

# The Better Way for Italy to Rescue Its Banks

**Rome should focus on simple guarantees on risky assets rather than creating multiple overlapping bailout funds.**

**By Marcello Minenna**

**T**he bad-loan storm swirling around Italian banks is intensifying, despite the claims from Italian and eurozone officials that everything's fine. With the European Central Bank's stress tests due soon and market valuations of bank stocks at historical lows, a round of forced recapitalizations seems inevitable.

Bad loans have grown at the astounding pace of €50 billion (\$55.05 billion) a year since the 2008-09 financial crisis as banks resisted writing down bad assets. Banks and policy makers awaited a strong economic recovery that would allow debtors to repay more of their loans while providing banks greater profits to cushion write-downs. The recovery didn't materialize, and the money injected into banks, up to €80 billion, via periodic market recapitalizations quickly dissipated as bank profitability stagnated due to an inefficient, fragmented financial system and near-zero or negative interest rates.

The government has tried to build a functioning market for nonperforming loans so that banks could sell their bad assets to other investors, but with little success. The gap between the book value at which bad assets currently are recorded on balance sheets (around 46% of face value) and the market value (in the interval of 20% to 30%) of loans is too wide. With Italy's recession of 2012-14 and the tougher rules introduced by the European Union's new Single Supervisory Mechanism, cracks began to surface as the ECB started pressing banks to dispose the distressed loans at an accelerated pace.

Now the problem is becoming more urgent. In the first three months of this year, Italian banks lost more than 30% of their market value amid the politically troubled resolution of four regional banks. One hundred thousand small bondholders lost

the value of their investments in a bail-in. Since last month's Brexit referendum, new worries have surfaced about Italian banks' ability to withstand economic shocks.

Monte dei Paschi di Siena (MPS) risks being the first institution needing rescue. The ECB has told it to write down or sell off at least €10 billion of bad loans by 2018. It's not clear yet how the bank will be able to do that without endangering its capital adequacy, and it may need to raise another €3 billion to €4 billion to fill the gap. Private investors would be unlikely to step in under current circumstances.

The government is struggling to manage it all. In February, Prime Minister Matteo Renzi proposed state guarantees on senior tranches of securities backed by bad loans in order to encourage private investments in troubled assets. In April, the government created a bailout fund, called Atlas and funded mainly by larger banks, that serves as a buyer of last resort for the equity of troubled banks. ECB President Mario Draghi on Thursday raised the prospect of a "public backstop" for nonperforming loans in the eurozone in general, but any solution from the ECB presumably remains far off.

It's not clear that these measures will be enough. Atlas already has helped rescue two banks to the tune of €2.5 billion. The guarantee mechanism isn't yet in use, but that moment may come soon as MPS prepares to sell a portfolio of €9.6 billion of distressed loans, perhaps by the end of the month ahead of the ECB stress test. Leaks suggest this sale could be structured into a senior tranche of €7 billion covered by the guarantee, while the remaining €2.6 billion would be a junior tranche to be bought by Atlas if no other investor is available.

But Atlas now has only €1.75 billion available. So the government may create yet another bailout fund (called Jason, according to some media accounts). The Società Gestione Attività, a small bad bank substantially controlled by the state, would contribute €600 million to the new fund. The Cassa Depositi e Prestiti (CDP), also a state-controlled bank that traditionally collected postal deposits and funded government public-works bonds, will contribute

€400 million. Atlas itself will be the third investor.

It's hard to imagine a more complex system for bailing out banks. Rome has created two different bailout funds, one of which is partly privately invested, one of which is mostly state controlled, one of which invests in the other, and both of which share at least one common investor in CDP. Among other problems, this may run afoul of EU rules prohibiting state aid.

This needs a rethink. Rather than focusing solely on disposing of bad loans, banks should be encouraged to sell off pools of assets that combine both sound and nonperforming loans. This will deprive banks of the income from the healthy loans, but the cash flow those loans generate will entice investors to take on the nonperforming loans that are bundled with them.

If Rome still needs to be involved after this, it should focus the state guarantee on the riskier mezzanine tranche of securities—those whose risk falls between the highest-rated senior level of assets and the riskiest unsecured junior tranche. By reducing the size of the junior tranche, this would make it easier for banks to place them with private investors, while pooling good and bad loans together would limit the risk to the state as guarantor on the mezzanine tranche. This could also provide enough security to make these assets eligible for purchase by the central bank under the ECB's asset-purchase program, or quantitative easing.

What would most help Italian banks would be a return to economic growth and more normal interest rates. But if neither prospect is due to materialize in the immediate future, Italy should focus on the simplest support mechanisms possible for a financial system already dragged down by complexity and inefficiency.

*Mr. Minenna is a doctoral lecturer at the London Graduate School of Mathematical Finance.*