INTERNATIONAL MONETARY FUND

IMF Country Report No. 13/350

ITALY

December, 2013

TECHNICAL NOTE ON SAFETY NETS, BANK RESOLUTION, AND CRISIS MANAGEMENT FRAMEWORK

This Technical Note on Safety Nets, Bank Resolution, and Crisis Management Framework on Italy was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed in June 2013. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of Italy or the Executive Board of the IMF.

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Price: $18.00 per printed copy

2013 International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

ITALY

FINANCIAL SECTOR ASSESSMENT PROGRAM

June 2013

TECHNICAL NOTE

SAFETY NETS, BANK RESOLUTION, AND CRISIS MANAGEMENT FRAMEWORK

Prepared By

Monetary and Capital Markets Department, and Legal Department

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program in Italy. It contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at: http://www.imf.org/external/np/fsap/fssa.aspx.

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Glossary

BI	Banca d' Italia
BCC	Credit Cooperative Banks
BL	The Consolidated Law of Banking (Legislative Decree 385/1993)
BRRD	EU Banking Recovery and Resolution Directive (draft)
MPS	Banca Monte dei Paschi di Siena
CAR	Capital adequacy ratio
CAL	Compulsory Administrative Liquidation
CMG	Crisis Management Group
CONSOB	Italian Companies and Stock Exchange Commission
CRD	Capital Requirements Directive
COVIP	Italian Supervisory Authority for Pension Funds
CSFS	Committee for the Safeguard of Financial Stability
DI	Deposit insurance
DIA	Deposit Insurance Agency
DL	Decree Law
DGS	Deposit Guarantee Scheme(s)
D-SIB	Domestic Systemically Important Bank
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ELA	Emergency Liquidity Assistance
FGDCC	Mutual Bank Depositor Guarantee Fund (covering mutual banks)
FITD	Interbank Deposit Guarantee Fund (covering banks incorporated as joint-stock companies and cooperative banks)
FMIs	Financial Market Infrastructures
FSB KA	Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions
G-SIFI	Global Systemically Important Financial Institution
ICCS	Inter-Ministerial Committee on Credit and Savings
ISVAP	Italian Supervisory Authority for Private Insurance Companies
LTRO	Long Term Refinancing Operations of the ECB
M&A	Mergers and Acquisitions
MEF	Ministry of the Economy and Finance
MIC	Collateralized Interbank Market
MoU	Memorandum of Understanding
NPL	Non-performing loan
OBA	Open bank assistance
OMT	Outright monetary transactions of the ECB
P&A	Purchase and assumption
RRP	Recovery and resolution plan

SA	Special Administration
SCV	Single Customer View
SSM	Single Supervisory Mechanism
SRM	Single Resolution Mechanism

EXECUTIVE SUMMARY[1]

This note elaborates on the recommendations made in the Financial Sector Assessment Program (FSAP) for Italy in the areas of contingency planning, crisis management, and bank resolution. It summarizes the findings of the FSAP mission undertaken during March 12–27, 2013, and is based upon analysis of the relevant legal and policy documents and extensive discussions with the authorities and private sector representatives.

The Italian financial system weathered the initial phases of the global financial crisis relatively well. Between October 2008 and February 2009, the authorities announced a range of measures to support the liquidity and solvency positions of banks. These measures helped preserve confidence despite not being significantly drawn upon by the banking sector in monetary terms. With the return of recession in 2012, and the escalating sovereign debt crisis, the banking sector has faced renewed funding pressures. While ameliorated by the European Central Bank's Long-Term Refinancing Operations and the Outright Monetary Transactions announcement, the outlook remains fragile and at risk of further buffeting from developments in the Euro zone.

The mission discussed lessons from the global financial crisis and made a number of recommendations for strengthening the crisis management and resolution regime. The mission's main recommendations are summarized below, and those which require legislative reforms should await, and be made consistent with, the final version of the EU Banking Recovery and Resolution Directive (BRRD):

- ***Institutional framework and coordination arrangements:*** The roles of the two inter-agency committees, chaired by the Minister of Economy and Finance, should be reviewed and streamlined. In light of the changes that will be introduced to set up a macroprudential authority, the Italian authorities should evaluate whether the Inter-Ministerial Committee on Credit and Savings can be eliminated and the Committee on the Safeguard of Financial Stability refocused on crisis preparedness and management. As envisaged in the proposed BRRD, legislative changes are required to enhance inter-agency cooperation and information sharing, domestically with the ministry and internationally with foreign resolution authorities that are noncentral banks/supervisory authorities, and with Ministries of Finance, with clarity as to what and when information is to be exchanged for resolution purposes.

- ***Supervisory early intervention of problem banks:*** The Bank of Italy (BI) is empowered to adopt a broad range of measures against banks, graduated to the gravity of the situation. However, it lacks early intervention powers to suspend and replace management, remove

[1] This note was prepared by Dawn Chew and Marc Dobler, initially on the basis of information received as of March 2013. Where appropriate it has been revised in light of the draft text proposed by the European Council for the EU Banking Recovery and Resolution Directive (June 27, 2013) and subsequent comments from the Italian authorities.

the statutory auditors, and apply pecuniary sanctions at the bank level; and the law will need to be amended to provide for such powers. The authorities should provide a statutory basis for recovery and resolution plans as soon as possible, and develop regulatory guidelines for preparing such plans, which should also be required for systemically important domestic banks.

- ***Orderly and effective resolution:*** The flexibility to selectively transfer assets and liabilities, with an exemption from the pari passu requirement, should be introduced in accordance with the FSB Key Attributes, along with a "No Creditor Worse Off Safeguard." Powers to prevent shareholders from blocking recapitalization, or mergers and acquisitions, as well as to override any caps on shareholders' voting rights should be available without requiring the firm's license to be revoked. In addition, powers to establish bridge banks and asset management vehicles, and to bail-in uninsured creditors (with the full flexibility specified in the Key Attributes) as well as afford a temporary stay on financial contracts should be adopted as planned under the forthcoming BRRD. The triggers for deploying this augmented set of resolution tools should allow for their early deployment when the firm is no longer viable or likely to be no longer viable, and has no reasonable prospect of becoming so. The mission also recommends introducing deposit preference, as recommended in the Council draft of the BRRD, and enshrining in legislation the least-cost test for the use of deposit guarantee funds.

- ***Deposit guarantee framework:*** The governance of the deposit guarantee schemes (DGS) should be revisited to remove active bankers who sit on the Boards and Executive Committees. Consideration could also be given to including voting representatives from the MEF and BI, and consolidating the two schemes. In line with EU proposals and to underpin the credibility of the DGS schemes, the currently ex-post funded DGS should move to an ex-ante funded scheme, with access to credible back-up funding. To ensure credible back-up funding, an unsecured credit line from the MEF should be made available at market rates. Efforts should also be made to assess and enhance public awareness.

This technical note is structured as follows: Chapter I sets out a brief overview of the impact of the global financial crisis in Italy and how the authorities handled the crisis. Chapter II analyzes the institutional framework and domestic and cross-border coordination arrangements; Chapter III assesses the supervisory approach to intervene with potential problem banks at an early stage; Chapter IV covers crisis management tools, including official financial support measures, the resolution framework, and the deposit guarantee framework; and, lastly, Chapter V deals with the issue of legal protection.

Table 1. Italy: Main Recommendations for the Crisis Management and Bank Resolution Framework

	Recommendations	Priority	Timeframe*
Domestic and cross-border institutional framework			
(i)	Refocus the Committee for Financial Stability on crisis preparedness and management.	Medium	Medium term
(ii)	Remove legal obstacles to sharing information with finance ministries (both domestically and overseas) and other cross-border safety net authorities.	Medium	Medium term
Crisis preparation			
(iii)	Require by statute recovery and resolution plans to be prepared for all firms of systemic importance and provide detailed guidelines.	High	Near term
Early intervention and resolution tools			
(iv)	Enhance early intervention powers by empowering the BI to replace Board members, managers, and auditors, and apply pecuniary sanctions at the bank level without needing to appoint a special administrator.	High	Near Term
(v)	Augment resolution tools with powers to selectively transfer assets and liabilities, bail-in creditors, establish bridge-banks, recapitalize and transfer ownership (including overriding caps on ownership, voting and pre-emptive rights); and remove courts' ability to suspend/ reverse resolution measures.	High	Near Term
(vi)	Ensure that triggers allow all existing and new tools to be deployed at an early juncture when the institution is no longer viable or likely to be no longer viable, including when liquidity requirements are seriously breached.	High	Near Term
(vii)	Provide a statutory basis for the least-cost test.	High	Near Term
Bank liquidation and insolvency			
(viii)	Provide for depositor preference in the legislation.	Medium	Medium Term
Deposit guarantee schemes			
(ix)	Remove active bankers on Boards and Executive Committees of DGS, and extend legal protection to DGS.	Medium	Near Term
(x)	Provide for ex-ante funding for the DGS, and back-up credit line from the MEF.	Medium	Medium Term
(xi)	Enhance public education on deposit insurance coverage.	Medium	Medium Term

* Near term: 12 months (or by the end of 2014, if legislative amendments are required); medium term: one to three years.

ITALY AND THE GLOBAL CRISIS: A BRIEF OVERVIEW

1. **The Italian financial system weathered the initial phases of the global financial crisis relatively well.** The "traditional" business model of Italian banks, with relatively low exposures to structured products and the United States, sheltered them from the initial effects of the global crisis. Nevertheless, large Italian banks that are more dependent on wholesale funding were hit by the decline in cross-border financing, the freeze in the interbank market, and falling equity prices. Credit conditions tightened and lending contracted, compounding the impact on economic activity of declining exports, consumption, and investment. Corporate balance sheets came under strain, unemployment rose, and the economy went into a severe recession that lasted for seven quarters, with a resulting impact upon asset quality of the banks.

2. **In response, the authorities announced a range of measures to support financial stability.** Between October 2008 and February 2009, a number of measures were announced, which supported the liquidity and solvency positions of banks, including a three-year deposit guarantee. These measures helped preserve confidence, despite not being significantly drawn upon by the banking sector in monetary terms. Rather than accessing the recapitalization schemes available, all but four banks strengthened their positions by raising capital from core shareholders, selling nonstrategic assets, and cutting dividends.

3. **With the return of recession in 2012 and the escalating sovereign debt crisis, the banking sector has faced renewed funding pressures.** Due to significant exposures to the Italian sovereign and the 'double dip' recession in 2012, concerns over bank balance sheets once again triggered funding strains. These were ameliorated by the extraordinary operations of the European Central Bank (ECB). After two three-year Long-Term Refinancing Operations (LTRO), ECB financing of the Italian banking system peaked at EUR 283 billion in July 2012, equivalent to a quarter of the total euro system take-up. In addition, the ECB's announcement of Outright Monetary Transactions (OMT) helped reduce Italian sovereign yields.

4. **The outlook remains fragile and is at risk of further buffeting from developments in the Euro zone.** The outlook for the real economy remains weak with a continuing impact on the credit quality and profitability for banks' balance sheets. The banks' fortunes are closely interlinked with those of the sovereign and benefit from significant liquidity support from the ECB. Continuing developments in the Euro area may adversely impact depositor confidence in the future.

INSTITUTIONAL FRAMEWORK AND DOMESTIC AND CROSS-BORDER COORDINATION

A sound institutional framework for crisis management and bank resolution requires clear and effective legal underpinnings, both within each institution's legal framework as well as among the relevant institutions. For example, each institution should have a strong and clear mandate. In addition, there should be an adequate allocation of labor across the institutions and explicit coordination mechanisms between the institutions, including solid legal bases for the exchange of confidential information.

A. Institutional Framework

5. The financial sector supervisors each have an explicit mandate for financial stability.[2] In addition to the financial sector supervisors: BI, the Institution for the Supervision of Insurance (IVASS), and the Italian Companies and Stock Exchange Commission (Consob), the institutional framework comprises the MEF, the Inter-ministerial Committee on Credit and Savings (ICCS), the Committee for the Safeguard of Financial Stability (CSFS), and the two DGS. Box 1 summarizes the powers and responsibilities of the key institutions.

B. Domestic Cooperation and Coordination

6. The legal framework expressly provides for cooperation amongst the supervisory agencies and DGS, but changes should be made to enhance cooperation with the MEF.

a. **BI and other supervisors**—Article 7(5) of the Consolidated Law of Banking (BL) provides for collaboration and exchange of information amongst the supervisory agencies and provides an exception to the principle of confidentiality. Memoranda of Understanding (MoUs) exist between BI and the financial sector supervisors.

b. **BI and DGS**—Article 7(9) of the BL provides for information exchange between the BI and DGS. BI and the Interbank Deposit Protection Fund (FITD) have MoUs in place for quarterly information sharing of bank business profiles, but no MoU in relation to the intervention procedures. While there are informal arrangements in place for the FITD to be informed of interventions, and information is shared informally via BI attendance (without voting rights) at the Board meeting of the FITD, the mission recommends formalizing such procedures in an MoU.

[2] Article 5 of Banking law, article 5 of the Consolidated Law on Finance, article 3 of the Code on Private Insurance. The extent to which information can be disclosed is restricted by the EU Directive relating to the taking up and pursuit of the business of credit institutions, Chapter 1, section 2.

c. **BI and MEF**—All facts, information, and data obtained by BI by virtue of its supervisory activity are required to be kept confidential and may only be disclosed to the Minister for the Economy and Finance (the minister) as chairman of the ICCS, the judicial authorities or when the information requested is needed for investigations or proceedings regarding crimes.[3] The legal framework should be amended to enable information sharing with the MEF, not only with the minister.

Box 1. Institutional Framework in Italy

BI—BI is the central bank and prudential supervisor for banks and financial intermediaries. As central bank, it is responsible for granting emergency liquidity assistance to banks that are solvent but face liquidity difficulties. BI's mandate includes sound and prudent management of banks (including cooperatives and mutuals), banking groups, financial intermediaries, electronic money institutions, and payment institutions; overall stability, efficiency and competitiveness (article 4 BL). It is also the resolution authority.

Consob—Consob supervises the Italian securities market. It aims to ensure transparency and proper behavior of securities market participants, accurate disclosure of information to the investing public by listed companies, accuracy of facts in prospectuses and it carries out investigations into insider dealing and market manipulation laws. Under the Consolidated Financial Law, BI and Consob share their supervisory responsibilities on banks performing investment services.

IVASS—Regulation and supervision of the insurance industry is the responsibility of the newly established IVASS, which supervises insurers, reinsurers, intermediaries as well as entities and organizations which, in any form, perform functions partly included in the operational cycle of insurance or reinsurance undertakings.

DGS—There are two deposit insurers: the FITD (for banks incorporated as joint-stock companies and cooperative banks) and the Deposit Guarantee Fund of Cooperative Credit Banks (FGDCC) for mutual banks. Its primary mandate is to provide depositor payout but has a broad mandate to support resolution actions.

Judiciary—The judiciary hears legal disputes relating to actions or orders taken by the authorities, special administrators or liquidators, upon a petition from interested parties. The Court of the place where a bank has its registered office can also declare the insolvency of the bank, upon petition by creditors and special administrators, the public prosecutor or on its own authority.

MEF—The MEF is responsible for issuing the decree of SA or CAL. The Minister chairs the CSFS and ICCS.

CSFS—The CSFS is a high-level coordination committee formed via a Protocol signed amongst the financial sector supervisors in March 2008. It comprises of the Minister of the Economy and Finance, the Governor of the BI, the Chairmen of Consob and the Italian Supervisory Authority for Private Insurance Companies (predecessor to IVASS). It is a permanent forum for discussion of issues affecting financial stability. It does not have a statutory mandate.

ICCS—The ICCS is a statutory body (article 2 BL) responsible for "high level supervision." It issues broad guidelines on prudential supervision. Apart from the Minister of the Economy and Finance (Chairperson), the other members are the Ministers for Agricultural, Food and Forestry Policies; Economic Development; Infrastructure; and European Affairs. The BI's Governor attends its meetings.

[3] Article 7(1) BL.

7. In the absence of the involvement of public resources, the MEF's role in commencing intervention proceedings could be reconsidered. The BI currently cannot commence special administration (SA) or compulsory liquidation proceedings (CAL). The BI makes the assessment for intervention, takes a decision at a high-level committee within the BI on the proposed course of action, makes a proposal to the MEF and, upon the issuance of the MEF decree, carries out the resolution action. As the resolution authority and the supervisor, the BI should be able to take the decision to commence SA and CAL (together with license revocation) independently. It will have in its possession all relevant information to make an informed decision and act on it quickly, without having to obtain another level of approval. The mission recognizes that the MEF has thus far not disagreed with the BI's recommendations to commence SA or CAL; and both the MEF and BI are content with the current decision-making arrangements. Nevertheless to enhance its role as the resolution authority and to prevent any future possibility of divergence of views or conflicts of interest, the mission recommends that consideration be given to empowering the BI to commence SA or CAL, without the need for MEF approval, for bank failures that do not present a systemic risk. However, where there is a systemic risk, or if public funds are required or likely to be required in the resolution process, then the decision-making process should involve the MEF.[4]

8. The roles of the CSFS and ICIS should be reviewed and streamlined. The CSFS is a permanent forum for discussion of issues affecting financial stability. Although the protocol establishing the CSFS provides for cooperation; exchange of information; and the prevention and management of systemic crisis, the CSFS does not meet regularly or undertake crisis preparedness measures. The ICCS is a statutory forum for the coordination of prudential regulation making amongst the supervisors, and last met in 2008. In light of the FSAP's recommendations to set up a macroprudential authority,[5] the Italian authorities should evaluate to which institution(s) the responsibilities of the ICCS should be transferred, so that it can be disbanded. In addition, the CSFS should be refocused on crisis preparedness and management and, in relation to domestic cooperation and coordination, be tasked with and resourced accordingly to:

- agree on a detailed road map for crisis management, including clarity on the individual roles and responsibilities for each agency taking into account their statutory mandate;
- meet regularly and prepare contingency plans to identify the necessary human resources, legal basis, lines of communication (including with foreign supervisors), and action plans for the failure of a systemically important financial institution (SIFI) or a systemic crisis;
- carry out crisis planning and preparedness, including undertaking simulations to test the capacity of the authorities inside and outside of the BI. In addition, stress tests should also be conducted on a regular basis and the results acted upon; and

[4] The draft BRRD of the European Council would require member states only to specify whether decisions of the resolution authority require "prior notification to, consultation with or consent of" the Finance Ministry.

[5] See the discussion under the FSSA (paragraph 24) in relation to the two options for the macroprudential policy architecture; the BI as the macroprudential authority or a new macroprudential committee.

- ensure all legal and operational hurdles for information exchange among domestic and foreign authorities, particularly with the MEF and foreign resolution authorities and Ministries of Finance, are cleared.[6]

C. International Cooperation and Coordination

9. The authorities have in place a framework for cross-border cooperation, primarily with EU member states.

a. **MoUs**: Cross-border cooperation takes the form of multilateral MoUs and bilateral MoUs,[7] mainly with EU member states.[8] Within the European Union, the authorities in June 2008 entered into a multilateral MoU (MMoU) on Cooperation between the Financial Supervisory Authorities, Central Banks, and Finance Ministries of the European Union on Cross-Border Financial Stability. This MMoU provides for common principles for the management of cross-border crises, the creation of a shared analytical framework for assessing the systemic impact of crises, and the development of common operational guidelines for cooperation procedures.

b. **Supervisory colleges**: The BI has set up a supervisory college for each of the 10 banking groups with cross-border operations of which BI is the home supervisor.[9] In addition, the BI has established fully-fledged colleges[10] for the two major cross-border banking groups—Unicredit Group (UCG) and Intesa Sanpaolo.

c. **Crisis Management Groups (CMG)**: As home supervisor, the BI in 2010 set up the CMG for UCG, the only Italian G-SIFI (see Box 2 for further details). As host supervisor, the BI participates in the CMGs for BNP Paribas (established June 2011), Credit Agricole (established June 2011), and State Street (established December 2012). The recovery and resolution planning (RRP) process for UCG is underway.

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[6] The draft BRRD would require legislative changes to introduce the necessary gateways and safeguards for the exchange of information with Ministries of Finance.

[7] Article 69 of BL provides that the BI shall establish, including by way of agreements with the supervisory authorities of other member states, forms of cooperation and coordination and the allocation of specific tasks to each authority with regard to the application of supervision on a consolidated basis to groups operating in more than one country.

[8] MoUs have been established with Austria, Belgium, France, Germany, Greece, Ireland, Luxembourg, the Netherlands, Spain, and the United Kingdom. Outside of the European Union, bilateral agreements have been reached with Albania, Argentina, Brazil, China, Croatia, Peru, Serbia, and Switzerland.

[9] Unicredit, Intesa Sanpaolo, Monte dei Paschi di Siena, Banco Popolare, Banca Popolare dell'Emilia Romagna, Unione di Banca Popolari Italiane, Credito Emiliano, Mediobanca, Banca Leonardo, and Banca Mediolanum.

[10] In line with the CRD provisions, fully-fledged colleges are required where there are at least two relevant subsidiaries or two significant branches (or one of each) in a host country and must comply in full with the Guidelines for the Operating Functioning of Supervisory Colleges, issued by the Committee of European Banking Supervisors.

d. **Institution-specific, cross-border cooperation agreements (COAG)**: The authorities are commencing their work on the COAG for UCG. A preliminary COAG has been discussed within the CMG for BNP-Paribas. However, the current draft is on a very general level and does not deal with institution-specific commitments. The approach likely to be taken is to first agree on the resolution strategy and then draft the COAG to tailor it to the specific resolution strategy.

e. **Resolvability assessments**—Envisaged in the Financial Stability Board's Key Attributes of Effective Resolution Regimes for Financial Institutions (FSB KA),[11] such assessments are designed to evaluate the feasibility of resolution strategies for the institution. To ensure authorities are able to effectively improve a firm's resolvability, the legal framework should provide the BI with clear powers to improve resolvability by requiring changes to firms' business practices, structures or organization, taking into account the impact of such requirements on the soundness and stability of the firm's ongoing business.

10. Legal amendments are needed to enable information sharing with foreign resolution authorities that are noncentral banks/supervisory authorities and with Ministries of Finance. Current legislation does not provide for the ability to exchange information with foreign ministries and resolution authorities that are noncentral banks/supervisory authorities. The authorities expect the BRRD to address this issue of cross-border information sharing by providing for information exchange with foreign finance ministries and noncentral bank/supervisory authorities who are resolution authorities.

11. While the authorities have achieved significant progress in the work on cross-border cooperation and information sharing, further work will need to be carried out. The Italian legal framework already provides for a statutory basis for cooperation and does not discriminate against creditors on the basis of nationality. The framework also requires the BI to take into account, in the cases of crisis or stress in financial markets, the effects of their own actions on the stability of the financial system of the other European Community states.[12] The progress so far, however, has been EU-centric and consideration will need to be given to cooperation with non-EU authorities, as well as cooperation with host authorities who are not members of the CMGs. In this regard, the FSB KA provides for various principles relating to cross-border resolution. Box 3 summarizes some of the relevant KAs.

[11] KA 10.

[12] Article 69(1) of BL.

Box 2. Experience of UCG CMG

CMG—UCG is the only Italian global G-SIFI. A CMG was set-up in 2010 and it had its inaugural meeting in June 2010, with subsequent meetings in July 2011, February 2012 and April 2013. The CMG comprises of the Italian, Austrian, German and Polish supervisory authorities, central banks and resolution authorities, with the European Banking Authority (EBA) as an observer. These countries were chosen on the basis of the relevance of the local subsidiaries for the group (i.e., RWA over 5 percent of the total RWA at the consolidated level). Due to legal obstacles to sharing information, the Ministries of Finance and deposit guarantee schemes are currently not part of the CMG.

RRP—The BI has been working with UCG on the preparation of RRPs. The process started in 2011 and is ongoing. The BI's practice has been to share information relating to the RRP freely with the members of the CMG. The exercise has been beneficial to both UCG and the BI as it has allowed both UCG and the BI to assess how the organizational structure and business lines can affect resolvability. The main elements under consideration in order to identify the most suitable resolution strategy are: (i) the geographical organization of liquidity management through four separate liquidity centers, (ii) the centralization of IT and back-office services, (iii) all the functions related to investment banking activities are entrusted to a subsidiary; and (iv) the uneven allocation of capital across the group.

A first proposal for the resolution strategy was discussed in the April 2013 CMG meeting, and is currently being revised by the BI, including in light of the views expressed by the host authorities. A revised version will be discussed by the end of 2013.

COAG—A preliminary discussion on the COAG took place during the April 2013 CMG meeting, and further work is underway.

Cross-border issues—In the course of the RRP preparation process, UCG faced problems receiving the necessary information from the Polish subsidiary. Polish law requires that any information request be founded on a legislative basis under Italian law before information relating to the Polish subsidiary can be provided to UCG. As a result, the recovery plan currently prepared by UCG does not sufficiently take into account the information relating to the Polish subsidiary.

EU Banking Union

12. **The mission understands that work on the single supervisory mechanism (SSM) is underway and proposals on the single resolution mechanism (SRM) will be put forth in the months following the adoption of the SSM.** Agreement was reached in December 2012 to establish the SSM within the ECB, open to non-Euro area members.[13] The regulation on the SSM is expected to come into force in July 2013, with a one-year implementation period. However, the SSM is only one of the steps to be taken in the EU's financial oversight architecture. In line with the recommendations of the EU FSAP carried out in December 2011, the SSM should be accompanied by an agreed roadmap to set up an SRM and a common resolution fund/DGS, with common fiscal

[13] Subsequent to the FSAP the proposal on the Single Resolution Mechanism was published by the Commission in July 2013, and negotiations at the EU Council were commenced.

backstops. It waits to be seen how the roles will be divided between the single resolution authority and the national resolution authorities, and what the coordination mechanisms will be. Clarity will also be needed as to the applicable legal framework for resolution purposes. The current BRRD is a directive that needs to be transposed into national laws, but provides for minimum harmonization and as such, there may still be significant variations in resolution frameworks in member states. However, resolution powers should not be transferred to a single resolution authority before credible common financing to fund the resolution has been ensured.

Box 3. Cross-Border Crisis Resolution: The Key Attributes

A common theme reflected in the FSB KA is the requirement that national resolution authorities consider the impact of a resolution action on financial stability in other jurisdictions. Moreover, the FSB KA establishes several important principles for cross-border cooperation that should be enshrined in national resolution frameworks.

Statutory mandate**:** The mandate of a resolution authority should empower and strongly encourage the authority, wherever possible, to act to achieve a cooperative solution with foreign resolution authorities.

No discrimination: National laws and regulations should not discriminate against creditors on the basis of nationality, the location of their claim, or the jurisdiction where it is payable.

Branches: The host resolution authority should have resolution powers over local branches of foreign institutions and the capacity to use its powers either to support a resolution carried out by a foreign home authority or, exceptionally, to take measures on its own initiative where the home jurisdiction is not taking action or acts in a manner that does not take sufficient account of the need to preserve the local jurisdiction's financial stability.

No automatic action: Legislation in jurisdictions should not contain provisions that trigger automatic action in that jurisdiction as a result of official intervention or the initiation of resolution or insolvency proceedings in another jurisdiction. However, the FSB KA recognizes that resolution authorities should be able to take discretionary national action, when necessary, to achieve domestic stability in the absence of effective international cooperation and information sharing.

Recognition and effect: Jurisdictions should provide for transparent and expedited processes to give effect to foreign resolution measures, either by way of a mutual recognition process or by taking measures under the domestic resolution regime that support and are consistent with the resolution measures taken by the foreign home resolution authority. Recognition or support of foreign measures should be provisional on equitable treatment of creditors in the foreign resolution proceeding.

Information sharing: The resolution authority should have the capacity in law, subject to adequate confidentiality requirements and protections for sensitive data, to share information with relevant foreign authorities, where sharing is necessary for recovery and resolution planning or for implementing a coordinated resolution. Jurisdictions should provide for confidentiality requirements and statutory safeguards for the protection of information received from foreign authorities.

Legal protection: The FSB KA provides for the protection for the resolution authority and its staff against liability for actions taken or omissions made in good faith domestically as well as in relation to actions taken in support of foreign resolution proceedings.

SUPERVISORY EARLY INTERVENTION IN BANKS

Early identification of problem banks and prompt remedial action is important to mitigate increased moral hazard risk.

13. The BI is empowered to adopt a broad range of measures against the banks, graduated to the gravity of the situation. The BL empowers the BI to take different measures when a bank is not in compliance with any applicable laws and regulations, or when the sound and prudent management is at risk. The measures are graduated depending on the seriousness of the case. The BI can carry out the following:

- **early intervention measures**, such as convening the governing bodies of the bank to examine its solvency and liquidity situations and identifying the appropriate solutions (article 53(3)(a)); requiring the call of or directly calling the bank collective bodies, such as the general meeting of shareholders, the Board of Auditors, or the Board of Directors, to discuss specific proposals (article 53(3)(b) and (c));

- **specific prudential measures**, such as the restriction of the activity; ban for specific operations; restriction on payments of dividends and on remuneration; and capital add-ons (article 53(3)(d)); and

- **other special measures**, such as closure of branches and prohibition of new transactions (article 78).

In more serious cases, the BI can propose to the MEF to commence SA or CAL.

14. The BI is also empowered to apply pecuniary administrative sanctions where any bank does not comply with the relevant supervisory provisions. In particular, Article 144 of the BL states that the BI may apply fines on banks' corporate officers for noncompliance with any applicable laws, regulations, and specific measures set out by the BI.

15. The BI, however, does not have powers to apply pecuniary sanctions at the bank level. Except for breaches of anti-money laundering requirements, the BI can only apply the sanctions at the individual level, not on the entity. The BCP assessment has highlighted these shortcomings, some of which will be addressed by the authorities in line with the upcoming Capital Requirements Directive (CRD) IV directive. The authorities should proceed swiftly to provide for all these powers in the BL.

16. The BI has no powers to remove and replace or suspend Board members, managers, and auditors. While the BI can require the bank to convene, or directly convene, a general meeting to decide on the dismissal of Board members, the outcome is still subject to the vote of the general meeting. Recent experience has highlighted this shortcoming, as moral suasion had to be relied upon to impel management changes at MPS. The BCP assessment of Core Principle 11 has highlighted this problem. The BI considers that this issue will also be addressed when the CRD IV directive is transposed into Italian law. The latest draft of the CRD IV directive provides that the supervisor should have the power to temporarily ban the bank's managers from exercising functions in financial institutions. However, in addition to a temporary ban, there should also be explicit powers of removal and replacement. The BI should also be empowered to remove and replace statutory auditors of a bank.

17. While the RRP process is underway for UCG, there is no clear regulatory framework for RRPs. The BI currently relies on its general power to obtain information to require the preparation of UCG's recovery plan. The lack of a legal basis for RRPs has, however, led to difficulties in obtaining the relevant information from the Polish subsidiaries of UCG (Box 2), as a result of which the RRP may not sufficiently take into account the Polish operations. The authorities should provide a statutory basis for RRPs as soon as possible, and develop comprehensive guidelines on what the recovery plans should cover. This should be required not just for G-SIFIs, but also for systemically important domestic banks.

CRISIS MANAGEMENT TOOLS

The tools for crisis management and bank resolution should include solid but flexible arrangements for official financial support (emergency liquidity assistance and solvency support) of banks; prompt intervention with robust resolution powers for banks as a going concern; a mechanism for orderly liquidation as a gone concern; and a well-designed deposit guarantee scheme.

A. Official Financial Support

Solvency support

18. The official sector provided a range of measures to support the banking system, which helped preserve financial stability. Between October 2008 and February 2009, a series of measures were announced by the authorities.

a. **Liquidity support:** Government guarantees and swaps for bank liabilities (Decree Law (DL) 157 of 2008, converted into Law 190/2008) were offered to banks, and also to nonbanks that swapped assets with banks. These powers expired unused at the end of 2009. A Collateralized Securities Loan Facility (CSLF) was established under which the BI could exchange government securities with assets held by Italian banks with ratings lower than eligible for Eurosystem operations. The CSLF was capped at a maximum of EUR 40 billion, the maximum maturity of the swap was one month, and 1 percent commission was charged by the BI. The value of transactions undertaken under the CLSF was in aggregate EUR 5.4 billion, and the last transaction was in March 2009. The BI also established a collateralized interbank market (MIC) under which it guaranteed collateralized interbank deposits with maturities of one week or longer. The outstanding amount of guaranteed deposits traded in the MIC reached EUR 10 billion before the facility expired at the end of 2010.[14]

b. **Deposit guarantee:** The authorities announced powers to afford a state guarantee to protect deposits against bank failures (including for deposit balances over the deposit insurance limit) for three years until October 2011.[15]

c. **Capital support:** In October 2008, the authorities announced powers to strengthen the capitalization of distressed banks (DL 155 of 2008, converted into Law 190/2008). These allowed the MEF to subscribe to capital increases by banks or bank holding companies deemed by the BI to be undercapitalized. The shares would not carry voting rights but would be accompanied by a stabilization and strengthening plan overseen by the BI, including constraints on dividend payments. This EUR 20 billion facility expired unused at the end of 2009. In November, a second recapitalization scheme (DL 185 of 2008, converted into Law 2/2009) was launched. Originally envisaged as providing support of EUR 10 billion to EUR 20 billion, it was announced with the objective of promoting bank lending. Ultimately, only four banks, the largest being MPS, accessed the facility, issuing EUR 4 billion of so-called 'Tremonti' bonds, eligible as core tier 1 capital. MPS has gone on to receive significant further official support (Box 4).

19. These measures helped preserve depositor confidence and maintain financial stability without entailing significant outlays by the authorities. Most banks strengthened their buffers instead by raising capital from core shareholders, selling nonstrategic assets, and cutting dividends without accessing the capital bonds and other support (e.g., liability guarantees). The deposit guarantee was a contingent liability and actual public outlays were low in comparison with other countries directly hit by the global financial crisis.

20. Capital support should be constructed in a way that first attributes losses to shareholders. Shareholders and subordinated creditors should be written off before new capital is injected and other measures adopted to mitigate moral hazard, such as quickly replacing the Board and culpable senior managers, and placing restrictions upon compensation to management and dividends to shareholders. Plans should also be put in place to secure new capital from shareholders with a clear and credible exit strategy mapped for the official sector support. In the interim, adequate control should be in place to reduce the risk of further losses accruing to the sovereign.[16]

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[14] For further details, see BI Economic Bulletin, January 2009 and Financial Stability Report, December 2010.

[15] In DL 155 of 2008, converted into Law 190/2008, but which required secondary legislation to formally implement, which was not issued.

[16] For example, see preamble to the KA, which provides, amongst others, that a resolution regime should make it possible for shareholders and unsecured creditors to absorb losses and that the regime should be credible and enhance market discipline.

21. MPS, under its new management is undergoing an ambitious restructuring, but there is uncertainty regarding the timing of its exit from state support. The latest public recapitalization scheme provides MPS with incentives to restructure and secure new private capital: the recapitalization instrument (so-called "Monti bonds") carry a high (9 percent) and escalating coupon, payable in cash or, if the bank is making losses, shares. In such a case, the state would own 35 percent of shares by 2015.[17] To avoid this outcome, MPS's new management is implementing a restructuring plan involving revamping services, cutting staff and administrative costs, closing branches, deleveraging limits on compensation and dividends, and ultimately raising new private capital. But this plan is ambitious, has to be implemented under difficult economic circumstances (the deleveraging assumed, particularly if accelerated due to funding pressures, could further impair loan quality), and is subject to change as it requires the approval of the European Commission (under state aid rules). While the state is providing EUR 4 billion of capital (1.6 times current market capitalization), dilution would only occur over time and, in the interim, the state is not represented at the Board and is reliant on the new management and BI supervision to protect its interests. This, along with the bank's reliance on LTRO funding and the likely future dilution by the state, draw into question where the EUR 1 billion of new private capital assumed in the plan might be secured from.[18] Intensified oversight by the BI should continue and the authorities should prepare contingency arrangements to assume earlier control, if necessary, to minimize the ultimate costs to the state of the resolution.

Liquidity assistance

The framework for emergency liquidity assistance should allow the state or an official agency (in particular, the central bank) to provide rapidly, and in a legally robust manner, emergency liquidity to illiquid but solvent banks. The liquidity provider should have tools to manage credit risks, including collateral requirements.

22. The BI as a member of the Eurosystem may provide emergency liquidity assistance (ELA) within the constraints of the system. The BI has the power to provide ELA on the basis of Article 35 of its Statute, which endows a broad provision to take all the actions and operations necessary to perform the BI's tasks not related to the European System of Central Banks. The possible recipients are banks that are solvent but which face a temporary liquidity shortage and which are able to provide adequate collateral. While granting ELA remains a decision of the National Central Bank (NCB) carried at its own risk, liquidity support through ELA is granted in accordance with the general guidelines agreed by the Governing Council of the ECB. In particular, the NCB must provide the ECB with a predefined set of information, also depending on the relevant amount of the ELA and depending on circumstances may require prior approval from the governing council

[17] Assuming a share price at EUR 0.20 and a 30 percent discount to the market price for conversion. Early repayment incentives are also incorporated into the repayment price, which increases by 5 percent every two years after 2015. From 2018, the bonds will also no longer be eligible as CT1.

[18] Subsequent to the FSAP, the 4 percent cap on private (non-Foundation) shareholdings was in July 2013, removed at a shareholders' meeting.

because these operations my interfere with single monetary policy.

23. During the crisis, the BI intensified its liquidity monitoring and oversight of risk management at leading institutions. Weekly liquidity reporting requirements were introduced for the large banks, which were also required to report counterparty risk and stress tests results regularly. BI oversight of risk management and the contingency plans of banks were stepped up and targeted inspections were undertaken. The terms and conditions for accessing and securing ELA are not disclosed to the banks in advance. While recognizing the need for flexibility, and that coordination between the Operations and Supervision Department seems to have worked well in practice, the BI may wish to formalize internal guidance on the conditionality that should be imposed on recipient banks, including for on-site and off-site supervisors and other measures to enhance supervision, which is currently applied on an informal basis. These would be important if a request were received from a bank not already identified as high risk (with a five or six SREP[19] rating) and not yet subject to enhanced supervision. Some of these aspects might also be publicly disclosed to improve transparency, without overly restricting the BI's flexibility, as consistent with the Eurosystem guidelines.

24. The current format for publishing the monthly balance sheet of the BI could undermine the effectiveness of ELA. The BI publishes a monthly balance sheet in the Eurosystem format, from which a disbursal of a significant value of ELA could be inferred and its amount roughly estimated. The single case of bilateral liquidity assistance reported by the BI during the crisis was an asset swap (with MPS in the fall of 2011) and as such was not recorded under this line item. The line item also includes non-ELA related transactions and since 2008, has fluctuated between EUR 100 million and EUR 3 billion. Revealing information on ELA shortly after it is disbursed could undermine its effectiveness as a tool to preserve stability by covering temporary liquidity needs at a solvent institution. Financial stability considerations may therefore justify flexibility in both the content and timing of the disclosure of information relating to ELA provision.[20] In this regard, consideration should be given at least to adopting a different format, with less granularity in the BI's monthly accounts.[21]

[19] SREP is the Supervisory Review and Evaluation Process of the BI.

[20] For example, see the explanation by the Bank of England on withholding details from its annual report and only reporting ELA to HBOS and RBS on a delayed basis: http://www.bankofengland.co.uk/publications/Documents/other/treasurycommittee/financialstability/ela091124.pdf. See also IMF Code of Good Practices on Transparency in Monetary and Financial Policies, http://www.imf.org/external/np/mae/mft/code/index.htm

[21] ECB Guideline (ECB/2010/20) does not require NCBs to apply the same reporting standards to national reports, it only recommends they do "to the extent possible" for consistency and comparability reasons.

Box 4. Recapitalization Bonds

Tremonti bonds

- Tremonti bonds are debt securities (bonds) issued by the banks and are perpetual, subordinated and hybrid, designed to augment Tier 1 capital of the issuing banks. The MEF could subscribe to these between February and December 2009.
- They were issued by four banks for a total of EUR 4.05 billion: Banco Popolare (BP) (EUR 1.45 billion), Banca Popolare di Milano (BMP) (EUR 0.5 billion), MPS (EUR 1,900 million) and Credito Valtellinese (CV) (EUR 200 million).
- The coupons of the Tremonti bonds are non-cumulative and paid only when there is distributable income. The rate steps up from 7.5 or 8.5 percent to 11 percent by 2019. The issuer could repay them, subject to the BI's determination that this would not jeopardize the bank's financial stability, or convert them into shares by 2019. From 2018, the bonds will no longer be eligible as core Tier 1 capital under Basel III.
- Banks issuing these securities must undertake not to delist their shares, effect a capital decrease, pursue aggressive expansion policies, or otherwise abuse the aid received. In addition 'social conditions' were attached on lending to small and medium-sized enterprises, loan collection for individuals laid off or unemployed were suspended, and limits set on the remuneration of senior management and traders.
- BP fully repaid with interest of EUR 86 million, on March 14, 2011. The Tremonti bonds issued to BPM and CV remain outstanding. BPM incurred a loss of EUR 430 million for FY2012 and the Board has approved a rights issue for EUR 500 million. CV reported a loss of EUR 322 million for FY2012. The Tremonti bonds issued to MPS were converted into "Monti" bonds.

Monti bonds

- The second recapitalization of MPS was triggered by the EBA stress testing exercise, which identified a EUR 1.7 billion shortfall at end-June 2012, versus the 9 percent Core Tier 1 ratio. MPS received EUR 4.1 billion from the state on February 28, 2013. This comprised the redemption of the Tremonti bonds of EUR 1.9 billion (including EUR 171 million interest for FY2012), plus the EBA capital shortfall and a buffer (EUR 2 billion).
- Technically referred to as "New Financial Instruments," these bonds pay a high coupon of 9 percent, increasing by 0.5 percent each year until 15 percent. If there is no profit, the bank will pay the coupon with new bonds (limited to years 2012 and 2013) or shares, contrary to the previous Tremonti bonds, where coupon payments are only due if the recipient bank is profitable.

B. Orderly and Effective Resolution

In terms of concrete tools, a legal framework for bank resolution should include powers for intervention and resolution before a bank reaches actual insolvency (going-concern powers), as well as powers to close and liquidate a bank in an orderly fashion (gone-concern powers). The FSB KA has set out in further detail the resolution powers that should be included in effective resolution regimes—including purchase and assumption (p&a), bridge bank, and bail-in powers.[22]

EU Council position on BRRD

25. The recommendations that follow in this part are broadly consistent with the European Council position on the draft BRRD. The proposed directive establishes a range of

[22] See http://www.financialstabilityboard.org/publications/r_111104cc.pdf.

instruments to tackle potential bank crises at the preparatory and preventive, early intervention, and resolution stages, with powers to appoint a special manager and a broad range of resolution powers, including sale of business, bridge institution, asset separation, and bail-in (Box 5). The proposed BRRD is a minimum harmonization directive. Negotiations with the European Parliament on the BRRD are now scheduled to take place and the aim is to have the BRRD approved before the end of the year. The mission encourages the authorities to transpose the BRRD into domestic legislation[23] as soon as it is passed by the European Parliament.

The Italian framework

26. The resolution framework and toolkit have been used to resolve successfully small banks and one banking group during the crisis. The regime already extends to parent banks, banking groups,[24] and investment firms, and has two main sets of powers typically (although not necessarily) deployed sequentially. Box 6 includes a description of the main powers, the triggers, and the potential role of DGS in funding a resolution in different stages of intervention.

Box 5. European Council Position on BRRD

On June 27, 2013, the European Council set out its position on the draft BRRD. The draft BRRD sets out a broad set of powers to support recovery and resolution planning, early intervention and resolution that is triggered if a bank reaches the point of "non-viability." Institutions would be required to draw up recovery plans and to update them annually. Resolution authorities would have to prepare resolution plans for each institution. Authorities would have the power to appoint special managers and the resolution measures would include sale of all or part of a business, establishment of a bridge institution, the transfer of impaired assets to an asset management vehicle and bail-in measures.

The draft BRRD introduces, amongst others, deposit preference and bail-in.

- **Deposit preference**—the draft BRRD introduces tiered deposit preference in the resolution or liquidation of a bank. The provisions rank deposits of individuals and small and medium enterprises as well as liabilities owed to the European Investment Bank above other unsecured creditors, such as bondholders and large corporate depositors. Insured deposits (or the deposit insurance scheme subrogating to their rights) would rank above uninsured deposits
- **Bail-in power**—the draft BRRD sets out a detailed framework for imposing losses in resolution, including a requirement for shareholders and unsecured creditors to absorb losses up to at least 8 percent of total liabilities (including own funds) before other funding arrangements can be tapped. Some liabilities are excluded from bail-in *a priori* (e.g., insured deposits, trade creditors and inter-bank loans). Other liabilities can be excluded in "extraordinary circumstances" where specified conditions are met.

The draft BRRD will be negotiated with the European Parliament. It is expected to be approved by the European Parliament by end-2013, with implementation by Member States by end-2014 and the bail-in tool to apply from January 2018.

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[23] While the BRRD needs to be transposed into domestic legislation, the European Commission proposal on the Single Resolution Mechanism envisages a direct application of rules relating to the functioning of the mechanism to the euro zone member states.

[24] Articles 98 to 101 BL.

27. The framework includes well-specified resolution powers. A special administrator can be appointed by the BI when a bank has suffered serious capital losses or if there are repeated serious irregularities or violations of the law or regulations.[25] The administrator assumes the powers of the managers but cannot take decisions pertaining to shareholders. If the special administrator is unable to restore the bank to viability, a CAL can be triggered[26] based on the same grounds as an SA, if of an exceptionally serious nature. These powers can be used to suspend payments[27] and, in the case of CAL, trigger a license revocation, liquidation, and DGS payouts, as well as to transfer assets and liabilities (P&A powers) without requiring shareholder approval. For the period commencing from 2009 to March 25, 2013, 31 small banks and one banking group had been placed into SA. These banks had a median size of assets of approximately EUR 190 million, of which 10 banks subsequently went into CAL and the remainder were successfully returned to ordinary operations following SA.

28. The resolution powers were used effectively to preserve depositor confidence but may increase the cost to the DGS. In very few recent resolution cases have losses been shared with uninsured creditors, e.g., in one case, out of 31 recent resolutions, DGS funds were used to pay out only insured depositors in liquidation. In most resolutions, DGS funds were instead used to support the recovery or merger of the bank (so called "open bank assistance") or to fund the transfer of all creditors, not just deposits, to a purchaser in CAL. Such transfers, also known as P&A transactions can deliver significant benefits,[28] e.g., by preserving the continuity of service for depositors. But transferring only retail deposits or even just insured deposits (if possible) would typically entail lower cost to the DGS and less moral hazard,[29] as uninsured creditors would also bear losses. Protecting uninsured creditors may be necessary in a systemic crisis, however, according to the authorities, the option to only transfer deposits (only) would not currently be available even in benign conditions due to the interpretation of strict *pari passu* provisions in the civil code and insolvency law.[30] The significant issuance of bank bonds to retail investors is also a complicating factor and will require enhanced public education to raise awareness that these are uninsured liabilities and as such will be treated differently from deposits under the new resolution regime (see below). In line with the FSB KA, which emphasize the importance of burden sharing with creditors, powers to selectively transfer assets and liabilities, with an exemption from the *pari passu* requirement in accordance with KA 5.1, should be introduced along with a "No Creditor Worse off Safeguard." Under the latter, creditors

[25] Article 70 BL.

[26] Article 80 BL. The CAL can also be triggered independently, without the need to go through SA first.

[27] Article 74 BL.

[28] See Chapter 5 of "Closing a Failed Bank, Resolution Practices and Procedures," D. Parker (IMF, 2011).

[29] While the term moral hazard is often associated with public bail-outs there is a significant body of literature on the moral hazard effects arising from deposit insurance, a risk which is exacerbated if deposit insurance funds are used to rescue uninsured creditors.

[30] Under Article 2741 of the Civil Code and Article 11 of the Insolvency Law, creditors have equal right to be satisfied out of the debtor's assets.

should be able to claim compensation if they receive less than they would likely have recovered in liquidation.[31]

Box 6. Special Administration (SA) and Compulsory Administrative Liquidation (CAL) Powers

The Italian regime (see Figure 1) basically has two sets of administrative resolution powers one for going concern resolution (SA), applicable where the institution can be resolved with limited interference with shareholders' rights, and one for gone concern resolution in more serious situations, requiring stronger powers of the authorities and more interference with shareholders' rights (CAL). These typically are deployed sequentially, with CAL following SA if a recovery of the firm cannot be effected under SA. These powers pertain to banks, investment firms, insurance companies and financial market infrastructures (see Appendix I for details on the legislation which applies to each). For banks and insurance companies, the powers also apply to holding companies and non regulated entities in the group.

Special Administration: The MEF acting on a proposal from the BI can trigger SA which normally can last for up to one year. In urgent cases the BI can take an intermediate step, without requiring approval from the MEF, of appointing a provisional manager (PM, article 76 of BL) for a maximum of two months. SA (and PM) can be requested by management or shareholders, or triggered by the authorities in case of:

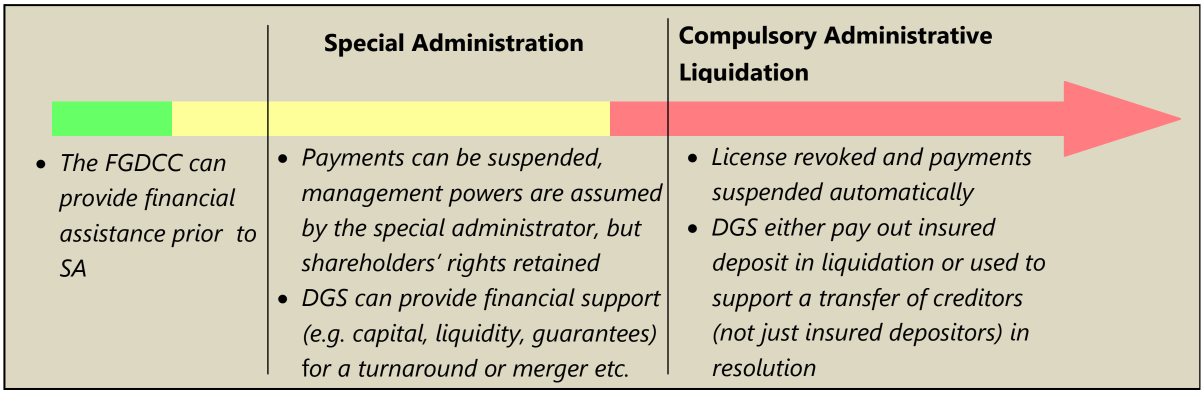
i) serious administrative irregularities or serious violations of laws governing the bank's activities;
ii) serious incurred or expected losses to capital; and
iii) a serious shock to the bank or group, including liquidity related, which could threaten the stability of the financial system (this new trigger was introduced by DL 155, 2008).

Under SA, the BI appoints one or more special administrators (individuals not firms) and an oversight committee (of three to five members). The special administrator assumes management powers with the aim of turning around the bank if possible and may propose a restructuring plan to implement a merger, acquisition, or sale of assets. The DGS can financially support these measures with guarantees, liquidity or capital injections on the basis of a "least cost assessment." Under SA, the shareholders maintain the right to decide upon any transaction that would normally be subject to their approval e.g., to approve a merger, large divestments, new capital issues etc. Subject to the authorization of the BI, the administrator(s) may suspend payment of the bank's liabilities (for up to three months under exceptional circumstances), without triggering insolvency. In almost two thirds of the 25 procedures completed between 2009 and early 2012, the institutions returned to ordinary administration, at times following mergers (Bank of Italy, Financial Stability Report, April 2012, p. 34).

Compulsory Administrative Liquidation: The MEF, acting on a proposal from the BI, can withdraw the license of a bank and commence CAL if the administrative irregularities, violations of laws or the capital losses are exceptionally serious or in the case of (iii) above. Liquidators can take any decision concerning the restructuring without shareholder approval. The law allows the liquidator under the authorization of the BI, to transfer assets and liabilities, the business or parts of the business to a third party. Transfers may be carried out at any stage once CAL is initiated although the authorities report that typically they are effected during the first days of the procedure thus ensuring the continuity of critical financial services and the protection of depositors as well as preserving value and reducing the resolution costs. The DGS may on the basis of a "least cost assessment" decide whether to pay out the depositors or fund the transfer of deposits and other creditors which rank "pari passu" to a purchaser (e.g., by covering the shortfall between assets and liabilities).

[31] See "Bank resolution and safeguarding the creditors left behind," G. Davies & M. Dobler (Bank of England, 2011) for further details.

Figure 1. Current Regime



29. **The mission also recommends introducing depositor preference.** Under the current creditor hierarchy in the insolvency law, eligible deposits (those eligible for deposit insurance coverage) rank *pari passu* with other senior unsecured creditors such as bondholders (both retail and wholesale). In a payout, the DGS subrogates for eligible deposits in the creditor ranking and eligible depositors only receive balances over the deposit insurance limit of EUR 100,000 if the costs of the DGS are first recovered in full. This ranking is, however, only observed in liquidation. In most interventions, whether in SA or a P&A under CAL, all creditors are typically, in practice, made whole. This may still be cheaper for the DGS than liquidation (the only alternative under the current regime), as liquidation lasts many years in Italy (typically five to eight years) and, as a result, recoveries are low. The authorities highlighted that the high proportion of deposit funding of resolved banks and the going concern value secured through prompt and effective use of the CAL powers were also contributory factors. But as noted above, resolution could be cheaper still if DGS funds did not need to be used outside of liquidation to rescue all senior creditors. This would be greatly facilitated if insured deposits, and potentially all eligible deposits (see deposit preference options in Table 2 below) were preferred over other senior unsecured creditors. Box 8 explains how compensation claims and legal challenges could otherwise arise if losses were imposed on uninsured creditors in resolution without revising the creditor hierarchy.

Table 2. Italy: Current and Proposed Creditor Hierarchies

<table>
<tr><th colspan="2">Current Creditor Hierarchy in Liquidation</th><th>Tiered Deposit Preference</th></tr>
<tr><td>Insured/covered deposits and DGS (subrogated for insured deposits paid out)</td><td rowspan="3">Other senior unsecured creditors (e.g., both retail and wholesale bondholders)</td><td>Insured/covered deposits and DGS (subrogated for insured deposits)</td></tr>
<tr><td rowspan="2">Eligible deposits over EUR 100,000</td><td>Eligible deposits over EUR 100,000[32]</td></tr>
<tr><td>Other senior unsecured</td></tr>
</table>

30. The introduction and form of depositor preference should be informed by quantitative impact assessment. In the long run, altering creditor hierarchies might not significantly change average bank funding costs (e.g., higher costs for less-preferred might be offset by lower costs on more preferred unsecured funding). However, in the short term, the higher cost or reduced availability of wholesale funding might exacerbate current vulnerabilities to liquidity stress or create incentives for deleveraging. Subsequent to the mission, the European Council agreed to recommend a form of tiered deposit preference (see Box 5 for the Council's position on the BRRD).

31. Additional safeguards should be introduced with respect to the use of DGS resources in resolutions. A statutory test[33] should be introduced in the BL to ensure that any assistance provided by the DGS is least-cost, net of estimated recoveries. The ability of one DGS (the FGDCC) to be able to provide open bank assistance (OBA) before SA is triggered needs to be reviewed. International experience suggests that the costs of OBA often prove larger than expected *ex post* because the extent of the problems are initially underestimated by authorities.

32. As planned under the proposed BRRD, the resolution toolkit should be expanded. Powers to prevent shareholders blocking recapitalization, or mergers and acquisitions, as well as to override any caps on shareholder voting rights should be introduced. The BI should have the express power to override shareholders' voting and pre-emptive rights. In addition, as envisaged in the draft BRRD, bridge bank, bail-in, powers to establish asset management vehicles and to afford a temporary stay on financial contracts should be adopted. As noted in the EU FSAP, these powers should be afforded the full flexibility specified in the KA.[34]

33. The triggers for the resolution powers should allow for their deployment at an early juncture when the firm is no longer viable or likely to be no longer viable. Currently, the SA powers benefit from the past favorable experience of the creditors of problem banks, in most cases

[32] Eligible deposits are those of natural persons and micro, small and medium-sized enterprises. Liabilities to the European Investment Bank also rank higher than ordinary unsecured, non-preferred creditors.

[33] The least-cost requirement is currently set out in the statute of the DGS, which is required under the BL to be approved by the BI. The statute of the DGS however does not have the same legal standing as the BL.

[34] See Box 1 of "European Union: Financial System Stability Assessment," IMF Country Report (13/75).

with banks successfully recovered under SA or resolved using CAL powers without losses being imposed on uninsured creditors. The mission considers that under the envisaged BRRD regime, which includes bail-in powers and deposit preference, there will be a greater likelihood of losses being incurred by uninsured creditors. This may undermine the current stability of the SA regime, in particular, appointing a special administrator, which is publicly disclosed, if it entails a reasonable prospect of losses being borne by uninsured creditors (such as in a bail-in) would entail a higher risk of triggering creditor flight.[35] The mission considers that this may accelerate the need to deploy the resolution powers, and these powers should be available accordingly, but not necessarily be deployed at an early juncture. While maintaining the ability to appoint a special administrator in accordance with the BRRD, the mission recommends that triggers be introduced to allow for the use of resolution powers such as bail-in, P&A, bridge-bank, etc., to be deployable when the firm is no longer viable or likely to be no longer viable. The mission recommends that these triggers be based upon quantitative, when regulatory liquidity or capital requirements are seriously breached and qualitative triggers of nonviability. When triggered, there should also be no automatic revocation of license, as is the case in the current CAL procedure. Certain tools, such as recapitalization and bail-in, would not work if the license of the bank is automatically revoked.

34. The BoI should develop a comprehensive set of internal guidelines and procedures for implementing the existing and new resolution powers. The BI should develop and enhance internal guidelines, procedures (including preparing draft contractual arrangements) for undertaking the new and existing resolution powers, e.g., in the form of a resolution handbook.

35. The scope of judicial review needs to be limited. Although the current system provides for strong deference to the specialized expertise of the BI and reversal by the courts is almost unprecedented, in theory, the decisions taken by the BI may be suspended or reversed in case of appeal. The remedies that the court can award are also currently not limited to monetary damages and could trigger the unwinding of transactions. The courts' powers to suspend or reverse resolution measures should be revoked and redress should be limited to compensatory damages only.

C. Deposit Guarantee Scheme

Introduction

36. The Italian DGS consists of two schemes, banks incorporated as joint-stock companies and cooperative banks are covered by the FITD and mutual banks are covered by the FGDCC (see Box 6. On DGS and Cooperative/Mutual Banks in Italy). The DGS are required to comply with EU DGS Directive 94/10/EC of 30 May 1994, amended by Directive 2009/14/EC of March 11, 2009[36] (EU DGS Directives).

[35] During SA creditors are free to withdraw their funds in accordance with their contractual terms.

[36] The framework for the DGS is set out in section IV of title IV of the BL and further elaborated in the statutes and by-laws of the respective DGS. Changes to the statutes and by-laws of the DGS are subject to the approval of the BI.

37. Both DGS are private-law consortia among banks administered by representatives of member banks and supervised by the BI. They are primarily entrusted with depositor payout in liquidation, but have a broad mandate to provide guarantees, credits, and acquire equity and fund P&A transactions, provided that it is less costly than a payout. Such interventions are subject to the approval of the BI. Both DGS are able to obtain information from their member banks for the purposes of carrying out risk assessments.

Scope and coverage levels

38. Membership is compulsory. As of December 31, 2012, there are 241 member banks in the FITD and 398 in FGDCC. Members include Italian banks and their branches in EU countries, Italian branches of EU banks, and non-EU banks.

39. In line with EU DGS directives, coverage is EUR 100,000 per depositor per bank and payout has to be made within 20 working days. The total value of covered deposits as a percentage of eligible deposits covered by the FITD is 68.7 percent, while that of the FGDCC is 65 percent. The FTID and the FGC have had to make very few cases of payout, as most cases are resolved using the transfer of assets and liabilities, with DGS support. However, in the few cases of payouts in recent times, e.g., Banca Network, the DGS have been able to effect a deposit insurance payout within the 20-day period. In line with evolving international best practices to boost depositor confidence, the payout period should be reduced to seven days.

40. The case for having two separate DGS in Italy should be reassessed. The distinct characteristics of, and close inter-relationships amongst the Banche di Credito Cooperativo, which, for example, co-owns a central clearing hub and has regional oversight bodies, provide the historical context for the two schemes. This should be balanced against potential improvements that would arise from rationalization, e.g., diversification benefits if insurance coverage were across the whole banking sector, economies of scale in managing ex ante funds (once they are introduced), and simplified depositor communication and education.

Governance

41. The governance of the DGS should be revisited to remove active bankers. Active bankers currently sit on the Boards and Executive Committees of the DGS. The BI is not represented on the Board and Executive Committee, but a delegate attends the meetings. The Executive Committee decides on most interventions. To the extent that they are privy to commercially sensitive information, there is a risk of conflicts of interests. Further, access to such information might be unduly exploited by competitor banks. While the FITD statute seeks to address conflicts of interest by precluding a Board member from attending meetings (the FGDCC statute has a similar provision in relation to the Executive Committee, but not the Board), if there is a conflict, the other active bankers nevertheless will have access to information. The mission recommends that active bankers should be removed from the Boards and Executive Committees and replaced with independent members. Consideration could also be given to including voting representatives from the MEF and BI.

42. Steps can be taken to continue to keep the banking community informed and consulted. A bankers' consultative committee, distinct from the Board and Executive Committee, could be established to keep the banking community informed and consulted on major policy changes, while protecting the confidentiality of the system.

Box 7. DGS and Cooperative/Mutual Banks in Italy

There are two different types of mutual banks in Italy and these are covered by two different DGS. Large cooperative banks—Banche popolari (BP)—and joint stock banks are covered by the FITD. The smaller mutual banks, Banche di credito cooperativo (BCC), are covered by the FGDCC.

Shared features of BP and BCC

- Both BP and BCC are cooperative banks, and subject to the governance principle of "one member one vote" and to special legal rules reflecting the mutual nature of these banks, such as legal limits to shareholdings for each member, minimum number of members (200), specific prescriptions governing the distribution of profits (see Articles 28 to 37 BL).

Differences between BP and BCC

- The operations and membership of BCC are subject to geographical restrictions: members must have their home or their place of business in the area of the bank's operations (Article 34(2) BL); the bank should grant credit primarily to its members, in compliance with the geographical operating limits and the other restrictions laid down by the BoI (Article 35 BL and Circular 229/1999, Title VII, Chapter 1).
- The distribution of profits to BCC members is strictly limited. At least 70 percent of net profits for the year (only 10 percent in BP) must be allocated to the legal reserve, and a portion of the profits must be paid into mutual funds for the promotion and development of cooperation (Article 37 BL). Only BP may be listed companies.

DGS	Number of Members (Dec. 2012)	Eligible Deposits billion euros (Jun. 2012)	Insured Deposits billion euros (Jun. 2012)
FITD	241	693	476
FGDCC	398	102	66

Funding

43. The DGS are both ex-post funded. Contributions are provided by participants as and when required. Member banks are committed to making available to the DGS the amount of resources required for interventions. For the FITD, this amount varies between 0.4 percent and 0.8 percent of the total covered deposits and is partially risk-adjusted. For the FGDCC, the rate is 0.8 percent of total deposits and the contributions are not risk-adjusted.

44. The DGS should move to an ex-ante funded scheme, with access to credible back-up funding. Although ex-post funded, both DGS have thus far been able to raise funds quickly to support transfers of assets and liabilities and, in the rare cases, deposit payout. However, the experience of the financial crisis highlighted the importance of DGS having unambiguous and immediate access to reliable funding sources. Further, ex-ante funded schemes underpin the credibility of the DGS by providing greater assurance to depositors on the ability of the DGS to make a fast payout, reduce the pro-cyclical impact of obtaining funds from surviving banks, and contribute toward perceived fairness by imposing a cost burden on the failed bank. This mission notes that this recommendation is also in line with current proposed amendments[37] to the EU DGS Directives as well as the European Council proposal for the draft BRRD.

45. The MEF could provide a credible source of back-up funding. As noted above, one of the crisis response measures was the announcement of powers to afford a state guarantee to protect deposits against bank failures (including for deposit balances over the deposit insurance limit) for three years. This expired in October 2011. There is currently no arrangement for back-up funding for the DGS. To ensure credible back-up funding, an unsecured credit line from the MEF should be made available at market rates.

Public awareness

46. Efforts should be made to assess and enhance public awareness. While information regarding the list of members is available on the DGS websites and member banks are required to inform depositors, a 2008 survey of household and income covering almost 8,000 households showed that awareness of the DGS is only about 30 percent, with 23 percent possessing only basic knowledge. An updated assessment of public awareness should be carried out and if found wanting, efforts should be made by the DGS, BI as well as the member institutions to increase public awareness of the existence and limits of deposit insurance.[38] This should focus on ensuring clarity as to what financial instruments are covered or not covered by deposit insurance, e.g., the public should be aware that retail bonds are not covered.

Single customer view

47. The mission supports the FITD's initiative for banks to implement a single customer view (SCV) recordkeeping. The FITD is considering whether to require banks to implement SCV recordkeeping. The SCV is critical to facilitating the reimbursement of insured deposits, enabling a shorter payout period of seven days. In the absence of such a system, the DGS will have to sort and

[37] Based on publicly available drafts. The mission is not privy to the ongoing discussions on the draft directive but understand that the proposal for ex-ante funding is still current.

[38] BCBS-IADI Core Principles for Effective Deposit Insurance Systems (June 2009).

aggregate accounts itself, and this may cause a delay in making payments to insured depositors in larger banks. In this regard, banks should be given a reasonable but relatively short timeframe for implementation (e.g., two years).

LEGAL PROTECTION

A strong crisis management framework should include provisions which sufficiently protect the supervisory and resolution agencies as well as their employees in the employment of the respective tools to address the crisis.

48. Employees of supervisory agencies and resolution authorities should be able to exercise their professional judgment and take necessary action where the circumstances require, and should not be inhibited by the threat of lawsuits against their actions. In the context of crisis management, liability may occur when the supervisory or resolution authority failed to take any action notwithstanding the knowledge of serious problems in the bank, when measures were inadequate in response to the problems or when a shareholder or creditor of a bank challenges the appointment of a special administrator, commencement of CAL, or other resolution measures. Hence, it is important that liability should accrue only in the event of gross negligence or willful misconduct on the part of the supervisory authority, resolution authority or its employees. Further, if the employees face personal action and have to defend the proceedings, they should have recourse to resources for defending the proceedings, including being indemnified for legal costs and expenses.

49. Legal amendments have been made to enhance legal protection. The law has been amended since the last FSAP to provide for legal protection. According to Article 24, paragraph 6, of Law no. 262 of 2005, the BI, the components of its governing bodies and its employees, are responsible only if the acts committed in the exercise of their functions, are grossly negligent or committed intentionally. Despite this express protection in the law, the BI has nevertheless faced a number of legal challenges relating to the SA and CAL procedures.[39] Further, the protection afforded under the law was limited to the extent that employees had to bear upfront the legal costs. Under BI's terms of employment (and until recently, employees are reimbursed for costs incurred for legal assistance in lawsuits related to the exercise of their functions, after the judgment absolving the employee has become final. This is undesirable, as the threat of legal action and exposure to costs may affect the employee's supervisory judgment and could lead to forbearance in some cases.

50. A recent BI Board decision has focused on this problem, but the legal framework should be amended accordingly. On December 18, 2012, the Board of BI made a decision to allow the anticipation of reimbursement to staff in cases of legal suits. The assessment of the BCP Core Principle 2 in January 2013 noted this welcome development, the effectiveness of which will be

[39] Between 2008 and 2012, SA measures have been challenged in court on 25 occasions and CAL measures on 9 occasions. These cases largely related to challenges on the triggers for commencing SA and CAL. None of the SA or CAL cases have thus far been decided against the BI.

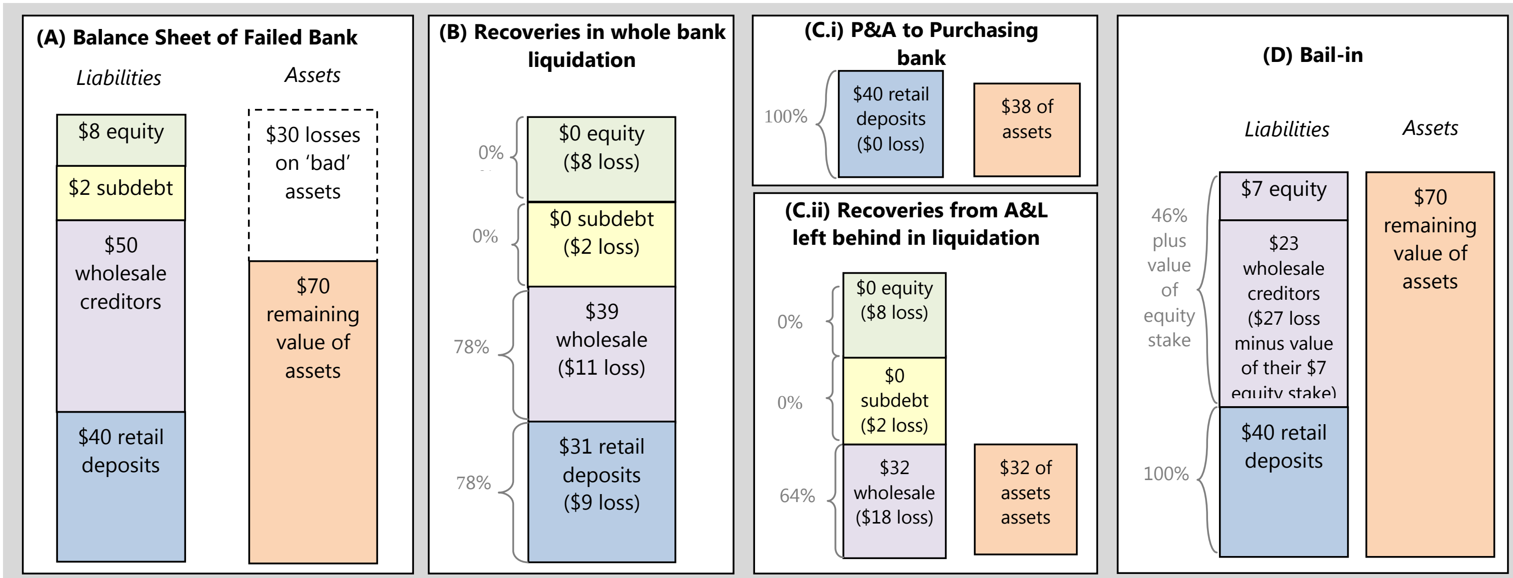
assessed only at the next BCP assessment. Since the time of the mission, the Board decision has been implemented via BI Circular No. 283 of April 15, 2013, which provides for an ex-ante indemnification for costs. The mission recommends, nevertheless, that such indemnification be supported by a statutory backing and the legal framework be amended to expressly provide for an ex-ante indemnification of costs.

51. The special administrator and liquidators also enjoy a form of legal protection against civil actions. Under the BL,[40] BI's authorization is required before civil action can be brought against the special administrator or members of the oversight committee appointed in SA, or against a liquidator or members of the oversight committee in a CAL for actions committed during the performance of their duties. In the event that the BI decides that no action can be commenced, the recourse is an appeal against the BI decision.

52. However, no legal protection is afforded to the DGS. As the DGS both play a role in resolution proceedings, in particular, providing funding assistance for assets and liabilities transfers, the DGS and their employees should also enjoy a similar degree of legal protection as that of the BI or the special administrator/liquidator.

[40] Articles 72(9) and 84(6) BL.

Box 8. Litigation and Compensation Risks if Creditor Treatment Diverges from the Creditor Hierarchy



The example shows how a P&A (panel C) or bail-in (panel D) could disadvantage other creditors, giving them grounds to pursue compensation claims/litigation, if retail deposits are protected in a bank resolution but would rank pari passu with wholesale/other senior unsecured creditors in liquidation. Panel A shows a simple balance sheet of a bank which is insolvent due to a $30 loss on assets. Panel B shows estimated creditor recoveries in a whole bank liquidation assuming no liquidation costs (it should be noted that these would typically be high). Panels C and D show recoveries if resolution powers were instead used to effect a P&A or bail-in respectively, and in both all retail deposits are fully protected.

P&A: Panel C.i assumes that the purchaser accepts $2 more of liabilities than assets in the P&A with the difference constituting a purchase premium for acquiring deposits and assets. Equity, subordinated debt and wholesale deposits, together with remaining assets, are left behind and liquidated. If the bank's $100 book value of assets were worth only $70 in insolvency, the percentages in grey represent the net recoveries as a proportion of the original claims of each creditor class. Wholesale creditors incur an extra loss of $7 directly as a result of the transfer compared to whole bank liquidation. As in the latter they would have had an equal claim over the $70 remaining value of the assets with the transferred depositors and would have received $39 (78 percent of $50) instead of $32 (64 percent of $50).

Bail: in: In panel D bail-in powers are used to write down to zero equity and subordinated creditors, write down a portion of wholesale creditors' claims and convert a further portion of their claim into equity, without imposing losses on depositors. Wholesale creditors incur an extra loss of $16 minus the market value of their equity stake, compared to their losses in insolvency.

Appendix I. Resolution Legislation for Different Types of Financial Entity

Banks: The resolution regime for banks is currently provided in Articles 70 to 105 of the BL.

Investment firms: The resolution regime for investment firms is currently provided in articles 56 to 58 of the Consolidated Law on Finance issued in 1998 (Legislative Decree No. 58/1998).

Insurance companies: The separate regime for insurers and reinsurers is envisaged by the Code on Private Insurance (Legislative Decree 7 September 2005, n.209), which has been in force since 1978.

Financial market infrastructures: The relevant provisions are provided for by the CLF. This regime, which originally applied to Central Securities Depositories, was extended to Central Counterparties and Securities Settlement Systems in 2007.