Italy

By Christian Nolting,
Global CIO

Italian banks: what could happen next?

Recent market developments. After the U.K.'s Brexit vote on June 23, European financial stocks fell sharply. Markets appear concerned that uncertainty around the departure of the U.K. from the European Union will depress growth and force the ECB to maintain very loose policy (e.g. negative interest rates) for some years to come and flat yield curves. Accordingly, they have focused on what they see as one of the other weak pieces in the European jigsaw puzzle: European banks.

Why the focus is on Italy. Within the banking sector, Italy could be seen as the weakest country. Here general concerns are amplified by high levels of non-performing loans (NPLs), undercapitalized institutions and a degree of political risk stemming from the planned October/November referendum. (The referendum is on reforming the Italian Senate, but has an even bigger importance as prime minister Matteo Renzi has said he will resign if the referendum rejects the reforms. Failure could hurt the pro-European Union political forces in Italy.) Italian bank equities have fallen by around 50% since the start of the year. The Italian government had already been acting before the crisis to shore up the system through revising bankruptcy procedures, guaranteeing securitized non-performing loans and creating a fund to help with capital raising and to purchase NPLs. But this response has proved insufficient to cope with investor worries: in fact, by tying together the fate of the weaker Italian banks with the stronger Italian banks, it may have made the situation worse.

With data rather opaque (and/or mistrusted), any quantification of the problem cannot be exact. Our colleagues at Deutsche Bank Research suspect that Italian banks may have to book EUR43bn of additional provisions to allow NPLs to be valued at current market prices: the capital hit from this could be EUR28bn, or about 1.7% of Italian GDP.

What happens next? We believe that some form of further state support may need to be extended to Italian banks. Growing hopes that this will happen have lain behind the partial recovery in Italian banking stocks in the past few days. Exactly how the rescue is done is important. Eurozone rules in force since the start of 2016 in theory stop state aid to banks until at least 8% of current liabilities have been "bailed in" (i.e. investors have been forced to take losses). Such action would therefore hit not only equity investors in banks but also holders of subordinated bonds. In Italy, this includes a large number of private investors, making a "bail in" a politically-hazardous undertaking, particularly if it then affects the result of the October/November referendum. (The possibility of separating out retail and institutional investors and avoiding or recompensing the former looks unrealistic.) Italy could, of course, decide to ignore EU rules and go ahead with a unilateral bail out without "bail in" conditions but this would undermine the European banking union and, more broadly, confidence in the European Union – and would likely to be as another step weakening European integration in the wake of the Brexit shock.

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More likely is some sort of creative compromise, agreed to either explicitly or implicitly by the E.U., possibly on the basis of Article 32 of the new rules which allow "extraordinary" support under exceptional circumstances. A trigger for this might be the planned publication on July 29 of European Banking Authority stress tests which should provide some clarity on where Italian banks stand. (However, it may be necessary to pre-empt them, with action before the stress tests are announced. Note that the ECB will have the results of the stress tests by July 21.) Before then, the European Court will opine on July 19 about aid previously extended to Slovenian banks in 2013, when the government put more than €3bn into the banking system, wiping out about €600m in subordinated bonds: this may give some idea of the scope for action. Cyprus could also prove an important precedent. Note that one element of a rescue is already in place: the ECB has already authorized Italy to provide a precautionary liquidity line for banks until the end of this year. In recent days, the IMF has tried to help the compromise process along by arguing that there was "adequate" flexibility within the 2014 European Bank Recovery and Resolution Directive (BRRD) and existing state aid provisions to allow this to happen.

Much will depend on how this creative compromise is done: there is a full spectrum of possibilities, from a limited recapitalization involving minimum "burden sharing" of a few banks, to a much broader "burden" sharing across all banks (perhaps involving senior debt), to a full-scale nationalization. History suggests that we are likely to start with a limited intervention. Italy and European institutions face a difficult balancing act: too small an intervention risks being ignored by the markets (or taken as evidence that nothing serious can be done or that there is no serious problem), whereas too large an intervention may increase worries about the scale of the problem, rather than serve to reassure.

An intervention is likely to provide an immediate lift to Italian banks' equities and bonds (assuming that it has not been fully priced in anticipation) and, to a lesser extent, to some other European banks. However, for a sustained market boost we believe that there may have to be co-ordinated action between the Italian government and the European institutions (most notably the ECB and European Commission) setting out exactly what is planned and also dealing with some possibly difficult questions around the eventual size, funding and timing of the package. In an ideal world, recapitalization would come directly from the European Stability Mechanism (ESM), set up in 2012 to provide financial assistance to governments and financial institutions, but legal and political constraints mean that recapitalization would much more likely need to be done at a national level. This will pose a range of other questions (e.g. if Italy is funding it, the likely size of the hit on its non-gold reserves) which will need prompt answers.

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What comes after the immediate intervention is open to question. This will be only the first step in a very long process. A possible "road map" to a lasting solution: European banking union would need to be accelerated via a euro-wide deposit insurance scheme and implied capital tightening avoided. They believe that the ECB would need to avoid further deposit rate cuts but have a dedicated TLTRO II (targeted long-term refinancing operations) rate that could move below the deposit rate. These are all very big "asks", even if there is general agreement that prevention is the best strategy. So we probably will end up with a muddling through scenario.

One other issue is worth considering. A unilateral government bail out in Italy or one funded by the Italian government could increase Italy's debt/GDP ratio – already Europe's highest – further. That, in turn, then could risk widening Italian yields spreads versus Germany perhaps leading to talk of more ECB QE/asset buying. The resulting even-lower bond yields in other European countries might not really improve profitability of the financial sector in other countries if the result is again a flatter yield curve. But it could increase the appetite for better-yielding corporate bonds elsewhere and also for emerging market bonds, as seen before.

A longer-term perspective. Even after an effective intervention, we believe that there may be reasons for investors to be wary of Italy and other European bank equity in the future. The Italian banking sector, even if recapitalized, faces longer-term structural problems (e.g. a high cost base resulting from excess staff and branches, implying a need for consolidation). But there are more immediate problems that affect European banks as a whole. European bank earnings are now expected to fall this year and this will exert further downward pressure on bank equities. Falling equity prices make it more difficult for banks to raise capital externally at a time when low and flat yield curves make it difficult to raise capital internally. This in turn will impact banks' ability to lend – with bank lending a much more important source of corporate financing in Europe than in the U.S. In this scenario, the worry is that while the immediate shock of a banking collapse is averted, the European economy will still suffer from lower availability of credit.

Conclusion. We believe that there will be some form of bail-out for Italian banks. Although Italian banks' problems are currently crystallizing against an uncertain economic and political background, one big positive is that the European Union now has a formal bank rescue system in place, based around the Bank Recovery and Resolution Directive (BRRD) and European Stability Mechanism (ESM). However, while such an intervention is likely to help Italian financial sector, it is unlikely on its own to resolve all the underlying issues. So we believe that investors should stay careful. Further volatility is certain and the potential for further problems will remain – with implications for European financial stocks more broadly.

Glossary

Bail-in refers to a rescue of a financial institution that requires creditors and depositors to take a partial loss on their holdings.

Bail-out refers to a rescue of a failing institution through the offer of funds.

Brexit is a combination of the words "Britain" and "Exit" and describes the exit of the United Kingdom from the European Union.

BRRD (Bank Recovery and Resolution Directive) harmonises the tools used in the recovery and resolution of credit institutions in the EU.

Deposit insurance is set aside to pay back the money lost due to the failure of a financial institution.

Emerging Markets are not as advanced as developed countries but maintain economies and infrastructures that are more advanced than frontier market countries.

ESM (European Stability Mechanism) is an intergovernmental financial institution to protect the solvency of euro-area member states experiencing temporary financing difficulties by employing tools such as granting loans or purchasing sovereign debt.

EUR is the currency code for the euro, the currency of the Eurozone.

GDP is the monetary value of all the finished goods and services produced within a country's borders in a specific time period.

IMF (International Monetary Fund) is an international organization created for the purpose of standardizing global financial relations and exchange rates.

NPL (Non-performing loans) are loans on which scheduled payments have not been made for (usually) at least 90 days.

Provisions are balance sheet items representing funds set aside by a company as assets to pay for anticipated future losses.

QE (Quantitative Easing) is an unconventional monetary policy in which a central bank purchases government securities or other securities from the market in order to lower interest rates and increase the money supply.

Securization is the process through which an issuer creates a financial instrument by combining other financial assets and then marketing different tiers of the repackaged instruments to investors.

Senior debt is borrowed money that a company must repay first if it goes out of business.

Subordinated bonds ranks below other loans and securities with regard to claims on a company's assets or earnings.

The **European Central Bank (ECB)** is the central bank of the European Monetary Union.

The **European Council** is a council of European Union Ministers, whose membership varies according to the topic under discussion.

The **European Union (EU)** is a political and economic union of 28 member states located primarily in Europe.

The **Eurozone** is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

The **Eurozone periphery** is usually understood as comprising Italy, Spain, Portugal, Greece and Ireland.

TLTRO (Targeted longer-term refinancing operations) are the Eurosystem's modified longer-term refinancing operations, which are intended to improve bank lending to the euro area's non-financial sector and, with it, the functioning of the transmission mechanism.

Volatility is a statistical measure of the dispersion of returns for a given security or market index.

Yield curve is a line that plots the interest rates, at a set point in time, of bonds having equal credit quality, but differing maturity dates.

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