CLEARY GOTTLIEB

ALERT MEMORANDUM

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Implementation and First Application of the BRRD in Italy

I. Introduction

Italy has recently adopted two Legislative Decrees (No. 180 and No. 181 of 2015)[1] aimed at implementing the EU Bank recovery and resolution directive ("**BRRD**").[2]

The first decree (the "**Resolution Decree**") applies to banks and banking groups and primarily implements the BRRD provisions related to resolution, while the second decree (the "**Amending Decree**" and, together with the Resolution Decree, the "**Decrees**") amends relevant provisions of the Italian Banking Act and the Italian Securities Act[3] in order to implement the BRRD provisions on recovery plans and to make additional changes required by the new resolution regime. The Amending Decree also regulates the resolution of Italian investment firms that are not part of a banking group.[4] While the Decrees generally mirror the text of the BRRD, there are several provisions that go beyond the mere transposition of the directive.

Shortly after the publication of the Decrees, the Bank of Italy and the Government took the first resolution actions under the new regime. In this memorandum, following a brief report on this first application of the Decrees, we summarize a few salient aspects of the Italian implementation of the directive.

II. The recent resolution of four Italian banks

The Bank of Italy has already applied the toolkit introduced with the Decrees in the resolution of four Italian banks (Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio della Provincia di Chieti), which were already subject to extraordinary administration (under Article 70 of the TUB). The resolution actions were adopted on November 21, 2015 and authorized by the Italian Ministry of Economics and Finance (the "**MEF**") on November 22, 2015.[5]

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1 Legislative Decrees No. 180 and No. 181 of November 16, 2015.

2 Directive 2014/59/EU establishing a framework for the recovery and resolution of credit institutions and investment firms.

3 Legislative Decree No. 385 of September 1, 1993, ("**TUB**") and Legislative Decree No. 58 of February 24, 1998, ("**TUF**"), respectively.

4 In this memorandum the term "banks" refers to all financial institutions that are subject to the new resolution framework.

5 The resolutions took effect as of 10 pm on November 22, 2015.

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The resolution measures adopted include:

i. the closing of the extraordinary administration and the entering of the original banks into administrative liquidation proceedings (*liquidazione coatta amministrativa*, *i.e.*, the bankruptcy proceedings applicable to Italian banks);

ii. the appointment of special managers and supervisory committees, replacing the functions of corporate bodies;

iii. the write-down to zero of reserves, share-capital and nominal value Tier 2 liabilities included in the bank's own funds, on the basis of a provisional valuation;[6]

iv. the transfer of the banking business to bridge banks (one for each of the four banks), except for the subordinated debt that is not included in the bank's own funds (which was left in the original banks subject to administrative liquidation); and

v. the transfer of non-performing loans (with a value reduced to €1.5 billion from an original book value of €8.5 billion) to a "bad bank"[7] (one "bad bank" for all four banks) that will cease to exist as soon as it sells or recovers the non-performing loans it holds.

Notwithstanding the small size of each of the banks involved (it is estimated that, in the aggregate, the four banks account for approximately 1% of total deposits in Italy), the Italian authorities held that a resolution action was "necessary in the public interest" (as requested by one of the conditions that must be met for an institution to be put in resolution).

The newly created national resolution fund (*Fondo di Risoluzione Nazionale* or "**FNR**") established on November 18, 2015 and managed by the Bank of Italy (through the new Resolution Crisis Management Unit described under III below) played a central role in the resolution of the four Italian banks. The total contribution by the FRN equals approximately €3.6 billion, including €1.7 billion to absorb losses in the original banks, €1.8 billion to recapitalize the new banks and €140 million to inject in the "bad bank" the minimum capital needed for its operations. The FRN is funded by the Italian banking sector and the liquidity required for its intervention in the resolution of the four banks was advanced by three large Italian banks through facilities at market rates with a maturity of up to 18 months.[8]

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6 Made in accordance with Article 25 of the Resolution Decree.

7 The "bad bank" is a newco that does not hold a banking license.

8 The European Commission approved the resolution of the four banks under EU state aid rules with four separate decisions announced on November 22, 2015. (The relevant press release is available here).

The write-off of the banks' subordinated debt in the hands of retail investors as part of the resolution measures has raised significant public controversy, which the Government is reportedly seeking to address through a fund to be managed by the Italian Deposit Guarantee Scheme, which will partially indemnify, on a case-by-case basis, retail holders who have been the victims of mis-selling.

III. The new Bank of Italy Resolution and Crisis Management Unit

A new Resolution and Crisis Management Unit within the Bank of Italy has been entrusted with the resolution powers and functions performed by the Bank of Italy as the Italian National Resolution Authority (or "**NRA**").[9]

In addition to all resolution powers (including sanction powers) provided under the Resolution Decree, the new unit has authority over administrative liquidation proceedings,[10] while early intervention powers[11] are retained by the Department of Financial Supervision of the Bank of Italy. In order to ensure operational independence and to avoid conflicts of interest between the resolution and supervision functions, the new unit reports directly to the Governing Board (*Direttorio*) of the Bank of Italy. This is in line with the BRRD,[12] which expressly requires these two functions to be kept separate when implementing the directive.

The Resolution Decree requires that the Bank of Italy obtain prior approval[13] from the MEF before placing an institution into resolution. In this respect, in an opinion released in October in connection with the drafts of the Decrees (the "**ECB Opinion**"),[14] the ECB invited the MEF to consider whether its role should be limited to instances in which it is required under the BRRD, *i.e.*, when the resolution measures have a direct fiscal impact or systemic implications.[15] Otherwise, in the ECB's view, the MEF may be regarded as a second resolution authority, in which case measures should be in place to ensure the operational independence of its resolution functions. However, the final text of the Resolution Decree does not expressly limit the role of the MEF to such instances, possibly because the relevance of a direct fiscal

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9 The Bank of Italy has been designated as NRA by Article 3 of Legislative Decree No. 72 of May 12, 2015 and Article 8 of Law No. 114 of July 2015 (*Legge di delegazione europea 2014*).

10 Pursuant to Article 80 of the TUB.

11 Including functions related to the extraordinary administration (*amministrazione straordinaria*) proceedings provided under Article 70 of the TUB.

12 See Article 3, paragraph 3 of the BRRD.

13 See Article 32, paragraph 2 of the Resolution Decree, pursuant to which "*the approval of the MEF is condition of effectiveness of the measure* [that places an institution into resolution]".

14 See the ECB Opinion of October 16, 2015 on recovery and resolution of credit institutions and investment firms (con/2015/35), Italy (available here).

15 See Article 3, paragraph 6 of the BRRD.

impact or systemic implications has been considered an integral part of the evaluation of the public interest that must support a resolution action (in accordance with Article 32, paragraph 1, let. *c*) of the BRRD).

IV. Depositor preference

Article 108 of the BRRD requires Member States to grant preference in insolvency ranking to covered deposits[16] and non-covered deposits held by individuals and small and medium-sized enterprises. The Amending Decree goes one step further by making "other deposits" (*i.e.*, deposits that are not covered by Article 108 of the BRRD) senior – in case of insolvency – to other unsecured debt of the bank. However, the Amending Decree provision providing enhanced protection to other deposits will enter into force in 2019.[17]

In particular, in liquidations ordered after January 1, 2019, "other deposits" (including those held by corporate clients) will rank senior to other unsecured debt, right after covered deposits, deposit guarantee schemes, and the portion of individuals' and small and medium-sized enterprises' eligible deposits exceeding €100,000 (*i.e.*, not covered by deposit guarantee schemes), which all benefit from preferential treatment under Article 108 of the BRRD.[18]

The rationale behind the new provision appears to lie in the lower risk expectation of bank depositors *vis-à-vis* investors in bank debt and counterparties in derivatives.[19] The ranking of certain unsecured debt below "other deposits" should also facilitate the bail-in of such unsecured debt, as it makes it easier to comply with the "no creditor worse off" principle.[20] However, with respect to Italian G-SIBs, the TLAC eligibility of such unsecured debt would require additional contractual or structural subordination.[21]

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16 Covered deposits are those benefitting from the protection of deposit guarantee schemes pursuant to Directive 2014/49/EU.

17 See Article 3, paragraph 9 of the Amending Decree.

18 See Article 1, paragraph 33 of Amending Decree amending Article 91of the TUB.

19 Also, despite being legally on demand, deposits are a more stable source of funding and pose a lower risk if compared to other types of bank funding, such as interbank liquidity.

20 See Article 34, paragraph 1 letter *g*) of the BRRD, pursuant to which "*no creditor shall incur greater losses than would have been incurred if the institution … had been wound up under normal insolvency proceedings…*".

21 See paragraph 3.7.2 of the ECB Opinion of October 16, 2015, and our memorandum of September 21, 2015 (available here) where we have analyzed in more detail this and other implications of the reform on insolvency ranking.

V. Set-off of claims in the context of administrative liquidation

The Amending Decree introduces certain limitations to the general set-off rights available to creditors under the Italian insolvency Law.[22]

Under the Insolvency Law, creditors may set off their receivables *vis-à-vis* the bankrupt estate (even if not yet matured) against amounts they owe to it. Pursuant to the Amending Decree, the application of this principle in the context of bank administrative liquidation proceedings will be limited to instances in which the set-off is claimed before the administrative liquidation is ordered.[23] This limitation, however, does not affect the operation of (i) voluntary set-off arrangements entered into pursuant to Article 1252 of the Italian Civil Code, (ii) set-off arrangements provided under financial collateral agreements, or (iii) "netting arrangements" (as defined in the BRRD and the Resolution Decree)[24], which include close-out netting provisions in relation to financial collateral (note that the operation of such a clause in an insolvency scenario is expressly protected by the Financial Collateral Directive and its Italian implementation and that, by contrast, such provision or arrangement does not apply in a resolution scenario, as the BRRD expressly amended the Financial Collateral Directive in this respect).[25]

The rationale behind this limitation to general set-off rights in liquidation proceedings appears to be to remove a potential impediment to the bail-in of liabilities that could be set off in insolvency, so that creditors of such liabilities who are at the same time debtors of the bank may not claim that, in a bail-in scenario, they would incur greater losses as compared to the losses that they would have incurred after the operation of the set-off under normal insolvency proceedings.

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22 Royal Decree No. 267 of March 16, 1942 (the "**Insolvency Law**").

23 See Article 1, paragraph 26 of the Amending Decree, which introduces a new paragraph *3-bis* into Article 83 of the TUB derogating to the applications of Article 56, paragraph 1 of the Insolvency Law, in the context of bank administrative liquidation proceedings.

24 See Article 2, paragraph 1, point (98) of the BRRD and Article 1, paragraph 1, letter *a*) of the Resolution Decree.

25 See Article 7 of Legislative Decree No.170 of 2004, which implements Article 7 of the Directive 2002/47/EC (the "**Financial Collateral Directive**" or "**FCD**") on recognition of close-out netting provisions in winding-up or recognition procedures, and Article 118 of the BRRD, which amended the FCD in order to exclude the application of Article 7 of the FCD in the case of resolution.

VI. Removal of impediments to intra-group financial support

Since the BRRD requires Member States to remove any legal impediment in national law to intra-group financial support transactions undertaken in accordance with the relevant BRRD provisions, the Amending Decree[26] provides that:

i. the approval (or cancellation) of such transactions does not trigger withdrawal rights[27] that shareholders not approving the decision may be entitled to;

ii. the rules on related-party transactions that apply to listed companies, and those that apply to banks (under the Italian Civil Code and Consob regulations, and under the TUB and Bank of Italy regulations, respectively) do not apply in respect of such transactions;

iii. the rules on statutory subordination of shareholders' loans (provided under the Italian Civil Code)[28] do not apply with respect to the financial support provided through such transactions; and

iv. such transactions may not be subject to claw-back (whether under the ordinary regime of the Italian Civil Code or the special regime set forth in the Insolvency Law).

VII. Judicial declaration of insolvency in case of resolution

If, at the time it enters into resolution, a bank satisfies the conditions under which it would be declared insolvent under the Insolvency Law, the court of the place in which the bank has its legal seat may declare it insolvent at the request of the public prosecutor (*pubblico ministero*), the special managers appointed by the resolution authority or, if no special manager has been appointed, the Bank of Italy.[29] Although the Resolution Decree does not fully clarify all the consequences that would stem from the judicial declaration of insolvency of a bank in resolution, it seems that the rationale behind the provision is to trigger the application of certain Insolvency Law provisions,

[26] See the new Articles 69-*duodieces*/69-*septiesdecies* of the TUB introduced by Article 1, paragraph 12 of the Amending Decree.

[27] Shareholders of Italian companies are entitled to withdrawal rights under certain circumstances provided by the law or set forth in the by-laws.

[28] Under Article 2467 of the Italian Civil Code, shareholders' loans made within one year prior to the company entering into bankruptcy are subordinated *vis*-à-*vis* other company's creditors if they were made when there was an "excessive imbalance" between the company's indebtedness and its net assets or when the company's financial condition would have reasonably required an equity contribution.

[29] See Article 36 of the Resolution Decree and Article 82 of the TUB.

most notably those concerning the avoidance of certain transactions undertaken by the bank before its entry into resolution. In particular:

i. transactions for no consideration and early payments of debts maturing on or after the date of entry into resolution may be voided if they have been carried out within two years prior to such date;

ii. certain transactions for inadequate consideration, discharge of due and payable debts effected through uncommon means of payment, and the grant of collateral to secure pre-existing debts not yet due and payable may be voided if carried out within one year prior to the date of entry into resolution; and

iii. the grant of collateral to secure pre-existing due and payable debts may be voided if carried out within six months prior to the date of entry into resolution.

In addition, bank executives may incur criminal liability in respect of bankruptcy-related offences set forth under the Insolvency Law and such liability may be applied even if the bank is no longer insolvent as a result of the resolution actions. In this respect, the Resolution Decree is consistent with the principle that "*...persons are made liable, subject to Member State law, under ... criminal law for their responsibility for the failure of the institution*", which is one of the principles that must inform the resolution action pursuant to the BRRD.[30]

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[30] See Article 34, paragraph 1 letter *e*) of the BRRD.

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