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Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

The impact of the bail-in on banking services and bank funding

by **Vincenzo Troiano** and **Gregorio Consoli**

Abstract: This paper examines the main implications for bank services and bank funding that arise from the introduction of the Bank Recovery and Resolution Directive (BRRD) and the bail-in rules in Italy. The paper addresses the functioning of the minimum requirements for own funds and eligible liabilities (MREL) and analyzes the potential impact on banks' funding criteria and which new products, such as covered bonds, could benefit from the introduction of the new rules. Furthermore, the analysis covers the approach to risk represented by the bail-in rules and implications for the structuring and subsequent offer of financial instruments that will be subject to the risk of conversion or write-down. We also describe the changing approach of the regulators to the assessment of the complexity of financial instruments consequent on the additional risks inherent in financial instruments that are subject the new rules. Finally, the paper addresses the impacts of the BRRD on the rules of product governance set forth in the MiFID II Directive, especially with regard to rules of conduct and distribution strategy with which issuers will need to comply. The paper also addresses the additional duties of disclosure and the duty of fairness that arise from the introduction of the new rules.

1. The focus of the paper is to examine the main implications for banking and lending businesses deriving from the introduction in the Italian legislation of the bail-in mechanism.

We start with an analysis of the incentives that the bail-in mechanism creates, and later evaluate the ways in which this new mechanism has been incorporated into the pre-existing legal framework applicable to the financial sector, which is highly regulated, segmented and fragmented, reflecting the varying degrees of protection required by the spectrum of end-users of financial services and products.

The main issues are as follows:

Firstly, the structuring of new instruments that may be subject to bail-in mechanisms. Important under this head are the governance procedures of issuers with regard to the creation and structuring of new products, understanding how they interact with the design of resolution and recovery plans and, more generally, with a bank's general funding requirements. The jurisdiction of issuance of the product and nature of the issuer are also key.

Secondly, the relationship between the issuer and distributor of products eligible for bail-in. In this area, we need to examine, in particular, the *product governance* mechanisms for the construction of the reference target and for the transmission of information on the characteristics of the instruments, also bearing in mind the rules on the responsibility of the *manufacturer* and *distributor* in light of the legal framework in place and, most importantly, the principles discernible from the MiFID II directive;

Thirdly, actual and prospective conduct rules for the offer and distribution of eligible products to customers in terms of both disclosure by and to customers, application of rules of appropriateness and suitability, methods of execution of the relevant services. Retail customers pose particular concerns with regard to consumer protection laws and conflicts of interest where the distributor and issuer are the same entity (so-called "self-placement") in the light of best execution obligations.

2. Examining the architecture of the BRRD as transposed by Italian Legislative Decree No. 180 of 2015 there is a significant incentive to create new products to which the bail-in legal framework will apply, especially in order to protect funding tools with a higher seniority. On the opposite, it is expected that the introduction of the BRRD will also lead to an increase in funding products, such as covered bonds, that are exempt from the application of bail in rules.

We refer to the implications deriving from the way the mechanism of the minimum requirements for own funds and eligible liabilities (referred to as the MREL) works. Under art. 50 of Legislative Decree 180, banks must meet minimum level of eligible liabilities for bail-in, at both individual company and group levels in order for the bail-in rules to work and thereby permit so-called "internal resolution" (where the legal conditions are met). The individual company level is set by the Bank of Italy, in consultation with the ECB (where the latter is the competent authority), and focuses on the primary need to ensure that in the event of bail-in the bank has sufficient liabilities to absorb losses, to ensure that the amount of Tier 1 Common Equity required for authorization to engage in banking activities is met, and to generate sufficient market confidence.

The Bank of Italy is also responsible for determining the characteristics of the liabilities that are taken into account for purposes of the requirement and for the calculation methods; the calculation of liabilities regulated by the law of a third party country are governed by specific rules.

This represents a considerable *operating restriction*: the introduction of potential bail-in mechanisms gives rise to a perceived increased risk associated with the subscription of instruments eligible for such treatment under the legal framework. Clearly, the risk-return expectations are greater with more risky securities and, therefore, may result in an increased cost of funding via such instruments. However, it should be borne in mind that banks ultimately do not have the freedom to devise funding policies that minimise the use of instruments eligible for bail-in since, quite to the contrary, it is precisely the need to meet the continuing requirement in question that effectively renders mandatory the issuance of such instruments.

Verification of whether the MREL for bail-in has been met rests with the resolution authority at the time of the preparation and updating of the individual or consolidated resolution plan of the issuer. Art. 102 of Legislative Decree 180, which sets out the transitional regime for resolution plans, expressly requires that such plans contain an indication of the MREL for bail-in and the deadline, if any, by which such requirement will be met. Yet more important is the provision which allows for the activation of powers and measures for the removal of impediments to resolution at the time of preparation of resolution plans by allowing the Bank of Italy, as the resolution authority, to order a bank to issue eligible liabilities in order to meet the MREL for bail-in (art. 16, 2.c).

It is very significant the impact that the MREL legal framework has on the funding dynamics of a bank and the policies that the bank has to put in place at the operational level in order to comply with the new legal architecture whose purpose is the preparation of the resolution or, prior to that, the recovery, of the relevant business. We should highlight the interaction between resolution and recovery plans: it would be surprising if the formulation of the recovery plans, in particular as to their composition, and the activation of capitalization instruments eligible for bail-in were completely detached from the needs to reach a resolution which, as mentioned, may even entitle the authority to require the issuance of such instruments.

Beyond such operational limitations, issuers remain entitled to seek to minimize the effects of debt instruments (with respect to the portion of funding that exceeds the minimum requirement) in terms of perceived risk/cost of the issuance, in particular where they operate within groups or conglomerates or multi-jurisdictional entities.

In addition to the need to seek new funding products to be included within the category of protected products, the following considerations would appear relevant: within groups, the need for full centralization of treasury operations with respect to non-bank business should be reconsidered, especially with regard to companies in which significant minority stakes are held. It may make sense for such companies to use direct forms of fundraising in the market as they would not be eligible for the application of the legal framework on bail-ins (see art. 2, Legislative Decree 180). Similarly, in conglomerates, it should be considered whether insurance related funding should be re-assessed, since the provisions on bail-in will not apply. Other considerations apply with regard to the issuance of funding products by entities located in different jurisdictions or subject to non-Italian governing laws. Generally speaking, the issuance by non-Italian entities of banking groups would be irrelevant for purposes of the application of the legal framework, since the scope of application of the provisions is extended to cover the entire banking group, and therefore the geographic location of the issuer would be irrelevant. However, as for the matter of the law governing the financial instrument issued, the provisions on the contractual recognition of the bail-in come into play. Indeed, when a liability eligible for bail-in is governed by the law of a third party country (meaning a country outside the European Union), banks must include in the agreement a clause pursuant to which the creditor acknowledges that the liability is eligible for a possible bail-in ordered by the Bank of Italy and agrees to accept and incur the effects of the same. In any event the clause is considered included by law in the agreement, and any non-conforming clauses that may be inserted by the parties are replaced, without any liability arising as a result of the absence of such clause. Such clause applies only to liabilities arising after January 1, 2016. Art. 59 of the Legislative Decree 180 also stipulates that the bail-in applies and is of binding effect on parties subject to the legal framework even where the above mentioned clause is absent or present but ineffective. This is a provision that remains rather opaque as to its ultimate scope of application, since while it is stipulated the definitive application of the bail-in to the bank, the ineffectiveness or absence of a clause that recognizes such effects continues to fall within the debtor-creditor relationships governed by the law of a third party country.

From a further, related, standpoint (again linked to the incentives created by the legal provisions of bail-in) the instruments falling outside the scope of application of the legal framework in question include liabilities owed to banks and SIM that are not part of the group of the entity the subject of resolution having a duration shorter than seven days (art. 49.1.f-e Legislative Decree). This is a provision which, according to the intentions of the European lawmakers, aims to reduce the risk of systemic contagion deriving from the resolution of an entity (recital 70 of the BRRD): the need to protect the financial system prevails over concerns regarding the uniform treatment of creditors of an entity subject to resolution measures. The same provision, which is now part of the legal framework, may also lead to the activation of forms of cross funding between third party institutions, for short-term maturities which are not subject to the restrictions of the bail-in, triggering operating solutions which perhaps today are seen as unprecedented, but certainly encouraged and fostered by the application of these legal provisions.

On the other hand, the implementation of the BRRD may lead to the expansion of new products, such as secured liabilities and covered bonds, that are exempt from the application of the new resolution tools introduced by the Directive. In particular, given that these instruments are protected from bail- in (up to the secured amount) and from the other resolution tools, such as the asset separation tool and the bridge institution tool, banks could find an interest in identifying secured liabilities to be offered to the more risk-adverse portion of their clients' base, developing a new market for such securities.

3. Any further analysis concerning the structuring and offering of financial instruments falling under the scope of application of the bail-in provisions requires a number of preliminary high-level considerations.

The eligibility of an instrument for bail-in gives rise to a *structural characteristic* of riskiness of such instrument, if issued by a party subject to the provisions of the BRRD. It is not a decision for the issuer, which does not even have formal control over the events that may give rise to the application of the bail-in provisions. This is perhaps the reason why the provisions of recital no. 81 pursuant to which the fact that instruments must be written-down or converted by the authorities in the circumstances envisaged under the Directive must be acknowledged in clauses that govern the instrument (and also in the related disclosure documentation) were not included in the provisions implementing the Directive (with regard to instruments governed by Italian law). Consequently, it is even possible that market practice will tend toward the failure to indicate such circumstance expressly in the contractual documentation (other than the disclosure documentation) that governs their issuance (obviously with the exception of instruments that are governed by a third party country, since in such case the provision on the contractual acknowledgment of the bail-in would apply). Similarly to the issuance of any financial instrument, whether it be an equity or debt instrument, the contractual provisions are supplemented – if not exempted subject to the limits of the possibility for exemption – by the provisions of law that govern the specific instrument. For those financial instruments falling under the scope of application of the bail-in provisions, the effects that the provisions in question allow for would apply directly and not indirectly.

Another matter altogether is that of disclosure: it is obvious that the risk factors related to the investment in such assets must include clear disclosure that the bail-in provisions may apply (where the relevant conditions are met), which would give rise to a possible conversion or reduction/cancellation of the value of the instrument.

Eligibility for bail-in is a *structural* element that translates into a risk. Such risk may be more or less remote, depending upon the current and prospective situation of the issuer, but it remains a risk.
Another matter, apart from risk, is that of the *complexity* of a financial instrument. There may in fact be instruments that are simple as to their structure but high risk and, on the other hand, instruments that might be very complex as to their structure, but low risk. Often, complexity is associated with risk, which often leads to confusion between conclusions formulated on complex securities and those formulated on high risk securities, almost as if high risk implies complexity.
In the case of the bail-in, the structural characteristic we discussed above may be associated with instruments which may *also* be complex or with instruments that are not complex. Let us imagine, with regard to this latter case, a situation of senior unsecured plain vanilla bonds issued by banks: they are not complex at all, their risk associated with the bail-in derives from the initial and prospective quality of the issuer's creditworthiness. In any event, risk is not correlated with complexity (which is absent in this case). We are fully aware that CONSOB, in the Q&A related to the Notice on the distribution of complex products, indicated that *perpetual plain vanilla bonds* are to be included in this category due to the difficulty in understanding the risks associated with them, "also due to the possibility of underestimating the factor of uncertainty in the restitution of principal". In our case, however, the risk of bail-in derives from the application of a provision of law the contents (or at least the principles) of which are clear, and which has and will continue to receive wide publicity as to its impact on the general public (as well as upon customers of intermediaries). This may have the effect of neutralizing criticism, that bail-in is unknown or poorly understood, even in the short time since its introduction. It may be that it is less easy to assess the risk of default of an issuer, and to understand exactly what the MREL is and, therefore, the number of eligible liabilities for bail-in, but these are aspects related, in reality, to the *issuer's class of risk* which is similar in nature, regardless of the security in which one is considering investing.

Let us take the opposite example: Italian covered bonds are usually fixed rate plain vanilla covered bonds guaranteed by a pool of assets. However, the pool of assets is segregated via market standard securitization techniques in a special purpose vehicle which, in turn, would issue a guarantee in favour of the bondholders. One could argue that the complexity of the techniques used to segregate the assets would qualify the instrument itself as "complex"; however the underlying bank obligation and the higher degree of comfort (from a credit perspective) renders the instrument much lower risk and, as such, it should receive a more favourable treatment than ordinary bonds from a product governance perspective.

In any event, we are of the view that any assessment as to the type of instruments eligible for bail-in as complex instruments or equivalent must be carried out on an individual, ad hoc basis for each instrument and must be applied uniformly in each jurisdiction of the European Union.

Each instrument must be assessed individually, since one cannot assume that the risk of bail-in may of itself constitute an element that worsens the rules of the offer, regardless of any considerations regarding the structure of the instrument. Such assessment must be carried out uniformly among the various jurisdictions, otherwise there would be a fragmentation of regimes that would inevitably result in a distortion of the rules of competition governing the funding of banks and the supply of financial services across the various countries. ESMA should analyze how and whether the characteristic of being eligible for bail-in would translate into a qualification as 'complex' for instruments possessing such characteristics, as was expressly indicated to be the case, for example, in relation to Contingent Convertible Bonds (eligible, under the new prudential legal framework, as Additional Tier 1).

At this point we would raise another general query, for simplicity of analysis, in relation to senior plain vanilla bank bonds, to which the bail-in regime also applies: Does the fact that the bail-in regime applies to them impact upon their nature as debt and funding instruments? We believe we must answer this query in the negative: the instruments continue to be debt instruments and are clearly funding instruments, and an obligation to repay continues to bind the issuer. Strictly speaking, Italian secondary legislation maintains that repayment obligation subsists even where it depends, as to its timing and amount, upon *objective parameters*, including those relating to the economic performance of the issuer. In our case, however, the law grants to the resolution authority the power to activate bail-in measures under certain circumstances established by regulatory provisions, the application of which requires the exercise of a somehow discretion, although of a technical nature. However, we do not believe that this circumstance leads to the conclusion that the nature of the instruments in question or their fundamental characteristics have changed.

If this is correct, secured liabilities should be granted the same regulatory treatment granted to ordinary plain vanilla bank bonds in a pre-bail-in scenario, if not an even more favourable treatment than could be justified by the low risk of the instrument.

4. The general rules relating to the creation of new financial products modelled to reflect the needs of target customers clearly also apply to the structuring of products falling under the legal framework governing bail-ins.

We are referring, obviously, to the rules on *product governance*, set forth in the MiFID II Directive, but already in many respects in force following the domestic implementation of ESMA's opinion (we refer, in particular, to the opinion issued in March 2014 on Structured Retail Products – Good practices for product governance arrangements) through Consob interventions on the matter (in particular, the Notice on the distribution of complex financial products to retail customers issued in December 2014). On the basis of this regulatory framework, investment firms that create financial instruments to be offered for sale to customers must adopt, exercise and control an *approval process* for every financial instrument and for every material change to existing financial instruments, prior to their commercialization or distribution to customers.

In particular, the *process of approving* the product must specify for each financial instrument the relevant *reference market* of end customers within the relevant category of customers and ensure that *all risks* specifically pertaining to such target customers *have been analyzed* and that the proposed distribution strategy is consistent with such target market.

The investment firm must moreover regularly re-assess the financial instruments offered or commercialized by it, taking into account events that may have a material effect on the potential risks for the target market, in order to assess, as a minimum, whether the financial instrument continues to meet the needs of the target market and whether the proposed distribution strategy continues to be appropriate.

These issues are also relevant in cases in which the *issuer and the distributor are different entities*: indeed, investment firm issuers must provide distributors with all necessary information relating to the financial instrument and to the procedures for approving them, including relating to its target market. In turn, investment firms that offer or recommend financial instruments that are not directly created by them, must take appropriate measures in order to obtain the above-mentioned relevant information and to understand the characteristics and identified target market of each financial instrument.
The rules referred to above, *in addition* to *being important from an organizational standpoint,* as regards internal mechanisms and information flows, are also relevant in terms of the *rules of conduct* to be followed by the intermediaries in question.
Indeed, it is envisaged that investment firms that create financial instruments for distribution to customers must ensure that such products are designed to meet the needs of a given reference market of final customers identified within the relevant customer category and that the *distribution strategy* for the financial instruments is compatible with the target market. In particular, the investment firm must *have full knowledge* of the financial instruments offered or recommended and *assess their compatibility* for the customers to which it provides investment services, taking into account the reference market of those end customers and *ensuring that the financial instruments are offered or recommended solely where this is in the customer's interest.*

These general principles have a significant impact on instruments which present features of particular risk due to the fact that they may not carry an entitlement to receive repayment of some or all of the principal, or may be converted into equity upon the occurrence of certain events (such as those that permit the resolution of the entity). In these cases the firm must carry a very in-depth assessment, in terms of overall governance, in order to ascertain that the needs of the target customers are met where it purchases an instrument having such characteristics.

5. As noted, the possibility that the instruments issued by entities subject to the provisions on the resolution of entities may be subject to the rules on bail-in represents a further risk of such instruments, different therefore with respect to securities of the same type issued by entities falling outside the scope of application of the above-mentioned legal framework.

Clearly, it follows that there is a need to highlight this particular circumstance throughout the entire supply chain of the offer and distribution of products of this type.

We referred above to product governance rules, including the rules concerning the information on the product that must be provided by parties that later sell or offer the products. We will now briefly mention the additional applicable rules of conduct which should apply.

We would, first of all, distinguish between *duties of disclosure* and *duties of fairness* in performing investment services.

Requirements of transparency. As for newly issued products, *prospectuses* will be required to highlight the specific risk that the instrument may be subject to the bail-in provisions. A similar risk warning will have to be included in the *summary note,* since the information in question is intended to be qualified as *key information,* for the purposes of the assessment of the risk related to the investment in instruments of such type. Even *simplified prospectuses within the meaning set forth in art. 34-ter* of Consob Regulation no. 11971/1999 (Issuer Regulation) must contain an express indication of the risks related to the applicability of the bail-in provisions. We are of the view that the supervening application of the bail-in provisions represent a new material fact capable of impacting the assessment of the relevant products, meaning that it would be necessary to draft a supplement to the prospectus pursuant to art. 94.7, of the Italian Consolidated Financial Law.

Rules of conduct. Under this head fall the rules of transparency and fairness in the supply of investment services. First of all, the rules of product disclosure will apply, with particular reference to the requirements of art. 31 of the Consob Regulation no. 16190/2007 (Regulation on Intermediaries) on the description of the nature and the risks inherent in the financial instrument in question. Sufficient detail must be provided so as to enable the customer to make informed investment decisions. The fact that the security is subject to bail-in is certainly a key information in terms of the characteristics of and risks inherent in the instrument. An indication of the risk of loss, including the possible total loss of the investment will also have to be provided, obviously stating that such risk will only arise where the criteria for the application of the resolution regime are met.

As for the rules of fairness, let us first of raise the obvious consideration that the *execution only* regime requires the definitive solution on the fact that a product is eligible for bail-in does not necessarily mean that such financial instruments are complex, otherwise at present the rules issued by Consob for the distribution of this type of products through the notice published at the end of 2014, as well as the ESMA guidance on the sale of complex products, would apply.

As for the rules on information provided by customers on their knowledge and experience relevant to the type of instruments, specific requests will be included aimed at verifying the customer's awareness of the specific risk associated with the instrument, as an instrument subject to the bail-in provisions.

6. In conclusion, the legal framework governing *bail-ins* will have a significant impact on the entire chain of production from the structuring to distribution and funding of financial instruments. This is in addition to the obvious impact of the market's perception of the risks associated with instruments issued by entities subject to such framework –being, first and foremost, banks and companies belonging to banking groups. The impact will be felt both in terms of the general structuring of funding policies, to which organizational safeguards of product governance are related, and also to the consequent rules of transparency and conduct applicable to the offer and distribution of the products, especially where the

target market is retail. The qualification of products eligible for bail-in as complex financial products would have a significant impact on the considerations raised above.

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Although this paper is the result of a joint reflection of the authors, Vincenzo Troiano wrote the paragraphs 1, 3, 6 and Gregorio Consoli wrote the paragraphs 2, 4, 5.

Open Review of Management, Banking and Finance

«They say things are happening at the border, but nobody knows which border» (Mark Strand)

Banking market and the lack of clients' protection. Paper from the conference «Bail-in and protection of savings»

by **Aldo Angelo Dolmetta**

Abstract: In November 2015, the Italian Government started a «resolution procedure» involving four central-Italy banks, which were basically insolvent.
In doing so, it applied the «burden sharing principle», thus bringing forward the entry into force of Bail-in Regulation (BRRD, which formally came into force on January 1st, 2016). Departing from the «four banks» affair's actual dynamics, this article deal with the systemic background behind the crisis the banking industry is currently going through: which is found in the absence of a law-in-action control on single banking operations' quality. Examples of this case-law permissive trend are provided. Furthermore, the very legitimacy of the Italian Government's and the Bank of Italy's conduct is questioned, as far as the compliance with Italian Constitution is concerned. In particular, the administrative order according to which the annulment of the entire share capital and of subordinated bonds was provided is considered in the light of private property's constitutional guarantee.

1.- The facts which occurred last November, relating to the central Italy so called «four banks», witness several level of unease, which go beyond what is merely contingent or episodic. Indeed, they go deep down: into the system's interstices and, therefore, the society's ones.

These levels of unease all relate to the diverse aspects, which comes along with the «four banks» affair. In other words, and to put it from a diachronic perspective: they unroll though the past, the present and the future of the affair itself.

The core themes are triple: the first one regards banks' management; the second one is about investment in securities (issued by banks, too); the third one relates to banks' crisis regulation. Moreover, one further aspect has to be added to the above-mentioned ones (which indeed partially overlaps with them): it is the conduct of the Italian Banking Authority and the Italian Government.

2.1.- As far as banks' management theme is concerned, first comments of the «four banks» affair seem to reflect a fully traditional perspective among scholars. Such a perspective seems to show two only alternatives: either the narrow bank, that is the bank that doesn't risk and, therefore, is useless (or very little useful; nevertheless, insufficient); or the bank whose stability is questionable, which is the bank you cannot and must not trust.

We have to ask ourselves if this perspective is truly necessary. In point of fact, the whole problem about bank crises (and it doesn't matter if it's about the «four banks», or others) cannot be taken for granted, as a fact that exists just because it happened. On the contrary, it also (I should say, firstly) has to be considered as something which is avoidable, from an *ex ante* standpoint. In sum, it has to be addressed from the perspective of banks' and their risks' governance.

Of course, the mentioned crisis cannot only depend on market risk (and on the unpredictability of its factors). In fact, it can also depend on a poor, reckless, crony-oriented management. The «four banks» affair seems to paradigmatically match with the one that regards non-performing loans. Which, precisely, have to be considered both in their origination phase and in their subsequent monitoring, long before foreclosure (and this be said regardless of the obscurity of the notion itself of «non-performing loan»; and regardless as well of the impact which could have the State warranty provided by last Wednesday banking «maxi decree»).

In these days, press reports tell us that the Bank of Italy has performed, on each one of the «four banks», several inspections: having then noted and reported anomalies and irregularities. That being so, a clearly fundamental question is inevitably raised (but such a question is bound – at least today – for no answer): why did not any action follow the reporting?

I am talking, here, of prompt and early action: the one that could have been less destructive than the actual one, for quality and quantity.

2.2.- One more point has to be stressed. Regardless of any shortcomings of the institutional control level, it has to be pointed out how widespread the lack of controls over product offered by banks on the market is. The lack of control not only relates to an *ex ante* perspective, referred to a certain «type of product» at its general level[1]. Indeed, it also involves decentralized control, carried out on single operations regarding single clients.
The level of control performed by law in action (: *ex post*) on concrete banking operations' dynamics is still set on a permissive approach. Situations of bank's conduct patent inefficiency are brought in front of courts (banking ombudsman included[2]). Still, these situations are often not properly sanctioned.
Two brief examples will suffice, in this respect. The first one is when a bank, which aims to recover his credit, is not able to show the court all the statements relating to the credit: but nevertheless wins the case (so called «saldo zero»: see Territorial Court of Brindisi, January 13th, 2014, available on *Expartecreditoris.it*). The second one is about careless handling of mortgages, with improper land valuation reports, or no reports at all. Such conducts are not sanctioned at all, as far as the mortgage contract validity is concerned (in this respect, it has to be recalled the renowned decision of the Italian Supreme Court, November 28th, 2013, n. 26672)[3].
In our cultural environment we face the lack of an exogenous pressure on firms' efficiency (once we could have called it «judicial and social control»). Still nowadays, the practitioner's mind-set, when it comes to dealing with a bank, is to try and provide for an *ex post* protection: minimizing losses that

could stem from misconduct, operation by operation (and this often happens under the hypocrite statement that this would be the only way to protect the general public of depositors and savers). In sum, we face the lack of an indirect corrective pressure in favour of fair business conduct[4]. Moreover, rewards of position that banks tend to accumulate are still protected, in the Italian law-in-action.

At the same time, scholars preach in favour of the return to «reasonable margins in the credit industry»; that is, the return to profits (but not necessarily to dividends). Very little focus is, instead, on reducing costs and wastefulness. And it’s not only about the amount of employees; but also, for instance, about real estate. Let’s think about – I am citing a real case – the historical palace in Milan, Piazza della Scala, who is named after the Italian bank of commerce: nowadays, this building hosts a bar, a restaurant, a museum.

3.1- Legislative act no. 208/2015 (so called 2016 «Stability act») has established, as it is renowned, a Solidarity fund, intended to indemnify investors who held subordinated bonds issued by the «Four banks»: the actual bringing into action of this fund hasn’t been completed, yet; the relevant «arbitration»[5] procedures haven’t started.

Under art. 1, comma 858 of the 2016 Stability act the right to be indemnified by the Fund is «subject to the ascertainment of liability due to breach of information, care, fairness and transparency duties set out by the Italian Financial Act».

My feeling – my fear, if you prefer – is that said provision will be construed as only referred to breaches of information duties. It can be legitimately questioned, however, that retail investors are effectively protected by a merely informational means. Regardless of the provision contained in art. 2411 of the Italian civil code – that in the year 2003 was considered one of the pillar stones of the revised Italian corporate law –, it nevertheless remains the case that the specific nature of subordinated bonds is inherently obscure to the average bank client (who has, in his life, a large amount of good reasons not to be aware of the difference between debt and equity, let alone the internal variation of that distinction). More importantly, even assuming he is made aware of what a subordinated bond is, he is anyway unable to follow the evolution of his investment and its risk over time: that is, he is not able to calibrate the timing of entry and exit from his investment.

Like even the European Commission currently seems to recognize, the only protection which is truly effective on retail investors is the suitability rule in product placement[6]; with all the consequences that it entails, as far as intermediaries are concerned. And even in this respect, some acquitting trends, which can be found among case law, are worthy of censure (at most, and with great difficulty, some court decisions rule that a generic statement of being properly informed doesn’t give proof that the bank complied with its duties of information: see Italian Supreme Court, April 17th 2015, n. 7922).

3.2.1.- Anyway, there is one more point that the «four banks» affair suggests, by way of its concrete dynamics. According to press reports, on Dec. 30th 2015, Fondazione Carife promoted a legal action before the Administrative Law Court (so called «Tar») against Bank of Italy’s administrative order providing the «reduction of the entire capital relating to stocks» as well as «the nominal value of tier-2 elements» (that is, subordinated bonds) with «subsequent extinction of the relevant administrative and pecuniary rights». It is reasonable to think that Fondazione Carife did so in order to question the legitimacy of the administrative order itself[7]; and to question the compliance with the Italian Constitution of both the Law Decree setting the bridge bank up and the ones (no. 180 and 181/2015, adopted last November) providing for the bail-in mechanism. I didn't have the chance to read the very text of the legal recourse (the hearing originally scheduled on February 2nd was apparently postponed to March 1st); and I also have to say that my knowledge of what occurred in Ferrara and of Fondazione Carife as a shareholder is generic: the one of a common Italian citizen.

This being said, I nonetheless have to stress the significance of such behaviour by Fondazione Carife, for three different reasons.

3.2.2.- At least from a general standpoint, this fact shows that the problem concerning products' suitability doesn't only regard retail clients, but also involves professional clients such as Fondazione Carife: professional clients who are little willing to undertake trash securities (or, from an *ex ante* perspective, highly risky products).
So the whole reasoning gets back to its starting point. If securities industry's future appears to be an equity-based one (see the joint statement by French and German Ministers of Treasury, as reported by Scalfari in an article on the newspaper *La repubblica* on February 10th, front-page and 33), the relevant risk has to be made fairly commensurate to each single operation. In particular, the *ex ante* risk of poor, reckless, dreamy management has to be reduced as much as possible. At the same time, the action of banks' whole board of directors has to be controlled [in this regard, some encouraging hints can be found in a recent decision by Italian Supreme Court, November 25th, 2015, no. 24048, about financial derivatives (which showed up to be unsuitable) entered into by a company, and non-executive directors' liability].
Otherwise, what we have is not an imprudent investment; rather, it is non-repayable money, given the absence of any control on its *an* and *quomodo*.

3.2.3.- Having said this, it has to be distinctively considered that – as far as Carife S.p.A. management is concerned – Fondazione Carife couldn't ever be put on the same level of any other professional client. In fact, it is sure that (to some extent, which I couldn't exactly say) it Fondazione Carife concurred, as a controlling shareholder, in producing the damage. In my opinion, there is no reason why this joint responsibility should not be recognized).

One last point which is noteworthy is that Carife's legal action seems to get the most important point concerning what Bank of Italy and the Italian Government did on November 27th. The «four banks» remaining assets were taken away from shareholders' and subordinated bondholders' entitlements in order to be transferred to the bridge bank and, as a consequence, offered on sale along with the bank itself.
This is a real expropriation, as a matter of fact. In the specific sense that the annihilation of a patrimony intended to cover liabilities (that is, the very notion of patrimony, as considered by art. 2740 of the Italian civil code) towards creditors and shareholders – which is, by the way, something very different form the reduction to zero of a share capital – ensues from an *ex ante* and conjectural evaluation that, besides, is functionally oriented to the immediate transfer of the bank (more properly: its firm) to the best bidder (and that being said regardless of the «choice» about which criteria have to be used in order to assess a bank's loss-making situation)[8].

Given all this, it seems difficult to me not to support the opinion expressed by who claims that the Authority's conduct is in contrast with the Italian Constitution (such as it is – according to press reports – submitted in the legal recourse brought by Fondazione Carife). This is, above all, an illegal limitation of the very nature of the investment made by clients through the purchase of equity and subordinated debt instruments: at the end of the day, a condition of risk was turned, by said Decree, into a condition of complete and permanent loss.

4.1.- Regardless of all this (when possibile), I still wonder if the Italian Government and the Bank of Italy could not, at the moment when they intervened such in a radical and punitive way towards investors, have taken care of the investors themselves. That is, to provide for and immediately put into action a «Solidarity Fund» (*aut similia*) back in late November.

Why did not they do this? Why the issue of «betrayed investors» came up later, after the fact? Besides, why such a long time is going by before the indemnity «arbitration» is actually made operating (good or bad it is, three months have already gone by)?

4.2.- It was noted – the gap in the reasoning is purposely harsh, in order to stress the significance of the point I have just considered – that bail-in regulation shows an inherent contradiction[9]: it is built on the cornerstone of a «mature» market situation, that is able to find within itself the most proper response to a single bank crisis (crisis which, in said view, is occasional by definition): in short, a market that is full of insolvent banks' potential purchasers. But this in not the case: from here the contradiction stems.
In fact, the present Italian situation is not the one assumed by bail-in regulation, as it is showed by the fact that not only any real bidder is apparently missing, but also several more banks are sailing through dangerous, if not very dangerous, seas[10]. Therefore, the point (made by Capriglione) is worthy of support: with the further clarification that bail-in regulation's sole (or main, anyway) concern seems to be the earliest resolution of the crisis (the «market hole»), by offering the banks' assets to the public of potential purchasers.
However, if the normative system doesn't match the real and actual system, there is no doubt that the first one has to be changed, in order to make it fitter to the second one. *Natura non facit saltum***[11]**.
It was noted that the bail-in rationale is a «negative» one: States (both at a worldwide and a European level, Italy included) don't have the economic resources to front banks' crises through bail-out intervention anymore [12]. One may wonder if such a reason actually implies the adoption of a bail-in oriented paradigm[13]. In any case, a thought is here needed, which is intended to be reflected into the latter. A situation of scarcity[14] entails – by its own nature – as much care and caution as possible, for all the aspects that are involved in such problem. That is: as concerns crisis prevention, crisis resolution, and transition from the old to the new regulation regime (once again: *natura non facit saltum*).

4.3.- One last point. In these days, there is much talking about «four banks» directors' liability going on. Obviously, this is correct and fair. He who made mistakes must pay. Nevertheless, we shall bear in mind that this tool gave very poor outcomes, in its long-standing application: since it comes into action when...the horse has bolted to unreachable off-shore paradises.

So the time has come to think about something new and different: being aware, however, that the lack of new and better solution – that could efficiently replace directors' liabilities – is going to increasingly emphasise the importance of direct and indirect controls over products offered on the market by each firm.

(*) Held in Trento, February 12th, 2016.

References:

[1] On *ex ante* government on products, see the presentation by Antonucci. By way of explanation, one point is enough: the «four banks» affair shows once more how the management of conflicts of interest requires a radical solution, with a mandatory rule stating a «juris et de jure» presumption of transactional conflict.

[2] A lot of expectations are being raised by the establishment of the new «Consob ombudsman» (once dropped the unsatisfactory experience of the Arbitration Chamber, an effort is being made to basically replicate the scheme of the Banking ombudsman), even if the actual and effective put into action of the organism is going through several difficulties (see Dolmetta and Malvagna, *Sul nuovo ADR Consob*, forthcoming on *Banca, borsa, titoli di credito*).

[3] Under this regard, it is worth noting that art. 120-*duodecies* of the Italian banking act, which is going to be introduced in transposing into Italian law directive 2014/17/UE «on credit agreements for consumers relating to residential immovable property», states that «the valuation» of immovable property for mortgage lending «is conducted by appraisers who are professionally competent and sufficiently independent from the credit underwriting process so that they can provide an impartial and objective valuation, which shall be documented in a durable medium and of which a record shall be kept by the creditor». The same provision devolves to the Bank of Italy the implementation of this piece of legislation, (the provision is such as follows: «the Bank of Italy sets out executing provisions of the present article, also taking into consideration the «observatory on real estate market» database; as far as comma 1 is concerned, the application of self-regulation standards can be provided»).

[4] With all the consequences which it entails, as far as compliance is concerned.

[5] On the non-arbitration (nor adjudicative) nature of these procedures, see the presentation by Fiorio.

[6] Presentation by Antonucci insists on the importance of «probabilistic scenarios» assessment to be performed when products are placed.
With reference to the existence of a general and actually binding suitability rule covering all three financial market sectors (banking, securities, life insurance) see my work *Trasparenza dei prodotti bancari. Regole*, Bologna, 2913, 123 ff.

[7] Even if comma 854 of 2016 Stability act stated the abrogation of Law Decree November 22nd, 2015, no. 183, it nevertheless provided that «there in no prejudice to any acts and administrative orders and already produced effects and already born juridical relationships».
This being the case, it's not clear what was actually repealed.

[8] As anyone can see, the concept just expressed is different from the one according to which «the involvement of subordinated bondholders in the bail-in process, which leads to the annulment of their entitlements in order to absorb losses, shouldn't contradict the liability rule that qualitatively depicts that security» (in these terms, Semeraro's presentation).
A different problem is, of course, the one about the «legitimacy» of the administrative body which ordered the above mentioned expropriation.

[9] See, in particular, Capriglione's presentation.

[10] On the importance of «early intervention» measures according to BRRD, see the presentation by De Polis.

[11] According to what is reported by the newspaper *Il Sole 24 Ore*, January 31st, 2016, President Visco noted that bail-in regulation «needs to be revised».

[12] This is effectively noted in Santoni's presentation.

[13] For instance, one could also think – as a *direct* remedy to the crisis bursting (that is, in addition to preventive measures) – of distributing losses among all other banks on the market [as a matter of fact, the cornerstone of such an idea con be found, as far as depositors (but not bondholders) are concerned, in the rule set out by article 96, co. 4 of the Italian Banking act].

[14] The reference is to «systemic» and objective scarcity, as opposed to distributive one.

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

The New European Framework For Banking Crisis Management. Will It Be Enough?

by **Giuseppe Boccuzzi**

Abstract: This paper concerns the regulatory responses to the financial crisis, focusing on the construction of Banking Union and the Bank Recovery and Resolution Directive. This paper takes into account that very few banking crises can be resolved without external support, as internal resources are not enough. The analysis shows also that external resources are certainly not government resources, because there is no line in the State budget for this. The Author concludes that the solution of banking crises is a delicate matter. He remarks how crises produce negative effects on a multitude of stakeholders and the the need for appropriate procedures for solving the crisis in as short a time as possible.

Summary: 1. The financial crisis and the institutional and regulatory responses. – 2. The construction of Banking Union: is it solid and resilient? – 3. The Bank Recovery and Resolution Directive: who covers the losses? – 4. Deposit guarantee schemes: which model? – 4.1 Some critical issues. – 4.2 State aid rules: which framework do we need? – 4.3 The European Deposit Insurance System (EDIS): What kind of EDIS do we need? – 5. The need to refine the European framework.

1. The international financial crisis of 2007-2009 and the turbulence in the Eurozone in the summer of 2011 from the vicious circle between sovereign risk and banking risk set in motion institutional and regulation reforms of the banking sector, especially with regard to mechanisms governing crisis management. These are still ongoing.

We all remember what happened in the first phase of the crisis: the run on Northern Rock in the summer of 2007, the Lehman Brothers bankruptcy in September 2008 and the serious effects produced by the turmoil on the financial system with a far reaching banking insolvencies chain. They requires a massive recourse to public bail-outs justified by the "too big to fail" (or too complex or interconnected to fail) principle. Banks could be so big that they could not be allowed to fail for fear of serious disruptive and contagious effects on the financial system and economic activity[1]. This sowed the seeds for a second phase of the crisis: the doom loop between bank risk and sovereign risk which was especially deep in countries with huge fiscal problems.

The Italian banking system emerged substantially unscathed from the first phase. Given their traditional commercial banking model, Italian banks had not been affected by the debacle in sub-prime mortgages and related structured products. However, they succumbed badly to the second phase. Italy was sent into recession.

The crisis has been a long one, unprecedented since the Great Depression. It has been characterized by many interacting factors: (i) a collapse of economic activity and employment levels; (ii) a reduction in loans to businesses and households (credit crunch); iii) an increase in non-performing loans on banks' balance sheets which hampered efforts to reduce operating costs; (iv) a weakening of own funds, addressed through massive recourse to market recapitalization; and, v) a crisis of banks with troubled or mismanaged governance structures.

Many answers have been given to the many questions posed as to the causes of the crisis. But many aspects still lack adequate explanation. Economists and regulators have not fully succeeded in getting at the root causes of such complex phenomena and less also in knowing how to anticipate them to enable timely intervention and mitigation of damages. Regulation and supervision revealed their limitations and deficiencies; banks' risk management systems were not able to cope. It was a mix of factors and pernicious effects on the overall economy and on financial stability. A great need was felt for reforms of the institutional architecture and of the rules in place to ensure the orderly performance of banking activity and the very fundamentals of the banking sector.

This is what triggered the European Banking Union project among Eurozone countries, a far-reaching project, meant to provide solutions for the underlying problems at the most acute phase of the financial crisis, to create a more advanced safety net in the Eurozone in defense of financial stability. New rules on supervision and banking crisis management have been put in place; specifically important are the Bank Recovery and Resolution Directive (BRRD) and the Deposit Guarantee Schemes Directive (DGSD). Deposit guarantee schemes have a crucial role, both for banks and depositors.

The new institutional and regulatory framework is innovative and complex: we have now new institutions, new rules and new principles and objectives. We are seeing a new way of thinking, a new way of interpreting phenomena and new conceptual categories. Our language is also changing, with new terms like resolution, burden sharing, bail-in, depositor preference, no creditors worse-off, MREL-TLAC. Legal and economic concepts, often very complex, often lie behind these new expressions.

In operational terms, we are given new ways for managing crises, having uniform procedural schemes, with approaches that can often be quite different from those followed at national level.

Deeper studies are needed to better understand the new framework and its consequences for the financial system. Market operators, professionals and even ordinary citizens are urged to become more acquainted with the issues and, especially, to become aware of their huge impact on the allocation of savings and society.

We all need to carefully analyze the new system in order to verify its overall substance. We need to consider the extreme breadth and variety of the issues and the legal and economic institutes involved, not fully understood until now, given the speed with which it came into being, fueled by the urgency to remedy the shortcomings that emerged during the financial crisis. The impact on national legal systems is significant, with far-reaching consequences, which must be considered from the point of view of the general principles of subsidiarity and proportionality featured in the EU legal framework.

A critical analysis is of the utmost importance, because up to now the different stakeholders have not been significantly involved during the legislative process. Legal and economic scholars need to look closely at the new rules, the new legal institutes that have been created, and their impact on national jurisdictions.

In Europe, there is no field of economic regulation in which differences among the various countries are so pronounced as in the sector of firms insolvency; very different philosophies and approaches as to how to resolve crises are in place and depend on many factors, often linked to legal traditions, basic guidelines for bankruptcy laws and to the stage of development of the economy and finance. Without careful investigation and consideration of the differences among individual legal systems, no appropriate European framework can be designed.

That is why transitional regulations and ex-ante and ex-post impact assessments of reforms are so important: from the very outset, there has been no blanket solution for all possible situations and cases. It is not possible to apply the "one size fits all" approach. Otherwise, we run the risk that initial regulatory weaknesses will lead to excessive regulation or inadequate choices or, above all, to mistaken interpretations that could result in doing even greater damage than the problems we wanted to remedy.

2. European Banking Union is often represented as a building, with three pillars (SSM, SRM and a single DGS) and foundations made up of common rules (the "Single Rule Book"): CRR-CRD IV, BRRD and DGSD.

Any building, to be robust and resilient, must have solid foundations and correctly located pillars. This simple rule is also valid for Banking Union. Consequently, we must look at the whole construction and ask whether the whole legal framework is complete and effective and sturdy enough to last; or do we think the foundations are a bit unsteady? Or perhaps, we need different or more pillars?

The overall design of Banking Union is very clear. Decisions on supervision, crisis management and deposit guarantee schemes must be taken at the same level: the European level for larger banks and the national level for smaller ones. Some decisions are exclusive of each authority; others are to be shared. Cooperation, then, between European and national authorities is crucial for the correct functioning of the entire system.

The third pillar – the single deposit guarantee system – has not been realized yet. In the meantime, this project has been replaced by maximum harmonization of regulation – through the Directive on Deposit Guarantee Schemes (2014/49/EU – DGSD) – as an intermediate step towards the Single European Deposit Guarantee Scheme.

We are now at an initial phase of the implementation of DGSD in national jurisdictions. Some countries have not implemented it yet. As a result, we have too little information as yet to evaluate how well it is working from one country to the next. However, we are aware that this is a transitional phase and we should move towards a single DGS in the Eurozone.

However, the single European deposit insurance system (EDIS) is controversial. Some countries are opposed to it because they consider premature, at this stage, the mutualization of national financial resources within the Eurozone, which could lead to the use of the stronger countries' money for the benefit of the weaker ones. As long as this opposition remains, Banking Union will remain incomplete.

A major question arises here. Is EDIS the only piece missing for the completion of Banking Union? In light of divergent approaches on the modalities and timelines for the European construction, perhaps something more than a European DGS is missing. Perhaps we have to find some force of gravity that will hold all the pieces together.

Apart from the lack of the third pillar, a more in-depth analysis needs to be conducted into the quality of the new rules, into their effectiveness to successfully address banking crises in Europe and into the efficiency of the decision-making processes.

3. The thinking behind the Bank Recovery and Resolution Directive (BRRD) is that the cost of a crisis must be borne by shareholders and creditors of the insolvent bank, as well as by the banking system as a whole, and not by taxpayers, as happened during the financial crisis. This would reduce the impact on a country's balance sheet and help minimize moral hazard.

The BRRD defines general principles (Article 34.1) and objectives (Article 31.1). It outlines a special regime for dealing with insolvent banks, involving new proceedings and tools different from those generally used with non-financial firms.[2] An administrative regime has existed in Italy since the 1936-38 Banking Code. But the BRRD special regime goes well beyond this traditional administrative approach; it is far more intrusive into bank businesses, even when they are in the course of their ordinary everyday affairs.

In order to make these key principles and objectives effective, BRRD introduces significant methodological changes with a clear strategic vision: an integrated approach to dealing with banking crises, well supported by economic theory and empirical evidence. In this vision, it is important not only to have the right tools that address banking crises once they occur, but also that underpin robust preventative measures.

The crisis of any firm, including a bank, hardly ever comes out of the blue; it is normally the outcome of a process of deterioration that develops over time. Prevention requires adequate preparation by banks and authorities (Recovery and Resolution plans) and the availability of a full toolkit by supervisors for early intervention when the first shows signs of deterioration appear (early intervention measures).

Preparation and prevention are key components of a crisis management system. Businesses face discontinuity at some point during their life and have to be prepared to address it with appropriate corrective measures. In a competitive market, crisis is a natural, inevitable phenomenon. Therefore, preparatory and prevention activities are integral parts of strategic, capital and liquidity plans (ICAAP and ILAAP) and of the policies and objectives of risk management (Risk Appetite Framework).

However, preparatory and supervisory activities – even if well-structured and effectively functioning – can reduce but not eliminate the risk of bank insolvency, given the multitude of internal and external factors that can change a situation from bad to worse. When a crisis occurs, authorities must have appropriate powers and tools available either for an orderly liquidation or resolution of the bank, in order to preserve its essential functions and protect depositors and at the same time reduce to a minimum the burden on taxpayers.

In this special regime, resolution is a new procedure aimed at restructuring the insolvent bank, as an alternative to liquidation, when the public interest is at stake (Article 32.1.c) and when liquidation under ordinary insolvency proceedings would not meet the resolution's objectives[3]. Resolution may be achieved using various tools: sale of business, creation of a bridge bank, good bank/bad bank separation, and bail-in.

The most important innovation is Bail-in. It addresses the need that coverage of an insolvent bank's losses should not be borne by the taxpayers, but rather by on those who invested in the bank, such as shareholders and creditors. The burden would be allotted according to a specific hierarchy established by national insolvency laws.

Bail-in is nothing more than the application of insolvency rules outside of a liquidation proceeding. In summary, these rules are applied to situations where the bank is failing or likely to fail; the bank is restructured, not liquidated, to preserve the business continuity (going concern solution) or to facilitate the transfer to another bank or to a bridge-bank (gone concern solution)[4].

But in this "superior" need to keep the insolvent bank alive and to preserve the continuity of the essential functions, to what extent can shareholders' and creditors' rights be sacrificed?

The implementation of bail-in has opened up a huge debate in many countries. Concerns have been expressed about the effects of bail-in on shareholders' and creditors' rights, also in light of the specific safeguards outlined by the Directive to protect their interests. The main questions are these: are the safeguards envisaged by BRRD sufficient, also in terms of jurisdictional safeguard? Can they strike a proper balance between restructuring the bank and protecting the stakeholders affected by the resolution measures? Many doubts have been expressed by the doctrine on this[5].

Additional problems may arise when bail-inable financial instruments are held by retail investors, who have little or no ability to judge the riskiness of their financial choices, often as a result of mis-selling of those instruments by banks. The issue here is not the bail-in in itself, but which savers and investors should hold these instruments and under what conditions.

The bail-in regulation states that "from the protection of savers we are going to the protection of depositors and taxpayers". This has resultant disruptive effects on the financial system in terms of the loss of confidence towards the liabilities (the deposits) issued by banks, those very liabilities the legal framework intends to protect, given that the recourse to last resort guarantee by the public sector is not possible[6].

Many argue that there could be a negative impact on the composition of liabilities and the cost of funding, and on the structure of the financial system.

Debate on Bail-in is currently underway in many international fora. There is not a unanimous consensus on whether the new tool is appropriate and effective. Some argue that it should only apply to

G-SIFIs (global systemically important financial institutions) – as was initially thought – and not to all banks, which seems to be happening in Europe. Others are concerned about applying bail-in to deposits over the 100,000 euro threshold.

The financing of resolution through bail-in could be combined with the use of the Resolution Fund fed in by banks.[7] Hence, the provision of financial resources to resolve banking crises is entrusted to the private sector, such as investors and creditors of the failing bank and the banking system as a whole.

A question remains in the background: To what extent may the private system be charged to solve major crises with systemic relevance? What is the limit to the private intervention?

It is worth noting that BRRD allows recourse to public financial stabilization tools. These can be used as a last resort when ordinary resolution tools are not sufficient to avoid a significant impact on financial stability or to protect the public interest (Article 56).

In Italy, at a time of extraordinary crisis involving significant public interest, a specific government instrument was available under the Ministerial Decree of 27 September 1974[8]. It was utilized until early 2000 and not replaced with another tool having the same function. The Legislative Decree implementing BRRD (No. 180 of 16 November 2015) has no provision in this regard.[9] Accordingly, there is currently no ex-ante instrument of public intervention for cases of crises of systemic importance. This is a gap in the Italian system.

4. Deposit guarantee schemes: which model?

4.1 Deposit insurance is an essential component of a safety net. Its function is to protect depositors and contribute to financial stability. Hence, it is a fundamental element of confidence, which is the connective tissue of any financial system. The experience of the two Italian DGSs is evidence of this. Depositors have never incurred losses in bank insolvencies. Banks' businesses and essential functions have always been preserved through support interventions, as an alternative to liquidation.

Interventions by the FITD since its formation in 1987 reflect this strategic approach. The FITD has intervened 11 times, only twice to pay depositors in the case of very small banks. The other 9 interventions were in the form of the transfer of assets and liabilities to another bank within the liquidation process, and support for banks under special administration.

Institutional mandates, i.e. the measures and types of intervention that deposit insurers are allowed to carry out, differ across the globe. They depend on the institutional setting of financial systems and the specific safety nets in place.

According to the classification by FSB-IADI,[10] a deposit guarantee scheme may have a mere payout function (pay box) or may perform wider mandates: pay-box plus, loss minimizer and risk minimizer. In many legal frameworks, this classification corresponds to the real evolution of the deposit insurance system over time.

The new European legal framework fully confirms this approach. The overall design aims at conferring on DGS the broadest institutional mandate, consistently with the evolution of DGS functions: from the simplest pay box function to loss minimizer. The DGSD, in line with FSB-IADI standards, outlines and recommends a broad mandate for DGS. Recitals 3 and 16 expressly state that Member States should enable the DGS to go beyond a pure reimbursement function to reduce the likelihood of future claims against it, using the available financial means to prevent the failure of a member bank. In any case, such interventions must comply with State aid rules. Such interventions can be utilized in the different phases of the crisis and in various forms.

In the new framework, interventions can be divided into two categories:

i) mandatory interventions, to reimburse depositors (Article 11.1) and finance resolution (Article 11.2, which makes reference to Article 109 of BRRD);

ii) voluntary interventions, consisting of "alternative measures" aimed at preventing the bank's failure in compliance with conditions established in Article 11.3, and help with the transfer of assets and liabilities of liquidated banks, as an alternative to payout (Article 11.6).

In addition to the intervention listed above for DGSD, BRRD (Article 59) states that when the bank is "failing or likely to fail", the crisis may also be addressed outside resolution through the write-down and conversion of capital instruments, in order to recapitalize the bank (pre-resolution). It is implicit in this provision that the bank may also be recapitalized through the intervention of other investors, in conjunction with write-down and conversion of capital instruments. This is pursuant to Article 32 of BRRD, which provides that "alternative private measures" may prevent the failure of the institution within a reasonable timeframe (if this is not possible, resolution is triggered).

Under Italian law, in order to recapitalize a bank, third parties may intervene including the Deposit Guarantee Scheme (Article 27 of the decree implementing BRRD).

The comprehensive legal framework deriving from the combination of DGSD and BRRD is anchored in a wide vision of banking crisis. It considers that a banking crisis is a complex phenomenon, the result of the interaction of multiple factors, interest and values, which require a wide array of tools to be triggered if needed.

However, this far-reaching capacity through alternative means of intervention seems to be contradicted by some provisions and application guidelines, which introduce constraints and limitations and thereby reducing the scope of operation. Uncertainties remain as to what DGSs can and cannot do.

With regard to depositor payout, the scope and limits of such interventions should be carefully considered. In other words, we should ask to what extent liquidation and reimbursement of depositors is realistic and practicable. Those who manage banking crises are well aware that in many cases, liquidation is not a viable solution.

According to the literature[11], depositor reimbursement is possible only for small banks, and not for medium to large financial institutions. In any case, it does not work in the case of systemic crises. Hence, when major shocks occur (insolvency of one large bank or of several small banks at the same time), liquidation and depositor reimbursement are not really a viable option, for two main reasons:

i) lack of financial resources to cope with the repayments, especially in a crisis with systemic implications. Furthermore, many DGS come from an ex-post system and are currently in the transitional phase of accumulating resources as provided for by the DGSD. In any case, even in ex-ante systems, financial resources may be insufficient and specific mechanisms should be in place for ensuring the availability of funds, also through alternative funding arrangements.

Such mechanisms are necessary to increase the financial capability and credibility of deposit guarantee systems. They may take, for example, the form of borrowing from the market, central bank financing, or a public backstop.

With a view to European integration, the mutualization of national resources should be speeded up, in order to effectively deal with far-reaching insolvency phenomena. The proposed European Deposit Insurance Scheme (EDIS) seems to move in this direction.

In any case, resorting to a public backstop seems to be inevitable. It solidifies the implicit public guarantee on which the market relies for the capacity of a DGS to repay depositors up to the protected amount;

ii) various forms of contagion that may trigger the liquidation of one or more banks, even if a deposit guarantee system is in place.

To prevent contagion, authorities often resort to solutions other than liquidation, in the form of financial support for the bank's restructuring and recovery.

For insolvent banks of large size or having systemic implications, the alternative to liquidation is resolution. For small and medium-sized banks, resolution could not be applicable, given the difficulty of proving the existence of a public interest, so as to avoid liquidation and restructure the bank through a recapitalization or a sale of business to third parties. Consequently, this scenario paves the way for only one solution: the liquidation of small and medium banks, with serious prejudice to the continuity of credit relations and to depositors. Unless alternative measures are allowed, both before/outside liquidation and within liquidation, through the sale of assets and liabilities to another bank.

This is the knotty part of European Directives and their implementation. And it is aggravated by the joint incidence of State aid rules and the "least cost" principle (applied together with the depositor preference principle)[12], which tends to reduce the space for maneuvre for such alternative interventions. In fact, alternative measures could turn out to be ineffective. So, Are the "alternative measures" contemplated by the DGSD actually "impossible alternatives"?

Circumstances seem to contradict the very principles and guidelines envisaged in the Directive (Whereas 3 and 16; Art. 11, par. 3; art. 11, par. 5; art. 19, par. 3). Specific regulatory interventions and a revision of applicable criteria can represent a remedy to the situation.

4.2. Many issues have been raised by the EU Commission Communication in force from 1 August 2013 on State Aid in the banking sector.[13] It provides that interventions other than depositor reimbursement – i.e. alternative measures – may consist of State Aid when certain conditions are met.

Therefore, the application of State aid rules is a possibility and alternative measures by DGSs are not automatically State aid.

The Communication clarifies that in principle, interventions by deposit guarantee systems to reimburse depositors of failed banks do not constitute State aid. However, the use of such funds to assist in the restructuring of credit institutions may constitute State aid “to the extent that they come within the control of the State and the decision as to the funds’ application is imputable to the State”. The Commission assesses the compatibility of State aid in the form of such interventions (point 63). Point 64 makes a similar provision for interventions by resolution funds.

In issuing these guidelines, the EU Commission has given quite an extensive interpretation of State aid rules and applies them to DGS. This is the case even when the DGS is a legally a private entity, financed by private banks and managed by private bodies and when interventions alternative to depositor payout are discretionary.

This peculiar application of Article 107 of the TFEU raises many doubts about the compliance of the Communication itself and the rationale of the TFEU, which is to avoid undue distortion in market competition through improper State intervention, not external support by DGS in case of a banking crisis. They represent “assisted solutions” of banking crises, with private resources.

We are well aware that very few banking crises can be resolved without external support, as internal resources are almost never sufficient. But external resources are different from State funds. It is as if some genetic mutation or magic touch turned private money into public: but they are certainly not government resources. The reality is that there is no line in the State budget for this.

Clear evidence of this (mis)interpretation of State aid rules is the case of Banca Tercas. After an in-depth investigation last February, on 23 December 2015 the EU Commission concluded that the Fondo Interbancario di Tutela dei Depositi (FITD), acting on behalf of the Italian State, had provided incompatible State aid to cover the bank’s losses and facilitate the sale to Banca Popolare di Bari (SA 39451)[14] .

In the subsequent press release, the EU Commission welcomes the plans of private funds to step in, mentioning that the FITD “has consulted its members as to whether they would voluntarily agree to support Banca Tercas. If private actors decide according to their own objective and from their own funds, without mandate from the State, to support banks in difficulties, no state aid issues would arise.”

In the same vein, we have the well-known case of the four Italian banks under special administration, in which the FITD – according to its by-laws and Article 11.3 of DGSD – decided to intervene for the recapitalization of the banks in a pre-resolution context, in conjunction with the write-down and conversion of capital instruments (Articles 59 and following of BRRD).

In this case, the EU Commission ruled that the FITD intervention qualified as State aid and Italy had to place the banks in resolution. It argued that FITD resources are public, since they refer to a compulsory scheme; State aid require the application of the resolution procedure provided for by the BRRD[15]; outside of the resolution, support measures should come from the private sector, identified in accordance with the rules on State aid.

The banks – declared failing or likely to fail – have subsequently been put in resolution, with the transfer of all business to four bridge banks and use of the national resolution fund for loss coverage and recapitalization. The results have been higher costs for the Italian banking system and for retail investors (and their families) than those foreseen with the FITD intervention. Furthermore, the resolution process and the tools used are even more akin to State aid than the FITD intervention that the Commission wanted to avoid.

With reference to these cases, the EU Commission has elaborated on the concept and consequences of State aid, again in the direction of supporting voluntary schemes for alternative interventions. It concludes that "(I)f an assessment leads to the conclusion that the use of the deposit guarantee scheme is State aid, resolution of the bank will be triggered under the Bank Recovery and Resolution Directive, which defines 'extraordinary public financial support' as being 'State aid...in order to preserve or restore the viability, liquidity or solvency of an institution'. Therefore, the conditionality under the Bank Recovery and Resolution Directive would apply. If on the other hand the use of the deposit guarantee scheme would not be assessed as State aid, and instead would be assessed as a purely private intervention, it would not trigger resolution under the Bank Recovery and Resolution Directive" (EU Commission, letter to Italian Minister of Economy and Finance of 19 November 2015)[16].

The EU Commission's arguments are not shareable, as we cannot understand why the DGS "voluntary arm", as suggested by the Commission, is different from the "mandatory arm". Clearly, both voluntary and mandatory schemes – under the same umbrella of the FITD – have the same characteristics: financial resources come from private banks and are allocated by private bodies, and interventions are discretionary. Furthermore, Article 11.3 of the Directive, which provides for alternative measures, refers to mandatory DGS and not to voluntary schemes. Finally, consistently with this provision, the Article 11.5 requires banks, when resources have been used for alternative measures, to refund the DGS to ensure that the target level of 0.8% of covered deposits is reached by 2024. As a consequence, alternative measures have no impact on the scheme's financial resources.

The EU Commission guidelines also contradict the very principles affirmed in BRRD and DGSD, based on the sole use of private resources to resolve banking crises without recourse to public funds. Indeed, a DGS's financial resources are private if provided by private banks.[17]

From here the question: Can a mere Commission's Communication be contrary to the letter of a Directive? More in general, can a Communication be the legal instrument to regulate such complex and delicate aspects, involving rights and obligations of various subjects?[18]

If such an interpretative approach should persist, we should conclude that the crisis management system created by the new directives needs to be reconsidered. Indeed, while, on the one hand, an articulated public system of powers and tools to solve banking crises has been designed, we, on the other hand, are obliged to resort to forms of voluntary interventions – as suggested by the Commission – outside of the compulsory deposit guarantee schemes, with resulting difficulties in their application. It would seem, then, that a system has been created that does not work, at least from the Italian perspective.

Italian DGSs, in order to follow the consolidated experience of banking crisis management, driven by the prevention of insolvency, have created voluntary schemes in order to intervene with restructuring operations, also for small and medium sized banks, before liquidation and resolution. Does this really make sense?

In evaluating the consistency of alternative interventions with market discipline, it is important to highlight that competition rules are in any case applied. The banks resulting from alternative measures are very different from the ones at the beginning of the crises, given the restructuring plans that are normally put in place to ensure their long-term viability. We should ask whether the antitrust rules alone would be sufficient to evaluate if a DGS intervention is compatible with the market principles, without the need for State aid rules[19].

4.3 The recent Five Presidents Report on “Completing Europe’s Economic and Monetary Union” deals with this topic within a wider strategic plan to be completed by 2025[20]. In order to implement such a plan, the EU Commission released a draft of the Regulation[21] to establish the EDIS and the Deposit Insurance Fund.

The draft Regulation on EDIS presented by the EU Commission envisages a gradual process of mutualization of financial resources and centralization of decisions. The project is divided into three phases: the first, with a system of deposit re-insurance (from 2017); the second, with a co-insurance system (from 2020) and the third, with the establishment of Single Insurance Fund, based on the full mutualization of financial resources at the European level (from 2024). Starting from the third stage, the DIF will have the same functioning of the SRF and will be managed by the Single Resolution Board.

The basic question during this delicate preparatory phase is not whether a European deposit guarantee scheme is necessary, but ‘What kind of EDIS do we need?’.

We wonder how, through what institutional architecture, we could shift to a single deposit insurance system, departing from a framework strongly rooted in national schemes with their own legal identities and operational structures, and specific institutional mandates. This is not an easy task.

Each model should necessarily start from the consideration of national experiences. There is no one silver bullet or ideal scheme. Any model must be consistent with the way a crisis is managed, using the tools and measures available in the various countries. The model developed by the EU Commission is geared toward mandatory interventions only, via depositor payout and contribution to resolution procedures. It is a very narrow model.

Therefore, we should ask whether such a configuration is sufficient and what is the rationale for excluding the alternative means of intervention, widely used in many national systems, where DGS are an essential component of banking crisis management. In the absence of such provisions, who is allowed to intervene? When? How?

A European deposit guarantee scheme is a key completing element of Banking Union, but it must be properly designed. The challenge facing European regulators is how to combine the payout function of EDIS with the BRRD-DGSD rationale and with national experiences and frameworks. Also, to what extent should the mutualization process apply: Is it reasonable to give EDIS the same solutions as those identified for the Single Resolution Fund? Finally, we need to consider proportionality: how will small and mid-sized banks be treated? Who decides?

Indeed, the introduction of EDIS regulation is an opportunity to settle many open questions.

i) The overriding need is to eliminate the State aid regulation applicable to DGS, since lacking valid arguments to consider DGSs intervention as State aid. In this sense, it should be considered that in non-European jurisdictions (including USA and Canada) there is no specific regulation for State aid in the banking sector applicable to deposit insurance systems, without prejudice of the general antitrust rules. As a second-best solution, the principles and application criteria should be re-thought, emphasizing the capability of the individual alternative intervention to determine potential distortions to the European internal market, in relation to the size and other characteristics of the bank;

ii) an effective principle of proportionality must be applied, preserving the role of national DGSs in EDIS framework. In general, in the performance of the traditional function of depositors repayment, national DGS would be in the best position to make payouts and have smoother relationships with depositors than a centralized body. Moreover, they may have an exclusive role in carrying out alternative interventions in favor of small and medium-sized banks, in cases where the public interest test is not met for the application of the resolution proceeding;

iii) in the context of alternative interventions, the transfer of assets and liabilities within the liquidation proceedings[22] should be enhanced, instead of the atomistic realization of assets and the repayment of depositors; this is the consolidated Italian experience, which could become a useful reference model also for other European regulations.

In Italy, the banking license of the bank under compulsory administrative liquidation is revoked. The legal entity, at the end of the liquidating process is extinguished.

In this context, the transfer of assets and liabilities to another bank configures as a way of realization en bloc of assets and of payment of liabilities, in alternative to atomistic liquidation (piecemeal liquidation). It speeds up the liquidation process of the insolvent firm, which otherwise could last many years and at higher costs. In substance, the operation is aimed at safeguarding the continuity of the bank's essential functions and maximizing the proceeds.

The transfer of assets and liabilities within the liquidation process would be equivalent to the sale of business applicable within the resolution (Article 38 BRRD). In such a way, a full equating of tools utilizable would be realized in the two procedures, even though in a different legal context;

iv) to this end, an appropriate solution should be found to the problem regarding the availability of financial resources for national DGS in the context of the funding mechanism of EDIS. We could think of the maintenance at the national DGSs of a significant part of financial means, within the target-level established by DGSD (0,8% of protected deposits). Therefore, reinsurance and coinsurance, envisaged for the first two phases of EDIS, could represent the steady-state solution, consequently abandoning the idea of the full mutualization of resources[23].

This set-up would be consistent with the overall picture of Banking Union, according to which the responsibility for supervision and crisis management of less significant banks is in the hands of national supervisors and resolution authorities. EDIS involvement would be limited to cases of large bank insolvency, when national DGS resources are insufficient.

This could be the proper balance between centralized and national competence, in keeping with the proportionality principle.

5. At present, it is difficult to assess whether the reforms have created the best institutional and regulatory framework. Accordingly, at this stage it is premature to draw conclusions on the adequacy of the individual components of the design, since there are no background information, over an appropriate period, about the effects of the new institutions and instruments introduced. Therefore, time is fundamental to perform a significant evaluation.

However, criticalities and uncertainties have been already identified, in Italy and in other European countries, as usual during a transitional period. The many doubts raised require a deep reflection.

The solution of banking crises is a delicate matter. Crises produce negative effects on a multitude of stakeholders (shareholders, creditors, corporate borrowers and families, depositors, other banks, the banking system as a whole). Therefore, there is the need to have clear rules, an effective design of decision-making processes and appropriate procedures for solving the crisis in as short a time as possible. When a banking crisis occurs, time is of the essence. It is key to finding the causes, assessing the damage and defining the suitable solutions.

In the new European set-up, meeting all these requirements is no simple task. Inconsistencies pointed up in this work require appropriate refining of the new legal framework. One thing is certain: Given the complexity of the reform, we still have a lot of work to do.

Many aspects should be given high priority

i) the complexity of the institutional architecture. A multi-level decision-making system (European and national) is in itself problematic, so if a consistent design is not established – and examples are numerous – there could be overlaps and redundancies. We have national and European supervisory authorities; national and European central banks; national and European resolution authorities. Who is responsible for doing what, is not always clear.

Just a few examples. Think about the involvement of the supervisory authority and the resolution authority in the preparatory phase of crisis management (recovery and resolution plans), where the resolution authority has powers and tools that are typical of the supervisory authority with regards to the design and implementation of resolution plans; or, the hybrid role of the European Banking Authority (EBA), acting as a regulator, a standard setter, a relevant actor in micro and macro supervision, and mediator, often not having clear boundaries with the regulatory and supervisory powers of ECB; or, the combination of regulatory and resolution powers of the EU Commission and the European Council, given their involvement in the bank resolution decision-making process in various forms and situations[24].

Then, there is the crucial role of EU Commission in the assessment of crisis management solutions in the implementation of State aid rules, also with regard to restructuring plans of the banks, with overlaps with supervisory and resolution functions. In the end, who decides the solution of banking crises? If we assume that hardly ever can we have a solution without external support (including DGS support), we should conclude that the EU Commission really has the final say. Is this consistent with the framework introduced by the Directives?

ii) the interaction between different types of rules from different authorities. Beyond regulations and directives, and the related recitals, we have implementing and regulatory technical standards, guidelines, recommendations, with the consequent proliferation of rules.

The rules have been written in a very short time frame, under the pressure of urgency, and not always consistently. Rules, we know, are often difficult to interpret. Who will interpret them? Who ensures the necessary equality of treatment? What are the coordination mechanisms to prevent the deadlock that might occur when an authority has to wait for decisions to be taken by other authorities?

iii) the lack of a transitional period for several rules. Given the enormous changes, the transition from the old to the new regime is extremely delicate, especially when the starting basis can be so different as in the field of banking crisis management. It is of utmost importance to provide graduality, flexibility and proportionality, and to give due consideration – even if only for a transitional period – to principles, experiences and practices rooted at the national level;

iv) the fact that BRRD is a discipline of minimum harmonization is not fully considered. The Directive allows the utilization of other instruments available at the national level, when these make it possible to achieve the same objectives.[25]

Experience during this first phase of the reform demands that we reflect on the new system we are creating. After a financial and economic crisis of such proportions, it is important to avoid rigidity in favor of a proportional, gradual and flexible approach, aimed at appreciating virtuous experiences in the different countries in keeping with the new principles. This applies to the many ways DGS can be used to finance solutions alternative to liquidation, which need to be preserved. Qualifying these as State aid limits the ability of the system as a whole to resolve banking crises. Formal considerations seem to prevail over substance; especially when the DGS is a private fund managed by private bodies, used for transactions that are not mandatory but decided on a discretionary basis.

Proportionality, a key principle of the European framework, must be ensured: the same rules and procedures cannot apply to operators of different sizes and complexity. The “one size fits all” approach may cause serious distortions.

To conclude, we cannot deal with complexity with rigidity.

References:

[1] G. BOCCUZZI, Towards a new framework for banking crisis management. The international debate and the Italian model, Bank of Italy Legal Research Papers, October 2011.

[2] G. BOCCUZZI, The European Banking Union. Supervision and Resolution, Palgrave McMillan, 2015.

[3] According to Art. 31 BRRD, resolution objectives are: i) to ensure the continuity of critical functions; ii) to avoid a significant adverse effect on the financial system, in particular by preventing contagion, including to market infrastructures, and by maintaining market discipline; iii) to protect public funds by minimising reliance on extraordinary public financial support; iv) to protect depositors covered by Directive 2014/49/EU and investors covered by Directive 97/9/EC; v) to protect client funds and client assets.When pursuing the above objectives, the resolution authority shall seek to minimise the cost of resolution and avoid destruction of value unless necessary to achieve the resolution objectives.

[4] According to Art. 2, paragraph 1, no. 57) of BRRD, "bail-in tool" is a mechanism for effecting the exercise by a resolution authority of the write-down and conversion powers in relation to liabilities of an institution under resolution. The bail-in aims at restoring the capital of the bank under resolution to the extent necessary to comply with prudential requirements or, in the case of a transfer, to reduce the nominal value of the transferred liabilities, including debt securities, or to convert these liabilities into capital.

[5] In particular, doubts concern the effectiveness of the safeguards designed to protect creditors' rights, with regard to many aspects of the discipline, including the "no creditors worse-off" principle (Article 34.1.g). This states that no creditors should incur greater losses than they would have if the bank had been liquidated under normal insolvency proceedings. On these issues, see J.H. BINDER, The position of creditors under the BRRD, Eberhard-Karls-University – Faculty of Law, December 2015; L. DI BRINA, Sulla dubbia costituzionalità degli Interventi comunitari e nazionali in materia di "risoluzione delle banche", FIRSTon line, 11.12.2015. R. LENER, Bail-in: una questione di regole di condotta? See Conference "Salvataggio bancario e tutela del risparmio", Rivista di Diritto Bancario, n. 2, 2016; F. CAPRIGLIONE, Luci e ombre nel salvataggio di quattro banche in crisi. See Confernce "Salvataggio bancario e tutela del risparmio", Rivista di Diritto Bancario, n. 2, 2016.

[6] F. PANETTA, Finanza, rischi e crescita economica, speech at the Conference: "Benchmarking the UK Market: A way to create an efficient and effective capital market in Italy", at Equita Sim, Milano, 27 January 2016.

[7] The Resolution Fund can be used to support any resolution operation, in different ways and technical forms, such as: (i) to guarantee the assets and liabilities of the insolvent bank, its subsidiaries, a bridge bank or an asset management vehicle; (ii) to provide loans to the same entities; (iii) to purchase assets from the bank under resolution; (iv) to provide contributions to a bridge bank or asset

management vehicle; (v) to pay compensation to shareholders and creditors within the safeguards provided for by Article 75; (vi) to make a contribution to the insolvent bank in place of the amount it would have obtained from the write-down or conversion of the liabilities of specific creditors, if the authority has decided to exclude some liabilities from the bail-in; (vii) to provide loans to other resolution-financing arrangements on a voluntary basis. In any case, the resolution fund cannot be used to cover losses directly or to recapitalize a bank or another entity referred to above. Moreover, if the resolution fund incurs indirect losses, the principles regulating the use of the resolution fund within the bail-in framework will apply, including the use of bail-in covering at least 8% of total liabilities and the rule that use of the fund may not exceed 5% of total liabilities.

[8] The Ministerial Decree of 27.9.1974 provided that the Bank of Italy could grant special financing to banks subrogating to the rights of depositors of a bank in liquidation.

[9] According to the report accompanying the Decree, the BRRD provisions on government stabilization tools have not been incorporated because such measures are not provided for in the SRM Regulation and their implementation would require the approval of a specific law including such measures.

[10] FSB Compendium of Key International Standards of Financial Stability. The IADI Core Principles for effective deposit insurance systems, as revised in 2014, are included in the Compendium.

[11] E. KANE, A. DEMIRGUC-KUNT, Deposit insurance around the globe: where does it work?, NBER Working Paper n. 8493, 2001; ED. J. FRYDL, M. QUINTIN, The benefit and costs of intervening in banking crises, IMF, 2000; S. SCHICH, K. M. BYOUNG-HWAN, Systemic financial crises: how to fund resolution, OECD, 2008.

[12] This principle provides for that reorganization (alternative) measures are allowed only when they are less costly than depositor reimbursement in case of liquidation. With the introduction of the "depositor preference" rule (Article 108 BRRD), it is highly likely that paying out depositors could be (ex-ante) less expensive than the alternative measures. Indeed, as a consequence of the depositor preference, deposit guarantee schemes, subrogating to the rights and obligations of covered depositors, have a priority ranking which is higher than the ranking provided for the claims of ordinary unsecured, non-preferred creditors in normal insolvency proceedings. The application of the "least cost" principle is a complex issue, as there are no standard assessment methodologies; calculating the cost of reimbursing depositors can not only be the result of the initial payment net of recoveries, but should also take into account spillover and other indirect effects (public confidence) on the whole banking system and the economy, that may result from the liquidation of the bank.

[13] EUROPEAN COMMISSION, Communication from the Commission on the application, from 1 August 2013, of State aid rules to support measures in favor of banks in the context of the financial crisis ("Banking Communication"), 2013/C 216/01, 30.7.2013.

[14] The case is very complex. It involves two issues: i) the qualification of the DGS intervention as State aid, and ii) the compatibility of State aid with the single market. Regarding the first issue, the

Commission stated that: the amounts paid by member banks are mandatory and can, therefore, be considered as public resources; the decisions to intervene are attributable to the State, in view of the role of the Bank of Italy in the decision-making process, that approved the intervention. On the second topic, the Commission stated that Italy did not present a restructuring plan, the burden-sharing principle was not applied (subordinated debts were not written down), and no measures were implemented to limit the distortion of competition created by the aid. On both aspects the EU Commission ignored the many strong arguments presented by the Italian Government, the Bank of Italy and FITD. Among others, the main argument was that Tercas, although still a going concern, was entirely controlled by Banca Popolare di Bari (BPB) after a recapitalization process and had been restructured with a view to its absorption by BPB. Moreover, at the time of the intervention, Italy had no burden-sharing rules in force (write-down or conversion of subordinated debts), so there were no legal conditions to apply burden-sharing.

[15] The qualification of DGS alternative intervention as State aid, de facto prevents DGSs from performing any activity different from the payout, triggering resolution for the bank in crisis: indeed, public interventions may be carried out only in a resolution procedure (as per BRRD Art. 56 on government financial stabilization tools), when conditions are met. The key point of the Commission's construction resides in the equalization of DGSs interventions to extraordinary public financial support, which is State Aid pursuant to Art. 2, paragraph 1, no. 28) of BRRD (incorporated in Art. 1, paragraph 1, letter mmm) of the Legislative Decree n. 180/2015). Under this provision, extraordinary public financial support means State Aid within the meaning of Article 107(1) TFEU, or any other public financial support at supra-national level, which, if provided for at national level, would constitute State aid, that is provided in order to preserve or restore the viability, liquidity or solvency of a bank. But this equation does not seem well founded, since the discipline called by Art. 56 concerns the direct intervention of the State in a resolution procedure (in the forms of capital support or taking temporary ownership) as a last resort remedy, decided by the Government in cooperation with the resolution authority. This case is, in all evidence, quite different from the interventions of a DGS carried out with private resources and determined by private entities.

[16] Published on Ministry of Economy and Finance website.

[17] On the issue, see the Sicilcassa case: Commission Decision of 10 November 1999 conditionally approving the aid granted by Italy to the public banks Banco di Sicilia and Sicilcassa (C81999) 38651). In that decision, the Commission stated that the contribution by FITD towards the liquidation of Sicilcassa to cover part of the losses resulting from the transfer to Banco di Sicilia of the assets and liabilities of Sicilcassa did not constitute State aid. State aid was excluded because the Commission verified the significant contribution of non-public-sector banks to the adoption of the decision of FITD. In fact, private banks accounted for the majority of votes in the Board of FITD, at the date of the decision.

[18] Case C 526/14, Kotnik and Others, Request for a preliminary ruling from the Ustavno sodišče (Constitutional Court, Slovenia), Opinion of Advocate General (AG), delivered on 18 February 2016. In this case, the AG, referring to the provisions of the Treaty on State aid, provided an interesting opinion

on the role of the 2013 Banking Communication of the European Commission in the qualifying of interventions in support of banks in difficulty as State aid. Pursuant to Article 108 TFEU, the assessment of the compatibility of specific aid measures with the internal market in principle concerns the exclusive competence of the Commission, subject to review by the EU Courts. In this field, the Commission has no general legislative power, as only the Council is empowered, pursuant to Article 109 TFEU, to adopt any appropriate regulations for the application of Articles 107 and 108 TFEU, on a proposal from the Commission and after consulting the European Parliament. This means that the Commission is not empowered to set general and abstract binding rules governing the situations in which aid may be considered compatible; for reasons of transparency, and in order to ensure equal treatment and legal certainty, the Commission may publish acts of 'soft law' (such as guidelines, notices or communications). The Court (See, to that effect, judgment in Grimaldi, C 322/88, EU:C:1989:646, paragraphs 18 and 19; and Opinion of Advocate General Kokott in Expedia, C 226/11, EU:C:2012:544, point 38) has held that the provisions of such acts of 'soft law' are, respecting the duty of sincere cooperation pursuant to Article 4, TEU, to be taken into account by the Member States' authorities, but that duty cannot be considered as making those rules binding – neither de facto – on pain of breaking the legislative procedure set out in the TFEU. The only effect those rules may directly produce is vis-à-vis the Commission, merely as a limit on the exercise of its discretional power. As a result, the Banking Communication cannot be considered to be, de jure or de facto, binding upon the Member States: any effect of those rules upon Member States can at most be indirect; after the publication of such a communication, Member States could notify the Commission of State aid which they consider compatible, although without respecting the conditions set in that Communication. Upon such a notification, the Commission would be diligently examine the compatibility of such aid measures taking into account the Treaty provisions. Accordingly, the mere fact that one or more rules in the Banking Communication are not complied do not represent a valid reason for the Commission to declare the aid incompatible. What is key is that, from a legal point of view, a Member State might be able to demonstrate that, despite the lack of any other criteria stated by the Banking Communication, aid to a bank in difficulty still satisfy the requirements of Article 107, TFEU. In the light of the foregoing considerations, in the present case, the Commission cannot consider burden-sharing a condicio sine qua non for declaring planned aid to a bank in distress compatible under Article 107, TFEU: burden-sharing is required only 'normally', 'in principle', and cannot be required where it may infringe fundamental rights or endanger financial stability or lead to disproportionate results.
[19] A. Argentati, Sistemi di garanzia dei depositi e crisi bancarie: c'è aiuto di stato? Mercato Concorrenza Regole, no. 2/2015.

[20] EUROPEAN COMMISSION, Completing Europe's Economic and Monetary Union, July 2015.

[21] EUROPEAN COMMISSION, Proposal for a Regulation of the European Parliament and of the Council amending Regulation (EU) 806/2014 in order to establish a European Deposit Insurance Scheme, 2015, accompanied with a Communication "Towards the completion of the Banking Union", COM (2015) 585.

[22] The transfer of assets and liabilities is regulated by Art. 90 of the Italian Banking Law, which provides for the liquidation of assets in a compulsory administrative liquidation. According to this

provision the liquidators, with the favourable opinion of the oversight committee and subject to authorization by the Bank of Italy, may assign assets and liabilities, the business or parts of the business, as well as assets and legal relationships identifiable en bloc. Assignments may be effected at any stage of the procedure, including prior to the filing of the statement of liabilities; the assignee shall be responsible only for liabilities appearing in the statement of liabilities.

[23] On this topic, for a different approach, see, D. GROS, Completing the Banking Union: Deposit Insurance, CEPS Policy Brief, No. 335, December 2015.

[24] See Regulation (EU) no. 806/2014, Art. 18 on the resolution procedure.

[25] The Directive contemplates a minimum set of tools for the orderly restructuring of the insolvent bank, while allowing Member States to add other tools available at national level which are consistent with the goals pursued by the Directive (recital no. 44).

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This paper develops, through further analysis and insights, the speech of the Conference “Preventing and Resolving Bank Crises in the European Banking Union and depositor Protection”, held in Turin on 12 February 2016, organized by the European Regional Committee (ERC) of the International Association of Deposit Insurers (IADI).

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

UK referendum and Brexit hypothesis (The way out perspective and the convenience to 'remain united')

by **Francesco Capriglione**

Abstract: This paper concerns the position of the United Kingdom in the framework of diversity that characterizes the European Union, by focusing on the uncertainty caused by a *referendum* on the 'Brexit hypothesis'.
The Author considers also the UK's will to base the decision on remaining or not within the Union on a *mere* 'cost-benefit analysis', by underlining that the relationships between European countries are now gradually carrying within a framework mainly characterized by financial patterns (with obvious, consequent limited possibilities to refer the abovementioned relationships to socio-political purposes).
In this context, the *Brexit* perspective increases the feeling of uncertainty, highlighting the difficulty of identifying a «way out» from the *impasse* situation in which the EU currently seems to be stuck. This is why the Author shows that the 'future fate' of Europe should be characterized only by economic and financial relationships aimed at increasing the 'common market', but not also adequate to support the concrete realization of a «political union dream», that risks to remain segregate in an unreal "wishful thinking".

Summary: 1. Introduction. – 2. UK's uneasy relationship with the European Union. – 3. The uncertainty caused by a *referendum* that will instead bring certainty. – 4. (*continued*): a cost benefit-analysis. – 5. (*continued*): an opportunistic logic in contrast to the European political project. – 6. The path toward a new regional context.

1. In a recent analysis on the reasons behind the complex relation between "politics and finance in the EU", I stressed how a general tendency, observed in the European environment, towards a Union with wider borders could practically lead to a weakening of the integration process; hence an obvious, consequent surrender of the possibility of a political union, in which only the most nostalgic of the "European Dream" continue to believe in[1].
Actually, in describing the current de-escalation of the original project of the founding fathers – at the moment reduced to the achievement of a simple «free trade» zone – I underlined how the United Kingdom has to be included among those Member States that, more than others, contributed in determining the conditions for a *revision* of the political plan of an «united and free Europe» (proposed

by Altiero Spinelli and Ernesto Rossi in order to oppose the totalitarianism prevailing in the "Old World" during World War II).[2]

This conclusion is coherent with the conduct of such State that – absent from the initial phase of the creation of the European Union started by six other States – only in 1973 ended the negotiations for entering in the «common market», after having overcome the obstacles behind the transition from a global context (to which it was traditionally connected) to a regional one (in which it has always wanted to participate in the decision making process).

The agreements signed in Bruxelles on February 2016 between Prime Minister David Cameron and the European leaders grant to the United Kingdom a peculiar *status* among the EU. Those concessions extend from the symbolic "statement" that the aforementioned State will never be a member of a «tighter» Union to variegated facilitations (among those the possibility of limiting aid towards EU migrants has a specific importance).[3] Those agreements have an important meaning as they are the ineluctable evidence of the difficulties met by the European Union and by its Members in overcoming the logics of the mere economic benefit, that were at the base of the method used in order to realize the project of the founding fathers, through progressive forms of convergence, all aiming at the political union.[4]

This difficulty has been displayed during the most crucial political phases that the Union had to face in the recent years, from the Greek crisis to the Libyan one and said difficulty is at the root of the undeniable weakening of the reasons that led the United Kingdom to participate first in the European Community and then in the European Union, (as is shown by the fact that in the UK has been prevailing a policy that prefers the economic convenience over value-driven motives shaped around cohesion and solidarity between Member States).[5]

The difficult moment during which a decision on Brexit has to be taken – characterized by hypothetical suspensions of the Schengen Agreement, by a problematic definition of the division of migrants between Member States and by an evident disparity between the level of growth inside the EU – could encourage other States to ask for a "privileged treatment", with the inevitable consequence of starting an opposite process compared to the one that, more than a half century ago, persuaded the subscriber States of the "Treaty of Rome" to unite and to hope in a common future. This would incite the mistrust in the construction of a «common house», hence the failure of the hope that it is still possible to search for another way to experience the European Union!

2. To fully appreciate the range of the agreements mentioned above, intended to influence the future relations between the UK and the EU, we have before to examine the position of the first one in the framework of diversity that characterizes the second.

In this regard it must be stated that United Kingdom – due to its cultural characteristics and its attitude towards EU policies – has often shown a sort of *detachment* from the rest of the continent, or, more precisely, the intention not to become fully involved in European affairs, which it sees as foreign, too distant from its domestic sphere, which is accorded a priority status to.

The United Kingdom, despite the image it gives of itself, was among the first European countries to realize the importance, in the aftermath of World War II, of a process capable of leading to the gradual integration of the nations of Europe.[6] It is very important, in the second half of the 20th century, a debate (in which a significant role was played by two important PMs, Harold MacMillan for the conservatives and Harold Wilson for Labour) on topic accession (as membership) to the EEC[7]; we have to remember also the French veto to repeated applications submitted by UK for membership of the «common market», vetoes ended only with the advent to power of M. Pompidou (who succeeded to M. de Gaulle in 1969) marked the beginning of negotiations – as already mentioned – in 1973, when the UK finally joined the ECC, this one so way looked for reinforcing itself in the perspective to better confront the United States of America and the Soviet Union.[8]

However, the British ‘choice of Europe’ (endorsed by a referendum), has not been accompanied by much empathy, and economic integration was not viewed as necessarily leading to a political union. Support for the latter outcome has remained very low over the years, with a preference for Community mechanisms based on intergovernmental decision-making procedures.[9] Its line of conduct is based on a traditional attachment to national sovereignty (to be intended in its various components), which, although understandable by reason of the pursued economic improvement (exports, occupation, etc.), nevertheless appears strongly contradictory, given the strong opposition to the European policies which often arose in such Country (including, in the 1970s, such authoritative politicians as Sir Teddy Taylor, who resigned from the Heath cabinet as soon as he was informed about the decision to sign the Treaties of Rome).[10]

What we are facing here is a context in which even the decision to scrap the pound is viewed as a loss of sovereignty! The United Kingdom, therefore, has kept out of the «single currency» and its policy towards European affairs, from 1992 (*i.e.* from the Maastricht Treaty) onwards, is seemingly oriented to protecting its national interests first and foremost. This, of course, entails frequent requests for legislative adjustments (*rectius*: changes), as well as taking positions that are inconsistent with the idea of an all-embracing membership, which, moreover, would be required in view of a form of integration, in which the common prevails over the particular interests of the EU member states. It is no accident that, in literature, the analysis of this situation contains evaluations and references to the «*gatekeeper*» attitude of the UK government towards the European Community (as a means for safeguarding national sovereignty) and to its obvious «semi-detachment» from the construction of the EU.[11]

If such circumstances are rooted in the differences that historically separate *Sceptered the Isle* from the *Continent*, cannot ignore that they are also been fueled by a certain distrust of Franco-German axis which has from the beginning influenced the destiny of the European project, not always in the light of the logics of cooperation, mutual respect and solidarity that were at the base of such project. [12] And this also due to Italy’s secondary role, which – for its old and continuous internal conflicts – have not been able for a long time to gain the political clout suitable to its socio-economic position[13].

This explains the positions assumed by the UK, with respect to certain of the main issues concerning the measures for coordinating the EU’s economic and banking policies. In relation to the above has to be first considered the *Report* prepared by the *House of Lords* on the crisis in the Eurozone and, in particular, on the proposed ‘*fiscal compact*’ (and connected measures), considered not compliant with the European Treaty structure;[14] from such point the clear intention of UK to avoid any form of responsible involvement in the affairs of the Eurosystem.

At the same time, the declaration according to which UK intends to submit the matter to the European Court of Justice (which will be allowed to decide on the issue of whether the member states are obliged to introduce in their domestic law the balanced budget rule) highlights its respect for the EU institutions and orientations, which (although formally flawless) is hardly consistent with the position mentioned above (being manifestly finalized at avoiding any possible marginalisation).

Moreover, further confirmation of this ‘detachment’ (*rectius*: substantial separateness) of the UK from the fate of the continent – or, more precisely, from the pre-ordered processes for achieving the highest possible degree of economic and financial stability of the EU countries – can be inferred from the statements released with regard to the revision of the rules regarding the capital requirements of banks as per the well-known normative package (enacted by EU Regulation 518/2013 and Directive 2013/36/EU, known as CRD IV); the imprecise and indeterminate arguments that have been used to justify the refusal expressed in such statements of introducing legislative rulings aimed at ensuring financial stability (and the compliance with the EU’s international commitments in the field of banking regulation)[15] represents the main evidence[16].

The UK’s determination not to join the EBU also responds to this logic. In fact, despite certain analyses – carried out with reference to criteria founded on a cost/benefit ratio – have demonstrated that the UK and Sweden are among the principal beneficiaries of an eventual adherence to the EBU,[17] this countries have not submitted any request on this matter and there are well-founded doubts that it may not be requested in the future, based on the first reactions to the proposal formulated on the matter by the Commission.[18] This is regardless of the further consideration, whereby countries not concerned by European supervision will inevitably express, in the competent European forums, *votes* and *judgments* that contrast with the success of the initiative, or who at least are oriented to downscaling its scope, thus fueling «*the undesirable development of a multi-speed Europe*».[19]

What we are faced with here is an approach that appears *defensive*, aimed at protecting the United Kingdom’s financial independence. It is, in fact, justified by a mindset based on the principle of separation of the supervisory mechanisms – and, therefore, on the possibility of continuing to manage banking supervision without external interferences – which is an essential prerequisite for the predominant role that the ‘London Financial Centre’ (which has always been the expression of an environment where operating freedom reigns supreme) plays on a worldwide level with practically no competition.[20]

3. The recent political events, with the victory of the Conservative Party at the elections, have probably worsened the so-called *ambivalence* that constitutes a hallmark of the UK’s relations with the EU, or, in any case, determines the prerequisites for establishing a different approach. Reference is made, specifically, to the migratory and refugees crisis, in addition to the difficult definition of certain general issues (relating to competitiveness, economic governance, the social security and free movement).

Despite the important signals sent out by the German Chancellor Angela Merkel, and other EU leaders, aimed at intensifying the cooperation (*rectius*: the participatory relationship) between the latter and the UK, signals remaining often without consequences. The possible changing is questioned, first and foremost, by the firmness of the Prime Minister, Peter Cameron, who reaffirms that «his demand for restrictions on freedom of movement within the EU», as observed by the British press.[21]

Once again the lack of willingness in accepting a unitary logic (which the accession to Europe should be founded on) leads UK to apply for exemptions to the requirements imposed to the majority of other European Member States! These requests – which express, *inter alia,* a decision-line distinctly diverging from the one that, within the European Union, have been hardly carrying out on migration policies[22] – reflects the described *ambivalence* of the behavior of this country towards the EU and, therefore, the limited interest to maintain its permanence in the European regional context hence the conditioning that does not hesitate to propose for the achievement of an unwarranted, privileged position (*rectius*: contrary) to the egalitarian spirit that must characterize the relationships within the Union.
The abovementioned requests (that ought to lead to changes in the EU Treaties, a highly outcome, especially at this moment in time, characterized by economic uncertainty and imbalance) could express the latent threat of a final separation from the EU sanctioned by the "*in/out*" *referendum,* which Mr. Cameron promised in 2013 and which he has confirmed after the recent Tory victory.[23] It follows that the concessions package now got from the English Premier (and, therefore, the commitment of the UK contracted with European summits) has become – in view of the consultation to be held on the next June 23rd – presupposition to a strict comparison between his position and that in favor of Brexit from EU (backed by some ministers and by the Mayor of London).[24]

This new scenario is dominated by unpredictability and it is difficult to make certain previsions. Obviously, we are going to observe a punctual evaluation of the various interests involved and this comparison could be essential in order to identify the ultimate political choices to be taken.

More in particular, concerning the United Kingdom, the eventual economic and financial advantages that could arise from an hypothetical exit from the EU should be compared with the negative implications regarding not only the current accounts, the capital flows, the stock market, the bond market, the British real estate market but also the pound sterling[25].
Hence, the necessity to consider, on the one hand, the various causes that could generate an economic weakening of the United Kingdom (having to considerate in this regard the current negative exposure of the balance of international payments, the high levels of the London real estate market and the possible capital flights)[26] , and on the other hand the serious political implications that could emerge from *Brexit*, such as the awareness that Scotland will not leave the European Union against its will[27], and the reactions of the United States, notoriously against the exit of Great Britain from the European Union, as they are willing to use their long-standing relationship with the UK in order to impose their influence on the EU.[28]
On the contrary, it seems that the consequences of this *way out* could be less significant for the European Union as they would be for Great Britain; this could be affirmed if we consider both the overall export amount of the Member States towards the United Kingdom and the intrinsic difficulty in calculating the negative effects of the decrease of the London "financial center" (thus, of the consequent possibility for many British banking operators to continue interacting within the EU markets, even if they allocate their products outside them)[29].
As a matter of fact, the most remarkable effect of an eventual exit from the European Union by the United Kingdom can be recognized in the risk that other Member States, characterized by strong populist currents (such as France and Italy), may promote initiatives for referendums that, regardless of their outcome, would lead to undeniable repercussions on markets stability; therefore, it would become

probable a loss of trust towards certain Member States, with a consequent restart of the perverse spiral that, through the fear of sovereign debts "consolidation" o "restructuring", to the detriment of Member States' creditors, originates the *spread* difficulties (calculated looking at the yield differential between the decennial State bonds issued by a country of the Eurozone and their German analogous).[30] Obviously this would generate the failure of certain Member States' reliability and, more in general, would increase the credibility of a separation of the European group.

Unfortunately, this referendum cannot clarify several uncertainties that could be created by this radical change, like the innovative ways that the British finance will use to present itself to the "single market" – particularly, the terms of agreements under which the United Kingdom will participate in the European Economic Area, contributing (even if to a lesser extent) to the Union balance sheet – and the existence (*rectius*: the identification) of remaining Member States' reactive capabilities. Actually, the increased autonomy and the diminished obligations that could be brought to the United Kingdom by a positive result will barely compensate the operative contraction (that the latter will have to bear), extended until now to «500 million customers in the European Union»[31].

Consequently, it is obvious that the real risk (for all the parties involved) behind the examined matter is that it has started a modification process that is going to directly affect the European "common destinies". In fact, analyzing the possible consequences of Great Britain *way out*, a distinguished scholar affirmed that, compared with the founding fathers' original project, had come to light (and it seems that it is going to be confirmed) «a federal structure, by now partially acquired by the European Union», that does not «automatically require a tighter union».[32] Therefore, *Brexit* accentuated the intervened, substantial failure of the aims that started the European integration process; thus, it could become a facilitator in determining a new institutional asset among Member States, probably more stable than the current one (and more inclined in granting a higher level of autonomy to Member States) but obviously not in line with the cohesion and solidarity forms than can be achieved only through a political union.

4. If we want to analyze the methods that will be probably behind the evaluations that will guide the British people in the difficult choice proposed by the referendum, we will come upon completely opposite reasons. Actually, together with observations arising from the United Kingdom scarce empathy towards the European Union, there are others that are otherwise founded merely on economic convenience.

More in particular, we are referring to the fact that, under the methodological point of view, the UK summits' action seems focused on forecasts based on a microeconomic "costs-benefits" calculation, used to verify (through a comparison between various elements associated with a growth program achievable together with other Member States) the economic convenience of the adhesion to the EU (thus, if there are quantitative data that could justify the UK remaining in the EU).[33] In other words, it seems to be fundamental, for Great Britain, a monetization of the "overall net benefit" determined by its stay in the EU; hence, it has been taken into consideration the convenience of keeping the current *status quo* intact, perceived by said country with increasing annoyance, as UK has always been scarcely prone to accept outer interference since it is believed that they could be a threat to the preservation of the high

level of welfare acquired (with obvious negative consequences on the domestic social and economic balances).
So, reasonably, these are the authentic reasons behind the choices that Great Britain will soon have to make on the continuation of a relation that said country would rather maintain characterized only by economic features (because a further political integration is perceived in contradiction with its history and with its traditions). Furthermore, different positions should be expected between the British economic *elite*, which feasibly restricts its evaluation focusing on costs-benefits aspects and, consequently, shows its propensity to remain in the EU (in this regard, it is significant that the financial field is supporting the "yes" option) and the rest of the British population. The latter, in fact, is often led by different estimations, nationalistic and xenophobic, that head to support the "no" option, regardless of the economic price that will be paid; this is also a consequence of the migration problem, perceived as "foreign invasion". Hence, the revelation of a discouraging reality, where there is no room for the Europeanist spirit that should be instead at the base of a justified stay of Great Britain in the European Union.
So, we are observing a logic that is not ascribable to a *pluralistic dialectic*, upon which the political debate, that should search for options of ideal democratic coexistence, should be founded; a logic that should create solutions aimed at reinforcing the bonds with the European Union, in line with a commitment that should end in a form of *unity*. In addition to that, it is clear that the UK is lacking in having a political intent aimed at throwing the British society (more efficiently than how it has been done until now) in an European framework that, overcoming the national barriers, could create a *supranational* organizational model, built according to behavioral standards (both qualitative and dimensional) suited for the needs of a world that is facing global changes. On the contrary, we are observing an impetuous success of an *economic rationality* that is establishing itself, in an auto referential way, as the *only* parameter of coexistence regulation.

Obviously, the aforementioned decisional criterion, associated with a "costs-benefits" calculus, however in line with market's principles, should be considered, at least theoretically, as an aid to accomplish an efficient allocation of the available resources. Therefore, said criterion is related with neutral evaluations, that, being unsuitable for analyzing the complex situation here depicted, emphasize the inadequacy of the aforementioned method for solving socio – political matters. This explains the reason why in Great Britain the existence of externality (or, more exactly, the occurrence of unpredictable and unexpected events, such as migrations of populations escaping from death, wars and famine), from which negative consequences on expected economic benefits could derive, becomes the premise for a policy aimed at promoting the exit from the European Union.

In addition to that, it can be deduced how rigid the application of the preceding evaluation method is. It can be understood, then, how using said method in situations regarding relations between Member States, causes the rejection of a recourse (considered to be a prerequisite of *sub optimal* balance) to a Member States common action (if appropriate, based on solidarity principles, like the one required for facing the above said migrant crisis) if the costs of the latter are considered superior than the benefits arising from remaining in the European Union.[34] This, regardless of the frequent use of said analysis method to verify the validity of a project, after having tested its capacity to create an economic value for the community.[35]

Therefore, the positive use of this method – from States that would use it in complex economic situations in which an integration between different factors is necessary – must not disregard the correlation between the before mentioned evaluations and the general nature purposes, towards which public interventions have to be oriented.[36] It is clear how the overcoming of national interests should be founded on a level of cohesion (or on a motion in that way) between Member States unlikely realizable in the European regional framework, a level of cohesion that should lead to the perception of the supranational general wealth as its own (and that should lead to the willingness of taking charge of said supranational general wealth, without expecting any advantage, either political or economic, for the domestic citizenry). Therefore, a first conclusion can be drawn, both on the identification of the cases in which the aforementioned operative criterion could be used (namely when there are great juxtapositions, if necessary also reconciling diametrically opposed situations) and on the modalities that should characterized its performance (avoiding to sacrifice the respect of value-driven scopes, first of all the solidarity, according to which public institutions initiatives should be adapted, in favor of the mere economic rationality principle).

In consideration of all of the above – and analyzing once again the evaluations that will be probably made by Great Britain regarding the European Union – it is evident how using the costs/benefits method could be limited to a short-sighted and restrictive microeconomic vision; with the consequence that the latter will not consider adequately all the *different* interests connected with the implemented interventions (interests that are inevitably destined to be neglected if the primary aim of common good is ignored).

5. The foregoing leads us to reflect on the meaning of the adhesion of Great Britain to the European Union and, more precisely, on the political impact attributed to it. The utilitarian intent that – as has been said – is identified on the base of the participation of that country in the regional context and hinges on an economic plan the adherence to the constitutional process which the Community's founding fathers intended to create; this, with inevitable negative consequences as regards the possibility to enable appropriate forms of integration between such country and the plurality of different subjects (often moved by different interests) with which it has to compare in the pursuit of an (organic) union design.

Such intention causes a "remarkable reversal" of the order that traditionally characterizes the inter-state relations, identifying in the politics a *prius* respect to the economics. Therefore, it is hard to acknowledge – in this case – the natural position of the financial-economic determinants in the 'decision-making' policy, in line with the logic that to the first is ascribed an essential role in the development of projects preordained countries willing to be open to innovative forms of modernization[37]

Consequently, in the relationship between UK and European Union, becomes difficult, if not even impossible, to find the shared reflection of an acute scholar that recognized the 'primacy of politics' in the design that "modern subject (does of)....its destinity"[38]; reflection which, as it is to be resized with regard to the European reality- characterized by "Powerful and efficient techno-structures" and by "a very powerful and invasive technocratic bureaucracy"[39] cannot be a postulate in the evaluation of the methods (*rectius*: the liberal democratic mechanisms) through which people seek optimal conditions for the fulfillment of their basic needs. It is evident, conversely, as a relational context in which it detects in prevailing way the verification of interest (involved in its traceability to the market logic) may have resulted in the configurability of a' new Leviathan ', symbol of the power whose roots, breaking free from the dialectic of political legitimacy, they appear hinged in the sacredness of a utilitarian culture that takes as its own epicenter the 'economic rationality.[40]

Returning, then, on the particular issue of *Brexit*, it can be said that we are certainly in the presence of a behavioral line guided by the well-known pragmatism of the British people! Therefore, despite the British public now seem divided on the issue concerning the outcome of the referendum, it is conceivable that will not take long to establish itself the reasons for demonstrating the prevalence of the advantages (compared to the critical) for the British economy to remain inside the Union. Of course, this result – from the point of view of the English electorate – postulates a level of information and a rationality of the choices which is not always natural to the decisions of the 'electorate', that in the case of Great Britain will also have to reach a conviction grade so high as to enable it to win the lack of empathy for the continental countries, which previously have been mentioned.

Intuitively, in fact, emerges the rational search of optimal conditions in the vital relationships of the country – to be achieved through the practical occur of behavior, in a logical due to the teaching of W. James' s for identification of processes to achieve the desired ends [41] -will end with the rise on deterministic settings that have their roots in the "deep-seated hostility of the British media and large parts of the political elite against the European Union"[42]; deep hostility that has found its political expression in the movement to promote Britain's exit from the Union.

That said, based reasons lead us to believe that the *referendum* will express a favorable vote to the consecration of the permanence of the U.K. in the European Union. 'Remain united' for mere economic gain: this is the justification the British people will give to itself to accept the surrender of a own full sovereignty. The Great Britain will continue , then , to be part of EU, with all its reserves, and with the traditional little empathy towards the 'old continent'; the desire of *exit* will remain for a large part of the population, together with the "hostility of those who have lost the referendum", since, as was correctly pointed out, "it will not reduce their ambition to bring back full sovereignty to the United Kingdom"[43]. Conversely, it seems poorly justified the EU's interest in maintaining, right inside, a state that clearly manifests its opposition to the community *acquis* and, therefore, it is configured to be oriented to firmly maintain attitudes that undermine the cohesion. The *favor* for the hypothesis of a Great Britain held with concessions and blandishments in the Union has a ratio only if, as it will be said in the next paragraph, credit is given to an evolution process of the latter intended to revisit the 'project' which had been drawn to the origins.

More specifically, the referendum to be held on next June 23th identifies a strategic move in line with the current legal framework, since the use of popular vote (that would reflect the popular unwilling to remain in the European Union) must be considered as a proper application of decision-making procedures recognized in modern democratic systems. However, even if this measure is going to certify the prevalence of the national sovereignty over the European regulatory approach, it is worth remembering that the referendum could support Prime Minister Cameron in order to achieve particular benefits from the political campaign against Brexit. Hence it is enough to realize that we are dealing with an improper use of referendum, which – although there could be specific socio-political reasons and it could be in line with the (voluntary, unilateral or negotiated) exit right provided by art. 50 EU Treaty – is actually related with political and economic issues that are going to change its real function!

Given this scenario, it is worth remembering the words of the President of the European Central Bank, intervening just few days ago in "political debate surrounding Britain's EU"; and, in particular, the precise statement, "I cannnot say which of the two sets of arguments is stronger, the economic or the political ones, neither am I going to enter into a domestic policy debate, but what I can say Is that Europe needs blackberries in European UK as much as the UK needs a British blackberries Europe". This is a wish that is common to all those who, despite the mentioned skepticism, continue to believe in the profitable cooperation between Britain and the Eurozone; moreover, Mario Draghi has further stated: "with such deep interconnections, the UK and the euro area share a common interest: the stability in the functioning of our economic system and Particularly our economic system and particularly our financial markets».

There is no doubt that higher forms of relationship between the British and continental realities (that would be realized in a renewed spirit of convergence) would enable all Member States to benefit from the cultural contribution of a country (that is the British one) that is characterized by high levels of organizational efficiency , social respect and, more generally, high civic sense, all together considered as underlying values to the 'government common thing'; hence the idea of a positive influence exercised by UK within Eurozone, which – it is good to recognize it – in some ways still seems far away from the advanced socio-political model that nowadays characterizes the British Government. Unfortunately the European Council summit in which Cameron's issues have been discussed was a missed opportunity for all EU member States and, indeed, it represented a step in the opposite direction. And this is the unfortunate, but not surprising, result caused by the absence of a true European strategic plan and, furthermore, by the Union's political weakness as a whole and its member States.

6. The most significant indication that seems to be deduced from the aforementioned *Brexit* issue concerns the general implications that can be inferred from it regarding the 'future fate' of Europe.
First it has to be considered that the above question has to be set within the specific historic phase that the Union is experiencing, characterized by its substantial absence in the definition of common social policies (highlighting, therefore, an inability to respond to the urgent need to seek uniform decisions to resolve the several issues on the table). We now have, therefore, a situation in which the EU is not able to take «tough decisions» in view of global events; in this respect, it comes out to ou r attention, in addition to the *migrations* which it has been said of, the fight against terrorism and those interventions aimed at tackle the 'winds' of war that, in the last years, involve the Middle East and the north Africa.
Dealing with a general necessity of cohesion and solidarity – which should confirm the idea of a «free and united Europe», born during the full raging of World War II – the Member States show insufficient sense of political responsibility, often rise 'walls' and refuse to deal with the humanitarian emergency that characterizes the present times. It is not considered that countries with a high level of civilization shall not remain unconcerned to the cries of pain coming from people who reassert the right to have their *dignity* respected.[44] It must be added to the above the ambiguities of a difficult convergence with Turkey, which intends to require (on the basis of an exchange of its availability on accepting migrants)

to play a greater role in the EU, regardless of the delays (*rectius*: lacks) that, in such Country, mark the process of democratization.
In such context, it appears extremely hard to compose the articulated *puzzle* that represents the relationships between Member States of the Union are now contained; hence the diffusion of *skepticism* in the continuity of the latter, depending – *inter alia* – on its growing inability to communicate ideas based on values. Unavoidable the consequent consciousness that, perhaps, the time to overcome the doubt, expressed by several parties, that the Europe of people and nations of the last decades has been replaced by the one governed by technocracies and financial capitals, is not ripe.
Thence, in the scenario analyzed above, the *Brexit* perspective increases the feeling of uncertainty, highlighting the difficulty of identifying a «way out» from the *impasse* situation in which the EU currently seems to be stuck. The aforementioned considerations on the 'cost-benefit' analysis, on the base of which the UK seems to base its decision on remaining or not within the Union, underline that the relationships between European countries are now gradually carrying within a framework mainly characterized by financial patterns (with obvious, consequent limited possibilities to refer the abovementioned relationships to socio-political purposes). It is clear that – according to what already clarified above – the 'future fate' of Europe will be characterized only by economic and financial relationships aimed at increasing the 'common market', but not also adequate to support the concrete realization of a «political union dream», that remains therefore segregate in an unreal "wishful thinking" (to use a common English phrase).

This is the important message resulting from the UK behavior, a message of sadness more than of wonder!

[1] See CAPRIGLIONE – SACCO GINEVRI, *Politics e Finance in the European Union*, Wolters Kluwer, 2016, p. 105 ff.

[2] Here can be recalled the reflections contained in the famous *Manifesto* – written in the August of 1941 in a small island in the Mediterranean Sea, Ventotene, where some anti fascists were confined – published (after the first edition went lost) by Colorni, in 1944 in a book titled *Problemi della Federazione Europea*, with the annex of two essays by di Altiero Spinelli («*Gli Stati Uniti d'Europa e le varie tendenze politiche*» and «*Politica marxista e politica federalista*») written between 1942 and 1943.

[3] See among others BUSSI, *Brexit, braccio di ferro finale*, in *Milano finanza*, February 19th, 2016, where Cameron's declaration is quoted «if we will reach a good agreement, I will sign it, but I am not going to sig n an agreement that is not in line with our needs»; GILES, *What are the economic consequences of Brexit?*, in *Financial Times*, February 22nd, 2016; ROMANO, *Brexit forza la mano all'Eurozona*, on *IlSole24Ore*, February 23rd, 2016, *www. ilsole24ore.com/art/mondo/2016-02-23/brexit-forza-mano-all-eurozona-072302.shtml?uuid=ACxSICaC.*

[4] This is the theoretical orientation – inspired by the «functionalism» of Mitrany (see *A working peace system*, London, 1943) and by the neo functionalism of Haas (see *The Uniting of Europe – Political, Social and economic Forces, 1950-1957*, London, 1958; Id. *Beyond the Nation State*, London, 1964) and Lindberg (see *The Political Dynamics of European Economic Integration*, London 1963) – according to which the beginning of a functional integration process (where some States combine

together certain activities and economic resources) would encourage other type of integrations (in line with a leaking mechanism, the so called *Spill Over*) also with a political value.

[5] See DE GRAUWE, *Why the European union will benefit from Brexit*, in *Social Europe*, February 24th, 2016, on *http://www.socialeurope.eu/2016/02/why-the-european-union-will-benefit-from-brexit;* see also the editorial *Niente Europa, siamo inglesi: il governo si spacca*, published on *Il Fatto Quotidiano*, February 21st, 2016.

[6] We would like to recall here the important speech by Winston Churchill, in Zurich, on September 19th, 1946. On this occasion the outstanding statesman, while expressing hopes for the establishment of United States of Europe – as already mentioned above (see *supra*, Chapter II, par. 19) – gives indications as to the institutional framework of this supranational organization; maintaining above all that both the United Kingdom and the Soviet Union should be the sponsors – but not members – of this new Europe, for the realization of which Churchill promoted the establishment of a Council, which – as we all know – will see the light many years later; see *Churchill Commemoration 1996. Europe Fifty Years on: Constitutional, Economic and Political Aspects*, edited by Thurer and Jennings, Zurich, Europa Institut-Wilton Park, Schultess Polygraphischer Verlag, 1997; see also, *Winston Churchill, His Complete Speeches 1897-1963*, edited by R. James, New York-London, 1974, vol. VI; Fondazione Europea Luciano Bolis, *I movimenti per l'Unità Europea 1945-1954, Proceedings* of the international Conference at Pavia in October 1989, ed. by Pistone, Milano, 1992.

[7] See PARR, *Britain's Policy Towards the European Community. Harold Wilson and Britain's World Role, 1964-1967*, London, 2005; TOOMEY, *Harold Wilson's EEC application: inside the Foreign Office 1964-7,* University College Dublin Press, 2007.

[8] See GOZZANO, *L'ingresso dell'Inghilterra nel Mercato Comune Europeo,* available at *http://www.cvce.eu/ content/publication/2007 /11/12.*

[9] See CHARTER, *Au Revoir, Europe: What If Britain Left The EU?*, London, 2012, where it is underlined that "*The organisation that Britain joined in 1973 was very different from the European Union of today and therefore, at that time, the true political and constitutional implications of the Treaty of Rome were not clear*".

[10] See CACOPARDI et al., *Ingresso del regno unito nella CEE. La Gran Bretagna nella CEE/UE,* which can be viewed at http://*http://www.geocities.ws/osservatore_europeo /approfondimenti/semi07.htm*.

[11] See, among others, GEORGE, *Britain and the European Community: The Politics of Semi-Detachment,* Oxford, Clarendon Press, 1992; MORAVCSIK, *Preferences and power in the European Community: a liberal intergovernmentalist approach,* in *Journal of Common Market Studies,* 1993, n. 4, p. 473 et seq.

[12] See CAPRIGLIONE – SACCO GINEVRI, *Politics e Finance in the European Union*, cit., p. 216 et seq.

[13] Significant, to this regard, the document of the Italian Ministry of Economics and Finance entitled *A Shared European Policies Stratgegy for Growth, Jobs and Stability,* February 2016, where it

is pointed out that «we have gone a long way towards more integration, but now Europe is at a crossroads: if we were to keep muddling through an uncertain recovery, progress in growth and job creation would fail to emerge and the Euro area would remain exposed to shocks, undermining its sustainability», requiring a main role.

[14] See HOUSE OF LORDS, *European union committee, 25th report of session 2010-2012, The euro area crisis.*

[15] This is the draft of regulation relating to «prudential requirements for credit institutions and investment firms», as well as the Directive «on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms» (amending Directive 2002/87/EC relating to the supplementary supervision on credit and insurance institutions and investment entities included in a financial conglomerate).

[16] See Council of the European Union, April 2nd, 2013, 7748/13, ADD2 (*Addendum* 2 to note "I"). In particular, is pointed out the fear of failure to conform such rules to the complex 'Basel 3' Accord and to the outcome of an 'impact assessment' on remuneration provisions; an argument that, by circumscribing its support to the EU initiatives, essentially reveals the intent of delaying the realization of common programs. This intent is unquestionably contrary to the participatory spirit that should underpin the members of the Union and raises concerns as to the actual will to remain in it for a long time.

[17] See, among others, SCHOENMAKER – SIEGMANNB, *Efficiency Gains of a European Banking Union,* Duisenberg School of Finance –VU University Amsterdam, January 31st, 2013, p. 17.

[18] See ONNO RUDING, *The Contents and Timing of a European Banking Union: Reflections on the differing views*, Ceps Essay30 November 30th, 2012, p. 4, available at *http://www.ceps.eu*., where it is outlined that «the UK has already declared its intention to opt-out», even if «its first signal was that it would not block the proposal as such».

[19] See ONNO RUDING,, *op. cit.*

[20] In line with this policy is the tendency to block the EU directives viewed as contrary to the interests of the UK financial sector, cfr., on this topic, the editorial by CAVALLITTO, *Mercati finanziari, il muro della vigilanza britannica contro le riforme UE,* at *http://www.ilfattoquotidiano.it/2013 /08/31 mercati_finanziari.*

[21] See the editorial «*EU referendum: Merkel will work with Cameron on EU – but will Tories let him?*», in *theguardian* of 9 May 2015, at *http://www.theguardian.com/politics/2015/may/09/ angela-merkel-cameron-eu-rightwing-tories.*

[22] The press has highlighted the support by the EU Commission President, Jean-Claude Junker, for the implementation of an 'emergency mechanism' for the definition of a refugee quota plan, forcing the states to 'share' the burden of the migrant crisis, cfr. the editorial «*Mogherini all'Onu: ecco il piano UE sui migranti*», published on *laRepubblica.it*, accessibleat *http://www.repubblica.it/esteri/2015/ 05/11/news/ mogherini_all_onu_ecco_il_piano_ue_ sui_ migranti*; this project, forcefully sponsored by the President of the European Commission, is opposed by the UK Government, as illustrated in the

editorial «*Cameron chiude all'immigrazione: insorgono i Paesi est europei*», published in *ilGiornale.it* on May 11th, 2015 and availableat *http://www.ilgiornale.it/news/mondo/ cameron-chiude-allimmigrazione-insorgono-i-paesi-est-europ ei -1127007.html.*

[23] See in this regard, the editorial «*Cameron plant EU-Referendum schon für 2016*» published in the *Frankfurter Allgemeine Zeitung* of May 12th, 2015, available at *www. faz.net/aktuell/politik/ europaeische-union/cameron-plant-schon-2016-referendumueber- eu-austritt-13588429.html.*

[24] See, *inter alia,* CAVALERA, *Cameron, referendum il 23 giugno. E punta la carriera sul «sì» all'Europa,* published in *Corriere della sera* of February, 20th, 2016 available at *http://www. corriere.it/esteri/16_febbraio_20/ cameron -lancia- referendum-punta-carriera-si-all-europa-70 269e9a-d7c6-11e5-afdf-d68b3faa1595.shtml*; Gessa, *Brexit, ora Cameron affronta i rischi di un'uscita dall'UE. e cinque ministri voteranno per dire addio all'Europa,* on *IlFattoQuotidiano.it* of February 20th, 2016; the artiche *Brexit, il sindaco di Londra gela Cameron: "Io voterò per l'uscita dall'Unione Europea",* available at *http://www.repubblica.it/esteri/2016/02/21/news/brexit _appell o_di_ cameron _a_boris_johnsonappoggiapermanenza_in_ue_-133909283.*

[25] It has to be mentioned that according to some scholars (see CAMPOS – CORICELLI, *Some unpleasant Brexit econometrics,* on http://www.voxeu.org/article/some-unpleasant-brexit-econome trics), regardless of the next «in-or-out referendum» outcome, the relationship between the United Kingdom and the European Union will change substantially.

[26] Significant, to this end, is how the specialist press reacted (see, among others, GIUGLIANO, *Brexit, i timori di una moneta più debole e i risparmi sui sussidi dei migranti: ecco i cinque scenari,* on *http://www.repubblica.it/ economia /2016/02/21/news/il_dossier_i_timori_di_una_ moneta_ piu_ debole_e_i_risparmi _sui_sussidi_dei_migranti _ecco _i_cinque_scenar*i) to the speech of «Mark Carney, Governor of The Bank of England,...during a parliamentary audtion held in January... (according to whom)... Brexit could lead to a risk premium increase on British assets, an event that could originate capital flights»; see also MAISANO, *Brexit, Carney a fianco di Cameron,* on IlSole24Ore, March 9th, 2016, where it is stressed that according to Camey the uncertainty regarding the future of the United Kingdom in Europe is one of the reasons behind the pound sterling weakness.

[27] See the editorial *Brexit: la Scozia si schiera con l'UE al referendum del 23 giugno,* on *http://it. euronews.com/2016/02/29/brexit-la-scozia-si-schiera-con-l-ue-al-referendum-del-23-giugno,* where it is specified that «the premier, Nicola Sturgeon, has already bounded the referendum outcome to the Scotland stay in the United Kingdom».

[28] See among others GABELLINI, *Gli Stati Uniti contro il Brexit,* on *http://www.lindro.it/gli-stati-uniti-brexit*, where the vetoes imposed by De Gaulle on «the entrance of the United Kingdom in the European Economic Community, based on the certainty that London would have immediately become an United States Trojan horse inside the 'old world'» are recalled and where it is underline that «the recent opinions of John Kerry seems to confirm the De Gaulle's worries, since the US Secretary of State has always interfere in British internal affairs as long as this could be helpful in order to mitigate the Brexit tendency that is spreading like fire».

[29] The analysts have esteemed an inevitable decrease of the City of London if the referendum would approve the Brexit, resulting in a transfer of the City's activities carried out in euro zone centers, see on this the editorial published by Milano Finanza on February 24th, 2016, entitled *L'impatto della Brexit in cinque punti*, on *http://www.milanofinanza.it/news/l-impatto-della-brexit-in-cinque-punti-201602241209213060*. A concurring opinion with this stance is expressed by the distinguished economist Krugman, see the interview by Haas and Tost entitled «PAUL KRUGMAN: What's going on in China right now scares», on *http://uk.businessinsider.com/paul-krugman-interview-china-greece-brexit-2016*, in which to the question «Turning to Europe, what do you think about Brexit?» an peremptory answer echoed: «For Britain to be pulling out of that is a bad thing economically».

A dissenting opinion has been instead expressed by another eminent economist Stigliz during an event organized by The Labour Shadow Chancellor John McDonnell, see the editorial Brexit better for Britain than toxic TTIP, says Joseph Stiglitz, http://www.rt.com/uk/334409-brexit-ttip-stiglitz-eu/, in which the following clarification is quoted «I think that the strictures imposed by TTIP would be sufficiently averse to the functioning of government that it would make me think over again about whether membership of the EU was a good idea».

[30] See CAPRIGLIONE, *Mercato regole democrazia*, Torino, 2013, p. 115.

[31] In this regard see also, among others, GIUGLIANO, *Brexit, i timori di una moneta più debole e i risparmi sui sussidi dei migranti: ecco i cinque scenari*, *cit*., where it is underlined that the Brexit consequences for the European Union «would surely be less significant than those experienced by the United Kingdom: for example, proportionally, Member States as a whole export less to Great Britain than the United Kingdom exports to them».

[32] See PADOA SCHIOPPA A., *Un accordo ambiguo. Ora più poteri all'Eurozona*, on *IlSole24Ore* February 23rd, 2016.

[33] In this regard see among others SEN, *The Discipline of Cost-Benefit Analysis*, in *Journal of Legal Studies*, 2000, 931-952; CAGLIOZZI, *Lezioni di politica economica*, Napoli, 2001; CAMPBELL – BROWN, *Benefit-Cost Analysis. Financial and Economic Appraisal using Spreadsheets,* Cambridge, 2003; ADLER – POSNER, *New Foundations of Cost-Benefit Analysis*, Cambridge, 2006; Boardman *et al.*, *Cost-Benefit Analysis: Concepts And Practice*, New Jersey, 2011; SINDEN, *Formality And Informality In Cost-Benefit Analysis,* in *Utah Law Review*, 2015. p. 93-172.

[34] On the tradeoff between efficiency and equity that leads to second-best solutions see the classic work of LIPSEY – LANCASTER, *The General Theory of Second Best*, in *Review of Economic Studies*, no. 24, 1956.

[35] It should be recalled the quantification of the environmental features in the researches for evaluating the environmental sustainability of a project, from where the required aims of the financial analysis are defined; see for example the indications published on *http://www.ecbaproject.eu/it/analisi-costi-benefici.html* regarding the *Ecba Project (Environmental Cost Benefit Analysis)*, aimed at supporting public institutions and private operators in realizing projects that are economically efficient, socially acceptable, environmentally sustainable and financially feasible.

[36] See ADLER, *Well-Being and Fair Distribution: Beyond Cost-Benefit Analysis,* Oxford, 2012.

[37] Cfr. CAPRIGLIONE – SACCO GINEVRI, *Politics e Finance in the European Union,* cit. p. 25.

[38] Cfr. MONTEDORO, *Democrazia rappresentativa e mercati finanziari,* in *Il giudice e l'economia,* Rome, 2015, p. 23.

[39] Cfr. COCCO, *L'Europa dei tre disincanti*, in *Politica del diritto,* 2000, p. 200 ff.

[40] Significant, in this regard, is the classical philosophical reflection that leads the political to the entity which owns the major expression of power, identifying the essence in the absoluteness of sovereignty; See, among others, BODIN, *Les Six Livres de la République,* published in 1576, a work in which it is argued that a cohesive society is based on unified and orderly management of power by the State expressed by royalty; HOBBES, *Leviathan or The Matter, Forms and Power of a Common Wealth Ecclesiastical and Civil*, published in 1651, where the problem of the state form and legitimacy is faced.

[41] See. JAMES, *Pragmatism, a new name for some old ways of thinking,* New York, 1907, for an historical reconstruction of the ideology characterized by "seeking to make the expanding rationality and behavior" see the essay of Kloppenberg.

[42] See DE GRAUWE, *Why the european union will benefit from Brexit,* in *Ivory Tower* of February 22nd, 2016, published also in *lavoce.info* on February 26th, 2016 with the title *E se la Brexit facesse bene all'Unione?*

[43] See DE GRAUWE, *Why the european union will benefit from Brexit,* cit.

[44] We have to remember that the fundamental rights of the person are expressly recognized by Art. 1 and ff. of the *European Convention on Human Rights* as modified by the provisions of the Protocol no. 14 (STCE no. 194) and by Art. 2 of the Treaty on European Union (TEU) in which is pointed out that «The Union is founded on the values of respect for human dignity, freedom, democracy, equality, the rule of law and respect for human rights, including the rights of persons belonging to minorities»; it represents the legal basis which several cases decided by the European Court of Human Rights and by the European Court of Justice, that significantly contributed to the definition of such principles, refer to.

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«They say things are happening at the border, but nobody knows which border» (Mark Strand)

The "preparation" function in the new banking legislative framework

by **Vincenzo Troiano – Andrea Sacco Ginevri** [1]

Abstract: This Article examines certain issues arising from the new regulation on bank crisis recovery and resolution, and specifically the so-called "preparation" function, which sets the rules regarding the prevention and early intervention in case of financial instability affecting credit institutions. The preparation function is analyzed herein taking into account the directive 2014/59/EU, considering its impact on the concept of sound and prudent management of banks and on their governance structure. Finally, this Article explains how the "preparation" function impacts on the "corporate interest" of banks.

Summary: 1. Introduction. – 2. The "preparation" function under BRRD: preliminary remarks. – 3. Recovery preparation and "qualified" prudent management. – 4. Recovery plans under a governance perspective. – 5. Preparation tools and corporate interest of banks.

1. The regulation on bank crisis recovery and resolution raises several interpretative issues concerning its systemic role and impact, also in relation to traditional concepts of banking and financial regulation.

Even without considering the trends deriving from the introduction of the single resolution mechanism in the Euro area, reference is made, for example, to the effect produced by the introduction of an internal guarantee mechanism to solve crisis situations or by the removal of clear distinctions between the *in bonis* supervision and the managing of instability.

In addition to such variations of previous concepts, new institutions, or disciplinary patterns, to be analyzed in the context of the new regulatory framework have been also introduced.

To such area of intervention belongs the so-called *preparation function*.
With this expression we summarize the set of rules aiming at regulating the prevention and early intervention in case of financial instability affecting credit institutions. This area has attracted close attention immediately after the 2008 financial crisis, in particular, since the late perception of the financial entities' weakening, as well as the lack of capacity of facing it (by financial institutions and competent authorities) have often been mentioned among those factors that would have triggered and made possible the abovementioned systemic crisis[[2]].

The matter as outlined above may be analyzed from several and different perspectives: the different institutions composing the function itself may be examined; the preparation function, and in particular the scope that covers the drawing up of recovery plans, may be analyzed: *(a)* in terms of restoring the concept of sound and prudent management of business, and in particular of prudent management and *qualified* prevention, *(b)* otherwise in terms of banking *corporate governance*, including the implications in terms of adequacy of governance arrangements. The preparation function may also be scrutinized in connection with the changing notion of corporate interest of banking entities.

A subject too extended even to simply attempt an approach; therefore, our analysis will be limited to some preliminary considerations.

2. The directive 2014/59/EU (Bank Recovery and Resolution Directive, "BRRD") – implemented in Italy by the legislative decrees no. 180 and 181 of November 2015 – aims at establishing a *recovery* and *resolution* framework for banks, in order to prevent the potential need to rescue credit institutions with taxpayer funds (so called *bail-out*); in other words, the new legal framework aims at preventing insolvency and, in the event of insolvency, at reducing its adverse effects[[3]].

The improvement of the capital adequacy and prudential tools introduced by "CRD IV", as hoped by the European lawmakers, should have reduced the possibility of future crises. However, there is a need to empower authorities with a set of tools to timely and quickly intervene for those intermediaries who face financial crises or instability.

Thus, specific attention is given to the *preparation* and *planning* of those interventions that should be implemented in case of unfavorable circumstances[[4]].
The *early* analysis of possible adverse scenarios and measures that may be taken if such adverse scenarios were to materialize, should serve as a safeguard to protect the functioning of the system as a whole (including the various actors involved, with their own responsibilities: consisting of entities, supervisory authorities, resolution authorities) to react *quickly and early* upon the emergence of situations of instability[[5]].
While from a *functional standpoint* this constitutes the main feature of the *preparation* phase, it should be noted that such phase will have to be structured differently depending on whether it is aimed at preparing the *recovery* of the entity in difficulty, or rather the *resolution* of the crisis faced by the entity.
The directive indeed identifies two separate measures comprising the preparation phase, revolving around *recovery plans* and *resolution plans*. The former contain measures aimed at restoring the financial situation of an entity after a *significant deterioration* of the same. The latter include resolution actions that the competent authority may implement when the entity meets the conditions for resolution provided under the directive.
The two instruments differ in several aspects; *(a)* the entities responsible for the drawing up of the plans; *(b)* the authorities involved in the drawing up and approval process; *(c)* more generally, in terms of introduction, the systematic placement of the two instruments.
Recovery plans are adopted by credit institutions themselves. It is true that the relevant legislation envisages significant occasions of dialogue with the competent supervisory authority during the plan preparation and, even more and in a more formal way, in the assessment phase; however, the plan remains an instrument that is drawn up and approved by the credit institution. On the contrary,

the *resolution plans* are drawn up by the competent resolution authority; in this case, the entity subjected to the plan does not play an active role, but rather is subjected to significant obligations to report to and cooperate with the authority in charge of preparing the resolution plan.
This differences in structure with regard to the responsibility for drawing up the plans shows the evaluation of the legislator in relation to the prevailing interest in these two distinct situations: in the event of recovery, precedence is given to the autonomy of the concerned enterprise in assessing, in a forward-looking manner, the appropriate responses to deterioration in its financial condition; on the other hand, in the case of resolution, precedence is given to the public interest underlying the orderly management of crises, also considering the possible systemic impact of the same[[6]].
These instruments differ also with regard to the *authorities* that take part in the plan adoption phase. With regard to recovery plans, the *competent supervisory authorities* on the individual entities that have prepared the recovery plan are the ones to carry out the *assessment* on the adequacy of the plan itself. In this regard, the role of the *resolution authorities* is limited to the possibility of formulating recommendations to the competent supervisory authority with regard to those actions, envisaged under the plan, which could have an adverse impact during a possible resolution phase[[7]]. The resolution plan is – on the other hand – directly implemented by the *entity's resolutionauthority* (and, in this case, the competent supervisory authority's position is limited to cooperation with the resolution authority in gathering information necessary for the preparation of the plan)[[8]].
It is clear from the foregoing considerations, with regard to the *systematic role* of the two instruments being compared, that recovery plans fall more clearly under the supervisory area, whereas resolution plans fall within the area of crisis management or within the resolution area.
Recovery plans are positioned intrinsically within the ambit of *ex-ante* tools as instruments through which a default may be prevented; they are characterized by the previous imposition of measures to be implemented in order to stabilize the financial situation of an entity after a significant deterioration. Resolution plans, also informed on a preparatory *ratio*, are however positioned conceptually within the ambit of *ex-post* tools, as corrective measures to be taken if a default becomes inevitable, when recovery measures are not adoptable anymore and resolution mechanisms have to be adopted.
That said, if this main distinction is clear, it is worth noting that recovery plans, if they pertain to an entity that is not facing financial difficulties, nonetheless plan the measures to be implemented in order to overcome a hypothetical situation of deterioration; conceptually they fall on the border between the areas of prudential supervision – including the so called *early intervention* measures – and crisis management[[9]].

The institutional and functional structure introduced by the directive must lead to the consolidation over time of roles and responsibilities; which to date has not been thoroughly defined.

3. The significant relevance recognized to the *preparation* function, in particular to the recovery preparation – and thus to all the preparatory activities and assessments included in the competence of the bank – can be analyzed also considering its impact on the current concept of *sound and prudent management* of a credit institution.
The general clause of the sound and prudent management of the banks has always been appreciated for its flexible nature, and therefore, for its capacity to include in the course of time an updated meaning of

an *agere* which results, at the same time, neutral in the interests pursued and aimed at achieving company's profits through a management based on the protection of company's assets[[10]].
The provisions of the package "CRD IV" gave reasons to view the *sound and prudent management* in the light of appropriateness of business organization and of capacity of assessing, monitoring and managing corporate risks[[11]]. The responsibility of the top-management in the definition of *risk appetite* of the banks summarizes this concept[[12]].
The introduction of specific instruments for the *preparation* of recovery of credit institutions, in case of potential events of (significant) capital and financial deterioration of the same, further *qualifies* the criterion of sound and prudent management. This latter is enhanced with a new meaning, identified in the need to prepare and adopt, and then observe and implement, specific *preparatory measures* which prevent and resolve the shallower and reversible crises, although these latter represent still far and potential scenarios[[13]].
In the drawing up of the recovery plan, the management body of credit institution is required to underline the risk factors – on the basis of plausible events, but still hypothetical – which could justify the provision, *ex ante*, of measures aimed at balancing the capital and financial situation of the company in case of its significant deterioration.
Therefore the concept of prudential management can be now read in the view of *planning* of the reaction measures for those risks that, even if non-current, are expected in case of adverse scenarios.

4. The considerations above explain the reason why the directive BRRD indicates that recovery plans are considered a *governance* arrangement under art. 74 of directive 2013/36/EU[[14]], with the consequence that, in the view of prudential supervision, the drawing up of such plans, their adoption, the monitoring on their periodic updating and so on, directly fall within the legal framework of the CDR IV and the related national legislation which concern such arrangements.

Equally, the prerogatives assigned to the competent authorities in relation to the prudential review, could be formally taken into account, in the overall assessment of the entity's situation, even the content of the recovery plans.

As known, *governance* arrangements consist of all those mechanisms, procedures, processes, technical tools, placement in the framework of such factors, remuneration policies, aimed collectively at achieving and ensuring the governance and internal functioning of the entity. All of this is accomplished through an overarching structure that ensures the effective and prudent management of the intermediary and, in particular, of the risks to which it is exposed.
Considered from this perspective, namely as a *governance* arrangement, the recovery plan (*rectius,* its adoption) becomes a key instrument through which one of the main functions assigned to credit institutions' management body is exercised[[15]].
The management body is assigned with general responsibility over the entity, approving and overseeing, *inter alia*, the implementation of its strategy concerning risk matter (article 8, paragraph 1, lett. a, directive 2013/36/UE).

The approval of the recovery plan constitutes an exercise in which the management body will have to demonstrate awareness of the bank's position and all of the circumstances that may jeopardize its stability.

In performing such exercise, the management body may also decide to adopt immediately measures, aimed at reducing the identified sources of exposure to potential risk and underlying the scenarios envisaged under the plan.

Construed in these terms, the approval and the following update of recovery plans may constitute an *element of regulation* in the bank and in the performance of the management body, regarding the bank's policies on the control of the exposure to risks[[16]].

On the other side, the particular depth of the analysis required during the assessment of recovery plans confirms the need, that has for some time been noted in the legal framework applicable to the sector, to enhance the qualitative composition of the management and supervisory bodies: in this sense, the deep knowledges and the diversified areas of specialized expertise constitute, for the management body as a whole, a fundamental requisite in order to be in a position to effectively fulfill the management body's duties of examining and approving the plans in question.

5. Do the above mentioned considerations have an impact on the "corporate interest" of banks? In other terms, does the need to plan and implement initiatives to protect the potential deterioration of the banks, aiming at preventing scenarios that can cause a resolution (and, therefore, at avoiding its connected impacts on public finances) modify the traditional concept of "corporate interest" in banks introducing new goals to be pursued?

As anticipated, the new regulation stressed a trend towards the *institutionalization* of banks and, in particular, of their corporate governance, highlighting a banking corporate interest that now includes also the stability aims of the financial system as a whole[[17]].

Such a feeling seems supported by the preliminary comments following the introduction of the BRRD directive in Italy, which – underlining the apparent *squeeze-out* power of the resolution mechanisms implemented in Italy at the end of 2015 – pointed out (i) their negative impact on the shareholders and on certain *stakeholders* particularly exposed to the risk connected with their financial investment in the bank, as well as (ii) the relevant benefit for taxpayers, who will not be charged anymore by the practice of *bail-out* funded with community resources.

Actually, although it is clear that the new legislation on banking crisis aims at reducing the *moral hazard* once allowed by the *bail-out* mechanism – and, therefore, increases the financial risk of equity investments (or, however, of investments having similar exposure) without an equivalent increase of the profitability of these investments – the introduction, and implementation, of a *preparation* function of the banking recovery (which characterizes the BRRD grounds) aims at strengthening the protections granted to shareholders and to other similar equity investors of banks.

Indeed, one of the cornerstone of corporate law is the principle according to which who bear first the "financial cost" of the company's insolvency are those who have invested in "equity": this explains the qualification – as "*residual claimants*" – which foreign scholars generally grant to shareholders and to other similar investors (such as, for instance, holders of subordinated debt or of equity instruments, *et similia*).

However, the new element introduced by the BRRD is founded in the provisions according to which credit institutions shall adopt and implement preventive and mandatory measures, aimed at excluding – or, at least, at mitigating – the possibility that equity investors would effectively bear corporate losses otherwise produced by the bank activity.

For such a purpose, the management body of the bank, on the one hand, and the competent supervisory authority, on the other hand, are called – since the beginning and with different tasks – to grant credit institutions a broad, effective and efficient *ex ante* set of tools useful to promptly react towards potential instability events or circumstances.
Thus, the *preparation* function of bank recovery contributes to substantially protect both the shareholders and other equity investors (who might bear the costs of a bank's crisis), justifying a current management of the bank which shall respect, among others, the precautionary measures mentioned in the recovery plan, and therefore, able to preserve the economic and financial balance, also potentially, of the bank itself[[18]].

The above produces clear consequences in terms business and management decisions and, thus, on the corporate interest of banks.

References:

[1] Text of the presentation, with the addition of notes, held at the Conference on "*Banking and bail-in Crisis: what changes for banks and depositors?*" at LINK Campus University of Rome, April 15, 2016. Although this paper is the result of a joint reflection of the authors, Vincenzo Troiano wrote the paragraphs 1, 2, 4 and Andrea Sacco Ginevri wrote the paragraphs 3 and 5.

[2] *See* Capriglione and Troisi, *L'ordinamento finanziario dell'UE dopo la crisi*, Turin, 2014, p. 81 ff.

[3] In this respect *see* Capriglione, *Regolazione europea post-crisi e prospettive di ricerca del 'diritto dell'economia': il difficile equilibrio tra politica e finanza*, in *RTDE*, 2016, I, 1 ff.; Stanghellini, *La disciplina delle crisi bancarie: la prospettiva europea*, in Banca d'Italia, *Quaderni di Ricerca Giuridica della Consulenza Legale*. *Dal Testo unico bancario all'Unione bancaria: tecniche normative e allocazione di poteri*, Acts of the convention held in Rome on September 16, 2013 no. 75, March 2014; Presti, *Il* bail-in, in *Banca Impresa Società*, 2015, p. 339 ff.; Di Brina, *Il* bail-in *(l'influenza del diritto europeo sulle crisi bancarie e sul mercato del credito)*, report held during the annual convention of Associazione Orizzonti del Diritto Commerciale, Rome, February 26 and 27, 2016, 1 ff.; Guizzi, *Il "bail in"nel nuovo sistema di risoluzione delle crisi bancarie. Quale lezione da Vienna?*, in *Corr. giur.*, 2015, p. 1485 ff.; Lemma, *La nuova procedura di risoluzione: indicazioni per una insolvenza obbligatoria?*, in *RTDE*, 2016, II, 23 ff.; Rossano, *Nuove strategie per la gestione delle crisi bancarie: il* bail-in *e la sua concreta applicazione*, in *Federalismi.it*, 2016, 2 ff.; Gardella, *Il "bail in" e il finanziamento delle risoluzioni bancarie nel contesto del meccanismo di risoluzione unico*, in *Banca e borsa*, 2015, I, p. 587 ff.; Canepa, *Crisi dei debiti sovrani e regolazione europea: una prima rassegna e classificazione di meccanismi e strumenti adottati nella recente crisi economico finanziaria*, in *Rivista*

AIC, 2015, p. 23 ff.; Cappiello and Capizzi, *Prime considerazioni sullo strumento del bail-in: la conversione forzosa di debito in capitale*, report held during the annual convention of Associazione Orizzonti del Diritto Commerciale, Rome, Febuary 21-22, 2014, 1 ff.

[4] *See* Stanghellini, *cit.*, p. 156 ff.

[5] *See* Passalacqua, *Diritto del rischio nei mercati finanziari: prevenzione, precauzione e cautela*, Padova, 2012, *passim*; John-Litov-Yeung, *Corporate Governance and Risk Taking*, in *The Journal of Finance*, Vol. 63, Issue 4, 2008, p. 1679 ff.; Laeven–Levine, *Bank Governance, Regulation, and Risk Taking*, in *NBER Working Paper* no. 14113, 2008; Stulz, *Governance, Risk Management, and Risk-Taking in Banks*, in *ECGI Finance Working Paper* no. 427/2014, 2014.

[6] The report attached to the Italian legislative decrees implementing the BRRD clarifies that the legislative decree no. 181 – which amended the "Consolidated banking act" (legislative decree September 1, 1993, no. 385) by introducing, *inter alia*, the regulation on recovery plans (but not the regulation on the resolution plans, which find their legal framework in the legislative decree no. 180) – expressly intended to keep in the consolidated banking act "*the institutions required by BRRD closer to the supervisory functions than the crisis management ones*".

[7] Article 6, paragraph 4, of the BRRD Directive, provides that the competent authority *shall provide* the recovery plan to the resolution authority. The resolution authority may examine the recovery plan with a view to identifying any actions in the recovery plan which may adversely impact the resolvability of the institution and make recommendations to the competent authority with regard to those matters. Compliant, art. 69-*sexies*, paragraph 2, of the consolidated banking act introduced by legislative decree no. 181/2015.

[8] *See*, in particular, art. 11 of BRRD Directive.

[9] Pursuant to art. 3 of BRRD Directive, Member States may *exceptionally* provide for the resolution authority to be the competent authorities for supervision for the purposes of Regulation (EU) No 575/2013 and Directive 2013/36/EU. In this case, adequate structural arrangements shall be in place to ensure operational independence and avoid conflicts of interest between the functions of supervision and the functions of resolution authorities.

[10] In these terms *see*, Maugeri, *Fusioni e scissioni di società per azioni bancarie*, in *Banca e borsa*, 1998, I, p. 34 ff.

[11] *See* Passalacqua, *Diritto del rischio nei mercati finanziari: prevenzione, precauzione ed emergenza*, *cit.*; Scotti Camuzzi, *Le nuove disposizioni di vigilanza sul sistema dei controlli interni nelle banche. Un commento introduttivo*, in *Banca e borsa*, 2014, I, 168-9.

[12] In these terms *see* Brogi, *Corporate governance bancaria e sana e prudente gestione*, in *Banca Impresa Società*, 2010, p. 300.

[13] *See* Rulli, *Prevenire l'insolvenza. Dal salvataggio pubblico alla risoluzione bancaria: rapporti con i principi della concorsualità e prime esperienze applicative*, in *RTDE*, 2015, 286 ff.; *see* also Bentivegna, *Fondi di garanzia dei depositi e crisi bancarie. Novità e profili problematici alla luce del nuovo framework regolamentare europeo in materia risanamento e risoluzione*, in *RTDE*, 2015, 25 ff.

[14] See Article 74, paragraph 4, of the directive 2013/36/UE, abrogated by Article 124 of the directive.

[15] The directive 2013/36/UE defines the management body as an institution's body or bodies, which are appointed in accordance with national law, empowered to set the institution's strategy, objectives and overall direction, and which oversee and monitor management decision-making, and include the persons who effectively direct the business of the institution.

[16] *See* Amorello–Huber, *Recovery planning: a new valuable corporate governance framework for credit institutions*, in *Law and Economics Yearly Review*, 2014, p. 314.

[17] In this regard *see* Aa.Vv., *Il governo delle banche* (edited by Principe), Milan, 2015; Aa.Vv., *La governance delle società bancarie* (edited by Di Cataldo), Milan, 2012; in these terms Capriglione, *La* governance *bancaria tra interessi d'impresa e regole prudenziali (disciplina europea e specificità della normativa italiana)*", in *La riforma societaria alla prova dei suoi primi dieci anni*, edited by De Angelis, Martina and Urbani, Padova, 2015, p. 89 ff.; Amorosino, *La conformazione regolatoria della governance delle società bancarie da parte della Banca d'Italia*, in *Dir. banc*., 2015, p. 209 ff.; Cera, *Il buon governo delle banche tra autonomia privata e vigilanze pubbliche*, in *Riv. soc*., 2015, p. 947 ff.; Montalenti, *Amministrazione e controllo nella società per azioni tra codice civile e ordinamento bancario*, 2015, I, p. 727 ff.; De Prà, *Il nuovo governo societario delle banche*, in *NLCC*, 2015, p. 525 ff.; Portale, *La* corporate governance *delle società bancarie*, in *Riv. soc*., 2016, 48 ff.; Calandra Buonaura, *Il ruolo dell'organo di supervisione strategica e dell'organo di gestione nelle Disposizioni di vigilanza sulla corporate governance e sui sistemi di controllo interno nelle banche*, in *Banca Impresa Società*, 2015, p. 19 ff.; Frigeni, *Prime considerazioni sulla normativa bancaria in materia di "organo con funzione di supervisione strategica"*, in *Banca e borsa*, 2015, I, p. 485 ff.; Hopt, *Better governance of Financial Institution*, ECGI Working Papers in Law, n. 207, 2013, p. 3 ff.

[18] It is also clear that, within the category of shareholders (and of other risk instruments' holders), those protected by recovery preparation instruments are *long-term shareholders* – increasingly protected and encouraged by the European and Italian legislator – in defense of their investment attitude, which is naturally oriented to the sustainable growth in the medium-long term (in line with their nature of "loyal shareholders"). The long-term shareholders, indeed, will benefit – during the period of their investment– of the potential benefits deriving from the recovery preparation tools, whose contribution in terms of stability of the bank can be appreciated in the long term (even if they may affect the shareholders' positions in the short term).

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