SPOTLIGHT

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ABOUT MONTE DEI PASCHI

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At the beginning of July, Monte dei Paschi di Siena (MPS), Italy's oldest bank, received a warning letter from the European Central Bank asking it to respond to its action plan for dealing with its high level of bad loans. This has moved investors' attention back to the Non-Performing Loans (NPLs) in Italian banks' balance sheets. These are estimated at around 360 EUR billion, of which EUR 200 billion are registered as bad loans, and has added further pressure to a sector already severely hit post-Brexit vote.

While at a systemic level a conclusive solution will require a medium term agreement among banks, government and authorities, it is now clear that some quick action has to be undertaken to rescue MPS as investors are becoming increasingly impatient.

The magnitude of MPS's problem "face value" problem can be seen in the following numbers: EUR 47 billion of gross NPLs out of EUR 135 billion of total loans. Net figures are lower, EUR 24 billion out of EUR 112 billion, but still worrying. A stress test of the bank's capital structure would therefore help assess the effective size of the problem and shape potential solutions.

If MPS were to immediately, instead of in 2018, fulfil the ECB's request to reduce NET NPLs from EUR 23.5 to EUR 14.6 billion and apply a sale price of 15% for bad loans, MPS would have total impairments (loss on sales plus additional coverage) of EUR 6 billion. Capital shortfalls relative to current requirements would be EUR 5 billion, with a cost to the buyers of NPL of an additional EUR 2 billion.

A first solution should consider a combination of private and public funding, without considering the bail-in of creditors, since the bank is not yet a failed concern and the risk of contagion is too high. The private sector, through the Atlante fund, could buy NPLs while the State would recapitalize MPS with EUR 5 billion via a convertible instrument, since it is hard to imagine private fresh money willing to invest as an equity investor at this stage.

The downside of such a plan is the need for political agreement with Brussels on how to justify state aid towards electorates and EU member states. Italy is claiming that Article 32 of BRRD allows "an injection of own funds or purchase of capital instruments at prices and on terms that do not confer an advantage upon the institution", under very specific circumstances and "to remedy a serious disturbance in the economy of a Member State and preserve financial stability", as would certainly be the case with a bail-in.

Since views within the EU typically split into two camps, a compromise solution could end up allowing state intervention in exchange for some private sector involvement through a bail-in of subordinated bonds, focusing on institutional holders and safeguarding retail investors.

The size of a bail-in will largely depend on the level of post-rescue capital requirements. Whilst compliance with Pillar I will require only EUR 2.5 billion of new capital or a 50% subordinated bond bail-in, at the opposite end of the spectrum to close the gap with current Pillar II requirement would need a 100% subordinated bond bail-in plus EUR 2 billion of state aid.

If a bail-in is the route taken, it is likely to be an intermediate solution involving no more than 50% of subordinated holders, with institutionals being at higher risk.

Both these options seek to reach the ECB target with a one-off operation, but a more benign outcome (for bondholders) would be a systemic solution by funding the Atlante SPV with additional resources and the government limiting its intervention by granting NPL sales, thereby improving NPL sales prices from 15% to potentially 30%.

Such a medium term solution would also benefit the banking sector as a whole, since it should prevent market pressure from mounting again and spreading to other lenders. Without a proper and forward- looking solution, in fact, the Italian NPL story will continue to weigh on Italian banks' valuations for a long while and also hit banks in a much less distressed situation than MPS.

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