ALLEN & OVERY

1st October 2015

The implementation of the Bank Recovery and Resolution Directive in Italy

CONTENTS

Speed Read

On 10 September 2015, the Italian Government approved, on a preliminary basis, the text of two legislative decrees (the **Draft Decrees**) implementing Directive 2014/59/EU of the European Parliament and of the Council of 15 May 2014 establishing a framework for the recovery and resolution of credit institutions and investment firms - the **BRRD**) in Italy. The Decrees need to be examined by the competent parliamentary Commissions and will have to be approved again by the Italian Council of Ministers in order to enter into force. The Draft Decrees closely implement the provisions of the BRRD, but also introduce preference for corporate inter-back deposits and limits on application of set-off rights.

The Decrees

The BRRD intends to harmonise and improve the tools for dealing with bank crises across the EU, following the principles set forth by the Financial Stability Board (**FSB**) in October 2011. The Italian Parliament passed Law No. 114/2015, which entered into force on 15 August 2015 and provides for a delegation of powers to the government to implement the BRRD (this is the way in which EU directives are typically implemented in Italy and the law of delegation provided for a more or less straight implementation of the provisions set forth in the BRRD itself). The delegation of powers expires after a period 3 months, meaning that actual implementation of the

BRRD should occur prior to 15 November 2015.

On 30 July 2015, the Italian Ministry of Finance launched a public consultation process in connection with the draft decrees which are intended to implement the Directive, with a deadline for comments as of 10 August 2015. The Draft Decrees were approved in principle by the Council of Ministers on 15 September 2015 and will be sent to the competent parliamentary Commissions for comment.

The first of the Draft Decrees will amend the Banking Law (the **Amending Decree**) and deals principally with recovery plans, early intervention and changes to the creditor hierarchy. This last item has attracted a great deal of market attention since, in addition to granting the preference mandated by Article 108 of the BRRD for covered deposits and non-covered deposits by individuals and SME's, the drafting contains a further, but lower, preference for all other deposits (which would include large corporate and interbank deposits). The motivation for this additional form of depositor preference beyond that which is strictly required by the BRRD can be seen as reflecting, primarily, concern for the negative impact which a haircutting of deposits may be expected to have on the "real" economy and the consequent risk of financial contagion and perhaps also, in part, a response to the FSB proposals made in November 2014 for a minimum total loss-absorbing capacity (**TLAC**) requirement for 30 banks identified as global systemically important banks (**G-SIBS**). It is noteworthy that a similar form of depositor preference has also been adopted in Greece, where the proposed FSB rules are not of relevance in light of the fact that no Greek G-SIBS have been identified.

The result of this change to the creditor hierarchy is that senior unsecured bonds are statutorily subordinated to deposits.

Another key area of risk identified by the FSB in setting its TLAC policy concerns operating liabilities other than deposits and, in this respect, the second of the Draft Decrees (the **Resolution Decree**[1]) closely implements the protections set forth in the BRRD for "financial contracts", including derivatives.

The resolution powers in the BRRD which are implemented in the Resolution Decree ensure that authorities will be entitled to undertake any of the following actions in relation to financial contracts:

- close-out the transactions for the purposes of bail-ing in only the relevant net, uncollateralised amount owing to a counterparty by the bank under resolution;
- calculate close-out amounts where contracts are terminated for the purposes of bail-in;
- cancel or modify the terms of a contract but only for the purposes of exercising a resolution power (for instance, a transfer of an ISDA Master may be made to a bridge bank even if the Agreement provides for no transfer without consent of the counterparty);
- temporarily suspend any of the following until midnight at the end of the business day following publication of notice to take resolution action:
  - the payment and delivery obligations of the bank under resolution (in which case also the obligations of the counterparty will be delayed and not come due until the suspension expires);
  - the counterparty's right to enforce security;
  - counterparty's contractual termination rights.

The fact that netting and collateral enforcement is ensured in the BRRD goes a long way to ensuring a form of *de facto,* if not legal, subordination of senior unsecured bonds of regulated institutions to derivatives and other financial contacts. This is principally because a creditor benefiting from set-off and collateral will be able to satisfy its claim in full up to the value of the net collateralised position. Both netting and collateral have received special protection in the context of ordinary insolvency proceedings (introduced by the Winding-up Directive and the Collateral Directive), with this protection confirmed by the BRRD in the situation of resolution (subject only to introduction of a brief temporary stay period for termination of transactions introduced by the BRRD). The point to note is that the only thing that could ever be bailed-in in resolution or subject to the rateable satisfaction process in liquidation is the unsecured portion of any net claim. In light of the requirements in the EU to move derivative transactions on to central clearing (EMIR) and to impose severe capital requirements for trades which remain purely OTC and are not collateralised (CRD IV), this is not likely to be a significant figure.

While the Resolution Decree follows closely the relevant provisions of the BRRD in terms of treatment of financial contracts, a potential complication in this regard is introduced in the Amending Decree, which proposes a direct limitation on exercise of rights of set-off in the context of insolvency proceedings for financial institutions by amending the provisions of Article 56 of the Italian Bankruptcy Law. Article 56 of the Bankruptcy Law provides for a general right of set-off which is available to creditors, subject to a one-year anti-build-up rule. The proposal put forward in the Amending Decree (found in Article 26(b) thereof), is that the right of set-off permitted by Article 56 be available only where the set-off has actually been claimed by one of the parties prior to the commencement of liquidation proceedings. This provision is in contrast to the consolidated jurisprudence of the Supreme Court which recognises that, for the purposes of recognising enforceability in insolvency, it is only necessary that the claim asserted by the creditor have its origin in a relationship which predates the admission to proceedings and not that set-off be claimed prior to such time.

It appears that this change to Article 56 may have been prompted by a desire to accommodate the FSB requirement that any debt claims purporting to satisfy the new TLAC requirements may not be subject to contractual or legal set-off. The FSB requirement in this regard is understandable since the loss-absorbing capability of bonds or other instruments issued by a bank could be severely impaired if creditors can use these to off-set amounts which they otherwise owe to the bank (eg. loans). Nevertheless, it is less than ideal to interfere with the common sense approach to set-off consolidated over many years of Supreme Court jurisprudence and it may also be argued that a more appropriate manner to introduce a limitation on rights of set-off for bondholders (particularly in light of the number of retail holdings in Italian banks), would be to insert a full waiver of set-off directly in the contractual documentation of the bonds, with the statutory framework being updated simply to recognise the effectiveness of such a waiver of set-off in the case of liquidation.

More importantly, the currently envisaged limitation on the efficacy of Article 56 of the Bankruptcy Law creates two potential problems for netting recognition in Italy going forward:

i. firstly, it is not entirely clear that the limitation proposed to Article 56 will not apply when a netting agreement and/or financial collateral arrangement is in place; and

ii. secondly, while the limitation in question would technically apply only to insolvency proceedings for financial institutions, the potential for application by way of analogy to proceedings for other types of entity cannot be wholly discounted. This is a significant issue in light of the importance of Article 56 for reliance on the enforceability of netting against Italian corporates where no collateral is in place.

In connection with point i) above, we note that, in keeping with the provisions of Article 77 of the BRRD, Article 92(2) of the Resolution Decree prohibits the modification or extinction of only a portion of the rights and liabilities subject to set-off or netting under a financial collateral arrangement or netting agreement. Unfortunately, this drafting does not clarify that nothing should interfere with the actual right to set-off, net or close-out for the reciprocally owed debts and credits and it is not therefore entirely clear that the limitation introduced on application of Article 56 of the Bankruptcy Law will not prevail. While we believe that it would ultimately be preferable to simply deal with the question of set-off by way of introducing statutory recognition of contractual waivers in insolvency, we believe that, if the current text of Article 26(b) is to remain, the drafting should clarify that the limitation on Article 56 will only apply in the absence of a financial collateral arrangement or agreement for set-off or netting. This change to the drafting would likewise reduce any risk of "contamination" of the netting analysis for Italian corporates, as highlighted under point ii) above, at least in cases where an ISDA or similar master netting agreement is in place.

Timetable - Entry into force

The timetable for the entry into force of the Decrees is as follows:

1. The Government's cabinet send the draft Decrees, as passed on 10 September 2015, to the Parliament;
2. The competent Commissions at the Senate and the Chamber of Deputies examine the draft Decrees and release an opinion, which is not binding for (but usually followed by) the Government;
3. The Council of Ministers examines again the draft Decrees in light of the opinions under 2 above and issue the final text of the Decrees;
4. The Decrees are published in the Italian Official Journal (*Gazzetta Ufficiale della Repubblica Italiana*) and enter into force.

The Decrees need to become effective by 15 November 2015 (i.e. three months following the entry into force of the relevant delegation law, as set out above).

Pursuant to the Directive and the Resolution Decree, the rules concerning bail-in will enter into force on 1 January 2016.

[1] In broad terms, the Resolution Decree identifies the Bank of Italy as the resolution authority for Italian institutions, addresses resolution plans, resolution funds and the conduct of resolution proceedings and the point of non-viability (PONV) conversion powers.

Contact information

Lisa Curran	+39 06 684271 lisa.curran@allenovery.com
Craig Byrne	+39 02 290491 craig.byrne@allenovery.com
Massimiliano Danusso	+39 06 684271 massimiliano.danusso@allenovery.com
Cristiano Tommasi	+39 06 684271 cristiano.tommasi@allenovery.com
Know-How	
Valentina Barbanti	+39 06 684271 valentina.barbanti@allenovery.com