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A Suboptimal NPL Plan for Italy

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An effective alternative to the proposed plan would be a securitization scheme based on the banks' gradual disposal of a suitable mix of good and bad loans

Italian banks were very resilient to the first wave of financial crisis in 2008, due to their low exposure to U.S. sub-prime products and the absence of a pre-crisis housing bubble. However, when the global financial crisis turned into a euro sovereign crisis in 2010, things started to deteriorate for the sector and they have not improved much since then.

The Italian banking system is currently choked by €350bn of non-performing assets, almost a quarter of GDP and four times the figure for 2008. About 60% of these are non-performing loans. For a bank-centric country like Italy, this is a very serious problem. Added to this is the concern of investors about how the problem of bad debt can be managed within the new EU banking resolution regime (BRRD), which came into force on January 1.

The banking resolutions carried out in 2015 are not a reassuring precedent. BRRD aims at reducing the cost of bank rescues for taxpayers, which would be especially problematic for states, like Italy, that have high public debt. But in order to do so, BRRD requires sizable bail-in of bondholders. For Italy, which ranks low in terms of financial literacy and where about 30% of total bank bonds are hold by households, even a limited bail-in could have painful social consequences.

In this context, the Italian government and European Commission agreed January 26 on a scheme of guarantees on banks' NPLs (so-called GACS, or Garanzia sulla Cartolarizzazione delle Sofferenze). This system of government guarantees should provide a coverage that allows resizing the gap between the net book value and the market value of NPLs. This in turn should facilitate the banks' disposal of impaired assets. The overall architecture of the GACS is quite complex and it presents some open issues.

First, the state guarantee will only cover the risks of the senior tranche of the ABSs issued by the bad bank and the senior tranche will have access to the state guarantee only if preliminarily endowed with an investment-grade rating of BBB-, BBB and BBB+. The possession of such rating by the senior tranche will be closely linked to the quality of the collateral portfolio and to the thickness of the subordinated tranches. In particular, the placement of the junior tranche will be a

key issue in determining the success of the GACS. In fact, the market will certainly demand exorbitant returns to underwrite these tranches, and the only alternative for the originating banks could be capital retention, which, however, could compromise the benefits of NPL disposal in terms of improved capital ratios.

Second, the pricing of the state guarantee is questionable. The Italian Treasury announced that the price will be the average of the CDS spreads of a basket of Italian private issuers (financial and otherwise) that have a rating close to that of the senior tranche. From a technical point of view, this metric does not correctly reflect the operating logic of the guarantee. The role of this guarantee is to give a credit enhancement to NPL-backed senior unsecured tranches, which are already rated in the BBB range. Hence, the price of such a guarantee should be the difference between the average spread required by the market on BBB-rated, NPL-backed, senior unsecured tranches and the rate of a sovereign bond of the same maturity issued by the Republic of Italy. The fact that the Italian Treasury had adopted a completely different pricing criterion means that it could deliver improper benefits either to banks or to the state.

This is crucial to the scheme’s effectiveness. Banks may never activate the state guarantee if they consider it too expensive or, conversely, may abuse it if it turns out to be very cheap and this would in turn raise doubts about the compatibility with state aid.

An effective alternative to GACS would be a securitization scheme based on the banks’ gradual disposal of a suitable mix of good and bad loans. In this way, the bad bank would have a better financial soundness because the cash-flow produced by the performing loans would support the payment of the coupons on the asset-backed notes. The state guarantee -- to be paid at market conditions -- should be attached to the mezzanine securities in order to further improve the overall credit quality of the ABS and reduce the junior tranche. Such a scheme would provide senior notes and mezzanine-guaranteed notes of good quality, increasing the chance to make these notes eligible for the European Central Bank’s quantitative easing programme.

This alternative setup would concretely support Italian banks in offloading their NPLs, improve their solidity and free up space on their balance sheets to restart the credit to the economy, with the significant advantage of keeping under control the state’s risk exposure.

Rather than spending time and energy advocating a revision of BRRD rules -- which have been collectively negotiated and previously agreed upon -- it would be better considering alternative to make the guarantee schemes as effective as possible.

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