BRIEFING

European Parliament

Recent measures for Banca Carige from a BRRD and State Aid perspective

On 8 January 2019, Banca Carige's Temporary Administrators issued a press statement setting out some initiatives they have taken to secure the future of the bank.

This briefing contains background information on the case of Banca Carige and links the initiatives taken to respective legal requirements stemming from the Bank Recovery and Resolution Directive (BRRD) and the rules for State Aid (SA).

Banca Carige

Banca Carige Group (or "Carige S.p.A - Cassa di Risparmio of Genoa and Imperia) is a middle sized Italian group of banks with approximately 4300 employees, 500 branches, and total assets of EUR 23,960 million (3Q '18).

Banca Carige came under direct supervision by the ECB from the very beginning of the ECB's day-to-day supervisory activities in November 2014 and was part of the ECB's 2014 Comprehensive Assessment, which at that time indicated a capital shortfall of EUR 1,83 billion (before new capital raised) and a very low CET1 ratio of 2.3% in the baseline scenario of the stress test. The shares of Banca Carige are listed in the Italian stock exchange (Borsa Italiana). Trading has been suspended since the 28 December 2018.

The size of Banca Carige's consolidated balance sheet has fallen over the past years, and at present the bank no longer fulfils any of the criteria determining "significant institutions"; the bank is now directly supervised pursuant to the three years rule in Article 47(1) SSM Framework Regulation (see list of supervised entities).

The main activities of Banca Carige are concentrated in the Liguria region, where the bank's branches have a market share of approximately 25%, while their market share in the other Italian regions nowhere exceeds 4% (see annex 1).

In 2018, the bank was loss-making, as in the year before (see investor presentation Consolidated results as at 30 September 2018).

Banca Carige's main source of funding are deposits from retail and corporate customers; according to the half-year report 2018, current accounts, demand deposits, and time deposits represented approximately 54% of funding in relation to the total balance sheet amount (adding up to approximately EUR 13.5 billion in absolute terms), bank funding accounted for another 18% (the majority of which, 77%, coming from central banks), and bonds issued by Banca Carige contributed some 14% (also see annex 1). Apparently, the bonds that Banca Carige has placed in the market in the amount of approximately EUR 3,5 billion are almost entirely held by the bank's clients.

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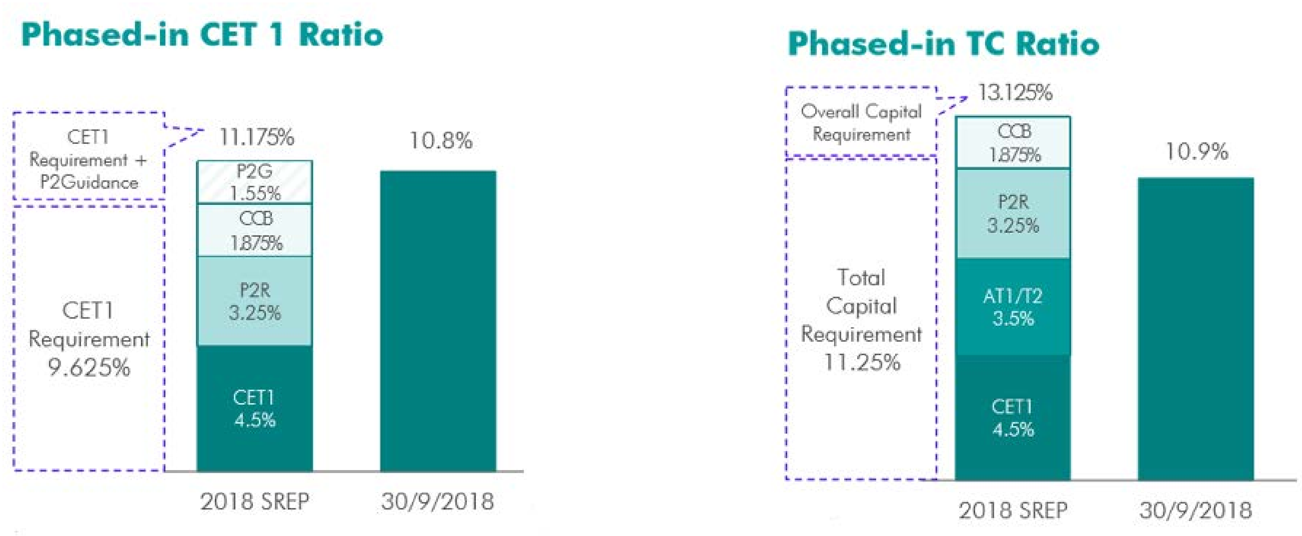
Banca Carige's capital position

As regards Banca Carige's capital position, **at end-September 2018** the bank reported actual capital ratios **below the ECB's capital requirements**, namely a CET1 ratio of 10.8% as compared to 11.175% CET1 required, and a Total Capital ratio of 10.9%, as compared to 13.125% required (see graph 1). The difference between those two capital ratios is explained by the little amount (0.1%) of subordinated debt that was issued by the bank at that point in time (also see annex 1).

The bank used a further issuance of Tier 2 capital to meet the supervisory requirements. On 30 November 2018, Banca Carige privately placed Tier 2 subordinated bonds for a total amount of EUR 320 million mainly with the Voluntary Intervention Scheme ('VIS') of the Italian Interbank Deposit Protection Fund, underwriting an amount of EUR 318.2 million, as well as a small stake of EUR 1.8 million that was undersigned by Banco di Desio e della Brianza. Those Tier 2 bonds have a ten-year maturity and came with a 13% fixed rate coupon. That placement was the first of two interconnected transactions, the overall process was intended to be completed with a EUR 400 million share capital increase.

Banca Carige explains in a that that placement of Tier 2 subordinated bonds allowed to immediately restore compliance with 2018 SREP targets, and points to further capital strengthening effects from transactions set out under the Capital Conservation Plan (CCP) approved on 29 November 2018 (in particular disposal of a bad loan portfolio approximately amounting to gross EUR 0.9 billion via a GACS[1] backed securitisation). The press release furthermore sets out that for 2019, even under the assumption that the fully loaded regulatory build-up of the Capital Conservation Buffer (+0.625% vs 2018) will be reflected in the bank's SREP targets, the completion of the capital strengthening effort via a EUR 400 million capital increase (in substitution for the subordinated debt) will make it possible to comply with the requirements.

Graph 1: Actual CET1 and total capital ratio in relation to SREP requirements, at end-September 2018



Source: Consolidated results as at 30 September 2018

[1] *Garanzia Cartolarizzazione Sofferenze*, the italian state guarantee scheme to banks' senior tranches of non performing loans securitisation structures. See Commission decision declaring the scheme compatible with State Aid rules.

On 19 December, hence still after the placement of Tier 2 subordinated bonds, the rating agency Moody's downgraded the bank's standalone baseline credit assessment (BCA) from “caa2” to “ca”, which is the next to last category on its non-investment grade rating scale, generally indicating that obligations are highly speculative and are likely in, or very near, default, with some prospect of recovery in principal and interest. The bank’s long-term deposit rating and the long-term issuer rating was kept at Caa1 and Caa3 respectively.

In the rationale for the rating downgrade, Moody’s pointed in particular to the overall capital situation: “*Moody's believes that the plan* [new *capital conservation plan], while restoring the bank's capital position, may* ***not be sufficient to ensure its longer-term viability****, necessitating further external support. This is evidenced by the bank's pursuit of strategic alliances, in respect of which it has mandated an investment bank.*” (our emphasis).

On 22 December, Banca Carige held an extraordinary shareholders' meeting but **failed to get the approval for an increase of the bank’s share capital** (i.e. CET1) by EUR 400 million.

Initiatives and measures taken by the authorities

On 2 January 2019, the ECB announced that it had appointed three temporary administrators and a three-member surveillance committee to take charge of Banca Carige and replace its Board of Directors, after a majority of board members of Banca Carige had resigned.

On 8 January 2019, Italy’s cabinet approved a **decree law** to provide a **state guarantee for future bonds** issued by Carige, as well as a guarantee to enhance the quality of collateral in order to access Emergency Liquidity Assistance (ELA), and to allow for the participation in a capital increase. The decree law *inter alia* states that the stress exercise conducted in 2018 by the ECB revealed[2] a **shortage of capital.** Referring to the same test, the financial press reported in November 2018 that Carige was categorized as “fragile”,” with a capital shortage in the “adverse” scenario.

Italy’s state guarantee for newly issued bonds has a nominal value of EUR 3 billion (Art. 1 of the decree law)[3].

That decree law moreover specifies the terms and conditions in case that the Italian state is asked to participate in a capital increase, by signing the subscription of new ordinary shares, subject to burden sharing measures, namely a write down or conversion of existing shares, additional tier 1 instruments, and tier 2 capital instruments, as may be necessary.

On 8 January, Banca Carige issued a press release announcing initiatives that the temporary administrators have taken, in particular as regards:

- a proposal submitted to the Voluntary Scheme for redefining subordinated debt terms,
- a due diligence process initiated for further reducing the portfolio of non-performing exposures (NPEs),
- the state-backed guarantee accessed to support the bank’s medium-term funding,
- and, announced only as a residual option, a precautionary recapitalisation[4].

[2] The ECB itself has not made the results of its 2018 stress test exercise publically available, details of the said shortfall - in particular the question how large the shortfall is in relation to the bank’s capital situation as well as whether that shortfall occured only under the stress scenario or even under the baseline scenario - are therefore not publically available either. Notably, in 2018 the EBA and the ECB carried out stress test exercises in parallel, based on the same approach, but for different samples of banks; only the results for banks tested by EBA, however, were published.

[3] Article 22 of the decree creates a fund of EUR 1.3 billion to finance the costs of guarantees, ELA enhancement and precautionary recapitalisation of Carige. The provision foresees EUR 1 million allocated to the share issuance and EUR 300 million allotted to guarantees and ELA enhancement. It also authorises the Ministry of Finance and Economy to rearrange the allocation if needed and to amend the national budget to ensure funds will be deployed from other sources to finance the fund. One should note that article 23 of the decree imposes submission of the decree to the national parliament to be converted into law.

[4] The press release states “It should be noted that the precautionary recapitalisation referred to in the press release of the Council of Ministers is to be considered as an additional measure for the protection of customers, to be activated only as a residual option”.

Requirements of the BRRD and State Aid legal framework

This section links the initiatives taken to the respective legal requirements stemming from the Bank Recovery and Resolution Directive (BRRD) and the applicable rules for State Aid.

Redefining subordinated debt terms

The Tier 2 bonds placed in November came with a high fixed rate coupon of 13% (in comparison, the bank's average total cost of funding stood at 0.86% at end-September 2018). In order to ensure the sustainability of the bank's funding costs, the bank's temporary administrators have reportedly met the management of the Voluntary Intervention Scheme to discuss the terms of the Tier 2 bonds.

Considering that the subscription of the Tier 2 bonds was done by the voluntary arm of the Italian Deposit Guarantee Scheme and does not involve public funds or any other form of state aid, this initiative is non-critical from a BRRD and State Aid perspective. This measure fits in with the early intervention powers of the ECB under Article 27(1(e) BBRD whereby supervisors may require the management body of a bank to "draw up a plan for negotiation on restructuring of debt with some or all of its creditors according to the recovery plan, where applicable".

Due diligence process of NPE portfolio

Banca Carige's press release further mentions that the temporary administrators have decided to start a due diligence on the bank's portfolio of non-performing exposures (NPEs), following a disposal of around EUR 1.5 billion that was just completed, with the aim of a further drastic NPE reduction to achieve a NPE ratio of 5 to 10% (as at end-September 2018, the bank's gross NPE ratio stood at 27.5%).

The press release, however, does not specify in which form Banca Carige aims to reduce its stock of NPEs, which could be a purely private placement (in which case there is no potential BRRD or State Aid issue), or a sale to a state-sponsored asset management company (with BRRD and State Aid implications), or a private placement that is facilitated by a guarantee scheme (likewise falling under State Aid rules). The press release mentions that "[S]*ome of the most qualified national and foreign investors will be invited to participate in the due diligence process*".

Different scenarios would need to be assessed:

- If the planned disposal of further parts of the bank's NPE portfolio is purely made to private investors, such measure would have no BRRD or SA consequences[5];
- If the reduction of NPEs was to be achieved by selling the impaired assets directly to a state sponsored entity, benefitting from what is called an "asset relief measure", the measure may amount to a [required] "extraordinary public financial support" according to Art. 32 (4) (d) of the BRRD and possibly triggering the bank's resolution[6].

It must be noted that Italy has a support **scheme in place that facilitates the securitisation of non-performing loans** (and thereby a private placement), without triggering the consequences of an "extraordinary public financial support" according to Art. 32 (4) (d) of the BRRD. In August 2018, the European Commission prolonged that guarantee scheme to facilitate the securitisation of non-performing loans (GACS) **until 7 March 2019**, **judging that the scheme does not constitute aid** within the meaning of Article 107 (1) TFEU. Under that scheme, Italian banks meeting certain conditions may request a State guarantee on the lower-risk senior notes issued by private securitisation vehicles that help them to finance

[5] Provided, of course, that the bank is genereally not in a financial situation under which it would be deemed to be failing or likely to fail according to Art. 32 (4) of the BRRD.

[6] Unless the conditions foreseen in article 18/4/d of SRMR (and article 12 of the Decree Law) are complied with.

the sale of their non-performing loan portfolios. The scheme has so far been accessed six times by five different banks, removing €33 billion (gross book value) of non-performing loans from the Italian banking system, which corresponds to over 60% of the total reduction of non-performing loans in Italy during that period. According to the Governor of Banca d'Italia, use of this scheme is "expected to increase considerably in the months to come"[7].

State-backed guarantee for funding

Banca Carige's has issued last 25 January EUR 2 billion bonds benefitting from the stateguarantee created by the decree law of 8 January 2019. The bonds (2 lines of EUR 1billion each) will mature on 25 January 2020 (and a coupon rate 0.5%) and 26 July 2020 (coupon rate 0.75%). That measure is related to the liquidity situation of the bank, not its capital position. The state guarantee will help the bank to refinance itself at the market at reasonable interest rates[8].

Under the exception clause[9] set out in Art. 32 (4) (d) (ii) of the BRRD, a bank can (provided this is necessary to remedy a serious disturbance in the economy of the Member State and preserve financial stability) make use of a State guarantee of newly issued liabilities, without being deemed failing or likely to fail (and hence without being put into resolution).

In addition, the decree law includes a possible state guarantee to liquidity funding provided by Banca d'Italia[10] as permitted under Article 32(4)(d)(i).

Such measuress, which areare a form of "non-consequential" extraordinary public financial support (i.e. they would not trigger resolution), shall be, in accordance with BRRD, of a "precautionary and temporary nature", and in any case confined to "solvent institutions".

The BRRD does not provide a definition of what a 'solvent institutions' mean.

EBA specified that "[*W]ithin* the *context of Article 32 of Directive 2014/59/EU (BRRD), the notion of solvent institution should be interpreted as referring to an institution which does not fall within Article 32(4)(a), (b), (c)".*

From that perspective, an institution that either:

- infringes the requirements for continuing authorisation in a way that would justify the withdrawal of the authorisation (i.e. banking license) under Article 32(4)(a);
- is in a situation in which its assets are less than its liabilities under Article 32(4)(b);
- or that is/will be unable to pay its debts or other liabilities as they fall due under Article 32(4)(c);

would not qualify to make use of a state guarantee on newly issued bonds.

In terms of compliance with capital ratios, Article 32(4)(a) refers to the "requirements for continuing authorisation in a way that *would* justify the withdrawal of the authorisation by the competent authorities including but not limited to because the institution has incurred or is likely to incur losses that will deplete all or a significant amount of its own funds".

Against this background, the assessment as to whether an institution is "solvent" would require supervisory judgment with respect to the losses an institution has incurred or is likely to incur. The competent authority (ECB) would be asked to ascertain Carige's solvency, under the Decree Law provisions (article 9/4 and 7).

[7] Also see the Commission's "Third Progress Report on the reduction of non-performing loans and further risk reduction in the Banking Union", published on 28 November 2018.
[8] DBRS assigned a short-term rating of 'R-1 (low)' to "Banca Carige 0.50% 25 January 2020 and a long-term rating of 'BBB (high)' to "Banca Carige 0.75% 26 July 2020. The trend on both issuances is 'Stable'.
[9] The BRRD stipulates that by 31 December 2015, the Commission was to review whether there is a continuing need for allowing the support measures under point (d)(iii) of the first subparagraph and the conditions that need to be met.
[10] Article 9 of the Decree Law.

It must be noted that a more straightforward definition of what is meant by a "solvent institution" has once been provided by the ECB in a comment published on 27 December 2016. At that time, the ECB explained that "*[F]or the purposes of a precautionary recapitalisation, a bank is considered solvent if it fulfils the minimum capital requirements (i.e. Pillar 1 requirements).*" The ECB updated that comment on 2 May 2018, and it no longer contains an explanation as to what is meant by "solvent insitution"[11].

The European Commission has cleared, from a state aid perspective, the state guarantee to Carige bond issuances. Details of the Commission decision are still not available[12].

Precautionary recapitalisation

Banca Carige's press statement finally mentions - though only as a residual option - that the bank may ask for a precautionary recapitalisation by the Italian government. As mentioned above, the decree law actually sets out the terms and conditions in case that the Italian government is asked to participate in a capital increase.

A "precautionary recapitalisation" is a form of extraordinary public financial support that is set out under the exception clause in Art. 32 (4) (d) (iii) of the BRRD. Like state guarantees on newly issued bonds, such measure is confined to "solvent institutions".

The question is raised as to whether a recapitalisation may be qualified as "precautionary" pursuant to Article 32(4) of BRRD.

As well explained on an ECB webpage, "*precautionary recapitalisation is limited to the capital injections needed to address a capital shortfall under the adverse scenario of a stress test. The ECB is asked to confirm that the bank has a capital* ***shortfall*** *– and to determine the amount of the shortfall –* ***under the adverse scenario*** *of the most relevant European Banking Authority/Supervisory Review and Evaluation Process stress test exercise, while confirming that the bank has* ***no shortfall under the baseline scenario*** *in this case*." (our emphasis)

Against this background, further clarity and transparency on the outcome of Banca Carige's stress test is critical. It must be noted that capital injection under Article 32(4) BRRD shall be limited to "*injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests, asset quality reviews or equivalent exercises conducted by the ECB, EBA or national authorities, where applicable, confirmed by the competent authority (i.e. the ECB)"*. A recapitalisation is hence contingent on the confirmation by the ECB of the results of stress tests or asset quality reviews or equivalent exercises.

According to the BRRD, an application for a precautionary recapitalisation is in any case subject to a final approval under the Union State aid framework, and the recapitalisation shall **not be used to offset losses that an institution has already incurred** or is likely to incur in the near future (the latter aspect is in particular relevant in view of the fact that Banca Carige's temporary administrators have only just decided to start a due diligence on the bank's portfolio of non-performing exposures).

[11] In another context, namely in the Emergency Liquidity Assistance (ELA) agreement in the version of 17 May 2017, the ECB has clearly specified what it understands by a solvent institution: "*A credit institution is considered solvent for ELA purposes if:*
(a) its Common Equity Tier 1, Tier 1 and Total Capital Ratio as reported under CRR on an individual (if applicable) and consolidated (if applicable) basis comply with the harmonised minimum regulatory capital levels (namely 4.5%, 6% or 8%, respectively); or
(b) there is a credible prospect of recapitalisation - in case (a) is not met, i.e. the Common Equity Tier 1, Tier 1 and Total Capital Ratio, on an individual and/or consolidated basis, do not comply with the harmonised minimum regulatory capital levels (namely 4.5%, 6% or 8%, respectively) - by which harmonised minimum regulatory capital levels would be restored within 24 weeks after the end of the reference quarter of the data that showed that the bank does not comply with harmonised regulatory minimum standards; in duly justified, exceptional cases the Governing Council may decide to prolong the grace period of 24 weeks."

[12] On 18 January 2019, the Commission issued a press release (Daily News) stating that the support measures envisaged by the Italian State to guarantee up to EUR 3 billion bond issuances of Carige are targeted, proportionate and limited in time and scope and, therefore, in line with the 2013 Banking Communication.

Resolution or orderly wound down under national insolvency law

The events reported in the press raise the question as to what might happen if all support measures prove to be not sufficient, and what kind of decision, if required, the Single Resolution Board might be inclined to take.

In 2017, the ECB declared two banks from the Veneto that were under direct ECB supervision "failing or likely to fail", which subsequently led to their wind down, as the Single Resolution Board decided that there was no public interest in a resolution since neither of those banks provided critical functions, and their failure was not expected to have significant adverse impact on financial stability (for more details, see a previous EGOV briefing). To facilitate the orderly wind-down of those banks, the Italian government at that time provided a cash injection of EUR 4.8 billion as well as state guarantees amounting to about EUR 12 billion to the buyer that was tasked with their liquidation, arguing that there was a need to mitigate economic disturbance at regional level. This is what Andrea Enria, at that time Chair of the EBA, called "*two different definitions of "public interest" [...] one at the EU level and another one by national authorities*".

Andrea Enria moreover pointed to the very high bar for resolution: "*The decision that there was no EU public interest at stake in the crises of two ECB-supervised banks that were hoping to merge and operate in the same region with combined activities of around €60 billion sets the bar for resolution very high*". Compared to the two Veneto banks, Banca Carige is smaller in terms of its balance sheet size, which might hence be an argument against resolution.

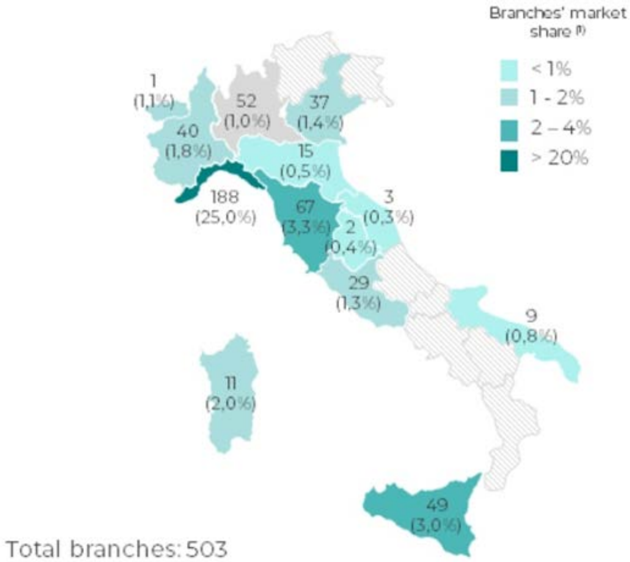
Where the SRB determines that Banca Carige does not meet a "public interest test", the issue is raised as to whether State Aid would be authorised to support the orderly wound down of Carige.

In terms of market share held, the situation might result in a treatment similar to the Veneto Bank (i.e. orderly wound down under national insolvency law involving State Aid). In the Commission's decision approving the liquidation aid *for* the two Veneto banks, it is mentioned that " *VB's market share in deposits as well as in loans is around 1% in Italy and around 4% for deposits and around 5% for loans in the Veneto region" and "BPVi's market share in deposits as well as in loans is around 1% in Italy and around 4.5% for deposits and around 6.5% for loans in the Veneto region*".

We note that, according to the information published by the bank itself (see annex 1), Banca Carige holds a much higher market share in the Liguria region than what the Veneto banks had in the Veneto region.

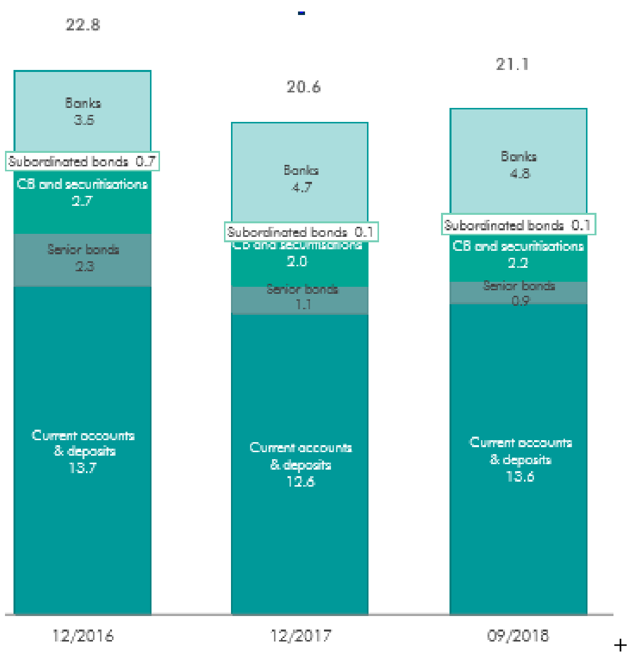
Annex 1: Banca Carige Group's positioning

Branches per region / market share 1H 2018



Source: [Banca Carige website]()

Total Funding / structure



Source: [Presentation to the market]() (Consolidated results as at 30 September 2018), p. 22

Annex 2: Overview of measures

	Private sector solutions	ECB Early Intervention measure	Guarantees under State Aid framework	Other measures
Done/ on-going	• Sale of NPLs to private investors	• Temporary administrators (BRRD Article 29)		
Planned	• [On 23/12/18: Capital increase by private placement of new shares; rejected] • Renegotiation of the terms of the €320bn subordinated bond held by the Italian Deposit Guarantee Fund		• €3bn government guarantee for debt issues (BRRD Article 32(4)(d)(ii)) and Banca d'Italia's liquidity facilities (Article 32(4)(d)(i))	• **Precautionary recapitalisation** (as in the Monte dei Paschi di Siena case) under BRRD Article 32(4)(d)(iii)
Other possible measures	• Merger with another bank with shareholder's approval	BRRD Article 27, e.g.: • Request for a plan for negotiation on restructuring of debt with more creditors • Require changes to the institution's business strategy • Require changes to the legal or operational structures of the institution	• Sale of NPL to SGA (IT asset management company)	• **Resolution** by the SRB in case of « public interest » • **Orderly wound down** under national insolvency law, including liquidation aid, where appropriate (as in Veneto banks case)