valuation of the riskiness of instruments riskiness of instruments in which to invest.
- Valuation of the bank solidity.

All this advice assumes that the customer is informed of the new regulations and of the soundness of the banks. Instead, the reality is different, the majority of banking customers are intimidated by these new mechanisms, and they need to be reassured by the banks. At this point, the figure of the financial advisor becomes fundamental in order to inform and advise the banking customers. Hence, the banking customers together with the financial advisors carry out an analysis of the bank solidity thanks to the classification of the rating agencies and to the ratios provided by the bank financial statement. In this way, the banking customers are aware and able to choose in which bank invest money or in which financial instrument invest.

2.4.6 Final consideration about bail in.

The analysis of bail in and its functioning is interesting in order to understand the real meaning of the new European rules about banking crises. Indeed, as it has already been said, the resolution procedure and the bail in tool represent the new way of banking crises management. As regards the effectiveness of these tools, is too early to say that they work really well. Certainly, there is no denying that, while the resolution procedure and the bail in tool have brought advantages in the European banking system, they have also brought worries and confusion.

First, focusing on the positive aspects, we can say that the bail in tool contributes and will contribute to the limitation of the state intervention and to a more responsible and orderly management of the banking crises.

Then, as regards the negative aspects, the main disadvantage is the contribution of the people involved in the banking business.

However, the negative aspect of the contribution in banking rescue of the people involved in banking activity is mitigated by a certain level of protection, as explained above in the case of depositors. Hence looking at the advantages and disadvantages, the bail in seems, in the

complex, a balanced instrument with great potential if used in compliance with European and national directives.

In conclusion, the bail in can be, at the same time, a very useful or a very dangerous tool. In particular, the degree of usefulness or riskiness depends to the context in which this instrument is applied. An important support to the application of this tool is provided by the national law of transposition of this European mechanism in each single national government. In addition to this, it is of fundamental importance the role of information. Indeed, the banks but also all the people involved in banking business must know how the bail in works, what they risk and how to protect themselves.

CHAPTER THREE

The case study of the four Italian banks in the European framework of Bank Recovery and Resolution Directive (BRRD).

The purpose of this chapter is the analysis of the case of the four Italian banks, on the brink of bankruptcy, which have been saved, first, by the insolvency proceedings of the Italian banking law and then, definitely, by the procedures provided by the new European rules about the management of banking crises.

After the brief description of the topic of this chapter, it is fundamental to highlight the subjects of this analysis. The protagonists of this analysis are the following four Italian banks: *Banca Marche, CariFerrara, CariChieti and Banca Etruria*.

Before proceeding with the analysis, it is necessary to make a clarification about the fact that, most of the times, in this chapter, for simplicity, the four Italian banks are dealt as a unique subject of the analysis. This is possible because the four Italian banks have many features in common first in terms of structure and size and consequently in terms of problems and related solutions.

3.1 The causes of the crisis of the four Italian banks.

Before explaining the causes that have led to the crisis of the four Italian banks, it is necessary to specify that the following causes must not to be attributed only to the four Italian banks but also to the general crisis condition of the entire Italian banking system. Substantially, the causes of the crisis of the four Italian banks are attributable to two main reasons. The first reason is due to the *weaknesses of the Italian banking system* and the second one is due to the *consequences of the international financial and economic crisis*. In particular, the second reason is referred to the high level of non-performing loans detained by the Italian banks. These causes represents the main problems that the Italian banks have faced in recent years and that they are facing today.

At this point, one might well wonder why these causes, common to the entire Italian banking system, have led precisely these four banks at a so high and unsustainable level of crisis as to require a timely banking rescue. The reason is probably due to the fact that these four banks are

characterized by small-medium local dimensions that have made them more susceptible to these problems and more unable to manage them. At this regard, in the following paragraph the attention will be focused on the local dimension of the four banks and on their close relation with the territory in order to understand the role played by these factors. Now, it is time to explain concretely in what the causes of the crisis of the four Italian banks consist.

3.1.1 The weaknesses of the Italian banking system.

As previously discussed, the first cause of the crisis of the four Italian banks lies in the weaknesses of the Italian banking system. The weaknesses that affect the Italian banking system are different because some derive from the structural problems of the banking system and other derived from the consequences of the international financial and economic crisis but, at the same time, they are closely related to each other. In order to understand the interaction between the different types of weaknesses, it is necessary to make an example. The *low profitability* represents the main weakness of the Italian banking system but it also depends on many other weaknesses. The first weakness that leads to a low level of profitability is a typical structural problem of the Italian banks that consists in the decentralization of the banking business through a *broad network of banking subsidiaries*. Clearly, in this way, the costs increase, the operational efficiency decreases and, in turn, the profitability also decreases. Another weakness that influence the level of the Italian banking profitability lies, instead, in the lending activity of the banks damaged by the economic and financial crisis. The lending activity represents the core activity of the Italian banking business but, in the last period, it also represents the riskiest activity in the banking scenario. Indeed, the lending activity of the Italian banks, after the international financial and economic crisis, has to deal with the problem of *the non-performing loans*. In particular, the non-performing loans are loans granted by the bank to individuals who later prove to be unable to repay them. During the years, the level of non-performing loans detained by the Italian banks is increased as a consequence of the economic and financial crisis and the banks due to the non-collection of these loans have incurred in such significant losses to sacrifice their capital to cover them. Hence, the Italian banks have a low level of profitability mainly due to the high level of non-performing loans. More precisely the non-performing loans influence the level of profitability through the deficit of capital used to cover the losses, the non-collection of the interest's loans and the increased difficulty in granting new loans. As previously discussed, the low level of profitability represents, together with the other weaknesses that determine it, the extremely weak point for the Italian banking system.

Moreover, the *vicious circle between the State and the Italian banks* represents another structural weakness that must be considered in this analysis. The vicious circle between the Italian banks and the State consists in an interaction between the two entities so strong that when one of the two entities is likely to fail the other contributes to its rescue. Furthermore, the investments of the Italian banks in government bonds reflects another aspect of the vicious circle between the banks and the state. Indeed, it is an advantageous opportunity both for the State and for the banks. On one hand, the State receives benefits in terms of credibility and on the other hand the bank in term of less risky investments.

In conclusion, it can be said that, beyond the structural problems, the amount of non-performing loans constitutes the principal problem of the Italian banking system and in particular of the four Italian banks. For this reason, the next paragraph will be entirely dedicated to the presence of non-performing loans in the Italian banking system.

3.1.2 The problem of non-performing loans in Italy.

Before going into the details of the analysis of non-performing loans in Italy, it is necessary to remember what they are. The non-performing loans, according to a general definition, are all those loans for which the recovery is uncertain due to the impossibility of the debtors to repay them. In particular, there are different levels of non-performing loans that, according to their descending order of severity and impossibility of recovery, are subdivided as follow:

- *Impaired loans*: the recovery of these loans is uncertain because the debtors are in insolvency conditions;
- *Substandard or watchlist loans*: loans overdue by 270 days. The recovery of these loans is uncertain because the debtors are in a temporary situation of insolvency;
- *Restructured loans*: these loans are the result of the deterioration of the economic and financial conditions of the debtors. The banks, due to the situation of debtors, change the contractual conditions of these loans but causing a greater loss for the banks themselves;
- *Past due loans*: loans overdue by 90 days.

These categories of non-performing loans represent the old Italian classification of non-performing loans before the introduction of the new European classification about non-performing loans recently introduced by the European Banking Authority. Indeed, after the European classification of non-performing loans provided by the European Banking Authority, the Italian banks are required to follow a new classification. This new classification implies the use of the term “non-performing exposures” rather than the term “non-performing loans” and the introduction of forborne loans, which are loans subject to changes of contractual conditions.

Hence, according to the European rules, the new classification of non-performing loans is the following¹⁰⁰:

- *Bad loans*: exposures of debtors in insolvency situations. This category is equal to the previous categories of bad loans but in addition, the forborne non-performing exposures (FNPE) take part of this category.
- *Unlikely to pay loans*: the loans that belong to this category are due to the inability of the debtors to repay them. This category substitutes the old substandard loans and restructured loans. Moreover in this category can be also included the forborne non-performing exposures (FNPE).
- *Past due more than 90 days loans*: exposures that do not belong to the bad loans and unlikely to pay loans categories and they are overdue by more than 90 days. Also in this category, there can be the segment of forborne non-performing exposures (FNPE)

Despite this fact, during all this analysis, for simplicity, is used the generic term non-performing loans to refer to all types of loans with the feature of uncertain recovery. Now, the attention is focused on the analysis of non-performing loans because they characterize the crisis scenario of the Italian banking system. At this point, in order to understand the magnitude of the problem of non-performing loans in Italy, it can be useful to look at the total value of non-performing loans compared with the value of GDP registered in Italy and in the other European countries¹⁰¹.

¹⁰⁰ PWC, December 2016, The Italian NPL market.

¹⁰¹ SCAGLIONI A., Marzo 2016, I crediti deteriorate in Europa, Approfondimento dell'Ufficio Studi e ricerca First Cisl.

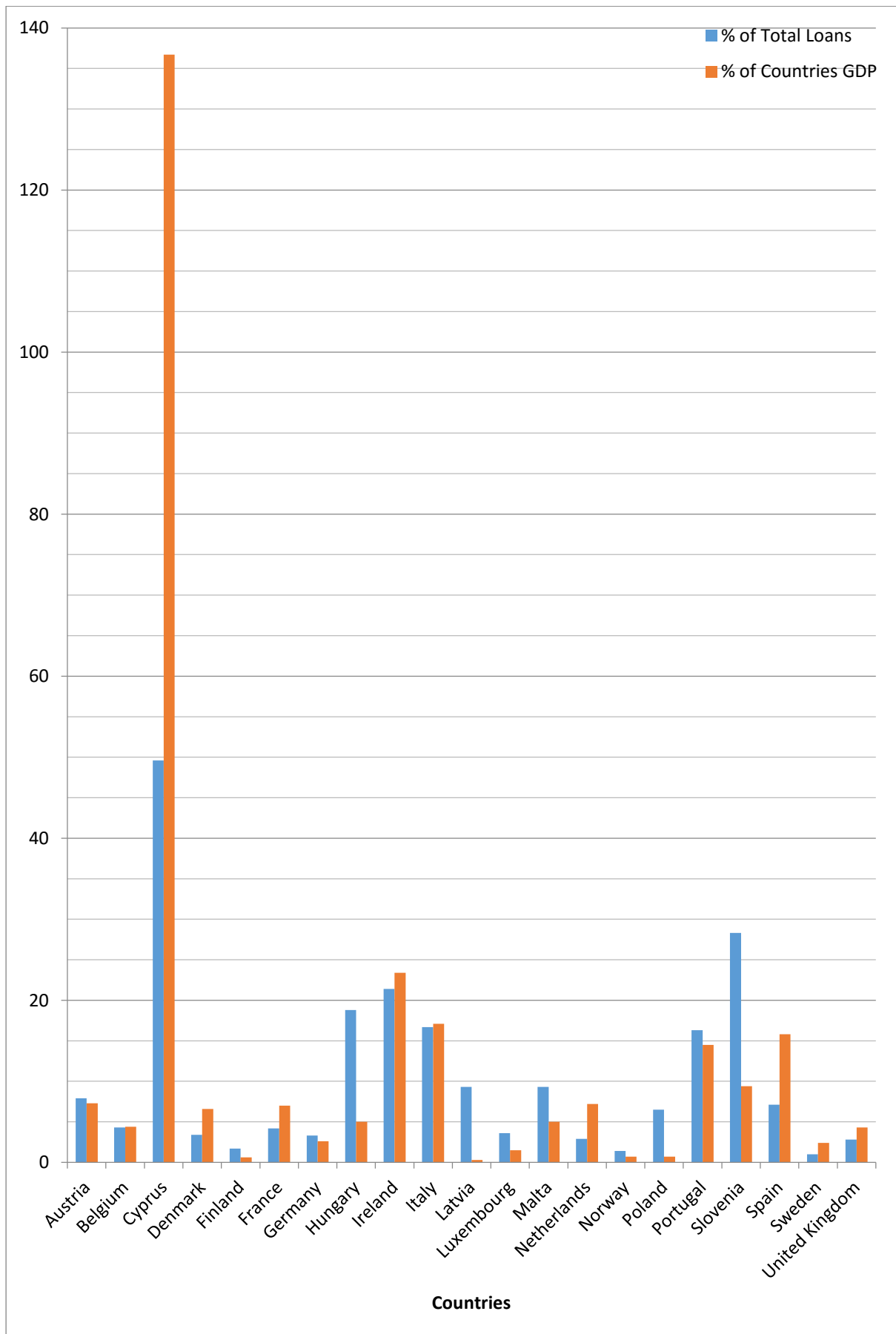


Figure 4: The comparison between the total non-performing loans and the GDP of European Countries. Source: SCAGLIONI A., Marzo 2016, I crediti deteriorate in Europa, Approfondimento dell'Ufficio Studi e ricerca First Cisl.

Looking at the data shown in the table above, it can be noted that Italy is in the third place, after Cyprus and Ireland, among the European countries with the high amount of non-performing loans. In particular the Italian percentage of non-performing loans on the total loans is equal to 16, 7% and corresponds to 17, 1 % of the Italian GDP.

At this regard, it is natural to wonder why the amount of non-performing loans is so high in Italy and why the non-performing loans weigh so much on the Italian GDP. It is possible to provide an answer to this question through the analysis of the effects of the financial and economic crisis on the Italian banking system and through the reference to the Italian banking weaknesses. Firstly, as regards the effect of the international crisis in determining the non-performing loans, it is necessary to consider the relation between the international financial and economic crisis and the Italian banking system¹⁰². In general, it is possible to say that the Italian banking system, although it has been affected by the crisis, has proven to be resilient compared to other banking systems. This fact is due to the traditional management of the Italian banking system essentially focused on the credit activity rather than the financial activity, the more susceptible activity during the crisis. Despite this fact, in a second stage, in which the international crisis affected the real economy, the credit activity, on which the Italian banking system is mainly based, although before it was considered a strength, during this second stage has proven to be a weakness.

Now, it is appropriate to explain in detail what happened during the crisis, how the credit activity has been affected and consequently how the non-performing loans have been produced. During the crisis, the financial resources of families and companies were reduced and this forced them to ask more and more loans to banks. Consequently, the banks granted loans to these subjects in difficulty without taking into account the creditworthiness of these subjects. This situation in the long run became unmanageable because, due to the worsening of the economic and financial conditions, those who had received a loan by the banks became unable to repay their debts. In this way, the banks began to register a significant amount of credits of doubtful collection, the so-called non-performing loans. More precisely, between 2008 and 2015, namely from the beginning of the crisis to the following years of recession, the amount of non-performing loans is increased from € 85 billion to € 350 billion with an increased incidence on the total amount of loans equal to 18%¹⁰³.

In addition to the macroeconomic factor of the crisis, there are other reasons at banking level that have contributed to the increase of non-performing loans that are, as anticipated before, the

¹⁰² PORTERI ANTONIO, Aprile 2010, La crisi, le banche e i mercati finanziari, Università degli studi di Brescia, Paper 102.

¹⁰³ RELAZIONE DELLA COMMISSIONE DI INDAGINE BANCA MARCHE, approvata il 24 maggio 2016, page 18.

weaknesses of the Italian banking system. The most relevant weakness that has contributed to the formation of non-performing loans is the old and conservative banking leadership, which during the years has granted loans recklessly to people unable to repay them or to people very close to the banking and political world. Thus summarizing, the main reasons that led the Italian banks to accumulate a so high amount of non-performing loans are:

- Precarious economic and financial conditions of the Italian families and companies due to the crisis.
- Banking system mainly based on lending activity.
- Bad management and weak governance in lending money.

Up to this point, the origins of non-performing loans and the causes of their high amount in the Italian banking system have been explained. In conclusion, it can be said that the non-performing loans represent a system wide problem because they affect the banks independently from their basic characteristics and sizes.

Despite this general consideration, it is necessary to explain, for the purpose of this analysis, why the non-performing loans in the four Italian banks have reached levels so high as to be considered the primary cause of their crisis. In order to explain why exactly these four banks have reached high level of non-performing loans must be analyzed two important factors that these banks have in common.

The first factor regards the banking category to which these banks belong. At this regard, should be specified that three of these banks belong to the banking category “Cassa di Risparmio” and one, Banca Etruria, to the banking category “Banca Popolare”. By definition these two categories represent the portion of the banking system mainly addressed to the activity of saving collection and to the activity of lending money. Hence, the credit activity represents the core activity of these banks and already this alone consideration justifies the high unsustainable amount of non-performing loans of the four banks.

Moreover, another important factor that must be taken into account is the relation with the territory, in which these four banks are located. Indeed, all these four banks have in common the fact of being banks of local dimension with a strong connection with the territory. In this case are exactly the concept of territory and the relation with the local institutions that lead these banks to accumulate high amounts of non-performing loans. More precisely, the local and territorial dimension of the four banks is, on one hand, important because these banks represent a reference point for many small-medium companies located in those territories, but, on the other hand, this

close relation with the territory can be very dangerous for the credit activity¹⁰⁴. The danger is represented by the fact that these banks, based only on the preservation and the improvement of the territory, grant easily and uncontrollably loans to any institution of the territory without thinking that there is the high probability that the borrowed money does not come back anymore. After this detailed analysis about the causes, it is equally important to analyze the consequences of the excessive presence of non-performing loans. As regards the consequences of high amounts of non-performing loans, the explanation is simple and intuitive. As previously discussed, the progressive deterioration of the economic and financial conditions and the increase of the amount of non-performing loans created serious problems in all credit institutions. Indeed, for these reasons the banks suffered huge losses, which, in turn, determined deficit of capital, difficulties in the prosecution of lending activities and, more in general, low profitability. Hence, as a consequence of this fact, the banking solidity was undermined so much that some banks were seriously likely to fail. This is exactly what happened to the four Italian banks but also to many other banks of the Italian banking system. Since the phenomenon of non-performing loans regards the entire Italian banking system, in order to avoid a repeat of the situation of the four Italian banks, affected by the non-performing loans so much that they absolutely needed of banking rescue measures, it is necessary to understand how to solve and limit the problem of non-performing loans in Italy.

Now, before looking at the possible solutions to the problem of non-performing loans, it is interesting to understand how and through what methods the authorities can assess and document the effective presence of non-performing loans recorded, due to the previous reasons, by the Italian banking system. At this regard, it is necessary to explain what authorities responsible of the problem of non-performing loans are and what the methodologies used for their finding are. First, the authorities responsible for the investigation on non-performing loans are, at European level, the European Central Bank and, at Italian level, the Bank of Italy. Both these authorities, designated respectively as the European and the Italian supervisory authority, conduct periodically with the technical assistance of the European Banking Authority the investigation about the solidity of banks.

In recent times, due to the problems of non-performing loans, the analysis of the solidity of the banking system is focused on the presence of non-performing loans in the banking financial statements. For the purpose of a greater control, starting from 2013, the European Central Bank and the national authorities implemented a process called “Asset Quality Review”. This process

¹⁰⁴ PICCONE B., Dicembre 2015, La farsa smascherata della banca del territorio e dei debitori di riferimento, *Econopoly*, Il Sole 24 Ore.

acts as a support of the traditional stress tests through a preliminary risk assessment and a specific review of the banking assets that, in turn, consists in a detailed analysis of the loans. After this review, the supervisory authorities subject banks to stress tests in order to evaluate their capital adequacy especially in situations of financial distress.

Moreover, in addition to the Asset Quality Review, starting from 2015, was implemented a periodic process of comprehensive review called “ Supervisory Review and Evaluation Process” (SREP). The aim of the SREP is the evaluation of the liquidity and capital conditions necessary to cover the banking risks, which, recently due to the non-performing loans, are increased. Thanks to these analyses, it is possible to obtain a realistic picture of the situation of non-performing loans in Italy.

After the understanding of the way through which the non-performing loans are evaluated by the authorities, the focus of the analysis shifts to the factors that have hindered the achievement of a solution to this problem. Starting from the assumption that the banks cannot fail and focusing on the objective that the banking business must be restored and free of the burden of non-performing loans, possible solutions to this problem must exist. However, the solution is low in coming because there are some factors, typical of the Italian system, which impede the finding of a solution and consequently the disposal of non-performing loans. The main factors that make the disposal process of non-performing loans very long are the complex legal system, the lengthy juridical process and the tax system. Despite these difficulties, the most simple and intuitive solution seems the renegotiation of the contractual conditions between the banks and the debtors in order to give to the debtors the opportunity to have more time to repay their debts. This is not always possible and the alternative is the sale of non-performing loans. Anyway, the sale of non-performing loans requires the existence of a market of non-performing loans in which the sellers are the banks and the buyers are investors or societies specialized in the management of non-performing loans. The main problem that extends the time of realization of this market is the difference between the price of sale and the purchase price of non-performing loans. In order to understand this problem, it is necessary to make a parenthesis about the accounting of non-performing loans in the banking financial statement.

The non-performing loans influence and contribute to determine the quality of assets of the banks exactly as the other loans but, more precisely, in this case with a negative impact. In general, the loans are recorded in the banking balance sheet considering the gross amount of their value but then, when they become non-performing they are evaluated considering their net

amount¹⁰⁵. The net book value of non-performing loans is obtained by subtracting, from the gross book value, the value of the reserves destined to the coverage of the losses generated by non-performing loans. Hence, the net book value of non-performing loans is nothing more than the loss recorded by the banks due to the impossibility to recover the loan.

Now, returning to the difficulties of developing a market of non-performing loans, the main difficulty regards the fact that the investors are willing to buy the non-performing loans at a price lower than their net book value causing so other losses for the banks. For this reason, the sale of non-performing loans to third parties is limited and the banks prefer to be autonomous in the non-performing loans disposal. However, starting from 2015 about € 5 billion of non-performing loans were sold to third parties specialized in their management. This fact is probably due to the situation, as we will be seen later, of the four Italian banks.

Hence, this means that something begins to change and the market of non-performing loans in Italy begins to take shape.

¹⁰⁵ • CIAVOLIELLO L. G., CIOCCHETTA F., CONTI F.M., GUIDA I., RENDINA A., SANTINI G., Aprile 2016, Quanto valgono i crediti deteriorati? Banca D'Italia, Note di stabilità finanziaria e vigilanza N.3.

3.2 The profile of the four Italian banks before the banking rescue.

The four Italian banks, protagonists of this analysis, are Banca Marche, CariFerrara, CariChieti and Banca Etruria. These banks have in common some basic features that have led them to the same destiny. As previously analyzed, the decisive reasons of their failure, to which then the rescue is followed, are attributable to the weaknesses of the Italian banking system and to the excessive amounts of non-performing loans. Despite these facts, common to many other Italian banks, the main feature that the four Italian banks share and that has greatly contributed to their situation is the small-medium and local dimension. Indeed, the medium and local dimension of the four Italian banks is a determining factor for two main reasons.

The first reason, according to which the small-medium and local dimension represents a trigger factor, regards the general and typical tendency of the small-medium Italian banks to expand their banking business in the local area. Indeed, the Italian banks of contained dimension expand their business through a close network of subsidiaries creating, in this way, small and inefficient credit institutions that, in turn, contribute to increase the costs and to decrease the operative efficiency.

Moreover, the second reason that attribute to the small-medium and local dimension the role of trigger factor is the high level of non-performing loans. Indeed, despite the small-medium size, the managers of these banks believe to increase the profitability through interests related to loans, granted recklessly to families and enterprises. This fact has led the four Italian Banks to accumulate high levels of non-performing loans, which are more difficult to sustain and manage for banks characterized by no so large dimensions. Now, after a brief explanation of the features of these four Italian banks and after the understanding of the main causes of their financial distress, it is time to go on with the analysis.

At this point, before explaining the measures taken in a first time according to the Italian insolvency proceedings and then according to the European Directive BRRD, it is important to figure out some more details about these banks and their history. Indeed, for the purpose of this analysis, it is interesting and fundamental to clarify who these four Italian banks really are and how their situations before the rescue measures are.

Before analyzing the individual situation of each bank, it is also necessary to specify the criteria according to which this study is developed. More precisely, for each of these four banks, are analyzed the historical origins and the first steps of their evolution, the phases of the supervision

activity conducted by the Bank of Italy and the more relevant accounting data¹⁰⁶ that show the principal and effective problems.

Hence, the cognitive profiles of the four Italian bank, from their origins to conditions that led them to extraordinary administration, are reported below.

*Banca Marche*¹⁰⁷: Banca Marche was founded in Ancona in 1994. It represents the result of the merger between “Cassa di Risparmio di Pesaro” and “Banca Carima”. After the foundation, the history of Banca Marche is characterized by a series of acquisitions of other regional banks in order to strengthen the presence of the banking group in the territory. More in detail, the project of the territorial expansion, through the opening of several subsidiaries, has involved not only the Marche Region but also other regions as Abruzzo, Umbria and Lazio. This situation is perfectly in line with the typical need of a medium-sized regional bank to act as a reference banking entity, to promote the territory and to serve it in capillary manner. Everything seems to go well but in reality, after the expansive phase that corresponds to the period between 2004 and 2010, the supervisory authorities detected the presence of some problems. As regards the detection of problems, it is important to say that they were identified through specific inspections conducted by the Bank of Italy with the objective of identifying critical situations. More in detail, during the inspections, three in this case, were monitored and evaluated with a precise score some management aspects. The overall opinion, after these three inspections, showed the presence of some weaknesses and critical points in the system of Banca Marche. The main problem regarded the amount of non-performing loans registered. Indeed, in 2011 the amount of non-performing loans detained by Banca Marche was increased, probably due to the financial and economic crisis, by 28,9% compared to 2010. In addition, also looking at the number of non-performing loans on the total amount of loans (NPL/Total amount of loans%), it is possible to note an increase of this ratio from the 7,5% of 2010 to the 9,8% of 2011. The other problems regarded respectively the weakness of the governance and the low capitalization. After the detection of the just mentioned problems, the Bank of Italy intensified its controls and required Banca Marche to implement specific actions in order to correct the problems identified. In particular, as regards

¹⁰⁶ The interesting accounting data used for the analysis of the four Italian banks regards two main aspects: the non-performing loans and the capital banking solidity. As regards the first aspect, it is necessary to specify that the term “non-performing loans” is used as a generic term, which comprises all the types of non-performing loans (past due loans, restructured loans, substandard loans and proper non-performing loans). Moreover, they are evaluated, according to the availability of data, through the NPL amount/ Total amount of loans% and NPL Coverage Ratio (value adjustment to non-performing loans/gross book value of non-performing loans%). As regards the capital banking solidity, it is evaluated, according to the availability of data, looking at capital indicators as CET1, Tier1 Capital Ratio and Total Capital Ratio.

¹⁰⁷ RELAZIONE DELLA COMMISSIONE DI INDAGINE BANCA MARCHE, 24 Maggio 2016. BANCA D'ITALIA, La crisi di Banca delle Marche, available on the website www.bancaditalia.it.

the problem of non-performing loans, Banca Marche was required to be more prudent in terms of reserves and loans. Moreover, it was necessary a renewal of the banking management in order to improve the efficiency of the governance. In the end, as regards the last problems, it was required an increase of capital to be in line with the new prudential rules set by Basel III. Subsequently, between 2012 and 2013, the Bank of Italy submitted Banca Marche to other inspections that this time proved to be decisive. Indeed, thanks to these last inspections, the Bank of Italy was able to verify that the problems diagnosed before were still present. It means that the corrective measures have not been sufficient or that the Bank has not done enough to solve its problems. For this reason, due to the irregularities founded in the inspections, a sanctions process against Banca Marche was implemented. However, the situation became particularly difficult at the end of 2012 and then precipitated in 2013. The deterioration of the economic and financial conditions of Banca Marche was attributable to succession of inappropriate choices taken by inefficient banking management and to the intensification of the economic and financial crisis that, in turn, was responsible of the significant increase of non-performing loans. The dramatic situation of Banca Marche appeared immediately clear looking at the data of the consolidated financial statement at 31 December 2012. An important point useful to understand the seriousness of this situation is the loss for the period of € 527.7 million compared to the previous (2011) profit for the period of € 133 million. Certainly, a loss of this magnitude is the clear result of the economic and financial crisis. Indeed, due to the crisis, the banking business of Banca Marche has been compromised. In particular, the effect of the crisis is visible looking at the decrease in banking collection of 6,9% and to the increase, from 9.8% in 2011 to 15,5% in 2012, of the amount of non-performing loans compared to the amount of total loans. Moreover, also as regards the capital situation, the decrease of Total Capital Ratio (from 11,98% of 2011 to 9,74 of 2012) and of the Tier 1 Capital Ratio(from 8,32% of 2011 to 6,46% od 2012) show a weakness of the capital system. Hence, at the end of 2012 Banca Marche appeared not to be in good conditions. After this situation, the management of Banca Marche prepared an industrial plan in order to face and manage effectively this problematic situation. The aim of the industrial plan was the strengthening of Banca Marche through a policy of capitalization and management of non-performing loans. Despite the attempts proposed by the management, as the industrial plan, in order to improve the situation of the bank, the conditions of Banca Marche appeared so critical and desperate that it became necessary to dismiss the current managements and appoint an extraordinary management. This means that in October 2013 Banca Marche was placed under extraordinary administration. During that period, the bank guaranteed the continuity of its essential activities through a management entrusted to extraordinary commissioner. Meanwhile,

the Bank of Italy continued its investigations in order to understand the reasons that led Banca Marche to this situation.

*CariFerrara*¹⁰⁸: this bank was founded in Ferrara in 1838 and represents the original and ancient “Cassa di Risparmio di Ferrara”. Starting from 2002, this bank became a group called “Carife” or “CariFerrara” and in particular, from 2002 to 2012, this bank was marked by a series of acquisitions of leasing societies and of other banks. Although the phase of continuous growth, thanks to the inspections of the Bank of Italy, the economic and financial situation of CariFerrara did not appear not entirely positive and profitable. Indeed, the banking financial statements until 2012 showed losses and amount of non-performing loans over the Italian banking average. The reasons lied on one hand in the financial and economic crisis that affected all the Italian banking system and on the other hand in the bad management of this bank. The financial and economic crisis was surely responsible of this result especially as regards the amount of non-performing loans that in 2012 reached the 33,1% of the total loans. In addition to the exogenous crisis, common denominator of all banks, the most peculiar and interesting factor, which affected the situation of CariFerrara, was internal to its own history. Indeed, due the excessive ambition of the management to increase and expand the banking group, with the aim of covering a central role in the Italian banking system, CariFerrara recorded huge losses. In particular, these losses were the results of the high sustained costs for the acquisition or foundation of small credit institutions that, over the time, proved to be inefficient and unprofitable. Moreover, there was another specific situation linked with the unadvised and unconscious choices of the banking management that contributed to increase losses and to worsen the conditions of the bank. At this regard, the reference was to the involvement of CariFerrara in risky real estate investments in 2006 and 2008. Indeed, in that period CariFerrara invested an amount of € 140 million in two real estate projects (Santamonica and Miluce) aimed to the construction of properties in Milan. The reason of this involvement was the fact that the project were signed by Vegagest, a saving company in which CariFerrara owned the 30, 52% of shares. After this large disbursement, CariFerrara recorded significant losses because these investments failed and it did not receive money back. In particular, about this fact were made a series of investigations and it emerged that the bank was cheated by gains in the purchase of lands for projects. Moreover, this situation led the Bank of Italy to conduct inspections and to evaluate the financial instability of the bank. In conclusion, due to the losses caused by the non-performing loans and by the bad management, CariFerrara was placed under extraordinary administration in 2013.

¹⁰⁸ Section of financial statements available on www.carife.it

*CariChieti*¹⁰⁹: CariChieti stands for “Cassa di Risparmio di Chieti”. This bank was founded in 1862 and represents the banking reference point in Abruzzo. CariChieti, as the other banks analyzed before, is a regional banking entity that, over time, expanded its radius of action in the Center of Italy and then in small part in Northern Italy. The first serious problems about this bank emerged between 2010-2012, after a ten-year period of territorial expansion and growth of funding. At this regard, the inspections of the Bank of Italy highlighted irregularities and bad management but the minimum capital requirements were considered sufficient. In general, CariChieti showed some difficulties but it was still able to resist. Then, in the first part of 2013, CariChieti showed an improved general condition documented by a small but important increase of the CET1, the main banking solidity indicator, from 8, 54% in 2012 to 8, 70% in 2013. Moreover, also the situation of non-performing loans is improved thanks to the write-off of € 83 million of non-performing loans and thanks to the increase of the level of coverage of non-performing loans (from 26,64% to 35,70%). However, only a few months later, the situation changed completely. The Bank of Italy showed, through its inspection, a general worsening of the conditions of CariChieti in terms of irregularities, capital and non-performing loans. In particular, it was noted that the capital reached scarcely the minimum requirement and that the amount of non-performing loans reached € 453.8 million. As regards the high amount of non-performing loans, it was also influenced by Flash Bank, a bank of Carichieti properties considered a receptacle of non-performing loans. For all these reasons, CariChieti was placed in extraordinary administration in 2014.

*Banca Etruria*¹¹⁰: this bank was founded in 1988 as “Banca Popolare dell ’Etruria e del Lazio” and, over the time, expanded its banking business in the Center of Italy and in the Northern of Italy. In the case of Banca Etruria, the Bank of Italy detected the first serious problem during an inspection started in December 2012 and concluded in March 2013. During these years, Banca Etruria, as the other banks of the Italian banking system, was significantly affected by the financial and economic crisis and for this reason, the results obtained by the inspection led the Bank of Italy to certify an unfavorable situation. In particular, in 2012, Banca Etruria, due to the general phenomenon of credit quality deterioration, showed a high level of non-performing loans equal to an amount of € 397.7 million, a percentage of non-performing loans on total loans equal to 6,6% and a NPL Coverage Ratio equal to 54,5%. Then, the situation in 2013 appeared even

¹⁰⁹ Section of financial statements available on www.carichieti.it .

¹¹⁰ Section of financial statements available on www.bancaetruria.it .

more problematic due to the increase of the percentage, from 6,6% in 2012 to 10,3% in 2013, of non-performing loans on the total amount of loans. Although the increase of non-performing loans, the NPL Coverage Ratio was more or less stable and equal to 52,5%. Substantially, after the examination of these data, Bank of Italy, thanks to its inspection, highlighted a general inability of Banca Etruria to manage the non-performing loans however balanced by the presence of capital in line with the minimum capital requirements. After this inspection, the Bank of Italy required Banca Etruria to develop some corrective actions especially in terms of capital increase in order to sustain the highest number of non-performing loans. More precisely, the Bank of Italy required Banca Etruria to consider the possibility of becoming part of a banking group with the goal of increasing the capital more easily. At this regard, Banca Etruria received but refused the offer of Banca Popolare di Vicenza. This fact showed the lack of interest by the banking management in applying the corrective measures and led the Bank of Italy, after a sanction process against the bank, to undertake another inspection. This inspection, started in November 2014 and ended in February 2015, showed a general worsening of the economic-financial conditions and a decrease of capital below the minimum requirements that led, immediately after the conclusion of the inspection, Banca Etruria to the extraordinary administration. The principal reason of this decision, taken by the Bank of Italy, can be attributable to the inability of the management to face the problems detected by the previous inspections.

3.3 The solutions of the Bank of Italy to the problem of the four Italian banks before the European Directive BRRD.

The objectives of this paragraph are essentially two: the understanding of the role and the decisions of the Bank of Italy in the management of this banking situation and the analysis of the Italian alternatives of banking rescue before the application of the new European rules. As regards the first point, the answer is already partially given by the detailed analysis of the inspections of the Bank of Italy, case by case, developed in the previous paragraph.

However, it is important to understand the way by which the Bank of Italy conducts its inspections and the underlying meaning and reason of extraordinary administration procedure. Firstly, it is important to specify that the Bank of Italy conduct inspections on the soundness of banks because it represents the supervisor of the Italian banking system. The power of supervision was assigned to the Bank of Italy thanks to the Legislative Decree No.385/1993 (TUB). Moreover, the central role of supervisor played by the Bank of Italy was strengthened by the entry into force of the Single Supervisory Mechanism in 2014. According to the conferred powers, the Bank of Italy applies instruments and techniques of control in order to assess the efficiency and transparency of the banking operations and more in general the solidity of the credit institutions. In addition, after the transposition in the Italian legislation of the European Directive BRRD, the Bank of Italy also plays the role of National Resolution Authority in Italy. All this, helps the Bank of Italy to have a complete picture both in terms of ordinary supervision both in terms of supervision in case of banking crises. Hence, thanks to its competences, the Bank of Italy plays a key role in the supervision and in the management of the situation of the four Italian Banks¹¹¹. Indeed, the prior detection of the problems of the four Italian banks is entrusted to the Bank of Italy and to its inspections. Everything begins with the ordinary supervision inspections, carried out by the Bank of Italy, which show irregularities and critical aspects in the management of each of these four banks. The inspections consist in a detailed analysis of the most relevant aspect of the banking business as for example the credit quality and the capital situation. In particular to each banking aspect is assigned a score, in order of increasing negativity, from 1 to 6. All the four banks have recorded high but negative scores that, in turn, are synonymous of problems and criticalities in some aspects. After this first stage, the Bank of Italy communicates to the management of the banks the detected problem and the respectively corrective measures to apply. In the case of the four Italian banks, the principal

¹¹¹ BANCA D'ITALIA, L'attività di vigilanza svolta dalla Banca d'Italia: linee generali e interventi nei confronti delle quattro banche poste in "risoluzione" available on www.bancaditalia.it

problems regard the high levels of non-performing loans and inefficiency of the management. As regards, instead, the capital situation, at the moment of the inspection all the four Italian Banks satisfy the minimum capital requirements. Then, at a later stage, the Bank of Italy verifies if the management of the banks has applied the corrective measures. More in details, if the management has not applied completely or in a sufficiently manner the corrections, the Bank of Italy investigates and starts the decisive inspection. This inspection has the aim to verify if the general condition of the bank, in respect to the previous, are worsened. In the case of the four Italian banks, the decisive inspections show a general deterioration of the conditions and especially highlight high losses and levels of capital below the minimum requirements. This situation leads the Bank of Italy, after the assessment of the existence of the preliminary conditions, to submit the banks under the extraordinary administration procedure¹¹². In particular, if the basic assumptions¹¹³ exist, and this is the case of the four Italian banks, the Bank of Italy through a decree of the Minister of Economy and Finance disposes the temporary receivership¹¹⁴ of the banks. During the extraordinary administration procedure, the banking administrative bodies are dissolved and replaced by one or more extraordinary commissioners and by an extraordinary committee of supervision¹¹⁵. Both these two new administrative bodies are responsible of the banking management and of the continuity of the essential banking functions for the duration of the extraordinary administration. The objective of the extraordinary commissioners is a more depth analysis of conditions and irregularities that have led to this situation with the ultimate aim of understanding if these banks have the possibility to survive or if they are necessarily destined to failure. After the execution of their functions, in a period of one year¹¹⁶, the extraordinary commissioners and the extraordinary committee of supervision are required to write and send a report of their activity to the Bank of Italy. Furthermore, thanks to the phase of extraordinary administration and to the activity of the commissioners, it is possible

¹¹²The discipline of the extraordinary administration procedure is contained in the Articles 70-76 of the Title IV of TUB.

¹¹³According to the Article 70 of TUB, the basic assumptions for the correct application of the extraordinary administration are:

-Serious administrative irregularities;

-Serious losses of capital;

-Dissolution of the original administrative bodies required by specific reasons of the extraordinary assembly.

If the Bank of Italy does not verify the presence of these assumptions and applies the extraordinary administration when the necessary conditions do not exist, it overcomes its powers.

¹¹⁴The term "Temporary receivership" stands for the Italian term "Commissariamento" and it is referred to the dissolution of the original banking management and to its replacement by extraordinary commissioners.

¹¹⁵Article 71 of TUB for the appointment of extraordinary bodies and Article 72 of the same Legislative Decree for their functions.

¹¹⁶The normal duration of the extraordinary administration is set at one year but can vary according to the need of the Bank of Italy. In particular cases, the procedure can be extended for a period that must not exceed six months. This is the case of Banca Marche.

to identify some individual administrative irregularities punished with a sanction process. At this point, after the explanation of the extraordinary administration, it is necessary to understand what the available possibilities for the banks are and what the banking rescue options for the four Italian banks are. Usually, after a period of extraordinary administration, two different scenarios are offered to the banks: the positive scenario of banking recovery and the negative scenario of compulsory administrative liquidation, which consists in the devaluation and liquidation of the banking assets and more in concrete in the close and failure of the banking business. As regards the serious situation of the four Italian banks, the possibility of a recovery is improbable but the alternative of compulsory administrative liquidation is very plausible. The solution of the compulsory administrative liquidation represents one of the possible alternatives for the final management of the four Italian banks. In addition to this solution, the Italian authorities examined other solutions in order to face the crisis of the four Italian banks. The first proposed hypothesis regards the intervention of the “Fondo interbancario per la tutela dei depositi”, called hereinafter “FITD”. The principal aims of this institution are the guarantee of the depositors of the banks that belong to this fund and the intervention in case of banking crisis. Indeed, the FITD can intervene in banking crises thanks to the contributions that each bank, participating in the initiative, pours into this fund. An intervention of this type allows to rescue the bank in crisis protecting, at the same time, the banking depositors and the stability of the entire banking system. A last possible alternative regards the intervention of a scheme of the FITD based on voluntary banking contributions¹¹⁷.

After a brief list of the alternatives, it is important to specify that neither of these alternatives have been applied because they are considered incompatible or non in line with the new European rules about the management of banking crises introduced by the European Directive BRRD. This European Directive, transposed in Italy through the Legislative Decrees No.180 and No.181 of 2015 introduces a new principle of banking crises management. According to this principle, the banks in crisis can no longer be saved by external and public aids but only by tools providing the internal sacrifice and contribution, following a pecking order, of the people involved in the banking business.

Now, it is time to analyze the reasons why it is not possible to apply these measures and why they are incompatible with the European rules. First, as regards the compulsory administrative liquidation, it was not be applied because it could lead to more worsening of the conditions of the subjects involved in the banking rescue than provided by the new European rules. Indeed, since the fact that the compulsory administrative liquidation leads to the integral devaluation and

¹¹⁷The voluntary scheme available on www.fitd.it

the sale of the banking assets, it affects not only the shareholders and the bondholders of subordinated bonds, as provided by the BRRD Directive, but also the other creditors and depositors. This, in general, means to record losses greater than those that would be obtained according to the new European mechanism. Instead, as regards the intervention of the FITD, it was not applied because it was considered a state aid¹¹⁸ and therefore against the new European rules of the European Commission. At this regard, there was a long debate between the Italian government and the European Commission. Indeed, on one hand, the Italian government defended the private nature of the FITD, entirely financed by the members banks, and, on the other hand, the European Commission considered this type of intervention of public nature. In particular, the European Commission, despite considering private the resources of the FITD, argued that the banks, belonging to the FITD, were forced by the government to use their funds for the banking rescue of the four banks and this underlying reason was sufficient for the European Commission to confirm the public nature of this intervention. Hence, according to the fact that the new European rules expressly prohibit any intervention of public nature, the alternative of the FITD intervention failed. The last alternative, not applied as the others, regards the voluntary nature of the intervention of the banks. Indeed, if the operation of banking rescue is financed by the banks, but on a voluntary basis, it can be applied because considered of private nature and not contrary to the principles of the new European rules. This is exactly what happened a bit of time after for the banking rescue of Banca Tercas. Substantially, it was created by the FITD a scheme based on the voluntary banking contributions that must reach the threshold of € 700 million and that can be used in case of banking rescue of credit institutions in financial distress. Although the compatibility of this intervention with the new European rules, it was not possible to apply it in the case of the four Italian banks because the amount of financial resources necessary for this banking rescue is too high to be found. At this point, the analysis of the possible alternatives proposed by the Italian authorities in order to rescue the four Italian banks is concluded.

Now, it is interesting to know what the real and effective solution for the case of the four Italian banks is. For this purpose, the following paragraph is entirely dedicated to the analysis of the solution adopted to save Banca Marche, CariFerrara, Carichieta and Banca Etruria.

¹¹⁸ EUROPEAN COMMISSION, 2016, Commission Notice on the notion of State aid as referred to in Article 107(1) of the Treaty on the Functioning of the European Union (2016/C 262/01). This communication of European Commission it is useful to understand the concept of “state aid” in order to avoid misunderstandings and difficulties in its application.

3.4 The rescue of the four Italian banks in the view of the European Directive BRRD.

Before analyzing the solution applied for the banking rescue of the four Italian banks according to the European Directive BRRD, it is important to remind the general principles on which this European Directive is based. First, it is necessary to explain why a bank should be saved. The answer to this question is very simple and lies in the fact that the function played by the banks is so important that the failure of even a single bank can determine the instability of the entire banking system. Moreover, the instability of the banking system determines, in turn, the instability and the weaknesses of productive and industrial system and in the end, the real economy result compromised. Exactly for this reason, it is essential to save the bank in financial distress. According to this general idea, the BRRD Directive states that the banks must be resolved and not liquidated. Hence, the BRRD Directive opposes to the insolvency proceeding of liquidation the procedure of resolution. In particular, the resolution procedure differs from the liquidation because the first one is aimed to the continuity of the banking business while the second one to its ending. The resolution introduces in the European banking system a new way to manage the banking crises based on the principle that the banking rescue must be internal and not external. This means that, as previously discussed, the public aid are not allowed and thus the banking rescue occurs through the contributions of the people involved in the banking business. Thus, the resolution procedure aims to the continuity of the banking business through a system of contributions, which does not provide the sacrifice of all the taxpayers, as in the case of public aids, but only the sacrifice of the people involved in the banking business according to a precise pecking order. Thanks to this new European mechanism of banking crises management, introduced in 2014 but operative from 2016, the prospective of banking rescues are changed. For this reason, the previous solutions proposed by the Italian authorities were rejected because they were considered inappropriate and not in line with the new European rules. At this point, returning to the problem of the four Italian banks, the only possible alternative, after the extraordinary administration, is the way of resolution according to the European rules.

Now, it is time to examine the application of the European rules to the case of the four Italian banks and the process of their banking rescue. First of all, it is important to remind that the European rules about banking crises management were transposed in the Italian Legislation thanks to the Legislative Decrees No.180 and No.181 of 16 November 2015 and shortly after the transpositions of these rules, it was possible to apply the tools of the resolution procedure to the four Italian banks. As regards Banca Marche, CariFerrara, CariChieti and Banca Etruria it was

possible to apply the resolution procedure precisely because these four banks respect the basic requirements, provided by the BRRD Directive, necessary for the implementation of this procedure. Indeed, as highlighted in the detailed analysis about the resolution procedure in the previous chapter, are considered necessary assumptions for the implementation of resolutions the assessment of the status of banking insolvency and the impossibility to apply other solutions of banking rescue. In the case of the four Italian banks, all these assumptions are respected because indeed, they register high losses and none of the solutions previously proposed is suitable to their rescue. Hence, after the assessment of the necessary conditions, the four Italian banks were subjected to the resolution procedure through the Legislative Decree No.183 of 22 November 2015¹¹⁹ issued by the Italian government. More precisely, the Legislative Decree No.183 of 22 November 2015, defined decree “Salva Banche” and entered into force on 23 November 2015, was designed specifically to allow the banking rescue of the four Italian banks according to the principles and tools provided by the European Directive BRRD.

Now, it is time to explain what the Legislative Decree “Salva Banche” provides, what resolution tools are involved and what the payers of this banking rescue are. Hence, starting from the Legislative Decree “Salva Banche” it is important to point out its objective. The main goals of this Legislative Decree, designed by the Italian government, are the rescue of the four Italian banks, ensuring to them the continuity of their banking business, and, consequently, the safeguarding of the Italian banking system, which, in turn, can be undermined by the banking failures. According to the European rules of the BRRD Directive and to the Legislative Decree “Salva Banche”, the banking rescue of the four Italian banks consists in the separation of the “good” banking side from the “bad” banking side through the institution of four bridge banks and of one bad bank. In particular, as regards the “good” banking side, it is entrusted to the institution of the bridge banks. According to the definition of bridge banks in the Article 38 of the BRRD Directive, the bridge banks are banks that hold the healthy assets and the liabilities of the insolvent banks ensuring the continuity of their business until the moment in which the insolvent banks become solvent through their acquisition by other banks or until their definitive liquidation. In particular, in the case of the four Italian banks, the Legislative Decree “Salva Banche”, according to its Article 1, based on the article 42 of the Legislative Decree No.180 of 16 November 2015, provides the institution of four bridge banks, on four each of the four banks. These four bridge banks are nothing more than four new societies, that replace the old diseased four banks with the aim to preserve their healthy side and to continue their essential functions.

¹¹⁹ The full text of Legislative Decree No.183 of 22 November 2015 is available on the edition n.273 of Gazzetta Ufficiale.

Hence, appear in the Italian banking scenario four new banks, denominated respectively Nuova Banca delle Marche S.p.A., Nuova Cassa di risparmio di Ferrara S.p.A., Nuova Cassa di risparmio di Chieti S.p.A. and Nuova Banca dell'Etruria e del Lazio S.p.A. The four new bridge banks were established thanks to the recapitalization intervention sustained by the National Resolution Fund and then were managed by the Unit of Resolution of the Bank of Italy, which precisely entrusted their temporary management to Roberto Nicastro. Instead, as regards the “bad” banking side of the four Italian banks, consisting in non-performing loans, it flows in a special society called bad bank, capitalized by the National Resolution Fund and represented, in the case of the four banks, by the company “REV Crediti S.p.A”. The bad bank, introduced in the banking scenario of crises management by the Article 42 of the BRRD Directive, represents a society, which deals with the management of the non-performing loans. The aim of the institution of the bad bank is to deprive and clean the banking financial statements from the high amount of non-performing loans, which, in the case of the four Italian banks corresponds to a gross amount of € 8.5 billion, then written down at the value net of adjustments of € 1.5 billion. More precisely, the activity of the bad banks consists, after the isolation of the toxic banking assets, in the scission of these assets through the subscription of government shares or through the issuing of ordinary shares tradable in the market. Before concluding the main part of the banking rescue, represented by the division of the banking business between the good banks and the bad bank, it is important to note that this subdivision is the first significant step in order to find a solution to the problem of the non-performing loans and to develop their market. In the end, the last stage that concludes the resolution procedure of the four Italian banks consists in the compulsory administrative liquidation of the four old banks and in sale of the four new banks to the big banks of the Italian banks.

After the explanation of the mechanism by which the banking rescue of the four Italian banks is implemented, it seems clear that the cost of this banking rescue of exceptional magnitude is very high. At this regard, indeed, it is necessary to figure out those from whom this cost was sustained. Before looking at the real contribution that financed this banking rescue, a clarification must be done. As analyzed in the previous paragraph, according to the European rules about banking crises management, the banking rescue of the four Italian banks is occurred entirely at the expenses of the Italian banking system and without the least involvement of the State. More in detail, the banking rescue is occurred, through the Legislative Decree “Salva Banche” of 22 November 2015, less than a month before the entry into force of the mechanism of bail in, set at the date of 1 January 2016. Despite the fact that the bail in was not yet in force, the banking rescue happened anyway through the principle of burden-sharing, provided by the

mechanism of bail in. Now, after these premises, the focus is on the real contributions to this banking rescue.

The main contribution of this banking rescue is at the expenses of the National Resolution Fund while the remaining part is at the expenses of the people involved in the banking business of the four Italian banks. The National Resolution Fund was established, according to the BRRD Directive and the Legislative Decree No.180 of 16 November 2015, through the disposition No.1226609/15 of 18 November 2015¹²⁰ issued by the Bank of Italy. The role of this Fund is to provide a tool of financial resources to be used to pursue the objective of resolution in case of banking crises. The financial resources that the National Resolution Fund provides for the Italian banks in financial distress are obtained through ordinary and extraordinary contributions that the Italian banks, members of this fund, periodically pour. In addition, the Article 2 of the Legislative Decree “Salva Banche” requires additional contributions to the banks, if the ordinary and extraordinary contributions were considered not sufficient to cover the losses and costs that the National Resolution Funds must sustain for the banking rescue the banks. Clearly, the contributions of the Italian banks into the National Resolution Fund are proportional to the size and the risk profile of the banks. In particular, in the case of the immediate use of the Fund in order to save the four Italian banks, the principal placing of money was supported by the three largest banks that are Banca Intesa Sanpaolo, Unicredit e Ubi Bank. As regards the contribution of the National Resolution Fund in the banking rescue of the four Italian banks, is amounted to € 3.6 billion. More precisely, the amount of € 3.6 was divided as follow: € 1.7 billion destined to cover the losses of the four banks, € 1.8 billion destined to the recapitalization and functioning of the four bridge banks and about € 140 million destined to the activity of the bad bank. The amounts of resources employed by the National Resolution Fund in this banking rescue it is estimated to be partially recoverable. In particular, the resources destined to the coverage of losses are considered hardly to recover while for the resources destined to the recapitalization of the four banks, there is the possibility to recover them through the sale of the new banks. The intervention of the National Resolution Fund reminds the previously proposed and rejected intervention of FITD. Despite the objective of the use of the two different funds was the same, it was not possible to use the FITD because considered of public nature and appropriate only for the repayment of secured deposits. For this reason, it was used the National Resolution Fund, designated by the European Directive BRRD as suitable resolution tool.

¹²⁰ The full text of disposition No.1226609/15 of 18 November 2015 is available on the website www.bancaditalia.it

Now, as regards the other side of contribution, according to the principle of burden sharing provided by the mechanism of bail in, the people involved in the banking business of these four banks are called to intervene. As it has already been said, the bail in provides that the people involved in the banking business contribute to the banking rescue following a precise pecking order. According to this specific hierarchy, the bail in stabilizes that the first subjects that must support the banking rescue, giving their savings up, are the shareholders and the holders of subordinated bonds. Then, in a second time are called to intervene the holders of less risky bonds and lately the depositors of current accounts $\geq \text{€ } 100,000$. Thanks to mechanism, however, the depositor of current account $\leq \text{€ } 100,000$ are protected. Hence, in the specific case of the four Italian banks, despite the fact that the bail in, at the date of their banking rescue, was not yet in force, it was however applied its principle. The banking rescue of the four Italian banks has led to the sacrifice of the people involved in their banking even if not all of categories as provided by the mechanism described above. Indeed, the rescue of these four banks involved only the shareholders and holders of subordinated bonds, which must bear the cost of € 800 million of losses, while the holders of others bonds and the depositors were not involved. At this regard, it is necessary to remember that, as required by the Directive BRRD, the shares and the subordinated bonds must be set to zero or converted in order to be used to cover the losses. The decision about the reset or the conversion is at the discretion of the resolution authorities and depends on the fact that the amount of losses is greater or lower than the value of shares and subordinated bonds. In the specific case of the four Italian banks, since the amount of their losses proved higher than the value of the shares and subordinated bonds, the National Resolution Authority decided to sacrifice them for their integer value. In conclusion, it can be said that, the banking rescue of the four Italian banks was expensive both for the Italian banking system, represented by the National Resolution Funds, and for the shareholders and holders of subordinated bonds of the four banks. Despite the high cost, the banking rescue of the four Italian banks, managed in this way, allows to avoid the involvement and the sacrifice of many other creditors and depositors that would be surely involved, starting from 2016, in the bail in mechanism, or, in the worst scenario, the involvement of taxpayers in the mechanism of bailout.

3.5 The four new Italian Banks and the final stage of their banking rescue.

3.5.1 General information.

The objective of this paragraph is the description of the four new Italian banks, Nuova Banca delle Marche S.p.A., Nuova Cassa di risparmio di Ferrara S.p.A., Nuova Cassa di risparmio di Chieti S.p.A. and Nuova Banca dell'Etruria e del Lazio S.p.A. constituted through the Legislative Decree "Salva Banche" No.183 of 23 November 2015 and fully operational from that date. The four new banks, after the recapitalization through the financial resources of the National Resolution Fund, started immediately their difficult and long path of recovery. The starting from scratch, the management discontinuity, the reconstruction of the relationship of trust with the banking customers, and the restore of their image of local banks represent the main difficulties for the four new Italian banks. Although the initial difficulties, the four new banks, already starting from the December 2015 and therefore only a month after their institution, have proved to be able to restart. The principal strength on which the four banks have focused their attention, in order to create a new image and new relationships with customers, is the renew management, which is composed in, almost all four banks, by the managers of the extraordinary administration. More concretely, the situation of the four new Italian banks is analyzed below, through the data provided by their financial statements at 31 December 2015. Before looking at these data¹²¹, it is necessary to specify that the financial statements at 31 December 2015 show the economic and financial results of the four banks taking into account only the first month of life of the new banks.

Nuova Banca delle Marche S.p.A.: the share capital of Nuova Banca delle Marche S.p.A, fully paid up by the National Resolution Fund, is equal, on 23 November 2015, to the amount of € 1,041 million subdivided in 10 million of shares. In addition to the contribution for the recapitalization, the National Resolution Fund also contributed to cover the deficit of capital with an amount of € 1,005million. Now looking at the accounting data, only shortly after its rebirth, Nuova Banca delle Marche S.p.A. appears in fast recovery of its banking activities and therefore

¹²¹ The accounting data of the four Italian banks are taken from their financial statements at 31 December 2015. As in their profile, before the banking rescue, the data reflects the aspect of the presence of non-performing loans and the aspect of capital solidity through the same indicators. Moreover, in this case, an additional information about their recovery process is given by the collection from customers. These data are available on the websites of the banks.

appears in general quite solid. The main signal of recovery is represented by a total amount of customer deposit collection equal to € 16.099 million. Moreover, its banking solidity is demonstrated by a level of CET1 above the national banking average and equal to 9,76%. As regards, instead, the aspect of non-performing loans, they are equal to a net amount of € 3,202.626 million¹²² and they have an impact on total loans equal to 28,7%.

All these data show, even if minimally, and despite the closure of the financial statement with a loss for the period of € 64.202 million, the capacity of reaction of this bank.

Nuova Cassa di risparmio di Ferrara S.p.A.: the share capital of Nuova Cassa di risparmio di Ferrara S.p.A, fully paid up by the National Resolution Fund, is equal, on 23 November 2015, to the amount of € 191 million subdivided in 10 million of shares. In addition to the contribution for the recapitalization, the National Resolution Fund also contributed to cover the deficit of capital with an amount of € 433 million. Also for this bank, as in the case of Nuova Banca delle Marche S.p.A, it is possible to note from the accounting data at the end of 2015 a substantial recovery both in terms of essential banking functions both in terms of capitalization. First, as regards the recovery of the banking functions, it depends on the capacity of the new management to renew the trust relationship with the customers. For Nuova Cassa di risparmio di Ferrara S.p.A this aspect can be considered achieved and it is demonstrated by the amounts of loans granted to families (€ 25 million of loans) and to companies (€ 205 million of loans). Moreover, on the other hand, the collection of deposits from customers is equal to € 2.807 million. Then, a particular focus is on the presence of non-performing loans, which reach a total net amount of € 499 million¹²³. Instead, as regards the capital solidity, it is in line with the national capital standard and it is precisely represented by the Tier 1 Capital Ratio and the Total Capital Ratio equal to 8,22%.

Nuova Cassa di risparmio di Chieti S.p.A.: the share capital of Nuova Cassa di risparmio di Chieti S.p.A, fully paid up by the National Resolution Fund, is equal, on 23 November 2015, to the amount of € 141 million subdivided in 10 million of shares. At this point, it is possible to identify, looking at the same information of the previous banks, a recovery of the banking activities represented by the total amount of loans to customers equal to € 1.433 million. In the net amount of total loans are also included the non-performing loans equal to a net amount of €

¹²² The precise categories of non-performing loans, which contribute to the total net amount of non-performing loans, are available on Appendix 1.

¹²³The precise categories of non-performing loans, which contribute to the total net amount of non-performing loans, are available on Appendix 1.

245.6 million¹²⁴. Moreover, the recovery of Nuova Cassa di risparmio di Chieti S.p.A is also sustained by good levels of capital deductible from the value of Tier 1 Capital Ratio equal to 9,53%.

Nuova Banca dell'Etruria e del Lazio S.p.A.: the share capital of Nuova Banca dell' Etruria e del Lazio S.p.A., fully paid up by the National Resolution Fund, is equal, on 23 November 2015, to the amount of € 442 million subdivided in 10 million of shares. In addition to the contribution for the recapitalization, the National Resolution Fund also contributed to cover the deficit of capital with an amount of € 283 million. Also in the case of this bank, the most interesting data to look at, in order to identify a sign of recovery, regard both the essential banking activities and the capital development. First, as regards the essential banking function, the slow recovery is represented by a level of direct and indirect collection from customers respectively equal to € 5.1 million and € 4.1 million. Instead, regarding the loans that Nuova Banca dell'Etruria e del Lazio S.p.A provides to customers the amount corresponds to € 3.8 million and among these it is also included a portion of non-performing loans equal to € 951.9 million¹²⁵. In particular, these amounts take into account also of the portion of loans to be allocated to the REV Crediti S.p.A in 2016.

At first glance, these data do not seem a so encouraging sign of recovery but it must be considered that they are the result of a period of economic recession. Despite this, the capital situation, looking to a value of CET1 equal to 11,1%, appears solid.

3.5.2 The sale process of the four new Italian Banks.

The sale process of the four new Italian banks is the last step in order to declare concluded the resolution procedure of these banks. More precisely, this last stage deals with the sale of the four good or bridge banks, which represent the sound and good side of the four old Italian banks. Indeed, as previously discuss, the banking business of the four Italian banks, according to the resolution procedure was split into two sides: one “good” and one “bad”. In particular, this subdivision allows the separation of the good banking side, which comprises current accounts, deposits and ordinary bonds, from the bad banking side, which, in turn, comprises non-performing loans and other toxic bonds. The bad banking side is transferred to a banking

¹²⁴ The precise categories of non-performing loans, which contribute to the total net amount of non-performing loans, are available on Appendix 1.

¹²⁵ The precise categories of non-performing loans, which contribute to the total net amount of non-performing loans, are available on Appendix 1.

company, called bad bank and in this case represented by the REV Crediti S.p.A, which deals with the management of non-performing loans and other toxic bonds. Instead, as regards, the good banking side, it flows in the so-called good or bridge banks, which ensure the continuity of the essential banking functions. Hence, the four new good Italian banks, which must be sold, represent the original banking entities cleaned up, almost entirely, by non-performing loans. The fact that, the four good banks are not completely free from non-performing loans, as also shown before by the data of the financial statement at the end of 2015, means that some non-performing loans require more time to be transferred to the bad bank. Although the disposal of non-performing loans is lengthy and complicated, the four good banks are, taken as a whole, sound and solid. This result is due to, first, the recapitalization process sustained by the National Resolution Funds, through which the capital was rebuilt to 9% of total assets weighted for risk, and then to the capacity of the renewed management. In conclusion, the four new good Italian banks are ready for sale and represent a good possibility of investment both for Italian and foreign entities.

Now, it is time to focus the attention, more concretely, on the process of sale of the four banks. The Bank of Italy announced the process of sale at the end of 2015 and its beginning is scheduled for the first month of 2016. This process of sale looks like a non-discriminatory and transparent process aimed at maximizing revenues, which are destined to the National Resolution Fund, or better, to the banks of the Italian banking systems that contributed to the banking rescue. The management and the supervision of this operation are entrusted to the Unit of Resolution of the Bank of Italy and to the National Resolution Fund. The first stage of the sale process, according to the European and Italian rules, consists in the selection and appointment of three advisors¹²⁶: a financial advisor, a strategic advisor and a legal advisor. The advisors necessary for the implementation and technical assistance of the process of banking sale are selected according to the criteria of the Italian “Codice degli Appalti”. The profile and the role of the advisors are explained below.

- The *financial advisor*: it is responsible of the valuation of the potential buyers, and it is selected among the financial operators spontaneously proposed to the Unit of Resolution of the Bank of Italy. More precisely, the selection of the financial advisor is based on the following criteria:
 - The financial advisor must be an entity of international reputation;
 - The financial advisor must be free of own investment activities;

¹²⁶ BANCA D’ITALIA, Procedura di selezione degli advisors ai fini della vendita delle quattro banche-ponte, available on www.bancaditalia.it .

– The financial advisor must be free of mandates that can generate conflicts of interest.

Hence, on the base of these requirements, the role of financial advisor in the sale process of the four Italian banks is assigned to Société Générale, an important European financial group.

- The *strategic advisor*: it is responsible of the valuation of the technical aspects of the banking sale. In particular, it has the task of deciding if it is better to sale the four Italian banks together or separately. The society selected for this role is Oliver Wyman, an international management consulting firm.
- The *legal advisor*: it is responsible of the technical and legal assistance in the communication of the preliminary information about the banking sale and in the definition of the banking purchase agreement. The selection of the legal advisors is the result of a negotiation procedure between Gianni, Origoni, Grippo, Cappelli & partners, BonelliErede and Chiomenti, three important Italian legal firms. The function of legal advisor in the banking sale of the four Italian banks is assigned, according to the criterion of the lowest price and on the base of the only concrete offer, to Chiomenti.

After the selection and the assignment of the advisors, the sale process of the four Italian banks takes officially effect from its publication on the most important Italian and foreign newspapers. In this stage, started on 19 January 2016, the potential buyers are required to express their preliminary and non-binding interests by 25 January 2016. At the end of this term, those who have made an offer receive from the financial advisor a teaser about preliminary information and potentialities of this investment. Moreover, the advisors through, an information memorandum, define the presentation of the offers and, then, plan the due diligence phase. In the subsequent phase, the advisors define the modalities of the binding offers and of the banking auction. In the end, after the banking auction, the results of the highest bidders and the relative bid prices are communicated to the Bank of Italy, which evaluates these result and identify, with the approval of the European Commission, the best buyer. In this banking sale, the European Commission plays an important role. Indeed, it is responsibility of the European Commission to decide the time span of the sale process. In particular, according to the strict rules of the European Commission, the first term for the sale of the four good banks is scheduled for 30 April 2016. Furthermore, it is also in the responsibility of the European Commission communicate that the failure to comply with this term implies the end of provision of the all essential banking functions except the disposal activity of non-performing loans. This precisely means that, at the end of April 2016, the four new Italian banks would be free of non-performing loans but especially free of their banking business and, thus, forced into the liquidation process.

Up to now, the sale process of the four Italian banks seems clear and well defined. Despite the linear theoretical implementation of the sale process, its implementation, in practice, results

much more difficult. In particular, the reasons that make the sale process complex and lengthy are all the difficulties faced during its implementation. The difficulties lengthen the time and postpone the terms of this banking sale from the first months of 2016 to today.

Now, it is time to analyze what the real difficulties and problems of this sale process are. The first problem that leads to the postponement of term of the banking sale, from the end of April to the end of September, is the delay in the approval and publication of the financial and economic results of December 2015 that, in turn, causes delays in the preliminary valuation of the sale process. During this period, until the end of September, the sale process of the four Italian banks faces another difficulty that regards the achievement of the target sale price in order to conclude successfully the banking sale. As previously discussed, the objective of this sale is the recovery of the amount of money used by the National Resolution Fund in the banking rescue. Thus, the amount to recover is equal to € 1.8 billion, exactly the amount paid by the National Resolution Fund for the recapitalization of the four banks. The problem is substantially due to the great difference between the target price and the price offered by the potential buyers. The problem appears evident already from the first concrete and binding offers. Apollo, Lone Star and Apax Partners are the first international investment funds interested in the purchase of the all four Italian banks. Then shortly after, the negotiation process takes place only between Apollo and Lone Star because Apax Partners retires itself from the competition. The prices proposed by the international investment funds are refused because they are much lower than the target sale price. Indeed, their offer is equal to an amount of € 400 or € 500 million against the target value of € 1.8 billion. The refusal of these offers in July gives rise to a competitive auction with a final deadline to the end of September. The objective of this second auction is finding a potential buyer of the four Italian banks willing to offer an amount as close as possible the target price. However, given the previous disappointing results, it is quite impossible to achieve the goal. For this reason, thanks to this auction it is possible to acquire not only the four banks together but also each single banks. Despite this fact, at the end of September, no new buyer has come forward. At this point, the European Union extends the deadline for another two weeks and if there are no other offers, it make themselves available for an additional postponement. After two weeks, the hypothesis of an extension of the deadline becomes reality. Therefore, the European Union announces, for good reason, an extension of the deadline of the sale process of the four Italian banks without specifying a precise term in order to ensure the success of this operation. At the beginning of the sale process, the authorities of the European Union imposed strict rules in the management of the sale banking process but then they decided to grant another opportunity to the Italian banking system. The reason of this change is the awareness that a non-concluded or failed sale process could lead to serious consequences. Indeed, if the banks are not

acquired there are two possibilities: the close-down and the subsequently liquidation of the banks or another banking rescue at the expenses of the taxpayers or, another time, at the expenses of the Italian banking system. Hence, since the fact that the objective is the maximization of the values of the four banks, the European Union upholds the extension of this process.

At this point, looking at this situation, some questions arise: “Why it is so difficult to sell the four Italian good banks? Why the potential buyers offer such low prices?”. These questions arise because it seems so improbable that any banks is not interested in their purchase although they represent sound banking entities with a level of credit quality quite good after the transfer of the non-performing loans in the bad bank. The reality appears different and there some important reasons that hinder their purchase. The reason that do not make attractive the purchase of the four Italian banks and that give an answer to the previous questions are easily identifiable in financial statement of the four banks at the end of 2015. The accounting data that scare the potential buyers are the level of costs significantly higher than the level of revenues, the low profitability of loans and the presence of non-performing loans not yet transferred to the bad bank. As regards the first two points, it is quite normal that the level of profitability is low and that the four banks have conclude the year 2015 with a loss for the period because these are the results of a trouble period. Instead, as regards the presence of non-performing loans, it does not mean that the cleaning of the financial statement from bad loans has not been effective but it means that not all non-performing loans are transferred in the bad bank or that some loans, considered recoverable, have become non-performing. Unfortunately, the non-performing loans represent a deterrent factor in the purchase of the four banks because many banks, especially Italian banks, are unwilling to buy also the amount of the non-performing loans. Moreover, there is another reason that make the four banks less attractive and it is the situation of the banking sector. Indeed, due to the international and national banking crises, the Italian banking sector does not seem a safe ground for an investment. Going on with the analysis of the potential buyers and offers for the purchase of the four Italian good banks, after a period of indifference and shortly after the extension of the deadline granted by the European Union, the offer of Ubi Bank takes place. In particular, the offer made by Ubi Bank regards the purchase of only three of the four credit institutions that are Nuova Banca delle Marche S.p.A., Nuova Cassa di risparmio di Chieti S.p.A. and Nuova Banca dell’Etruria e del Lazio S.p.A. Instead, as regards the purchase of Nuova Cassa di risparmio di Ferrara S.p.A., which does not raise interest in Ubi Bank probably for its small size, the offer is made by BPER Bank.

Now, it is useful to understand the long process through which Ubi Bank awards the three of the four Italian good banks. The sign of interests in respect of these banks comes from Ubi Bank in the autumn of 2016. The process of sale was long and difficult not for the competition with

others bidders, since there were none, but for the negotiation between Ubi Bank and the European Union about the contractual conditions required by Ubi Bank. The main condition imposed by Ubi Bank regards its unwillingness to take charge of the amount of non-performing loans of the three banks. Hence, Ubi Bank proposed itself as a potential buyer of the three banks only if these banks are deprived as much as possible of their non-performing loans. For this reason asks the Italian banking system to relieve, another time, the banks from their burden of non-performing loans. This condition is object of a long negotiation process among Ubi Bank, Bank of Italy and the banking authorities of the European Union. After several months, precisely a year after the banking rescue of the Italian banks, the purchase proposal made by Ubi Bank becomes, probably to the lack of other buyers, concrete. Anyway, it must be taken into account that the purchase of the three Italian banks is a complex operation, and requires the Italian banking system and by Ubi Bank to make a significant effort in order to complete the operation successfully for all parties. As regards the Italian banking system, in this case represented by the National Resolution Fund, as the seller of the good banks, it must sustain another economic effort in order to satisfy the binding conditions of sale imposed by Ubi Bank. Indeed, as said before, Ubi Bank is unwillingness to buy the amount of non-performing loans still present in the three good banks. For this reason, it is provided a non-performing loans assignment of an amount equal to € 2.2 billion to Atlante 2, a fund specialized in the investment of non-performing loans. Moreover, the three banks, for the purpose of acquisition, should have requirement as: coverage ratio of unlikely to pay loans equal at least to 28,8%, coverage ratio of bad loans equal at least to 60%, an average liquidity coverage ratio $\geq 100\%$ and an average CET1 ratio $\geq 9,1\%$. The National Resolution Fund in order to satisfy these conditions contributes with an increase of capital of € 450 million in favor of the three banks. On the other side, instead, Ubi Bank increases, thanks to a guarantee agreement with Credit Suisse and Morgan Stanley, its capital of an amount equal to € 400 million. This capital increase is made not only in order to sustain the acquisition of the three banks but especially in order to not negatively impact its CET1, considered one of the highest (CET1>11%) of the Italian banking system. At this point, the analysis of the purchase proposal of UBI Banks is done and it becomes official and binding starting from 12 January 2017 and the approval of the National Resolution Fund and the Bank of Italy is expected by 18 January 2017. Hence, at the end of a long process, the sale agreement of three of the four Italian banks is concluded, symbolically at the price of 1€, in favor of Ubi Bank. Now, it is interesting to see how Ubi Bank changes after the acquisition of the three banks and what the objectives and the future prospects both for Ubi Bank and for the three banks are. The positive results of this operation were visible immediately through the increase of the share values of Ubi Bank in the stock exchange shortly after the preliminary sale agreement. Indeed,

thanks to this acquisition Ubi Bank could increase its market share and extend its banking network in other territories through an increased number of subsidiaries and employees. Moreover, Ubi Bank plans good future prospects for the three banks setting a target of fully loaded CET1>11% to achieve in 2017 and a target of fully loaded CET1>13% to achieve in 2020. According to the director of the good banks, the operation of the sale of the three good banks to Ubi Bank should be officially concluded in the spring of 2017. In conclusion, Nuova Banca delle Marche S.p.A., Nuova Cassa di risparmio di Chieti S.p.A. and Nuova Banca dell'Etruria e del Lazio S.p.A. have found their official buyer and they can finally be considered saved after two years.

As regards, instead, Nuova Cassa di risparmio di Ferrara S.p.A., the only purchase offer is from BPER Bank. The first signal of interest goes back to early 2017. The negotiation is still going on but there are good prospects for arriving at its conclusion. Meantime, in order to pave the way for the acquisition of Nuova Cassa di risparmio di Ferrara S.p.A by BPER Bank, the management of BPER and the Bank of Italy are engaged in a process of internal restructuring in order to prepare this bank to the acquisition. The objective of the restructuring is the improvement the economic and financial situation of this bank. In particular, a preliminary operation that BPER Bank requires during this stage is the reduction of the number of the personnel employed in the subsidiaries of Nuova Cassa di risparmio di Ferrara S.p.A in order to cut the costs. Clearly, this requirement is not so easy to satisfy because it generates a bad mood between the employees and the time of realization becomes longer. Hence, at this date, the purchase proposal of BPER Bank is concrete but far from its realization.

3.6 Final considerations: Who gains and who loses from the banking rescue of the four Italian banks?

Now, it is reasonable to say, looking at the overall and almost completed process of banking rescue, that the issue of the four Italian banks has reached its happy ending. After this consideration, a question arises: “Does the banking rescue of the four Italian banks represent a really happy ending for all the parties involved?”. The answer to this question is not completely affirmative. Indeed, remembering the overview of the banking rescue of the four Italian banks, it is evident that from this method of banking rescue some subjects have gained and other have lost.

Before analyzing the subjects that have gained from this rescue, it is important to highlight the subjects not involved in this mechanism. Among the subjects not involved in this banking rescue must be mentioned the account holders, the depositors, the holders of non-subordinated bonds and in the end the employees of the four banking entities substantially protected by the continuity of the banking business during and after the resolution.

However, as regards the subjects involved, those who have clearly gained from this rescue are:

- The banks that have bought at a low price the four restored banks;
- The National Resolution Fund, which, thanks to the sale of the four banks, has recovered the money used for the recapitalization of the four banks;
- The societies specialized in management of non-performing loans;
- The banks of the Italian banking system that, through the National Resolution Fund, have contributed to the capitalization of the bad bank.

Regarding the societies involved in non-performing loans management and the Italian banks contributors of the capitalization of the bad bank, instituted for the disposal of the non-performing loans of the four banks, it is necessary to specify that they have obtained a gain from the significant devaluation of the non-performing loans of the four banks. At this point, it is useful to remember that the amount of the non-performing loans of the four Italian banks, before the rescue, was equal to € 8.5 billion and then, after the rescue, it was equal to € 1.5 billion. This means that the non-performing loans of the four Italian banks were written down by a percentage of 17,6% of their real value. A write-down like this has amazed the Italian and the European banking system because, on average, the Italian banks are used to estimate the value of non-performing loans at 40% of their real value. Despite this singularity, this situation represents a revenue opportunity if the bad bank will be able to sell the non-performing loans at a value

higher than 17,6% and if this will happen the gain will be up to the Italian banks belonging to the National Resolution Fund.

On the other side of the issue of this banking rescue, there are the subjects for whom this banking rescue proved to be very costly. Indeed, as previously analyzed, the banking rescue of the four Italian banks took place before the entry into force of bail in but despite this, it occurred following the principle of burden sharing provided by this new European mechanism. The fact that the banking rescue of the four Italian banks it is not occurred through the mechanism of bail in means that some subjects have been spared from the specific pecking order of contribution provided by this mechanism. Hence, in this case, the principle of burden sharing has been applied only to shareholders and holders of subordinated bonds without the involvement of other categories of bondholders and depositors. In practice, the shareholders and the holders of subordinated bonds have contributed to the banking rescue through the resetting of their shares and financial assets and, in this way, they have lost everything. At this point, it is necessary to understand if these subjects were made aware of this risk in case of default and if there is the possibility to recover their money used for the banking rescue.

At this regard, although shareholders and holders of subordinated bonds have both lost everything, it is important to make a clear distinction of the reason why these subjects have lost money. First, as concerns the shareholders, since they are considered the “owners” of the banking institutions, the risk of losing money in case of default is implicit in their definition and, therefore, the possibility of redemption does not exist. Instead, on the other hand, the situation of holders of subordinated bonds is completely different.

In order to understand better the risk in which the holders of subordinated bonds have incurred, it is necessary to remind the definition of subordinated bonds. The subordinated bonds are financial instruments characterized by a high rate of return, which implies for the people who invest in them a higher return of capital and for the banks that issue them an increase of capital. Contrary to this positive feature, the subordinated loans are also characterized by a low level of guarantee. More precisely, this means that in case of liquidation or failure of the bank, according to the subordination clause, the redemption of the subordinated bonds occurs only after the redemption of the ordinary bonds.

Hence, the subordinated bonds represent attractive but, at the same time, risky financial instruments. In particular, their attractiveness and riskiness are demonstrated by the ten thousand holders of subordinated bonds of the four Italian banks that, at the resolution date, have clearly

contributed to the banking rescue, losing, in this way, a total amount of about € 67 billion¹²⁷. Then, after the banking rescue, the holders of subordinated bonds have accused the banks of cheat because they were not completely informed or they were poorly informed, because of technical and difficult to understand financial documents issued by banks, about the risk of investing in subordinated bonds. At this regard, the responsibility is not only of the banks that, for the obvious reasons mentioned above, have issued subordinated bonds but also of authorities as Bank of Italy and Consob that, probably, have not supervised the banking business of the four Italian banks. In particular, to the authority of Consob is notified the fact of not having checked the issuing statements of subordinated bonds that all the banks are required to register to Consob. Hence, for all the reasons mentioned above, the holders of subordinated bonds have asked for the refund procedure of their bonds.

Now, at this point, it necessary to explain how the refund procedure of subordinated bonds really work. First, at this regard, it has been set up, internally to Fondo Interbancario di Tutela dei Depositi (FITD), a special fund, called “Fondo di Solidarietà”¹²⁸ to which the redemption of the subordinated bonds has been entrusted. More precisely, the Fondo di Solidarietà and the refund procedure have become operational as from the issue of the Legislative Decree No.59 of 3 May 2016¹²⁹, later converted into the Law No.119 of 30 June 2016¹³⁰. Thanks to this law, entered into force on 3 July 2016, it has been provided for the holders of subordinated bonds the lump sum refund of their bonds, through the funds¹³¹ provided by Fondo di Solidarietà. The refund procedure¹³², is based on specific criteria and this means that not all the holders of subordinated bonds can have access to this procedure. Hence, according to the criteria of this procedure, the holders of subordinated bonds can ask for the redemption of their bonds only if:

- The subordinated bonds, for which the refund is claimed, were purchased by 12 June 2014,
- The direct relationship with one of the banks in liquidation exists.
- The effective detention of the subordinated bonds at the date of 22 November 2015 is ascertained.

¹²⁷ BANCA D’ITALIA, 11 Febbraio 2016, Informazioni sui detentori di obbligazioni subordinate, available on www.bancaditalia.it.

¹²⁸ Fondo di Solidarietà belongs to Fondo Interbancario di Tutela dei Depositi (FITD) and it is powered by the same mechanism of contributions of FITD.

¹²⁹The full text of Legislative Decree No.59 of 3 May 2016 is available on Gazzetta Ufficiale edition n.102 of 2016, available on the website www.gazzettaufficiale.it .

¹³⁰The full text of Law No.119 of 30 June 2016 is available on Gazzetta Ufficiale edition n.153 of 2016, available on the website www.gazzettaufficiale.it .

¹³¹ Initially, the maximum limit of contribution of Fondo di Solidarietà had been set at € 100 million and then, due to the magnitude of the refund procedure of holders of subordinate bonds, it has not been set any limit. This means that the Fondo di Solidarietà must meet until the final redemption request.

¹³² FONDO INTERBANCARIO DI TUTELA DEI DEPOSITI, Agosto 2016, Regolamento del Fondo di Solidarietà. Procedura per l’indennizzo forfettario. Ai sensi della legge 119 del 30 giugno 2016, available on www.fitd.it.

- The heritage of bondholders is less than € 100,000 and the total income is less than € 35,000 in 2014.

After the fulfillment of the conditions mentioned above, the holders of subordinated bonds, in order to obtain a refund, must submit for each bond bought a specific request to FITD no later than 3 January 2017. Once the request has been received, the FITD analyzes the correctness and completeness of the documents received and proceeds, within 60 days of the receipt of the request, to the repayment of 80% of the value of the subordinated bonds. More precisely, the request, submitted to FITD, must contain the following information: personal data of the bondholder, name of the bank where the financial instrument were purchased and precise information about the bonds purchased. Instead, as regards the documents, must be attached : the purchase agreement and the purchase order of the subordinated bonds, the confirmation of purchase order and the declaration of heritage. In the case in which these documents are not present, the FITD can suspend the time limit of the 60 days until the all correct documents are received. This is the general functioning of the redemption procedure of subordinated bonds but there is another refund procedure called arbitrary procedure. More in detail, through the arbitrary procedure, can ask for the redemption of subordinated bonds the following categories of bondholders:

- The holders of subordinated bonds, purchased after the date of 12 June 2014.
- The holders of subordinated bonds that do not meet the necessary condition, previously mentioned, to access to the lump sum refund procedure.
- The holders of subordinated bonds that ask for the total repayment (100%) of the value of subordinated bonds

This type of procedure requires the presence of arbitration panels, organized by Anac (Autorità nazionale anticorruzione), which exercise a function of intermediation between the holders of subordinated bonds and the FITD. In particular, in order to be submitted to this procedure, the bondholders must be able to prove to the arbitration panels, which evaluate case by case, that they have been deceived by the banks in the purchase of subordinated bonds. In conclusion, this procedure can be considered more complex and more difficult to realize than the previous one especially because the authority¹³³ to which assign the role of arbiter and the funds¹³⁴ with which establish the arbitration panels are still be defined.

¹³³ Despite the fact that the Consob authority has been accused of not having monitored the issuance of subordinate bonds of the four banks, the role of arbiter could be assigned, even if with many doubts, to this authority.

¹³⁴ Another unresolved question regards the source of the funds through which the arbitration panels must be established. At this regard, the proposal to use the resources of the FITD was rejected because, in this way, the resources destined to depositors could be decreased.

However, as regards the results of the refunds of the holders of subordinated bonds, they have reached, until now, the amount of € 50 million but clearly not all the bondholders have been paid. For this reason, the deadline of the refund procedure has been extended until 31 May 2017, thanks to the Legislative Decree No.237 of 23 December 2016¹³⁵ turned into law No.4280 of 16 February 2017. Furthermore, this law has extended the possibility of requesting a refund of the subordinated bonds to those who have received them as a donation by spouses, cohabitants and relatives within the second degree.

These final considerations, about the winners and the losers of the banking rescue of the four Italian banks, provide an overview of the case study of the four Italian banks and they are useful to understand the positive and the critical aspects of this banking rescue. In particular, looking at these final considerations, it is possible to say with certainty that the banking rescue of the four Italian banks, occurred following to the new European rules on this subjects, has reached its overall positive conclusion, causing, however, negative effects but, anyway less than those of the Italian insolvency proceedings.

¹³⁵ The full text of Legislative Decree No.237 of 23 December 2016 is available on the edition n.299 of Gazzetta Ufficiale.

Conclusion

The purpose of this analysis is the demonstration of the change in the management of banking crises, due to the introduction of new European rules, through the case study of the four Italian banks. As previously discussed, the rules are changed after the events of the global economic and financial crisis of 2007 and, in particular, thanks to the birth of the European Banking Union, whose goal is precisely to promote European integration and to restore the financial stability compromised by the crisis. Among the objectives of the European Banking Union takes place the realization of the Single Resolution Mechanism, which provides the orderly management of the banking crises. The legal basis of this mechanism is the European Directive BRRD No.59 of 15 May 2014 that can be considered one of the most significant result of the project of the European Banking Union. After the entry into force of this Directive, the banking crises must be managed in a unified manner across the European countries and the European banks in serious conditions of financial distress must be submitted to the resolution procedure and its tools. More precisely, this means that the European countries, which belong to the European Banking Union, are required to transpose the BRRD Directive in their legislation and to apply, in case of financial distress, the new rules and tools of resolution. Among the resolution tools, the tool that better represents the essence of the resolution procedure is the bail in. In particular, the bail in is the tool that marks the effective change in the management of the banking crises because it is based on the principle that the banks must be saved not through the state aids, as it was done up to this point, but through the contribution of the people involved in the banking business following a precise hierarchy.

A concrete example of application of these new rules and tools is given by the case of the four Italian banks, submitted to the European resolution procedure on 22 November 2015, thanks to the transposition of BRRD Directive in the Italian Legislative Decrees No.180 and No.181 of 16 November 2015. The issue of the four Italian banks takes places into the regulatory framework provided by the European Banking Union. Indeed, starting from the analysis of the banking criticalities, the investigation was conducted by the European Central Bank and the Bank of Italy, according to the rules of supervision provided by the Single Supervisory Mechanism, the first pillar of the European Banking Union. Thanks to these investigations were detected two main problems: serious administrative irregularities and high levels of non-performing loans. For this reason, shortly after, Banca Marche, CariFerrara, CariChieti and Banca Etruria, the four banks in question, were placed under extraordinary administration. After the period of

extraordinary administration, the situation of the four banks appeared so serious enough to suggest an imminent banking failure. At this point, the Italian authorities tried to rescue the four Italian banks in order to avoid a banking failure that would have resulted in serious consequences for the Italian banking system. More precisely, the Italian authorities proposed solutions as the compulsory administrative liquidation and the intervention of Fondo Interbancario di Tutela dei Depositi, which were not applied because considered incompatible and inadequate compared to the new European rules. For this reasons, the only solution for the banking rescue of the four Italian banks, was submitting them to the European resolution procedure. As previously discussed, the resolution of the four Italian banks began on 22 November 2015, immediately after the issuing, on the same date, of the Legislative Decree No.183, called “Salva Banche”. According to the provisions of the Legislative Decree “Salva Banche”, the resolution of the four Italian banks occurred through the institution of four good banks, which represent the sound side of the banking business, and through the institution of one bad bank in which, the toxic side of the four Italian banks, constituted by the high amounts of non-performing loans, flowed. In this way, thanks to these two resolution tools, the banking entities have been preserved and their financial statement have been cleaned up by the non-performing loans.

The cost of the banking rescue, although it took place before the entry into force of bail in on 1 January 2016, was supported by the principle of burden sharing, but without the precise application of the hierarchy of bail in contributions. This means that the cost of this banking rescue was supported internally by the Italian banking system, represented by the National Resolution Fund, and only by two categories of subjects involved in the bail in, which are the shareholders and the holders of subordinated bonds.

In the end, the resolution procedure can be considered concluded only when the four restored Italian banks will be sold. At this regard, the sale process of three of these banks is almost concluded thanks to the acquisition by Ubi Bank, while it is still under negotiation for Nuova Cassa di Risparmio di Ferrara S.p.A.

Now it is necessary to express an opinion on the banking rescue of the four Italian banks.

At this point, it can be said that the Italian banking rescue is overall positive due to these reasons:

- The four banks have not failed but have been restored.
- The cost of the rescue have been supported only by two of the categories of subjects involved in the bail in mechanism, avoiding, thus, any financial involvement of account holders and holders of other bonds.

However, this case study shows that, since the bail in mechanism has not precisely applied in all its elements, the Italian banking rescue has not occurred in complete accordance with the BRRD Directive.

The difference between the rules provided by European Directive BRRD and the rules applied by Italian government point out that there is a level of discretion in implementing the European regulation.

At this regard, it is useful to make reference to the Annual Report of 2016 on Banking Union¹³⁶ issued by the European Parliament. In this report it is explicitly highlighted the necessity to harmonize the insolvency hierarchy in order to avoid discrepancies in the resolution of the banking system and to make the application of BRRD Directive more coherent and effective.

¹³⁶ HÜBNER D. M., February 2017, Annual Report 2016 on Banking Union. The full text is available on the website <http://www.europarl.europa.eu>

Appendix I

Nuova Banca delle Marche S.p.A.	Net Value of Exposure	
Bad loans	€	1,239.369 mln
Unkikely to pay loans	€	1,852.990 mln
Past due loans	€	110.267 mln
Total non-performing loans	€	3,202.626 mln

Nuova Cassa di Risparmio di Ferrara S.p.A.	Net Value of Exposure	
Bad loans	€	247.000 mln
Unkikely to pay loans	€	208.000 mln
Past due loans	€	44.000 mln
Total non-performing loans	€	499.000 mln

Nuova Cassa di Risparmio di Chieti S.p.A.	Net Value of Exposure	
Bad loans	€	100.400 mln
Unkikely to pay loans	€	131.600 mln
Past due loans	€	13.600 mln
Total non-performing loans	€	245.600 mln

Nuova Banca dell'Etruria e del Lazio S.p.A.	Net Value of Exposure	
Bad loans	€	464.500 mln
Unkikely to pay loans	€	452.200 mln
Past due loans	€	35.200 mln
Total non-performing loans	€	951.900 mln

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