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MONTE DEI PASCHI DI SIENA: THE BALL IS IN THE ITALIAN GOVERNMENT'S COURT

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Introduction

In the final days of 2016, the definitive failure to implement a market recapitalization of Monte dei Paschi di Siena (MPS) led to the launch of a public "precautionary recapitalization" and connected decree-law (see *Decreto-Legge* 237/2016, December 23d: DL 2016). However, the MPS saga is far from over.

This is not good news, as there are a number of pending questions in the Italian banking sector. UBI Banca's acquisition of three out of the four new small banks (Banca Marche, Cassa di Risparmio di Chieti, and Banca Popolare dell'Etruria, with the fourth unpurchased bank being Cassa di Risparmio di Ferrara) created upon the bankruptcy of the old corresponding banks over a year ago (November 2015), is on the cusp of being settled. However, the acquisition will take place at a symbolic price (€1), thus transferring the costs of the previous rescue to the entire Italian banking sector. Moreover, UBI Banca has imposed two additional conditions: the shift of all unsettled contentions between the original three failed banks and their old bondholders and shareholders to the single "bad bank", created from the spin-off of the non-performing loans (NPL) of the old four banks; the prior transfer of the new flows of NPL that emerged in the balances of the three new banks during this year's operations, to market funds or, more likely, to Fondo Atlante 2.[1] Banca Popolare di Vicenza and Veneto Banca's new owner (i.e., Fondo Atlante 1) has yet to recapitalize and merge these two banking groups, the process having been frozen until old shareholders can agree on the reimbursement amount for settling previous fraudulent selling practices. Cassa di Risparmio di Genova is about to request some form of public recapitalization for the securitization of an additional

[1] Fondo Atlante was launched in April 2016 and endowed with an initial capital of €4.25 billion by the large majority of Italian financial institutions. Its two original aims were: to underwrite new recapitalizations by Italian banks (up to 70% of its capital), playing the role of 'shareholder of last resort' and to act as a purchaser for the junior tranches of securitized Italian NPLs (up to 30% of its capital). However, Atlante had to cover the full recapitalization of Banca Popolare di Vicenza and Veneto Banca (May-June 2016). Hence, a second Fondo Atlante was created in August 2016 (called Atlante 2, whereas the original Fondo Atlante was renamed Atlante 1), with an initial endowment of €1.715bn. Atlante 2 is focused on the purchase of junior and mezzanine tranches of securitized Italian NPLs.

portion of its NPL, and a few small banks are revealing difficulties in their ordinary operations. Finally, in the background, there is the €13bn market recapitalization of Unicredit, the most international Italian banking group, and a possible further recapitalization of the new banking group created by the merger between Banca Popolare di Milano and Banco Popolare.

Under this backdrop, a few days after the public intervention of Monte dei Paschi di Siena was announced, the Supervisory Board of the European Central Bank (ECB) informed the MPS Board of Directors and the Italian government that the new public recapitalization would need to meet a capital shortfall of up to €8.8bn, around 75% more than the capital injection agreed upon for the failed market solution (€5bn). This change in the requested recapitalization amount by ECB Banking Supervision (EBS) led to unfavorable reactions from the Italian government. These reactions were amplified by the Italian media that, aside from a few exceptions, accused the EBS of arbitrarily exercising its discretion to the detriment of Italian banks. These reactions rekindled debate among the German media, which, in turn, accused the Italian government of ignoring the spirit of the new European rules on banking regulation. Thus, another controversy between Italy and Germany ignited.

The aim of this paper is to underline three issues: (i) as detailed in a Bank of Italy note on December 29th, 2016 (Banca d'Italia 2016), the EBS decision on MPS' public recapitalization applied European rules, even if the connected communication was fouled by a certain degree of discretion, (ii) the Italian government, which will become the majority shareholder in MPS, needs to push for the definition of a new plan for reorganizing the bank and liquidating its non-performing loans (NPL), and (iii) the polemical spiral, which tends to set Italian and German public opinion against each other, is a very risky game that needs to end.

A Bit of Algebra

After the failure of the private capital injection characterized by the ineffective strategy of the two leading investment banks in charge of the process (JP Morgan and Mediobanca), MPS avoided triggering the European resolution process and the connected full involvement of holders of its unguaranteed bonds and deposits over €100,000 (*bail in*) thanks to an exception in the EU Bank Recovery and Resolution Directive (BRRD). The BRRD provides for a so-called *precautionary recapitalization*, which allows a troubled but solvent bank to be recapitalized with public funds in order to address its capital shortfall, as calculated by the European Banking Authority's (EBA) most recent stress test (in the case of an adverse scenario). Precautionary recapitalization activates *burden sharing,* implying the compulsory conversion of the bank's subordinated bonds into new shares.

Therefore, the amount of MPS' precautionary recapitalization could have coincided with the capital injection required by the unsuccessful private process only by chance. The latter was based on an immediate and complete securitization of the riskiest portion of MPS' NPL, as well as on additional funds covering the remaining NPL, and it included some facilities. Article 32 of the BRRD states, instead, that the amount of precautionary recapitalization for a given bank can reach, at the most, its capital shortfall deriving from stress test results under adverse conditions. Thanks to the aforementioned Banca d'Italia (2016), it is easy to show that this shortfall amounts to a total of €8.8bn for MPS.

In the (adverse scenario) stress tests conducted by the EBA last summer (July 2016), MPS was found to have a largely inadequate ratio of highest quality capital (Common Equity Tier 1 or CET1) to total risk-weighted assets. This ratio was not only well below the minimum threshold set by international standards and European rules (8%) but was actually in the negative (-2.44%). As a consequence, MPS' equity capital increase necessary for meeting the 8% threshold is equal to €6.3bn. Based on burden sharing rules, €4.2bn (or perhaps, as will be explained later, €3.7bn) of this €6.3bn would be covered by a mandatory swap: MPS' subordinated bonds, held by the private sector (institutional, professional, and retail investors), must be exchanged for MPS' shares. The activation of burden sharing and the government's majority stake would, however, impede MPS from issuing new subordinated bonds. This would negatively affect the level of its total capital, which is the sum of its CET1 capital and subordinated bonds. According to European regulations, a bank's total capital needs to be at least equal to 11.5% of total risk-weighted assets. To reach this 11.5%, MPS has to collect an additional €2.5bn. The sum of €6.3bn and €2.5bn is, in fact, equal to €8.8bn.

How much of the €8.8bn in precautionary recapitalization will be paid for by the public rescue still remains undetermined. The decree-law (2016, art. 23, par. 3) states that, at the request of MPS, three types of liabilities formerly issued by MPS and held by the private sector have to be forcibly converted to newly issued MPS shares at different conditions. In particular, a first subset of subordinated bonds, mostly held by institutional and professional investors and amounting to around €2.1bn, will be forcibly converted at 75% of their issue value. A second subset of subordinated bonds, mostly in the hands of retail investors (to a great extent, Italian households) and roughly amounting to the same figure, will be forcibly converted at 100% of their issue value. Moreover, the decree-law (2016, art. 19, par. 2) states that, in the event of any precautionary recapitalization and in order to avoid unmanageable accumulation of appeals due to apparent fraudulent selling, the Italian Ministry of the Economy will be entitled to purchase newly issued shares of the bank under recapitalization from the new "forced" shareholders, formerly retail investors of subordinated bonds. In exchange, the latter will receive new senior bonds, issued and transferred by the same bank. This exchange will be at par.

In the specific case of MPS, the shared interpretation of this rule is that the Ministry of the Economy will propose the at par conversion between MPS' newly issued shares and MPS' newly issued senior bonds to the vast majority of holders of the second subset of subordinated bonds mentioned above. Hence, these bonds will be first converted to MPS shares at 100% of their issue value and then later exchanged, again at par, to new senior bonds (possibly guaranteed by the government), which are issued and transferred by MPS (see DL 2016, art. 2-6).

According to Banca d'Italia (2016), the process of recapitalizing MPS will require the following public expenses:

- **€2.1bn** to make up the difference between the €6.3bn needed to reach 8% of the highest quality capital ratio and the €4.2bn recouped from the subordinated bond-for-equity swap;
- **€2.5bn** for the additional capital needed to reach 11.5% of the total capital ratio; and
- **around €2.0bn** to cover the cost of converting newly issued MPS shares forcibly transferred to retail investors that, upon request, may be exchanged for senior bonds.

The total comes out to around **€6.6bn**.

However, even if some ambiguities in the exchange between a portion of newly issued MPS shares and newly issued MPS senior bonds were ignored (see section 2, below), there would still be some indeterminacy. Assuming that one of the two sets of subordinated bonds will actually be valued at 75% of nominal value, their conversion into MPS shares will arrive at a little less than €1.6bn, instead of the full nominal value of €2.1bn. Consequently, the total maximum cost to the Italian government for the precautionary recapitalization of MPS could reach €7.2bn.

False and Real Problems

Beyond the tedious details of the above calculations, two formal but extremely relevant factors should be emphasized: (a) the €8.8bn in precautionary recapitalization, fixed by the EBS, resulted from the very European regulations that helped MPS avoid resolution procedures, and (b) the communication of this new amount to the MPS Board of Directors, the subject of the recapitalization, and the Italian government, the principal actor in the recapitalization, was a required procedure for the EBS. It could be said that the manner in which the EBS communicated the new amount of MPS' public recapitalization was not transparent. Instead of informing the market that the €8.8bn constituted the maximum level of MPS' precautionary recapitalization based on the results of the EBA's previous stress test in the case of an adverse scenario, the EBS sent the Italian government and MPS the results of its calculations by implicitly suggesting, also referencing previous unpleasant cases of precautionary recapitalization (the Greek banks), that the amount of €8.8bn was the request of the European supervisory authority and modifiable only through negotiation.

Now, the ambiguity has been clarified. The effective amount of MPS' precautionary recapitalization, which the Italian government will be called upon to cover, will depend on the restructuring plan for this banking group and, in particular, the liquidation of the amount of NPL in excess of the European average. It is highly probable that a fast-moving, credible, and effective plan will lower the amount of MPS' recapitalization to somewhere between €8.8bn and the old €5.0bn threshold previously set for the failed market process. It is, therefore, essential for the Italian government, in its role as the future shareholder with an absolute majority, to stimulate and monitor MPS management to quickly come up with a plan that is compliant with European rules, and that pursues the objective of restoring the bank's full operability.

There is talk of a timeframe of at least two months for providing a draft plan, which will need to be discussed in its entirety with the EBS and submitted to the European Commission to verify compliance with state aid and antitrust rules. Then, according to article 16-18 of the decree-law (2016), the approval of the final version of the plan will allow the implementation of the different steps of MPS' recapitalization. This type of schedule risks postponing the approval of the final MPS plan and implementation of the actual precautionary recapitalization to the end of spring 2017 and, therefore, to a politico-institutional context characterized by a possible new referendum campaign and the tensions connected with the new electoral law. The risk of delay is aggravated by the idea of further postponing the liquidation of NPL in order to increase their market values. Investors and European supervisory and regulatory authorities could interpret these signals as proof that the government's involvement in MPS is not temporary, ending with the efficient restructuring of this banking group, but a medium-to-long-term endeavor comparable to the one started in the 1930s.

Beyond the market's reaction, a prolonged rescue could also compromise one of the cornerstones of the public intervention in the Italian banking sector. As stated above, the Italian government intends to ensure the complete protection of a segment of MPS creditors, offering them a subsequent exchange at par of the newly issued MPS shares forcibly swapped for their subordinated bonds to senior, and possibly state-guaranteed, bonds. However, this option presents at least two weaknesses: (i) a strain of BRRD rules, and (ii) the risk of adopting discriminatory or unintended measures towards holders of MPS bank bonds.

The BRRD only allows the protection of the portion of subordinated bondholders who were victims of fraudulent selling practices. Therefore, the proposal for the fully protected debt-to-equity-to-debt swap for a given subset of MPS retail bondholders, designed by the Italian government in Article 23 of the decree-law (2016) and justified by the understandable need to avoid a costly and interminably contentious selection process (see the previous section), would only be compatible with European regulation if it were possible to prove that each of the various retail buyers of this type of subordinated MPS bonds were a victim of fraudulent selling practices. Such an assumption would hardly stand up to close scrutiny by European authorities because it would require the analytical check of risk profiles and purchase events for around 42,000 retail investors and proof of fraudulent selling in each of these events.

Moreover, it is highly probable that, in the recent past, various original holders of the fully protected type of subordinated MPS bonds sold them to specialized investors at market prices much lower than the issue value. In this case, the debt-to-equity-to-debt swap at par proposed by the Italian government could create significant profits for these specialized investors. Article 19 of the decree-law (2016) seems capable of avoiding this potential distortion. It specifies that the Italian government will be entitled to implement the exchange at par between its purchase of newly issued MPS shares and transfer of newly issued senior MPS bonds only under the condition that the original purchasers, as well as current holders, of subordinated MPS bonds (i.e., the new forced shareholders) are retail investors (see par. 2, letters a and c). However, it risks arbitrary discrimination (for legal and market reasons: see the recent case of Novo Banco in Portugal) between counterparts who own and have to convert the same type of bonds and are ready to sell the same new MPS shares. Furthermore, avoiding opportunistic transactions of these bonds between professional and retail investors ready to share the potential profits promised by the Italian government intervention appears quite difficult. Therefore, the Italian government would have to adopt fully informed case-by-case choices. Otherwise, it risks unintentional transfer of substantial capital gains to certain speculative investment funds. These speculative gains would be added to the generous compulsory conversion also reserved for subordinated MPS bonds mostly in the hands of institutional and professional investors, as 75% of their issue value is largely above their market prices.

Conclusions

The Italian government can only manage the mentioned problems in cooperation with European institutions. The thesis, posited in the introduction, is thus reinforced—it would be convenient for the Italian government to tone down rhetoric against European institutions and quickly proceed toward a new plan for the restructuring of MPS and the liquidation of its NPL. This is also, if not above all, further supported by a more general and concerning factor. The case of MPS was the final ring in the chain of increasingly acute disaccord between Germany and Italy. German media sustain, at this point openly, that Italy does not respect the essence of European rules and has become an element of grave instability for the euro area. Likewise, Italian newspapers assert that European institutions are prone to German or Franco-German agendas aimed at weakening the financial and productive structure of Italy.

The dynamic, thus triggered, is an awful novelty for the EMU. It appears dangerous in itself and entails grave negative consequences for the Italian economy and society. In fact, if this atmosphere were to recur in the upcoming months, Italy would risk finding itself in an extremely vulnerable position. After the German elections and likely confirmation of Angela Merkel's leadership at the end of 2017, there will be a revival in the evolution of EMU governance. Combined with Italy's low economic growth, stagnation in different forms of productivity, growing public debt, and fragile banking and financial sectors, the government's combative stance vis-à-vis European institutions and 'core' EMU member states could be the final grain of sand that tips the scales toward Italy's marginalization with respect to the European Project.

There is still room to invert the unfavorable momentum. This remaining opportunity should be taken advantage of to overcome or attenuate Italy's internal fragilities and to escape the comfortable but false position of attributing the country's ills to discriminatory measures of a malevolent Europe.

References

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