No easy fix for Italian banks

The uncertainty of the UK leaving the EU has had ripple effects on Italy

By Nicolas Roth

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After an already disastrous start to the year, Italian banks plunged 30% following the Brexit vote. Obviously, there is no direct link between Brexit and Italy, but the uncertainty of the UK leaving the EU had ripple effects on Italy, shaking up its very fragile banking sector. Although the problems are far from unknown or new, things have accelerated lately with the resolution of non-performing loans (NPL) and potential bail-in / bail-out for the weaker banks. How long will it take for the country to find a credible solution and will it be sufficient?

As an initial response in tackling the ramping problem of NPL, Italy created Atlante, a private fund designed to participate in distressed bank recapitalisation, but also to buy NPL from banks. Although the initiative is probably a step in the right direction, from a capacity standpoint, the size of Atlante is not sufficient to act as a pseudo bad bank and is just a baby step. Italy needs to create a functioning market for NPL by accelerating the reforms of the judicial processes and adjusting the fiscal treatment of provisions in order to incentivize banks to (i) take write downs (ii) sell their non-performing exposure to private investors. A few bold investors have already set foot in the country to buy NPL from willing sellers; however, the market remains far behind Spain from a liquidity perspective.

If Italy was hoping to solve its NPL problem at its own pace, the letter from the ECB received by the oldest bank, Banca Monte Paschi di Siena early in July was the nail in the coffin. The Central Bank has stressed that Monte Paschi has to reduce their bad loan exposure by around EUR 10bn over the next three years, adding more strain to the sector and pressing the Italian government to come up with something better than a second Atlante fund.

As if the situation weren't unstable enough, European Banking Authorities (EBA) released the results of the second stress tests at the end of July, which advised that Monte Paschi requires a recapitalisation.

EU state-aid rules on additional capital requirements are governed by the European Bank Recovery and Resolution Directive (BRRD), which states that before any public money can be used, the bank must use 8% of total liabilities as a preliminary bail-in. In Italy, approximately 30% of bank bonds are being held by retail investors due to preferential tax treatment of fixed income instruments. The legal side of the headache lies in the strict application of article 32 (4.d) of BRRD, which has an exception to the trigger of a resolution. “Extraordinary public financial support” could be granted to a solvent institution “in order to remedy a serious disturbance in the economy of a member state and preserve financial stability”, but the amount will be limited to the shortfall identified by the EBA stress test. Under this exception, only equity and junior bond holders would share the pain, helping Renzi to soothe voters in October's referendum.

The political headache involves not only Matteo Renzi but also Germany. Angela Merkel and a number of other EU members are also calling for a flexible application of EU state-aid rules. In the case of bail-in involving senior bond holders, which would most likely result in the end of Renzi's political career, the populist and anti-establishment movement 'Cinque Stelle' would probably win in October, and this is exactly what German Chancellor Merkel is trying to avoid.

What's next for Italian banks?

Different scenarios could emerge from the outcome of the EBA stress tests, but something has got to give in all scenarios.

In the most basic case, a number of banks are due to recapitalise and unable to do it without hurting equity and subordinated debt holders. Since junior debt is massively held by retail investors, private investors are bailed-in and bear the losses. More recently, there have been talks on differentiating institutional and private bond holders in a bail-in process, which seems highly unlikely after the failed bail-in of Novo Banco that has triggered a number of institutional investors, such as PIMCO, Blackrock and Elliott Capital, to sue the Bank of Portugal.

The worst case would be a very strict EBA outcome, with a requirement to drastically reduce non-performing exposure, resulting in a severe shortfall for a number of banks. Bail-in would therefore hit the entire capital structure, including senior bond holders, and diminish the already low levels of confidence in the Italian banking system.

The best case would be if the EU allows Italy to trigger article 34 (4.d) of BRRD for the injection of public money without triggering a bail-in, which seems very unlikely if the EU is not willing to be flexible in the application of the Bank Recovery and Resolution directive.

There are clear risks in all scenarios. On the one hand, the political future of Matteo Renzi might be at stake as the savings of Italian private investors would be at risk in the case of a bail-in. On the other hand, the credibility of the EU and its set of regulations are at risk if it is willing to bend the rules for Italian banks, which would set a dangerous precedent and negatively impact the confidence of investors. There is no easy fix for Italian banks and either way, the country is likely to be on the growing concern list for investors over the coming months.

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