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Italian Guarantee Scheme¹

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Abstract

The collapse of Lehman Brothers on September 15, 2008, and its severe impact on global credit markets impelled governments around the world to enact stabilization measures to calm and protect their domestic economies. The Italian Republic, while not directly affected by the US subprime mortgage crisis, preemptively implemented emergency procedures and programs to ensure the stability of their banking system. Announced with the passage of Decree-Law No. 157 on October 13, 2008, and legally enforced under Law 190/2008 of December 4, 2008, the Italian Guarantee Scheme (the Guarantee Scheme) was aimed at protecting institutions whose interbank lending abilities had the potential to be impacted by the global credit crunch. Specifically, the Guarantee Scheme allowed Italian banks, including Italian subsidiaries of foreign banks, deemed to be solvent by the Banca d'Italia to apply for guarantee coverage for debt instruments issued after October 13, 2008, with maturities of between three months and five years. Although no overall cap was initially specified, Italian authorities determined individual participation according to official capital requirements. The Guarantee Scheme was never utilized and concluded with the expiration of its issuance window on December 31, 2009.

Keywords: Italy, government guarantee, guarantee scheme, credit institutions, short-term debt, medium-term debt, mortgage banks

¹ This case study is part of the Yale Program on Financial Stability (YPFS) selection of New Bagehot Project modules considering the responses to the global financial crisis that pertain to bank debt guarantee programs. Cases are available from the *Journal of Financial Crises* at <https://elischolar.library.yale.edu/journal-of-financial-crises/>.

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Italian Guarantee Scheme

At a Glance

In response to the volatile state of the global economy following the collapse of Lehman Brothers on September 15, 2008, governments around the world implemented a series of stabilization measures to calm and protect their domestic economies. The Italian Ministry of Economy and Finance, for its part, acted swiftly to adopt Decree-Law No. 157 on October 13, 2008, which outlined provisions for the Italian Guarantee Scheme, a temporary bond swap program, and a separate guarantee program for banks looking to refinance within the Eurosystem.

The Guarantee Scheme allowed solvent Italian banks, including foreign subsidiaries of Italian banks, to apply for state guarantees for senior debt instruments issued after October 13, 2008, with maturities of between three months and five years. Eligible debt instruments were required to be denominated in euros.

While there was no overall cap specified for the Guarantee Scheme, participating institutions were subject to individual limits based on official capital requirements. Participation fees were to be based on the maturity of the debt to be guaranteed and the soundness of the issuing bank, according to the guidelines set forth by the European Central Bank. In addition, participating banks were required to adhere to limits on growth in balance sheet volume.

No bank ever applied for coverage under the Guarantee Scheme. Following a six-month extension of its issuance window, the program concluded on December 31, 2009.

Summary Evaluation

There has been little formal evaluation of the Guarantee Scheme. In submitting its request for a six-month prolongation of the program, Italian regulators noted to the European Commission that high guarantee fees, Italian banks' strong credit profiles, and the condition of Italy's sovereign spread contributed to disinterest in the program.

Summary of Key Terms	
Purpose:	To relieve liquidity pressures on the Italian economy following the US subprime mortgage crisis and to support Italian banks' short- and medium-term financing needs by providing State guarantees on debt issued by solvent institutions
Announcement Date	October 13, 2008
Operational Date	December 4, 2008
Date of First Guaranteed Issuance	N/A
Issuance Window Expiration Date	Originally June 16, 2009; later extended to December 31, 2009
Program Size	Unspecified
Usage	None
Outcomes	N/A
Notable Features	High fees relative to value of guarantee given low sovereign credit rating

Italian Guarantee Scheme: Italy Context	
GDP (SAAR, Nominal GDP in LCU converted to USD)	\$2.2 trillion in 2007 \$2.4 trillion in 2008 <i>Source: Bloomberg</i>
GDP per capita (SAAR, Nominal GDP in LCU converted to USD)	\$37,823 in 2007 \$40,778 in 2008 <i>Source: Bloomberg</i>
Sovereign credit rating (5-year senior debt)	As of Q4, 2007: Fitch: AA- Moody's: Aa2 S&P: A+ As of Q4, 2008: Fitch: AA- Moody's: Aa2 S&P: A+ <i>Source: Bloomberg</i>
Size of banking system	\$2.1 trillion in total assets in 2007 \$2.6 trillion in total assets in 2008 <i>Source: Bloomberg</i>
Size of banking system as a percentage of GDP	96.0% in 2007 107.3% in 2008 <i>Source: Bloomberg</i>
Size of banking system as a percentage of financial system	Data not available for 2007/2008 <i>Source: World Bank Global Financial Development Database</i>

<p>5-bank concentration of banking system</p>	<p>55.0% of total banking assets in 2007 62.6% of total banking assets in 2008</p> <p><i>Source: World Bank Global Financial Development Database</i></p>
<p>Foreign involvement in banking system</p>	<p>7% of total banking assets in 2007 6% of total banking assets in 2008</p> <p><i>Source: World Bank Global Financial Development Database</i></p>
<p>Government ownership of banking system</p>	<p>Data not available for 2007 18% of banks owned by the state in 2008</p> <p><i>Source: World Bank Group</i></p>
<p>Existence of deposit insurance</p>	<p>Data not available for 2007</p> <p>100% insurance on deposits up to \$147,000 in mid-September 2008</p> <p><i>Source: OECD</i></p>

I. Overview

Background

Citing exceptional market volatility and restricted access to credit following the collapse of Lehman Brothers on September 15, 2008, governments around the world sought to implement stabilization measures to support their domestic economies. Even Italy, with low exposure to the US subprime mortgage crisis, reacted rapidly to protect solvent banks that had the potential to be severely impacted by soaring interbank lending costs.

The Italian Ministry of Economy and Finance (MEF), in cooperation with the Banca d'Italia, responded to the global financial crisis (GFC) by introducing a coordinated package of interventions intended to support banks' medium- and long-term financing needs. On October 9, 2008, the MEF issued Decree-Law No. 155 on "Urgent measures to guarantee the stability of the credit system and the continued availability of credit to enterprises and consumers in the current crisis on international financial markets," which granted the government extraordinary administrative powers and outlined measures for a bank recapitalization program, a new deposit guarantee program, and an emergency liquidity facility.³ Four days later, on October 13, 2008, the MEF adopted an addendum to Decree-Law No. 155 entitled Decree-Law No. 157 regarding "Additional urgent measures to guarantee the stability of the credit system." This follow-up legislation provided the legal basis for the Italian Guarantee Scheme, a temporary bond swap program, and a separate guarantee program for banks looking to refinance within the Eurosystem.⁴

The interventions outlined in the Decree-Laws were submitted to the European Commission for authorization on November 11, 2008. Having found the scope of the measures to be in accordance with State aid rules, the European Commission granted its approval on November 13, 2008. Both Decree-Laws were made official with the passage of Law 190/2008 by Parliament on December 4, 2008.

Program Description

Jointly administered by the Italian Ministry of Economy and Finance and the Banca d'Italia, the Guarantee Scheme was implemented with the passage of Law 190/2008 by Parliament on December 4, 2008. Italian authorities believed that the intervention, which would provide

³ Under Italian law, in extraordinary circumstances a Decree-Law can be adopted by a ministry and take legal effect, subject to ultimate confirmation by Parliament.

⁴ Among other measures announced in Decree-Laws No. 155 and 157, the Italian Ministry of Economy and Finance introduced a separate State guarantee program whereby non-bank institutions would lend guaranteed high-quality bonds to banks in exchange for distressed assets. The banks would then use these bonds as collateral to refinance within the Eurosystem (European Commission 2008). The purpose of the program was to encourage the transfer of high-quality bonds to the banking sector from other financial sectors of the economy (European Commission 2008). Under this program, temporary loans greater than €500,000 and with durations of less than three years were eligible for guarantees equal to the market value of the bonds. Participation fees reflected those assessed for banks benefiting from the Guarantee Scheme.

government guarantees on debt issued by Italian banks, would assist in improving the flow of liquidity between banks by supporting the short- and medium-term financing needs of institutions impacted by the international credit crunch. Participation in the Guarantee Scheme was voluntary and required the approval of the Banca d'Italia. In the event of default, the Italian government would assume coverage for 100% of principal and interest guaranteed.

The Italian Guarantee Scheme did not have a prescribed overall cap. Instead, all guarantees provided under the program were to be issued at "market conditions" and prioritized according to individual banks' liquidity levels and capital ratios (Shearman & Sterling 2008). Such assessments were to be conducted by the Banca d'Italia.

Institutions eligible for the Guarantee Scheme included solvent banks incorporated in Italy, including Italian subsidiaries of foreign banks. Solvency was to be determined by the Banca d'Italia prior to the MEF's approval of any guaranteed debt issuance, based on core capital and total capital ratios, as well as accounting losses over the last three consecutive years (European Commission 2008).

The Guarantee Scheme covered debt issued in euros with maturities of greater than three months and less than five years. Although there were few specific guidelines pertaining to the eligibility of debt, guaranteed instruments were required to have been issued at a fixed rate after October 13, 2008. They also had to "provide for the repayment of the principal in a single installment at maturity" (European Commission 2008). Explicitly excluded were subordinated debt, guaranteed bank bonds, structured instruments or complex products, products with a derivative component, and regulatory capital.

Caps on individual institutions' participation in the credit guarantee, bond swaps, and refinance guarantee program were determined by the Banca d'Italia according to capital requirements (*patrimonio di vigilanza*): "each beneficiary bank cannot benefit from the various measures included in [Decree-Law No. 157] for an amount higher than their capital for supervisory purposes including its Tier 3 capital" (European Commission 2008). Additionally, no more than 25% of guaranteed liabilities could have maturities longer than three years.

Participation fees were assessed according to the guidelines laid out in the European Central Bank's "Recommendations on Government Guarantees on Bank Debt" of October 20, 2008. For short-term debt with maturities of between three months and 12 months, the fee equaled 50 basis points (bps) on an annual basis. For medium-term debt with maturities greater than 12 months, the fee equaled 50 bps on an annual basis, plus a variable fee calculated based on the issuing bank's five-year credit default swap (CDS) rating or credit rating. For banks without any ratings, the fee equaled the median of the five-year CDS spreads recorded in the same period from major banks that have registered offices in Eurozone countries but were of the lowest available rating category, plus 50 bps on an annual basis.

Further, guaranteed issuances for debt with maturities of longer than two years incurred an additional top-off fee of 50 bps on an annual basis, beginning 24 months from the original granting of the guarantee.

Although there were no restrictions on either the issuance of non-guaranteed debt by participating banks or the minimum amount of each guaranteed issuance, the Ministry of Economy and Finance did impose limits on balance sheet growth for institutions partaking in the Guarantee Scheme. Italian authorities would thus monitor banks' activities to ensure that the aggregate balance sheet volume did not exceed the higher of the annual growth rate of Italian nominal GDP in the preceding year, the average historical growth in balance sheets in the Italian banking sector between 1987 and 2007, or the average growth rate of the balance sheet volume in the European Union (EU) banking sector in the preceding six months (European Commission 2008).

Outcomes

The issuance window of the Guarantee Scheme was originally set to expire on December 31, 2009. On June 16, 2009, the European Commission approved a request by the Italian Ministry of Economy and Finance to extend the program by six months due to ongoing turbulence in global financial markets and to preempt any "deterioration of [Italian] banks' risk profile (European Commission 2009).

As of May 2009, no bank had applied for coverage under the Guarantee Scheme. Italian authorities suspected that this lack of usage was due to the high participation fees charged, as well as the stronger credit profile of Italian banks and "different sovereign spread of Italy" as compared with other EU countries (European Commission 2009). Specifically, the fact that guidance from the European Central Bank called for a uniform fee structure across European countries with very different sovereign credit ratings meant that Italian institutions had to pay the same guarantee fees as similarly rated institutions in other countries despite the guarantee they received being worth less.

The Guarantee Scheme issuance window expired on December 31, 2009, at which point no bank had applied for coverage (European Commission 2011).

On December 15, 2011, the European Commission approved a request from the Italian Ministry of Economy and Finance to reintroduce the Guarantee Scheme with slightly amended terms (see Appendix A: The 2011 Reintroduction of the Italian Guarantee Scheme).

II. Key Design Decisions

- 1. The Guarantee Scheme was implemented by the Italian Republic as part of a package of stabilization measures announced on October 13, 2008.**

On October 9, 2008, the Ministry of Economy and Finance adopted Decree-Law No. 155 on “Urgent measures to guarantee the stability of the credit system and the continued availability of credit to enterprises and consumers in the current crisis on international financial markets.” This legislation provided for a number of interventions intended to stabilize and protect the domestic economy, including a bank recapitalization program, a deposit guarantee program, and an emergency liquidity facility. The Decree-Law also allowed for the possibility that a bank could be taken under “extraordinary administration” by government-appointed officials if it were to face “a crisis situation (including liquidity crisis) that could jeopardize the stability of the financial system” (European Commission 2008).

On October 13, 2008, the Ministry of Economy and Finance adopted an addendum to Decree-Law No. 155 entitled Decree-Law No. 157 on “Additional urgent measures to guarantee the stability of the credit system.” In addition to supplying the legal basis for the Guarantee Scheme, the amendment provided the necessary legislation for a temporary bond swap program and a separate guarantee program for banks looking to refinance with the European Central Bank.⁵

2. Although it was proposed on October 13, 2008 by the Italian Ministry of Economy and Finance, the Guarantee Scheme was not implemented until the signing of Law 190/2008 into force on December 4, 2008.

The adoption of Decree-Law No. 157 on October 13, 2008 supplied the legal basis for the Guarantee Scheme, but the program was not implemented until the signing of Law 190/2008 into force by Italian Parliament on December 4, 2008. It was then published as part of the public record in the December 6, 2008, edition of the *Gazzetta Ufficiale della Repubblica Italiana*.

3. In accordance with State aid rules, the Guarantee Scheme required European Commission approval for implementation.

The Italian government notified the European Commission of Decree-Law No. 157 on October 17, 2008, and received approval on November 13, 2008. As discussed in more detail in the Evaluations section, the need to structure the Guarantee Scheme in such a way as to ensure EC approval significantly influenced the design of certain program features.

4. There was no overall cap set for the Guarantee Scheme

Though there was no overall limit specified at the time of the Guarantee Scheme’s inception, all debt guaranteed under the program would be issued at “market conditions” and prioritized according to banks’ individual liquidity levels and capital ratios (Shearman &

⁵ See footnote 4 for a description of this separate guarantee program.

Sterling 2008). The Banca d'Italia assumed responsibility for monitoring banks' capitalization and assessing their needs under the Guarantee Scheme.

5. Eligibility for the Guarantee Scheme was restricted to solvent banks incorporated in Italy, including Italian subsidiaries of foreign banks.

An individual bank's solvency was determined by the Banca d'Italia according to the following criteria:

- 1) Neither core capital nor total capital ratios could be lower than the regulatory ratios "at the time of the last available supervision report" (European Commission 2008) and
- 2) The bank must not have experienced any accounting losses in more than one of the last three consecutive accounting years.

Branches of foreign banks were excluded from the Guarantee Scheme, since they owned only about 8% of the total assets owned by banks in Italy, and all except one—which had a market share of 2%—possessed market shares below 1% (European Commission 2008).

6. Eligible debt instruments were required to be senior debt issued at a fixed rate and "provide for the repayment of the principal amount in a single installment at maturity."

Explicit exclusions included subordinated debt, guaranteed bank bonds, structured instruments and complex products, products with a derivative component, or regulatory capital.

7. Debt ranging from three months to five years could be issued under the Guarantee Scheme.

Additionally, no more than 25% of guaranteed liabilities could have maturities longer than three years.

8. Only debt issued in euros was eligible for the Guarantee Scheme.

Program documents did not provide a specific rationale for limiting the Guarantee Scheme to euro-denominated debt.

9. Individual caps on participation were to be determined by the Banca d'Italia according to banks' capital ratios and the maturity of the debt guaranteed.

Banks' individual utilization of any combination of the three interventions outlined in Decree-Law No. 157—the Guarantee Scheme, the temporary swaps, or the guarantee program for ECB refinancing transactions—could not surpass their "capital for supervisory purposes, including Tier 3 capital" (European Commission 2008).

10. The fee for issuing debt pursuant to the Guarantee Scheme varied based on the maturity of the debt to be guaranteed and the soundness of the issuing bank.

Italian authorities relied on the guidelines set forth in the European Central Bank's "Recommendations on Government Guarantees on Bank Debt" of 20 October 2008 (European Central Bank 2008) in determining the approach to Guarantee Scheme fees.

For short-term debt with maturities of between three months and 12 months, the fee equaled 50 bps on an annual basis.

For medium-term debt with maturities greater than 12 months, the fee equaled 50 bps on an annual basis, plus the lesser of the following:

- 1) The median of the five-year CDS spreads of the bank during the period January 1, 2007, to August 31, 2008, or
- 2) The median of the five-year CDS spreads in the same period for the rating category to which the bank belonged.

For banks issuing medium-term debt with maturities greater than 12 months that did not have CDS data or representative CDS data, the fee was calculated as follows:

- 1) For banks with an official credit rating, the fee equaled the median of the five-year CDS spreads recorded during the period January 1, 2007, to August 31, 2008, from major banks which have both registered offices in Eurozone countries and whose senior unsecured debt is rated in the same category as the bank in question.
- 2) In the case of banks without any ratings, the fee would equal the median of the five-year CDS spreads recorded in the same period from major banks which have registered offices in Eurozone countries but are of the lowest available rating category, plus 50 bps on an annual basis.

Additionally, guaranteed issuances for debt with maturities longer than two years incurred a supplementary top-off fee of 50 bps on an annual basis, beginning 24 months from the original granting of the guarantee.

11. To prevent abuse of the Guarantee Scheme, Italian authorities imposed limits on the growth of banks' balance sheet volumes.

Guidance issued by the European Commission in October 2008 on the creation of credit guarantee programs called for the inclusion in programs of a set of safeguards "to minimize . . . distortions and the potential abuse of the preferential situations of beneficiaries brought about by a State guarantee" and "to avoid moral hazard." Although the guidance did not specify exactly what safeguards a program should include, it did require "an adequate combination" of elements including restrictions on advertising based on the guarantee, balance sheet growth, share buybacks and executive compensation (European Commission 2008).

Growth in balance sheet volume during participation in the Guarantee Scheme could not exceed the higher of:

- 1) “The annual rate of growth of Italian nominal GDP in the preceding year;
- 2) “The average historical growth of the balance sheets in the Italian banking sector during the period 1987–2007; or
- 3) “The average growth rate of the balance sheet volume in the banking sector in the EU in the preceding six months” (European Commission 2008).

12. The Guarantee Scheme issuance window was prolonged by six months on June 16, 2009, to expire on December 31, 2009.

No banks had applied to issue debt under the Guarantee Scheme as of May 2009. However, due to the perceived weakness of the domestic economy following the height of the global financial crisis (GFC), the Italian authorities opted to extend the original issuance window by six months (European Commission 2009).

On December 15, 2011, the European Commission approved a request by the Italian government to reintroduce the Guarantee Scheme under modified terms. This second iteration was then prolonged on February 2, 2012, to expire on June 30, 2012 (see Appendix A: The 2011 Reintroduction of the Italian Guarantee Scheme).

III. Evaluation

In their justification for extending the Guarantee Scheme, Italian authorities described the measure as a preemptive “element contributing to the path to normal banking market conditions” (European Commission 2009).

Italian authorities submitted to the European Commission three possible reasons for the program’s non-use through May 2009, a point at which no bank had applied to issue guaranteed debt (European Commission 2009). The high price of the guarantee, the strength of Italian banks’ credit ratings compared with other European banks, and the “different sovereign spread of Italy in comparison to other countries” were seen to have been the dominant factors in the program’s lack of utilization (European Commission 2009).

Aside from this internal assessment, there has been little formal evaluation of the Guarantee Scheme.

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V. Key Program Documents

Summary of Program

[Italian Measures for the Stabilization of the Banking System](https://ypfsresourcelibrary.blob.core.windows.net/fcic/YPFS/Cleary_Gottlieb_Italian_Measures_Stabilization_Banking_System_Oct_2008.PDF) (Cleary Gottlieb 2008) – *Report summarizing the slate of Italian government interventions introduced in response to the GFC.*

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Implementation Documents

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Legal/Regulatory Guidance

Opinion of the European Central Bank of 23 October 2008 at the Request of the Banca d'Italia on Behalf of the Italian Ministry for Economic Affairs and Finance on Two Decree-Laws containing Urgent Measures to Guarantee the Stability of the Banking System and the Continuity of the Provision of Credit (European Central Bank 2008) – *Official document*

detailing the ECB's approval of the Italian guarantee scheme.
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https://ypfsresourcelibrary.blob.core.windows.net/fcic/YPFS/EC_State_Aid_Overview_Decisions_Financial_Institutions_2016.pdf.

Key Academic Papers

The Design of Government Guarantees for Bank Bonds: Lessons from the Recent Financial Crisis (Levy and Schich 2010) – *Report comparing the various bank debt guarantee schemes implemented by governments around the world in response to the GFC.*
https://ypfsresourcelibrary.blob.core.windows.net/fcic/YPFS/Levy_and_Schich_2010_0.pdf.

VI. Appendix

Appendix A: The 2011 Reintroduction of the Italian Guarantee Scheme

On December 15, 2011, the European Commission approved a request from the Italian Ministry of Economy and Finance to reintroduce the Guarantee Scheme for six months to address the “challenges arising from the current tensions in the funding markets, which also reflect the sharp repricing of sovereign risk” (European Commission 2011). The proposed purpose of the reintroduction of the Guarantee Scheme, which was legally founded in Law 190/2008 of December 4, 2008, was to “enhance the capacity of banks to place debt instruments in the market” (European Commission 2011).

This new iteration of the Guarantee Scheme provided for the issuance of up to €80 billion in debt guaranteed by the government. Only solvent banks incorporated in Italy, including Italian subsidiaries of foreign banks, were eligible for participation. New debt instruments issued by banks with maturities of greater than three months and less than five years were eligible for coverage. Covered bonds issued after January 1, 2012, with maturities of up to seven years could also be guaranteed. As specified in the terms of the original Guarantee Scheme, eligible debt was required to be denominated in euros and “provide for the repayment of the principal amount in a single installment at maturity” at a fixed rate (European Commission 2011). Subordinated debt, structured instruments or complex products, products with a derivative component, and regulatory capital were explicitly excluded from eligibility.

Although there were no flat limits on individual participation, no bank was to be allowed to “benefit from the various measures for an amount higher than its capital for supervisory purposes,” as determined by the Banca d’Italia (European Commission 2011). Additionally, the proportion of bank’s guaranteed debt with a maturity longer than three years was not allowed to exceed one-third of the total value of liabilities covered by the Guarantee Scheme.

Participation fees were assessed based on the issuance date and maturity of the debt to be guaranteed, as well as the soundness of the issuing bank. Beneficiary banks were subject to regulation by the Banca d’Italia regarding the expansion of commercial activity and communication, although no mention was made of limits on growth in balance sheet volume (European Commission 2011).

On February 22, 2012, the European Commission approved an amendment that increased the Guarantee Scheme’s overall cap from €80 billion to €110 billion (European Commission 2012).

Unused throughout its operation, the reintroduced Guarantee Scheme concluded with the expiration of its issuance window on June 30, 2012.

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