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Private Bankers

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What next in the Italian banking?

What can be expected for Monte dei Paschi? Just 4 possible outcomes.

- Banca Monte dei Paschi di Siena (BMP), the third largest bank, has found it impossible to raise more capital from the market. (after burning through €12bn of new capital since the onset of the financial crisis). A proposed €5bn rights issue from BMPS fell through in December.
- The Italian authorities did secure permission from European Union regulators for a “precautionary” bail-out of BMPS but just provided that private buyers could be found for a portfolio of the bank’s bad loans with a face value of €28bn (Brussels is insisting the private sector must contribute at least €1.25bn before the Italian state can inject the extra €5bn necessary). Just recall that the two banks bailed-out this past week end had a joint NPL of 18.8bn EUR and no private investor showed interest).
- After the two private sector partners of Italy’s Atlante rescue fund last week walked away from a potential deal for BMDP, having failed to agree a price, it is doubtful now whether a privately funded rescue may proceed
- **What next?** Just four possible outcomes can arise for BMPs
    1. **Other big Italian banks are persuaded to put up the capital to buy and recapitalize BMPs.** I can hardly see this as a realistic possibility after Unicredit, Intesa Sanpaolo, and Generali, put up the capital to fund Atlante to acquire the two troubled banks just to be forced to write down the value of their stakes by as much as 50%.
    2. **Private funds (a single big banks or a group of banks) put up the capital to buy the NPLs portfolio of BMDP, enabling the government to continue with the precautionary recapitalization and use public funds to be injected in BMDP.** Well, considering that many of the NPL belong to the sofferenze category (no chance of recovery), and considering also the past experience (write-offs following Atlante’s purchase of troubled banks), I just wonder what is going to be the price paid to buy BMDP’s non performing loans and whether the government will guarantee public funds in case of future losses in this portfolio
    3. **As seen with Vicenza and Veneto, Monte dei Paschi could also be broken up and bailed-out with public funds**. A big player could acquire BMP’s good assets for a “token payment” (while receiving public funds and government guarantees for potential losses), while the government will need to create another “bad bank 2” in order to acquire and manage the NPLs (many of which belong to the category known as “sofferenze”, the poorest quality category within

the bad loan portfolio, with little or no chance of recovery). In the case of Vicenza and Veneto, this category amounted to more than 50% of their NPLs. However, for this to take place it would be necessary that the bank's resolution to be guided by Italian law, and for this to happen, the EU should first consider the bank as a non-systemic bank. I honestly think that this would be surreal but, Who knows? Given the capacity of the Europeans for reinterpretation, as well as their flexibility to break every rule that they impose themselves, I certainly believe that we can see anything.

4. **The Italian government and the EU let Monte dei Paschi to fall.** In my humble opinion, rescuing two small banks and let the third largest bank to fall would be a big mistake. Given what we have witnessed this past weekend, I cannot consider this as a realistic possibility.
5. **The Italian government could simply allow Monte dei Paschi to continue as a zombie institution.** Probably the most easiest course and the most politically expedient with an election approaching, but under a purely economic criteria, this would prove the worst option in the mid-to-long run (as zombie banks might be able to just roll over loans, but in any case to extend credit to promising new business and, thus, they do nothing to promote growth. Instead, when the next cyclical downturn occurs, their bad loan ratios will balloon again.

How is the situation of the Italian banking sector after Vicenza and Veneto are bailed-out:

- Admittedly, Italian banks had managed to reduce system-wide NPLs in the last two years, however this was not, in any case, the improvement that they wanted make us to believe since NPL fell by just a meagre amount, from €360bn in 2015 to €349bn
- Following Vicenza and Veneto rescue, the total NPL will be set at 332bn, meaning that aggregate NPL ratio will barely improve from 17.3% to 16.45%.
- If we add that the common equity tier one ratio will remain similar to the one seen as of Friday 23rd (proven that these two banks have been considered as “not relevant” by the EU’s Single Resolution Board”) it will be fixed circa 11.5%, still some 2pp below Eurozone average, and suggesting that the Italian banking system’s position is certainly precarious.
- Some may argue that Capital and NPL figures have been improving during 1H17 but you must consider that this was entirely due to Unicredit (Italy’s largest bank and the only one of global systemic importance) which raised €13bn (nearly doubling its capital). We all must also consider that Unicredit, as a large bank whose shares feature in international stock indexes, benefits from a broad investor base, making raising capital relatively easy. For the rest of Italian banks (most of them domestic and local) recapitalization is a tougher proposition.

Could Popular work-out provide a suitable model for cleaning up Vicenza and Veneto, or BMP?

- For two important reasons, it would be difficult to apply the same model in Italy:
    1. Firstly, In Italy the private sector is no longer willing to throw good money after bad. Private sector institutions, including Unicredit, Italy's second largest bank Intesa Sanpaolo, and insurer Generali, put up the capital with which rescue fund Atlante last year acquired Vicenza and Veneto. However, Atlante's backers have since been forced to write down their shareholdings by as much as 50%. Understandably, they are reluctant to risk further capital on what so far has proved an unrewarding investment.
    2. Secondly, the two Italian banks have relatively little subordinated debt outstanding. That raises the possibility that a resolution under the SRM could involve the bail-in of senior bondholders. And in Italy, banks' senior bonds are commonly held by retail investors, largely the banks' own customers who were sold the debt as a high yielding alternative to deposits.

Why Vicenza and Veneto did not face a liquidity crisis?

- After Atlante acquired the two banks last year and wrote down a sizable tranche of bad loans, Vicenza and Veneto continued to make losses in 2016 (of €1.9bn and €1.4bn respectively), and were left with CET1 ratios of just 8.2% and 8.1%, and were still sitting on gross NPLs of €18.8bn, equivalent to a combined NPL ratio of 37%. Worse, more than half of these NPLs are classed as *sofferenze*, the poorest quality category with little or no chance of recovery, nevertheless, as of Friday, these two banks held provisions against their sofferenze loans of just 60% (meaning that they required injections of fresh capital to raise their provisioning to more realistic levels.
- Given the two banks' precarious situation (due to bad loan burdens and weak capital positions), **depositors have understandably taken fright**, **with direct funding (deposits) of Vicenza and Veneto falling by €3bn and €4bn, respectively, or by -14.4% and -17.8%.**
- **How they did manage to avert the possibility of a liquidity crisis of the type that struck Spain's Banco Popular earlier this month?** To replace the lost liquidity, the banks relied on two sources of funding: the ECB and government-guaranteed bond issues (Since February, the two banks had issued around €10bn of these bonds, lifting their liquidity coverage ratios)

Best regards,

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