Italy Slowly Moves Toward Comprehensive Bank Rescue

Summary

- For the past several years, the European Central Bank (ECB) under Governor Mario Draghi has carried the world of banking in the European Union on its shoulders. Kroll Bond Rating Agency (KBRA) believes that the political shock of the vote in the UK has forced the EU to begin moving towards some type of direct aid for banks, but there remains enormous opposition from some EU member states.

- KBRA believes that the core nations of the EU led by Germany must quickly put aside their reluctance to commit resources to support a comprehensive bailout of Italy's banking sector. Just as the U.S. learned through bitter experience in the S&L crisis of the 1980s that delaying the clean up of troubled banks greatly increased the ultimate cost of resolution, the EU's political leaders seem unwilling to take the painful steps needed to avoid financial contagion.

- One way or another, KBRA believes that the EU must collectively face the problem of bank solvency. By delaying the inevitable process of restructuring, the EU runs the risk of a "surprise" to the financial markets that could quickly metastasize into a larger political crisis. Indeed, precisely that scenario seems to be unfolding in the EU today.

Discussion

For the past several years, the European Central Bank (ECB) under Governor Mario Draghi has carried the world of banking in the European Union on its shoulders. The extraordinary efforts of the ECB, however, have not been sufficient to avoid a crisis of confidence in Italy, a crisis that now threatens investor confidence in the community as a whole. While the markets were recently roiled by the vote in the UK to leave the EU, KBRA believes that the festering problems affecting the financial institutions in many of the EU member states is a far more serious issue. As we noted in our previous report, **Will Negative Interest Rates Save Europe's Banking System?**:

> "Now over eight years since the financial crisis, the European Central Bank (ECB) has embarked upon a radical policy of debt purchases and outright subsidies for banks. ECB Governor Mario Draghi seeks to do via monetary policy what German Chancellor Angela Merkel and other elected officials in the EU cannot or will not do, namely deal directly with the asset quality problems festering inside the EU banking system by writing down bad debts and converting debt to equity."

The political shock of the vote in the UK has forced the EU to begin moving towards some type of direct aid for banks, but there remains enormous opposition to direct state aid. The European Commission finally authorized Italy to use government guarantees to provide liquidity support to its banks, the first intervention by an EU government into its banking system.[1] Like the efforts by the ECB to provide financial support to the community's banks via monetary policy, however, state support in the form of official guarantees represents yet another temporary expedient. As we've noted in our previous reports, the €1 trillion in bad loans publicly acknowledged by the EU represent a fraction of the overall asset quality problem.

Italian Prime Minister Matteo Renzi reportedly remains at loggerheads with Brussels as the EU insists that investors take losses before taxpayers provide new cash. Meanwhile, the Italian government wants to protect investors, as many households have bought the banks' subordinated bonds. Italian banks have disclosed a combined €360 billion ($401 billion) of bad debts, equivalent to about a quarter of gross

[1] Valentina Pop et al, "European Commission Authorized Italian Government to Support Banks," *The Wall Street Journal*, June 30, 2016.

domestic product. While the official statistics are bad enough, KBRA notes, the reality may be far worse, in part because international accounting rules allow banks and governments to indefinitely delay recognition of non-performing assets. Significantly for debt investors, timelines for the resolution of bad loans in the EU can extend out years, even decades, and are driven by government-appointed administrators that frequently take a pro-debtor position in restructurings.

One of the major sources of public anxiety is the fact that the EU nations have not followed established rules for dealing with troubled banks in a consistent and transparent fashion. EU officials also have refused to consistently "bail in" bond holders of EU banks by converting debt to equity, a partial solution to the solvency problem that apparently is politically unacceptable. The fact of a bail-in, however, while reducing debt service expenses, does not provide the financial institution with significant new cash. Because the EU lacks a federal fiscal agency with receivership powers similar to the Federal Deposit Insurance Corporation in the US, the community is essentially in the position of the US prior to 1933. Before the FDIC was created in that year, bank insolvencies were dealt with by receiverships overseen by the courts of the individual states. This arrangement made it problematic, for example, for the Federal Reserve System to lend to banks because the state courts would not give preference to the security interest of the central bank for discount window loans.

In the case of Italy, over the past decade the country's banking system has moved from institutional funding sources to selling junior bonds to retail investors. As a result, the political system's reaction to growing problems in the nation's banks is one of growing alarm. Italian Prime Minister Renzi says he wants urgent bank reform but does not say how it should be accomplished. Significantly, the Bank of Italy has called for a ban on the sale of subordinated bank debt to private individuals. Such a ban would effectively cut off the remaining funding source for Italy's banks.

Authorities ranging from Bank of England Governor Mark Carney to Deutsche Bank chief economist David Folkerts-Landau have called for a direct bailout of some $150 billion, but KBRA believes that this figure is inadequate and represents merely a down payment on a full solution to the crisis. Meanwhile, EU officials refuse to consider direct infusions of capital from the governments of the member states. Dutch Finance Minister Jeroen Dijsselbloem has stated that he is not "particularly" worried about Italian banks:

> "The only thing that to me is very important is that we respect what we have agreed between us, because otherwise everything will be questioned in Europe… There have always been and will always be bankers that say 'we need more public money to recapitalize our banks.... and I will resist that very strongly because it is, again and again, hitting on the taxpayer… the problems with the banks need to be sorted out in the banks and by banks."

Bail-In vs. Bail Out

Under EU rules requiring the "bail in" of debt holders in the event of bank , Italy faces the prospect of wiping out millions of retail investors. Estimates of the total amount of money that is potentially subject to a bail-in easily exceed €1 trillion, or twice the amount of bad loans admitted in official statistics. The pressures building on elected officials in the EU are intense and have caused Renzi to publicly attack ECB head Mario Draghi for not doing enough to help Italy's banks. These striking developments have gone largely unnoticed by investors, media, and policy makers outside the EU.[2]

For years now, the ECB has been pouring liquidity into the Italian banking system, in part because the banks are funding the debt issuance of the Italian government. As one well-placed EU analyst told KBRA last week, "the priority during the 2008 financial crisis was for the banks to fund the state, and for the private sector to fund the banks." The liquidity provided by the ECB ran right back out the door, however,

[2] War Of Words Erupts As Italy's PM Slams Mario Draghi: "You Could Have Done More To Help Italian Banks" *Zero Hedge*, July 5, 2016.

as retail and institutional investors frequently have been bailed out and the insolvent banks have been supported with government guarantees and inflows of fresh funds from new retail investors.

Earlier this year, Italy created a fund known as Atlante, which raised €4.25 billion from domestic and foreign institutions to help the country's lenders raise capital and reduce bad debt.[3] Italy has been seeking approval from the EU for a waiver of the requirement to bail in bond holders of troubled banks. Such an exemption, however, requires unanimous approval by EU member states. The EU approval of official loan guarantees marks a significant change in previous opposition to state aid, yet KBRA believes that the amounts raised by Atlante are clearly insufficient to address the bank solvency problem.

Meanwhile, the EU continues to put pressure on Italy's banks to clean up bad assets. Monte dei Paschi di Siena (MPS), the third largest bank in Italy by assets, confirmed last week that it had received a letter from the ECB demanding that the bank reduce bad debt by a third over the next several years. But with MPS trading at a fraction of net asset value, there seems to be no possibility of the bank funding the cleanup on its own. Without significantly increased resources from the cash-strapped Italian government or, more likely, the other EU member states, MPS's successfully shedding bad assets will require the large-scale conversion of subordinated debt to equity and new cash. In the event of a bail-in scenario, retail investors in Italy would be forced to take significant losses, which could lead to a political crisis.

Deliberate Action Needed to Avoid Contagion

KBRA believes that the core nations of the EU led by Germany must quickly put aside their reluctance to commit resources to support a comprehensive bailout of Italy's banking sector. By delaying the inevitable resolution or recapitalization of insolvent banks, the EU member states have allowed the mass flight of junior and unsecured investors, leaving the various EU member governments to shoulder the burden and/or worsening the outcome for other investors.[4] Achim Dübel (2013) of Finpolconsult notes:

> "A particularly bad example is Germany, which only weeks prior to the 2013 DG Competition ruling on 'junior bank bond bail-in first' coming into force got EU clearance for implicit protection of €3 billion in junior bank bonds through government guarantees at the ship finance bank HSH Nordbank. These guarantees have come due in the last months, inducing major fiscal stress at the guarantors, the German states Hamburg and Schleswig Holstein… Italy of course has gone to great length to protect junior bond investors at MPS and in other historic cases, with the same result. The junior bank bailout in Greece added some €2-3 billion to the Greek government debt that could be better invested in a country in depression… Spain is a prominent case that was forced through delays in junior debt bail-in, which permitted professional investors to exit the banks, to concentrate the eventual bail-in on retail investors, which maximized the political costs."

The U.S. learned through bitter experience in the S&L crisis of the 1980s that delaying the clean up of troubled banks greatly increased the ultimate cost of resolution. EU political leaders (the ECB not withstanding) seem unwilling to take the painful steps needed to avoid financial contagion. Just as the failure of small non-bank financial institutions in 2007 precipitated the collapse of large commercial banks and even government-sponsored enterprises in the U.S. in 2008, the festering problems in the Italian banking sector could eventually lead to the failure of banks in other EU states. One way or another, the EU must collectively face the problem of bank solvency. By delaying the inevitable process of restructuring, the EU runs the risk of a "surprise" to the financial markets that could quickly metastasize into a larger political crisis. Indeed, precisely that scenario seems to be unfolding in the EU today.

[3] Thomas Hale et al, "Italy's Atlante bank fund shoulders big burden," *Financial Times*, April 20, 2016.
[4] Hans-Joachim Dübel, "The Capital Structure of Banks and Practice of Bank Restructuring Eight Case Studies on Current Bank Restructurings in Europe," Center for Financial Studies, University of Frankfurt, October 8, 2013. (www.finpolconsult.de/)

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