David Benamou
+44 330822 03 74
david.benamou@axiom-ai.com

Jérôme Legras
+44 330 822 03 75
Jerome.legras@axiom-ai.com

Gildas Surry
+44 778053 27 89
Gildas.surry@axiom-ai.com

Adrian Paturle
+33 14469 43 90
Adrian.paturle@axiom-ai.com

June 26, 2017

The state of the (Banking) Union

The Italian government liquidates Banca Popolare di Vicenza and Veneto Banca. On June 25th 2017, at 19h10, the Banking Union died. But relax, everything will be fine.

On June 25th 2017, at 19h10, the European Commission approved Italian state aid measures to facilitate the liquidation of the two Venetian banks, Banca Popolare di Vicenza and Veneto Banca.

Axiom had no exposure to these two banks in its UCITS funds[1] but these developments are extremely important**.**

1. How did we get there?

Banca Popolare di Vicenza and **Veneto Banca** are two Italian commercial banks, located in the Veneto Region, with combined total assets of 63bn€. Both banks suffered losses from increasing NPLs and recapitalised themselves by issuing shares to their clients. After further losses and, in one case, revelations that the bank had funded the capital increase without taking appropriate capital deductions, the banks tried to do a second round of capital increase. These were respectively underwritten by Intesa and Unicredit but, following insufficient investor demand, they both tried to walk out of the deals. To solve that crisis, the government sponsored the creation of Atlante, a fund financed by the Italian financial industry and designed to recapitalize the two banks.

Both banks were excluded of the last public stress tests, but losses continued to materialize and it eventually appeared that further

capital was necessary. In order for the solvency ratios to remain over the regulatory minimum, Atlante injected a further 1bn€ last December, which allowed the banks to present a merger plan to the SSM and to request a precautionary recapitalisation from the Italian government – the procedure used by Monte dei Paschi.

Talks started with the European Commission on the precautionary recapitalization, but it soon appeared they were stuck on one major issue: the EC considered the two banks insolvent and requested further private capital (1.2bn€). Unicredit, Intesa and Mediolanum reluctantly said they were ready to contribute their fair share, but no other bank did. Later, Intesa said its board had approved the takeover of Veneto and Vicenza on three conditions: that only performing assets would be transferred, that the deal would leave the CET1 ratio unchanged and that litigation and restructuration costs would be "sterilised" (=paid by someone else.) Considering the huge amount of NPLs (12bn€ net) and the insufficient amount of performing assets, this meant that Intesa could not absorb all existing senior debt without state aid (either in the form of cash or of a transfer of some senior debt to the bad bank with a public guarantee.)

[1] Stock market regulations do not allow the disclosure of the exposures of our listed fund in anything but a very specific format.

Finally, on June 23th - 25th, the following sequence of events unfolded (the sequence is important):

1. The SSM declared that both banks were failing or likely to fail
2. The Single Resolution Board (SRB), deemed that resolution was not necessary because the banks do not "*provide critical functions, and their failure is not expected to have significant adverse impact on financial stability.*" Consequently, "*the banks will be wound up under normal Italian insolvency proceedings.*"
3. But, as all Italians know, there is no such thing as ***normal*** in Italy; the Italian government used a little known specific procedure, known as the *Liquidiazione Coatta Amministrativa,* only available for banks and companies that have a public interest. This allows a BRRD-like administrative insolvency, instead of a regular judge-led insolvency procedure, with the possibility to auction assets immediately. A decree allowed the sale of the two banks' good assets to Intesa for 1€, the transfer of employees, a cash injection for Intesa (€4.785bn), a 12bn€ state guarantee on Intesa's funding to the bad bank that will keep the NPEs, and a 1bn€ subsidy to help the restructuration (=fire up to 4000 staff according to the Italian press.) The various press releases are slightly unclear on this, but it is very likely that all equity and subordinated debt of Veneto and Vicenza have been wiped out.
4. The European commission approved the state aid granted by Italy.

From a straightforward investor's point of view, with no interest in the legal minutiae, the consequences are the following: shareholders and junior debt holders are wiped out, senior debt holders will now be holding Intesa senior debt.

Why is this significant?

What the Italian government has achieved is nothing short of extraordinary.

Its overriding political goal has always been to protect senior bondholder in order to mitigate political and contagion risks. However, since 2016, the problem for the Italian authorities was twofold:

- the bail-in tool, which is enshrined in the BRRD, requires senior debt haircuts before public money is used,
- resolution powers have been transferred to the SRB, an independent EU entity. Due to their sizes, the two Venetian banks were under the SSM and the SRB's remits.

Under the BRRD, the only alternative to senior bail-in is the precautionary recapitalization – allowed for solvent banks. When it appeared that the EC would not approve it, probably because the two banks were undercapitalized, the Italian government needed another creative route – and found it with the *Liquidiazione Coatta Amministrativa.*

This is essentially a BRRD-lite procedure that allows the allocation of liquidation losses to creditors without waiting for a full liquidation process under the authority of a bankruptcy judge (i.e. what the sale of business or bridge banks tools in the BRRD are designed to achieve…) However, since this Italian procedure is outside of the BRRD, it is not considered a "*resolution*" but a "*national bankruptcy*", and a such does not need to meet the strict BRRD requirements, but only the simpler state aid requirements – i.e. only subordinated debt bail-in and not senior debt bail-in are required before any state aid!

To achieve this, the Italian authorities needed to have three EU bodies on board:

- The SSM needed to say the banks were likely to fail – probably the easiest decision.
- The SRB had to consider there was no systemic risk attached to the bankruptcy of the two banks and allow national bankruptcy proceedings. This was probably a tougher sell, since the very reason why the Italians wanted to protect the senior bondholders was to mitigate…systemic risk! Still, the SRB accepted the transfer of power to the Italian authorities, possibly under considerable political pressure (hugely important general elections will take place in Italy by H1 2018), but also, and this is obviously paradoxical and twisted, because the SRB knew that there would be no systemic risk as the senior debts would be left unharmed!
- Since Intesa demanded state aid to take-over Veneto and Vicenza, the EC had to approve it. Technically and legally, this does not raise significant difficulties: senior debt bail-in is not necessary under bank state aid guidelines and the specific guidelines for liquidation state aid mostly require that asset sales are done after a transparent auction (it is likely that Unicredit was also offered the two banks, but declined.) However, the very purpose of the transaction – to bypass the BRRD – certainly did not escape the EC's attention. Moreover, the total amount of public money involved (12bn+5.4bn, less the possible upside on NPE recovery) is way above the amount which would have been required under a precautionary recapitalization, something that is not obviously consistent with the principle of "*minimum aid amount*". Clearly, the EC's approval was not a given, but it was granted on Sunday evening, presumably after intense political discussions.

Where does this leave us? We draw three key conclusions:

- **Any country willing to protect senior bondholders (preferred or not) has now a legal route to so**: indeed, the Italian authorities have unearthed a formidable loophole in the BRRD. If the bank is systemic enough, systemic risk can be invoked to justify senior bail-in exemption under BRRD resolution, and if the bank is not systemic enough, national bankruptcy proceedings can be applied. These proceedings can mimic most of the BRRD to provide the very useful tools (bridge bank, sale of business, *etc.*), without the dreaded senior bail-in!
- **In that context, state aid rules become the only binding constraints**. This is positive news for senior debt, but raises three difficulties:
    - The guidelines can change overnight, as they are established by the EC and the EC only. In fact, we would be very surprised if these state aid guidelines were not changed quickly to include mandatory burden sharing on non-preferred senior bonds, and possibly all senior bonds.
    - The guidelines are not binding: the ECJ ruled that the guidelines were compatible with EU law but not binding for member states. In theory, another approach could be used, which leaves some legal uncertainty.
    - The democratic process is not very satisfactory: unlike BRRD, which was approved by the Council and the Parliament, the state aid guidelines are a simple Commission decision, established on competition grounds, which seems a bit weak and unusual for the more general goal of safeguarding financial stability.
- **As ever in Europe, politics trump the other considerations.** We doubt all countries would have been allowed to pull a "Vicenza-Veneto" deal, but also point out that there is, in Italy, a wider political

consensus **in favour** of state bailouts than in many other EU countries, probably because the country was less hit by the first leg of the financial crisis.

Last but not least, **this is a major step in the direction of a cleaner Italian banking sector.** Monte dei Paschi, Veneto and Vicenza were the three main concerns and they are now dealt with – one way or another. True, Carige or even Credito Valtelinese remain weak banks, but to a lesser extent than those three.

What about the banking union?

We mostly know the Banking Union for what it has achieved, namely a common supervision (SSM), a consistent rulebook (EBA) and a resolution framework (BRRD, SRB.) **All this will remain, unharmed and still extremely helpful.**

But this is not what the banking union is *about*.

The banking union was designed to reduce systemic and redenomination risk in the Eurozone. When a systemic crisis starts, either within the banking sector (e.g. Ireland) or the public sector (e.g. Greece), it quickly involves both the banks and the sovereign, and leads to capital flight, Target 2 imbalances, inflows of deposits in stronger EU banks, and this ultimately jeopardises the common currency. The Greek crisis was the best example; Greek depositors withdrew their money from Greek banks not only because of default risk but also because they expected their new German deposits to be repaid in German marks, not Drachmas, in a doomsday scenario – a scenario which is only reinforced by the capital flight.

Before the banking union, the only tools available to fight systemic risk were the emergency ECB funding (ELA) and the various non-conventional policies (OMT, QE, *etc.*)

The end game scenario of the banking union, the strongest policy available to fight redenomination and systemic risk, is the common deposit guarantee: a guarantee that every deposit below 100k€ is guaranteed **by a reliable EU body, and is guaranteed in Euros**. But the "strongest" EU countries, i.e. the likely net contributors of this scheme, have demanded several prerequisites before its implementation:

- Common supervision and rulebook to avoid national "fudging" with the rules;
- A resolution procedure (BRRD) to be sure public or EU money is only used as a very last resort;
- And, presumably, (this is less clearly expressed) a disentanglement of bank and sovereign risks via new rules on sovereign exposures for banks.

The solution applied to Veneto and Vicenza clearly jeopardises the second requirement: if, in contradiction with the spirit of the BRRD, public money can be used to protect senior bondholders and depositors when they should be bailed in, the countries currently reluctant to approve the common deposit guarantee are even less likely to accept it.

But not all is lost, far from it. Italy was allowed to bypass the BRRD thanks to a very creative bankruptcy regime. All it would need to close that loophole would be to introduce a common bankruptcy regime for EU banks[2], a new pillar to the Banking Union, and one that is now urgently needed.

The Banking Union is dead, long live the Banking Union!

[2] Of course, the EC could also change its state aid guidelines to include mandatory senior bail-in, but this would raise the same concerns we detailed above.