Bank-Crisis Management Practices in Italy (1978-2015) and Their Perspectives in the Italian Cooperative Credit Network

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Abstract

Bank recovery and resolution practices so far applied have shown strong limits in the aftermath of the 2007-2008 global financial crisis. The new EU legislation concerning bank-crisis management is intended to challenge such practices. The Italian Cooperative Credit (CC)'s pioneering experience of the Guarantee Central Fund (FCG) – established on a voluntary basis in 1978 in line with the spirit of mutuality shared by the credit cooperation movement across Europe since the late 1800s – contains important lessons on how to re-conceptualize and re-design the financial safety-net of a small banks' network within the Banking Union. Past research has shown that a private-sector approach to deposit insurance can function better than a government-based one, preventing moral hazard behaviours of small member banks and the adverse effects of their failures on the economic output of associated communities. The *ex-ante* self-financing mechanism implemented by FCG to support Cooperative Credit Banks (CCBs) successfully avoided depositors pay-outs, further disbursements by member banks, and pro-cyclical effects on local economies. Overall, the Italian CC financial safety net enabled the market exit of 400 CCBs over the last 40 years without any failures, contagion spillovers to the country's economic system or societal value destruction. Two key lessons that, among others, can be drawn are that (a) a sectoral DGS should better serve

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as a "*risk-minimizer*" so as to reduce the likelihood and amount of losses for member banks; (b) cohesiveness produces high economic and social returns at both micro and macro levels. Conclusively, the fruitful results of the above experience should be contrasted with the consequences of small-bank failures in the U.S. market and the huge amount of state aid granted worldwide during the recent global financial crisis.

"The "Fondo Centrale di Garanzia", an unicum within the Italian Banking System, links together in a unique framework credit assistance, economic promotion, services development with depositor insurance for Credit Cooperative Banks… it concerns the way our Banks face the market and not only the underlying insurance mechanism… since it represents a key mode for cooperative networking, the improvement of its governance and operations is a matter that should involve the Group in its entirety" (ICCREA Commentary Report - Financial Statements, 1978).

1. Introduction

The new EU legislation – concerning bank-crisis management (Directive 59/2014/EU, "BRRD"), deposit insurance ("DI") (Directive 49/2014/EU, "DGSD") and state aids rules (EU Commission "Banking Communication", 2013/C 216/01) – is intended to challenge the practices of bank-recovery and resolution so far applied and the current structures of financial safety nets across European countries. Such prior mechanisms have shown strong limits when utilized to address failures of systemically significant banks in the aftermath of the 2007-2008 global financial crisis, with a huge spending of state-aid resources (about $ 5 trillion worldwide) to the detriment of tax-payers[1].

[1] See Montanaro (2013) on the causes of financial crisis due to a biased institutional context. See Bredice (2015a, b), for an analysis of objectives, rules and players of the novel bank-crisis management legislation in the aftermath of the financial crisis, as well as the fragile balance between regulation and supervision practices in the banking sector

The Banking Union, after the publication of the so-called "Five Presidents Report" (EU Commission, 2015), is under completion through the implementation of the Third Pillar based on the proposal of a pan-European Deposit Insurance Scheme (EDIS)[2]. In this respect, the Italian Cooperative Credit (CC)'s pioneering experience of the Guarantee Central Fund (*Fondo Centrale di Garanzia* - FCG) established on a voluntary basis in 1978, followed by the creation of the Depositors' Guarantee Fund (*Fondo di Garanzia dei Depositanti* - FGD) with compulsory membership in 1997, may serve as a precursory model of a modern Deposit Guarantee Scheme (DGS) of "*risk-minimizer*" type[3], thus providing food for thoughts in the current public financial-policy debate.

An in-depth analysis of the FCG model allows us to gather important lessons on how to re-conceptualize and re-design the financial safety net of a small banks' network and to accomplish an effective implementation of the "proportionality" principle, thus safeguarding *banking biodiversity* within the new financial legislative context.

Past research has shown that a private-sector approach to DI can function better than a government-based one (see for all Calomiris, 1990). The conception of FCG and its concrete experience seem to be in line with such empirical results.

In 1978, the Italian CC, after reinforcing federal structures and establishing central institutions in the 1960s-1970s, still faced (a) ope-

from an historical standpoint. For an in-depth analysis of the Banking Union, see Boccuzzi (2015). It should be noted that the newly-established complex architecture, despite the effort to ultimately reduce moral hazard and enhance financial stability, is exposed to an "*ineffectiveness risk*", due to the *(i)* lack of proportionality, *(ii)* controversial interpretation of how to apply the rules and *(iii)* absence of safeguards avoiding retroactivity (e.g., past underwriting of bonds by retail investors). For an illustration of the hazardous consequences of an unfair implementation of the novel crisis management tools, see note 48.

[2] An estimate of changes in the amount and re-allocation of contributions due by national deposit guarantee schemes (DGS), because of the introduction of a risk-based, pan-European DGS, was conducted by Arnaboldi (2014). Interestingly, the analysis shows that, for instance, German banks would pay lower fees.

[3] Core principle 2, *IADI Core Principles for Effective Deposit Insurance Systems*, November 2014.

rational limits, (b) negligible market shares, (c) modest level of attention from the supervisory authorities (e.g., opening of new branches). To overcome these structural difficulties, new initiatives – the most important of which was the establishment of FCG – were launched. Such an effort enhanced the network reputation, resulting in the authorization by the supervisory authorities of more than 110 new Cooperative Credit Banks (CCBs) and the doubling of branches between the late 1970s and the early 1990s (from about 11,700 in 1978 to over 22,100 in 1993). At the same time, more than 90 CCBs abandoned the market, with the FCG ensuring their orderly exit through an early-intervention mechanism. Such a mechanism was based on medium-term financing at a subsidized rate and the resulting "differential profits" reimbursement by the CCB upon recovery or, in the event of a merger, by the acquiring bank.

In the wake of the Economic and Monetary Union conception (Maastricht Treaty), in 1993 the Italian banking system entered a new era, with enhanced business operations' capacity (under the new banking law "*Testo Unico Bancario*"- TUB), better aligned with that of competitors. This yielded a new risk appetite for the Italian CC, which, until that moment, had predominantly relied on high returns of less risky government bonds. The side effect was a wave of banks' crises, principally rooted in those idiosyncratic factors outlined by extant research (see for all Thies and Gerlowski, 1989). In the 1990s the self-financed support mechanism implemented by FCG successfully avoided depositors' pay-outs, further disbursements by member banks, and pro-cyclical effects on local economies.

Successively, FGD facilitated the structural consolidation process of the Italian CC via the granting of early intervention and resolution financing to distressed CCBs, thus fostering intra-network acquisitions and avoiding (especially over the last decade) extra-network acquisition, as well as market-share loss. As a result, the Italian CC strongly contributed to local economic development in Italy, also preventing the adverse effects of small banks' failures on the economic output of associated communities (Gilbert and Kochin, 1989; Kandrac, 2014).

After the recent global financial crisis, the Italian CC decided to extend its financial safety net by promoting a new voluntary scheme, named as *Fondo di Garanzia Istituzionale* (FGI), added to the existing (also voluntary) *Fondo di Garanzia degli Obbligazionisti* (FGO, 2004). Both were aimed at further safeguarding CCBs reputation by insuring protection to bondholders and other investors beyond the FGD compulsory coverage limit of € 100,000 for deposits.

The cohesion ultimately reflected in all financial safety-net strategies pursued by the Italian CC over the last forty years – successfully hindering centrifugal forces sometimes originated by local interests – is fully aligned with the spirit of mutuality in credit cooperation, as implemented across Europe since the late 1800s (see for all Galassi, 1996; A'Hearn, 2000).

This article proceeds as follows. Section 2 provides an overview of relevant literature. Section 3 illustrates the functioning of FCG and the anti-cyclical role that its financial support activity played in the 1990s. Section 4 outlines the subsequent early intervention and resolution experience of FGD, in conjunction with the most recent introduction of voluntary schemes such as FGI and FGO. Section 5 discusses the implications for bank-crisis management within the Banking Union, drawing the seven lessons that can be learnt from the past organization of the Italian CC's financial safety net. Section 6 concludes.

2. Literature Review

Four streams of prior research are relevant to our article. The first investigated the link between bank failures and the pace of national and/or local economic activity. The second examined the determinants of bank failures. The third studied the role of DI, and more specifically, of the financial safety-net of a country in preventing bank collapses. The fourth looked at cooperation initiatives in the banking industry.

With regard to the first research stream, some studies conducted

in the 1980s provided empirical evidence showing that bank failures tend to reduce economic activity at both national (Bernanke, 1983) and sector (farm) level (Calomiris, Hubbard and Stock, 1986), attributing such effects to the restrictions on the quantity of credit available to borrowers. Inspired by the above studies, other researchers succeeded in demonstrating that the effects of small, local banks' bankruptcies on the economic activity of local areas served by failed banks may be even larger than those generated by larger institutions on the national economy. Using data for rural countries (Kansas, Nebraska, Oklahoma) in 1981-1986, Gilbert and Kochin (1989) showed that failures of local banks depress local sales and, in some regions, local employment, thus causing subsequent declines in the economic activity of those communities where the insolvent and closing banks are located. More recently, Kandrac (2014) – looking at U.S. bank failures in the 2007-2010 period – argued that, in addition to the inevitable adverse effects of an economic downturn on many of these financial distress situations, "*there is also the possibility of feedback from bank failure to poor economic performance*".

The second research stream of some relevance is that on the causes of past bank failures. While past studies (Thies and Gerlowski, 1989) pointed out that bank insolvencies in the early 1980s were mainly determined by misbehaviour of managers (e.g., insider dealing, diversion of funds, deceptive accounting practices)[4], more recently, researchers demonstrated that failures of depository institutions which occurred in the 1985-1992 banking crisis were significantly influenced by excessive exposure to construction-lending (Cole, 1993; Cole *et al.*, 1995; Cole and Fenn, 2008). More interestingly, Cole and White (2012) found that real-estate loans also played an important role in determining which banks survived and which banks failed in 2009, as a result of the recent financial crisis (2008-2010)[5].

[4] For a recent survey on bank misconduct risk see ESRB (2015).

[5] The FDIC reported that it closed more than 300 small depository institutions during the 2008-2010 period at a cost of more than $80 billion. It should also be noted, that during the 1984-2011 period, more than 10.000 banks left the U.S market, 17% of which went bankrupt.

The third important stream of relevant literature is concerned with the role of DI in thwarting bank crises. The main objective of DI is to protect the economy's payments system from financial panics (Calomiris, 1990). Indeed, banks' vulnerability originates from their unique role of offering short-term, demandable claims backed by longer-term assets, whose value is not easily observable to depositors. Hence, banks are exposed to the risk of panics induced by depositors' uncertainty about the value of their loan portfolios (Calomiris, 1990). As the disruption of a banking system may, in turn, disrupt all an economy's abilities to transact effectively, the concern for the viability/availability of liquidity prompted the creation of DI programme, which started in New York State in 1829 and culminated with that of the U.S. Federal System in 1933[6].

Following the early experience of individual states, a federal DI fund, named as FDIC (Federal Deposit Insurance Corporation), was created at the U.S. system level by the Glass-Steagall Act of 1933 to avoid the risk of the bank runs of the Great Depression (Jaffee, 1989). The goal of this scheme was that of maintaining public confidence in the banking industry by insuring deposits within a specified limit

[6] Two waves of disastrous, state-sponsored deposit insurance experiments were recorded in the U.S. banking system: the first initiated in 1829 with the New York's Safety Fund and the second started in 1907 with the Oklahoma's Guaranty Fund) (Thies and Gerlowski, 1989). Illiquidity (arising from loss-driven depletion of accumulated resources), supervisory laxity (favouring excessive risk-taking behaviors) and freedom for solvent banks to switch to alternative private schemes prevented the New York fund from providing protection to the payments system, causing most of member bank collapses (10 out of 16) between 1829 and 1842. The collapse of the New York's Fund was followed by those of the mimicking funds of Vermont (1831) and Michigan (1836). Three antebellum experiments of deposit-insurance schemes (Indiana, Ohio, Iowa) were still successful. Calomiris (1990) noted that design weaknesses were the key motive for the poor performance of early government DI funds (NY, Vermont, Michigan). While the desire to preserve unit banking encouraged government-based DI (and excessive risk-taking), branch banking could have fostered the diffusion of more effective private DI arrangements among banks, thus lowering the rate of insolvency. Similarly, in describing the Florida banking crash of 1926, Vickers (1994) showed how DI had removed depositors' incentive to monitor banks, while promoting risk-taking among banks, claiming that the removal of DI could not be enough to reinforce depositors' monitoring when customers are cheated by bankers and regulators.

(Clark, 2013). The insurance limit, initially set at $ 2,500, was raised several times since the establishment of the fund and is now equal to $ 250,000. Insurance payments to depositors of a defaulted bank under liquidation are made by the FDIC through a fund financed by the collection of risk-based premiums from insured member institutions. In addition to premiums, the FDIC can also rely on a line of credit from the U.S. Treasury accessible under specified conditions.

The success of a U.S. Federal System-sponsored DI was immediate. From a peak of bank failures (9,106) recorded between 1930 and 1933, the number of collapses declined rapidly remaining low for the next 50 years[7]. However, in the late 1980s, the situation changed dramatically with the FDIC suffering major losses as a result of bank failures due to an increase in bad energy and agricultural loans[8]. As highlighted by Thies and Gerlowski (1989), state-sponsored DI funds exhibited the same perverse incentives to moral hazard behaviors that are still evident at the federal level today. The existence of DI encourages depositors to choose a bank without concerning themselves about their business practices, thus spurring

[7] Benston (1983) argued that at the start of the 1980s there was "*no more reason for regulating banks*". Those supporting deregulation in U.S. were against the so called "risky asset argument", based on the idea that a fierce competition in the banking industry could cause excess risk-taking. Over the same period, researchers in U.K. had a opposite view (Revell, 1978). For a survey of the historical debate on competition and regulation of banks in U.K. and U.S. in the 1970s-1980s, see Bredice (2015a). The deregulation in the U.S. banking industry reached a peak with the repeal of the Glass-Steagal Act in 1999. This process was once again reversed with the so called Volcker Rule included in the Dodd-Frank financial reform legislation and ultimately entered into force on July 21 2015.

[8] In the same period, the other federal agency in charge of insuring savings and loans associations (FSLIC) became insolvent as a result of 357 members' closings. In 1982, the FSLIC closed 252 thrift institutions (a post-1933 record). However, because of limited cash and personnel, another 201 insolvent thrifts were left open. With negative net worth but continued DI, the owners and managers of the latter had a strong incentive to increase their risk exposure. Because FSLIC closed fewer and fewer institutions in the 1983-1984 period, the number of insolvent thrifts rose to over 400 (Thies and Gerlowki, 1989). The financial turmoil that hit the federal DI system in the late 1980s led the Bush administration to sign into law the act named as FIRREA that abolished the FSLIC and transferred its role to the FDIC.

managers and shareholders to pursue higher profit-maximizing, but also higher risk-taking strategies than those uninsured depositors would be willing to accept. Because the lost market discipline cannot be fully replaced by government oversight, a federally-insured banking system would end up showing more risk-taking than one operating without such guarantees[9]. Furthermore, as financially sound banks are not free to exit such a system, federal DI flat-rate assessments are effectively subsidies from sound to reckless banks[10].

As far as the fourth relevant stream of literature is concerned, several studies were conducted on cooperative banking, a movement which had its origins in mid-nineteenth century Germany as an instrument for the economic and moral improvement of the lower classes, with the first mutualist initiatives promoted in urban areas by Hermann Schulze-Delitzsch (Guinnane, 1994, 1997; Leonardi, 1998; A'Hearn, 2000). In 1863, Germany's Schulze-Delitzsch credit unions were taken by Luzzatti as a model to transplant the principles underlying the credit cooperation movement in Italy through the establishment of the "*banche popolari*"[11]. Solidarity among members, mutual access to reliable information and enforcement mechanisms in the community made it possible for such cooperatives to turn a profit where larger commercial banks could not. Inspired by

[9] The experience of the over-insured German banking system corroborates such an argument. Indeed, Germany ranked first in bail-out through state aid support amounting to € 247 billion in the 2007-2013 period. The new EU DGS discipline aims to reduce the inherent risk-taking incentives of banks across Europe by limiting depositors' coverage to € 100,000 in the event of bank liquidation. For a critical analysis of the German financial safety net, see EPSC (2015). Conversely, with specific regard to the German Cooperative Financial network, it should be underlined that the current sectoral IPS (BVR-SE) was established on May, 14 1934. Its main features were (a) regional structure, (b) separation between "Volksbanken" and "Raiffeisenbanken" (until 1977), (c) decision-making at regional level. Over the past 80 years, the BVR-SE was never involved in payouts, bank runs or use of tax-payers' money.
[10] Should instead DI systems make such an exit possible, then insurers would suffer adverse selection, with the consequence of sound banks leaving and an increasingly risky and uninsurable pool of banks remaining, thus causing the shutdown of the federal DI.
[11] Luzzatti L., *La diffusione del credito e le banche popolari*, 1863.

the German Raiffeisen cooperatives, smaller, rural cooperative banks called "*casse rurali*", subject to unlimited liability, were introduced in Italy by Leone Wollemborg in the late 1800s (Galassi, 1996; Cannari and Signorini, 1996).

3. The financial-support activity of the Guarantee Central Fund (FCG)

To better understand the role played by FCG within the financial safety net of the Italian CC, three important issues must be investigated: the overview of the historical development of CCBs in the context of the concurrent, emerging banking industry trends; the internal organizational requirements put forward at the National Federation level at the end of 1970s; the functioning of FCG and the evolution of its financial support activity over the 1980s and 1990s.

3.1 The history of Italian CC until the late 1970s

The first Italian CCB was established in 1883 in Loreggia (Padua, Veneto region) by Leone Wollemborg, who, as mentioned above, was inspired by the model originally developed in Germany through the contribution of Friedrich Wilhelm Raiffeisen. Such a model was grounded in the Christian tenets and characterized by a strong entrenchment in the local territory.

The development process of the Italian CC may be classified into three stages:

- Stage 1 - Giolitti's age (1891-1921)
- Stage 2 - Fascism (1922-1945)
- Stage 3 - Post-war II (1946-1978).

The beginning of stage 1 coincided with the issue of *Rerum Novarum* (1891), the well-known encyclical in which pope Leone XIII spurred Catholics to take social action against poverty by engaging in mutual support initiatives. This encyclical rapidly became the *manifesto* of the Italian CC. In the spirit of the *Rerum Novarum*, at the end

of the century the active CCBs in Italy were above 900, of which 775 had a Catholic identity[12]. The provision of membership services to Italian CCBs started with the establishment of the National Federation in 1905[13]. Following the first national congress (1918) of the Italian CC, the number of active CCBs reached the peak of 3.540 in 1922.

During the Fascist regime (stage 2) the Italian CC experienced a downturn due, initially, to an increase in deposit withdrawal caused by the military repression against the activity of local bank branches. The rise of state intervention in the economic and financial system leading to the nationalization of large banks favoured the market exit of several CCBs[14]. In the wake of the Italian banking system reform (1936), a special law regulating CCBs came into force in 1937[15].

The first years of stage 3 were characterized by the re-foundation of the National Federation, "*Federcasse*" (1950). Ten years later new important initiatives were taken to relaunch the presence of the Italian CC in the banking industry, also promoting internal cohesiveness, unity and the ability to compete in the market[16]. Regional federations were reorganized with the aim of ensuring coordination and providing technical assistance to member banks.

3.2 The need for a financial safety net of the Italian CC

The competitive landscape faced by the Italian CC in the late 1970s was characterized by two key exogenous factors that limited its further domestic expansion.

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[12] Remarkable was the effort made in Sicily by Don Luigi Sturzo, the founder of the Italian Popular Party in 1919.

[13] The actual functioning of the National Federation was postponed to 1917.

[14] At the end of stage 2 the number of CCBs was reduced to about 800.

[15] The 1937 law (T.U.C.R.A.) mainly restricted the business operations of CCBs to rural and craftsmanship sectors.

[16] In 1963 ICCREA was established with the role of central institution of CCBs. In 1967 the Italian CC joined *Confcooperative*, the confederation of Italian Catholic cooperatives, which arose from the historical break-up with the socialist cooperatives in 1919. Leasing operations were started in 1977 with the establishment of the owned company *Banca Agrileasing* (today *Iccrea Banca Impres*a).

First, according to the 1937 special banking law (T.U.C.R.A.), business operations and dispersed ownership of CCBs were still constrained (e.g., with a rural sector) notwithstanding the fast-growing pace of development of the country's industrial and financial system.

Second, the establishment of new CCBs and the opening of new branches were subject to the strong planning powers of the supervisory authorities, implying high entry barriers in the mostly state-owned banking sector[17].

Furthermore, there was a misalignment between the business practices of the Italian CC and those of the most developed foreign CC networks, whereby mutual banks could operate with a relevant market share, as compared with the rest of local industry.

In 1978, after almost twenty years from the innovative strengthening of regional and national associative bodies, the management of the Italian CC perceived the need for a further organizational improvement. Hence, it was high time CCBs pursued a new growth strategy.

In conjunction with the 60° anniversary since the organization of the first national congress, a wide debate began to spread across the network, thus leading to the development of a new strategy, aimed at achieving a threefold objective:

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[17] As reported in the minutes of the National Federation's board of directors held on 12 May 1978, the total number of branches in Italy grew from 10,085 to 11,662 between 1965 and 1976. The establishment of these new 1,597 branches was approved by CICR (the Special Purpose Government Committee on Banking) following 4 main criteria: (a) n. 232 to facilitate bank recovery; (b) n. 463 in local areas where no bank was present; (c) n. 550 in response to economic dynamics and population mobility; (d) n. 352 in 3 regions with "special autonomy" (Sicily, Trentino and Alto Adige), where the request of the Italian CC was mainly accepted. In 1978, the Bank of Italy launched the first "Branch Planning" initiative by approving the establishment of 375 new branches that were assigned to the various banking juridical categories as follows: (a) 55 to public bank entities (e.g. "Banco di Napoli", "Banco di Sicilia"); (b) 37 to the 3 large "national interest" banks ("Banco di Roma", "Banca Commerciale", "Credito Italiano"); (c) 74 to privately-owned banks; (d) 104 to savings banks owned by regional governments; 87 to mutual banks ("banche popolari"); 18 to CCBs. The National Federation board complained about the outcome of such an assignment process, with the chairman Badioli pointing out his bitter disappointment to the Italian Banking Association (which CCBs joined only later in 1981) and to the Bank of Italy.

1) establish a resource accumulation mechanism serving as a promotional instrument towards the external environment (i.e. new potential shareholders, customers, competitors, supervisory authorities) so as to enhance the credibility of CCBs and their value as a close-knit "financial group";
2) enable recovery of distressed member banks, also avoiding the loss of shareholders' and board directors' personal assets as a consequence of bank crises;
3) run a depositor guarantee mechanism, in line with the one implemented by foreign CC networks (e.g., Germany, Austria) and innovative for the Italian banking system.

In so doing, the Italian CC intended to reinforce and enforce the social function of mutual banking within and outside the network. Such a cooperation philosophy, combined with the restatement of the group organization and coordinated autonomy principles[18], allowed management to differentiate better the banking business approach of CCBs versus that of competitors. This "different approach" still inspires today the corporate strategy as well as the marketing and brand-promotion efforts of the Italian CC. This was the strategic mood in which the idea of the FCG was conceived. As reported in the minutes of the National Federation board of directors held on 4 February 1978, such a fund was "*aimed at making administrative constraints imposed by the government control* [e.g., establishment of new banks, branch development, T.U.C.R.A.-related restrictions] *further unnecessary*" so as to foster growth and profitability of CCBs. Indeed, the availability of special-purpose financial resources at network level could secure the appreciation of the supervisory authorities and, as a result, the desired removal of the constraints. The effective creation of FCG was initiated with the approval of the project by the National Federation board of directors in the above-mentioned meeting, in which it was decided to sche-

[18] The preferred motto conceived by Enzo Badioli (1921-1995), chairman of the National Federation of CCBs (1963-1982) and chairman of ICCREA (1964-1984), was "*coordinate is better than centralize*".

dule (in March and April) meetings with regional federations and member banks (including representatives at national level) with the purpose of promoting full cohesion in joining the new initiative.

In a following board meeting (12 May 1978), the chairman Enzo Badioli reported that, after CCBs shareholders' annual meetings, the number of member banks willing to join and contribute to FCG was 386 out of 651 outstanding entities (59%). This apparent lack of participation could be explained by looking at the actual internal mode of decision. On one hand, CCBs operating in the provinces of Trento and Bolzano delayed their membership due to the fact that the local central institutions were assigned the role of collecting individual subscriptions from regional federations[19]. On the other hand, as reported in the minutes of the National Federation board of directors held on 12 October 1978, the representative of Tuscany regional federation reported that in 1977 their member banks had already established a deposit-linked mutual fund in addition to an existing regional guarantee scheme-sponsored by a portion of annual net profits. For this reason, they were in favour of creating the FCG as an aggregate of several regional funds endowed with a high degree of autonomy.

The chairman Badioli heartbrokenly replied that it was important "*to proceed united*" especially when decisions taken at central level were "*deemed to deeply impact on the network reputation*". In this respect, it should be noted that the "accompanying report" of the FCG project, presented during the National Federation board meeting on 4 February 1978, highlighted a crucial issue related to the emerging structure of the network. In fact, both the high geographical dispersion (with some concentration in specific regions) and the size diversity of CCBs would not favour the creation of several region-based Funds. Their intervention capacity would have been unequal, with excess resources in some regions and inadequate fi-

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[19] In 1973, the two central institutions for CCBs operating in Trentino-Alto Adige were established, having the role of providing certain services to local member banks in the place of ICCREA (which supplied residual services).

nancial means in others. Hence, a single national Fund was needed, being complemented by the attribution of a strong proactive role, in terms of proposal and coordination, to local federations.

Eventually, CCBs from Trentino-Alto Adige and Tuscany jointly joined FCG, showing strong cohesion[20]. Overall participation in FCG was fairly spread across all regional federations with the only exception being CCBs from Calabria (3 out of 23). At the start of the Fund's operations (as of October 1978), the share of participation was about 89% (577 out of 651) (Table 1)[21].

TABLE 1
Regional Distribution of Subscriptions at FCG start-up date

Local Federation	Number of CCBs	Subscriptions	Quota (%)
Trento	132	132	100.00
Bolzano	56	56	100.00
Tuscany	39	39	100.00
Abruzzi and Molise	11	11	100.00
Lombardy	76	73	96.05
Piedmont	17	16	94.12
Emilia Romagna	43	40	93.02
Lazio, Umbria and Sardinia	37	34	91.89
Campania	22	20	90.91
Friuli Venezia Giulia	28	25	89.29
Marche	22	18	81.82
Veneto	59	47	79.66
Apulia and Basilicata	35	27	77.14
Sicily	51	36	70.59
Calabria	23	3	13.04
TOTAL	651	577	88.63

Source: Federcasse, Minutes of the Board of Directors' meetings.

[20] At the end of the above discussion during the board meeting (12 October 1978), the representative of Tuscany said that "We are still having an internal discussion. When everything will be completed, no one will complain about the final decision of the Tuscany Federation".
[21] Such a quota remained stable in the following years. ICCREA 1982 annual report indicates 581 participants to FCG out of 660 CCBs, operating with the federal central institution (88%).

3.3 *The functioning of FCG*

On 8 February 1978, the Italian CC filed for the Bank of Italy's approval of the FCG project by enclosing the internal regulation of the Fund. The following board meeting (12 May 1978) unanimously approved the final internal rules (11 articles) for operating the Fund. In providing financial support to member banks, FCG was assigned – over the time – the role of achieving the following set of crucial goals to[22]:

a) accumulate financial resources aimed at enhancing CCBs' reputation and preserving the outstanding number of the Italian CC's branches;
b) provide early intervention-financing to CCBs in temporary distress so as to enable them to recover viability;
c) provide financing to CCBs in the event of crisis resolution, with the aim of safeguarding depositors within the limit of available resources;
d) provide assistance to newly-established CCBs so as to facilitate their start-up and market positioning;
e) promote technical assistance and auditing activities at CCBs' premises through regional federations, in order to prevent the onset of potential crises.

The Fund had no juridical personality, being operated directly by ICCREA, but it could rely on full accounting autonomy. The granting of financial support to CCBs upon their request was not automatic, but based on a case-by-case analysis. It could also be revoked before maturity in the event of non-fulfillment of agreed terms by the financed bank. All financial support interventions of FCG were subject to the prior approval of the Bank of Italy (art. 8, internal regulation).

There were two types of disposable resources: the "*available financial means*" (art. 3, internal regulation) and the "*FCG capital reserves*" (art. 4, internal regulation).

[22] The FCG objectives were stated in the latest version of the internal regulation that ruled the Fund's operations for most of its life until its termination.

The "available financial means" were obtained through the obligation for member banks to open a restricted deposit account at ICCREA, using 1% of its own total deposits. Such special accounts were remunerated, at least, at the fixed floor interest rate of 5%, which could be on discretion raised following a deliberation of ICCREA's board. The decision was based on the actual annual rate of return earned on related investments. In fact, the available financial resources were allocated to three types of investment:

- provision of guaranteed loan financing to distressed CCBs at a subsidized rate;
- stable high-yield inter-bank deposits at high-standing institutions (e.g., Banco di Napoli);
- long-term Italian government bonds.

The spread between the weighted average rate of return on investments and the fixed funding rate on special-purpose deposits was used to partially enhance the remuneration on the latter and, for the remaining part, to form *after-tax profits* booked into the "FCG capital reserves".

The Fund's capital reserves were also increased via the so-called mechanism of "differential profits' reimbursement". A member bank receiving financial support was required to invest the proceeds from the loan into Italian government bonds[23] in the form of a guarantee administered by ICCREA.

A differential profit originated from the positive difference between the bond interest rate and the loan subsidized rate (usually 1%). The size and maturity of the loan were determined so as to generate the amount of future "differential profits" that was needed to allow for the recovery of the distressed CCB. Once the bank had recovered full viability, based on an appropriate recovery plan, it was asked to reimburse the loan principal through the sale of the

[23] The maturity of the government bond had to match that of the loan. The interest rate on a 5-year Italian government bond (BTP) remained stable at around 12% over the 15-year period 1979-1993. The bond yield decreased progressively from 10% to 4% between 1995 and 1998.

government bond and subsequently repay differential profits on an on-going basis according to an agreed amortization plan. Such a mechanism ensured that FCG could recover (partially or fully) foregone differential profits with a delay. In this way, enhanced FCG reserves could be exploited, if necessary, to fund prospective CCBs crisis-resolution through the granting of non-recoverable cash intervention, with the aim of protecting depositors.

3.4 The development of FCG activities in the 1980s

All FCG financial-support decisions in favour of member banks were taken by the board of directors of ICCREA. However, the delicate power balance between national and regional federations was struck through the creation of an original governance process. Financing requests from CCBs could be considered only if accompanied by the proposal and the positive assessment of the regional federation. The National Federation also had to express its opinion, which – only if negative – was binding. Such a process acknowledged the initiating and exclusive role of regional federations, while limiting internal centrifugal pressures.

On 12 October 1978, four pending requests for financial support, previously submitted to ICCREA, received the favourable judgment of the board of directors of the National Federation.

The first request was submitted by "Cassa Rurale di Capralba" (Lombardy) to facilitate the merger with "Cassa Rurale di Torlino". The loan had a 5-year maturity and an interest rate of 1%, generating differential profits of about 124,000 euro (240 million Italian lire).

Further requests were made by "Cassa Rurale di Aurisina" and "Cassa Rurale della Bassa Friulana", both under a special administration regime, with the aim of covering losses due to stopping negotiation frauds. The loan had a 5-year maturity, yielding differential profits of about 155,000 euro (300 million Italian lire) and 232,000 euro (450 million Italian lire) respectively. These interventions of FCG replaced those already approved by the regional federation through the sole involvement of local member banks.

The fourth request was submitted by "Centrale Altoatesina Raiffeisen" to compensate for actual and expected loan losses, threatening the level of the outstanding equity capital, caused by employees' misbehaviour. The loan had a 4-year maturity with associated differential profits of about 325,000 euro (630 million Italian lire).

After such a rapid start-up, the activity of FCG spanned more than two decades, which can be ideally divided into two main periods: the mainly "early intervention" period (1978-1992) and the starting "resolution" period (1993-2000). It should be noted that, from 2001 onwards, there was a gradual reduction of the loan financing activity due to the presence of FGD, the newly established DGS, whose role will be illustrated in Section 4.

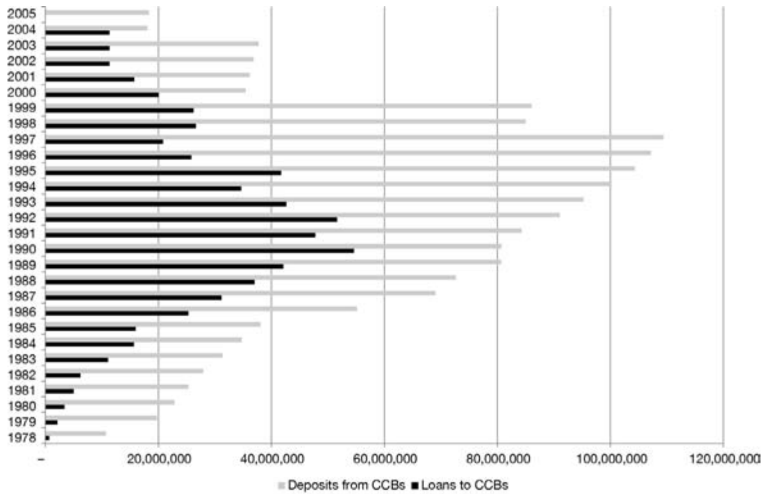
Figure 1 shows the yearly outstanding amounts of restricted deposits from CCBs and loan-financing associated with all the early intervention operations of FCG in the 1978-2005 period. The loan financing activity, after reaching a peak in 1990, experienced a smooth decline over the following years. On the liabilities side, with the actual start-up of FGD (1997), FCG occasionally began to repay the "available financial means" to member CCBs[24]. This dataset has been collected from the annual financial statements of ICCREA (FCG section).

With regard to the time pattern of early-intervention transactions, the data on the new loans and subsequent reimbursements have been extracted, tallied and elaborated *per transaction* from FCG original, hand-written book-accounts for the period 1983-1997.

It can be highlighted that, until 1990, the loan-financing activity (expressed in terms of annual flows) grew at a steady pace, while afterwards reimbursements of prior loans prevailed (Figure 2). The number of new loan transactions peaked in 1988 (17), while since then the number of reimbursements was predominant, on a rising trend (Figure 3).

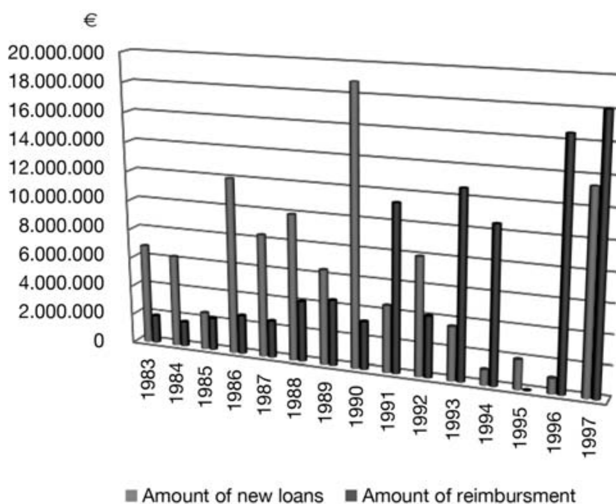
[24] After the establishment of FGD, FCG made the reimbursement of restricted deposits to CCBs in several instalments: € 24.4 million (1998), € 50.6 million (2000), € 19.7 million (2004). On 1 January 2006 the National Federation approved the final reimbursement of € 18.3 million.

FIGURE 1
FCG Early-Intervention Operations: Restricted Deposits from CCBs and Loan Financing (annual outstanding amounts)



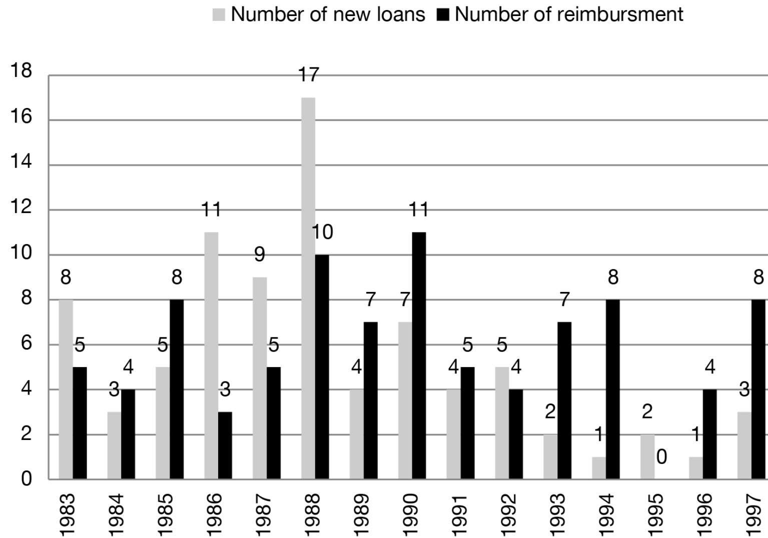
Amounts in euros.
Source: ICCREA Financial Statements, FCG section.

FIGURE 2
FCG Early-Intervention Operations: Loan Financing and Subsequent Reimbursements from CCBs (annual flows)



Amounts in euros.
Source: Authors' elaboration of data from FCG original hand-written transactions book account.

FIGURE 3
FCG Early-Intervention Operations: Loan Financing and Subsequent Reimbursements from CCBs (annual total of transactions)



Source: Authors' elaboration of data from FCG original hand-written transactions book accounts.

3.5 The evolution of FCG in the 1990s

In 1993 the Italian banking system went through a landmark structural reform (known as the "Amato Law")[25], which, in the wake of the Economic and Monetary Union conception (Maastricht Treaty):

a) privatized state-owned banks;
b) introduced a single banking law (*Testo Unico Bancario* - TUB), enforceable for all juridical categories of banks, removing the dated rules limiting long-term financing provided by commercial banks;
c) abolished CCBs special law (T.U.C.R.A.), thus widening the extent of their business operations and aligning them with those of competitors[26]. A renewed growth strategy emerged.

[25] Interestingly, in 1986 the major Italian (non-cooperative) banks established their own first voluntary DI scheme (*Fondo Interbancario di Tutela dei Depositi* - FITD) being inspired by the FCG experience (Boccuzzi, 2007).
[26] The constraints still remaining at the current date are: (a) limited activity outside branch territory; (b) limited activity vs. non shareholder customers; (c) limited subscription of shares per single shareholder.

During the 1980s more than one hundred new CCBs had been established, although in the meantime many of them had been expelled from the market[27]. The implemented capacity of CCBs enabled a strong development of local economies in Italy, due to their increasing lending support activity, marked by the almost doubled loan-to-deposit ratio of CCBs between 1993 (47% for CCBs vs. 95% for the rest of the industry) and 2010 (88% for CBBs vs. 86% for the rest of the industry). Such a growth of CCBs' business operations also enabled a significant increase in their market share[28].

In this new context, FCG faced the first real potential bankruptcies of CCBs, which urged the execution of resolution made. To facilitate liquidations of distressed member banks via the transfer of their assets and liabilities to third parties, FCG started granting unrecoverable cash contributions.

The FCG activity in the 1990s is illustrated by Tables 2 and 3 and Figure 4, as follows. Table 2 displays the amount of the "FCG Capital Reserves" stock at the start of each year, its uses and sources, as well as the end-of-year amount over the 1978-2005 period. Between 1978 and 1993, capital reserves, resulting from the accumulation of annual net income[29], were never used. Starting from 1994 and mainly until 2000, the FCG utilized a cumulative amount of capital reserves for about € 8 million (uses).

[27] Only in 1993 more than 40 CCBs left the market. Despite the increase in new CCBs market entries occurred during the previous decade, at the end of 1993 the total number of banks operating within the Italian CC network was 671. This number was not far from that of CCBs active in 1978 (when the FCG was established), with the relevant difference that the number of branches had almost doubled (22,133 vs. 11,622). As indicated in Section 4, successively the number of CCBs steadily decreased to 370, with a consolidation process still ongoing.

[28] In 1978 CCBs' market share of loans was 1.8% and increased up to 7.0% in 2014. The market share of deposits was 0.8% in 1978 and reached 7.5% in 2014. Such market-share growth was not achieved at the expense of competing banks, but mainly through the strategic positioning in local territories, where most competitors had no interest in establishing branches.

[29] The annual net profit (Sources) was formed by the income of net investments plus the residual quota of actually reimbursed "differential profits" (from CCBs after recovery) that were not used for new unrecoverable cash contributions due in a given year.

TABLE 2
Evolution of "FCG Capital Reserves" (Amounts in euros)

	Start of Year	Uses	Sources	End of Year
1978	–	–	31,514	31,514
1979	31,514	–	136,414	167,927
1980	167,927	–	605,209	773,136
1981	773,136	–	924,458	1,697,594
1982	1,697,594	–	1,190,950	2,888,543
1983	2,888,543	–	14,977	2,903,521
1984	2,903,521	–	128,081	3,031,602
1985	3,031,602	–	383,727	3,415,329
1986	3,415,329	–	219,494	3,634,824
1987	3,634,824	–	142,026	3,776,849
1988	3,776,849	–	100,709	3,877,558
1989	3,877,558	–	186,441	4,063,999
1990	4,063,999	–	48,547	4,112,546
1991	4,112,546	–	339,829	4,452,375
1992	4,452,375	–	153,904	4,606,279
1993	4,606,279	–	714,776	5,321,055
1994	5,321,055	-1,265,319	1,182,170	5,237,906
1995	5,237,906	-213,297	1,956,855	6,981,464
1996	6,981,464	–	804,640	7,786,104
1997	7,786,104	-1,970,283	221,560	6,037,381
1998	6,037,381	-1,054,089	–	4,983,293
1999	4,983,293	-2,586,416	–	2,396,876
2000	2,396,876	–	103,808	2,500,684
2001	2,500,684	–	–	2,500,684
2002	2,500,684	-787,684	–	1,713,000
2003	1,713,000	–	22,000	1,735,000
2004	1,735,000	–	25,000	1,760,000
2005	1,760,000	–	159,000	1,919,000

Source: Authors' elaboration of data from ICCREA Financial Statements, FCG section.

It must be noted that, over the same period, the amount of unrecoverable cash-contribution requirements totalled about € 31 million (Table 3), with the difference between the latter amount and the utilized capital reserves (€ 8 million) being covered through the new

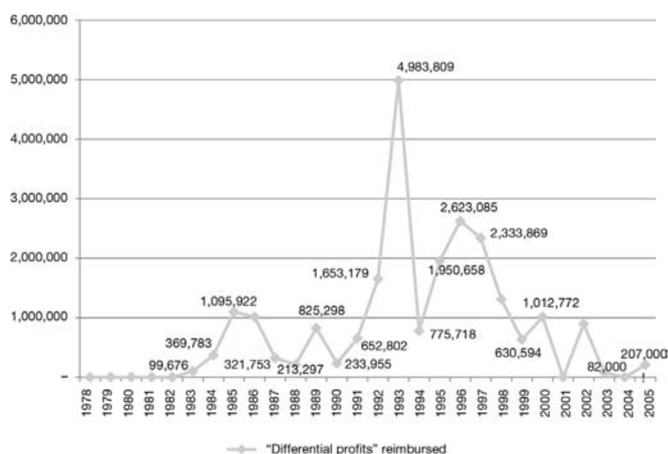
"differential profits" (about € 23 million) annually accruing to FCG (Figure 4)[30].

TABLE 3
FCG Resolution Operations: Unrecoverable Cash Interventions
(Amounts in euros)

Year	Distressed Bank	Acquirer	FCG Disbursement
1993	CRA Palma di Montechiaro	Credito italiano	4,911,505
	CRA di Avigliano	Banca Popolare di Bari	
1994-1995	CRA Benevento	Banca Popolare di Ancona	1,478,616
1996-1998	Bcc Benestare	BCC Cittanova	13,427,879
1997-1998	CRA Caluso	Banca Sella	3,024,372
1999-2000	Bcc San Giorgio la Molara	Banca Popolare di Ancona	7,337,303
2000	Bcc San Marcellino	Fed, Campana delle Bcc	1,032,914
TOTAL			31,212,589

Source: Authors' elaboration of data from ICCREA Commentary Report.

FIGURE 4
Reimbursement of "Differential Profits" from CCBs after Recovery
(Amounts in euros)



Source: Authors' elaboration of data from ICCREA Annual Commentary Report.

[30] Such a complex financial activity carried out by FCG in the 1990s is not clearly evident looking only at the capital reserve evolution displayed in Table 2. Detailed data shown in Table 3 and Figure 4 have been reconstructed by collecting information from the Commentary Report accompanying ICCREA annual financial statements, FCG section.

In 1993, FCG closed two important operations leading to the acquisition of CCBs by banks outside the network of Italian CC, with a loss of market share and branches. In this respect, the Board of Directors of ICCREA, as indicated in the 1993 annual report, argued that "*all the above-mentioned interventions were aimed at complying with the general principle of defending network reputation, in response to the National Federation's guidelines, in the context of a particularly complex phase. Undoubtedly, the 'prospective' FCG mechanisms will enable to better manage future crises of this kind, through the strengthening of roles and functions of federal bodies*". Indeed, as shown in Table 3, in the context of FCG resolution operations, carried out in the mid-1990s, the acquirers of distressed CCBs were institutions mainly operating outside the network.

What was illustrated above demonstrates that the new era starting from the "Amato Law" featured CCB crises quite different from previous experience, thus leading to the conception of an improved type of Fund. Many interesting features of the "prospective" Fund should be noted. It was mainly focused on the strengthening and promotion of the Italian CC network through;

a) safeguarding CCBs (current Institutional Protection Scheme – IPS function);
b) insuring protection of customers' savings (current Deposit Guarantee Scheme - DGS function);
c) providing financial support to newly-established CCBs.

In contrast to the FCG being operated by ICCREA, the "prospective" Fund had its own juridical personality, with the following independent governance bodies:

- meeting of member banks as shareholders;
- board of directors, composed of 21 persons representing member banks. Directors were appointed as follows: one-third from member banks' representatives, one-third from central institutions' representatives, one-third from national and local federations' representatives. Duration of the (renewable) mandate was 3 years;
- executive committee of "financial interventions section";

- executive committee of "deposit guarantee section";
- board of auditors, composed by 5 persons, with 3 years-mandate (renewable).

The "prospective" Fund operated with two sections: the "financial interventions section" and the "deposit guarantee section". Each section had its own accounting autonomy and was run by a distinct executive committee, composed by members selected among the directors of the board. The chairman of the board was also the chairman of both committees.

The "financial interventions section" performed the task of providing financial support to distressed, but potentially viable, CCBs under the following forms:

i. granting of loans;
ii. provision of guarantees;
iii. purchase of assets;
iv. acquisition of equity holdings of newly established CCBs with the aim of strengthening their regulatory capital;
v. provision of technical and managerial assistance services for the restructuring of member banks.

The "deposit guarantee section" could intervene in the event of the liquidation of a CCB pursuing two distinct but connected strategies that, in the opinion of the designers, might facilitate a faster and effective solution to the crisis, if jointly used. The first was deposit reimbursement[31], which could be performed only after a relevant share of existing resources from potentially outstanding regional funds had been utilized. The second was the acquisition of assets and liabilities of the CCB under liquidation, in accordance with the liquidator and conditional on the approval of the Bank of Italy, also involving the coverage of the capital unbalance. According to art. 24 of the drafted Statute, prior to bank liquidation and potential depositors' payout, the "financial interventions section" was called on to actively implement early intervention measures in order

[31] It should be noted that, at that time, there was neither legally enforced depositors' protection, nor an upper limit to the amount that could be potentially reimbursed.

to avoid bankruptcy[32]. Exceptions were allowed by the Bank of Italy only under special circumstances.

Both "sections" could rely on an autonomous funding mechanism. The above-mentioned "FCG capital reserves" was planned to be transferred to the "financial interventions section", because of its predominant role in crisis management. The allocation of restricted deposit accounts at ICCREA pertaining to member banks was unevenly split between the two sections, depending on the size of "differential profits" planned to be accruing to them based on their actual needs. Additionally, new *ex-ante* contributions were conceived as an "admission fee" proportional to member-bank size (e.g., balance-sheet ratios). Such fee-based financial resources had to be annually determined by the shareholders' meeting and allotted to both sections according to their needs.

As far as "prospective" Fund profit distribution is concerned, art. 31 of the drafted Statute provided that:

a) a minimum of 20% of net income had to be allocated to ordinary reserves;
b) a variable share of net income had to be allocated to the above-mentioned "sections";
c) a quota, fixed by the shareholders' meeting, could be paid out as a dividend to members banks, within the limit set according to the fiscal law;
d) a residual portion could be used to sponsor mutual support initiatives among cooperatives.

The establishment of the "prospective" Fund was then actually suspended, due to the incoming approval of the Directive 1994/19/EU, which, in turn, inspired the final shape of the current DGS of the Italian CC, the above-mentioned FGD.

[32] This operational aspect, that was designed in the project of the new Fund, can be considered as precursor to the current DGSD/BRRD framework of early intervention tasks assigned to national deposit guarantee schemes. It also corresponds to the opinion expressed by Dr. Stefano De Polis (Head of the Italian Resolution Authority) during a European Forum of Deposit Insurers (EFDI) meeting (Rome, 26 June 2015).

4. The development of the modern financial safety net of the Italian Cooperative Credit network

In compliance with the legislative decree n. 659 of 4 December 1996 that promoted Directive 1994/19/EU[33] (subsequently amended by the Directive 2009/14/EU)[34], in 1997 the Italian CC established the current FGD as a private consortium of CCBs based on compulsory membership enforced by law. Such a scheme, funded through an *ex-post* financing mechanism[35], had a broad mandate that was made through a *loss-minimizer* approach (IADI core principle 2). Support-financing could be supplied by FGD to member banks under two conditions: a) in the event of temporary distress (early intervention) or special administration (*going-concern*); b) in the event of transfer of assets and liabilities or liquidation (e.g., depositors' payout) (*gone-concern*). Interestingly, the granting of support-financing to foster recovery of viability for CCBs under special administration, or when assets and liabilities had to be transferred to a potential acquirer, was subject to the least-cost principle[36].

The FGD activity was characterized over the years by voluntary intervention decisions, within the law-regulated interaction with the Bank of Italy as follows:

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[33] The Directive 1994/19/EU imposed the obligation for EU member states to establish a national DGS. Given their special "cooperative" nature and the need for promoting aggregation, Italian CCBs were encouraged to create their own DGS with the endorsement of the Bank of Italy (Boccuzzi, 2007). See also Boccuzzi *et al.* (1998) for an analysis of the Italian DI case in the late 90s, compared to international experiences.

[34] The Directive 2009/14/EU introduced the following new deposit protection principles: i) coverage set to the harmonized level of € 100,000 per depositor per bank; ii) payout to depositors within 20 working days; iii) elimination of the 10% co-insurance clause applicable to depositors.

[35] Contributions due by member banks were not adjusted for risk but calculated in proportion to deposits (20%), cash loans (40%) and regulatory capital (-40%). Ex-post financing was based on commitments made by member banks amounting to 0.8% of total deposits on an annual basis (as of 30 June of the previous year).

[36] The least-cost was calculated comparing two options: a) the liquidation of the distressed bank, entailing the cost of a depositors' payout (determined through the application of appropriate cuts to individual assets) and b) the implementation of "alternative measures", such as the transfer of assets and liabilities of the distressed bank to a third-party acquirer, with all costs that needed to be incurred to make the sale attractive to the latter (e.g., the coverage of the capital unbalance, the retention of bad loans).

i) changes to the internal regulation (e.g., statute) was subject to the approval of the Bank of Italy;
ii) all support financing interventions of the Fund had to be authorized by the Bank of Italy;
iii) a senior officer of the Bank of Italy was admitted to take part in the FGD board meetings, although with no voting right, in line with the private ownership of the Consortium.

A long-term analysis of the factors leading to CCB crises shows that, since the inception of the new Fund, they were determined by two main groups of factors, such as (1) malfunctioning of governance bodies due to conflicts of interest, flawed competences or lack in internal control activities and (2) territorial influence, exacerbated by adverse economic conditions (persistent recession). Such combined factors, in turn, caused the deterioration of business operations (e.g., inaccurate creditworthiness of loan customers, credit concentration, increase in non-performing loans) and cost inefficiency (e.g., increasing cost/income ratio, rise in personnel expenditures).

Facing an increasing number of CCBs' crises – especially over the past 6 years, due to the so called "*great recession*" and its local effects – the Italian CC was capable of developing an innovative early intervention and resolution model (Baldi *et al.*, 2011), actually implemented by the FGD, which is remarkably close to that envisaged by the new European crisis-management framework. For instance, in anticipation of the asset separation (or bad bank) tool, the FGD was engaged in purchasing bad (or non-performing) loans (NPLs) *pro soluto* from distressed banks with the purpose of maximizing expected cash flows from troubled creditors for future distribution to member banks of the consortium[37]. Additionally, FGD applied an *ante litteram* "*burden sharing*" mechanism to share holders when distressed banks, after receiving an intervention, were subject to compulsory liquidation forcing their shareholders to an equity capital write-off (totalling € 32.6 million associated with 25 liquidation procedures in 1997-2015.

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[37] With this activity, FGD was compliant with par. 215 "Guidelines for identifying and dealing with bad banks" (BISn July 2015).

In the 1997-(June) 2015 period, the number of FGD interventions[38] amounted to 80 under the following technical forms:

- guarantees (on issues of subordinated debt) for about € 587 million;
- cash contributions[39] for about € 299 million;
- loan financing from member banks (for purchase of NPLs and other assets) for about € 477 million.

Most of FGD activity was carried out in the past 6 years (2010-June 2015) with the granting of 37 interventions (47% of total interventions; 90% of total euro amount). FGD total interventions (1997-June 2015) may also be reclassified into depositors pay-outs, early measures and resolutions in line with the BRRD discipline (Figure 5)[40]. Resolution-like interventions were almost 6 times the amount of alternative early financing provided to distressed CCBs under the ex-post funding regime[41]. The *ex-ante*, risk-based contribution mechanism set up by the DGSD is expected to endow FGD with lower financial resources that can be conversely devoted to an increasing early intervention-based failure prevention activity. The strategic rationale of FGD action may thus be reversed to address the upcoming EU challenges in bank-crisis management.

A beneficial side effect accomplished by FGD was the restraint put against the gradual loss of branches and exit of CCBs outside the network over the past years. This goal was obtained despite the steady historical trend reduction in the number of CCBs, as clearly mirrored in the evolution of the CC network structure between 1997 and 2015 (Table 4).

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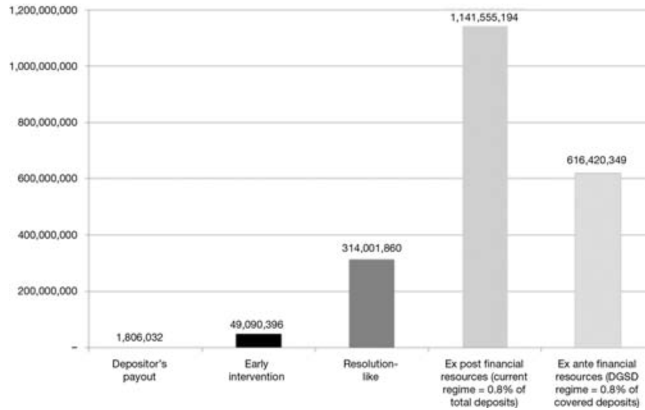
[38] Approved by the Board of Directors.

[39] They include coverage of (i) capital unbalances in the context of the transfer of assets and liabilities; (ii) all costs associated with NPL purchase; (iii) the quota of interests on subordinated debt, otherwise payable by the issuer.

[40] Both early and resolution-like interventions include (i) unrecoverable cash disbursements; (ii) realized quotas of guarantees; (iii) impairments and losses on acquired NPLs.

[41] More specifically, the severe and long-lasting recession that characterized the Italian economy was reflected in the sharp increase of both the early intervention and resolution activities conducted by the FGD in 2014-2015 (amounts of interventions doubled compared to those reported at the end of 2013). Such adverse effects were amplified by the credit crunch, generated also by a tighter micro-prudential supervision as a result of the global financial crisis.

FIGURE 5
BRRD-Based Reclassification of FGD Interventions and Available Financial Resources (1997-June 2015) (Amounts in euros)



Source: Authors' elaboration of FGD internal data.

TABLE 4
Evolution of CCBs Membership to FGD

YEAR	NEW ENTRIES	EXITS (due to intra network mergers)	EXITS (due to outside network acquisitions)	No. of CCBs (end of year)
1997		11	3	584
1998	5	21	2	566
1999	7	30	11	532
2000	6	25	11	502
2001	6	24	5	479
2002	3	16	1	465
2003	1	13	3	450
2004	4	10		444
2005	2	3		443
2006	4	5		442
2007	6	2	1	445
2008		8		437
2009	1	13		425
2010	2	7		420
2011		5		415
2012	1	18		398
2013	2	10		390
2014	1	10		381
2015	2	13		370
Total	**53**	**244**	**37**	

Source: Author's elaboration on FGD internal data.

FGD's operations, and in general, the financial safety net of the Italian CC, were further reinforced through two initiatives that, based on the experience of peer banking networks (e.g., BVR in Germany)[42], anticipated the orientation of the EU legislation on the key role of preventative measures for bank-crisis management (DGSD, BRRD), leading to the establishment of a bondholders' guarantee fund (FGO) in 2004 and the start-up of an institutional protection scheme (IPS) (FGI) in 2009[43]. Because of its private and voluntary nature, FGI could be exploited (in conjunction with FGO) to complement FGD support activities under no constraints related to the EU-level State Aid discipline.

5. Implications for bank-crisis management within the Banking Union

The Banking Union directives created a new legislative context with innovations that significantly impact on the functioning and everyday operations of DGSs. Some key features of such new European legislation – that is, burden-sharing, least-cost principle associated with depositor preference – practically make the coverage of capital unbalances of banks under liquidation, needed for completing the transfer of assets and liabilities to the acquirer, no longer

[42] In 2003, the BVR performed the centralization of regional IPSs also introducing a new legal framework and risk-based contributions.

[43] FGO is a voluntary, private consortium among the majority of CCBs aimed at insuring their bondholders within the limit of € 100.000 (valid for covered deposits according to the Directive 2009/14/EU) in the event of bank failure. If a CCB is liquidated with associated depositors' reimbursement, the FGO offers principal reimbursement to bondholders within the same limit. The creation of FGI underwent a lengthy preparation process due to the inherent voluntary membership mechanism. Effectively, FGI provided its first intervention in 2015. In compliance with the burden-sharing principle set in the new EU discipline, which inhibits any DGS intervention unless shareholders' capital and subordinated debt are written off, FGI insured subordinated bondholders, thus avoiding charging losses to the customers of a distressed CCB under liquidation because of the transfer of its assets and liabilities to the acquirer. In future resolution procedures, FGI and FGO may enable a distressed CCB to fulfill its obligations towards subordinated and senior debt-holders respectively via full (or partial) reimbursement of the related principal, subject to burden-sharing and/or bail-in mechanisms.

feasible through the DGS activity. This, indeed, corresponds to one of the main activities performed by FGD in the past six years, as described above.

More specifically, under the old bankruptcy-law regime in effect for the Italian banking industry, all FGD support interventions in favour of distressed CCBs could be performed ensuring the fulfillment of the least-cost principle. This result may no longer be possible under the new bankruptcy-law regime designed by BRRD, due to the fact that the "depositor preference" rule could apparently make depositors' payout even convenient for DGSs. For this reason, to foster an orderly solution to crises of CCBs and avoid the risk of a depositors' payout, the Italian CC should rely on all tools provided by its "enlarged" financial safety-net also exploiting the voluntary schemes (e.g., FGO, FGI) in addition to the FGD.

In this new legislative and operational environment, the lessons that can be learned from the past experience of FCG and the most recent one of FGD are remarkable, especially in view of the fact that a new role must be assigned to the Directive 49/2014/EU-compliant DGS of the Italian CC.

LESSON 1 – *cohesiveness is paramount to implement contractual cooperation mechanisms that are effective and beneficial to member banks*

As highlighted by several circumstances, the Italian CC was successfully inspired by a sense of general interest each time local interests threatened the network unity (e.g., Badioli's call for unity made on 12 May 1978; the FGI actual start when the network was in the need of an effective solution to voluntarily insure subordinated bondholders)[44].

LESSON 2 – *the burden-sharing mechanism applied in the event of a bank failure should also work at "local" level (e.g., involving employees, shareholders of member banks of the same region) to reduce moral hazard behaviours*

[44] Boccuzzi (2007) noted that the transposition of the Directive 1994/19/EU in Italian law had a small impact on the pre-existing domestic Funds (FITD and FCG). For example, the compulsory membership of both non-cooperative and cooperative banks to the respective DGSs was only a formal duty, as their participation to prior Funds was insured almost in its entirety.

The FGD experience shows that a local federation in charge of monitoring and conducting auditing activities at member banks operating in the relevant region may be called on to contribute to loss absorption more heavily in the event of a crisis striking a bank in the same geographical area. Assuming that the financial distress of a bank monitored at local level may also be caused by a prior supervision oversight, a disadvantaged contribution to subsequent financial support should create an interest-aligning mechanism preventing local federations from engaging in moral hazard behaviours. Furthermore, employees of the distressed bank (whose assets and liabilities are transferred to a third-party) may be involved in the burden-sharing procedure by accepting a reduction in their wages. Outstanding (or new) shareholders of a sound member-bank operating in the same region may subsidise the acquisition of the distressed sister bank by underwriting equity capital increases aimed at funding the transfer of assets and liabilities. For the same reason, newly-issued subordinated debt may be offered to outstanding (or new) bondholders.

LESSON 3 – *the depositors' payout is not an efficient way of forcing inefficient banks out of the market, as any bank-liquidation procedure, by its nature, destroys corporate and societal value*

What is illustrated above demonstrates that, historically, the culture of the Italian CC network has never been inclined towards deposit reimbursement in the event of a bank crisis. Such an option has been viewed as the most costly one, not only because of its corporate value-destroying nature (e.g., the liquidation value of assets is much lower than that associated with a going-concern), but also due to its adverse social consequences. Indeed, the "prospective" Fund, that was designed in the 1990s to improve the FCG model adopted in the 1970s and 1980s, could rely on a "deposit guarantee section", which was never yet utilized. Even later, the FGD has never been in position to reimburse depositors, with the only exception of a minor payout carried out in 1997 to liquidate a very small bank[45].

[45] Boccuzzi (2007) argued that, upon the transposition of the Directive 1994/19/EU in

LESSON 4 – *the ex post funding mechanism of a DGS has strong pro-cyclical effects*

The FGD funding mechanism, based on ex-post resources compulsorily committed by member banks on a yearly basis in proportion to total deposits, and utilized only in the event of financial support interventions granted to distressed banks, has inevitably (by its nature) pro-cyclical implications. In recent years (2010-2015) CCBs were called on to sponsor the resolution of sister banks' crises or aid temporally distressed (but potentially viable) sister banks through granting early intervention measures right in the period of the most severe downturn of the business cycle. When economic recession may cause a deterioration of business conditions and potential operating losses, CCBs are forced to intensify their financial support toward sister banks, thus accelerating credit crunch effects, to the detriment of customer enterprises, and/or worsening their own profit-and-loss accounts.

LESSON 5 – *the self-financing mechanism of a DGS – based on the accrual of returns from stable investments, the granting of financial support to distressed (but viable) banks and the rendering of such benefits (e.g., principal and interest repayment) to the DGS – may create a virtuous circle*

On the contrary, the FCG was capable of designing a self-financing mechanism, generating reimbursement of "differential profits" from prior loan-granting associated with early intervention operations, carried out in booming economy periods and usable (out of capital reserves) in the form of unrecoverable cash interventions to rescue failing banks during recession times. In essence, the resolution of distressed banks, carried out in the recessionary mid-1990s mainly through the transfer of assets and liabilities, was fostered and

Italian law, the pre-existing deposit coverage level was € 103,000 (higher than the Directive-set level of € 20,000), being justified by the fact that Italian DI schemes were assigned the relevant task of not only paying out in the event of liquidation (pay box), but also – to a greater extent – safeguarding the financial stability of the banking system and related depositors' confidence.

funded by relying on the "FCG Capital Reserves" and "Differential Profits" accumulated over the prosperous 1980s. Such an ex-ante self-financing mechanism created a virtuous circle of excess funds' generation with no pro-cyclical effects, enabling efficient financial support activity of the FCG.

LESSON 6 – *the early-intervention activity of a DGS minimizes the likelihood and amount of losses to the member banks and the DGS itself*

The empirical evidence on the early intervention activity of the FCG in the 1980s, as illustrated above, shows that a "sectoral" DGS, endowed with the dominant task of preventing member banks' failures through the use of early-intervention measures, may reduce the likelihood and amount of subsequent losses suffered by the Fund, thus avoiding corporate reputation damage. The same rationale of an early-intervention focus was maintained in the "prospective" FCG project, whereby the "deposit guarantee section" could perform the deposit reimbursement function as a last resort only after making sure that the "financial interventions section" had put its best effort into rescuing a potentially viable CCB, using "alternative measures".

Following the successful experience of the FCG, an early intervention role was also assigned to the FGD, with evidence of some operations carried out in the 1997-2015 period (see Figure 5). As a result, depositors' payout operations were, in fact, very limited (only one event concerning a small bank occurred at the start of the FGD operations).

LESSON 7 – *the DGS should be assigned the mandate of serving as a risk-minimizer for member banks. Such a role may be fully implemented only with the aid of appropriate governance mechanisms*

In line with the requirements and the opportunities offered by the "DGSD", the sectoral DGS of the Italian CC may serve as a "*risk-minimizer*" in compliance with the IADI core principle 2 definitions. (Core Principles, IADI, November 2014). In so doing, it can rely on

its dormant features as a risk-minimizing entity originally defined and regulated in its Statute and never fully implemented, thus evolving from a pure *loss-minimizer* (or absorber) – engaged in the selection of a range of least-cost resolution strategies – to a *risk-minimizer*. According to the above IADI core principle 2, a deposit insurer performs a comprehensive risk minimization function when (a) risk assessment, (b) prudential oversight, (c) early intervention, and (d) resolution activities are conducted at member banks. Prospectively, the FGD turnaround operations can be enriched with preventative monitoring and risk-assessment activities, innovative financial support lending, enforcement of early intervention measures and associated governance mechanisms, technical and organizational tutoring. To accomplish these results, a DGS may also be aided by adequate governance structure and rules.

6. Conclusions

Historically, one of the key roles that a financial safety-net plays in the economic system is to promote stability and proactively react to financial crises by minimizing their adverse effects through enabling risk-sharing among members.

FCG represented the very first experience of a financial safety-net in Italy, being endowed with both *institutional protection* and *DI scheme* functions. Its financial support activity in favour of distressed CCBs was then followed in 1997 by that of FGD, the compulsory DGS, designed and activated to comply with the European Directive II on DI.

Both FCG and FGD, enhanced with the subsequent creation of FGO and FGI, contributed to ensuring financial stability in Italy by granting jointly about 200 interventions over almost forty years (1978-2015).

The effectiveness of such a fully-private mutuality-based approach is displayed by the fact that, over the same period, about 400 CCBs left the market without any failures, contagion spillovers to the coun-

try's economic system or negative impacts on (a) financial stability, (b) tax-payers, (c) bondholders, (d) relationship-based lending practices and, in the end, (e) the wealth of local communities. Conversely, the raising trends of both CCBs' market share of deposits and loans and loan-to-deposit ratio provide significant empirical evidence of their past contribution to the gradual development of local economy (the core "lending" business of CCBs as opposed to large, non-mutual banks which are not interested in this market)[46]. The fruitful results of such experience should be contrasted with the consequences of small banks failures in the U.S. market and the huge amount of state aid granted worldwide during the recent global financial crisis.

The "private" nature of the Italian CC financial safety net also discouraged moral hazard behaviour advancing the burden-sharing principle through the provision of a greater contribution to the crisis-solution by the local community (e.g., shareholders, board members, employees) and the regional federation (which is, in turn, responsible for conducting auditing activities on member banks)[47].

Interestingly, both preventative measure-based schemes adopted by the FCG since the late 1970s and those foreseen for the "prospective" FCG in the 1990s display their modernity within the current regulation framework. This clearly emerges looking at the current experience of FITD, which has recently provided for the en-

[46] CCBs appear to have followed a successful "*Blue Ocean Strategy*", based on the development of unexploited markets, rather than facing competition in more mature markets (Kim and Maurbogne, 2005).
[47] To some extent, the way the Italian CC safety-net worked is similar to the recent EDIS proposal of the EU Commission, with specific regard to the first transition stage of the process envisaged for its implementation, in which the EU-wide re-insurance scheme may intervene only after national DGSs. This should avoid moral hazard behaviours of national DGSs in excessive use (and potential depletion) of available resources. At the same time, the suggested structure of the EDIS seems to be biased, due to the fact that not enough room has been left for the application of the *proportionality principle* and for the role of the DGS as both a "*risk-minimizer*" and as a "*loss-absorber/loss-reducer*" in the early intervention context, at least at national level and for sectoral DGSs. This approach is clearly inconsistent with art. 11(3) of DGSD (into force since 3 July 2015), that is with the national discretionary application of "alternative measures", aimed at avoiding bank failures.

hancement of its Statute enabling the creation of an additional section, financed on a voluntary basis, devoted to "alternative measures". Such a scheme complies with the DGSD, BRRD, and State Aid rules allowing for some degree of flexibility in bank-crisis management, upon the condition of a broad voluntary participation and effective cohesiveness across member banks[48].

Conclusively, a substantial reform of the Italian CC's financial safety net is needed in the light of the Banking Union[49]. Governance processes and bank crisis management practices may be further improved at both local and federal level by relying on a reinforced cohesiveness, with the aim of enhancing effectiveness of moral hazard reduction[50]. This is the key lesson the reader should accept with on

[48] The new art. 35 (4) of the FITD Statute decrees that at least 90% of participants – representing at least 95% of covered deposits – should join the voluntary section, otherwise it should be suppressed. As recently argued by the Italian journalist Federico Fubini (*Corriere della Sera*, 23 November 2015), the lack of such a cohesive approach among FITD's member banks – in the recent experience concerning the rescue of 4 distressed banks under special administration and their return to ordinary business – prevented a prior voluntary intervention that would have been much cheaper if rapidly adopted. This ultimately led to an untimely and more expensive resolution procedure at national level (with an estimated incremental cost of about € 1.6 billion), in which the entire banking system – under the guidance of the Bank of Italy, acting as National Resolution Authority – was compulsorily involved (including, for the first time, CCBs that were called on in the rescue of non-cooperative banks). This first resolution procedure executed in Italy poorly implemented the proportionality principle: a too-complex procedure (involving several actors) disallowed, in the first place, a cheaper intervention by a compulsory sectoral DGS (FITD), enabling a more expensive intervention by the equally compulsory Resolution Fund, thus diverting capital also from those banks (CCBs) that are members of a distinct sectoral DGS. This first resolution experience suggests that regulation (e.g., 2013/C 216/01 "Banking Communication") and practice in banking-crisis management should be better and more consistently aligned, especially with regard to the role of DGS as a "*risk minimizer*" and the fair, as well as effective, implementation of the burden-sharing principle.

[49] A structural reform of the Italian CC has been recently planned and is about to be implemented in 2016.

[50] Interestingly, the German Cooperative Banking network, in transposing the DGSD, opted for the creation of a "*Dual System*" based on the official recognition of a new EU-compliant DGS/IPS (BVR-ISG) and the maintenance of the pre-existing, voluntary non-recognized IPS (BVR-SE). Governance structures were duplicated (with the same persons in charge). This approach may be considered as a benchmark model for reforming the safety net of the Italian CC, which – as discussed in the early sections of this article – historically has often been inspired by German cooperatives' experiences.

the way toward stronger financial stability, long-term economic value creation and cultural enrichment arising from the presence of *banking biodiversity* within a genuine level playing field.

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