Social Europe

The Italian Bad Bank: A Better Alternative

by Marcello Minenna on 8 February 2016 @MarcelloMinenna

The severe financial crisis of recent years hit Eurozone industrial production; in a bank-centric currency area this resulted in tremendous growth of NPLs (non-performing loans), amounting today to €900 billion. In some countries, banking system issues arose from real estate bubbles and structured finance transactions. The absence of a unified economic policy and of a risk-sharing vision of the Eurozone led to uncoordinated interventions by various member countries.

Apart from this problem, more and more structural, the target of these interventions was clearly to reduce the risks in bank balance sheets. As for the management of NPL they consisted in transferring these risks into a SPV (special purpose vehicle), i.e. the bad bank. The most significant cases were hitherto those of Spain and Ireland but on 26 January, the Italian Minister of Economy Pier Carlo Padoan managed to wrestle a green light for the bad bank from the European Commission. In order to obtain the required funds to buy distressed loans, Italian bad banks will issue Asset Backed Securities (ABS) with their usual waterfall structure.

A government guarantee would be awarded solely on senior tranches under strict conditions: a rating substantially in line with that of the Italian government (S&P BBB-). In order to obtain this, the size of the junior tranche must be tailored in such a manner that it could absorb the potential losses on distressed loans not yet written down. Who would have any interest in buying such a tranche? The same bank that issued the ABS could be a candidate, but it would have no benefits in terms of capital requirements. From this perspective, one could certainly question the rationale behind the usefulness of a government guarantee that does not really aid the banks. The alternative would be selling to a vulture fund, but the required yields would surely have to show double-digit returns that in turn would have to be funded in some way.

The Bank of Italy's governor, Ignazio Visco, has publicly declared that a delay in the application of the bail-in rules would be necessary for the Italian banking system. It seems a late awakening, if we consider that the problem of *burden sharing* in case of a bank rescue (i.e. the involvement of shareholders, subordinate bondholders and maybe also of senior bondholders and large depositors in the recapitalization process), has not come from nowhere; the banking communication of the European Commission (on state aid) is dated 1 August, 2013.

Despite the key role of banks in supporting Italy's manufacturing sector, we've been unable to decipher an overall strategy for governance of the banking system, apart from the will to avoid at all costs direct intervention by the state. This line has not been crossed even in the case of Monte dei Paschi di Siena (MPS), where a nationalization appeared the most natural outcome after the issues of "Monti Bonds".

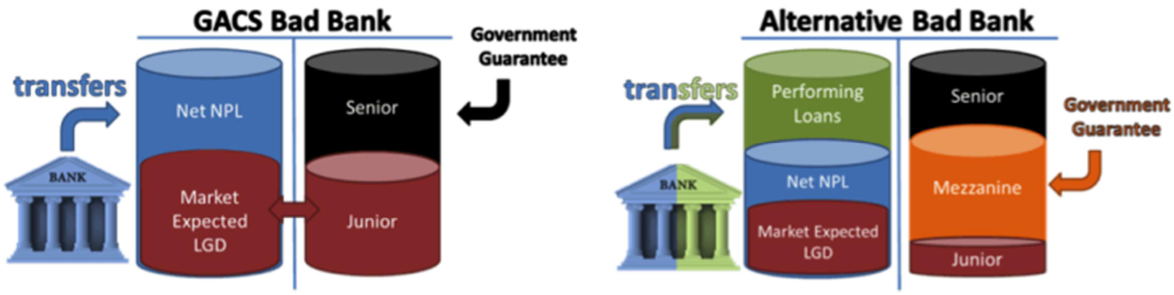
The stark facts underline that avoiding state intervention does not mean the protection of domestic savings. For example, MPS has carried out three share capital increases for a total of €9 billion that have now been completely depleted. The infamous rescue of the four banks in November cancelled share and subordinated bonds worth €5 billion.

The most recent estimates suggest that at least € 20 billion of subordinated bonds are in the hands of retail investors. Moreover, the Non Performing Loans (NPLs) in the Italian banking system have reached the staggering amount of €350 billion but have already been accounted for as losses only to the tune of 60% of their value. By making the conservative hypothesis of a further €50 billion of losses to be written down, even the government would be hit by a tax shortfall of €20 billion, since the recognition of losses grants an automatic fiscal credit to the banks.

It may be comforting to know that these fiscal credits are recognized as an integral part of the capital structure of the banks: more than 10% of Italian banks' regulatory capital is made of fiscal credits. Somewhat ironically, the European Union is currently reviewing this issue, to make sure that the Italian government hasn't overstepped state aid rules. If that proves to be the case, banks will be forced to recapitalize to the tune of over €50 billion.

Hence the decision not to intervene directly in support of the banking system does not even protect the taxpayer; for sure, it implies abdication from any control of how and when domestic savings would be affected.

Another way: Figure 1



In my opinion, the Italian government plan could be made more palatable by providing a mixture of distressed and performing loans. In this way, the risk of the credits portfolio would be mitigated and the bad bank would be more solid since the interest flows from performing loans would sustain the payments made by the ABS. The government could therefore limit itself to guaranteeing the *mezzanine* tranches at market conditions. This scheme would further improve the ABSs' credit worthiness; moreover, it would lower both the interest paid and the size of the junior tranche, thus offsetting the government plan's lack of attractiveness.

In other words, by exploiting the *junior* tranche and the state guarantee, banks could gradually write down their losses over a longer horizon with clear benefits in terms of capital requirements. Size of the *junior* tranche, cost of the guarantee for the *mezzanine* tranche and ABS yields should be calibrated, taking into account the given mix of distressed and performing loans.

This strategy has the potential to make the *senior* and *mezzanine* tranches eligible for the ECB asset-backed securities purchase programme, along the lines defined with the decision no. 45 of November 2014.

This new plan would free the banks' balance sheets of at least € 100 billion of bad debt in order to make room for fresh loans. The renewed credit expansion would strengthen the banks' role in the recovery of the Italian manufacturing sector.

The game is not over: it is about exploiting existing room for manoeuvre within the European regulatory framework, with a different strategic mindset as the key card to play.