Government and Opposition (2024), **59**, 187–206
doi:10.1017/gov.2022.27

Government & Opposition

ARTICLE

Banking Nationalism and Resolution in Italy and Spain

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(Received 7 December 2021; revised 15 April 2022; accepted 24 May 2022; first published online 2 August 2022)

Abstract

This article contributes to the comparative literatures on varieties of financial capitalism, economic nationalism and bank resolution with a focus on Spain and Italy's management of bank insolvency and resolution between 2008 and 2018. Both countries' alternative banks faced enormous challenges through prolonged economic decline and declining loan repayments, both turned to depositors to become investors in lieu of attracting arm's-length investors to inject capital, and both had strong connections with local political authorities that resisted bank reform. But Spanish banks were restructured successfully in accordance with EU law while local government ties complicated Italian resolutions. We explain this outcome through two factors: state strength buttressed by outside assistance from the European Stability Mechanism; and strong international marketization, which enhanced the drive to restructure quickly. Spain's decision to ask for loans from the European Stability Mechanism to help restructure its heavily marketized savings banks allowed it to finish reforms after 2012.

Keywords: banking union; single resolution mechanism; Spain; Italy; economic nationalism; varieties of financial capitalism

Europe's Single Resolution Mechanism (SRM) was designed to solve the problem of too big to fail (TBTF) banks and cut through the doom loop of the eurozone crisis (Howarth and Quaglia 2014). The doom loop was a vicious circle of bank instability and sovereign financial instability that the Bank Recovery and Resolution Directive (BRRD) was intended to minimize by forcing failed banks to be restructured or closed down, and for bondholders to lose part or all of their credits to the bank in the process. Crucially, this includes bank customers who invest in their own banks by purchasing bonds instead of holding bank deposits. However, implementation varies greatly, and its effects remain a matter of further study, given the seven years since it was instituted. An interesting comparison to test the SRM's ability to cut through the doom loop is how two countries with a history of financial fragility – Italy and Spain – have managed financial problems within non-commercial banks. These are local and regional credit institutions specialized in savings and loans for local households, to small and medium-sized enterprises and to city and regional councils. Alternative banks are the most financially fragile in Spain and Italy, compared to their larger, more commercial, internationalized and diversified counterparts. Their closure or restructuring creates local political pressure that national governments either seek to overcome or support through resisting technocratic rule application (Hall 2022). Has the SRM helped these two countries solve their problems, or do other factors weigh more heavily?

Spain tackled very serious banking problems requiring recapitalization and resolution without falling foul of EU rules restricting state aid, requiring bail-ins or orchestrating national ownership of banks. It consolidated its banks with the blessing of the European Commission, the Single Resolution Board (SRB), the European Stability Mechanism (ESM) and the involvement of international investors. Italy, on the other hand, encountered difficulties in all these areas. It fell short on finding funding for banks that was legal, found it impossible to follow through on bail-ins in accordance with SRM rules, and negotiated exceptions without restructuring banks in ways that would attract international investment. Banking ownership also remains national, but also financially fragile for the foreseeable future.

These outcomes leave us with some puzzles. Generally speaking, how do state institution and financial system characteristics facilitate or impede bank resolutions in Europe? More specifically, why is it that Spain did so much better than Italy at restructuring its banks? Did it make a difference that Spain involved the ESM while Italy did not? Do the outcomes mean that foreign investment in Italian banks is unlikely for the foreseeable future?

This article contributes to two main literatures. First, it adds to the literature on varieties of financial capitalism (VOFC). Some VOFC literature examines the secular liberalization of banking systems in coordinated market economies (Hardie and Howarth 2009, 2013; Hardie et al. 2013) or studies continued diversity and the challenge of balancing national public policy priorities with international expectations (Grittersová 2014; Johnston and Regan 2018). Some studies are single-case (Deeg 2012; Royo 2013) or compare Italy and Spain prior to the SRM (Quaglia and Royo 2015). Diversity is generally understood to complicate bank resolution, since closure may damage related public policy goals tethered to banks, from simple economic nationalism to social policy responsibilities (Butzbach 2016; Goyer and Valdivielso del Real 2014). However, the success of resolution in Spain despite such features warrants further study. Second, this article adds to the small but growing literature on the implementation of eurozone rules, institutions and policies surrounding bank resolution (Donnelly 2018; Donnelly and Asimakopoulos 2020; Finke 2020; Woll 2014) that inform open questions about the strengths and weaknesses of the Banking Union's construction. In this piece, we additionally underline the political agency of European, national and local governments in determining the course of the supervision and resolution process and the overall effectiveness and national acceptance of European economic governance (Hall 2022; Merler 2021) that fit the interests of this journal.

Framework

The framework of analysis is taken from the comparative political economy of financial systems. It focuses on two key aspects that are of relevance to the long-term viability of alternative banks in particular: bank commercialization versus politicization; and state power over banks. The first dichotomy is expected to determine the degree of acceptance or practical resistance to bank resolution by both private and public actors (the question of political choice), while the variable of state power is focused on the national capacity to carry out intended changes.

Commercialized versus politicized banks

The first distinction we make is between *commercialized* and *politicized* banks. The former are treated as private enterprises without public functions. Operating banks should be free to solicit finance from financial markets if they wish (Hardie and Howarth 2013), at the potential cost of vulnerability to investor flight during crises. Failing banks are to be resolved (transferring accounts to another bank while imposing investor losses) or sold to investors of any nationality. In contrast, local and national governments expect politicized banks to fulfil public policy goals. This includes alternative banks that were established and designed to offer financial services to underbanked local communities and governments (Butzbach 2016; Calomiris and Haber 2015; Cassell 2021; Deeg and Donnelly 2016). Such banks are permitted to have institutional protections on bank ownership in the public interest (Goyer and Valdivielso 2014). We make a new distinction between what Iain Hardie and David Howarth (2013) call international marketization and domestic marketization. International marketization generates incentives during a crisis to resolve the bank and keep ownership open, so that the bank remains commercialized (Howarth and Quaglia 2016). Domestic marketization creates incentives to block resolution and protect local control, which keeps the banks politicized by threatening widespread voter losses during a bail-in.

State strength

We add to marketization versus politicization the variable of *state strength*: the propensity (willingness and capability) of national government and/or regulators to intervene in the economy (Hall 2018) – in this case to supervise and resolve banks (Woll 2014). Standing across from financial systems, the SRM relies heavily on state institutions to ensure resolution in compliance with the BRRD. Individual country weaknesses and strength in Italy and France are demonstrated in Lucia Quaglia and Ivo Maes's study (2004). These authors see the state's capacity as incorporating *horizontal coordination* across state institutions to ensure policy coherence (in this case, between the finance ministry, central bank and prime minister's office), and *vertical infrastructural power* to overcome resistance to policy implementation (directed at both banks and local government where required). To these institutional factors we also consider *financial resources* available.

We posit further that the power of national governments is strengthened or weakened by which EU institutions a national government chooses to work with. Rather than argue that EU institutions uniformly strengthen national commitment to EU rules (Moravcsik 2018), we posit that the ESM reinforces state strength to implement EU economic policy (Jones 2021), including Banking Union policy, while the Commission and SRB are more accommodating of national requests for leniency in applying EU law (Donnelly 2018).

Key to this outcome is the ESM's mission to ensure restructuring of state and/or bank finances as a condition of financial assistance. Also relevant is the ESM's intergovernmental, non-EU status (Gocaj and Meunier 2013), which shields it from political pressure to relax its conditionality. In contrast, the DG Competition's mission in resolution matters is to balance restrictions on state aid with implications of failure for the general economic interest.

Interactive effects

Where commercialization is strong and the state is weak, bank resolution is likely to follow a *liberal* model, allowing bank shareholders and creditors to lose their investments as the bank is sold or closed in accordance with the BRRD. Where both commercialization and the state are strong, we expect governments to pursue *liberal economic nationalism*: protecting and promoting national banks as much as possible within the limits of European rules and institutions (Clift and Woll 2012), to avoid scaring off investors and undermining bank resolution.

The combination of a strong state and politicized banks is expected to support *economic nationalism*: mercantilist measures to keep ownership national, regardless of international commitments and rules (Helleiner and Pickel 2005). Banking nationalism was widespread throughout Europe into the mid-2000s, but is generally seen as a thing of the past. However, we expect a combination of a weak state and politicized banks to generate *functional economic nationalism* in which governments pursue leniency on BRRD implementation from friendlier EU institutions. Local governments especially expect banks to support social policy, economic development and public finance in return for patient capital and regulatory forbearance that stabilize banks during downturns (Cassell 2021; Deeg and Hardie 2016; Epstein 2017). These politicized banks are unable to write off non-performing loans (NPLs) and raise new capital without state aid as the BRRD expects. Weak national government then lobbies EU institutions for exemptions for lack of perceived alternatives instead of enlisting ESM help. Table 1 encapsulates these ideal types and their conditions.

The two countries investigated below, Italy and Spain, had significantly different experiences of bank resolution between 2009 and 2021. Both countries experienced

Table 1 State–Bank Relations and Bank Resolution Approaches

Commercial versus politicized banks/ state strength	Commercialized banks	Politicized banks
Weak state	Liberalism	Functional economic nationalism
	Ø	*Italian banking policy*
Strong state	Liberal economic nationalism	Economic nationalism
	Spain	*Italy pre-2006*
		Italian regional councils

enduring economic stagnation, increasing rates of NPLs, difficulty securing fresh investment due to local political and/or family control of banks that stymied reforms, and an increasing inability of national government to finance restructuring by selling bonds of its own. But differences existed. Italian banks were marketized domestically, using their customers to refinance and then as hostages to resist bail-ins, which the Finance Ministry supported. Spanish banks were marketized internationally, and state institutions were built up to restructure and reopen Spanish banks to international finance. When local government limited these resolutions, the state leveraged financial support and contractual obligations from the ESM to finish the job it had started.

The remainder of this article assesses the degree of commercialization or politicization in banking, state actions to involuntarily restructure and recapitalize banks, the interactions between the national government and EU institutions, and the degree of fit with the typology above. The next section provides an overview of EU rules and institutions pertaining to bank resolution and state aid that Italy and Spain have to contend with. The following two sections analyse bank resolution institutions and practice in Spain and then Italy, respectively. The final section discusses the results.

The single resolution mechanism, competition policy and TBTF

The SRM is part of the Banking Union, which is designed to break the link between financially fragile banks and the governments they rely on during systemic crises. It has a bicephalous structure, with one set of rules applying to European systemically important banks (E-SIBs), and another applying to other banks. E-SIBs are automatically resolved under the conditions of the Bank Recovery and Resolution Directive (BRRD). This means that E-SIBs must have ready-made plans for resolution filed and approved with national resolution authorities and approved by the SRB, and that any resolution plans start with bail-ins of creditors and large depositors before considering any state aid to sweeten a deal for the bank's takeover by another institution. These thresholds are significant: creditors must lose up to 8% of assets in a resolution before accessing an EU-wide Single Resolution Fund, or any state aid. Other banks may be resolved either under the same rules, or under national rules that are often based on much slower and more complex bankruptcy procedures (Howarth and Quaglia 2014). National efforts to break these conditions constitute evidence of mercantilist or functional economic nationalism.

The definition of an E-SIB favours banks that are large by absolute volume of the assets they hold (over 30 billion euros), by the weight of those assets compared to national GDP, or whether they constitute one of the three largest banks in a national eurozone economy. This leaves out banks that are systemically important due to their central position in local banking markets (making them difficult to replace), and due to their interconnectedness, rather than size. This might be connections beyond the region in which a bank operates (to which supervisors and resolution authorities are well attuned), or to the public and private ecosystem of businesses and local government (to which they are not).

The SRB has the discretion to decide whether a non-E-SIB is considered systemically important and to be resolved under BRRD rules, or whether national rules apply. But there are reasons to question whether the Board has the resources and will to use that power, particularly with regard to strengthening national resolution authorities that are confronted with banks failing or likely to fail, as has been seen in Italy (European Commission 2017a). We contend that the SRB's combination of discretion and dependence on national resolution authority resources encourages negotiation over Board decisions and national responses. This in turn means that the Board will likely accommodate any national variety of economic nationalism that is not overtly mercantilist. This poses no challenge for liberal regimes and liberal economic nationalist regimes. For functional economic nationalism, in which national governments push EU institutions to condone bending and breaking EU law, the European Central Bank (ECB) remains impartial, but the Commission and Board will likely accommodate national authorities to avoid an escalation into outright economic nationalism.

Spain

Spain underwent privatization, liberalization and increasing commercialization of banking generally, including regional savings banks (*cajas*), dating back to the 1980s. The intent was to take advantage of a seven-year transition period after Spain's accession to the Single Market to modernize and make Spanish banks more competitive. Larger banks were consolidated by 1994 and transformed from state-owned to private, commercial enterprises, with Santander and BBVA surviving the wave of mergers. Cajas were liberalized as well. Branches were opened beyond traditional service areas, mortgage lending was expanded and outside investors permitted, who were attracted by Spain's rising economic fortunes.

However, the cajas remained heavily politicized: intertwined with local councils and obligated to pursue public service goals, particularly in the provision of housing and social services. This era can already be typified as liberal economic nationalism (Deeg 2012), with a transition period before full exposure to competition ensued. Cajas remained heavily politicized at the local level, however (see below), which made restructuring difficult.

The crisis of alternative banking arose through the sharp and prolonged deterioration of the Spanish economy following the 2008 Great Financial Crisis. House prices had risen sharply in the previous years, financed by increasingly high levels of mortgage borrowing that households and businesses could not repay in a deep and extended downturn, as after 2008. Financial problems originating in nonpayment of loans and mortgages mounted and became more visible up to and including 2012. As non-commercial banks, they could not list on the stock market, nor effectively attract additional private investment capital (since they could not be allowed to control the board or the caja) or otherwise act as private companies. Cajas also continued to have very close connections to local councils and a series of legally binding mandates to perform social policy functions for them, including the provision of city and regional infrastructure and social housing (Royo 2013). With their options limited, and the Bank of Spain conducting stress tests and demanding that they improve the quality of their assets or raise capital, cajas turned increasingly in 2008 and 2009 to the ECB for loans secured with collateral (repo operations) and purchased government bonds to replace the non-performing mortgages on their books.

State intervention

At the same time, strong state intervention by the Spanish Finance Ministry was driven by a sense of urgency to clean up the banking sector. In part, this was to assuage international investors' fears that the state would not be called upon to bail out insolvent cajas.[1] This led the ministry to attempt consolidation of the problem-ridden assets of Spanish banks, including those of the cajas, as early as 2009. The Fond de Reestructuración Ordenada Bancaria (FROB) was established with a capital of 99 billion euros of public money as a bad bank to take on troubled assets and to funnel loans and cash injections into banks as needed. A German-style institutional protection scheme, in which banks would monitor each other and become responsible for the losses of failing banks (Deeg and Donnelly 2016), was introduced as the Banco Financiero y de Ahorros (BFA) in December 2010 (see below). The country's deposit insurance system (Fondo de Garantia de Depositos en Cajas de Ahorro) would serve as the final line of defence against insolvency spreading to other banks (in theory). The European Commission would oversee that state aid would not distort economic competition by advantaging particular institutions (European Commission 2010). This was designed to prevent bank failures from becoming systemic crises.

Cajas were pushed to merge together in the hope that healthier banks would compensate for the weaknesses of others over the next three years. Bankia was established as an amalgamation of several cajas that had been resolved and recapitalized and had non-performing assets removed into the FROB for long-term resolution.

By May 2010, the state aid and financial engineering initiatives had proven insufficient to deal with the financial challenges cajas had to deal with (economic stagnation increasing non-performing loans), and a series of mergers further consolidated the sector. Caja Castilla-La Mancha had failed to recover after state aid in 2009 and was taken over by Cajasur with the government guaranteeing against losses. The FROB then provided five-year loans to establish the BFA as a bad bank, which would acquire and gradually sell off NPLs and foreign investment for seven other cajas (Bankia, Bancaja, Caja de Canarias, Caja de Avila, Caja de Laeitana, Caja de Segovia and Caja de Rioja), with Bankia becoming the new 'good bank' for Spaniards. The BFA became a combination of holding company and institutional insurance system. Following this, Bankia attempted to raise capital on the stock market to increase its available funds. This was an important test of market confidence that the restructuring to date was sufficient to solve the sector's problems. Bankia raised 3.5 billion euros, which was significant but later turned out to be insufficient to keep the bank solvent (Johnson 2011).

The government also re-regulated cajas to restrict their behaviour and prevent future aggressive risk taking. In 2011, the Spanish government mandated that cajas return to their original role as local/regional providers of basic financial services, particularly savings and loans. Their own deposit insurance was forcibly merged with that of the large commercial banks, effectively subsidizing them through their commercial counterparts (Deeg 2012).

These interventions ameliorated the cajas' financial problems, but problems remained. Rumours of undisclosed financial shortcomings at various cajas continued until Bankia requested financial assistance from the national government in May 2012. The state's reaction resulted in the successful turnaround of the Spanish alternative banking sector.

Personnel changes and audits were the first changes made. Bankia president Rodrigo Rato stood down on 9 May 2012 and was replaced by Jose Ignacio Goirigolzarri from BBVA, who promptly announced a capital shortfall of 4.3 billion euros (rather than a small surplus, as previously reported), requested a bailout from the government, and submitted to stress tests by the Bank of Spain and consultancy firm Oliver Wyman. They found 21 billion euros in losses for 2012, and 59 billion for the Spanish banking system as a whole (Aguado and Pinedo 2020). Bankia was unable to repay its initial loan from the FROB. The FROB then converted its debt into shares, owning 45% of Bankia, closed down the BFA and added 19 billion euros of financial transfers to assert state control and ensure continued service. The rest of Bankia's board resigned. All cajas lost their investments, not just the original seven, but others that had invested in the BFA.

Calling on the ESM

In June 2012, government efforts had failed to end the vicious circle fully, and the government called on the ESM to strengthen its mandate and available resources to further reduce bank politicization. The Spanish government asked for 37 billion euros in loans from the European Financial Stability Facility, which would soon become the ESM, to help cover these costs, adding that the funds were needed solely to restructure and recapitalize the banking system. Negotiations for a Memorandum of Understanding were undertaken with the ECB, Commission and International Monetary Fund (IMF). The hope was that financial markets would not question the country's commitment to balancing its budget; above all that restructuring banks would stop the need for state aid to prop up the financial system. The Eurogroup met this request with an open mind, and the two sides negotiated terms that included a fuller audit and stress testing of the Spanish financial sector over the rest of 2012, so that the country's borrowing needs could be assessed, and conditions calibrated to meet the perceived shortcomings of Spanish banking practices.

This arrangement gave the Spanish state time and political room to make changes to the banking system that went further than had hitherto been possible. Spain gave the FROB fully fledged resolution authority powers in August. It could order any bank to transfer NPLs to a bad bank. In December, the state created Sociedad de Gestion de Activos procedentes de la Reestructuracion Bancaria (SAREB) as this bad bank, with a time horizon of 15 years to hold and gradually sell NPLs. At the same time, it would solicit investment primarily from remaining cajas, from Santander, Deutsche and Barclay's banks, as well as other investors abroad to buy the assets (de la Torre Viscasillas 2013).

SAREB's creation allowed the Finance Ministry to collect 55% of the capital required to finance the NPLs on its books from private investors, with the other 45% coming from the Spanish treasury. Beyond this, SAREB was allowed to attract further investment by selling subordinated debt to leverage its capabilities, which were purchased primarily by foreign insurance companies. Finally, the ECB suggested that SAREB also act more like a bank to extend credit to potential buyers of NPLs, or to contract outside asset managers to do this on SAREB's behalf. The Spanish government chose the latter, with the result that international private equity firms TPG, Apollo, Blackstone and Cerberus invested in platforms to invest in NPLs from specific cajas (Chassany et al. 2013). With these facilities in place, SAREB was able to take on another 55 billion euros of NPLs from a variety of cajas by January 2013. Overall, banks were retained, and commercialization/marketization enhanced thanks to enhanced state power, both in authority and resources.

At the same time, the reforms envisaged that the cajas would become less politicized at the local level. They would lose their responsibilities for funding health, housing and social services that were part of their original mandates. In the Spanish government's eyes this meant ending the co-dependence of cajas and local councils, both as purveyors and shapers of social policy, and as mutual providers of financial capital and financial guarantees on a long-term basis. Henceforth, separate foundations would be established to undertake these functions. They received initial funding in the process of restructuring the banking system but were expected to solicit funding from the private sector as well.

Critical in understanding the Spanish state's goals, and its capacity in achieving them, is the experience of the preceding three years, and in its strategy of working with the ESM to force through the kinds of highly political changes that severed cajas from local politics and public policy (Tymkiw 2012). The previous three years had been dominated by the central government attempting to consolidate the caja system, and having partial but insufficient success. Ties to local government and to social policy provision were by this point considered a stumbling block to reducing loans (to local communities), and therefore NPLs over the long term (*El País* 2012). Caja sales of subordinated bonds to depositors threatened to further politicize and slow reforms.

Although controversial and perhaps undesirable in itself, depoliticization was hoped to stop the banks' increasing financial problems. This was not the entire strategy, however. It was hoped that external investment would support Spanish cajas once the restructuring was over, so that the Spanish VOFC would be even more internationally commercialized than before the reforms. Reduced political ties and responsibilities, and a bail-in of small subordinated debt holders, were an important part of this strategy to lure international investors back to banks seen as more commercial and less politicized (Johnson 2013). Introducing the legislation, the Spanish finance minister Luis de Guindos underlined that the reforms were unfortunate, but necessary demands of the ESM, the ECB and the European Commission (Johnson et al. 2012). External pressure was used to complete reforms that otherwise would have been much more limited, and more like the Italian reforms discussed below.

The outcome of these changes allowed further restructuring. In May 2013, subordinated debt holders were bailed in and new capital raised through preferential shares. Bankia was able to access capital markets once again, although the state through the FROB retained 60% of shares in 2019. The plan was that once Bankia's share price rose strongly enough to issue new shares and pay off its debt to the FROB, that it would do so. In 2021, a deal was struck to sell Bankia to Catalonia-based CaixaBank (Bankia Caixa 2021), which had a distinct commercial strategy (Buck 2015).

Banco Popular

Banco Popular's resolution five years later demonstrates the consequences of the Spanish state's increased institutional capacity and its willingness to resolve banks within the BRRD's rules. Popular, based in Madrid, was one of Spain's larger alternative banks that had survived earlier restructurings and mergers by absorbing smaller competitors, securing foreign investment (Varde Partners, Citibank, Bx+ and Dexia), selling off various assets and divisions to raise capital and using the proceeds to deal with the financial problems of the cajas it took over. By June 2017, when the ECB declared it failing or likely to fail (FOLTF), it represented nearly 14% of all deposits in Spanish banks and was therefore nationally significant.

The FROB and the Bank of Spain interacted primarily with Santander as a potential takeover candidate and, with an agreement in hand, presented a proposed takeover to the SRB as a fait accompli. The Board promptly recommended resolution along the terms of the proposal, which the Commission approved within hours, making final administrative approval a one-day procedure. The terms and the speed of the approval demonstrate how the SRM was envisaged to work, in a relatively simple resolution from the perspective of the resolution authorities. (International Association of Deposit Insurers 2014: 13–15). In short, the SRM worked well because the Spanish resolution mechanism worked well, and because there were good preconditions for making it work for the Spanish authorities.

Under the BRRD, banks and national resolution authorities should have established and agreed resolution plans before a real insolvency arises. When insolvency is on the horizon but not imminent, these plans can be supplemented with a search for specific solutions. For example, is there a takeover candidate, for what parts and on what terms? This happened in the Popular case in Spain. Subordinate bond holders were wiped out in accordance with the bail-in provisions of the BRRD and shareholders lost their investments as well. Santander paid 1 euro to take over the bank. Moreover, because Santander was willing and able to purchase Popular outright and then deal with the separation and sale of assets itself, it saved the FROB, as the Spanish resolution authority, the task of managing this itself (MercoPress 2017). These were not insignificant business dealings. Popular had subsidiaries in Portugal, Latin America and the United States that were sold off to local competitors, as well as a significant real estate portfolio. Santander sold just over half to the Blackstone real estate group for 5 billion euros. This both raised capital and reduced (potential) NPL exposures. The Spanish state prepared this resolution over the course of six months or more, allowing it to construct terms of its own choosing and have them approved.

The interim conclusion on Spain is that we witness an overall pattern of liberal economic nationalism that works well within the institutional and legal constraints of the BRRD. The state was early and vigorous in its establishment of mechanisms to restructure bank finances, push mergers, mandate cross-subsidization, and eventually, to cut cajas off from their local political obligations and connections. The latter did not emerge until after the agreement with the ESM to strengthen the

Spanish state's surgery on the banking sector, however. This suggests that it worked well because the state had leveraged terms with the ESM to enhance the interventionist power of the state, both in mandate and resources. Had this not happened, Spain might have ended up stuck with local, politicized limits to its capacities to reform. Furthermore, when problems resurfaced with Popular years afterwards, the institutional capacity and will to impose bail-ins facilitated the bank's transfer to Santander, meaning the state needed no additional financial resources. Overall, Spain's successful resolution outcomes are not just a question of being hit earlier and harder by a financial crisis, and of acting earlier than Italy, but are also related to a combination of state strength, magnified by binding agreements with and resources from the ESM, designed to accept and impose terms of resolution as set out in the BRRD.

Italy

Italian banks were considered politicized, public entities until the 1990s. The Amato reforms of 1990 started the process of privatizing and commercializing a significant portion of the banking sector, but banks were still controlled by foundations in which political stakeholders such as local councils were heavily represented. The 1998 Ciampi reforms reduced these holdings to no more than 50% of bank shares. The Italian government and Bank of Italy encouraged mergers, resulting in hundreds of acquisitions from 1995 onwards (Bilotta 2017; Culpepper and Tesche 2021; Deeg 2012). A result of these reforms was the formation of three large commercial banks: Intesa San Paulo, Unicredit and Monte dei Paschi di Siena (MPS), and a larger number of regional, politicized banks. Meanwhile, the Bank of Italy engaged in mercantilist economic nationalism. President Antonio Fazio blocked takeovers by foreign investors, as when he thwarted Banca Antonveneta's takeover by the Dutch bank ABN AMRO in 2005, in violation of European competition law. The state's capacity to act as a gatekeeper for investment in the banking sector was sufficient for this role. Fazio's replacement, Mario Draghi, ended such overt nationalist intervention.

The Finance Ministry also effectively backstopped the country's deposit insurance system (Fondo Interbancario di Tutela dei Depositi), which it traditionally used to restructure rather than resolve banks until the practice fell foul of European Commission rules on state aid (Banca Tercas, December 2015). The Finance Ministry did not require the power to force domestic banks to run their affairs in a certain way, which was a more demanding task. This restriction caused further difficulties for Italy's capacity to handle bank insolvencies, and turned attention once again to the state's capacity to intervene in the affairs of troubled domestic banks. As with other EU Member States, Italy added a bank-financed National Resolution Fund in 2015 to add to available resources in conjunction with the Single Resolution Fund. Unlike in Spain, however, in Italy the resolution authority remained within the central bank and by this time, the BRRD had restricted the ability of the state to inject capital into bad banks to hive off NPLs.

Unlike Spain, Italy's banks derive their funding more strongly from deposits, and operate in a more established but lower-growth economy, without exposure to housing bubbles or (international) marketization (Deeg 2012). Their difficulties also followed a different trajectory. While UniCredit and Intesa were more aggressively commercial and international, MPS remained more national and traditional despite its enormous size, and therefore less diversified between Italian and foreign businesses. It therefore felt economic problems more directly than its two commercial rivals. Nevertheless, its lending profile and interconnectedness with local communities ensured that it was exposed to many of the same challenges as smaller, alternative banks. Regional banks, meanwhile, performed primarily financial services for local households and communities, including city councils, but remained largely within their regions and traditional lending practices. In short, Italian banks were less risky and fragile than Spanish ones based on international marketization. But their capacity to respond to declining economic fortunes proved to be weakened by the very links to local communities and councils that supported them in better times.

The crisis for Italian alternative banks arose through the deteriorating, stagnating economic situation of the country, which led to higher incidences of nonpayment of loans, particularly after the 2008 global financial crisis, but preceding it as well. In contrast to their Spanish counterparts, Italian banks had no foreign investors concerned about the viability of the bank, and so were less keen to restructure and write off loans to local communities to secure foreign investor confidence (Quaglia and Royo 2015). This bulwark against investor pressure did not last, however, as banks increasingly turned to their own depositors to finance the bank under difficult conditions – depositors who then were exposed to losses if a bank were bailed in under the BRRD. In sum, the Italian banking crisis was compounded by domestic marketization.

These secular weaknesses were exacerbated by extraordinary bank reluctance to countenance bail-ins, or any significant reduction in the value of (non-performing) loans on their balance sheets, given the impact on local stakeholders. This in turn was driven by corporate managers and stakeholders with links to important investor families and local councils. For them, declaring loans as non-performing and insisting on liquidation would hurt investments and public finances, and place additional pressure on them to provide additional capital themselves, or open up the bank to outside investors, who would first arrive when a thorough cleansing of the balance sheets had been done (Pometto 2018).

State initiatives

There were four issues working against a Spanish-style restructuring. The first two were discussed above: bank resistance and reliance on domestic marketization. The third was weaker state intervention, both horizontally and vertically. While the Bank of Italy recognized problems in Italian banks and demanded that banks raise capital, the Finance Ministry denied the existence of structural problems that required more than temporary liquidity support. This is reflected in the lack of a bad bank that could separate NPLs from bank balance sheets with state aid assistance, and a resolution authority benefiting from an initial public investment from the government, when it was still possible. The window for using state financial resources had closed by 2014, once the extraordinary allowances of the DG Competition for state support of banks following 2008 had expired, and the

Banking Union had decided to restrict state aid in favour of private investor bail-ins as the first and heaviest contribution to bank resolution under the BRRD (Howarth and Quaglia 2014). Importantly, the absence of a bad bank made it possible for MPS (and other Italian banks) to resist the sale of NPLs at any significant haircut.

This lack of intervention meant that in 2015 and 2016, when it became clear that reducing NPLs was unavoidable, the government found itself cajoling private banks into creating private funds (Atlas 1 and 2) that would effectively act as bad banks, but without state support, since this was no longer possible. The Atlas fund ran from April 2016, funded with 5.5 billion euros by five banks (the big three banks plus Popolare de Milano and UBI), to help with recapitalizations of other banks if they could not raise the money on the markets (Schoenmaker and Véron 2016). These special-purpose vehicles were underfunded considering the magnitude of problems faced, leading to concerns that it could not be used for systemic problems (see particularly the cases of smaller regional banks below), and fraught with suspicion by the participating banks that money would either be siphoned off quickly into subsidizing bail-outs of specific banks, or subsidizing a particular bank's takeover of a failing institution.

Fourth, the Italian legal system's handling of insolvencies, bankruptcies and haircuts posed obstacles for outside investors seeking to secure rights to discounted assets, and led to concerns between banks about collectively funding special-purpose vehicles. Silvia Aloisi and Paola Arosio (2016) underline that Italian insolvency law meant that court proceedings could take eight years on average to sort out claims over discounted assets rather than the four years typical across the EU, making investment less attractive and financial support from other banks riskier. These legal features led to concern by outside analysts that NPLs would neither be sold nor reduced in value, that financial problems would persist, and that healthy banks would bleed for sick ones in the Atlas funds. Some speculated in particular that the money would be used to subsidize UniCredit's underwriting of 1 billion euros in capital raising for Vicenza. At the same time, the understanding from Intesa was that the assets would be sold at close to book value, and not at a heavy discount to (foreign) private equity firms. The government pressured banks to invest to avoid a systemic run on Italian banking (Aloisi and Arosi 2016). The study below will look first at small regional banks, and then at MPS, which remains unresolved.

Regional banks

A pattern of distressed regional alternative banks replicates the pattern of politicized banks having difficulty shedding losses, raising capital and returning to health. Initial problems had less to do with commercialization than with poor economic circumstances leading to high NPL levels. In three regional banks resolved between 2013 and 2015, the primary deviation from their traditional, regional focus was expansion into nearby markets rather than financial engineering or wholesale finance. But local identity and political ties led those banks to double down on local sources of political and financial support and pose barriers to resolution. In each case, the Bank of Italy demanded recapitalization, which led the banks to turn to local businesses and depositors instead of outside investors.

Carige failed to raise sufficient capital after 2009 and entered administration by 2013, with parts sold off to Ferrera and Banca Popolare dell'Emilia Romagna (in 2017). Other resolutions failed due to local political and bank resistance. Banca Etruria e del Lazio refused a central bank demand to write off NPLs, selling subordinate bonds to its own customers and raising additional capital from local businesses instead in 2013. It further refused a takeover from rival regional Banca Vicenza in 2014 on grounds of regional identity and in 2015 was charged with negligence and failure to act on supervisory orders (Bank of Italy n.d.). Banca delle Marche also turned to its own depositors and local businesses but entered administration in 2013 and was resolved in 2017 (Pometto 2018).

Veneto and Vicenza

Two larger regional banks, Banca Veneto and Banco Popolare di Vicenza, demonstrated similar reluctance to reduce NPLs and recapitalize between 2014 and 2017, making a BRRD-compatible resolution impossible, and pressuring the national government to seek special terms from EU institutions. V&V, as these two banks would become known, enjoyed political patronage from local businesses and politicians, and resisted pressure from national authorities to govern the bank in accordance with Italian banking law, with lending sometimes being dictated by political rather than other criteria.

Vicenza had great financial problems and undertook a recapitalization in 2014 without informing or getting consent from shareholders, and then requested state aid. The ECB and the Italian Financial Markets Authority (Consob) investigated for corporate mismanagement, demanded Vicenza open its financial accounts, have an investment bank underwrite a listing on the stock market and raise 4 billion euros. UniCredit, the prospective underwriter, discovered that a billion euros from the 2014 recapitalization had 'vanished' and backed away from promises to guarantee the share sale. The Atlas fund, financed by contributions from other Italian banks, eventually insured UniCredit for potential losses and ended up buying 99% of the shares when investors refused to buy. Meanwhile, Vicenza continued to book losses amounting to 1.9 billion euros in 2016.

Veneto faced similar problems. In 2014 plans to raise 1 billion euros failed and were followed by a 1.5 billion euro loss in 2016 and ECB calls for a 3.1 billion capital raise. The Italian government drew up plans to support a merger of Vicenza and Veneto (now V&V) comprising a recapitalization, emergency liquidity assistance from the ECB and state debt guarantees through the newly formed Salvabanche fund in December 2016. The total requirement was 6.4 billion euros. In May 2017, the DG Competition was willing to approve the plan if 1 billion euros came from private capital. But Italian banks failed to finance an Atlas rescue package that would leave bondholders unscathed, citing fears about future NPL overexposure (*La Repubblica* 2017).

V&V's case led to functional economic nationalism. The Finance Ministry, along with the prime minister's office, refused to accept a BRRD bail-in, due to the damage it would inflict on a large number of stakeholders, particularly bank clients (Sanderson and Arnold 2017). It acknowledged it needed EU approval to use a BRRD loophole permitting a so-called precautionary recapitalization, state aid in the form of temporary loans to be viewed as patient capital (precluding mercantilist economic nationalism) that required the ECB and Commission to approve. The government asked the ECB to declare V&V solvent so that it could proceed (allowing temporary loans for an otherwise solvent bank). The ECB refused and declared V&V insolvent.

However, the SRB and Commission then came to Italy's aid. The SRB, with the Commission's support, declared that V&V were not systemically important, allowing Italy to resolve them under national bankruptcy law without a bail-in. The government then sought and won Commission approval to use state aid (4.8 billion euros) and guarantees against future losses (12 billion) to sweeten a takeover. Intesa San Paolo bought V&V for 1 euro under these conditions in 2017 (Culpepper and Tesche 2020). The Commission approved on the basis of V&V's systemic importance – that its interconnectedness with the local economy was so crucial that they were systemically important despite their small size (European Commission 2017a). Shareholders and subordinated bonds lost value, but not as much as under the BRRD, and with EU-sponsored state intervention. We see here that weak state coordination and domestic marketization lead national government to pursue functional economic nationalism.

Monte dei Paschi di Siena

MPS is a large bank but shares features of local political connections and support with regional banks. It similarly promotes Italian government resistance to BRRD implementation, regardless of the Bank of Italy's efforts to get the bank restructured and recapitalized. Italian state demands that Italian banks increase capital began as early as 2009, with the Bank of Italy, the European Banking Authority and the IMF raising concerns about the level of capital required by MPS. In this case, we see an explicit involvement of the Finance Ministry to indirectly support the bank, given a lack of private investor enthusiasm. MPS issued Tremonti bonds (subordinated, hybrid, government-backed bonds that could be converted into shares) and Monti bonds to raise 4.1 billion euros in capital in 2009, but the Ministry of Finance bought almost all of them when investors failed to buy. MPS borrowed another 5 billion euros in new bonds in 2014, and then attempted to raise another 3 billion in 2015 to backfill repayments to the state. When investors failed to bite, MPS's stock price plummeted, making a future capital increase unlikely to succeed (*Il Fatto Quotidiano* 2015).

When the ECB used its supervisory power to demand that MPS shed NPLs from 2014 onwards, MPS would not sell at a large enough discount to entice investors. The ECB demanded in April 2016 that 7 billion euros worth of loans be liquidated. When MPS offered NPLs at a rate of 30% in an attempt to raise 5 billion euros in July, investors failed to buy, and the bank turned to its own depositors as investors, selling them subordinated bonds instead. By December, this had failed to raise more than half of the sum MPS sought. The bank requested assistance from Atlas but failed to get it from other banks.

On 23 December 2016, MPS, together with the Bank of Italy and the Italian Finance Ministry, requested an exceptional precautionary recapitalization. The Commission and ECB agreed, declaring MPS solvent and eligible on 26 December. On 4 July 2017 the Commission approved 8.1 billion euros in assistance, including 5 billion in state-owned shares. Loans booked at over 26 billion euros were sold for 5.5 billion (representing a larger discount than previously offered), and investors who had transferred deposits into subordinated bonds were bailed in. However, the Commission approved state compensation of 1.5 billion euros to them by the Italian state after heavy lobbying by the Italian government, effectively nullifying the application and intent of bail-ins in accordance with the BRRD (Nicoletti 2017). The Commission's permission cited consumer protection, given MPS's mis-selling of subordinated bonds to unsuspecting customers (European Commission 2017b).

While MPS remained a nominally private bank, significant state ownership and bond guarantees remained a reality, and the bank was obligated to pay back the state (or be taken over by another bank that would) by the end of 2021. By then, however, the bank could not pay, and the state retained its stake. Overall, NPL reduction was achieved through this exceptional initiative to a degree that had not happened previously, and without the conditionality of the ESM. Instead, the conditionality of the ECB and European Commission served this function (Moschella and Quaglia 2019).

MPS restructuring and resolution demands attracted strong political resistance at that national level as well as the local. Guido Bastianini, former head of Carige, was appointed CEO in 2020 at the behest of the Five Star Movement party (Fonte 2022). He opposed privatization and restructuring in line with EU institutional and legal requirements, and resisted demands from other voices in government that he resign to pave the way to repay state aid.

By the end of 2021, under the terms of the agreement with the European Commission, the Italian state was obligated to sell off its stake in MPS to another bank. This would fulfil the terms of viewing the state as a temporary provider of patient capital, which would be permissible, rather than outright state aid, which would not. Either way, MPS would have to repay the money invested in it by the end of the year. However, it was not possible to find a domestic buyer.

All this while, UniCredit was approached as the candidate to take over MPS. Its hesitancy was high, underlined by the CEO's condition that a takeover pass five tests. These included that a merger could not increase UniCredit's NPL load, and not worsen its capital position (Walker and Ghiglione 2021). By its own calculations, UniCredit demanded 7 billion euros in payment to offset these risks, while the government would not pay more than 2.5 billion (Morris 2021). Reports started to circulate as a result of this impasse that the Draghi government would request an extension of the five-year period during which the state could act as patient investor (Ghiglione 2021) to the European Commission.

However, in February 2022, the Draghi government flexed its muscles to achieve a critical change that could allow a more liberal economic nationalist outcome in accordance with EU law. MPS needed another 2.5 billion recapitalization; the Draghi government was negotiating state aid with the Commission, but also insisted Bastianini step down for refusing to restructure (Sciorilli Borrelli 2022). Bastianini was replaced by Luigi Lavaglio in February 2022, a specialist in restructuring from UniCredit (Za and Fonte 2022). The appointment of Lavaglio from UniCredit opened the door for a restructuring that would satisfy a future takeover by UniCredit. While the pre-2022 behaviour fits the expectation of functional economic nationalism, Lavaglio's appointment suggests that state strength to force changes within Italian banks was stronger under the Draghi administration than its predecessors.

Conclusions

This article shows that the implementation of European bank resolution is largely a story of state power and bank politicization. We see the importance of coordination powers across state institutions in resolving banks at the national level, but also of local government and domestic retail investors that politicize bank ownership, and complicate and sometimes place limits on resolution, even when national authorities attempt to meet their obligations under EU law. We also see that political will to intervene in banks and resolve them without hesitation is part of state power as well. Spain not only acted quickly and comprehensively, it had a unified, coordinated approach between central bank, Finance Ministry and newly established resolution authorities that made quick, decisive interventions in Spanish banks possible. In contrast, the Italian central bank, Finance Ministry and prime minister's office played different roles, with the latter two institutions slowing and amplifying resistance to resolution, at least until the second Draghi government's efforts in 2022 to resolve Monte dei Paschi.

The outcomes were further influenced by national government strategies towards European institutions when resolution became complicated. Spain strengthened its power over local retail banks by allying with the European Stability Mechanism to push through the last of its reforms in 2012 and restore international confidence with thorough resolutions. This initiative furthermore strengthened the state's capacity to resolve a major bank in 2017, long after the Banking Union had introduced limits on state aid. Italy's strategy of seeking adjustments from EU institutions, meanwhile, meant that its own institutions remained less powerful.

This article has also shown that when banks seek outside investment, it matters greatly whether those investors are domestic or international in the variety of financial capitalism. Where it was international, government incentives to act quickly and decisively to sweep aside domestic politicization of banks were strong. Where it was largely domestic, politicization, poor coordination and resolution increased. Marketization indeed increases bank fragility, but in different ways with important consequences.

Finally, this article has built on the literature of economic nationalism by showing how these factors lead to specific state strategies of domestic and European resolution policy. In both Italy and Spain, the governments seek to ensure a bank system owned and operated by domestic companies, but in different ways. Spain not only complies with EU rules, but uses its own role within the Single Resolution Mechanism to produce ready-made solutions for EU institutions to approve. Italy, in contrast, requires a more complex, bespoke process involving EU, national and local levels of government that is distinct from either liberal or mercantilist economic nationalism. A result is that while both Italian and Spanish banking systems are less tethered to public policy goals than they were a decade ago, that politicization remains stronger in Italy – with consequences for the Banking Union's potential to end the country's vicious circle of bank and state financial fragility.

https://doi.org/10.1017/gov.2022.27 Published online by Cambridge University Press

Acknowledgements. We thank Pálma Polyák, Magnus Schoeller, David Howarth, Tobias Hofmann, Claudio Matera and the anonymous reviewers for their helpful comments.

Note

1 Despite low levels of public debt after 2009, bond markets demanded enormous interest rate increases to buy Spanish treasuries through 2012, when Spain reached a loan agreement with the ESM in return for the promise to restructure alternative banks.

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Cite this article: Donnelly S, Pometto G (2024). Banking Nationalism and Resolution in Italy and Spain. *Government and Opposition: An International Journal of Comparative Politics* **59**, 187–206. https://doi.org/10.1017/gov.2022.27