

Contacts:

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Federico Cornelli, *Chief Operating Officer*
email: fcomelli@federcasse.bcc.it, tel. +39.06.7207.2611

Ignace Gustave Bikoula, *International Office*
email: bgustave@federcasse.bcc.it, tel. +39.06.7207.2734

Andrea Pezzotta, *Risk and Control Department*
email: apezzotta@federcasse.bcc.it, tel. +39.06.7207.2729

Emanuele Spina, *International Office*
Email: ESpina@federcasse.bcc.it, tel. +32.22.35.28.66

CREDITO COOPERATIVO

COMMENTS ON BAIL-IN TOOL

1. BACKGROUND

On 6 June 2012, the European Commission (EC) has released its proposal for a Directive regarding Banks Recovery and Resolution Framework. The Framework equipped Member States with tools to deal adequately with banks and other financial institutions in distress. **The Framework shall apply to all credit institutions, regardless to the size and in particular the legal status adopted by institutions (co-operative entities and joint-stock companies).** While Federcasse appreciates and really supports the effort taken and the objective laid down in the proposal, we consider that a number of highly relevant aspects for small and co-operative banks, like the Italian Banche di Credito Cooperativo (BCCs), require clarification and adjustments. This document deals with the bail-in tool and the consequences of its application to BCCs. Regarding this issue, criticalities arise because of the specific legal, governance and business model of BCCs and their strategic organization. As a result, the bail-in tool doesn't seem workable for small co-operative banks, while it is for large joint-stock companies banks.

2. BAIL-IN TOOL AND PARTICULARITIES OF CO-OPERATIVE BANKS

There is an urgent need to take certain particularities of small co-operative banks on board. As currently envisaged the mechanism is conflicting with the specific legal, governance and business model of co-operative banks. Furthermore, due to the typical funding profile of BCCs (i.e. local banks issue only merely retail senior unsecured debt), the application of bail-in regime will have profound consequences for bank's abilities to fund themselves. Therefore a monolithic approach to bail-in tool would require a modification of BCCs features, structure and identity.

- **BCC legal model and governance**

BCCs issue only one type of shares. Admittance to the BCCs undergoes an application process regulated by law and statutes. In order to become a member of a BCC, the applicant must be resident or continuously operate in the local area of competence of the bank. Every member, regardless to the amount of share capital held, have the right to only one vote (one man-one vote principle). Furthermore each member can own a total amount of shares up to 50.000 euros. BCC shares are not listed but they are usually settled by redemption to the bank. This redemption is nothing but a surrogate for market trading. According to the current laws and regulations, those instruments qualify as common equity instruments (Core Tier 1).

In the light of above observations the conversion of debt into co-operative shares is absolutely inadequate for BCCs fundamentally for legal and governance reasons. **The bail-in tool should not be applied to BCCs or at most should be limited to writing down on bail-inable debt as a last resort resolution tool to accompany the orderly wind-down of a failing institution (closed bank scenario).** Therefore, in the case of BCCs, we are opposed to using the bail-in tool for the recapitalization of a failing institution and restoring its ability to carry on its activities (open bank scenario).

- **Unintended consequences to funding ability**

We consider that competent authorities shall carefully assess the case of the small co-operative banks for an exemption from the application of bail-in tool, taking into account their business model and funding profile. Indeed, if BCCs were required to comply with the bail-in regime, they would face constraints in their funding model and higher funding cost which may be particularly acute. BCCs are small-size banks that operate in merely local markets both for lending and funding purposes. Debt instruments they issue are not of sizable amount and are held by unsophisticated retail investors (households and SMEs). Those instruments have a plain-vanilla profile. Whenever they were required to include a bail-inable option, they would no more be suitable for retail investors (cf. MifiR and MifiD) since the credit profile of senior unsecured debt will be altered, changing the investor base. Therefore, implementing a bail-in regime would have profound consequences for BCCs' abilities to fund themselves and to support the local community.

- **Liabilities with contingent funding obligation**

It should take account of that bail-in power if it is not well-designed could trigger a run by "short-term creditors" and aggravate the institution's liquidity problem. Therefore we think that liabilities associated with contractual or non-contractual obligations to repurchase bank's own debt upon the holder request should also be excluded from the scope of bail-in tool. Otherwise they can be subject to extreme volatility in the case that the institution is approaching the point of non-viability.

▪ **“Liquidity system” within the BCC network and the scope of bail-in tool**

Within the BCC network, due to a robust division-of-labour-arrangements, the central institutions play a primary role as a wholesale product and service provider for BCCs which, in almost all cases, do not have access to settlement systems, and capital/money markets. By virtue of those agreements the central institutions are able to ensure the balancing of liquidity within the network, and BCCs are able to offer customers a complete range of banking/financial products and services and to carry out their own financial operations. In particular, the central institutions provide BCCs with clearing, custody and cash management services. Such services are provided under a legally-binding agreement. For these operational functions each BCC holds a specifically designated account at the central institutions and place deposits, also in the form of sight deposits, into this account. Therefore, these deposits are by-products of the underlying services provided by “central banks”.

In addition the central institutions offer a wide range of services and products specifically designed for BCCs (such as repo, time deposits, etc.) which can be utilised for investing liquidity surpluses – i.e. amount of money estimated in excess to the above operational functions - to maximize profitability. The related funds collected by the central institutions from BCCs may be either transferred to another BCC which needs funding, or used for their own lending activities, or placed on financial/money markets at better conditions than the local banks individually could obtain.

Therefore, to avoid jeopardizing the proper functioning of the “liquidity system” within the network and creating a disincentive for centralized mechanisms of liquidity management, which have been demonstrated their efficiency also in period of stress, **at least liabilities related to clearing, custody and cash management services should be excluded from the scope of bail-in tool.**

3. KEY STRATEGIC ORGANIZATIONAL FEATURES OF BCCS NETWORK AND THE BAIL-IN TOOL

In order to further strengthen internal cohesion and to realize more stringent and effective mutual support mechanisms the BCC network:

- introduced in 2004 The Bondholders’ Guarantee Fund (in addition to the existing Deposit Guarantee Scheme); and
- has been implementing the Institutional Guarantee Fund (IGF) in accordance with art. 80(8) of Directive 2006/48/EC.

The IGF will provide for support to any member bank that may run into financial difficulties. A fund will be built up by ex-ante contributions. Furthermore, member banks commit to provide ex-post additional resources if the ex-ante resources are not enough to deal with an intervention.

Moreover IGF will incorporate the Bondholders' Guarantee Fund and will guarantee a predetermined amount of: (i) bond issued by member banks; and (ii) deposits not covered by the deposit guarantee scheme. The whole mechanism is based on strong risk monitoring processes and tools, strict corporate governance and sharp law-enforcement capacity by the IGF.

One of the most relevant shortcomings of the EC proposal is the silence on the role that co-operative mutual solidarity systems, notably an IPS, can play in the daily operations of individual banks, and especially in recovery or/and resolution phase.

▪ **IPS and the scope of bai-in tool**

According to Art. 38(2) of EC proposal *"Resolution authorities shall not exercise the write down and conversion powers in relation to the following liabilities:*

(a) deposits that are guaranteed in accordance with Directive 94/19/EC;

(b) secured liabilities¹;

(...)"

As above mentioned the IGF will guarantee a predetermined amount of bonds issued by member banks. We believe that those liabilities, like deposits covered by DGS and the secured one, should be excluded from the scope of bail-in toll.

▪ **IPS and the minimum amount of bail-inable liabilities to be held**

Art. 39 (3) lists criteria for the determination of the minimum aggregate amount of bail-inable liabilities. Among other things, it is stated that that amount shall be determined taking into account *"the extent to which the Deposit Guarantee Scheme could contribute to the financing of resolution in accordance with Art. 99"*.

As observed above, the IGF will provide for support to any member bank that may run into financial difficulties. Therefore, in case a resolution process has to be started, the IGF would intervene. As a consequence, when calculating the minimum aggregate amount, the contribution of the IGF to the financing of resolution phase shall be considered, akin the contribution of the Deposit Guarantee Scheme.

4. CONCLUSION

¹ "Secured liability" means a liability where the right of the creditor to payment is secured by a charge over assets, a pledge or lien, or collateral arrangements including liabilities arising from repurchase transactions and other title transfer collateral arrangements".

To sum up, we consider that the bail-in tool shall be apply in the first place to systemically important financial institutions (SIFIs). With regard to small size and co-operative banks like BCCs, due to their legal, governance and business model and their funding profile, we think that other resolution tools are more suitable and effective than the bail-in one. Should BCCs were required to comply with the bail-in regime we do believe that the role that co-operative mutual solidarity systems, notably an IPS, can play in the resolution phase should be properly recognize. This can be achieved by:

- excluding from the scope of bail-in toll liabilities, other than insured deposits, which are guaranteed by an IPS;
- taking into account the contribution of the IGF to the financing of resolution phase when calculating the minimum aggregate amount of eligible liabilities.