Italy Issues Decree Aimed at Rescuing Troubled Banks

By Bruno Cova, Eriprando Guerritore, Patrizio Braccioni, Marc-Alexandre Courtejoie & Fabio Cozzi

Introduction

After months of drama prompted by the intertwined destinies of a constitutional referendum and the recapitalization of Monte dei Paschi di Siena ("MPS"), Italy’s third largest bank, and following the resignation of the Renzi government, the first important measure approved by the new Italian cabinet was an emergency decree aimed at safeguarding the Italian banking sector.

Law Decree No. 237 (the "Decree") was passed on 23 December 2016 and empowers the Ministry of Economy and Finance ("MEF") to support Italian banks through two main instruments: (x) a State guarantee on newly issued liabilities and (y) direct recapitalizations. With a separate measure, Parliament authorized funds of up to €20 billion to finance the measures contemplated in the Decree.

The Decree was approved after the failure by MPS to complete by the deadline set by the European Central Bank the €5 billion increase of capital, required following the negative outcome of a stress test last summer. As the measures in the Decree are of general application and the amount of €20 billion goes well beyond the requirements of MPS, the new measures are clearly intended to address also other possible emergency situations in the Italian banking sector.

The Decree in the Context of EU Legislation

According to Directive 2014/59/EU (the "BRRD"), a credit institution is deemed to be failing or likely to fail when, inter alia, extraordinary public financial support is required and there is no reasonable prospect that any alternative private sector or supervisory action would prevent the failure of the institution within a reasonable timeframe.

In derogation to the above, extraordinary public financial support will not trigger any failure when, in order to remedy a serious disturbance in the economy of a Member State and preserve financial stability, the extraordinary public financial support takes any of the following forms:

1. a State guarantee to back liquidity facilities provided by central banks according to the central banks’ conditions;

2. a State guarantee of newly issued liabilities; or

3. an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution, upon certain conditions that must be satisfied at the time the public support is granted.
The above measures are confined to solvent institutions, are conditional on final approval under the EU State aid framework (and must be compliant with the same, including the Banking Communication issued by the European Commission on 30 July 2013), must be of a precautionary and temporary nature and proportionate to remedy the consequences of the serious disturbance, and must not be used to offset losses that the institution has incurred or is likely to incur in the near future.

**State Guarantee of Newly Issued Liabilities and to Back Emergency Liquidity Assistance Provided by Bank of Italy**

The MEF is entitled under the Decree until 30 June 2017 (with an option to extend for a further six-month period subject to the European Commission’s prior approval), to issue a State guarantee on debt securities issued by Italian banks upon satisfaction of certain conditions, among which:

1. the guarantee must be compliant with the EU State aid framework and may be granted only following the positive decision of the European Commission on the guarantee regime or, where a bank with a capital shortfall is in urgent need of liquidity or with respect to an Italian bank under resolution or to a bridge institution, an individual notification to the European Commission is required;

2. the debt securities must be issued after the entry into force of the Decree, have a residual maturity of at least three months and not exceeding five years, and be senior debt (subordinated debt is excluded), at fixed rates and denominated in euro;

3. the maximum amount of the guarantee is capped to the extent necessary to replenish the medium-long term lending capacity of the bank;

4. the guarantee must be onerous, unconditional, irrevocable, and at first demand; and

5. the remuneration of the State guarantees shall be determined on a case-by-case basis according to criteria defined under the Decree.

Applications for the State guarantee must be submitted by the issuer to the Bank of Italy and to the Department of the Treasury of the MEF. Applications must be filed based on an application form sample drafted by the Department of Treasury of the MEF. A restructuring plan to confirm the profitability and the long term raising of capital capacity without recourse to public support must be submitted to the European Commission within two months for any credit institution which enjoyed the State guarantee for which, at the time of the granting of such guarantee, the total outstanding guaranteed liabilities exceeded both a ratio of 5% of total liabilities and a total amount of € 500 million.

The MEF may also issue, within six months from the entry into force of the Decree, the State guarantee to supplement the collateral, or its realizable value, allocated by Italian banks as collateral for loans disbursed by the Bank of Italy to face severe liquidity crisis (emergency liquidity assistance).

The Italian bank receiving the assistance shall submit a restructuring plan to confirm the profitability and the long term raising of capital capacity without recourse to public support, in particular to limit the reliance on liquidity provided by Bank of Italy.

The MEF, after consulting the Bank of Italy, is mandated to issue the implementing regulations of the State guarantee measure.
Recapitalization

The Decree sets the terms and conditions for the subscription or purchase of shares of: (x) Italian banks; (y) Italian holding companies at the head of a banking group; by the MEF. The main features of this instrument are the following:

1. **Timing.** The MEF is authorized to subscribe or purchase shares issued by Italian banks until 31 December 2017.

2. **Program and request.** Before applying for the intervention of the State, the issuer (whose need of capital injection resulted from stress tests in adverse scenarios) must have previously submitted to and agreed with the Bank of Italy or the European Central Bank (depending on what entity is the regulator of the relevant bank) a program of capital strengthening. The issuer’s request must contain, inter alia:
   a. an indication of the instruments affected by the burden-sharing provisions (see below at paragraph 7), and their book value, together with the assessment, prepared by an independent expert, of their economic value for the purposes of determining their conversion rate;
   b. a valuation report, prepared by an independent expert, on the actual value of the issuer’s assets and liabilities without considering any form of public support and assuming that the issuer is subject to liquidation on the date of the request;
   c. a restructuring plan drafted in compliance with the EU measures on State aid applicable to the recapitalization of banks within the financial crisis context.

3. **State aid compliance.** The request shall be accompanied by a statement by the issuer of compliance with the provisions set out in the 2013 Banking Communication (including the undertaking not to pay dividends on shares or coupons on hybrid capital instruments or not to repurchase any of their own shares or call hybrid capital instruments for the duration of the restructuring period without prior approval of the European Commission).

4. **Procedure.** Once the intervention (including the burden-sharing provisions—see below) is approved by the European Commission, it must be reflected in a ministerial decree of the MEF, to be adopted based on a proposal made by the Bank of Italy.

5. **Features of the shares.** The newly issued shares subscribed for by the MEF must be ordinary shares with full voting and patrimonial rights (CET 1). For instance, the shares shall qualify neither as senior nor as junior shares.

6. **Effects of the subscription.** To facilitate the intervention of the MEF, a recapitalization under the Decree does not trigger the mandatory tender offer rules and certain other rules are disapplied.

7. **Burden-sharing.** For the purposes of limiting recourse to public funds, the Decree sets out the application of the burden-sharing as follows:
   a. mandatory conversion, in whole or in part, in ordinary Tier 1 shares of the Additional Tier 1 instruments (hybrid instruments), including the instruments qualified as class 1 additional capital instruments according to the grandfathering clause of EU Regulation 575/2013 as well as any other liability with the same subordination degree on the basis of bankruptcy principles.
b. in the event the measure referred to in subparagraph (a) is insufficient, mandatory conversion, in whole or in part, into Tier 1 shares of the Tier 2 instruments (subordinated instruments) including the instruments and loans qualified as class 2 instruments according to the grandfathering clause of EU Regulation 575/2013 as well as any other liability with the same subordination degree on the basis of bankruptcy principles; and

c. in the event the measures referred to in subparagraphs (a) and (b) are insufficient, mandatory conversion, in whole or in part, into Tier 1 shares of the other subordinated instruments.

The burden-sharing provision must comply with the following limits and conditions:

a. creditors and shareholders must be treated uniformly based on their respective category and bankruptcy principles;

b. the loss imposed to creditors and shareholders must be so that they do not receive a treatment worse than they would receive in the liquidation scenario of the issuer (the so-called no creditor worse off principle), assuming that it takes place without public support (in case of breach of this provision, the damaged creditor or shareholder can be compensated only with the granting of additional new shares);

c. the conversion of the hybrid and subordinated instruments must be made following a methodology and formulae described in an attachment to the Decree; and

d. the issuer must have converted into Tier 1 shares the convertible instruments issued (contingent capital) in compliance with the relevant contractual terms and conditions.

The Decree also contains a number of provisions aimed at facilitating the adoption of the burden-sharing measures and discouraging litigation. In this respect the Decree provides that:

a. the adoption of the burden-sharing measures implies the ineffectiveness of any contractual agreement the issuer may have in connection with its own shares or capital instruments and concerning the relevant patrimonial rights;

b. the burden-sharing provisions under Article 22 of the Decree are overriding mandatory law provisions for the purposes of international conflicts of law rules (in practice, creating the conditions for such provisions being applicable to non-Italian governed instruments issued by Italian banks and Italian courts declining to recognize and enforce foreign judgments whose content would be deemed to be contrary to the burden-sharing provisions);

c. all possible termination or acceleration clauses that might be triggered by the request of recapitalization by the issuer are ineffective;

d. the administrative courts have exclusive jurisdiction over any claim against the burden-sharing measures.

8. **Measures to compensate retail bondholders.** The Decree contemplates that the burden-sharing and recapitalization measures of an issuer may include the settlement of potential claims by retail bondholders against the issuer with the exclusion of any settlement of potential claims by professional bondholders. In such case the MEF may purchase the shares of those shareholders which became shareholders in the framework of the burden-
sharing measures which included the settlement of the potential claims. In practice this provision will allow retail bondholders to receive cash for the shares they will obtain as a result of the mandatory conversion under the burden-sharing measures.

**Monte dei Paschi di Siena**

While the Decree is of general application, its provisions are often tailored to address the specific circumstances of the MPS situation. The Decree sets out the conversion rate of certain instruments issued by MPS and a number of provisions in Article 22 of the Decree (dealing with the burden-sharing mechanism) appear to be aimed at addressing the situation of certain instruments issued by MPS (in particular the 2008 FRESH) and generally at discouraging the litigation that may stem from Italy having adopted this kind of coercive measure outside a banking resolution situation, or from the months-old saga of MPS’s failed recapitalization.

**Entry into Force**

The Decree came into force on 23 December 2016 following its publication on the Italian Official Gazette on 23 December 2016 no. 299 and it is immediately applicable. As it was adopted as an emergency decree, it will automatically expire unless it is converted into law by Parliament within 60 days from its publication date on the Italian Official Gazette. It is possible that during the parliamentary process to convert the Decree into law, certain provisions of the Decree will be amended.

**Conclusions**

The Decree has created a comprehensive framework to address situations in which a solvent Italian bank may require State support and has contributed to sedate the uncertainties prompted by MPS’s unsuccessful attempt to complete its complex maneuver contemplating the sale of a large NPL portfolio, a liability management exercise through voluntary conversion of debt into equity, and a rights issue. Assuming the Decree is converted into law, the next few months and its application to the MPS situation will be an important test of its adequacy to meet the challenges of the situation of certain Italian banks and the country’s banking system in general.

*If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings Milan lawyers:*

- **Bruno Cova**  
  39.02.30414.212  
  brunocova@paulhastings.com

- **Marc-Alexandre Courtejoie**  
  39.02.30414.230  
  marcalexandre.courtejoie@paulhastings.com

- **Eriprando Guerritore**  
  39.02.30414.000  
  eriprandoguerritore@paulhastings.com

- **Patrizio Braccioni**  
  39.02.30414.210  
  patriziobraccioni@paulhastings.com

- **Fabio Cozzi**  
  39.02.30414.220  
  fabiocozzi@paulhastings.com

- **Lorenza Talpo**  
  44.020.3023.5158  
  lorenzatalpo@aulhastings.com

---

1 EU licensed banks carrying out into Italy activities admitted to mutual recognition either on a freedom to provide services basis or via an Italian branch establishment may not therefore enjoy any of the Decree provisions.

2 In such occasion, MPS passed the test in the baseline scenario but obtained a negative result in the adverse scenario.

3 Article 32, paragraph 4, letter d, of the BRRD.

4 Equity securities may not enjoy the State guarantee of newly issued liabilities.

Paul Hastings LLP

Stay Current is published solely for the interests of friends and clients of Paul Hastings LLP and should in no way be relied upon or construed as legal advice. The views expressed in this publication reflect those of the authors and not necessarily the views of Paul Hastings. For specific information on recent developments or particular factual situations, the opinion of legal counsel should be sought. These materials may be considered ATTORNEY ADVERTISING in some jurisdictions. Paul Hastings is a limited liability partnership. Copyright © 2017 Paul Hastings LLP.
The application form may be downloaded from the Department of Treasury website.

According to paragraph 19 of the 2013 Banking Communication, before granting any kind of restructuring aid, be it a recapitalisation or impaired asset measure, to a bank all capital generating measures including the conversion of junior debt should be exhausted, provided that fundamental rights are respected and financial stability is not put at risk.

For instance reference is made to the following kinds of professional bondholders: (i) credit institutions; (ii) investment firms; (iii) other authorized or regulated financial institutions; (iv) insurance companies; (v) collective investment schemes and their management companies, etc.