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AND THE INVESTOR"**

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Introduction

Everything begins in 2007-2008 with the emergence of the first signs of Financial crisis. Many economists had expected that a systemic financial crisis would never arise again. But it did. The 2008 financial crisis developed into the worst crisis in the USA since the Great Depression, and it turned into a global crisis. The depth and scope of this financial crisis were unprecedented and also affected the Europe.

The financial crisis has exposed major weaknesses in global financial systems, including the threat to financial stability posed by banks that were too big, interconnected and complex to be closed or go bankrupt. As a result, many banks have been rescued using public support, allowing for an uninterrupted provision of their services, but effectively shifting (most) of their losses to taxpayers instead of banks' owners or investors.

This paper analyzes the new EU Bank Recovery and Resolution Directive (BRRD), to determine the level of guidance on instruments. The aim is to provide certain practical guidance to future resolution planning and execution.

The construction of a European Banking Union is one of the most significant developments in European integration since the agreement on Economic and Monetary Union in the Maastricht Treaty. Banking Union was proposed by the European heads of government and State in June 2012 to restore confidence in European banking systems weakened by the double whammy of the international financial crisis and the sovereign debt crisis.

From June 2012, there were negotiations on four of the five elements of a banking union, and with the exception of the deposit guarantee scheme, agreements were reached by spring 2014. In September 2012, European Commission proposed a regulation for the establishment of a single supervisory mechanism. The BRRD was proposed by the Commission on 6 June 2012, was agreed by the Council on 27 June 2013, approved in an institutional dialogue of Council, Commission and European Parliament on 12 December 2013, and finally adapted by the European Parliament in April 2014.

BRRD which applies to all European Union Member States, sets out roles for the bail-in of failing banks that enable authorities to recapitalize a failing bank by writing-down liabilities and/or converting them to equity with the aim to continuing a bank as a going concern, decreasing

financial system instability and giving authorities the opportunity to reorganize the bank or resolve it.

These are the main terms in which consists this work, but we will explain in a few words what we have discussed in each of the chapters of this work.

In the first chapter we have analyzed the origins of the Bank Recovery and Resolution Directive, how it was created in response to the global financial crisis; the insertion of the Directive in the European banking Union project. In this first part of the work we have explained the history of creation of this directive with all the steps the European Commission takes until its first presentation.

In the second chapter we analyzed how this directive works, its mechanism and organs, from the recovery and resolution plans to the use of bail in explaining also the bail-out. The latter term which is used when the government transfer money to a failing business in order to avoid the consequences that could arise from the business downfall, to bail-in (the internal saving). In this second part, a considering attention had also the Minimum requirement for own funds and eligible liabilities (MREL) to ensuring the continuation of the bank's critical function without resource to public funds in case of critical moment.

The third chapter is about the famous financial crisis in Italy. We explained in details how this crisis appeared in the Italian legal system; the implementation of the BRRD for the first time in Italy through the two legislative decrees 180/2015 and 181/2015. We also analyzed the case of the crisis of the four banks in Italy, to take more specifically some examples about the case of the crisis of the Monte dei Paschi, and also the liquidation of the two Veneto banks.

Finally, we have made an overview on the financial crisis in Spain, explaining the case of bad bank, taking a perfect example the SAREB. Then we made a comparison of the current crisis in study for the Bank of Spain and the Bank of Italy.

Chapter 1: The origin of the Bank Recovery and Resolution Directive (BRRD)

1.1 A little view on the 2007-2008 global financial crisis and the need to create a single mechanism for solving the banking crisis.

Initiated in the United States in the summer of 2007, the financial crisis worsened and became global in 2008¹. We can nominate some factors of the crisis situation that is dominating the world scene from the end of 2007: the first characterized by the explosion of the financial and banking crisis in the summer of 2007. Second with the definitive collapse occurred in autumn 2008 with the bankruptcy of Lehman Brothers² dated September 15th an event to which it generally associates the beginning of the crisis which led to the spread of the international of banking crisis, but which in reality represents it simply an event. Another period, which takes in considering the years 2009 and 2010 and is characterized by a strong recession economy, characterized by the sovereign debt crisis.

The year 2008 will be remembered as the year that was followed by a financial crisis, which occurs once in a century. The crisis triggered strong shifts in Wall Street³, weakened the banking system and shaken the stock markets, but also led to radical government intervention. The crisis in question had deep roots and caused major changes both in the economic and political fields. During this year radical action was taken by the authorities in order to minimize the crisis.

Between 2007 and 2008 some of the largest US investment banks they were literally overwhelmed by the crisis and in a climate where the perception of the risk continued to grow and the global stock exchanges suffered severe collapses. The intervention of governments which moved along the following lines of action, proved to be avoidable: guarantee liquidity, provide a public guarantee on bank liabilities, recapitalize intermediaries with losses from State holdings, and finally intensify the action of deposit guarantee schemes.

¹ FEDERAL RESERVE BANK OF SAN FRANCISCO, Cross-Country Causes and Consequences of the 2008 Crisis: Early Warning, Andrew K. Rose Haas School of Business, U.C. Berkeley Mark M. Spiegel Federal Reserve Bank of San Francisco, July 2009

² the bankruptcy of the Lehman Brothers investment bank, dated 15 September 2008, which led to the spread of the international banking crisis

³ 2008, weakened the power of Wall Street, as we know it, as one of the largest financial institutions that faced huge loan losses.

In this period in Europe was a little bit difficult for introducing an affective framework for bank resolution. Some factors of this fact are that the Eu is in a state of systemic banking fragility, and its financial system is dominated by banks with a high degree of banking sector concentration in many of its member states. As most past cases of bank failures have been handled though public bail-outs and/or nationalization.

Italy is characterized by a banking system for the most part focused on the offer of services to retail customers, therefore more oriented towards operations in the traditional sector, and therefore with a lesser risk compared to the US and foreign banks, in general. But the consequences of this crisis were fundamental to all countries of the world, which should be solved in one way or another.

The crisis is reflected in a World and European economic situation always worse and finds its cause, in large part, in the slow implementation of the reforms of the financial and banking sector. There was the need to create the European Banking Union, so a complex system of Community rules that leads to the stabilization of the financial market, connected to a harmonization of the regulation rules of the banking sector⁴.The major regulatory reforms (Basel III and the European Banking Union) entered into force only at the end of 2014.

In May 2012 the European Commission firstly called for a banking union to restore confidence in banks and the euro.The European Council meeting of 28-29 June 2012 marked the starting point of an ambitious project to create a European banking union as part of a collective European effort to resolve the current crisis and build a more resilient policy infrastructure for Europe's financial system. (European Council, 2012 a)⁵. The first step will be the creation of the Single Supervisory Mechanism (SSM), being finalized following an agreement at the Economic and Financial Affairs Council meeting of 13 December 2012 (ECOFIN, 2012)⁶. In its subsequent meeting on 14 December 2012, the European Council outlined a tentative vision for the next steps towards the aim of creating a banking union, which will involve significant legislative work alongside other policy initiatives (European Council 2012 b)⁷.So, on 12 September 2012, the Commission proposed a Single Supervisory Mechanism (SSM) for banks led by the European Central Bank (ECB) in order to strengthen Economic and Monetary Union.

⁴ Giuseppe Di Gaspare - Diritto dell'Economia e Dinamiche istituzionali, pag 265

⁵European Council (2012 a) Conclusions of the European Council 28/29 June, EUCO 76/12, http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ec/131388.pdf

⁶ ECOFIN (2012) Press Release 17598/12, 3214th Council Meeting, Economic and Financial Affairs, 13 December, http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ecofin/134287.pdf

⁷ European Council (2012b) Conclusions of the European Council 14 December 2012, EUCO 205/12, http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/134353.pdf

The creation of a Single Supervisory Mechanism (SSM) is considered as an important move that will not compete the creation of a European banking union but enable the direct intervention of the European Stability Mechanism (ESM) under the terms of the euro-area summit statement of 29 June 2012. So, it can lead to a major improvement in crisis management and the handling of banking aspects of the crisis. The set of proposals should constitute a first step towards an integrated banking union, which includes additional components such as a single rulebook, common deposit protection and a single bank resolution mechanism.⁸

The extension, during 2011, of the effects of the economic and financial crisis also to the sovereign debts of some Eurozone Member States (specially the so-called "peripheral States") has brought to the attention the problematic relationship that binds the banking systems with national public debts and, therefore, highlighted the need for a consolidation of the process of integration within the Eurozone through the construction of a real European Banking Union based on three fundamental elements.

1. Single Supervisory Mechanism (SSM)⁹: The Single Supervisory Mechanism (SSM) is the first element of the banking union. From the point of view of non-euro countries, the draft SSM regulation as amended by the EU Council includes strong safeguards relating to decision-making, accountability, attention to financial stability in small countries and the applicability of national macroprudential measures. The consequences of the financial crisis have been a process of unification and supranational centralization of the banking supervision system by the European Central Bank through Council Regulation (EU) no. 1024/2013 of 15 October 2013. The governance underlying this mechanism is now fully operational, in fact the Supervisory Board and the Steering Committee have already met several times. The European Central Bank has assumed supervisory powers over the major credit institutions in the euro area. This has begun to exercise direct supervision over about 120 banking groups, while for smaller institutions it has the task of defining the supervisory standards and verifying their application, in collaboration with the competent national authorities (the Bank of Italy in the case of the Italian State). The Council Regulation, which consists of conferring specific tasks to the ECB on policies relating to the prudential supervision of credit institutions and the establishment of a single supervisory mechanism (SSM), is based on Article 127 (6) of the Treaty on the Functioning of European Union

⁸ European Commission 2012

⁹ DANUBE: Law, Economics and Social Issues Review, Should Non-Euro Area Countries Join the Single Supervisory Mechanism? 2013/07/09

(TFEU), which provides a legal basis for conferring specific tasks to the ECB on policies relating to the prudential supervision of credit institutions.

2. Single Resolution Mechanism (SRM)¹⁰: The December 2012 European Council Conclusions state that the European Commission will submit in the course of 2013 a proposal for a single resolution mechanism for Member States participating in the SSM. The SRM should safeguard financial stability and ensure an effective framework for resolving financial institutions while protecting taxpayers in the context of banking crises, and should be based on contributions by the financial sector itself and include appropriate and effective backstop arrangements. The Commission has announced it will publish a proposal before the summer of 2013 (Barroso, 2013), and the adoption of the final text is desired in advance of the European elections scheduled in June 2014. But other documents from the Commission and the Council suggest that the SRM proposal will be published only after the adoption of the BRRD and the DGS Directives.¹¹In addition to a recovery and resolution plan as proposed in the Commission's The Directive 2014/59/EU also called BRRD (Bank Recovery and Resolution Directive), consisting of bail-in instruments and minimum capital standards (like Basel III), the High-level Group recommended a separation of banking business as follows: proprietary trading and other significant trading activities should be assigned to a separate legal entity if the activities to be separated amount to a significant share of a bank's business. So, trading activities should be carried out on a stand-alone basis¹². The directive establishes instead a framework of rules for the rehabilitation of non-performing credit institutions and for the harmonization of procedures aimed at solving banking crises at the European level through the Mechanism of Single Resolution (SRM: Single Resolution Mechanism). This mechanism is based on the centralization of the Bank resolution management function under the Single Resolution Board (SRB) and the creation of a Single Resolution Fund (SRF) to cooperate in financing the resolution, powered by the contributions of the banks. The directive introduces preventive procedures to reduce possible future crises and to improve the resistance of banks to economic shocks. According to the European Commission the legal basis of the Single Resolution Mechanism proposal is found in Article 114 TFEU (Treaty on the Functioning of the European Union), which allows for the adoption of measures relating to the harmonization of national provisions for

¹⁰ European Commission (2013): Commission proposes Single Resolution Mechanism for the Banking Union, Press Release, Brussels, 10 July 2013

¹¹ Van Rompuy (2012) 'Towards a Genuine Economic and Monetary Union', Brussels, 5 December

¹² F. Breuss European Banking Union: Necessary, but not enough to fix the Euro crisis. CESifo Forum, Vol. 13, No. 4, Winter 2012, 26-32; F. Breuss Towards a New EMU. WIFO Working Paper. 447. March 2013.

the creation and functioning of the internal market. In order to limit the impact on public budgets of the rescue interventions of troubled banks by the States (so-called "bail-out"), the principle has been established that the recapitalization of credit institutions is entrusted primarily to shareholders, bondholders and creditors of banks (bail-in). The uniform application of a single set of rules of bank resolution, as well as access to a single European resolution fund, has the task of restoring the functioning of the Union's banking markets and of removing obstacles to the exercise of fundamental freedoms.

3. The harmonized European deposit guarantee scheme¹³ (DGS): The global financial crisis has woken up the European authorities prompting them to review the existing frameworks to manage the crisis both domestically and on a cross-border basis. In view of the series of events in the autumn of 2008, the established public safety net arrangements, designed to create safeguards for depositors, investors and policyholders, failed to ensure market confidence in the midst of a long-lasting systemic crisis. The third and last pillar that would lead to the creation of the Banking Union and thus to a total stabilization and regulation of the European financial market is the establishment of a single deposit guarantee scheme at European level. This last foundation, however, clashes with the opposition of the German Constitutional Court, which through a decision published in February 2014, denied the possible participation of Germany in the rescue of deposits not belonging to German citizens.

The effectiveness of the banking union as a whole will also depend on the capacity of the mechanisms mentioned above to promote the recovery of substantially sound banks but in a temporary situation of difficulty, also seeking to ensure exchange of information and collaboration between the various authorities involved.

1.2 Reasons for and objectives of the proposal for the Bank Recovery and Resolution Directive (BRRD).

Over the past years the European Union (EU) implemented a substantial reform of the financial services regulatory framework to enhance the resilience of financial institutions in the EU, largely based on global standards agreed with the EU's international partners.

¹³Journal of Banking Regulation: Proposals for reforming deposit guarantee schemes in Europe, June 2010, Volume 11, Issue 3, pp 210–222

These measures were taken in response to the financial crisis that unfolded in 2007-2008. The absence of adequate crisis management and resolution frameworks forced governments around the world to rescue banks following the financial crisis. The subsequent impact on public finances as well as the undesirable incentive of socialising the costs of bank failure have underscored that a different approach is needed to manage bank crises and protect financial stability.

Within the Union in line with the significant steps that have been taken in international fora, Directive 2014/59/EU (Bank Recovery and Resolution Directive (BRRD)¹⁴ and Regulation (EU) No 806/2014 Single Resolution Mechanism Regulation (SRMR)¹⁵ have established a robust bank resolution framework to effectively manage bank crises and reduce their negative impact on financial stability and public finances. A cornerstone tool of a robust resolution framework is the “bail-in” which consists of writing down debt or converting debt claims or other liabilities into equity according to a pre-defined hierarchy. The tool can be used to absorb losses of and internally recapitalise an institution that is failing or likely to fail, so that its viability is restored. Therefore, shareholders and other creditors will have to bear the burden of an institution's failure instead of taxpayers.

Why were the European Commission proposing a Single Resolution Mechanism in addition to the draft Bank Recovery and Resolution Directive?

The proposed Directive on Bank Recovery and Resolution (BRRD) would determine the rules for how EU banks in difficulties were restructured, how vital functions for the real economy were maintained, and how losses and costs were allocated to the banks’ shareholders and creditors. It would provide more comprehensive and effective arrangements to deal with failing banks at national level, as well as arrangements to tackle cross-border banking failures.

The draft Directive would rely on a network of national authorities and resolution funds to resolve banks. While this network would be a major step forward to minimising different national approaches and fragmentation of the Single Market, it would not be sufficient for Member States who share the common currency or are supervised by the European Central Bank (ECB) in the Banking Union.

¹⁴ Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms, OJ L 173, 12.6.2014, p. 190.

¹⁵ Regulation (EU) No 806/2014 of the European Parliament and of the Council of 15 July 2014 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 Resolution Fund and amending Regulation (EU) No 1093/2010, OJ L 225, 30.7.2014, p. 1.

In December 2012, the European Council recognised that in the Banking Union, bank supervision and resolution needed to be exercised by the same level of authority. They confirmed this at their meeting of 28 June 2013. Indeed, it is not possible to have a single European mechanism for the supervision of banks but to leave the resolution of banks to national authorities as tensions between the supervisor (ECB) and national resolution authorities could emerge over how to deal with ailing banks. At the same time, market expectations about Member States' ability to deal with bank failure nationally could persist, reinforcing negative feedback loops between sovereigns and banks and maintaining fragmentation and competitive distortions across the Single Market.

The financial crisis highlighted the need for swift and decisive action backed by EU-level funding arrangements in order to avoid a situation in which bank resolution conducted at national level would have a disproportionate impact on the real economy, and to curb uncertainty and prevent bank runs and contagion of other parts of the euro area and the Single Market.

Compared to a mere network of national resolution authorities, a Single Resolution Mechanism with a strong central decision-making body and a Single Bank Resolution Fund would provide key benefits for Member States, taxpayers, banks, and financial and economic stability in the entire EU, for example:

- I. Strong central decision-making would ensure that resolution decisions across participating Member States were taken effectively and quickly, avoiding uncoordinated action, minimising negative impacts on financial stability, and limiting the need for financial support.
- II. A central body with expertise and experience on bank resolution would be able to resolve banks more effectively, and with more limited effects on taxpayers, than individual national authorities with more limited resources and experience.
- III. A Single Resolution Fund would be able to pool significant resources from bank contributions and therefore protect taxpayers more effectively than national funds, while at the same time providing a level playing field for banks across participating Member States.

It should be noted that the transposition and implementation of the directive 2014/59/EU has caused significant changes within the member states of the European Union as well as in Italy.

1.2.1 The origins and the proposal of the directive. The preparatory work.

With respect to BRRD directive, it is crucial to mention not only the European context in which it was created but also the international context from which the directive itself has taken its origins. It is very important to remember that, as a result of the 2007 financial crisis, not only European governance, but also the international one, has taken great steps to regulate those gaps that have allowed the crisis in the financial system to influence even the real-world economy.

The Basel III Agreements are a set of new rules relating to banking supervision, approved in 2010 following the financial crisis by the Basel Committee¹⁶. The objective of these new rules is to prevent excessive assumption of risk by credit institutions and to make the financial system more robust and less vulnerable to systemic shocks. The new measures are aimed at targeting financial intermediaries by imposing: minimum liquidity standards, greater capital requirements, containment of the level of financial leverage and greater coverage of market risks.¹⁷

Beyond Supervision, the Council Identified two initiatives that it wants completed before the end of June 2013:

First, an “operational framework” for the direct recapitalization of banks by the ESM, the euro area crisis-management fund created in 2012.

Second, the adoption of two pieces of legislation that were proposed before the June 2012, Council decision to create a banking union: (BRRD) adopted by the European Commission in Early June 2012, which would create or reform national bank resolution regimes in a harmonized way in compliance with the Financial Stability Board’s recommendations (FSB 2011)¹⁸, including a provision for bail-in unsecured bank debt and the proposed recast of the Deposit Guarantee Schemes (DGS) Directive adapted by the commission in July 2010 which would further harmonize national deposit guarantee systems.

On 6 June 2012 was presented the Commission's proposal for the directive for the establishment of a framework for the reorganization and resolution of the credit institutions crisis that led to the great

¹⁶ BASEL COMMITTEE ON BANKING SUPERVISION (1988), Convergence of Capital Measurement and Capital Standards, July, URL: <http://www.bis.org/publ/bcbs04a.pdf>.

¹⁷ BANCA D’ITALIA (2006), Nuove disposizioni di vigilanza prudenziale per le banche. Circolare n. 263 del 27 dicembre 2006, URL: https://www.bancaditalia.it/vigilanza/normativa/norm_bi/circreg/vigprud/Circolare_263_2006.pdf.

¹⁸ The principles for the resolution of banking crises developed in October 2011 by the Financial Stability Board

project of the European Banking Union¹⁹. The proposed directive aimed to adopt the (2014/59/EU) directive that aimed to strengthen the European banking sector through the “bail-in”. In August 2013, the European Commission issued a new Communication on the application of state aid for the support of banks in the context of the financial crisis, the New Banking Communication, which replaced the previous one which dates back to 2008. The purpose of this Communication was to introduce for the first time the concept of bail-in, which was then reaffirmed in the proposal for a directive and aimed at ending the first period of derogation from art. 107 TFEU²⁰ which lasted 5 years.

The legal basis of the proposed directive resides in the art. 114 TFEU which allows for the adaptation of measures to harmonize national provisions which has as their object the establishment and functioning of the internal market. In this specific case the harmonized framework has the objective of promoting financial stability in the internal market of the euro area.

The most important argument analyzed in this directive is the so called ‘bail -in’, which is the most innovative among the instrument mentioned in the proposal in case of collapse. The new tools for the resolution of failing institutions that the authorities can apply are: the bridge institution tool, the sale of business activity, separation of activities, the bail-in tool. Such instruments can be applied both individually and in combination, but must always be consistent with the EU state aid framework.

In the proposal is specified that the provisions relating to bail-in will be subject to a longer transposition period than the directive, therefore they will be applied from 1 January 2018.

The European Directive 2014/59/EU²¹ is therefore part of a large set of reforms promoted at European and international level that tend to reduce the systemic effects of the non-performing banking system. The reforms can be attributed both to the creation and the recent implementation of

¹⁹ COMMISSIONE EUROPEA, Proposta di Direttiva del Parlamento Europeo e del Consiglio che istituisce un quadro di risanamento e di risoluzione delle crisi degli enti creditizi e delle imprese di investimento e che modifica le direttive del Consiglio 77/91/CEE e 82/891/CE, le direttive 2001/24/CE, 2002/47/CE, 2004/25/CE, 2005/56/CE, 2007/36/CE e 2011/35/UE e il regolamento (UE) n. 1093/2010, COM(2012) 280 final 2012/0150 (COD), 6 giugno 2012

²⁰ Article 107 TFEU consists of three paragraphs. In the 1st there is the notion of so-called "incompatible" state aid, in the 2nd are listed by law the derogations to the incompatibility, and in the 3rd paragraph there are hypotheses in which the European Commission can discretionally declare the aid compatible.

²¹ L 173/190 Official Journal of the European Union 12.6.2014 DIRECTIVE 2014/59/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 15 May 2014, file:///C:/Users/PcOtto/Desktop/Tesi%20di%20laurea/BRRD-Direttiva-2014-59-UE_ENGLISH.pdf

the European Banking Union, and to the amendment of the Basel Accords²², which have set new rules which allow the European and international banking system to remain more solid and to be less prone to systemic shocks. These changes therefore aim to make the banking system less risky by providing it with more capital, greater liquidity and a lower degree of leverage than in the past. However, if on the one hand these new prudential measures have the stated aim of making the banking system less risky, on the other hand many economists have objected that these same measures could lead to a reduction in the profitability of the banks and therefore also of the whole credit system, which could result in a reduction in the availability of finance from the real economy. Through the creation of Directive 2014/59/EU, the principles for the resolution of banking crises developed in October 2011 by the Financial Stability Board (FSB) were implemented and submitted to the Heads of State and Government during the G-20²³ in November 2011. Under the proposed Bank Recovery and Resolution Directive (BRRD), member states will be required to provide for bail-in powers to restructure failing financial institutions.

How does the BRRD relate to work undertaken at international level?

It conforms to international commitments in this area:

- In November 2008, G20 leaders called for a ‘review of resolution regimes and bankruptcy laws in light of recent experience to ensure that they permit and orderly wind-down of large complex cross-border institutions.’²⁴

In order to better deal with large and more complex cross-border groups, the consolidating supervisor would play a leading role in overseeing the development of a recovery plan and the group resolution authority (the authority in the Member States in which the consolidating supervisor under the EU banking rules is situated) will be responsible for designing a resolution plan for the whole banking group.

- At the Pittsburgh summit (September 2009), the G20 committed to act together ‘create more powerful tools to hold large global firms to account for the risks they take’ and, more specifically, to ‘develop resolution tools and frameworks for the effective resolution of

²² The Basel Accords refer to the banking supervision Accords (recommendations on banking regulations)—Basel I, Basel II and Basel III issued by the Basel Committee on Banking Supervision (BCBS). The Basel Accords is a set of recommendations for regulations in the banking industry.

²³ The G20 is a forum of finance ministers and central bank governors, created in 1999, following a succession of financial crises to foster economic internationality and concertation, taking into account the new developing economies. It includes the 19 most industrialized countries (those of the G8 in the first place) with the exception of Spain, the Netherlands and Switzerland. Furthermore, the European Union is present.

²⁴ <http://www.g20.org/images/stories/docs/eng/washington.pdf>

financial groups to help mitigate the disruption of financial institutions failures and reduce moral hazard in the future.’

- In Seoul (November 2010), the G20 endorsed the Financial Stability Board (FSB) Report on ‘Reducing the moral hazard posed by systematically important financial institutions’ which recommended that ‘all jurisdictions should undertake the necessary legal reforms to ensure that they have in place a resolution regime which would made feasible the resolution of any financial institution without taxpayer exposure to loss from solvency support while protecting vital economic functions through mechanisms which make it possible for shareholders and unsecured and uninsured creditors to absorb losses in their order to seniority.’
- In Cannes (November 2011), the G20 endorsed the Financial Stability Board FSB’s core recommendations for effective resolution (Key Attributes of Effective Resolution Regimes for Financial Institutions)²⁵ which jurisdiction should implement to achieve the G20 commitments.

The BRRD is fully in line with the Financial Stability Board (FSB) recommendations. It delivers a comprehensive bail-in tool (such as mentioned above) that ensures that shareholders and creditors bare the cost of bank failure, minimising the burden of taxpayers. It also includes a number of elements where the specificities and divergences in Europe’s markets and regulatory structures require particular solutions. (resolution colleges, role of the European Banking Authority).

The directive was adopted on 6 May 2014 and published on OJ L 173, on 12 June 2014; it is entered into force on 1 January 2015.

The regulation was adopted on 15 July 2014 and published on OF L 22, 30 July 2014.

1.3 Bank Recovery and Resolution Directive as part of European Union. The insertion of the directive in the European Banking Union project.

Among the numerous initiatives of the European Commission implemented after the crisis of 2008 there is, as already mentioned, the proposal for the constriction of a major European integration through the creation of the so-called Banking Union, that is a single banking

²⁵ The Key Attributes of Effective Resolution Regimes for Financial Institutions set out the core elements that the FSB considers to be necessary for an effective resolution regime. Their implementation should allow authorities to resolve financial institutions in an orderly manner without taxpayer exposure to loss from solvency support, while maintaining continuity of their vital economic functions.

supervision mechanism at European level which provides the attribution of new supervisory powers to the Central Bank. Banking Union integrated was indicated by the President of European Commission Barroso as an indispensable step to be realized within the project of the Economic and Monetary Union because of the objective assigned to it to strengthen the supervision and the fiscal stability of the whole Union.

In the process of European integration, it is indicated as indispensable to proceed with the creation, first of all, of a fiscal union and of a political union.

The construction of a European ‘banking union’ is one of the most significant developments in the European Integration since the agreement on Economic and Monetary Union in the Maastricht Treaty. Banking Union was proposed by the European heads of government and state in June 2012 to restore confidence in the European Banking systems weakened by the double whammy of the international financial crisis and the sovereign debt crisis. Banking Union was to be based on five components; a single rulebook on bank capital and liquidity; a single framework for banking supervision; a single framework for the managed resolution of banks and financial institutions; a common deposit guarantee scheme; and a common backstop for temporary financial support (European Council, 2012).

From June 2012, there were negotiations of four of the five elements of a banking union and, with the exception of the deposit guarantee scheme, agreements were reached by the spring 2014. In September 2012, the European Commission proposed a regulation for the establishment of a single supervisory mechanism (SSM) (European Commission 2012), which was agreed in amended form by the December 2012 European Council (2012) and adapted by the European Parliament (EP) and the Council in October 2013. The adoption of EU capital requirements legislation in early 2013 reinforced the single rulebook- although many lacunas remained. A directive on banks recovery and resolution (BRRD), proposed by the commission on 6 June 2012 (European Commission 2012), was agreed by the Council on 27 June 2013, approved on an institutional dialogue of Council, Commission and EP on 12 December 2013, and finally adapted by the EP in April 2014. The BRRD which applies to all EU Member States, sets pot rules for the ‘bail-in’ of struggling and failing banks that enable authorities to recapitalize a failing bank by writing-down liabilities and for converting them to equity with the aim of continuing a bank as a going concern, decreasing financial system instability and giving authorities the opportunity to reorganize the bank or resolve it (European Commission 2014).

The package of proposals, presented in September 2012 by Commission includes: a proposal for a regulation conferring powers on the ECB (European Central Bank) for the supervision of all the banks of the Euro area; a proposal for a regulation containing amendments to the EBA (European Banking Authority) settlement regulation; finally, a communication of the Commission with a view to Banking Union and related initiatives. The ECB will have the task of monitoring all of banks in the euro zone and not just those that threaten stability Global Finance, or the 'too big to fail institutions'- identified with the acronym of G-SIBs from the Financial Stability Board.

It is important to highlight some critical aspects of Banking Union. First of all, it is advisable to make an observation on the role of national authorities. To these belong to all supervisory tasks not expressly assigned to the ECB; is assigned an important assistance function towards the ECB in preparing for the implementation of the acts pertaining to the supervisory activities. The ECB has the role to play directly the supervisory action against major systemic banks, while this action is carried out indirectly on the remaining intermediaries, through of the national supervisory authorities.

Further information concerns the role of the EBA, which maintains its function, thus continuing to issue regulations effective on credit institutions of the entire European Union, but which changes the rules of operation internal, such as voting methods and the composition of the board of administration, in order to guarantee a 'level playing field' among all the States members, including those who do not participate in the Single Supervisory Mechanism as not belonging to the Eurozone. It is however expected that the countries who do not adopt the euro can apply to become part of the supervision system with the ECB in the center, under specific conditions.²⁶

Finally, another critical point concerns the need to ensure a net separation between monetary and supervisory functions, both carried out by the ECB. For this purpose, the new supervisory functions are expected to come carried out by administrative bodies and divisions separate from those in charge of the monetary policy.

The issue of Banking Union is therefore linked to a series of proposals already previously carried out by the European Commission between 2010 and 2012, such as the already named

²⁶ To see how the Commission Proposals, consider the situation of States that have not adapted the Euro, see European Commission, Proposal for a Council Regulation conferring specific tasks on the ECB concerning policies relating to the prudential supervision of credit institutions, COM (2012) 511 final, Brussels, 12 September 2012, p.6.

‘CRD 4 Package’ (Capital Requirement Directive), regarding the capital requirements of the banks; the proposal on the harmonization and simplification of the deposit guarantees in July 2010; acceleration of repayments and improvement of the financing; finally, the common framework on rehabilitation and resolution of banking crises (BRRD).

If, on the one hand, the strengthening of the Union supervisory framework through the creation of Banking Union is proposed to improve the solidity of the banks, on the other hand, it is necessary to guarantee an orderly liquidation in the case that the crises occur.

Furthermore, the Commission has already expressed its volition once it has been reached agreement on pending proposals – in particular with regard to proposals on Deposit Guarantee Scheme and on Bank Recovery and Resolution – to proposals to establish further measures for an integrated European management system bank failures, such as the establishment of a single European Mechanism for resolution of banking crises through the creation of an independent structure – that is a resolution authority at European level, considered more efficient than a network of national resolution authorities- with the task of monitoring banks in crisis or failed and to manage cross-border banking crises.²⁷

²⁷ European Commission Memo, Brussels/Strasbourg, 12September 2012, Commission Proposes a package for banking supervision in the Eurozone. [http://europa.eu/rapid/press-release MEMO-12-662_en.htm](http://europa.eu/rapid/press-release_MEMO-12-662_en.htm)

Chapter 2: How BRRD works, the mechanism and organs.

2.1 Overview

The financial crisis highlighted that public authorities are ill-equipped to deal with ailing banks operating in today's global markets. Already from the following year of the financial crisis the regulators of different countries have been analyzing the several aspects. The aim was to fill the various regulatory gaps that have emerged both at domestic and international level. As mentioned in chapters before the distress of banks generates a chain reaction: bank in trouble would not provide loans anymore, firms and companies cannot raise money to invest, and consumption falls. We know the consequences and that it is important to keep even the banks in trouble alive. Therefore, during the financial crisis, in order to maintain essential financial services for citizens and businesses many governments rescued insolvent banks using the taxpayers' money. As a consequence, in the last seven years, many European countries bail their banks out, such as Ireland, Greece, Austria, Spain, Portugal, Germany, Cyprus and Slovenia. The recent bailouts have required 800 billion Euros and have determined increases in deficit and public debt, and in the level of taxation and services. This averted massive banking failure and economic disruption, but has burdened taxpayers with deteriorating public finances and failed to settle the question of how to deal with large cross-border banks in trouble.

Below some historical instances of bail-outs:

- In late 2008, the federal government bailed out AIG for \$180 billion, and technically assumed control, because some believed its failure would endanger the financial integrity of other major firms that were its trading partners ([Goldman Sachs](#), [Morgan Stanley](#), [Bank of America](#) and [Merrill Lynch](#)).
- In October 2017 it was announced in India a Rs 2.11 trillion PSU Bank recapitalization so that stressed Public sector banks with high NPAs could meet CAR and see revived credit growth.
- Greece bailout from sovereign debt crisis.

There are several examples of banks' bailouts: Citigroup (USA), Royal Bank of Scotland (UK), Anglo Irish Bank (IR), Slovenian banks. The impact on public finances and the undesirable effects of socializing the cost of bank failure have the European authorities intervened. On 15 May 2014, the European Parliament and the Council approved the Directive 2014/59/EU, which establishes a framework for the recovery and resolution of credit institutions and investment firms, the so-called BRRD (Bank Recovery and Resolution Directive). It provides that in the future the shareholders and the creditors will have to bear the burden of bank failure, minimizing in this way the moral hazard and the risk for the taxpayers.

The new instrument is the bail-in, which is the opposite of a bailout. It is defined as rescuing a financial institution that is on the brink of failure by forcing its creditors and depositors to take a haircut on their holdings. It is an “internal rescue” through the depreciation of shares and the conversion of specific types of bonds to absorb and recapitalize the bank in trouble. Hence, with the bail-in the authorities decided that the governments do not have to subsidize anymore the banking system.

The European Commission wants to ensure that in the future authorities will have the means to intervene decisively both before a problem occurs and early on the process if they do. The new EU rules require the imposition of greater losses on the creditors of failed banks, not on taxpayers. Therefore, if the financial situation of a bank deteriorates beyond repair, the proposal ensures that a bank's critical functions can be rescued while the costs of restructuring and resolving failing banks fall upon the bank's owners and creditors and not on taxpayers. With the new system, regulators will have stronger powers to force senior creditors to take losses before the public money is used. In particular, they want to hit also senior bondholders, which were the best-protected investors during the crisis.

The golden rule is that 8 percent of a stricken bank's liabilities, which is referred to as MREL (Minimum Requirement for own funds and Eligible Liabilities), must be wiped out before any public money can be injected in the bank. This new concept means that when a bank is not viable, those liabilities will be used to recapitalize the institution and guarantee that the critical functions of the bank will survive.

The two main authorities competent in this field are EBA (European Bank Authority) and SRB (Single Resolution Board). The first one has provided the technical standard on the criteria for determining MREL. Indeed, SRB is a new European organ appointed to ensure an orderly resolution of failing banks with minimum impact on the real economy and public finances. The

BRRD has entered into force since 1st January 2016. Later we will see more in detail what bail in is and what are the differences with bail out. Now I will make a brief explanation of recovery and resolution plans.

2.2 Recovery and resolution plans

Under the bank recovery and resolution directive institutions are required to prepare and regularly update recovery plans that are set out the measures they would take to restore their financial position following a significant deterioration. In other words, the BRRD is requiring to prepare recovery plans to overcome financial distress. The BRRD also requires resolution authorities to plan for effective resolution of an institution in the event of future failure. Such plans should be detailed and based on realistic assumption applicable in a range of robust and severe scenarios. The directive includes rules to set up a national fund that must be established by each EU country.

2.2.1 Recovery plans

Institutions are required to draft detailed recovery plans setting out the actions to be taken to restore long-term viability in the event of a material deterioration in its circumstances. The core of the recovery plan outlines a wide range of credible and feasible recovery options to restore viability. The plan has to be taken into account how the institution will react in different scenarios. In other words, in its recovery plan, the bank sets out it monitors negative developments and how it could steer away from severe stress should it occur. Moreover, institutions must not assume that there will be any access to public financial support as part of their planning.

Recovery plans are both a preparative and a preventive tool. They have added value for banks and supervisors, also under business as usual conditions. The proposed tools by this directive are divided as following with intervention by the authorities becoming more intrusive as the situation deteriorates:

1. Preparation and prevention

- a. Institutions are required to draw up recovery plans where will be explained the measures that will be taken to restore their viability in case of a deterioration of their financial situation;
- b. Resolution plans have to be prepared by the authorities that have the responsibility of resolving banks;

- c. The authorities can require a bank to change its legal or operational structure in case they identify obstacles to resolvability in order to ensure that it can be resolved with the available tools in a way that does not compromise critical functions, threaten financial stability, or involve costs to the taxpayer.
 - d. In order to limit the development of a crisis and quickly boost the financial stability of the group as a whole the financial group may be asked to enter into intra-group support agreements.
2. Early intervention: in case the financial situation or solvency of an institution is deteriorating the supervisors will be permitted to intervene at early stage. In this case, the authorities could require:
 - a. To the institutions to implement any measures set out in the recovery plan;
 - b. To the management to identify measures and draw up an action programme to address any issue;
 - c. A shareholders meeting to adopt urgent decisions;
 - d. A plan to be drawn up restructure's debt with creditors.
3. Resolution powers and tools take place if the preventive and early interventions measures fail to redress the situation from deteriorating to the point where the bank is failing or likely to fail.

2.2.2 Resolution plans

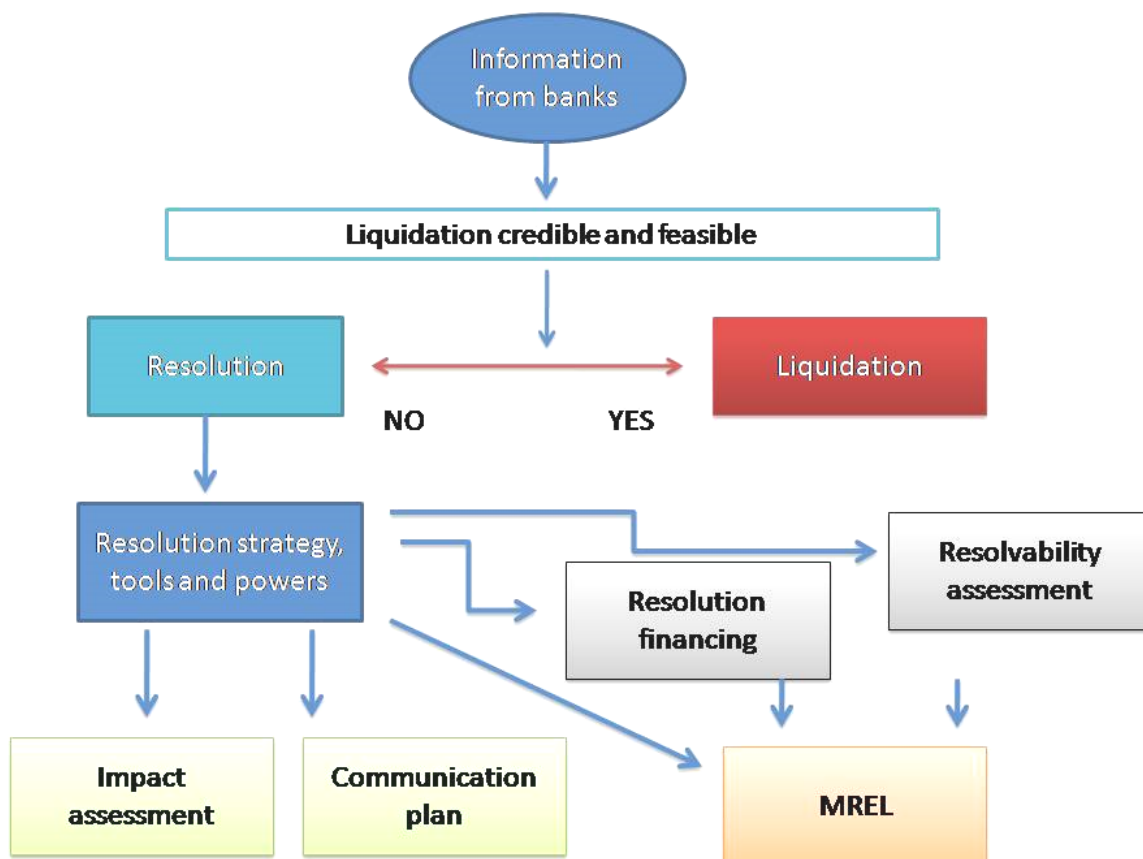
Unlike recovery plans we have that resolution plans are not drawn by the banks but are prepared and regularly by the SRB and national resolution authorities. With a bank resolution is intended the restructuring of a bank by a resolution authority through the use of resolution tools in order to safeguard public interests, including the continuity of the bank's critical functions, financial stability and minimal costs to taxpayers.

The resolution planning it better prepares for future crisis situations by assessing the significance of a bank with a focus on its critical functions and possibly implications of a failure. In other word, the resolution plans prepare the measures and the process for the potential orderly resolution of a bank by ensuring the continuity of its critical functions. The first essential component of effective resolution is to ensure that resolution authorities have all the information necessary. In order to draw up resolution plans the resolution authorities can request all the information they need both from institutions directly as well as from supervisory authorities.

A resolution strategy and a full resolution plan will be required only where the resolution authorities conclude that a wind down may not be feasible and credible. The full resolution plan may at least provide the following information:

- A description of the resolution strategy;
- Arrangements to ensure operational continuity and information arrangements;
- Financing arrangements;
- A resolvability assessment; and
- A communication plan with all stakeholders.

Below a scheme that describes the key elements of a resolution plan.



In case an institution is failing, a resolution authority should have a harmonized minimum set of resolution tools, which includes:

- A sale of business tool, which enables resolution authorities to sell the institutions to one or more purchasers with or without the consent of shareholders. The sale may be applied

individually or in combination with other tools²⁸. The price of the entity will be based on a fair, prudent and realistic valuation of the assets and liabilities.

- A bridge institution tool: which aims to bridge time until a private sector solution is found, preserving the critical functions of the failing bank. The bridge institution tool is controlled by the resolution authority and authorized by the supervisors. The bridge institutions must be wholly or partially owned either through direct state ownership or the resolution financing arrangement, or one or more public authorities, and will be controlled by the resolution authority.
- An asset separation tool: this is used to transfer assets and liabilities to a separate asset management vehicle (AMV). The AMV goal is to maximize those assets and liabilities value for an eventual sale, or an orderly gradual wind-down. The asset management vehicle must always be applied with another resolution tool and it is justified only if immediate liquidation would be disadvantageous at that point in time.
- A bail-in tool: this tool is ensuring that most unsecured creditors of an institution bear appropriate losses. Below it will be seen in detail this tool.

2.3 From bail-out to bail-in

As mentioned before, the bail-out it is when the government transfer money to a failing business in order to avoid the consequences that could arise from the business downfall. In most countries, part of the banking sector is protected through implicit or explicit government guarantees. Some of these guarantees, such as deposit insurance, affect all banks more or less in the same way; others privilege a subset of banks, such as public banks or large banks that are “too big to fail”. It is a widely maintained hypothesis that these public guarantees distort competition in the banking sector. The reason of believing such a hypothesis is that publicly guaranteed banks are able to refinance at more favorable terms than other banks because the protected banks’ creditors expect to be compensated by the state if their bank is in danger of becoming insolvent. It has been showed²⁹ that such competitive distortions may undermine financial stability because they provoke higher risk-taking by the protected banks’ competitors. In the same way, we have that public bail-out guarantee to a subset of banks lead to a reduction of rents at the competitor banks. Therefore, for those banks that are not expected to be bailed out there will be a risk-shifting problem.

Since bail-out is using the taxpayers’ money to rescue the insolvent banks, and in order to protect them and block unsustainable bail-outs, policymakers around the globe reacted with a

²⁸ Article 37 of BRRD

²⁹ Hakenes and Schnabel , Credit Risk Transfer and Bank Competition (October 2009).

profound revision of the framework for bank crisis management and the related resolution tools. The aim of bail-in (together with the power of resolution authorities to “write down capital instruments”) is to ensure that the burden of banks’ losses is borne by shareholders and creditors.

The main objective of bail-in, understood as one of the most innovative tools given to resolution authorities by the BRRD in the context of bank resolution, is the recapitalization of the insolvent banks. This tool is allowing resolution authorities to write down subordinated debt and convert it into capital. And, in order to achieve the widest loss-absorbing capacity, bail-in it is also allowing writing down and converting into capital the remaining eligible liabilities. In other words, the bail-in tool achieves loss-absorption by either converting the liability into common equity instruments, such as a share, or by writing down or writing off the principal amount of the liability. It is important to note that as debt claims are converted into equity instruments, the holders will benefit from future profits of the relevant entity, whether from the payment of dividends or an increase in value of the equity instruments.

In order to achieve the conversion to equity the following steps are needed:

1. The resolution authority could issue certificates of entitlement to creditors holding liabilities subject to bail-in;
2. The title to all existing shares could be transferred to a depositary to hold on behalf of the certificate holders;
3. Once the resolution valuation has been completed, and the final terms of the conversion/write-down have been determined, the certificates of entitlement would be exchanged for the new shares.

As laid down by the insolvency law, bail-in is applied according to a specific sequence:

- a. Shareholders;
- b. Holders of other capital instruments and subordinated debt;
- c. Other unsecured creditors;
- d. Deposits of other capital instruments;
- e. Lastly, the deposit guarantee scheme (DGS) which intervenes in lieu of the insured deposits.

The definition of bail-in in the BRRD is wide and regards all bank liabilities that are not explicitly excluded³⁰. Therefore, in order to make the resolution effective the BRRD provides that banks must comply with a minimum requirement of own funds and bail-in-able (MREL, which will be explained later in details on this chapter). The bail-in-able liabilities in principle are all liabilities not expressly excluded by law. There are two types of exclusion: permanent and optional.

The permanent exclusions regard the following liabilities:

- Covered deposits which are the deposits up to the amount covered by a deposit guarantee scheme (DGS);
- Liabilities arising by virtue of the holding by an institution or by virtue of a fiduciary relationship;
- Interbank liabilities with a remaining maturity of less than seven days;
- Liabilities deriving from the participation in the payment system having a remaining maturity of less than seven days;
- Lastly, liabilities towards the DGS for contributions pursuant to the Deposit Guarantee Scheme Directive.

Instead, the optional exclusions can be applied by the resolution authority when exceptional circumstances occur. Obviously, this option to exclude certain liabilities is regulated by the BRRD. The exceptional circumstances where the resolution authority may wholly or partially exclude certain liabilities from bail-in are the following:

- It is impossible to bail-in the liability within a reasonable timescale; or
- In order to achieve continuity of critical functions and core business lines the exclusion is necessary and proportionate; or
- There is a concern that the bail-in may cause destruction in value, in particular as regards deposits held by individuals and micro, small and medium size enterprises; or
- Finally, bailing-in would cause higher losses to other creditors than not bailing it in.

Technical advice on how to assess the conditions under which exclusions from bail-in tool are necessary has been issued by the European Banking Authority (EBA). When applying resolution tools, the resolution authorities must observe the no creditors worse off than under liquidation principle. Therefore, provided that the other creditors would not suffer greater losses

³⁰ BRRD, Article 44(1).

then they would have under normal insolvency proceedings, where a resolution authority decides to exclude all or part of an eligible liability from bail-in have to take account also of such exclusions. The BRRD allows use of the resolution fund only where bail-in has been applied to an amount of not less than 8% of the bank's total liabilities (including own funds, which are always the same as assets, except where is negative equity). However, the last word is on European Commission, resolution authorities must notify the European commission which can prohibit the exclusion.

The BRRD also foresees the possibility of public support outside the resolution; therefore, public support is not necessarily a signal of falling or likely-to-fail conditions. But the public intervention is allowed only on a precautionary and temporary basis and not to cover banks' losses. Moreover, in order to address moral hazard and to limit the distortion of competition in the banking sector, State aid is allowed only if burden sharing is applied according to the 2013 Communication on State aid rules in favor of banks.

2.4 The MREL

As mentioned before in this chapter, in order to deter institutions from structuring their borrowing to be immune from bail-in tool, the BRRD provides that resolution authorities must set a minimum required level of loss-absorbing liabilities (MREL). The MREL is expressed as a percentage of total liabilities and own funds of an institution. Due to doubts as how to easily eligible liabilities could be bailed-in in an actual scenario, some of those liabilities even if are eligible for bail-in are likely not to count towards an institution's MREL. The setting of MREL by the resolution authority could be influenced by the desire to limit any contagion effects and negative impacts of bail-in of the bail-in on non-professional's creditors. It is set on a case-by-case basis by the resolution authorities and based on at least six common criteria established in the BRRD. The main aim of the MREL is to ensuring the continuation of the bank's critical function without recourse to public funds in case of critical moments.

The eligible liabilities, required to be hold as MREL, are the liabilities of an institution, which are not excluded from the bail-in. The rule does not regard only credit institutions, but also large investment firms, which are subject to the fourth Capital Requirements Directive (CRD) of €730,000 to be hold as initial capital. The Directive extents those requirements also to the EU-based parent and intermediate: financial holding companies, mixed financial holding companies and mixed-activity holding companies; and to financial institutions that are subsidiaries of an EU credit institution or of an investment firm or of the financial holding companies mentioned above.

The MREL is not a fixed percentage, indeed the resolution authorities, nominated by each Member State, can set that requirement differently depending on the financial situation of each bank. Concerning those authorities, the Directive demand a functional separation of the resolution activity from any other supervisory activities if the resolution authority is a central bank, a supervisor or a competent ministry.

The BRRD establishes that the level of the MREL should be fitted with the risk profile, the business model, the resolvability, the systemic importance and others characteristics of each institution. To guarantee a minimum level of convergence on the requirements application around the Member States, and to ensure that similar MREL will be applied to similar institution with similar risks, the BRRD has specified 6 common criteria. The criteria are the followings:

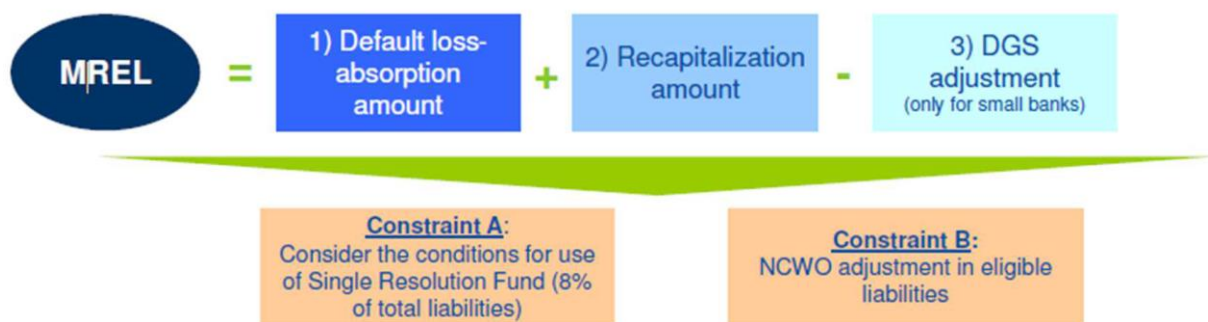
1. The resolvability and capital adequacy, which take especially in consideration the importance of the MREL to ensure that the funds are enough to absorb losses and to contribute to the recapitalization.
2. The establishment of the amount of recapitalization should be sufficient to put in fact the preferred resolution strategy identified in the resolution planning process. Therefore, this is required only at that institution for which a liquidation process would not be feasible and credible, for any other this amount should be equal to zero.
3. The MREL should be sufficient to cover losses or to participate to recapitalization, even if some liabilities are not eligible under the art. 44 (2) of BRRD or the resolution authorities excluded them.
4. The Deposit Guarantee Scheme could contribute to finance the resolution, according with art. 109 of BRRD, which limits in any case this contribution to the lesser of: (a) the amount of losses covered by depositors would have borne in insolvency, or (b) 50% of the target level of deposit guarantee fund.
5. It should be taken in consideration for the establishment of the MREL the size of the institution, the business model, the funding model and the risk profile. Any decision took by the resolution authority should be clearly articulated and discussed.
6. The final criterion concerns the potential adverse effects on financial stability of the failure of the institutions, which should be taken in consideration by the resolution authority. In fact, the resolution authority has first of all to identify the institutions whose failure is reasonably likely to pose systemic risk and for them the MREL should continue to be set in a way that ensures that the first five criteria are adequately followed.

Let's see in details how MREL is defined.

2.4.1 Components of MREL

The MREL is considered individually per institution and it will take into account the recapitalization needs based on the preferred resolution strategy. In this case-by-case basis, the role of the resolution authority is crucial when determining the specific requirement criteria in each institution. In addition, it will have a quantitative floor based on total liabilities and the treatment of senior unsubordinated debt is slightly different.

EBA proposes five elements to be taken into account:



The MREL criteria is expressed as a percentage of total liabilities and own funds of each institution. However, the MREL's quantum will be determined in monetary terms based on several factors, in which the capital and leverage ratios play a main role. Here the explanation of the three elements of MREL criteria and the two critical constraints.

1. The “default loss absorption amount” definition

It is the capital requirement currently applicable to an institution or group and it is the Maximum among capital ratio requirement, leverage ratio requirement and Basel I floor.

The capital ratio requirement includes Pillar 2, Basel I floor and the so-called “combined buffer”, which is the combination between the capital conservation, countercyclical, systemic entity (either Global Systemically Important Banks or Other Systemically Important Banks) and a systemic risk buffer. The leverage ratio, known as the “debt-to-equity ratio” mostly of times, recognizes diversity among European banks and takes into account the RWA (Risk-Weighted

Asset) density. Basel I floors are a fix set of risk weights, which are roughly 0 percent for loans to public sector entities, 50 percent for loans secured on residential property and 100 percent for corporate loans. An upward or downward adjustment may take place depending on **the Supervisory Review and Evaluation Process (SREP)**, which takes into account the idiosyncratic characteristics of each institution (business model, risk profile, governance, etc.) To do this, the resolution authority should use the outcome of the SREP that supervisors will carry out for all institutions. It may be a failure, though, because often, the dialogue, coordination and information shared between the resolution authority and the supervisors are critical.

2. The “recapitalization amount” definition

One of the main objectives of the Bail-in tool is to recapitalize the failed institution at a level that promotes market confidence and meets the going concern regulatory capital requirement.

The optimal level of recapitalization should be the median of the CET1 (Common Equity Tier 1) of a peer group. However, sometimes, the best resolution strategy is to discontinue or to close down some subsidiaries rather than continuing the entire business; one of the main objectives of this resolution plan is to identify which functions are economically critical and should be preserved, and which are not and should therefore be liquidated. If a Parent Bank has very risky subsidiaries, its recapitalization amount should be higher than other Parent Banks (same Total consolidated assets, same Risk profile of its own). To avoid this situation, the Parent chooses to wind down the riskiest activities. (This is will be better explained in the subsequent paragraph “The effects of MREL on capital”)

3. The “DGS adjustment” criteria

The resolution authority uses the DGS (Deposit Guarantees Scheme) as a contribution limit to the resolution, instead of its own function: in case of liquidation under normal insolvency. The contribution limit is the amount of covered deposits or the 50% of the target level. Therefore, the resolution authority may reduce the MREL in order to take into account any estimated contribution, or increase the MREL to protect the DGS levels.

a. The “8% of total liabilities floor” constraint

The EBA ensures that banks, at least the significant ones, have enough liabilities before deciding to use other measures:

$$\frac{MREL}{RWA} \times \frac{RWA}{Total Liabilities} = \frac{MREL}{Total Liabilities} \approx 8\%$$

If RWA density rises in a bank, then the bank will require a reduction on MREL floor.

- b. The “Non-Creditor Worse off than in Liquidation adjustment” principle (NCWO)

The EBA is concerned about the legal and operational problems when senior debt is eligible for Bail-in and uncovered corporate deposits are excluded. There is a consensus among authorities: unsecured debt may pose credible or legal loss-absorbing risks. That is why, the EBA is considering not including in the MREL all the unsecured debt, when it counts for less than 90% of the total liabilities in the same rank.

2.4.2 The effects of MREL on capital

The capital adequacy, as we have seen before in the part dedicated to the components of MREL, has two elements: loss absorption and recapitalization. But, let’s deepen “the recapitalization amount” component.

The recapitalization is the amount needed to satisfy applicable capital requirements necessary to comply with the condition for authorization after the implementation of the preferred resolution strategy. This recapitalization amount is not necessary for those banks that can be liquidated (in this case the recapitalization amount is equal to zero), but only for those institutions for which liquidation under normal insolvency processes is assessed not to be feasible and credible.

The recapitalization criterion consists of two parts:

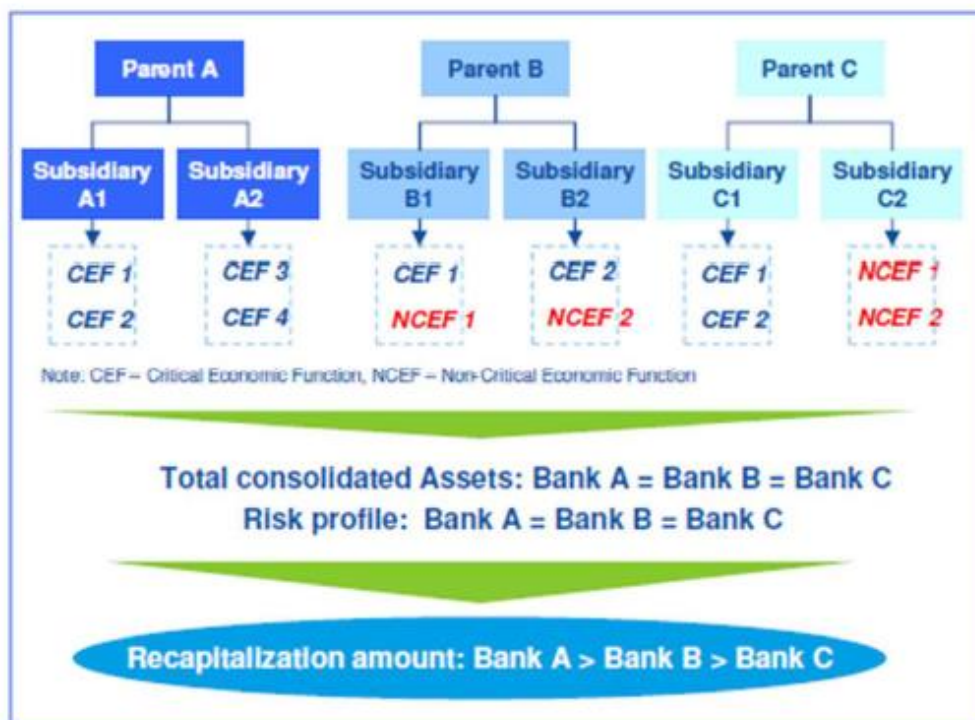
1. In the first part a link is created between the MREL and the capital ratio necessary to comply with conditions for authorization for the institution after resolution. In case an institution can’t no more meet the prudential requirements, the competent authority may withdraw the authorization. This means that the institution, immediately after resolution, have to comply, at a minimum, with the 8% total capital ratio requirement and any Pillar 2 capital requirement that the authorities have set. At least in the immediate post-resolution period, capital requirements are likely to need to be met through Common Equity Tier 1 (CET1).
2. The second part of the recapitalization amount consists on ensuring sufficient market confidence in the institution. This should be evaluated by taking into consideration how much is needed to restore the capital buffers established by CRD IV (Capital Requirements

regulation and Directive) and to review if the resulting capital is appropriated when compared to capital levels in the firm's peer group. The peer group approach is used because it is likely that market confidence depends on capital levels relative to peers. The resolution authorities may conclude that some components of capital requirements would not be applicable in the aftermath of resolution.

However, the resolution plan may not imply that the entire group is recapitalized in the same form as happens when it enters resolution. The resolution authorities take into account whether setting the loss absorption and the recapitalization amount of the specific features of subsidiaries of groups and of financial market infrastructure firms which are subject to the MREL requirement.

The recapitalization amount should not be the same for bank that have different critical economic function or that are structured in a different way, even if they have the same balance sheet and same risk profiles.

One of the main objectives of the resolution plan and the resolution strategy is to identify which functions are economically critical and should be preserved, and which are not and should therefore be liquidated. This approach creates incentives for bank to reduce barriers or impediments to resolvability. The involvement of the entire organization and investments of large amounts of money and resources are required for removing such impediments. Banks may need incentives to invest on resolution, and therefore discriminate between resolvable and less resolvable banks, for example, through lower MREL requirement. The bank that should have more capital after resolution should be the bank with more critical functions (Let's call it bank A), so the bank which may pose higher systematic risk. The bank that would have fewer impediments to wind down the non-critical function is the bank that organizes their critical and non-critical functions in independent legal entities (bank C). Bank B presents an intermediate situation between bank A and bank C with both subsidiaries having CEF and NCEF; management of this bank can be critical in time of crisis.



2.4.3 Single Resolution Board

The Single Resolution Board, like we said before, is the European reply to the Euro area crisis and was founded on 1st January 2015. It is one of the pillars of the newly created Banking Union and its "Single Resolution Mechanism" (SRM).

It works in close cooperation in particular with the national resolution authorities of participating Member States, the European Commission and the European Central Bank. Its mission is to ensure an orderly resolution of failing banks with minimum impact on the real economy and public finances of the participating Member States and beyond.

Those are the main tasks of SRB:

- To draft resolution plans for the banks under its direct responsibility. This includes the banks under the direct supervision of the SSM and all cross-border groups
- To carry out an assessment of the banks' resolvability and to adopt resolution plans
- To address any obstacles to resolution and cooperate on resolving them
- To set the minimum requirements for own funds and eligible liabilities (MREL)
- To follow up on early intervention measures
- To trigger resolution (with the ECB)
- To adopt resolution decisions, to choose and decide on the use of resolution tools
- To closely cooperate with and give instructions to national resolution authorities.

When the Single Resolution Board adopts a resolution scheme, it also determines which **resolution tools** are to be applied; the one it has available are sale of business, bridge bank, asset separation, bail-in.

One of the first problems that Elke König, Chair of the SRB, her team has to face is the detailing of the standards, known as MREL; this is necessary to make a bail-in as simple as possible to execute. It is a very complex process, according to Ms König, and their aim is to have set MREL for all major banks by the end of 2016. Another issue that the SRB have to face is the problem of international overlapping rules: TLAC (Total Loss Absorbing Capacity), which were outlined last year.

2.4.3.1 MREL and TLAC: similar but different.

In November 2014, the Financial Stability Board (FSB) opened a consultation on a proposal for a common international standard on total loss-absorbing capacity (TLAC). A year later, the FSB published its final TLAC standard for G-SIBs (“Globally Systematically Important Banks”) together with the Basel Committee on Banking Supervision (BCBS), which published a consultation document on this proposal.

The MREL could be seen as a transposition of this instrument into the European Union, both instruments (MREL and TLAC) seek to ensure that banks have enough liabilities with loss absorbing capacity to deal with banking crises, but even if their purpose is the same, they have some divergences:

- **Recipients:** TLAC sets a global standard which covers only the 30 largest global banks which have been designated “Globally Systematically Important Banks” (G-SIBs), while MREL is only for all EU banks (among them, only 13 banks belong to the G-SIBs);
- **Implementation date:** TLAC is enter into force in 2019 with a step up in 2022, instead MREL has a 48 months phase-in (2016-2020) is been established;
- **Pillar 1, Pillar 2 and capital buffers.** The FSB term sheet proposes a standard pillar 1, as minimum TLAC requirement, which is the maximum between the 16% of RWAs or 6% of total exposure, rising to 18% and 6,75% in 2022, and an additional pillar 2 requirement set on a bank by bank basis to keep into account the differences between each bank. Moreover, in order to ensure that a G-SIB has sufficient outstanding debt to recapitalise the failed institution when the common equity tier 1 is wiped out, the FSB includes an additional constraint requiring that at least 33% of the TLAC is composed of junior and senior debt.

TLAC minimum requirements do not include capital buffers. BRRD instead does not set a fixed requirement, but resolution authority have to set it on a case by case basis.

- **Denominator:** The FSB pillar 1 requirement is setted as a percentage of RWAs or leverage ratio. The BRRD requires the MREL to be set as a percentage of own funds and total liabilities
- **Eligibility of instruments:** Both have more or less the same eligibility, but even here there are some differences, the main one is the subordination exceptions. Debt instruments (including subordinated to other non-TLAC liabilities) are expected to comprise at least one third of the minimum TLAC requirement, just to ensure that some additional loss-absorbing capacity is available in the event that a bank enters resolution after a significant depletion in the amount of equity left to absorb losses has already occurred, while the BRRD does not explicitly require that any portion of MREL be met by subordinated debt.

	TLAC	MREL
Tier 1 and tier 2 regulatory capital	✓	✓
Debt that is:		
More than one year remaining maturity	✓	✓
Unsecured and uninsured	✓	✓
Not subject to any depositor preference		✓
Contractually (or under governing law) subject to bail-in in a resolution	✓	
Subordinated to all other non-TLAC liabilities	✓	

Source: KPMG International

How to fit them together: The attempt of the UK.

The TLAC and MREL features need to be sufficiently flexible to arrange different business models. It is necessary to avoid forcing changes against the nature of the entities. However, the main concern regarding the implementation of the two instruments, is related to the lack of harmony in resolution frameworks. Not only there are two different bail-in tools, but there exists differences among resolution frameworks across countries, since the rules governing the BRRD are implemented differently among Member States, so there are divergences in national implementation.

UK -the first country that try to fit the two instruments together- proposes to integrate both in one ratio, with a calibration depending on the size of the entity, so the banks are divided into three groups:

1. SMALL BANKS: institutions with fewer than 40.000 “transactional accounts”. Their failure would not require the use of stabilization powers in the public interest and they will have a MREL equal to their minimum capital requirements;
2. BANKS which will use a PARTIAL TRANSFER as their main resolution tool (with more than 40.000 “transactional accounts”) will have to maintain a larger MREL equal to that of small banks plus an additional amount depending on the amount of assets transferred;
3. Banks with bail-in as their main resolution tool (G-SIBs and OTHER LARGE BANKS with a balance sheet size greater than £15bn to £25bn) will have to hold an MREL equal to double the one of the small banks, even if with some adjustments.

The UK proposal respects the resolution strategy of each bank and takes into account their business models when setting their MREL. EBA is monitoring the FSB’s activities about the conclusion of the regulation of TLAC, in order to prepare a report, within September 2016, on the consistency between MREL and TLAC. Based on this report the EU Commission, if appropriate, may submit by 31 December 2016 to the EU Parliament and to the Council a legislative proposal to harmonize MREL in Europe. One of the expected modifications is the introduction of the TLAC, either by adding a new requirement or by amending MREL to include additional Requirements for G-SIBs. For that purpose, European authorities will surely take into account the UK’s approach.

Chapter 3: The implementation of the Bank Recovery and Resolution Directive in Italy. Policy implications

3.1 The banking crisis in Italy. Vigilance and crisis management from the Italian Bank.

The Italian banking system has been affected by the financial crisis on the international financial markets relatively less intensively than in other economies. The bottom international monetary policy has recently indicated its main reasons. Among these, a model of brokerage based on closed customer relations. An adequate system of protection of the deposits and a vast network of branches assure Italian banks a stable source of funding at the families. In comparison with the main European banks, the top five Italian banking groups³¹ are characterized by a greater incidence on the assets of both loans (customer loans) both deposits with ordinary non-banking customers (customer deposits). In June 2008 the loans accounted for an average of 65% of assets, compared to a European average of 43%; deposits amounted to 36% of the assets, compared to a European average of 33%.

A second factor, linked to the one just illustrated, is the reduced incidence on the budgets of the Italian banks of the operations most exposed to the international financial crisis: up to the third quarter of the year 2008, the last period with reference to which listed banks have made note to consolidated quarterly reports, the major banking groups, which have provided evidence of exposures not particularly relevant, recorded devaluations related to the crisis for a much lower than that of the main foreign banks.

In the Italian legal system, the T.U.B.³² (Testo Unico Bancario) deals with the banking company from the moment of its constitution up to that of its exit from the market, be it voluntary or caused by a serious crisis. So, the T.U.B. includes the forecasts that make up the regulatory framework in terms of “crisis discipline”. Having said this, crisis management is found in two aspects: the first derives from the fact that the regime design by the Italian legislator is of administrative law; the

³¹ The classification of banks in size groups has been reviewed in the Report on 2012; The “top 5 groups” include banks belonging to the UniCredit, Intesa Sanpaolo, Banca Monte Dei Paschi di Siena, UBI Banca, and Banco Popolare Groups. The “big”, “small”, and “minor” categories include banks belonging groups or independent with total funds brokered, in the order, exceeding 21.5 billion euros, ranging between 3.6 and 21.5 billion, less than 3.6 billion.

³² Legislative Decree 1 September 1993, n. 385 (Consolidated Law on Banking and Credit Law) and subsequent amendments and additions.

second aspect, is about the central role attributed to the Supervisory Authority, which is also Resolution Authority.

The discipline currently contained in the Consolidated Banking Law (Testo Unico Bancario) with reference to the crisis issue, is substantially the same as expected in the old one banking law of 1936. The directive 89/646/EC- commonly known as Second Banking Directive – of which the Consolidated Law is about the transposition, in fact, it did not contain precise indications on the subject, which therefore came left to the full autonomy of individual Member States.

The Financial system in Italy is characterized by the fact that the Bank of Italy performed the dual function of supervisory and resolution of financial crises even before the implementation of directive (BRRD) in Italy. The coexistence of the two functions within the same organ has always allowed to exploit the presence of useful synergies between the two sectors, namely that prevention, on the one hand, and the management of interventions on crises, on the other hand, making dialogue between intermediaries and the responsible body of control, allowing greater flexibility and speed of action.

Supervisory activities are carried out by the Directorate General for Financial Supervision and Regulation at the Bank of Italy's Head Office in Rome and by its branch network. In addition to on- and off- site inspections to verify compliance with the requirements for engaging in banking and financial activities, the bank of Italy's supervisory action extends to activities include the adoption of administrative measures. The most important measures, involving banks and authorizations, sanctions, and those relating to the management of problematic situations.

The law assigns the Bank of Italy responsibility for safeguarding the stability of the national financial system³³. The Bank of Italy performs this task both through the exercise of microprudential supervision of banks, in partnership with the ECB (European Central Bank) within the Single Supervisory Mechanism, of other financial intermediaries and of some markets, and by implementing macroprudential policies oriented to the system as a whole.

The legal basis of the Bank of Italy's powers consists of Directive No. 2013/36/EU³⁴ and Regulation No. 575/2013³⁵, on access to the activity to the credit institutions and the prudential

³³ The financial system is a complex infrastructure that allows households, firms, general governments entities and other economic agents to make payments, transfer resources and manage risks.

³⁴<https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013L0036&from=IT> DIRECTIVE 2013/36/EU OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC

supervision of credit institutions and investment firms, both adapted by the European Parliament and by the Council. The European legislation specifies a set of macroprudential measures for the banking sector that the competent or designated national authorities may take in order to prevent or mitigate risks to the stability of the financial system. The Bank of Italy is the authority to designated to take such measures in Italy. In addition, the Bank of Italy can adopt measures to address the systemic risks that may originate from other financial intermediaries and from the market it supervises.

The bank of Italy performs its tasks of safeguarding financial stability through intense analysis and supervision of the financial system's single components and of the system as a whole, in order to promptly identify vulnerabilities and risks for financial stability.

Another peculiarity of the Italian system is constituted by the fact that, besides being a Supervisory Authority and a Resolution Authority, the Bank of Italy is also central bank. This aspect should not be underestimated since one of the tasks that it performs as a central bank is that of lender of last resort ("Lender of Last Resort"): this means that it has the power to grant a particular line of credit that takes the name of Emergency Liquidity Assistance (ELA)³⁶. This instrument consists in providing funds to a credit institution located in one temporary liquidity crisis and that would otherwise be unable to find the resources necessary to get out of them.

In fact, the solution to the bank's crisis was mainly found through recapitalization operations or the block sale of assets or liabilities to another intermediary, of primary standing, which allowed the orderly exit of the intermediary from the market and guaranteed the continuity of relations with customers. The transfer transaction was sometimes accompanied by the provision of a public loan to the assignee bank to cover the negative difference between assets sold and liabilities assumed. In other cases, the crises have been resolved, even with the support of guarantee fund interventions, which have prevented the emergence of losses for depositors³⁷. The Italian banking crisis

³⁵ REGULATION (EU) No 575/2013 OF THE EUROPEAN PARLIAMENT AND OF THE COUNCIL of 26 June 2013 on prudential requirements for credit institutions and investment firms and amending Regulation (EU) No 648/2012

³⁶ Emergency liquidity assistance (ELA) is a form of exceptional financing granted to solvent financial institutions (as a rule banks) facing temporary liquidity needs. These operations allow the Bank of Italy to act, on a discretionary basis, as a lender of last resort, providing temporary loans against adequate collateral. The exceptional financing disbursed by the Bank of Italy can take the form of an injection of liquidity or a collateralized securities lending.

³⁷ Between 1995 and 2015, more than 100 banks were subject to extraordinary administration. In more than half of the cases, the crisis has been resolved by returning the bank to ordinary management or through aggregation with other intermediaries, while in almost all the remaining cases the insolvent banks have been subjected to compulsory administrative liquidation, accompanied by the sale of assets and liabilities to another intermediary.

management model has on the whole given good evidence of itself, even in the context of the last recession. The disruption involved a few small or medium-sized intermediaries, depositors did not suffer losses and public support was relatively small.

In Italy the banking crisis manifested itself much later than the corresponding bank insolvencies that occurred in other European countries and in the rest of the world. This delay appears essentially due to the fact that Italian banks had, and still have, a predominantly commercial rather than a financial vocation. The fact is that the crisis of Italian banks has developed when the possibility of activating the resolution procedures laid down by national law has failed and the need to apply European Legislation has emerged. Emblematic in this regard are the episodes of crisis that affected, between 2015 and 2017, four regional banks, two Veneto banks and MPS (for which we will speak later)

3.1.1 The Bank of Italy as National Resolution Authority

The Bank of Italy, which shares supervision tasks for Italian banks with the ECB within the Single Supervisory Mechanism (SSM) established by the regulation (EU) no. 1024/2013, has also been designated as the Italian national resolution authority. This is allowed by article 3 paragraph 3 of the Directive, under the condition that structural arrangements are put in place that “ensure operational independence and avoid conflicts of interest”.

The Bank of Italy has been entrusted with the crisis management of banks and financial intermediaries for decades. It is well known that such a concentration of functions has advantages (effective exchange of information between supervisory and resolution functions, smooth operational coordination of the many tasks that the two authorities must perform, especially during a resolution action) and disadvantages (mainly, conflicts of interest between the functions of supervision and resolution, along the excessive concentration of powers).

The Italian Parliament has deemed that the advantages outweigh the disadvantages. Path-dependence and the overall good track record of orderly bank crisis management by the Bank of Italy have obviously played a role in this choice. Accordingly, a special unit has been created within the Bank of Italy, with reporting lines separate from those relating to supervision and to the other functions of the institution³⁸. Therefore, since 1 January 2016 the Bank of Italy also shares the

³⁸ The reporting lines rejoin at the level of the governing body (“Directory”)

resolution powers with the Single Resolution Board (SRB) in Brussels, within the framework of the Single Resolution Mechanism (SRM) created by the regulation no. 806/2014³⁹.

3.2 The first application of Bank Recovery and Resolution Directive (BRRD) in the Italian Legal System. The law under which this Directive take life in Italy.

In Italy, in the past, the solution to the crisis or bank failures was mainly found through the processes of acquisition and absorption to the institution in crisis by other banks. Aggregation policies through corporate mergers, the sale of assets and liabilities, the purchase of companies or business units, within the framework of the Bank of Italy's institutional Supervision action (which has sometimes been defined as *moral suasion*), have made it possible to avoid the precipitations of the crisis have allowed the continuity of the active and passive relations to be saved in the hands of other banking operators able, or enabled, through public aid or the guarantee system, to absorb the instability through integration and reorganization.

The change in the economic cycle, the modifications of the same structure of the banking company, less and less interested in occupying the market with widespread networks of branches always too expensive in relation to the charges related to the structures and staff and above all overcome by the increasingly widespread use of services of home banking, make such negotiating solutions more difficult and more uncertain.

At the same time, European legislation does not allow the provision of public aid as it is incompatible with the rules of competition.

The crisis or the failure and even insolvency must necessarily find a different solution that allows the achievement of objective competitors: the continuity of the bank or at least part of it, the absence or recourse to public funds. Hence the need to bear the burden of losses on investors (shareholders, creditors and depositors) to allow taxpayers protection.

The response to these needs was provided by Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 on the resolution of credit institutions and investment firms "Bank Recovery and Resolution Directive" (BRRD).

³⁹file:///C:/Users/PcOtto/Downloads/DOC_1.en.pdf , Regulation (EU) 806/2014 of the European Parliament and of the Council of 15 July 2014 establishing uniform rules and a uniform procedure for resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund and amending Regulation (EU) no. 1093/2010.

The implementation of Directive 2014/59/EU took place in Italy through the law of 9 July 2015, n. 144 (European delegation law 2014), in which the delegation criteria through which the Government implemented the implementation of the BRRD Directive⁴⁰ were inserted into Article 8. The implementation of the directive was carried out by means of two legislative decrees issued by the Government because of the need to urgently implement European legislation. In fact, given that the transposition deadline had already expired on 31 December 2014, when the legislative procedure started, the Commission had already started the infringement procedure against Italy⁴¹.

The BRRD Directive has been incorporated into national law by two legislative acts, pursuant to the mandate law 114/2015: legislative decree n. 180 also called “resolution decree legislative” and the legislative decree n. 181 also called “decree legislative TUB (consolidated law on banking), TUF⁴² (consolidated law on finance)” amendments, both on 16 November 2015.

The first decree was drawn up in close collaboration with the Bank of Italy. This sets out the regulations regarding the preparation of resolution plans, the initiation and closure of resolution procedures, adaption of resolution measures, management of cross-border group crises, powers and functions of National Resolution Authority and resolution fund regulation. The second decree, modified the legislative decree of 1 September 1993, n. 385 TUB (Consolidated Law on Banking) and Consolidated Law on Finance (TUF) to make them compliant with the new Directive 2014/59/EU. This decree makes changes to the Consolidated Law on Banking to introduce the regulation on recovery plans, financial support within banking groups, early intervention, the regulation of extraordinary administration and compulsory administrative liquidation is also reviewed, in order to adapt it to the new European regulatory framework.

Of the various resolution measures⁴³, the reduction of actions, as well as the reduction and conversion of credits, are certainly the most innovative. They can apply independently from the start of the resolution procedure, and constitute one of the significant features of the absorption process

⁴⁰ The Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the reorganization and resolution of credit institutions and investment firms and amending Council Directive 82/891/EEC, and Directives 2001/24/EC, 2002/47/EC, 2004/25/EC, 2005/56/EC, 2007/36/EC, 2011/35/EU, 2012/30/EU and 2013/36/EU and regulations (EU), n. 1093/2010 and (EU) n. 648/2012, of the European Parliament and of the Council.

⁴¹ With a letter dated 28 January 2015, the European Commission initiated the infringement procedure 2015/0066 against Italy for failure to transpose into Italian law the 2014/59/EU directive.

⁴² To these two legislative decrees correspond respectively the Government’s act n. 208n and the Government act n. 209.

⁴³ Thus, defined by art. 39 in the legislative decree 180/2015, whose regulations apply to banks with registered offices in Italy, to the Italian parent companies of a banking group and companies belonging to a banking group pursuant to art. 60 and 61 of the TUB to companies included in consolidated supervision pursuant to art. 65, paragraph 1, of the TUB, to banks, having their registered offices in Italy included in the consolidated supervision of a member state.

of losses, together with the bail in. The later expression, which the Italian legislator has mentioned and taken over from the original one of the Directive, is defined in art.1, paragraph 1, Legislative Decree n.180/2015, the reduction or conversion into capital of the rights of shareholders or creditors and can be understood as a measure of internal bailout, carried out by own means.

The interest in the entirely new and certainly, it can be said, revolutionary discipline has become a case of great importance, when in the days immediately following the entry into force of the two legislative decrees (16 November) the Bank of Italy, in the new quality as a resolution authority, applied (on November 22nd) the regulation of the resolution to four banks⁴⁴ in a state of serious crisis and for which it had long been adopted and the extraordinary administration procedure was in progress under Article 70 of the Single Banking Text.

Considering the particular reasons of urgency to implement the Directive, by way of derogation from the ordinary period of *vacatio legis*⁴⁵, within the decree it is prepared to enter into force the same day of its publication in the Official Gazette. Regarding specifically the legislative decree n. 180, the Treasury Department has submitted the provision to a public consultation. The urgency of the transposition did not make possible a long consultation, this in fact lasted only 13 days. Most of the observations focused on the relationship between the 2014/59/EU Directive and the SRM Regulation, which establishes the Single Resolution Mechanism.

The BRRD Decree (legislative decree n.180, art. 3) attributes the exercise of resolution powers to the national resolution authority that has been identified in Italy the Bank of Italy. The later, in the event of failure or risk of failure of an institution and in the presence of other conditions required, and subject to approval by the MEF (Ministry of Economy and Finance), adopts a resolution program that, among other things, identifies the specific resolution tools applicable, defining also the modalities of the possible recourse to the resolution fund.

Alongside the reorganization plans, the two legislative decrees of BRRD Directive provide that the Bank of Italy must prepare, in consultation with the ECB or CONSOB⁴⁶ (Commissione Nazionale per le Società e la Borsa), as appropriate, a resolution plan that provides for the resolution actions

⁴⁴ The four banks are: Banca delle Marche S.p.a, Cassa di Risparmio di Ferrara s.p.a, Banca dell'Eturia e del Lazio s.p.a, Cassa di Risparmio di Cheti s.p.a, subsequently cited for the sake of brevity as "four banks".

⁴⁵ In jurisprudence and in law, the latin term *vacatio legis*, generically translatable as "lack of the law", indicates a condition of nonexistence of a norm, both because there is one already issued and which has yet to come into force. The *vacatio legis* is a period of time (generally 15 days) between the publication and the entry into force of the law.

⁴⁶ CONSOB (the National Commission for Companies and the Stock Exchange), established by law 7 June 1974, n. 216, is an independent administrative authority, endowed with autonomous juridical personality and full autonomy whose activity is aimed at investor protection, efficiency, transparency and development of the Italian securities market.

that the Bank of Italy can implement if the bank or the institution meets the conditions for termination. The resolution plans describe how, in the event of a failure of the institution, this can be resolved in an orderly manner and its essential functions preserved through to use the tools and resolution powers provided by the BRRD. The Bank of Italy has at its disposal a kit of resolution that include: a) the transfer of assets and legal relationships to a third institution, b) the transfer of assets and legal relationships to a bridge institution, c) the transfer of assets and legal relationships to a vehicle company for asset management, d) the bail-in, defined as “the reduction or conversion into share capital of the rights of shareholders and creditors”.

The legislative decree has not implemented articles 56, 57, 58 of the BRRD Directive, which provides for the possibility of public financial support for the bank in difficulty and in the resolution phase. In fact, these articles are not provided for the SRM Regulations, so if the need to implement these articles due to a serious bank failure should arise, the Italian Government has provided for the reference to the primary authorization regulation for public intervention.

3.2.1 The content of the two legislative decrees and a clearer decision map with respect to the implementation of the Directive in Italy.

As mentioned above the implementation of the BRRD Directive in Italy is strictly related with two separate Legislative decrees. Legislative decree 16 November 2015, n.181 amends the existing Consolidated Banking Act. This important piece of law now includes recovery plans, intra-group financial support, and the early intervention measures provided for by article 27 of the Directive. With respect to early intervention, the Bank of Italy has the power to require the management body of a bank to implement one or more of arrangements or measures set out in the recovery plans, the power to remove one or more members of the management of supervision bodies or of the senior management, and the power to demand the complete replacement of the managements and supervision bodies. Where replacement of the senior management or management body is deemed to be insufficient to remedy the situation, the Bank of Italy can appoint one or more temporary administrators, either working with the board of directors or more likely replacing it. Italy has a long and overall successful experience of temporary administration.

Early intervention measures and resolution plans

Legislative decree 16 November 2015, n.180, in contrast is the new law on bank resolution. It includes all the rules that must be applied by the resolution authorities (the SRB and, at the national level, the special unit set up within the Bank of Italy). It includes individual and group resolution

plans, assessment of resolvability, the powers to address and remove impediments to resolvability, and, in its full procedural complexity and tools, resolution. The early intervention measures vary in intensity depending on the gravity of the situation, up to the more invasive form of the extraordinary administration, with the dissolution of the administrative and control bodies and the appointment, in their place, of extraordinary directors with the task of managing the financial difficulties of the institute, in order to avoid that their deterioration is such as not to leave alternatives to the start of the resolution procedure. Both the legislative decrees provide that the resolution authority, the Bank of Italy in this specific case, or the Single Resolution Board, for Systemic banks, must prepare a resolution plan after consultation with the ECB or with the CONSOB (as mentioned above). The preparation of the procedures to be implemented rapidly, immediately, by the Resolution Authority is, therefore fundamental for ensuring the concrete functioning of the resolution tools, and ensuring the continuity of the intermediary's activity, revealing itself, the speed intervention, essential to safeguard systemic stability.

Article. 20, admits, first of all, the possibility of resolving the failure by only reducing the shares and converting subordinated liabilities (burden sharing), if the bank of Italy assessment suggest that this solution will restore the balance sheet, necessary for the correct continuation of banking activities, without resorting to other measures envisaged (transfer to third parties, bridge institution...).

The resolution tools, provided in art.39 of the legislative decree n. 180/2015, coincide with the European directive transposed and include the forced sale of assets and legal relationships to a third party, or a bridge institution (bridge bank), or a special purpose vehicle for the management of liquidation (bad bank), or finally, the application of the bail in, defined as the conversion into capital of the rights of the shareholders and creditors.

In case of a particularly serious failure, the declaration of insolvency of the bank in resolution, determines the applicability of the criminal discipline of bankruptcy (art. 219 and following of bankruptcy Act). Given the particular nature of the resolution procedure, which does not resolve bank failure or insolvency with liquidation, but with the cleaning of assets from liabilities, Legislative decree n. 180/2015 expressly provides that the bankruptcy penal rules take place regardless of the overcoming of the state of insolvency as a result of a resolution. In particular the configuration of any bankruptcy crimes and criminal penalties must take place with reference to the situation of insolvency established at the time the resolution is initiated, since it is irrelevant that this situation is than overcome during the resolution procedure, due to the absorption of liabilities and the reduction of receivables.

Recovery plans

In addition, the Legislative decree 16 November 2015, n. 181, has slightly amended the “liquidazione coatta amministrativa” (Compulsory administrative liquidation), the special insolvency procedure for banks that is still regulated in the Consolidated Banking Act. The main amendment aims to introducing the depositor preference set forth in article 108 of the Directive.

In particular, the intermediaries targeted by the BRRD must map their business structure, identifying the “core” sectors to be preserved in the event of failure, and the business units that could instead be sold (the so-called bad society). The recovery plan must be based on realistic assumptions, which also include the adverse scenarios that it intends to tackle (a sort of mapping of possible risks), and outline strategies to address any type of risk identified, without being able to count in any way on extraordinary forms of public financing.

The organization plan must be subject to the assessment of the Supervisory authority (the Bank of Italy, for the less significant Italian banks, and the ECB, for large banks), which may ask the intermediary for any changes and additions, for the next approval. The information contained in the recovery plan of each intermediary constitutes the fundamental information support of the subsequent preparation of resolution plans by the resolution Authority.

To be noted that Italy has Opted for a strong version of depositor preference, one which establishes preference for any deposit over unsecured debt, and which will come into force in 2019 (article 91 of the Consolidated Banking Act). After that date, liquidation and resolution will affect depositors (covered and uncovered) only in extreme cases. Quite significantly, the new law does not contain any provision for extraordinary public support.

The bail in

In accordance with the BRRD, the bail-in tool came into force on 1 January 2016 and may be used in conjunction with the order resolution tools provided for by Legislative Decree 180/2015.

The most innovative instrument of the resolution procedure, introduced by the legislative decrees of transposition of the directive in question into national law is the bail in, intended as an internal bailout, that is, with its own recourses, as opposed to the external bail out, traditionally implemented by the State through public finance instruments. The bail in consists, in essence, in the forced reduction of the value of the shares and the debt of the bank in crisis, or in conversion of the

latter into capital, depending on the absorption of bank losses, and the restoration of a level of capitalization, adequate to maintain-, or restore, market confidence. In accordance with the European directive, the bail in instrument came into force at the beginning of 2016 and can be used in combination with other resolution tools implemented.

The bail-in attributes to the resolution authority the power to provide for the write-down and conversion of some liabilities of the rated entity, depending on the absorption of the losses suffered and the restoration of the capitalization levels that are appropriate to maintaining the confidence of the market.

The hierarchical order of application of the bail in, can be represented, in an extremely concise manner, through the following succession: shareholders, holders of other equity securities, other subordinated creditors, unsecured creditors, natural persons and small and medium enterprises, owners of deposit, for the amount exceeding the sum of 100 000 euros, deposit guarantee fund. The BRRD decree excludes from the bail-in a series of liabilities, including, for example, guaranteed deposits (deposits up to 100,000 euros), inter-bank liabilities (excluding intragroup transactions) with an original duration of less than 7 days and guaranteed liabilities, including covered bonds.

Article. 53 of the “resolution decree”, in fact, provided for an exceeding of the limits of shareholding and of the proximity requirements that are within the legislative provisions applicable to them, and established a deadline by which the bank rehabilitated will have to re-establish requirements for the adoption of the cooperative form.

Moreover, in exceptional circumstances, when the application of the instrument (bail-in) involves the risk of financial stability or compromise the continuity of essential functions, the Bank of Italy, upon notification to the European Commission, may order the exclusion of certain liabilities from the application of bail-in. in this case, the losses not absorbed by the excluded creditors may be transferred to the resolution fund which may intervene to a maximum of 5 % of the total liabilities, provided that at least 8 % of the losses have been bailed-in total liabilities.

Among the different resolution tools provided in the BRRD, the bail-in tool has a potential adverse impact directly on bondholders’ rights and banks’ funding costs on the markets.

The bail-in tool is regulated by article 48. Most rules, if not all, are the translation of the detailed provisions of the Directive, adapted to the general framework of Italian law. When the SRB, pursuant to article 23, regulation (EU) n.806/2014, will require the Bank of Italy to implement, according to Italian law, a resolution scheme adopted by the same SRB with respect to an Italian Bank, it should not receive any bad surprises.

The structure of Italian law on bank crisis appears clearer than the Directive not only with respect to the distinction between “supervision” and resolution tools, but also with respect to the process that has to be followed to resolve a bank (article 19 of the legislative decree n. 180/2015). The process set by the Directive and by the Regulation (EU) n. 806/2014 (the latter for the states of the Eurozone and the Member States which have joined the SSM in accordance with article 7 of regulation EU n.1024/2013) is indeed quite difficult to follow even by specialists.

The decision plan is as follows:

- 1) The competent authority (the ECB or the Bank of Italy), or the same Bank of Italy as resolution of authority, can make the determination as bank is failing or likely to fail;
- 2) The resolution authority than makes the determination that there is no reasonable prospect that any alternative private sector measures or supervisory action can taken in respect of the institution, would prevent the failure of the institution within a reasonable timeframe (article19)⁴⁷.

When these two conditions are met, the resolution authority:

- a) Executes a “restorative write down and conversion”, if this action alone is sufficient to prevent the bank from failing, exercises the power to write down the reserves, the shares (and other capital instruments in the Common Equity Tier 1⁴⁸ if any) and Additional Tier 1 and Tier 2 instruments, up to the point the losses are eliminated, and, subsequently, to convert what is left of those instruments in shares up to the point the desired level CET 1(Common Equity Tier 1) is reached⁴⁹;
- b) If a restorative write down and conversion would not be sufficient, the resolution authority makes a fundamental choice;
- c) Opens the resolution, when this is necessary and proportionate measure to protect the public interest as detailed in article 21 (which almost literally transposes article 31 of the Directive:

⁴⁷ It is to be noted that it is somewhat strange that the resolution authority makes the determination that there is no reasonable prospect that any supervisory action (which depends on the initiative of the competent authority) would prevent the failure, but this is explicitly written in the Directive (article 32, paragraph 1)

⁴⁸CET1 is a component of Tier 1 capital that consists mostly of common stock held by a bank or other financial institution. It is a capital measure that was introduced in 2014 as a precautionary means to protect the economy from a financial crisis. It is expected that all banks should meet the minimum required CET1 ratio of 4.5% by 2019.

⁴⁹ Art 20, paragraph 1, which transpose the principles confusedly emerging from art. 32, para. 1, and art 59, para 3 of the Directive. The write down (up to the point the losses are eliminated) and conversion (up to the desired level of CET 1) is done according to the priority ranking deriving from company law and contract (in reverse order, the lowest ranking claims, being affected first: art. 60, para 1, of the Directive).

ensuring the continuity of critical functions, preserving financial stability, protecting depositors and clients in general);

- d) Opens the ordinary insolvency procedure for banks (“liquidazionecoattaamministrativa”), in any other case. As said earlier, this procedure is regulated by the Consolidated Banking Act and is aimed at a quick sale of the assets.

The margins of discretion granted to national legislation.

It is important to underline that the art. 1, paragraph 2, of the BRRD Directive expressly offers the possibility for Member States to make changes at the time of implementation. In fact, national legislators are allowed to adopt or maintain stricter provisions already present within the legal system that they consider fundamental and mandatory, provided that the integrations do not conflict with the provisions of the BRRD Directive and that they have a general applicability. By inserting this article into the directive, the Community Legislator has achieved the implicit objective of leaving the Member States autonomous operational areas. In this regard, in fact, the German and Spanish⁵⁰ legislator have modified and integrated the order of priority of the subjects involved in the rescue of the banks. In particular, the Spanish legislator has decided to lower the protection threshold of some senior unsecured securities that in the BRRD Directive have priority over other unsecured liabilities.

As regards the transposition of the directive in Italy, the legislative decrees n. 180 and 181 applied the extended depositor preference, which makes it possible to extend to all depositors the treatment that is reserved in the directive only to unsecured individuals and SMEs, so as not to discriminate between creditors. The European Central Bank itself has underlined its approval regarding the extension of the deposit preference in the opinion expressed on October 16, 2015 on the two legislative decrees mentioned above. In fact, according to the European institution “the allocation of a higher rank to all deposits should minimize the risk of claims based on the principle of No Creditors Worse Off (NCWO)⁵¹.”

The possibility of Member States being able to use margins of intervention during the implementation of the BRRD Directive, however, has been seen by the doctrine as a weakness of European Legislation, which can lead to the risk of substantial divergences between the different

⁵⁰ G. Martin, BRRD transposition in Spain: a milestone in implementing an effective resolution regime, del 19 June 2015.

⁵¹ ECB Opinion of 16 October 2015 on the reorganization and resolution of credit institutions and investment firms (CON/2015/35)

Member States in the resolution of banking crisis. In fact, the objective explicitly mentioned in recital 4 of the Directive 2014/59/EU⁵² could be strongly impeded.

3.3 The crisis of the “four local banks” in Italy, and their resolution in 2015.

The adoption for the first time of the measures provided for by the directive and by the legislative decree n. 180/2015, entailed several effects: the simultaneous closure of the extraordinary administration, the complete reduction of shares and subordinated bonds (which, moreover, were placed not only with corporate customers but also with retail investors), the establishment of the four bridge entities (entiponte)⁵³, recipient of the four banking companies respectively through transfer measures implemented by the Bank of Italy, as resolution authority, and the start of the resolution of the four banks.

The first case of application of the new rules on bank crisis management is that of the four local banks. On 22 November 2015 the Bank of Italy, acting as a resolution authority for failing institutions, subject to authorization by the European Commission, applied the regulation governing the resolution of the four banks corresponding to around 1% of the market Italian Banking, for which the extraordinary administration procedure had already been adopted in line with Article 70 of the TUB.

The “four banks” are: Banca delle Marche, Cassa di Risparmio di Ferrara, Banca dell’Etruria and Lazio, Cassa di Risparmio Chieti. The first application of the BRRD Directive has imposed on all shareholders and part of the creditors of these four banks to contribute to the rehabilitation of these for the full value of their rights⁵⁴, precisely for this the measures that have implemented the directive have been protagonists of heated debates and questions about their compatibility with the constitutional and supranational regulations.

The collapse of these banks, affected like all the others by the deterioration of the quality of loans deriving from the long and deep recession of the Italian economy, have contributed to serious phenomena of bad management.

⁵² The objective is indeed the effective harmonization of credit institution procedures at EU level.

⁵³ First with the Legislative Decree 22 November 2015, n. 183 subsequently, in the 2016 Stability Law, December 28th2015, n. 280 the discipline is merged with article 1, paragraph 842-861. In paragraph 854 of the stability law, the repeal of the Decree Law of 22 November n. 183, paying the entire contents in paragraphs 842: of the stability law and providing for the salvation of the effects already produced as a result of the repealed law decree.

⁵⁴ D. Messineo, the “Safe Bank” provision: the treatment of the shareholders and creditors in the new discipline of banking crisis.

In line with the provisions of the law, the decision to place a bank under extraordinary administration is adopted in the force of large losses and serious irregularities, such as to compromise the compliance with the capital ratios and its stability, when it is no longer possible to the directors designated by the property to ensure a credible business reorganization program. Before proceeding to the commissioner, according to the circumstances, interventions that include a change in corporate governance structures, the preparations of new business plans, the adoption of measures to strengthen capital, the sale of assets or business units are carried out.

This sequence of actions was implemented, in in the four cases we are studying (four banks), as in all other cases of banking crisis faced by the Supervision (about 100 in the last 15 years), with attention and timelines in compliance with existing rules.

Unlike what happened in past crisis, it was not possible to make use of the intervention available by the Interbank Deposit Protection Fund, because in the interpretation of the European Commission the Fund's actions, even if carried out with recourses from the participating banks, would be similar to State aid and as such – according to the practice announced and followed by the commission since 2013, which can only be disbursed after the imposition of losses on shareholders and subordinated creditors (the so-called burden sharing). In this regard, the interaction between the Commission and the Italian Government has been thorough and laborious.

At that stage, a dispute with the Commission, even before the Court of Justice of the European Union, not only lead to serious uncertainties for the stability of the system, with even more serious consequences for the banks involved and for savers, but also required to the same banks – pursuant to accounting rules – a provision equal to a future payment connected with a possible negative outcome of the dispute, with risks for the continuation of their activity. The intervention of the Fund would in any case have required authorization from the ECB, as a supervisory authority, which in turn could not have disregarded the judgment of the Commission's Directorate for Competition and State Aid.

Having verified the absence of concrete alternatives, with the exception of the much more traumatic nature of the liquidation of the four banks, the Bank of Italy, with the approval of the Minister of Economy and Finance, has applied the new resolution procedure foreseen by the BRRD, as soon as it was incorporated into Italian Law, on 16 November 2015. The use of this procedure enabled the use of the new instruments introduced by it, in particular the establishment of four bridge banks and a management company for bank loans in resolution. The intervention guaranteed the continuity of the essential services provided by intermediaries.

The assessment of the losses and, therefore, of the costs of the resolution was conducted not in the discretionary manner, but on the bases of precise European standards. The particularly conservative assessment of bad debt responds to the provisions of the BRRD and to the interpretation of the state aid framework adopted by the Commission in comparison with the Italian Government; corresponds to the approximation of the theoretical value that would have been assumed, on average, in the hypothesis of their immediate sale on the market. The costs were supported, as well as by the holders of shares and subordinated bonds, for the most part by the banking system through the newly constituted Resolution Fund; there were no transfers of public resources. The considerable sacrifice for shareholders and holders of subordinated bonds was invertible in the new regulatory framework. In the absence of this intervention, a compulsory administrative liquidation would have lost value and generated losses also for holders of ordinary bonds and unsecured deposits; would have prevented the continuation of normal banking activity; it would have repercussions on the whole local economic fabric.

With the new capital endowment and the good quality of the assets, and under the guidance of fully renewed corporate bodies, the bridge banks to which the business complexes have been sold have resumed lending to local economies, a function that intermediaries in crisis they could no longer perform. In particular, the new banks that emerged from the intervention were cleaned up from the bad loans and recapitalised, thus creating the conditions to make them attractive on the market. In approving the bailout package, the European Commission has asked for the transfer of new banks to the market very quickly. The process of disposal has been started during the 2016.

The parliament, during this period, has recently ordered the establishment of a Solidarity Fund, entirely at the expense of the banking system, to provide indemnities to investors who held subordinated bonds issued by the four resolution banks; in the arbitration procedure the payment of the indemnities is consolidated by the ascertainment of the responsibilities charged to the banks for violation of the duties of care, correctness and transparency provided for by the Consolidated Law on Finance. The terms and conditions of access to the fund be established by ministerial decrees. The Bank of Italy assures all the requested cooperation to the authorities involved.

Pursuant to the correct legislation, and in line with European Law, the Bank of Italy does not exercise controls over the issuance of bonds or other bank collection instruments; decisions are taken autonomously by the intermediary and must take place in compliance with the limits and conditions set by law and by the authorities responsible for controls.

Savings flow to the banking system in heterogeneous forms and ways. The bank deposit is the form of savings that enjoys maximum protection, on three levels: the supervision of the stability of the

banks, now entrusted to the Single European supervision mechanism, of which the Bank of Italy is part; the rules of transparency and correctness imposed on intermediaries in the opening and managements deposits, on which the Bank of Italy supervises; the guarantee system that, in the event of a crisis, protects the sums deposited up to 100,000 euros for each account holder from any loss.

Bonds and shares of banks are investment instruments. There is no guarantee of preservation of value, but in their placement the obligations of diligence, correctness and transparency for the protection of investors, harmonized in Europe, must be respected, and for each instrument they must be correctly represented, and fully understood, yields and risks.

Supervisory authorities usually carry out unceasing control over intermediaries who are in a state of difficulty, without this becoming public knowledge. In most cases this activity allows to prevent the emergence of crisis and thus avoid the costs associated with their management and resolution. No supervisory activity in any country is able to eliminate the risk of banking crisis, especially in times of severe recession.

The resolution of these four banks represented an alternative to the ordinary insolvency procedure that would not have allowed the maintenance of financial stability, the containment in the burden of public finances and the protection of the depositors and customers that was instead guaranteed application of the new resolution tools provided for by the European Directive.

In the autumn of 2015 the technical situation of the four banks deteriorated further, especially with regard to liquidity profiles. Postponing the activation of the measures necessary for the resolution of the crisis could have led to the blocking of banks, their disintegration and the termination of the relations with customers, with negative repercussions on the productive and social fabric and employment levels. With this in mind, on 22 November 2015, a few days after the implementation of the BRRD directive in Italy, the Bank of Italy initiated the procedure for the resolution of the aforementioned banks, with measures approved by the Minister for the Economy and Finance. In extraordinary administration, applying burden sharing.

It is important to underline that during this first application of the BRRD directive the bail-in measures were not adopted, since the 2014 European delegation law which provided for the transposition of the Directive envisaged that the instrument would apply from 1 January 2016. The European Commission has granted that the Resolution Fund would make available to the recapitalization of the four major recourse banks. If the bail-in tool had been applied in that period, it would have been avoided to make immediate use of the Resolution Fund, but the impact on

liabilities would have been more extensive, leading to a wider loss of what was credit of shareholders, bondholders and creditors.

The resolution was implemented according to a program that included the following steps:

- Creation of four bridge banks (as mentioned above), in which all healthy activities have been merged to ensure the continuity of essential services;
- Establishment of a single bad bank, without a banking license, to which the bridge banks sold the non-performing loans of the four original banks, with the aim to maximizing their recovery value;
- Intervention of the Resolution Fund with an outlay of 3,640 billion euros, of which 1.7 billion to cover the losses of the original banks and 140 thousand euros to provide the bad bank of the capital necessary to operate⁵⁵.

The solution adopted, considered by the European Commission in line with the state aid framework, has enabled:

- a) To preserve the continuity of essential functions;
- b) Protect depositors and customers;
- c) Enhancing the positive components of the banks;
- d) Do not burden tax payers.

On 30 December 2015, the Bank of Italy, as a national resolution authority, initiated the procedure for the sale of the four bridge banks. The transaction took two steps:

- 1) On 10 May 2017 with the sale to UBI Banca of Nuova Banca delle Marche, Nuova Banca dell'Etruria and Lazio and Nuova Cassa di Risparmio di Chieti; and
- 2) On 30 June 2017 with the sale to Banca Popolare dell'Emilia Romagna of Nuova Cassa di Risparmio di Ferrara.

The sale of bridge banks took place of one euro, subject to a capital increase and the issue of guarantees by the Resolution Fund.

It should be added that the resolution of the four banks did not involve any burden on the state budget, since the costs of the procedure largely fell on the Italian Banking System, shareholders and holders of subordinated bonds.

⁵⁵ The liquidity necessary for the Resolution Fund to start operating (€ 4 billion) was brought forward by a banking pool, made up to Intesa Sanpaolo, Unicredit and UBI, at market rates and with a maximum maturity of 18 months.

The activation of the resolution procedure has however provoked indignation in the public opinion and the angry reaction of investors, especially of subordinated bonds holders who have seen their investments reset from one day to the next. This critical situation was partially remedied by Law 208/2018 which established a Solidarity Fund, fed and administered by the FITD⁵⁶ (Fondointerbancario di tutela deidepositi), in order to compensate investors who had subscribed subordinated bonds issued by the four banks, on the date entry into force of the Legislative Decree 183/2015, which ordered the resolution. The procedures for access to reimbursement were then governed by Decree Law 59/2016 (so-called “save banks” decree), converted into Law 119/2016, which introduced two distinct procedures: those who purchased the bonds by 12/06/2014, date of publication in the BRRD Official Journal, can alternatively access the lump-sum or arbitration compensation procedure; those who have invested in bonds after that date can only request compensation through an arbitration procedure.

3.3.1 The liquidation of the “two Veneto banks” in 2017.

Banca Popolare di Vicenza and Veneto Banca (often called “the Veneto banks”) have been operated in the prosperous Veneto region in north-east Italy. Since 2014, both were directly supervised by the ECB, as at the end of 2016 they were Italy’s 10th and 11th biggest banks by assets.

During 2015, the liquidity position of the two banks began to deteriorate, partly due to a marked decrease in funding. In this context, renewed administrative bodies of the banks approve a re-launch plan that should have led to the transformation into a S.p.A. (later effectively realized), to a capital increase and to stock market quotation.

In 2016, the overall technical situation worsens further, resulting in a serious injury to the survival of the two banks. In resolution to this, the respective administrative bodies draw up a detailed restructuring plan which provides for: the merger between the two intermediaries; the issuance of the State guarantee on new bond issues; access to precautionary recapitalization measures to bridge capital shortfalls. The restructuring project is not, however, “passable for the unavailability of private resources”. The failure of consolidation initiatives irreparably undermines customer confidence, which results in further funding outflows. In this context, the hypothesis of precautionary recapitalization requested by the two banks is abandoned, given the negative

⁵⁶ The interbank Deposit Protection Fund established in 1987 and initially voluntary, is from 2011 a mandatory consortium recognized by the Bank of Italy and whose activity is governed by the statute and by the regulation.

evaluation of the European Commission regarding the existence of private funds sufficient to cover, as required by the BRRD, the “probable losses in the near future” from it estimated.

Due to the law of 2015, the banks demutualized. Veneto banca S.p.A. changed from a cooperative society to a limited company. Following a field stock market listing in June 2016, it was taken over by a bail-out fund Atlante⁵⁷, which has prevented its resolution. Both banks become insolvent again in 2017. Consequently, on 23 June 2017 the ECB declares the state of “instability or risk of collapse” for Veneto Banca and Banca Popolare di Vicenza and the Single Resolution Committee, in confirming this assessment, decides that there is no public interest in starting a resolution procedure against the two banks.

Banca Popolare di Vicenza (BPVI) was among the four Italian banks (together with Banca Popolare di Milano, Banca Carige and Banca Monte dei Paschi di Siena) that failed the ECB stress tests in 2014. Both BPVI and Veneto Banca have a very high amount of non-performing loans (37%, compared to the Italian average of 18%) and high operating costs. They have been loss-making for a number of years and between June 2015 and March 2017 the banks lost 44% of their deposit base.

As a result of the actual situation, the MEF issues, on the proposal of the Bank of Italy, the Legislative Decree 99/2017 with which Veneto Banca and Banca Popolare di Vicenza are placed in compulsory administrative liquidation. The decree provides for the following measures:

- ✓ Transfer of the business combination of the two banks and the related subsidiaries to Banca Intesa San Paolo, on intermediary selected on the basis of an open and transparent procedure, which took over the relationships of the transferring banks with customers without continuity solution;
- ✓ Liquidity injection of approximately € 4.3 billion and the granting of state guarantees, for a maximum amount of € 12.4 billion, on the bankruptcy mass financing by Banca Intesa, in order to guarantee the continuity of credit support to the territory, as well as for the management of the restructuring processes of the banks in liquidation.

The government decree also provides for a refreshment mechanism for retail investors who have underwritten or purchased subordinated bonds directly from the two banks in liquidation before the publication date of the BRRD and have retained their ownership until the liquidation starts.

⁵⁷An important step forward, which was made thanks to the private initiative of the banking sector, was the announcement on 11 April 2015 the creation of the Atlante Fund. A large number of banks, insurance companies and pension funds, have joined the launch of this alternative investment fund, which is managed by Quaestio Capital Management SGR spa, a company of private operators to avoid the risk that the intervention may be in contrast with the European framework for State aid.

With the first start of the liquidation procedure, the cost of the crisis was first made of ownership and subordinated bonds subscribers, whose rights can only be satisfied if the State fully recovers the amounts paid and is satisfied the claims of their creditors. Overall, the solution adopted allowed: to preserve business continuity; avoid serious repercussions of the crisis on the local productive fabric; safeguard the employment of employees; minimize the cost of solving the crisis.

3.3.2 The crisis of the bank Monte dei Paschi di Siena.

The crisis of the Monte dei Paschi di Siena bank is due to the interaction of many factors, including the protection of the deep recession that hit the country in 2012-2013 and fraudulent behavior put in place since 2008 by top members, “which have weakened the intermediary and have questioned their reputation”⁵⁸. On the basis of the Bank of Italy’s reconstruction during the hearing at the Parliamentary Investigation Committee, the effects of the MPS crisis begin to emerge from the second half of 2008. Between 2008 and 2011, the Supervisory Board ten inspections at MPS, three of which concern credit risks and two financial risks. The result is a capital shortfall, to which the bank remedies a capital increase operation, and a strong weakening of the liquidity position which causes the Supervision to request the Bank of Siena to act quickly, also assessing the assumption of divestments of assets. By letter dated 19 January 2012, the Bank of Italy asked the management to draw up an extraordinary plan of measures to normalize the technical-organizational situation, which includes, among other things, the sale of assets and a reasonable increase of capital to support the necessary strategic reconfiguration and the operational relaunch of the group.

The liquidity crisis does not stop, however, and in December 2012, the bank requested the issuance of the State Guarantee on 10 Billion financial liabilities to be offered as collateral to obtain financing from the market and the ECB. In 2014, following the in-depth assessment exercise of the financial statements of the main banks in the euro area, which reveals, for MPS, a capital shortfall in the adverse scenario, amounting to 2.1 billion, the Bank deliberates to fill the shortfall with a capital increase of a 3 billion, to be implemented in 2015; of these 1.1 billion are intended for the repayment of the residual portion of the securities issued in 2012 (so-called Monti bonds) as part of

⁵⁸ Barbagallo C, Monte dei Paschi di Siena bank, Hearing at the Parliamentary Committee of Inquiry of the banking and financial system, Rome, 22/11/2017.

the recapitalization operation aimed at bridging the capital deficiency that emerged from the year conducted by the EBA in the second half of the year 2011⁵⁹.

Following the stress test carried out by the ECB in 2016, which revealed the total erosion of regulatory capital in the adverse scenario at the end of 2018⁶⁰, the Board of Directors of the Siense bank resolves a plan (so-called “Project Charles”) which provides for “two closely related transactions”:

- The sale of the entire non-performing portfolio and the increase in the coverage rates of the other categories of non-performing loans (up to 40 per cent) and;
- The capital strengthening through a capital increase of up to 5 billion.

However, the project does not find fulfillment, due to the impossibility to find on the market the necessary resources to complete the recapitalization operation. On December 23, 2016 the Legislative Decree 237/2016, containing measures of public support for banks, liquidity and capital. The intervention of the State is aimed at avoiding that the hypothetical difficulties of an intermediary, deriving from capital shortcomings emerging from the stress test, translate into real difficulties, with consequences for the intermediary itself and for the overall stability of the financial system. On the same day, MPS requested the release of the public guarantee on newly-issued liabilities and the following 30 December it sent to the MEF, the ECB and the Bank of Italy the request to access the precautionary recapitalization⁶¹, presenting the main guidelines of the restructuring plan⁶².

The public support measure is definitively approved by the European Commission on 4 July 2017. The maximum amount of public intervention is estimated at € 5.4 billion, of which € 3.9 billion for the capital increase and 1.5 for the restoration of holders of subordinated retail bonds that have been converted into shares as part of burden sharing measures. Following the precautionary

⁵⁹ The exercise was aimed at simulating the impact on equity of the effect on an assessment at market values at the end of September 2011 of the portfolio of government securities.

⁶⁰ Against a required capital ratio of 8 percent, MPS had a negative difference of -2.4 %, which translates into a capital requirement of € 8.8 billion.

⁶¹ The ECB has quantified for regulatory MPS a regulatory capital requirement of € 8.8 billion, of which € 6.3 billion to realign the CET1 ratio to the threshold of 8% and € 2.5 billion to reach the Total Ratio 11.5 percent.

⁶² In particular, the plan envisages: the return to a substantial budget balance in 2018 and achievement of profit starting in 2019 with ROE of more than 10 percent in 2021; the reorientation of the bank’s business model towards retail customers and SME’s; the improvement of credit risk management to a salary cap; the transfer to the market conditions of the non-performing loan portfolio, amounting to € 26.1 billion, to a privately funded vehicle company.

recapitalization, the State now holds, control of the bank, with an interest share of 68.3 percent of the capital.

3.4 No creditor worse off, NCWO

As already mentioned, correctness of the procedure for absorbing liabilities and distributing losses on creditors is guaranteed by the provision of the cardinal principle defined in the jargon as no creditor worse off (NCWO), widely stated in Decree 180/2015.

The principle is established by article. 52, paragraph 2, let. b, legislative decree n. 180/2015, which outlines the rules for the treatment of shareholders and creditors in the matter of bailing procedure. The same is confirmed in Title VI, Safeguarding and judicial protection, in art. 87, paragraph 1 of the legislative decree 180/2015, which states that in the event of application of the bail-in, shareholders and creditors, whose credits have been reduced or converted, can not incur greater losses than they would have suffered if the institution under resolution had been liquidated when existence of the conditions for the resolution was established.

The same art. 87, paragraph 2 of the legislative decree n. 180/2015, provides for the extension of the same principle to the hypothesis in which the partial assignment of the rights, asset or liabilities of the entity under resolution was made, establishing in this case that the shareholders and creditors that have not been sold they should not be treated worse than they would have received if the institution had been liquidation.

The evaluation which, as already described, must precede, and which is the prerequisite for the commencement of the resolution or reduction or conversion of shares in other equity investments or equity instruments (Article 23, legislative decree 130/2015), provides the resolution authority with various elements that can justify the aforementioned actions.

The same can be obtained from the provisions contained in article 24, paragraph 1 of the legislative decree 180/2015 and, consequently with the nature and purpose of the procedure, consists:

- 1) In the quantitative determination of the amount of the reduction and conversion necessary to cover the losses to ensure compliance with the prudential requirements and consequently;
- 2) In the identification of the various categories of shareholders and creditors on which, in accordance with the respective priority order applicable in the bankruptcy proceedings, the weight of the losses falls;

- 3) In the estimate of the treatment that each category of shareholders and creditors would receive if the entity, rather than being submitted to resolution, was subjected to compulsory administrative liquidation.

Therefore, the Bank of Italy as a resolution authority in the assessment must make a preliminary appreciation of the principle of no creditor worse (NCWO). To this end. Certain hypothesis must be considered, including: the duration of the compulsory administrative liquidation procedure that is estimated in ten years, with the realization of assets through block sale transactions in the first two years; the estimation of the liquidation scenario for intangible assets, tax assets, receivables appropriately written down according to whether they are performing, non-performing or impaired loans, thus making the necessary write-downs. The costs of the settlement procedure must also be estimated, including those deriving from the early termination of employment relationships in relation to the resources employed, as well as the costs for legal expenses connected with the possible litigation, also referring to the formation of the liabilities.

The values of presumable realization of the assets net of the costs of the liquidation procedure must therefore be compared to the needs expressed by the overall debt exposure of the bank, with an estimate based on the different categories of social creditors, in compliance with the established satisfaction order by the law in the insolvency proceedings, in such a way as to assess the compliance with the NCWO criterion.

Since, as we have analyzed, the process of distributing the loss, takes place on the basis of forecasts, the regulation of the legislative decree 180/2015 provides for an opportune period of verification of the conditions for resolution actions and their effects on the subjects involved through a further estimate made by an independent expert, specifically appointed by the Bank of Italy (article 88, legislative decree n. 180/2015). The assessment of the difference in treatment must determine the treatment that shareholders and creditors, and where appropriate also a depositor guarantee scheme, would have received if the institution had been subjected to compulsory administrative liquidation and then ascertain the possible difference in treatment that they received as a result of the resolution actions.

The art. 89, legislative decree n. 180/2015, establishes a principle aimed at mitigating ex post the consequences suffered by shareholders and creditors as a result of the reduction action and recognizes them, if they suffered greater losses than they would have incurred in the event of compulsory administrative liquidation, the right to receive compensation equivalent to the difference determined on the basis of the difference in the treatment assessment.

The principle of law from which the provision of compensation envisaged by art. 89, legislative decree 180/2015. It should be noted that while in the latter case the obligations arising from the adjustment of the contract fall on the contractors who took advantage of the calculation error, according to a logic that traces the ratio of the indebted, in the case of compensation art. 89. The letter on the basis of new data could in turn reduce the size of its intervention, thus compensating the burden of providing such compensation.

Chapter 4: Some cases of banking crisis and comparisons in Italy and Spain.

4.1 The model of “bad bank” and the Spanish SAREB.

The “bad bank” is a bank that receives disadvantageous goods (assets that have lost their value) and harmful loans (debts that are unlikely to be settled) by other banks and organizations. European institutions are thinking over how best to rid Europe’s banks of their bad loans. Spanish SAREB bank could be the perfect model to explain this model.

The objective assigned to the management of the bad bank is, identified in the maximization of the value of assets, or in liquidation orderly business, but there is no maximum deadline within which achieve these results.

Previously we have mentioned the concept of the “bridge bank”, in which there is the fact that the management vehicle may be a different subject from a bank, that is also understood by the lack of the forecast.

Therefore, even if at a first reading of the text for the proposal of the directive, it is difficult to fully understand the differences between the two instruments, but from a deeper analysis it is clear that the purpose pursued from the establishment of the bridge bank and the bad bank is different:

- The *bridge bank* aims at guarantee, in the short term, the continuity of essential services and to maintain the value of the assets transferred until the transfer to buyer is made definitive.
- The *bad bank*, on the other hand, serves to ensure the management of impaired assets or difficult to evaluate with the ultimate goal of recovering its value, too taking longer time horizons into account.

A particularity that distinguishes the style compared to all the other tools, it is that the European legislator is expressly provided that it should be only in combat with another resolution tool. A normative prediction based on the fact that otherwise the separation of the activities would not welcome the achievement of all the objectives envisaged by the directive (first of all ensuring the continuation of essential functions and avoiding the destruction of unnecessary value).

In fact, based on in the article 31, par. 5 of the proposal for the directive when using the bad bank instrument – as well as for the instrument of the sale of the business activity and that of the bridge institution – the remaining part of the entity that is not sold must be liquidated. So, if not used

another tool in combination of that of separation, it would be that the whole of the intermediary would be subject to liquidation proceedings, a party immediately following the application of the resolution and a part (the one sold to the bad bank) in the long term. The combined use of bad bank more another one of the foreseen instruments, instead, would allow to “save” the healthy parts intermediary.

It should be noted that in Italy the idea of setting up a bad bank attracts opinions particularly favorable given the awareness confirmed by some studies – of high percentage of impaired loans that characterize the budgets of the national banks. In this sense, the solution proposed by the creation of one bad bank would allow such assets to be brought to light, and banks cleaned up increasing their ability to refinance and recapitalize⁶³.

A brief reflection on the model of a bad bank is the Spain’s SAREB. The acronym SAREB derives from “Sociedad de Gestion de Activos procedentes de la Reestructuracion Banking” and indicates the name of an asset management company. This society is born as part of a Memorandum of intent signed in July 2012 by the government Spanish and the European Union which provides for a restructuring process and recapitalization of the Spanish banking sector.

SAREB is a real bad bank: it collects impaired loans, in particular real estate loans, that is credit related to the real estate market, of the banks that received public support and in return issues debt securities guaranteed by the Spanish state. The support from the Union takes place through two routes: on the one hand, through an injection of capital into the Spanish FROB (Spanish Fondo de Reestructuracion Ordenada Bancaria), whose participation in the capital of SAREB can’t exceed 50%, and on the other hand, allowing the European Central Bank to accept as collateral the debt securities issued by SAREB. As for any other bad bank, the purpose of SAREB is to manage the assets received in order to maximize its value in view of their future sale.

4.1.1 The liquidity crisis of Spanish banks.

The management of the crisis of some Spanish banks, which occurred prior to the launch of the BRRD, in some respects is closer to the characteristics of the resolution governed by the directive. Following the liquidity crisis of the Spanish banks, caused by the bursting of a housing bubble and which particularly hit the savings banks (Cajas), in 2012 Spain requested financial assistance from

⁶³ Guiso L -Tabellini G., “The solution is the European bad bank”, in *Il Sole 24 Ore*, March 24, 2013. In the article the authors argue that “the banks prefer to keep hidden losses hoping to recover in the future, rather than further eroding a capital already too low and difficult to reconstitute; in this way, the disbursement of credit is “contaminated by distorted incentives” because “banks keep companies alive when it is already clear that the probability of being repaid is very low”.

the European Union for the recapitalization of banks (the request amounted to 100 billion euros, but the necessary resources turned out to be much lower). In July 2012 a financial assistance program for recapitalization was adopted by the Eurogroup and the European Stability Mechanism (ESM) provided, between December 2012 and February 2013, € 41.3 billion to the Spanish State for the recapitalization of the banking sector⁶⁴. Spain successfully emerged from the assistance program in January 2014.

The program was governed by the “Memorandum of Understanding of Financial Sector Policy Conditionality” (MoU), between Spain and the European Authorities⁶⁵. The MoU included: the creation of the public/private asset management company SAREB, to manage the real estate portfolio of the beneficiary banks (bad bank); the identification of capital requirements through an independent asset quality review and a stress test for each bank; the drawing up of plans to address capital needs highlighted by stress tests that provided for the recapitalization, restructuring or resolution of banks; the application of measures to address capital shortages; including the bail-in of junior debt and contributions of public capital; completion of the reform of the legal framework of the financial sector. In defining the latter, the Spanish legislator, as established by the MoU, took into account the BRRD plant that was being defined at that time, strengthening the resolution powers of the FROB (Fondo de Reestructuración Ordenada Bancaria) and providing for specific resolution instruments, such as to sale of business activity and the bridge bank.

To reduce the costs borne by taxpayers, the MoU established that, after the shareholders had borne the losses, the Spanish authorities should require the beneficiary banks of state aid to share the burden on the part of hybrid capital holders and subordinated debt, through the activation of subordinated Liability Exercises (SLEs) voluntary or, where necessary, mandatory. The new Spanish legal framework on the banking sector has introduced the principle of the “no creditor worse off” of the directive, establishing that the losses imposed on those investors should in any case be lower than those they would have incurred in the event of liquidation of the bank⁶⁶.

⁶⁴ The ESM funds served for the direct recapitalization of ten Spanish banks through the FROB, which has subscribed shares and convertible contingent bonds. 2.5 billion euros was used to recapitalize the asset management company SAREB (World Bank).

⁶⁵ http://ec.europa.eu/economy_finance/eu_borrower/mou/spain-mou_en.pdf, European Commission, Post-Program Surveillance Report, Spain, Autumn 2016 and International Monetary Fund (IMF), Country Report n.13/54, Spain, Financial sector reform- Second Progress Report, <https://www.imf.org/external/pubs/ft/scr/2013/cr1354.pdf>

⁶⁶ FROB, Spanish financial sector restructuring, January 2014.

The public support of the ESM was necessary for the recapitalization of several banks, for which the European Commission approved the restructuring plans⁶⁷ and was applied the burden sharing to shareholders and holders, of subordinated debt. The beneficiary banks, in return of the transfer of their liquid and impaired assets to SAREB, received as payment the senior bonds guaranteed by the State issued by SAREB.

4.2 Italian and Spanish bank business models and banking systems.

In the run up to the global banking crisis, Italian and Spanish banks had a “traditional” business model, as compared to other European banks. In Italy and Spain, the majority of bank’s assets were loans to customers, and a significant part of these assets involved government securities, which at that time were considered among the safest possible asset investments. There was, however, one main difference between Italy and Spain as far as assets were concerned. Unlike Spanish banks, Italian banks did not fuel a property bubble; namely, they lent to households less frequently than either Spanish or Greek banks. Italian banks predominantly lent to non-financial corporations; the bulk of these loans went to services and industry, not construction.

A property bubble can also come from residential mortgage lending, but there was no significant rise in consumer lending by banks in the years preceding the crisis in Italy. Lending to non-financial corporations (NFCs) was somewhat higher in Spain, than in Italy and Greece. However, in Spain, the non-financial corporations lending included a large proportion of property developers, especially among *cajas*⁶⁸. Moreover, loans made to consumers for the purpose of house purchases were the vast majority of the total loans to consumers.

On the liabilities side, both Italian and Spanish banks had a broad and stable funding base. Funding from retail customers (considered more stable than wholesale funding) constituted a large share of the total liabilities in both countries. However, banks in both countries depended on wholesale inter-bank funding, with some important differences. To begin with, Italian banks primarily lent to each other. Indeed, the average home bias for Italy was the highest among the euro area’s national

⁶⁷http://europa.eu/rapid/press-release_IP-12-1277_en.htm

⁶⁸In Spain, a saving bank is a financial institution that specializes in accepting savings deposits and granting loans. Spanish banks fall into two categories: Privately owned banks (*bancos*) and government owned banks (*cajas* – literally pay office, or pay desk). The original aim was to encourage thrift among the very poor, but the evolved to compete with and rival commercial banks. Over time, most *cajas* colluded with regional political establishments to create a self-serving system or unscrupulous financing for regional governments provided by politically stuffed, savings banks’ boards which in turn, thrived in what has been defined as “a culture of greed”. This system was exposed in the aftermath of the global financial crisis.

banking systems. Furthermore, Italian banks issued several debt securities, selling them to their customers, a funding method that exposed them less to the vagaries in the financial markets. Italian banks had greater access to retail investors for bond issues compared to other European banks (Bank of Italy, 2011).

Considering both assets and liabilities simultaneously, a crucial difference between Italian and Spanish banks is that Spanish banks borrowed on the interbank market and channeled this funding to the construction sector through mortgage loans and loans to property developers. Hence, the banking system in Spain intermediated capital inflows, sustaining a massive construction boom (Gros, 2012). On the interbank market, Italian banks borrowed to a more limited extent than their Spanish counterparts, and did not use this funding to provide credit to property developers and mortgages. Italian banks did not fuel a credit boom. Contrary to Spain, Italy experienced lower capital inflows, which were not intermediated by banks; most of these capital inflows, were purchases of government bonds.

The other important difference is that Spain, unlike Italy had a dual banking system of (private) commercial banks and (public) savings banks, the *cajas*, which were unlisted in the stock market and accounted for half of the financial sector's assets. *Cajas* were peculiar credit institutions because they used to dedicate a significant portion of their provisions (usually over 20 per cent) to social causes; and prior to the crisis, they hold strong links with their regional and local governments. Moreover, *cajas* were subject to a distinctive regulatory framework, and Bank of Spain had limited supervisory competences on *cajas*.

In Italy, savings banks were subject to the same regulatory regime as a commercial bank in addition to the stringent supervision of the Bank of Italy. Indeed, many *casse* (formerly, public saving banks) had been merged with commercial banks during 1990s and 2000s, after the Amato-Carli reform⁶⁹. Prior to the Amato-Carli reform (named after two treasury ministers who proposed and enacted it), Italian savings banks were publicly owned with close ties to local institutions and politicians.

⁶⁹ The Law of 30 July 1990, n. 218, is a rule of Italian Republic concerning provisions for restructuring and asset integration of public sector credit institutions, with which a process of change in the Italian banking system was initiated. The law is commonly known as Amato Law named after the former Minister of the Treasury Giuliano Amato (1987-1989), promoter and rapporteur of the aforementioned norm, during the subsequent Government Andreotti VI.

4.3 An overview on the history of Banking crisis in Spain, and the comparison with the Italian case.

Initially, after the US collapse of the subprime market in late 2007 and the bankruptcy of the US financial firm of Lehman Brothers in October 2008, Italian and Spanish banks weathered the banking crisis rather well; they experienced no major losses and required no state recapitalization.

Italian and Spanish banks were relatively sheltered from the most intense forces of global financial contagion in 2008-2009. On the assets side, they had a limited amount of market -based assets; they had not invested in ‘fancy’ financial products that later proved to be ‘toxic’ and the majority of bank’s assets comprised of customer loans. As for liabilities, Italian and Spanish banks had a broad and stable Funding base, mainly from retail customers.

Moreover, the bank of Spain had imposed a regulatory framework requiring higher provisioning thereby providing cushions to Spanish banks to initially absorb losses caused by the outset of the global financial crisis. The single most important factor to account for the positive performance of the Spanish financial system, which established a countercyclical capital regime for bank.

Spanish financial institutions at the end of 2011 accumulated 405 billion euros in loans associated with the real estate sector given to developers and companies, and, of those, 188 billion were considered toxic and at risk of default. The cajas had to write down 50 billion euros in their property portfolios in 2011.

A crucial explanation for the divergence performance between banks and cajas was the differences in their regulatory framework. As opposed to banks which were directly regulated by the bank of Spain and the Ministry of Finance, cajas were regulated both the national government and by the autonomous communities’ governments. When the economic recession reached the country following the banking global crisis, the cajas were exposed to the collapse of the construction sector and the payment difficulties of mortgage holders. Cajas highly dependent on international wholesale financing because of their business model, where forced to ask the government and the European Central Bank (ECB) for liquidity when wholesale markets froze⁷⁰. Since the inception of the crisis, Spain adopted five financial reforms in three years and implemented three rounds of bank mergers.

⁷⁰ Spanish banks increase their ECB borrowings by more than six times between June 2011 and October 2013. In March 2012, they borrowed a record 316 billion euros from the ECB, 28 per cent of the euroarea total, the highest level in absolute terms among euro area banking systems.

The Spanish government repeatedly increased capital provisions, those banks unable to meet the new standards could borrow additional money in state-backed convertible bonds carrying a ten per cent interest rate. Furthermore, banks could transfer their riskiest assets to state-guaranteed asset management companies to help hurry the sale of real estate assets the bank held. Each bank was forced to create a bad bank into which it put physical property assets at devalued prices, in preparation for potential sales to outside investors.

In May 2012, the Spanish government was forced to nationalize Bankia, the country's largest real estate lender that was created by the merger of several ailing cajas. The failure of Bankia validated concerns regarding insufficient regulatory oversight, as well as the perception that Spanish banks and the Bank of Spain had downplayed the risk posed by real estate loans. In August 2012, the Spanish government created a bad bank as a result of a new financial reform which was approved in response to the EU financial rescue package.

From the other side we have the case of Italy. Italian banks did not suffer provide substantial funding to the construction sector; instead they mainly lent to small and medium enterprises. The number of banks lending to consumers was moderate; especially loans made to consumers for the purpose of house purchases. When the global banking crisis broke, Italian banks mainly restricted credit to the real economy, which deepened the economic recession but did not cause major losses for banks on the assets side. On the liabilities side, at the highest of the crisis, banks cut their lending to those abroad for more than their lending to those domestically based. So, the fact that Italian banks lent to each other meant that inter-bank borrowing was more stable than in those systems where inter-bank funding was largely from abroad. For the case banking crisis in Italy, we saw and explain above the crisis of "four banks" and this of Monte di Paschi di Siena.

The Bank of Italy, like the Bank of Spain, discouraged lenders from adopting risky "off balance sheet" accounting methods, as well as from acquiring billions of euros repackaged US subprime mortgages and other toxic assets. Moreover, the Bank of Spain, and the Bank of Italy forced all banks to focus on conservative risk management and quality of capital, limiting their leverage and debt equity ratio.

Conclusions

The aim of this work is to reflect the new rules of bail-in, in response to the global financial crisis. The protection of investors and clients, preserving banks from losses and bankruptcies. All of these concepts are linked to the Bank Recovery and Resolution Directive (BRRD), which was created by the European Commission in June 2012 with this scope. To help all the banks that were going through a difficult period as a result of the economic crisis.

The BRRD was agreed in 2014, it builds on other EU legislation, such as the capital adequacy requirements for banks (CRR/CRD), the Deposit Guarantee Scheme Directive (DGSD), and the European state aid rules, as a potential game-changer in creating a more stable banking system that serves the economy at large.

The BRRD regulates the different stages and elements of a problem bank's recovery and resolution process, including advanced planning and restructuring. It rests upon the following key elements:

- Recovery and resolution planning including the removal of obstacles to resolvability;
- An enhanced set of early intervention measures to foster forward looking supervision and crisis prevention;
- A harmonized set of resolution tools and powers to manage bank failure, aiming to ensure that losses are absorbed by shareholders and creditors while allowing the continuity of critical functions.

The four main resolution tools are the:

- 1) Bail-in tool: ensuring that losses are absorbed by shareholders and creditors.
- 2) Sale of business tool: allowing the resolution authority to sell all or part of the failing bank to a private acquirer.
- 3) Bridge institution tool: transferring the good assets and essential functions of the problem bank into a new temporary institution (bridge bank) with the aim of selling it.
- 4) The asset separation tool: isolating the "bad" assets of the bank in an asset management vehicle for orderly wind down, if immediate liquidation is not justified in current market conditions.

The MREL rules, as set now in the BRRD, may be useless to assure the practical viability of a Bail-in and they need to be amended. The European authorities already envisaged this need, proposing to align the MREL rules to the TLAC standard, forcing the European banks to rely increasingly on more expensive equity and subordinated debt instruments. The TLAC and MREL features need to be sufficient flexible to arrange different business models.

In Italy the banking crisis manifested itself later than the corresponding bank insolvencies that occurred in other European Countries and in the rest of the world. All this is due to the fact that Italian banks had, and still have, a predominantly commercial rather than a financial vocation. The BRRD was transposed in Italy and entered into force in 2015, with the bail-in rule starting in January 2016. On 22 November 2015, the Italian Resolution Authority (bank of Italy) and the Italian Government decided to place under resolution the following “four Italian banks”: Banca Marche, Banca Popolare dell’Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio di Chieti.

The BRRD which establishes a framework for the reorganization and resolution of credit institutions and investment firms through the two legislative decrees n. 180/2015 and 181/2015, based on the principles recently reiterated with the aforementioned communication from the European Commission of 2013, regulate the banks crisis through a series of instruments that, in the event of failure, are broken down into resolution and bail-in.

In Italy and in Spain, the majority of bank’s assets were loans to customers. Unlike Spanish banks, Italian banks did not fuel a property bubble; namely they lent to households less frequently than either Spanish or Greek banks. The SAREB of Spain is a perfect example of the bad bank.

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