Outline

I- What is the risk of default for Banca Monte dei Paschi di Siena (MPS)?
- MPS credit default swap (CDS) and subordinated bond spreads – Debt maturity profile
- Plummeting MPS Capital trust and bank share prices

II- What are the possible scenarios for September?
- Who will bear the cost of a MPS bail-in?
- Are there incentives for local financial investors to provide additional fresh capital?
- Could the government inject public money within the new regulation?

III- What are the likely financial, political and macroeconomic effects?
- Risk of contagion within the Italian banking sector
- Political risk: the constitutional referendum
- Macroeconomic impact
Executive summary (I)

- Despite the announcement by Banca Monte dei Paschi (MPS) of a “structural and definitive solution to the bad loan legacy” just before the release of the EBA stress tests results, the market is still pricing in a significant risk of default by MPS.

- The success of the rescue package is not guaranteed as it is conditional on the sale of MPS’s non-performing loans (NPLs), which will be securitised. A consortium of banks led by JP Morgan has to find €5bn of fresh capital by the end of September to cover the negative impact on capital from the NPLs’ disposal.

- If the plan fails, Italian retail customers will be the first to incur a loss. During the financial crisis, banks sold households (very risky) MPS’s junior subordinated bonds as a safe placement, paying a very low 2.4% coupon. (This compares with the 7% paid to institutional investors for less risky bonds.) Tax incentives were even provided to bolster the purchases of these bonds.

- The political impact of failure will also be strong, with the ‘No’ campaign more likely to win the constitutional referendum in the autumn. Italy could then see a period of political gridlock.

- Given the risk that investors may not rush to buy the senior tranche of the securitised NPLs – even with some state guarantee – the Italian government may either put pressure on local insurers and banks so that they increase their contribution to Atlante II (a fund arranged by the Italian government and financed by Italian banks, insurers and pension funds) or claim an exemption clause to the Bank Recovery and Resolution Directive (BRRD), in order to be able to inject public money in MPS.
Executive summary (II)

The likelihood of the first safety net will depend on the potential losses of local financial institutions from their existing exposure to the Italian banking sector (mainly their additional Tier 2 capital), as AT2 bonds could be converted into equity and wiped out in the case of a bail-in. But local banks and insurers could also be reluctant to increase their exposure to Italian banks, given the perception of the sector as a “house of cards”.

The second safety net is the exemption clause (Article 32(4)(d)(iii)) in the EU BRRD, which would allow the government to provide “extraordinary public financial support” to MPS. This clause could be activated to “remedy a serious disturbance in the economy of a Member State and preserve financial stability”.

But it is not clear whether this way of avoiding a full bail-in will still mean some burden sharing by private investors. Whether the MPS junior creditors (Italian households) could avoid incurring losses will largely depend on Renzi’s ability to convince its European peers to interpret the EU Directive in a flexible way a few weeks before the constitutional referendum.

We attach a 15% probability to a scenario in which the consortium of banks is not able to find the €5bn by the end of September, the Italian insurers and banks refuse to provide additional capital and the exceptional circumstances can’t be triggered and the government is unable to provide support to MPS. We would then expect strong contagion effects not only to Italian banks but also to the European banking sector.
Monte dei Paschi: a risk of default still priced in

- CDS spreads of Banca Monte dei Paschi di Siena (MPS) provide a market-based insight into which bondholders could suffer from a bail-in solution.

- Losses are likely to be concentrated among subordinated bondholders, while senior bondholders would appear relatively immune.

### Banca Monte dei Paschi di Siena: CDS spreads

Credit Default Swap spreads

- 5Y senior CDS spread
- 5Y subordinated CDS spread

Source: Oxford Economics/Bloomberg
I- MPS default risk also present in bond discount

- Looking at bonds issued by MPS, only subordinated bondholders would be impacted in the event of a bail-in. Unlike senior bonds, subordinated ones are trading at a 20% discount.

- The discount is higher for the *junior* (riskier) bonds bought by the Italian households (30%, the dark blue column) and for the perpetual MPS capital trust bonds (55%).

- The junior subordinated debt maturing in September this year is trading at only a 9% discount, given the small amount left to be repaid.

*Discount on MPS subordinated bonds*

% CC rated bonds

Source: Oxford Economics/Bloomberg
I- MPS default risk also present in bond discount

- The discounts on MPS bond prices suggest that the market is concerned about the bank’s solvency.
- However, these discount levels are lower than those reached during the global financial crisis or the Eurozone sovereign crisis.

**Monte dei Paschi subordinated bond prices**

- 30/09/2016
- 31/11/2017
- Perpetual MPS Capital Trust I
- Jr subordinated 15/05/2018

Source: Oxford Economics/Bloomberg
I- MPS debt maturity profile

- A large share of debt is due in 2017 (more than €12bn), while substantial repayments are due in 2018 (more than €7bn) and 2019 (more than €6bn).

- Reimbursements peak in Q1 2017, mainly consisting of senior debt, while more than half of subordinated debt is due in 2018 (€2.36bn).

![Monte dei Paschi: debt maturity profile](source: Oxford Economics/Bloomberg)
The MPS share price has plummeted since the global financial crisis, reflecting very serious concerns about the bank’s solvency. It has continued to fall since the announcement of the rescue plan, which was supposed to provide a structural and definitive solution to the bad loan legacy. The falling MPS share price makes it more difficult for MPS to raise fresh capital.
I- Monte dei Paschi’s rescue plan

- The sale of a big chunk of its NPL portfolio to a securitisation vehicle
  - Sale of €27.7bn gross non-performing loans (valued at €9.2bn in Q1 2016)
  - The transfer price will be 33 cent/€ against 37 cent/€ current book value
  - An increase in the coverage ratio of other non-performing exposures (NPE) to 40%

- The securitisation of NPLs
  - A senior funding with some state guarantee: senior notes at 21 cent/€ of gross book value
  - A mezzanine tranche: 6 cent/€, underwritten by Atlante II (a consortium of Italian and insurers, whose aim is to buy NPLs)
  - An equity tranche of 6 cent/€ kept in the MPS’s balance sheet (first loss piece)

- The issue of €5bn of fresh capital to cover the capital impact from NPL disposal
  - €1.1bn loss arising from the sale of NPLs: 
    \[(37-33)\times 27.7\text{bn}\]
  - €1.6bn equity tranche retained in MPS’s balance sheet deductible from CET1 capital
  - €2.2bn increased provisions to reduce the non-performing exposure ratio to 18% - below the 20% imposed by the Single Supervision Mechanism (SSM)

  - In total, the capital need is slightly less than €5bn (accounting from the slight improvement in CET1 capital ratio in Q2 2016).
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II- Who will incur losses, if the rescue plan fails?

- The first bondholders to incur losses in the case of a bail-in of MPS would be Italian households. Unlike institutional investors, who bought subordinated bank debt, Italian households bought junior subordinated bank debt (circled below in red).

- Despite the riskier nature of junior debt, the coupon paid on these bonds (2.36%) is much lower than that paid to institutional investor for less risky bonds (7% for subordinated bonds maturing in March 2019). In the middle of the financial crisis in 2008, banks have sold these bonds (€2.16bn) as safe investment products to their retail customers.

- Were MPS to be bailed-in, the households’ losses would be around half of the total losses from MPS subordinated debt.

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- **€4.57bn**
- **€5.20bn**

- **€5.15bn**
- **€6.70bn**
II- Which scenario going ahead?

Scenario 1: €5bn of fresh capital is found by the consortium of banks
Probability 45%: no bail-in
- Under this scenario, the consortium of banks led by JP Morgan finds the €5bn of fresh capital. If it doesn’t manage to get the full amount, the Italian government will put pressure on Italian banks and insurers to provide additional support to Atlante II. Some of these institutions accept to increase their contribution, given their substantial exposure to Italian bank subordinated debt (AT2 bonds), which could be converted into equity in the case of bail-in of MPS.
- No immediate contagion effect to the Italian banking sector to be expected, but vulnerability will persist in the medium term given the rising cross-holding of equities and bonds within Italian banks and insurers.

Scenario 2: The government intervenes under “exceptional circumstances”
Probability 40%: partial (or no) bail-in of junior creditors
- If the local financial institutions (banks and insurers) are reluctant to increase exposure to the Italian banking sector (and refuse to put additional capital into Atlante II) – to what may look like a house of cards –, the government could decide to inject public money in MPS, citing “exceptional circumstances”. In the BRRD, there is an exemption clause (Article 32(4) (d) (iii)), whereby a government could be allowed to recapitalise a bank, if it is “limited to injections necessary to address capital shortfall established in the national, Union or SSM-wide stress tests”. This clause could be activated to “remedy a serious disturbance in the economy of a Member State and preserve financial stability”.
- But it is not clear if this way of avoiding a full bail-in will still mean some burden sharing by private investors, in particular for junior creditors. The bail-in of four small banks last November had involved losses for junior subordinated bondholders (Italian households).

Scenario 3: The consortium only manages to raise part of the €5bn needed
Probability 15%: full bail-in
- The consortium of bank fails to provide the €5bn and the local financial investors refuse to increase their exposure to the Italian banking sector. The exceptional circumstances can’t be triggered and the government is unable to provide support to MPS. Losses will be incurred by Italian households but also by other subordinated bondholders (insurers and banks).
- Expect severe spillover and contagion effects on other Italian bank share and bond prices. Political uncertainty.
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III- Contagion risk within the Italian banking system

- In November 2015, four small banks were bailed in, totalling about €4bn cumulative losses. Shareholders and subordinated bondholders incurred part of the losses but the rest drew on the Resolution Fund (whose capital had been advanced by Banca Intesa Sanpaolo, Unicredit and UBI Banca).

- The Resolution Fund injected €1.7bn to cover the losses of the original banks and €1.8bn to recapitalize the good banks. If the eventual sale of the good banks takes place at a lower price, the Italian banking system will see additional losses.

- Any further losses for Unicredit, UBI Banca or Intesa Sanpaolo could prevent them from providing additional capital to Atlante II if JP Morgan fails to raise the needed €5bn. This is one major risk looking ahead.

- We could then expect contagion effects to other Italian banks with CDS spreads widening, given the importance of cross-holdings of shares and subordinated bonds.
III- Systemic risk in the Italian banking system

- A bail-in solution of MPS in September or October would very likely trigger an increase in systemic risk to higher levels than that reached after the bail-in of the four small banks.

- Our systemic risk indicator, which is based on CDS spreads of individual banks and the correlations between equity prices of Italian banks, measures the probability that two banks defaults simultaneously.

**Italy: systemic risk indicator**

Probability of two banks defaulting simultaneously, %

Source: Oxford Economics/Bloomberg
The banking situation is linked to the political environment as PM Renzi is aiming for a “Yes” vote in the Referendum on the Senate reform:

- **When?** In the autumn (dates to be confirmed, but probably October or November)
- **What is it about?** Senators to become unelected and have weaker legislative powers, while the upper and lower houses of parliament currently have equal power.

- Populist 5 Star Movement is now leading the opinion polls.
- Opinion polls suggest voters’ intentions in the referendum are balanced, but **Renzi is likely to lose further support in case of a bail-in (the failure) of the MPS.**
III- Negative spillovers on the political front

- If Renzi loses the referendum, he has said he will resign.

- If new elections are called, it is very likely that there will be no clear majority in the Senate. This is similar to what happened after the 2013 election.

- A **sustained period of political deadlock and policy inaction** could then be expected, similar to the situation in Spain. But unlike Spain, Italy needs to deepen supportive economic and structural reforms and political gridlock would bring a halt to this process.
III - Spillover to the economy

- The Italian bank stock index is a good indicator of bank credit growth to private non-financial corporates, with a lead of about 6 months.

- The recent fall in Italian bank share prices raises the risk of credit contracting further in the next two quarters. Banks may be tempted to reduce their risk-weighted assets to meet regulatory capital requirements, cutting riskier loans to non-financial corporates.

**Italian bank stock index and loans to firms**

Source: Oxford Economics/Bloomberg & Haver Analytics
Households’ exposure to MPS’s subordinated bonds is not significant (€2.2bn ≈ 0.1% of net household financial wealth). However, if a wider banking crisis were to materialise, the overall exposure of Italian households to all bank subordinated bonds is €29bn.
Banking sector turmoil could have a snowball effect on business and consumer confidence, with negative consequences for consumer spending and investment.

Further negative credit action from the rating agencies is likely. The DBRS rating agency has put Italy’s credit rating on negative watch. A downgrade from the current A rating would mean higher funding costs at the ECB for Italian banks, as the result of higher haircut to Italian government bonds posted as collateral.
A public intervention would have negative effect on Italy’s fiscal position. Public support of €5n would increase the fiscal deficit by around 0.3 percentage points to 2.6% of GDP. This would increase public debt even further, limiting the fiscal space for next year’s budget.

*Recapitalization and Impaired-assets measures
Source: Oxford Economics/European Commission
The dreaded link between banks and sovereign appears finally to have been broken. Since the adoption of the negative interest rate policy by the ECB, the high correlation between our systemic risk indicator and the 10-Year spread between Italian and German sovereign yield has plummeted.

Global factors such as the search for yield that has compressed risk premium but also the new regulation (BRRD) that came into force in January this year may explain the declining correlation.
Conclusion

- Were a bail-in of MPS to take place and junior bondholders to incur losses, it is very likely that the European Commission (DG Comp) would allow Italian households to be compensated for losses resulting from what could be considered as mis-selling. This was done in the case of four small bailed-in banks last November. But the Italian households are still waiting for their money and the compensation will only be partial and subject to strict criteria. The main groups of investors at risk would then be Italian banks and insurers.

- Regarding the macroeconomic consequences, households’ exposure to MPS’s subordinated bonds is not significant (around 0.1% of net household financial wealth). But banking turmoil could have a snowball effect on business and consumer confidence. This in turn would have negative effects and on investment and spending. Furthermore, the recent fall in Italian bank share prices raises the risk of credit contracting further in the next two quarters.

- A public intervention to recapitalise MPS would have negative effect on the fiscal balance. In the worst case scenario, where no additional money could be raised outside Atlante II, a public support of €5bn will increase the fiscal deficit by around 0.3 percentage points to 2.6% of GDP. This would not affect the structural balance but it would increase the public debt, limiting the fiscal space for next year’s budget.

- Finally, the political uncertainty associated with a bail-in of MPS would also weigh on the growth outlook. The combination of a banking crisis and political deadlock could represent a serious threat to the already weak recovery (GDP growth in Q2 was flat).