FINANCIAL TIMES

ALPHAVILLE

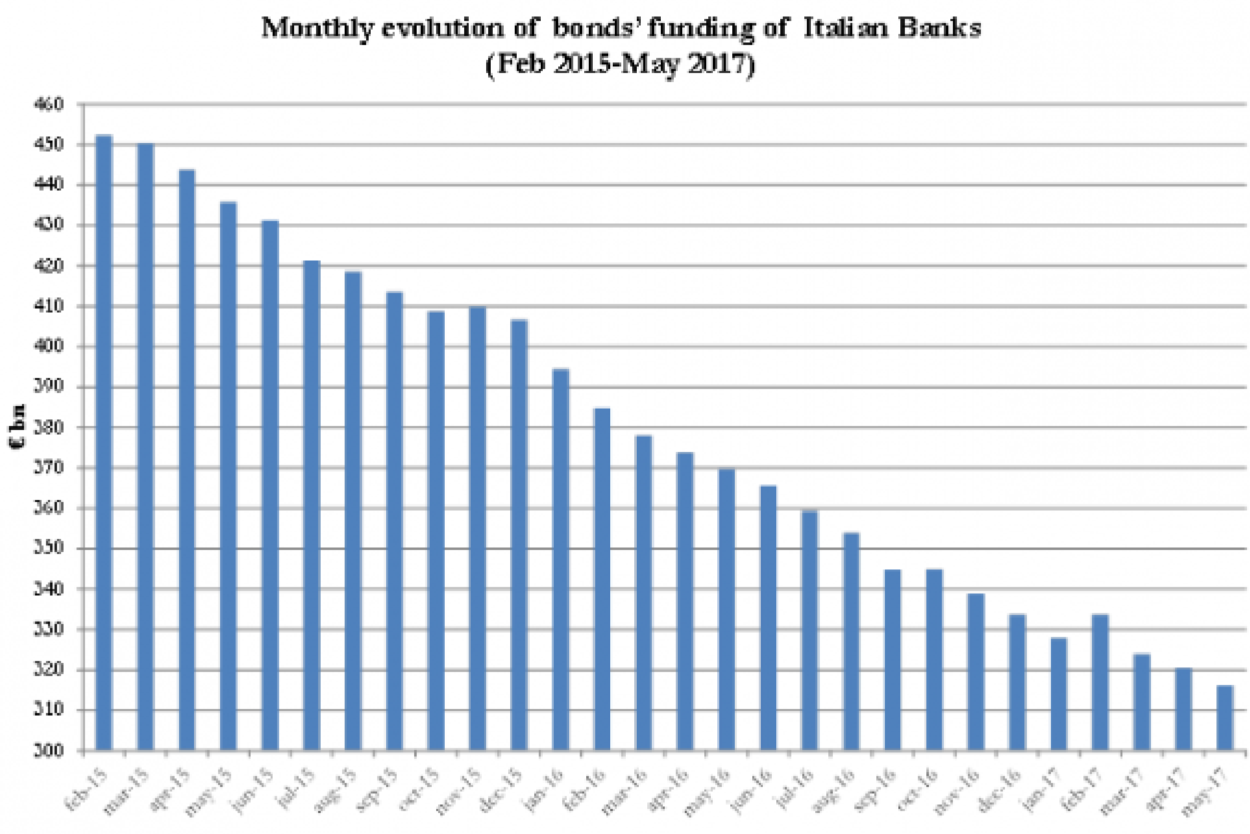
How Italian banks are disadvantaged by new MREL rules

JULY 21, 2017

The following guest post on MREL rules is from Marcello Minenna, the head of Quantitative Analysis and Financial Innovation at Consob, the Italian securities regulator. The views expressed here are his personal opinions and do not necessarily reflect the views of Consob.

It's hard to be a confident investor in Italian bank debt. The recent rescues of Monte Paschi di Siena, Popolare Vicenza, and Veneto Banca are simply the latest reasons over the past few years.

Markets have responded by cutting off bond funding to Italian lenders. The amount of Italian bank bonds outstanding has shrunk by about 30 per cent since the start of 2015:



The decline in volumes has gone along with increasing yields on subordinated and senior unsecured notes. This is not a small matter for a country where bonds have traditionally been an important share of banks' liabilities.

Making matters worse is Europe's new Bank Recovery and Resolution Directive (BRRD). Each credit institution has to meet a Minimum Requirement for own funds and Eligible Liabilities (MREL) eligible for bail-in in order to prevent tax-payers bailouts and – possibly – the involvement of creditors sitting in the top ranks of the repayments' hierarchy.

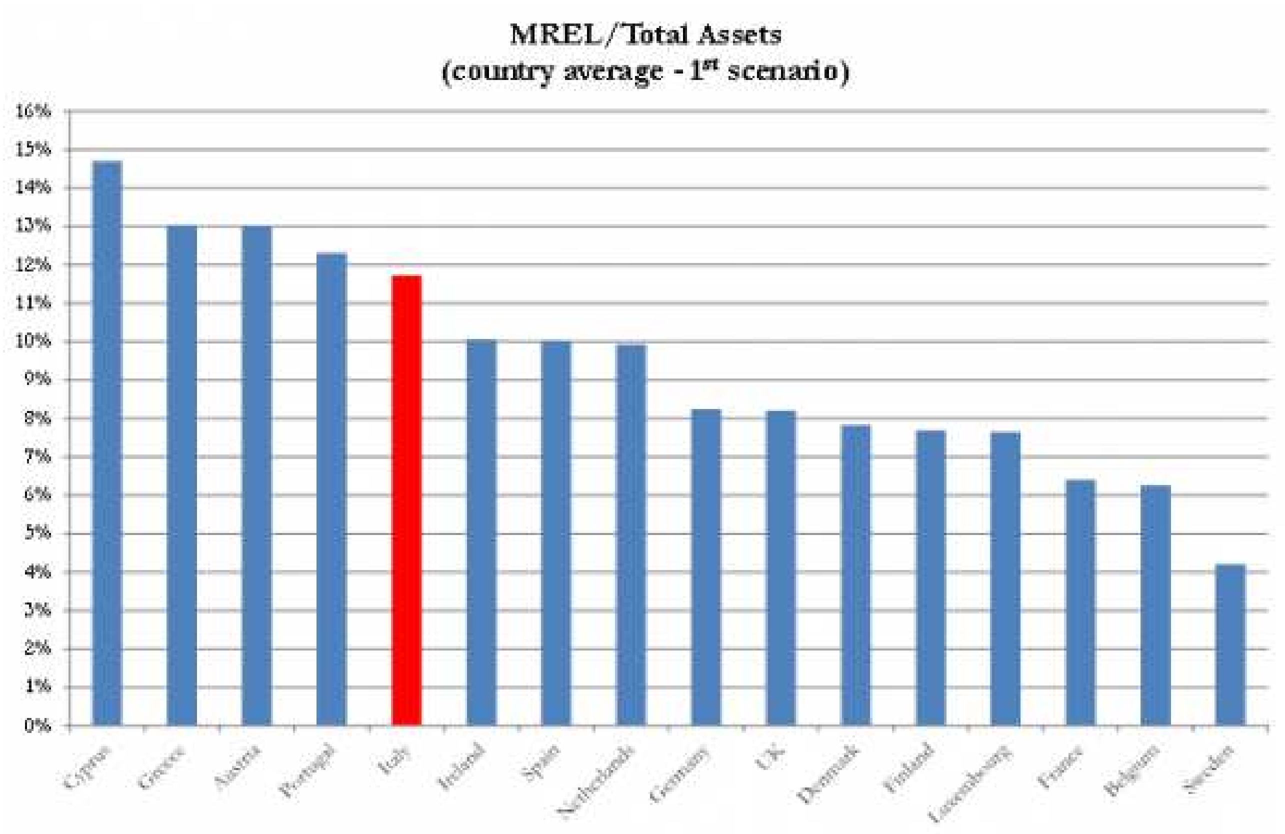
The MREL shall be set on a case-by-case basis and shall be the sum of two components: a *Loss Absorption Amount* and a *Recapitalization Amount*. The calculation method is not yet definitive, but it seems agreed that it will be at least twice the requirements of Basel's 1st and 2nd pillars plus an additional capital buffer.

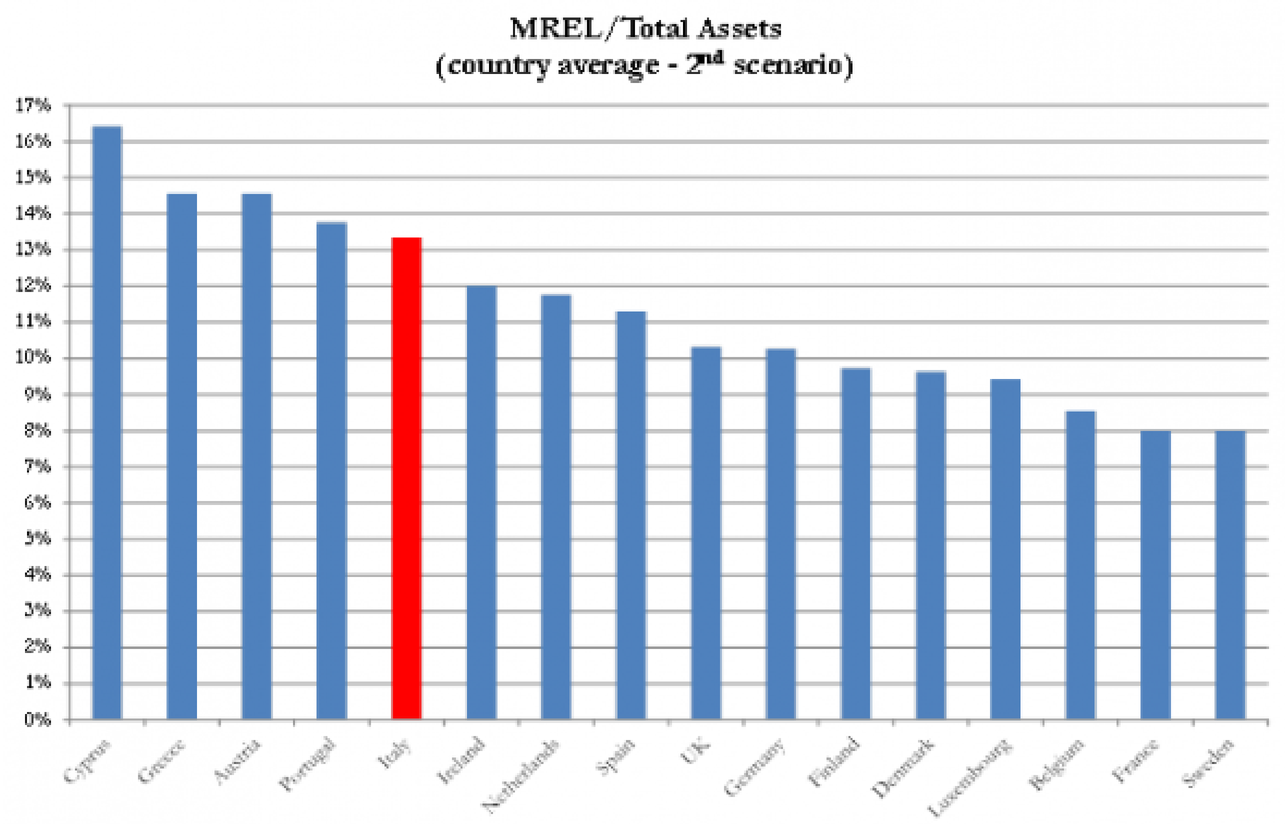
In a report released last December, the European Banking Authority estimated that the financing needs of a sample of 133 EU banks to be theoretically compliant in 2016 were in the range €186-276 bn.

The MREL will become operational soon. It fits alongside rules about Total Loss Absorption Capacity (TLAC), which are based on risk-weighted assets and apply only to global systemically important institutions.

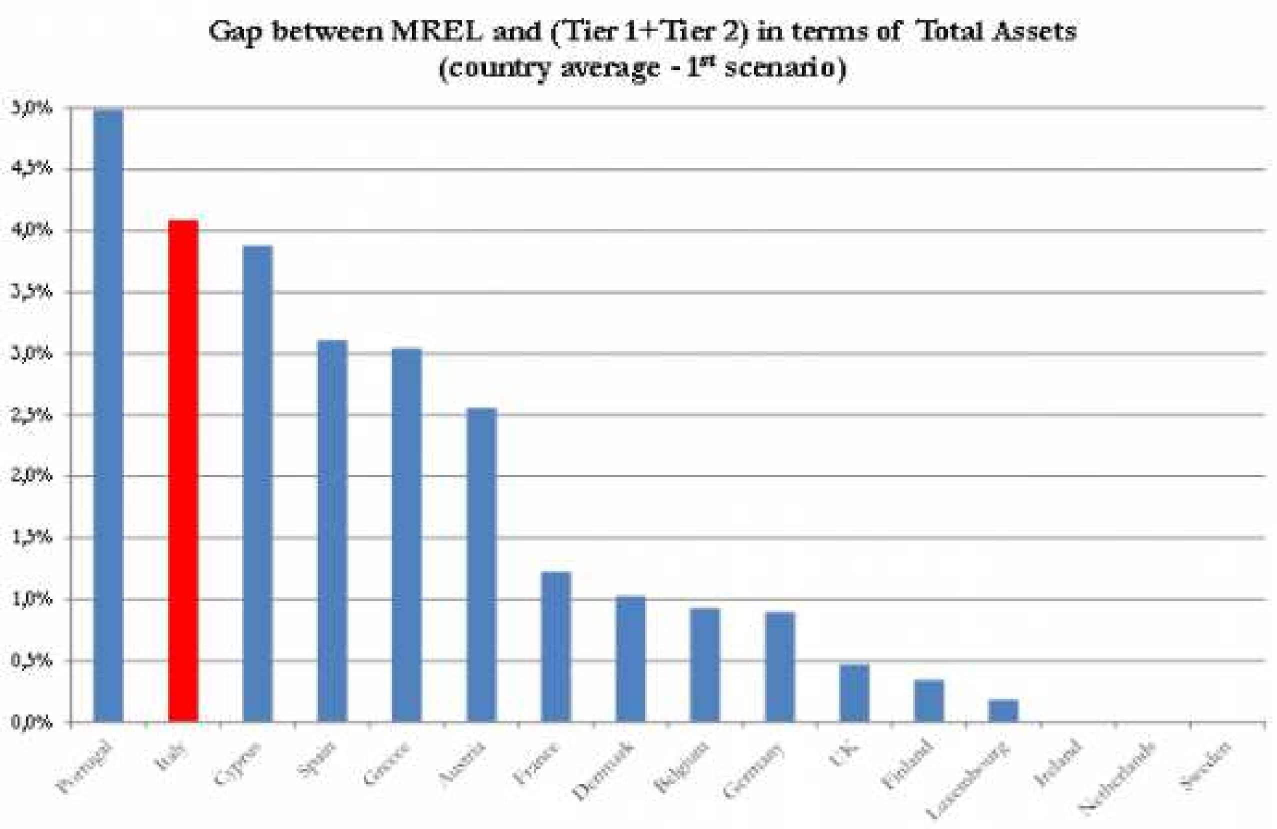
Simulations performed on the top 162 EU banks in terms of Tier 1 capital show that on average Italian banks have a MREL between 11.7 per cent and 13.3 per cent of the total assets, considerably higher than French, German and even Spanish institutions.

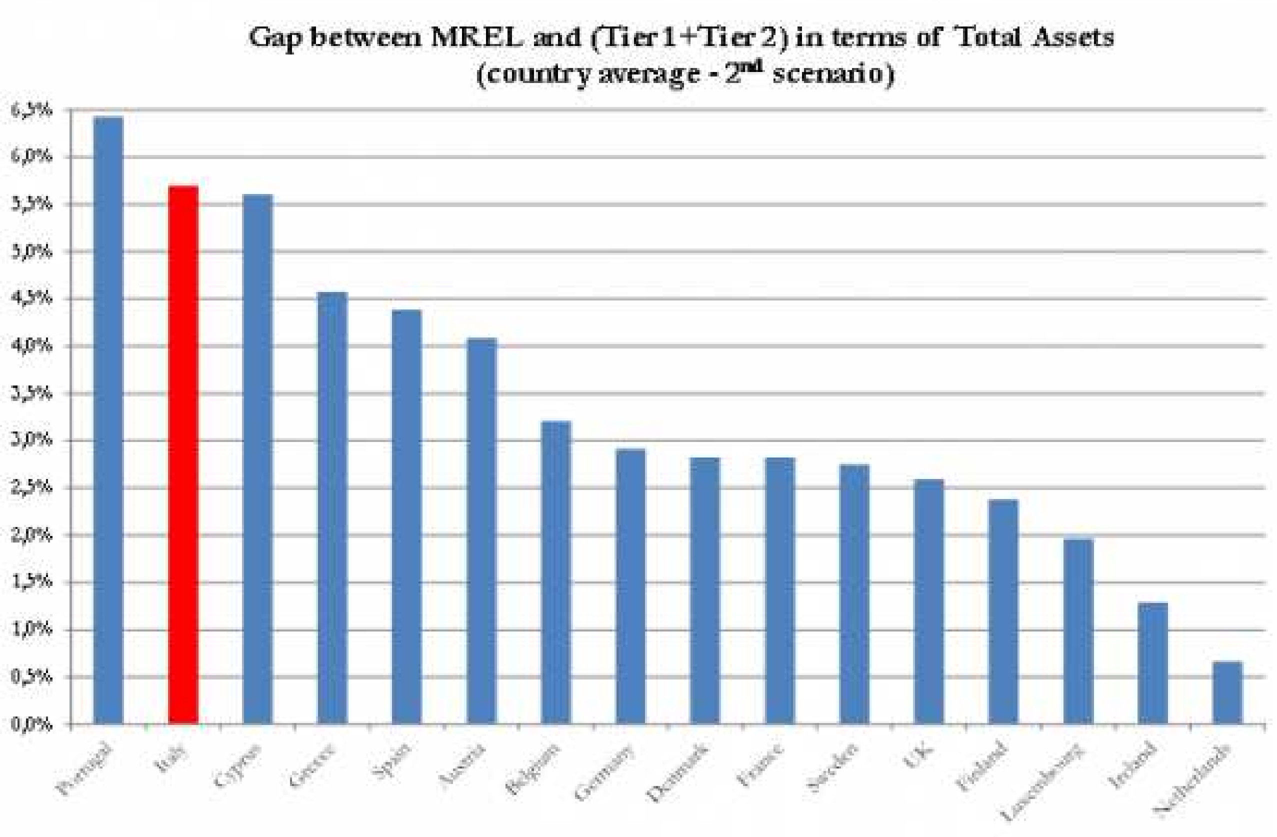
The charts below show aggregate MREL across national banking institutions under two different scenarios:





Italian banks have the second-highest gap between their MREL and their aggregated Tier 1 and Tier 2 capital. That gap is worth about 5 per cent of assets, depending on the simulation used. Only Portuguese banks fare worse. Italian credit institutions will have to rely more on liabilities other than subordinated debt to meet the MREL, compared to their European competitors:





Italian banks need to add between €79 and €111 bn in subordinated debt financing under these rules. That's less than other countries such as France (€97-197 bn) and Spain (€98-135 bn), but their banking systems are larger than Italy's in terms of total assets.

Italy will have to work hard to comply with these new rules. One solution could be the issuance of senior non-preferred notes, i.e. debt securities safer than subordinated bonds but without any collateral or preference and, hence, eligible to take losses in a bail-in. In France, large groups such as Crédit Agricole have already issued senior non-preferred bonds (introduced by a decree of November 2016) and last June 23 also Spain adopted a similar decree.

The actual riskiness of the new bonds will depend on the quality of the issuer's assets and on the amount of loss-protection provided by equity and subordinated notes. The thinner this buffer is, the greater the risk borne by anyone buying one of these senior non-preferred bonds.

In Italy, where the first burden sharing experiences have rescinded over €5 bn of subordinated notes, non-preferred bonds may simply be a new name for subordinated bonds. The whole exercise could become a façade operation to dismiss a label that has now fallen into disrepair and sell an old product with a new packaging.

The first step to avert a similar outcome is offloading bad loans from banks' balance sheets *before* entering manifest distress. Italy is undoubtedly the country most affected by non-performing loans which count for more than 15 per cent of all loans. That's three times the European average.

Bad loans aren't just an Italian problem: the total NPLs of European banks at the end of 2016 amounted to €548bn net of write-downs. Beside raising capital requirements and the MREL, low-quality assets lower banks' profits and their lending ability, which explains why the ECB and the EU Commission stressed the importance of accelerating NPL disposals.

Unfortunately, the lack of a liquid secondary market in Europe can force hurried banks to bear further huge losses as – despite recent episodes in Italy – state interventions or other local remedies cannot solve a systemic and super-national problem.

Time is ripe for authentically shared solutions, starting with a *federal bad bank*charged to purchase EU banks' NPLs at reasonable prices and re-engineer their risks through well-thought securitisation schemes. This would spread the pain across countries, but the unexciting alternative is accepting that the banking sector will remain intrinsically fragile.