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HOW THE LARGEST ITALIAN BANK HAS SURVIVED THE FINANCIAL CRISIS:

UNICREDIT CASE STUDY

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Abstract:

This brief case study aims to analyze the story of UniCredit during the economic downturn of the last decade, which had been the major difficulties and how the bank managed to overcome them. The narration starts with the merger between the former Uni Credit and Capitalia in 2007 and finishes at the beginning of 2018, when the bank seemed to have found its direction to exit the crisis. At the end of the case, a brief teaching note explores further some of the main topics that arose during the story telling.

Keywords: Italy; financial crisis; banking.

It was back on the 20th of May 2007 when a small Italian saver, Claudio Marchi, decided to invest part of his reserves in a newly created bank, becoming a minor shareholder, under the suggestion of his personal financial advisor. Actually, what triggered his decision was the ambitious merger plan between Capitalia and Uni Credit, whose aim was to create the first Italian bank and the fifth largest group in Europe[1]. The investment seemed promising both strategically and financially, and safe indeed; what he could not know at that time were the massive impact of the upcoming financial crisis and the subsequent implications for banks' shareholders.

1. The Profumo era (2007-2010)

After the general meetings of the two banks, at the end of July 2007 the merger was approved and it would have been effective starting from the first day of October of the same year[2]. The operation was favorably supported by the stock market, even if the negative trend made the stock loose 14%, in line with other securities (Exhibit 1). In the new holding, a pivotal role would have been played by the three foundations that historically had constituted the core in the old Uni Credit ownership: CariVerona, Cassa di Risparmio di Torino (Crt) and Carimonte would have continued to own 12% of the new bank overall.

Nonetheless, the event that gave birth to UniCredit Group almost coincided with the beginning of the worst economic downturn after the Great Depression, making the deal between the two banks impressively ill-timed.

Despite its beginning, the impact of the financial crisis was not immediate in UniCredit's performance: for the first semester, the Italian bank recorded a consolidated net income of 3.6 billion, +16.6% compared to the previous year, and the exposure to US subprime loans was declared as marginal[3]. These positive figures persuaded Claudio think that the bank in which he had invested was in good conditions and probably its savings would have been preserved.

Things started to slightly change in the beginning of November, when UniCredit shares closed at -4.68% (1st of November) and the crisis became a fully-fledged European matter. Furthermore, although low, UniCredit exposure to subprime loans was the highest among the Italian banks[4].

[1] *Il Sole 24 ORE* 2007
[2] *Il Sole 24 ORE* 2007
[3] UniCredit Group 2007
[4] *Il Sole 24 ORE* 2007

In the middle of November, the results of the third trimester remained largely positive, with an increase in net income of 19% and a Roe of 17.5%[5]. However, since the beginning, one of the most critical aspect have been the massive amount of non-performing exposures originated in the domestic market: even if at that time the situation did not seem alarming, given an insolvency rate of 1% compared to a 20% in the US, UniCredit tried immediately to contain this issue. It offered a free renegotiation to its clients who were experiencing difficulties, caused by the higher interest rates in the market: thus, the maturity was extended and the mortgage payment was adapted to match the new unfavorable conditions (Bufacchi 2007).

In the beginning of 2008 the financial crisis worsened and the Italian bank started to counteract. In February it reduced its exposure to US subprime loans, passing from 246 million to 164 million at the end of 2007. This move was judged not sufficient by the rating agency Moody's, which cut the ratings for UniCredit and revised its outlook. The main reasons lied in the scarce capital adequacy and reflected the fear that UniCredit would not be able to reinforce its capital structure[6]. In fact, Core Tier 1 in December 2007 was 5.83%, with an increase of 0.01% compared to the previous year, and the solvency ratio lowered of 0.39%, from 10.50% to 10.11%. However, UniCredit kept reporting positive results, with a net income of almost 6 billion, EPS of 0.54 and a dividend payment of 0.26 per share[7].

Following Moody's verdict, in the beginning of October 2008 UniCredit declared that it would have transferred part of its real estate portfolio to a closed-end real estate fund. This operation was said to increase the Core Tier 1 ratio by 0.15%. Other transactions completed in September implied an improvement in the same ratio of 12 basis points. However, also Fitch unfavorably modified the ratings for both UniCredit Group and UniCredit on individual basis: this time, the negative outcome was reasoned by the lower commissions gained during the period and the general difficulties in the asset management sector[8].

Consequently, the 5th of October the Italian bank launched a 5-billion operation, in order to restore its ratios. The main aim was to take back the Core Tier 1 over 6%, having reached 5.5% in June. The plan was articulated in two moves: the first consisted in paying 2008 dividends through shares, thus avoiding a cash outflows of approximately 3-3.5 billion. The second phase consisted in the emission of a convertible and subordinated hybrid equity-linked (so called "cashes") bond of 2 billion, that would be included in the calculus of Core Tier 1 ratio, thus

[5] *Il Sole 24 ORE* 2007
[6] *Il Sole 24 ORE* 2008
[7] UniCredit Group 2007
[8] *Il Sole 24 ORE* 2008

determining a strengthened capital. With the combined impact of the previously announced real estate dismissal, these operations would account for a total amount of 9 billion capital restructuring[9]. Especially the debt issue was favorably approved by the market: Profumo, UniCredit's Ceo, declared that just three days after the pronouncement all the cashes bond were subscribed[10]. In addition, UniCredit's exposure to Asset backed securities reduced of 5.3 billion compared to the previous year and the total risk weighted assets were expected to lower in 2009, passing from 85 billion to 74 billion[11].

All these efforts were not enough anyway to reinvigorate the bank capitalization: a study conducted by R&S Mediobanca certified that UniCredit and Intesa, the two major Italian banks, had capital ratios below the European average. Specifically, for UniCredit the solvency coefficient was more than 2 points below (9.8% against 12%) and the Core Tier 1 was 5.6% against 6%[12].

Capital injections, both in the form of equity and debt, continued until the beginning of 2009. In November the bank issued 23-billion residential mortgage backed securities, with the declared objective of accumulating instruments that may be used as collaterals in refinancing operations with the European Central Bank, with a prudential scope[13].

In the end of December 2008 a capital increase of 3 billion was announced and soon approved by Consob[14].

Later on, Profit Participation Rights (PPR) for 1.1 billion were transferred from Bank Austria to B&C Privatsiftung, implying the Core Tier 1 to increase and reach 6.7%[15].

The beginning of 2009 was mainly dedicated to the realization of the capital increase. Some frictions arose when CariVerona Foundation, the first shareholder in UniCredit, refused to participate and to subscribe 500 millions of convertible bonds. However, through the purchase of shares on the secondary market, the foundation remained the major shareholder. Some days later, on the 8th of February, the remaining part of convertible bonds was subscribed by the second and the third shareholders of the bank, Central Bank of Libya and Munich Re

[9] Graziani 2008
[10] *Il Sole 24 ORE* 2008
[11] Elli 2008
[12] *Il Sole 24 ORE* 2008
[13] Bufacchi, 2008
[14] *Il Sole 24 ORE* 2008
[15] UniCredit Group Sells B&C Profit Participation Rights to B&C Holding GmbH 2008

respectively[16]. At the end of February, all the cashes resulted underwritten and the capital increase was completed, for an overall amount of 2.99 billion[17].

As previously announced, UniCredit did not distribute any dividend in form of cash for the year 2008. Instead, the bank distributed new shares to existing shareholders, thus determining a script dividend[18]. Claudio, who sustained the capital increase without diluting his share, continued to believe that UniCredit would grow again.

But once again, the fresh infused capital was not adequate and a second issuance of a 3-year maturity bond of 1.5 billion soon followed[19]. Additionally, in June the Italian bank prepared an emission of covered bonds, with the aim of gathering at least one more billion[20].

At the end of June UniCredit completed the issuance, in which 4 billions were collected through preferred bonds with a 7-year maturity.

The capital gathering had a significant impact on the bank's Core Tier 1: in June it increased of 31 basis points compared to the end of March, reaching 6.69%[21].

While UniCredit was completing its capital booster, Italian banking sector was in serious difficulties, so the government offered its help through the so-called "Tremonti bonds", that is debt instruments that the public sector would have subscribed to reinforce banks' capital and to support Italian SMEs. However, UniCredit and Intesa Sanpaolo declined the offer, declaring that they would rely on their own private sources in order to restore their capital structure. In particular, the former announced a new rights issue of 4 billion to meet its capital requirements[22].

Meanwhile, in the beginning of November, a structural change in the Italian bank was about to be launched: following the examples of Bnp Paribas and Santander, all the corporate divisions (UniCredit Banca di Roma, UniCredit Banca, UniCredit Private Banking, UniCredit Corporate Banking and Banco di Sicilia) were going to be merged, mainly to achieve cost savings that would have benefited the financial situation. The unified structure was supposed to be effective by the 1st of November 2010[23].

In the end of the year, the road toward financial strength was still long and another effort was requested to UniCredit's shareholders: that was the previously proclaimed capital increase of

[16] *Il Sole 24 ORE* 2009
[17] *Il Sole 24 ORE* 2009
[18] UniCredit Group 2008
[19] *Il Sole 24 ORE* 2009
[20] *Il Sole 24 ORE* 2009
[21] *Il Sole 24 ORE* 2009
[22] *Il Sole 24 ORE* 2009
[23] Festa 2009

4 billion, to be completed between January and February[24]. In addition, at the end of November, a new emission of 1.5 billion bond aimed for the reinforcement of Tier 1 ratio.

In the beginning of February 2010, the former operation had been completed and later the yearly results were published: a significant decrease in net income compared to the previous year but a dividend distribution equal to 0.03 euro per ordinary share and 0.045 euro per preferred share[25].

The capital storage did not conclude and on the 14th of July UniCredit launched a new issuance of hybrid bonds, that presented both debt and equity characteristics, for an overall amount of 500 million[26].

2. The first change in leadership and Ghizzoni management (2010-2016)

Although recognized as an excellent leader, especially during the last years of financial crisis, on the 22nd of September Mr. Profumo offered his resignation as Ceo of UniCredit. The main cause was the so-called Libyan issue, in which Tripoli property (composed by Central Bank of Libya and Libyan Investment Authority) reached 7.6% through a rapid escalation. During this phase, Profumo was judged too autonomous and independent from the Board and shareholders, which strongly claimed for his leaving, especially the three foundations[27].

The change in governance was fast and eight days later the new Ceo was appointed, Mr. Federico Ghizzoni. Soon after, Q3 results were published and with a Core Tier 1 of 8.61% UniCredit seemed ready for Basel III regulation[28].

2011 might be considered as the year of contradictions: while in the beginning UniCredit management, included the Ceo, continuously declared that no other capital increase would have been necessary, in the 15th of October a new operation was launched for an amount of 7.5 billion, partly compromising Ghizzoni's reputation and accountability.

The year began with a cleaning in the bank's financial statement, impairing losses for 359 million originated in one of UniCredit's subsidiaries, Atf Bank from Kazakistan[29].

It is in the middle of April that Ghizzoni started to affirm that UniCredit would have not incurred in other rights issues, at least in the short run, given its solid capital structure.

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[24] *Il Sole 24 ORE* 2009
[25] UniCredit Group 2009
[26] *Il Sole 24 ORE* 2010
[27] *Il Sole 24 ORE* 2010
[28] *Il Sole 24 ORE* 2010
[29] *Il Sole 24 ORE* 2011

Furthermore, in 2013 the bank should have been able to reach a common equity ratio equal to 8.4%, above the amount required by Basel III regulation[30].

At the end of the same month, results of the previous year were published, with a positive net income and a dividend yield of 1.7%, with 0.03 euro per share distributed to shareholders[31].

On the 28th of May UniCredit prepared the restructuring of 3 billion of "cashes bond" used during the capital increase that had occurred between 2008 and 2009. In fact, according to the new rules of Basel III, those instruments would not have been included in the computation of Core Tier 1 ratio. The restructuring would imply the bonds' yield to be connected to the dividend, in order to align them with the equity capital[32].

In the meanwhile, the Board of Directors approved an eventual operation for the securitization of up to 14 billion of retail loans, guaranteeing new liquidity. The results of the first half of the year were encouraging: net income registered a +97.5%, Core Tier 1 reached 9.12% and also the intermediation margin recorded an improvement compared to previous period (+1.6%).

Despite what had been previously stated and the good outcome achieved, UniCredit's Ceo Ghizzoni, during an interview with Financial Times, revealed that both the market and that bank's investors were ready to sustain a new capital increase, in order to lead the Core Tier 1 capital ratio above 10%[33]. Soon after, UniCredit launched a capital rise of 7.5 billion, accompanied by a strategic plan aimed for a significant cost reduction within the bank structure.

In addition, the European Banking Authority required UniCredit to cover a supplementary buffer of approximately 7.4 billion, that would reduce to 4.4 billion, considering the operation of bond restructuring previously explained[34].

After the transaction had been approved by both shareholders' meeting and Consob, on the 5th of January 2012 the details of the operation were delineated. The discount was 43% compared to Theoretical ex-rights price (TERP)[35] and each shareholder received the right to purchase a new share every two ordinary shares formerly owned[36]. On one hand, the so-called issue-price irrelevance hypothesis states that the sole reason of discounts is to ensure that the offer price remains lower than the market price until the offer closes; thus, deep discounts are irrelevant

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30 *Il Sole 24 ORE* 2011

31 UniCredit Group 2010

32 *Il Sole 24 ORE* 2011

33 *Il Sole 24 ORE* 2011

34 European Banking Authority 2012

35 A theoretical ex-rights price (TERP) is the market price that a stock will theoretically have following a new rights issue. The computation of TERP is based on the company's market capitalization and the number of shares outstanding, both before and after the rights issue.

36 *Il Sole 24 ORE* 2012

for the wealth of subscribing or non-subscribing shareholders and they do not represent a cost for the company (Armitage 2000; Tsangarakis 1996). Other studies sustain the signaling hypothesis (Heinkel and Schwartz 1986), according to which subscription discounts conveys a signal about the firm quality. In fact, in UniCredit's case, the excessive discount became a matter of alarm both for stock market and analysts, interpreted as an indication of the deep and ongoing crisis that was hitting the European banking sector and the difficulties faced to raise fresh capital[37]. On the 28th of January the capital increase was officially concluded, with the 99.8% of shares subscribed[38].

The outcome of the capital rise was shortly exhibited: the main aim of extending Core Tier 1 up to 10% was achieved, with the latest value of 10.35%.

Thereafter, the results for the previous financial year were disclosed: in 2011 the Italian bank recorded a loss of 6.35 billion. Despite the huge and increased amount of provisions for bad loans (Exhibit 2), the net operating result remained positive, although decreasing of 70.5% compared to the previous year. The most negatively affecting voice was "goodwill adjustments", whose amount was caused by intensified regulation and worsening of macroeconomic scenario. Given the harmful results, the meeting agreed to not distribute any dividend to shareholders[39].

On the 4th of September, a new issuance of 1 billion covered bond was completed, trying to gather new funds[40].

The 2013 showed first signals of recovery. At the beginning of the year, in January, the Italian bank sold 9.1% of Pekao, one of its Polish subsidiaries, although remaining its major shareholder, with a share of 50.1%[41]. Later on, the results of the previous year were announced, with a positive net income of 865 billion and a dividend per share of 0.09 euro. Funds for deteriorated debt amounted to 9.6 billion, but Core Tier 1 registered a growth of 2.4%, passing from 8.40% in December 2011 to 10.84% in the same month in 2012[42].

During the year, Core Tier 1 kept growing, reaching 11.03% in May. Moreover, a significant drop in provisions for bad loans (1.2 billion against 4.6 billion in 2012) gave the hope of a rapid improvement.

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[37] Aloisi 2012
[38] *Il Sole 24 ORE* 2012
[39] UniCredit Group 2011
[40] *Il Sole 24 ORE* 2012
[41] Da Rold 2013
[42] UniCredit Group 2012

The results of the first semester confirmed the positive performance, with a net income higher than expected (449 million against the 349 predicted), a growth rate of 31% and a slowdown of the impact of deteriorated loans[43][44].

Supported by the favorable trend, UniCredit decided to invest again in the Eastern Europe market, expanding its presence in Poland. It did a preliminary offer to the bank Bgz, controlled by the Dutch bank Rabobank. Meanwhile, it dismissed its participation in FondiariaSai, for a share of 6.7%[45].

In the first half of November, Q3 results were published. UniCredit recorded a positive performance, despite the difficult macroeconomic situation in Italy and the burden of its bad loans. In terms of capital strength, the bank was already meeting the requirements that would have been imposed by Basel III: Core Tier 1 reached 11.71% and Common Equity Tier 1 was equal to 9.83%[46].

2014 began with the securitization of a portfolio of 910 million loans, mainly Italian credits derived by project finance investments. Almost half of the securitization was underwritten by an American investment group, confirming the foreign interest for the European and Italian market. [47]

In March, the financial statement of the previous year showed a loss of 11 billion. The main components responsible for the loss were impairment of goodwill for 9.3 billion and deteriorated loan provisions for 13.7 billion. However, the capital composition of the bank reinforced, with a Cet1 equal to 10.4% and a Cash covered ratio of 52%. In addition, a script dividend for the amount of 0.10 euro per share was distributed to shareholders, despite the negative net income[48].

With the results of 2013, a new strategic plan for the period 2013-2018 was presented. The plan was based on cost cutting and optimization of the operations, including the layoff of 8,500 employees, of whom 5,500 are Italians[49]. Moreover, the Ceo announced the future Ipo of Fineco Bank, that would occur during 2014[50].

The efforts for "cleaning" financial statements made by Italian banks, UniCredit in particular, were explicitly appreciated by rating agencies: Italian banking sector as a whole increased its

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[43] Ferrando 2013
[44] *Il Sole 24 ORE* 2013
[45] Festa 2013
[46] Ferrando 2013
[47] Monti 2014
[48] UniCredit Group 2013
[49] Ferrando 2014
[50] Ferrando 2014

provisions for bad debt, with UniCredit accounting for 70% of the impairment losses announced[51].

Additionally, at the end of March the bank prepared the issuance of a perpetual bond with a call option to be exercised after 10 years; the operation was done in collaboration with a pool of joint book runners. The bond, with a coupon rate that exceeded 5.125%, would be included in the computation of Common equity tier 1[52].

The second part of 2014 was characterized by some initial and timid operations to restructure the bank portfolio, especially on the asset side, by transferring part of its non-performing exposures and by selling non-core business (Exhibit 5).

In April, the bank presented a formal prospectus to Consob, for Fineco listing in Milan stock exchange. According to the strategic decision, after the IPO UniCredit would have maintained control, remaining the major shareholder[53].

Few days later, UniCredit together with Intesa Sanpaolo started working to restructure their loan portfolios. The two banks agreed to transfer their Non-performing loans (NPLs) to an ad-hoc vehicle in order to optimize their asset performance. At that time, it seemed that the whole amount subjected to transfer was approximately 2 billion euros, originated from 10-15 companies of medium dimensions. In the meanwhile, bad loans kept decreasing, registering a -1.3% in May compared to the previous trimester[54].

In August, UniCredit proceeded to sell its share of DAB online bank to Bnp Paribas and the results of the first semester seemed promising: net income was equal to 11.4 billion and the fully-loaded pro-forma CET1, considering the IPO of Fineco and the selling of DAB, amounted to 10.4%[55].

Continuing the restructuring process of its assets, at the end of the summer new rumors about the selling of Pioneer, UniCredit's Asset management subsidiary, started to circulate.

Meanwhile, in September UniCredit prepared the issuance of 1.3 billion of Asset backed securities in Dublin Stock Exchange[56]. In October 2014, the outcome of stress tests performed by EBA was published, with the Italian bank recording good results: its surplus of capital

[51] Redazione Radiocor 2014
[52] *Il Sole 24 ORE* 2014
[53] *Il Sole 24 ORE* 2014
[54] *Il Sole 24 ORE* 2014
[55] *Il Sole 24 ORE* 2014
[56] Monti 2014

amounted to 8.747 billion[57]. Given those achievements, UniCredit Ceo confirmed the target of 2 billion for the net income of 2014[58].

This target was confirmed to be reached, at the beginning of 2015. For the financial year ended in 2014, the bank distributed a script dividend of 0.12 euro per share[59].

In 2015, the efforts to reduce the amount of NPLs continued, in a more vigorous manner.

First, UniCredit proceeded to the disposal of UniCredit Credit Management Bank S.p.A. (UCCMB) to the consortium formed by Fortress and Prelium, including a portfolio of 2.4 billion of bad loans[60]. In July, another operation involving non-performing exposures led UniCredit to the selling of 625 millions of NPLs to Pra Group Europe[61]. After two years of proceedings, the Italian bank completed the disposal of a total amount of 1.9 billions of non-performing loans.

The achievements of the first semester were published at the beginning of August. UniCredit reached a Common equity tier 1 of 10.38%; its net income amounted to 1.03 billion for whole period of 6 months and 552 million for Q2. Bad loans experienced a further decrease of 4.3%, especially thanks to the latest disposals coming from the non-core bank, whose assets had lowered of 2.2 billion[62].

In November 2015, two major events impacted on bank's performance. First, the negative and persistent macroeconomic conditions forced UniCredit's management to revise the strategic plan, that was supposed to guide the years from 2014 and 2018: negative interest rates, difficult growth of the banking industry and flat inflation led to a negative correction of the previously established targets.

Secondly, the Financial Stability Board (FSB) issued an international standard for global systemically important banks (G-SIBs) on loss-absorbing and recapitalization capacity in case of resolution. The main innovation was the introduction of the so called "minimum Total loss-absorbing capacity" (Tlac). Tlac comprises both capital instruments (CET1, Additional T1 and T2) and long-term unsecured debt (subordinated and senior debt), that can be written down or converted into equity in case of resolution. FSB determined that the minimum Tlac G-SIBs needed to reach was 16% of risk-weighted assets by January 2019, rising to 18% by the

[57] European Banking Authority 2014
[58] *Il Sole 24 ORE* 2014
[59] UniCredit Group 2014
[60] *Il Sole 24 ORE* 2015
[61] Festa 2015
[62] *Il Sole 24 ORE* 2015

beginning of 2022. In addition, Tlac had to account for 6% and 6.75% of the Leverage ratio exposure by 2019 and by 2022 respectively[63].

These two episodes deeply influenced the strategy UniCredit followed onward. The bank concentrated only on core activities, continuing the disposals of non-essential assets and cost cutting.

On the 12th of November, the new strategic plan was published, in which two of the main pillars were a consistent reduction of operative costs and the disposal or the restructuring of non-performing assets. Moreover, capital objectives were set, to be reached by 2018: Cet1 should amount to 12.6%, net income to 5.3 billion, Roe at 11% and in the following three years the dividend distribution would account for 40% of net income[64].

3. The French way: Jean Pierre Mustier (2016-now)

The first part of 2016 was marked by the second main change in leadership: at the end of May the previous Ceo Federico Ghizzoni resigned and on the 11th of July Jean Pierre Mustier, formerly head of the Corporate and Investment banking division, was elected as his successor in UniCredit guidance[65]. In 2016 the overall Italian banking sector was in a serious and difficult moment: despite the efforts made, the burden of Non-performing loans has remained elevated. In addition, the market seemed to hope for a new capital increase to reinforce capital stability of the bank. Just after his election, Mustier stated that the bank would adopt a diversified approach for its assets, with the main aim of creating value for its stakeholders.

The new Ceo immediately showed his resolution and determination, through two powerful operations that delivered a clear message to the market[66].

First, an accelerated book building was announced, consisting of the launch of 10% of Fineco's shares. The process was concluded just one day after, on the 12th of June, for a total price of 328 million and an increase of Cet1 of 8 basis point[67].

Secondly, the disposal of 10% of Pekao was prepared, for an estimated price of 750 million. UniCredit would have remained the major shareholder at the end of the process, retaining 40.1% of shares[68].

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[63] Davi 2015
[64] Ferrando 2015
[65] Ferrando 2016
[66] Graziani 2016
[67] D'Ascenzo 2016
[68] *Il Sole 24 ORE* 2016

In just 5 days, UniCredit's capital requirements registered an increase in Cet1 of 20 basis points and its share price rose of about 17.7%, thus confirming the satisfaction of investors regarding the previous two moves. However, despite the improvements accomplished, the President Giuseppe Vita admitted that a new capital increase would be necessary, because European Central Bank would not probably consider enough the already made efforts[69].

In August, UniCredit pushed further on the valuation of strategic disposal of assets. Two of the major candidates, according to the rumors, were the remaining share of the Polish bank Pekao and the asset management company Pioneer, after that the deal with Santander was off.

In October, a new accelerated book building was launched for a further 20% of Fineco. After the operation, UniCredit retained 35% of the shares, collecting 550 million and increasing the Cet1 of 12 basis points[70].

Few days later, Pekao's disposal was confirmed, positively welcomed by stock market[71]. Meanwhile, another Polish company, Kruk Group, agreed to purchase 940 million euros of bad loans from UniCredit[72].

Finally, between the end of November and the first half of December, final arrangements were reached both for Pekao and Pioneer. The deal for the former imposed the transfer of 32.8% of the Polish bank to Pzu-Pfr (a listed insurer and a state-owned development fund respectively) for 2.4 billion, to be concluded in the first half of 2017 and impacting on Cet1 by 55 basis points. On the 12th of December, a binding accord between UniCredit and Amundi[73] established the selling of Pioneer for 3.545 billion plus a special dividend of 315 million. The successful operation provided to UniCredit a capital gain of 2.2 billion and a positive impact on Cet1 of 78 basis points[74].

In the meantime, the Italian bank continued with its liability restructuring, selling a 1.4 billion portfolio of bad loans to Pimco, an American investment management firm. The relationship between UniCredit and Pimco led to another impressive divestiture of 17.7 billion euros of bad loans in favor of the American company and of Fortress Investment group, signing the so-called Fino project (Failure Is Not an Option)[75].

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[69] *Il Sole 24 ORE* 2016
[70] *Il Sole 24 ORE* 2016
[71] Ferrando 2016
[72] *Il Sole 24 ORE* 2016

[74] Lodi 2016
[75] Festa 2016

On 13th of December, what investors had already forecasted was finally revealed and detailed by UniCredit's management, through the publishing of the so-called Transform 2019, the bank's new strategic plan[76]. First, it was announced another capital increase, the largest that the bank has faced so far: 13 billion euros of new issued shares would have been necessary to cover the capital demand. With this new operation, UniCredit would have almost doubled its market capitalization. However, the feedback was encouraging, with a share price rise of 44% in 30 days from the end of November until the 22nd of December, determining a clear and explicit approval on UniCredit's conduct[77].

The other major points that Transform 2019 took into account were the reduction human resources, for approximately 14 thousand estimated redundancies. Additionally, maxi-provisions for Non-performing loans of 8 billion would contribute to definitely clean the balance sheet of the Italian bank from non-performing exposures. The declared aim of this set of operations was to reach a Rote of 9% and a Cet1 of 12.5% by 2019.

The burden of this cleaning process remarkably encumbered financial results of 2016: an additional impairment of "Fondo Atlante[78]" for 1 billion brought the overall loss to 11.8 billion, diminishing Cet1 to 8%. According to the general meeting, dividends would not be distributed[79].

The agenda for the capital increase started on the 5th of February 2017[80] and the whole process was finished at the end of the same month. The discount offered on the theoretical ex-rights price was 38%, implying that each share could be bought for 8.08 euros. The operation was a success, accompanied by the deep reorganization in UniCredit's asset side: on the 3rd March, the stock price registered an increase of 15% during the previous traded week and a +3.7% compared to the previous day[81].

Few months later, by the beginning of July, the disposals of both Pekao Bank and Pioneer Investments were finally concluded. The former was sold for a price of 2.5 billion and impacted on Cet1 for +70 basis points, while the latter implied a capital gain of more than 2 billion (as already negotiated) and an increase in Cet1 of 84 basis points[82].

[76] Ferrando 2016
[77] *Il Sole 24 ORE* 2016
[78] Fondo Atlante is a private investment fund established in April 2016 with the participation of both private and public banking institutions (banks, banking foundations, the Italian Treasury and Cassa Depositi e Prestiti). The aim was funding banks that were experiencing liquidity shortage.
[79] UniCredit Group 2016
[80] Davi 2017
[81] *Il Sole 24 ORE* 2017
[82] Carletti 2017

In addition, UniCredit acted on the liability side of its balance sheet, issuing new instruments that have reinforced its Tier 1 and Tier 2 capital levels. By the first half of June, the Italian bank had completed four different issuances, for a total of approximately 4.2 billion euros gathered[83]. Thanks to this operation, the bank succeeded in lengthening the duration of its subordinated notes and it strengthened its Tier 2 ratio, that was already above the regulatory requirements.

Meanwhile, the first part of Fino Project was concluded, with the successful disposal of the first half (50.1%) of its portfolio composed by 17.7 billions of bad loans; the remaining 49.9% was to be reduced to 20% in the second phase of the operation[84].

Results of the first semester were a breath of fresh air compared to the difficult time UniCredit had passed: net income increased of 40.6% compared to the same period in 2016, with a slight reduction in the interest margin (-0.7%) but an improved performance in net commissions (+7.7%). Capital ratios were showing signs of recovery, after the capital increase and the clean-up of 2016 financial statement: Cet1 fully loaded amounted to 12.8% (against 10.33% of the previous year). Bad loans kept decreasing and cost cutting, implying a reduction of branches and employees, continued according to Transform 2019[85].

Despite the discouraging moments that he has passed during the crisis, Claudio Marchi kept his participation in UniCredit capital, believing that the bank's performance would have improved. His efforts have been rewarded only after Mustier's nomination as Ceo in 2016, when the condition of the major Italian bank started to recover again and its share price slightly increased.

However, he felt that something went wrong during the crisis and that something better could have been done at management level in order to overcome all the issues that the bank faced. In the initial part, large capital injections were required, both on the equity and debt side. Afterwards, with Ghizzoni's guidance, Claudio had the sensation that the bank kept pretending it was in good shape. Finally, Mustier in 2016 opened the giant Pandora's box, which revealed a bank oppressed by the amount of NPLs and undercapitalized.

[83] Monti 2017
[84] Paronetto 2017
[85] UniCredit Group 2017

Teaching note

I. Why UniCredit decided to raise its capital for four times during financial crisis, instead of asking the whole amount at once to its shareholders?

All in all, UniCredit raised 27.5bn from 2008 to 2017 through issuance of new shares, sustained by shareholders. It is a massive amount, especially regarding the last equity injection of 13bn, that has almost doubled UniCredit capitalization.

At least three different hypotheses may be formulated in order to explain why the bank preferred to repetitively ask for fresh capital instead of requiring funds all at once:

1. <u>Evolution of capital requirements throughout the years of financial crisis</u>

According to this hypothesis, it is fair to assume that the bank did not actually have a capital shortfall of more than 25 billions at the beginning of 2008, but it rather had to deal with it for all the duration of the economic downturn due to the increase in capital requirements imposed by European regulation and supervisory authorities.

In fact, at the very beginning of the crisis, the sole capital boundary was the one enforced by Basel II Accord, in which the sum of Tier 1 and Tier 2 capital had to equal at least 8% of risk-weighted assets.

Since the earliest phases of the crisis, the accord showed its flaws and the need for a more prudential set of rules arose, aiming to prevent future systemic crisis and to create a more resilient banking sector. Consequently, works for the so-called Basel III started right after and in 2013 two legislative acts (Capital Requirements Directive and Capital Requirements Regulation – CRD IV/CRR) implemented new and more binding standards for European banks. Common Equity Tier 1 was set to a minimum of 4.5% of RWA, new liquidity requirements increased the level of liquid assets a bank needed to keep and three additional buffers of CET1 capital were established to ensure capital conservation, contrast countercyclical effect and avoid systemic risk. Additionally, another buffer was provided for globally systemically institutions.

Moreover, stress tests carried out by EBA highlighted the relatively weak position of the UniCredit compared to its European peers in terms of capital position. This has pushed the bank to strengthen its capital structure through the emission of new shares to be directly computed within Core Tier 1 capital.

These two elements, the new regulation and authority-performed stress tests, and thus the increasing need for capital, may be the reason that led UniCredit to opt for repeatedly fund gathering procedures instead of one operation at once.

2. <u>Risks associated with high capital increases</u>

Another possible explanation may rely on the risks that UniCredit would have incurred if it had chosen to request larger amounts but with fewer procedures.

In literature, it is well documented the stock underperformance of firms that conduct seasoned equity offerings compared to ones that do not issue new equity (Loughran and Ritter 1997; Spiess and Affleck-Graves 1995). The explanation is connected with the theory exposed by Myers and Majluf (1984), according to which there is an intrinsic adverse selection problem associated with SEOs. SEOs may occur as result of a management internal decision or because bank regulators force the institution to raise new capital. In both cases, the issuance of new shares will send a negative signal to the market: in the first circumstance, because investors will think that management has negative information and the firm is overvalued, therefore they have recourse to equity. In the second situation, the bank will be regarded as in distress situation, although the effect may be much smaller, given the fact that all the financial institutions would be required to boost their capital ratios.

Another risk that may be associated with large calls for equity is the fear that majority shareholders do not sustain, fully or partially, the rights issue. Since the approval of the operation is subject to the consent of existing shareholders, they may be reluctant to accept mainly because this would mean investing more in order to maintain the same voting power or diluting their share, by selling the rights. Thus, it becomes problematic to realize rights issue if shareholders do not agree.

Additionally, a recent empirical study by Elyasiani, Mester and Pagano (2010) evidenced how larger capital infusions impact on return and risk performance of financial institutions over the business cycle. Results show that investors reacted negatively to the news of larger SEO announcements in the short-term and larger issuers faced higher post-announcement systematic risk.

The theoretical foundation and the empirical evidence confirmation may suggest a good explanation to (at least partially) justify the strategy followed by UniCredit: they tried to limit the amount asked and probably hoped to not ask further funds each time they recurred to a SEO, in order to minimize negative effect related to this operation.

3. <u>Extend-and-pretend strategy/wait-and-see approach</u>

Lastly, the concluding hypothesis is that the bank, although recognizing its capital shortfall since the beginning of the crisis, did not voluntarily show to the market its vulnerable position, expecting better conditions in future periods and temporarily hiding its capital inadequacy. In this way, the bank avoids to report the full amount of its losses, postponing restructuring or deleveraging, until a certain threshold is met, thus requiring a capital injection.

This approach, often referred to as extend-and-pretend or wait-and-see strategy, was indeed quite frequent for European banks, that delayed in recognizing losses; this, in turn, led to reduced lending, as delays force banks to increase provisions during stress times, namely when losses materialize and regulatory capital requirements become most binding (European Commission 2018).

II. Considering needs for additional capital that the bank experienced for all the crisis years, why UniCredit kept paying dividends to its shareholders, except in 2016?

Two main reasons may be identified in order to answer the question:

1. The first and simplistic view, that may explain the 2007-2008 dividend policy, relies on a declaration of Profumo himself in 2008: the bank had underestimated the effects and impact of financial crisis and there had been "some errors of judgement" internally (*The New York Times* 2008). This may justify why the bank, that did not expect a so-severe distress, initially maintained a positive payout to its shareholders instead of conserving its net income in the form of retained earnings, as potential buffer for subsequent losses or capital requirements.

   If this might be a possible clarification for the initial period of the crisis, the subsequent continuation of a positive dividend distribution falls into contradiction: it is clear that, once the bank had realized the real repercussions of the economic downturn, it should have corrected its strategy by cutting payout. Instead, UniCredit kept remunerating its shareholders even when the share price was shrinking and several capital injections were needed to restore a sufficient level of capital strength.

2. Therefore, a second hypothesis should be searched among the theories that explain why companies pay dividend in place for retaining the earnings and subsequently investing them, rewarding their shareholders through capital gains and avoiding the double taxation.

   Several academic authors have proposed different approaches to study this phenomenon: Miller and Scholes (1978) based their intuition on limit on interest deduction; Auerbach (1979), Bradford (1979) and King (1977) developed a model that compared market value of retained earnings and net value of dividend; Feldstein (1979) built his explanation on shareholder's risk aversion and existence of shareholders in different tax situation. However, the theory that seems more consistent with UniCredit's behavior is the dividend signaling. According to this (Bhattacharya 1979), dividends are required because of the separation of ownership and management and information asymmetry related problems: they become a signal of the sustainable income of the firm and its growth opportunity. Through dividend distribution, management testimonies that the firm is in good shape and able to generate a return for its investors (Miller and Rock 1985). This is needed because it is clearly difficult for external agents to assess the bank assets' quality: through dividends, shareholders, creditors and depositors receive an implicit signal about the bank solvency (Floyd, Li, and Skinner 2015), avoiding runs and other costs of distress.

Strictly linked to dividend signaling, dividend smoothing hypothesis affirms that dividends are infrequently decreased but also not increased to an unmaintainable level, to avoid cutting and send a negative message to the market.

In fact, UniCredit continued to declare its financial health and the meeting of its targets throughout the years, even when incurring in serious troubles. Only with Mustier management and the deep cleaning of its balance sheet, UniCredit could not avoid to show its real nature: an undercapitalized bank that needed the fourth capital issue and with a massive amount of non-performing exposures.

The dividend signaling hypothesis is corroborated if we observe the other European banks' behavior during 2008-2013: despite their worsening financial situation (in some cases even when receiving bailout money), many banks were reluctant to cut dividends or did so relatively slowly (Acharya et al. 2011; Basse et al. 2014).

Having said this, two main criticisms arise:

- First, an empirical study of Basse T. et al. (2014) observed the correlation between dividends and earnings among European banks during crisis. According to their model, if finding indicated that dividends explain corporate earnings, this would be supportive for the dividend signaling hypothesis; while the opposite relation would be supportive for the dividend smoothing. The results showed that "quite clearly (…) there is no empirical evidence for dividend signaling or dividend smoothing because neither the response of dividends to a shock to corporate earnings nor the reaction of earnings to a shock to dividends is statistically significant".
- Second, even if a sort of correlation between earnings and dividends held, the market would not interpret as a negative signal a dividend cutting made by all the banks simultaneously, given their needs for capital. The collective behavior might compensate for the adverse effect generated by single bank decisions. However, the issue seems to assume the connotations of a prisoner dilemma: all the banks would be better off by cutting dividends, but deviations may lead to contrasting signaling. Thus,

in the end, all the banks chose to keep paying dividends.

These two main points suggest that a dividend cutting or dividend omitting strategy should have been pursued, not only by UniCredit but also by the other European banks, to improve their financial strength.

III. What are the main risks associated with having foundations among the bank ownership? Did the bank take corrective measures throughout the years and, if so, why?

Italian banking foundations are a peculiar phenomenon that originated in 1990s after the privatization of the banking system. Before the so-called Amato Laws, the Italian credit system was composed by public savings banks, involved in both lending activities and philanthropic actions whose beneficiaries were local territories. Soon after, the two elements were separated, by the creation on one hand of privately owned banks, appointed for the credit activity, and on the other hand of charitable foundations, which have kept the humanitarian pursuit. However, a participation relationship continued to bound the two entities.

In UniCredit, the three foundations (CariVerona, Crt and Carimonte) had maintained a relevant stake for all the years of the crisis, significantly reduced only after the last and major injection of capital in 2017. Their power was also reinforced by the combination of a particular mechanism of election for the Board of Directors (*voto di lista*) and a specific shareholder agreement, in which they commit to vote for a common list of Board members (Exhibit 6): thus, even with a share of less than 10%, they were able to nominate more than 80% of the Board (Jassaud 2014).

Bearing this in mind, at least four risks are identifiable in having banking foundations among the ownership of a bank (Jassaud 2014):

1. The financial position of foundations has deteriorated, arising concerns about their ability to provide further support, if needed. In fact, their participation in UniCredit has continued to decrease over time, not keeping up with the capital needs of the bank. However, this did not prevent UniCredit to raise the capital it needed through the entry of new shareholders. In other cases, foundations may exclude the access of new investors, causing a major impact on financial strength of the bank.
2. Foundations bear high concentration of risks. Although Italian law (n. 461/1998) requires diversification among the assets owned by foundations, for some of them the participation in the original bank still represents the core activity (Exhibit 7): in 2010, UniCredit share constituted more than 50% of CariVerona portfolio (Filtri and Guglielmi 2012).

It is fair to assume that this led to a greater pressure on banks' management to pay out dividends, even when incurring in net losses. Even if UniCredit Group is considered one of the most emancipated bank and the closest to the Anglo-Saxon model (Filtri and Guglielmi 2012), it is not excludable that internal forces led to non-optimal decisions for the bank.

3. Foundations are subject to political influence. On average, according to the study conducted by Filtri and Guglielmi (2012), 22% of BoD seats are appointed by politicians. In all the three banking foundations of UniCredit, every council member is nominated by local mayors, universities, episcopates and other regional institutions. The local politicians in turn may exert an influence on the corporate governance of the bank: this might be the possible explanation for the troubled resignation of Alessandro Profumo back in 2011. During Profumo's guidance, Libyan shareholders reached a share of 7.5%, something that the right-wing and anti-immigration Northern League party did not appreciate, thus pressuring for a change in management. Apparently confirming this hypothesis, Flavio Tosi, major in Verona and significant shareholder, remarked his satisfaction few days after the abandonment of Profumo.
4. Internal accountability and external surveillance are still limited. This is probably the most controversial aspect. Foundations are peculiar private institutions that do not have a clear ownership, law on foundations is still limited and governance practices remain weak. Transparency and accountability are two crucial aspects in which banking foundations are not harmonized.

Banking foundations are now over the control of MEF and since 2015 they have started a so-called "auto-reform", improving their risk exposure and corporate governance practices. However, it seems remarkable and paradoxical that banks, which are the most regulated financial institutions, may be indirectly influenced by organizations with blurred supervision.

In UniCredit, ownership structure has changed throughout the years of financial crisis, mainly due to capital injections that have progressively diluted the rights of traditional shareholder. This indirectly led to an improved situation in terms of political influences exerted on the bank's Board. In addition, two main events contributed to a change in the conventional equilibria in 2017, at the beginning of Mustier's direction:

- The elimination of 5% cap imposed for the voting rights;
- The explicit introduction of a new rule to nominate the components of the Board: the *majority list* would now be presented by outgoing members instead of majority shareholders, therefore limiting their power. Subsequently, the general meeting will approve (or refuse) the choices made.

In line with what recommended at an international level (Basel Committe on Banking Supervision 2015), the board nominated the future candidates and promoted appropriate succession planning for board members. As a consequence, every undue influence by single shareholder is prevented, at least in the election phase.

These two interventions were done to finally transform UniCredit in a public company, aligning its governance to international best practices. The aim, in turn, was to increasingly attract foreign investors by making the bank more independent and competitive (Repubblica.it 2017).

IV. What impact did NPLs have in UniCredit performance and lending ability? What are the main corrective measures that have been taken?

According to the definition given by European Banking Authority (2013), "Non-performing loans are exposures to debtors who are no longer able to meet all or part of their contractual obligations, because their economic and financial circumstances have deteriorated". Additionally, three subclasses are identified:

- Bad loans, in which debtors are insolvent or in similar circumstances;
- Unlikely-to-pay exposures, those for which debtors are expected not to fully meet their obligations unless action such as the enforcement of guarantees is taken;
- Overdrawn and/or past-due exposures are those that are overdrawn and/or past-due by more than 90 days and for above a predetermined amount.

While this classification does not have a "first-order" impact on financial statements, because it is a mere categorization of already existing loans, NPLs affect financial performance and results when provisions or write-offs are included in income statement. A primary effect is the reduction of the net operating profit and net income in the period in which the provisions are reported; a secondary effect is a lower availability of capital to be used for new and performing loans in the future periods; finally, substantial resources within the bank, included human capital, are used to manage exposures that with high probability will not pay back the entire amount, thus withdrawing further funds.

In an empirical study conducted in 2015 by Cucinelli, lending behavior of a sample of 498 Italian banks was explained through a series of different variables, both macroeconomic (unemployment, inflation and GDP growth rate) and bank-specific: among them, non-performing loans over gross loans and loan loss provision ratio were used as measures of credit portfolio quality. Results exhibited that credit risk variables have a significant negative impact on bank lending behavior; in particular, loan loss provisions at time T – 1, that directly affect

the cost income and financial performance, show an immediate effect on lending strategy for the following period.
Furthermore, NPLs, even if adequate provisions are accrued, absorb valued bank capital that could be instead freed up to support fresh lending (Jassaud and Kang 2015).
By analyzing the evolution of UniCredit's Non-performing exposures from 2011 onwards, it is easy to notice that a significant reduction in the overall amount of NPLs has solely occurred starting from 2016, in which the gross figure showed a decrease of approximately 30% compared to the previous year. This was mainly due to the disposal of bad loans through the FINO project and the write-off of past-due exposures, strongly wanted by Mustier.

(Exhibit 3)

Throughout the years, UniCredit's performance seemed affected by the burden of loan loss provisions: in 2013 and 2016, the years in which this figure was higher, the bank reported a loss of 13.9bn and 11.9bn respectively, that almost correspond to the impairments.

(Exhibit 2)

In addition, net loans toward customers showed a decreasing trend until 2015, while NPL over total loans ratio increased for the same period. These two figures exhibited an opposite direction in 2016-2017, finally with a slight increase in loans granted, consistently with Cucinelli study.

(Exhibit 4)

However, it is important to underline that these are data extrapolated from UniCredit's financial statements, thus no causation nor correlation relationship has been tested. Other factors, also economic crisis itself, may be responsible for the explanation of the reported trends.
Finally, by approximating the cost of holding NPLs with the cost of the bank Non-core assets (NCAs), it was observed that in UniCredit NCAs absorb approximately 6% of Core Tier 1 capital of the bank (Jassaud and Kang 2015).
As it emerged from the case, UniCredit management of NPLs substantially started when the new Ceo Mustier was appointed; the two main actions taken have been the disposal of 17.7bn of bad debts with FINO and the huge write-off in 2016 balance sheet, leading to a considerable cleaning in the bank's financial statements.
Previous management was reluctant to do serious write-offs, in alignment with the other Italian banks. Keeping NPLs within balance sheet and waiting for (partial) repayments was even worsened by the slow Italian insolvency law, that did not favor a rapid recover (Humblot 2017).

V. Back in 2009, UniCredit and Intesa Sanpaolo, the two major credit institutions in Italy, declined the offer of the Ministry of Economy and Finance, which would have subscribed ad hoc debt instruments issued by Italian banks in order to reinforce their capital structure. Later, UniCredit launched a capital increase of 4bn, preferring private funds instead of public ones. What are the reasons that led to this decision?

The so-called “Tremonti bonds” (recalling the name of the former Minister Giulio Tremonti) are special financial instruments explicitly envisaged by the Italian government first with a decree and later converted in the law n. 2/2009. According to the 12th article, titled “Funding of the economy through the public subscription of exceptional bank bonds and related parliamentary and territorial controls”, Ministry of Economy and Finance (MEF from now on) was authorized to underwrite instruments issued by banks or banking groups whose characteristics made them eligible for inclusion in regulatory capital, more specifically in Core Tier 1.

The bonds exhibited the following features:

1. Subordinated: because, in case of voluntary or administrative mandatory liquidation (*liquidazione coatta amministrativa*) or other insolvency proceedings, the outstanding debt will be reimbursed after all of the bank’s other debt and will rank equally with the ordinary shares;
2. Hybrid: because they present peculiarities of both debt and equity securities. Furthermore, they are convertible in ordinary shares upon request of the issuing bank;
3. Perpetual: because, unless converted or redeemed earlier, they do not bear any maturity.

The subscription was subordinated to a prior request by interested banks and a subsequent valuation and approval by Bank of Italy (Bazzano and Pagnoni 2009).

A crucial point of Tremonti bonds, that made them controversial, was the execution of a memorandum of understanding (*protocollo di intenti*), arranged between the issuing bank and MEF. Specifically, the bank committed to:

- Assuring the full availability of credit, in particular for small and medium enterprises, through the preservation, for at least three years following the emission, of financial resources for a value greater or equal than the amount of such resources available in 2007-2008;
- Applying credit conditions that reflected the lower risk of financing;
- Assuring adequate liquidity level for creditors of state entities;
- Assisting families that were having difficulties caused by temporary suspension (*Cassa Integrazione*) or loss of their jobs, interrupting for at least 12 months the repayment of mortgage arrears, without any additional cost;

- Promoting agreements with enterprises in order to provide financial resources needed to pay the unemployment benefits (*Cassa Integrazione*); and
- Modifying the dividend policy in order to favor the bank recapitalization.

  In addition, the issuing bank had to adopt an ethical code (*codice etico*), including limits to the remuneration of top management and bank staff (Bazzano and Pagnoni 2009).

  The reimbursement might be executed according two different models, each of them providing advantages and disadvantages for the bank. In the long-term modality of repayment, the bank would pay a lower coupon rate, while the principal amount would be above the nominal value of the bond. In contrast, in the short-term repayment the principal amount would be equal to the nominal value, while paying higher interests in the first four years (Il Sole 24 ORE).

  The interest rate paid should be equal to the greater of three rates: a coupon step-up identified by the law; a set percentage (increasing during the years) multiplied by the dividend distributed by the bank; or the average return on the issue of 30-year BTPs increased by 300bp (for 2011 and 2012) and by 350bp (from 2013 onwards). However, the rate cannot exceed 15%(Il Sole 24 ORE).

Having said this, at least three reasons are accountable for the refusal of UniCredit:

1. **Economic motive:** at that time, UniCredit's cost of equity[86] was 12.57%[87], given the results of FTSE MIB index and UniCredit stock price. The yield was higher than the interest rate requested by Tremonti bonds (on average 7.5%-8.5% for the first years), but lower than UniCredit cost of debt (3.65% in 2008[88]). Therefore, for the Italian bank it was notably cheaper to fund itself through own debt capital rather than employing those debt instruments.
2. **Limitation motive:** the mentioned conditions, apart from penalizing the bank from an economical perspective, would have limited its freedom of action, by imposing a series of obligations to the requesting institution: essentially, the bank would have been forced to grant credit when the conditions were not favorable or even unacceptable.

   First, the stated and main objective of Tremonti bonds was incentivizing the supply of credit to small and medium enterprises, to avoid credit crunch and to boost real economy. In fact, credit expansion to private sector (firms and households) decreased from nearly 12% in the first half of 2008 to a null rate in 2009. The figure for the solely corporate sector was even

[86] The cost of equity is computed according to the CAPM formula:

$$r_e = r_f + \beta(r_m - r_f)$$

[87] Data source: Bloomberg

[88] UniCredit Group 2008

more alarming, with a funding contraction rate of approximately -5.8% per year (Accornero et al. 2017). However, according to the same study, the decline of the loan volume in the first part of the financial crisis was mainly due to a decrease in the corporate loan demand rather than a contraction in the loan supply by Italian banks. The principal reasons lied in a drop in investments and deteriorated creditworthiness: thus, major issues to be resolved were on the demand side. By accepting the conditions of Tremonti bonds, the Italian bank would have participated in riskier (lending to struggling enterprises) and less profitable activities, ultimately damaging its returns. Moreover, the bank should have accepted restrictions (liquidity level for creditors of state entity, the suspension of mortgage repayment) that would have implied a significant intromission in its governance by the public sector.

In addition, the modification of dividend payout policy in favor of a recapitalization would have negatively impacted on bank shareholders' yield.

Finally, the adoption of the ethical code would have lowered salaries and bonuses of top management, imposing moderate control over their retribution policy.

It is easy understandable why this potential interference did not like both to top management and to major shareholders, at that time the three foundations.

3. **Signaling motive:** the last reason that might be identified to explain the refusal of UniCredit may lie on signaling purposes. While the institutions with greatest difficulties (MPS, Popolare di Milano and Banco Popolare) requested and obtained the state aid, it is worthy of attention that the two most solid financial intermediaries declined the offer. As the CEO Profumo himself declared, this was the "demonstration that the banking sector was sound and able to operate". Also the former President of supervisory board in Intesa Sanpaolo, Giovanni Bazoli, asserted that this decision proved the good state of health of Italian credit system.

   By rejecting the public aid and instead resorting to private fund, the bank signaled to the market and institutional investors its better conditions and performance compared to the other peer institutions.

Exhibits:

Exhibit 1: UniCredit stock price (April 2007-May 2018). Source: UniCredit.com

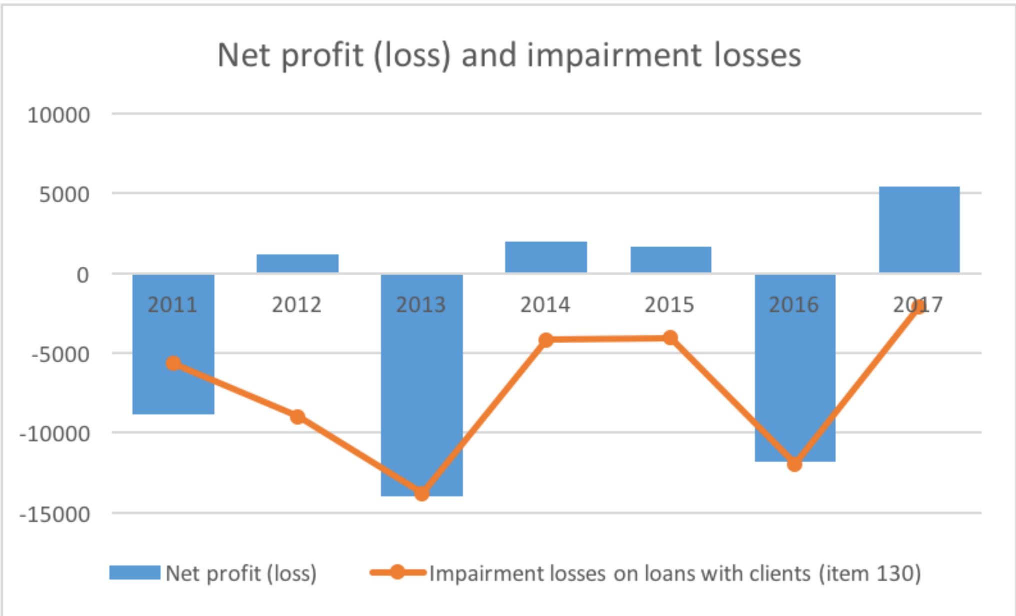

Exhibit 2: Net profit (loss) and impairment losses (2011-2017). Source: UniCredit's annual reports and personal elaboration

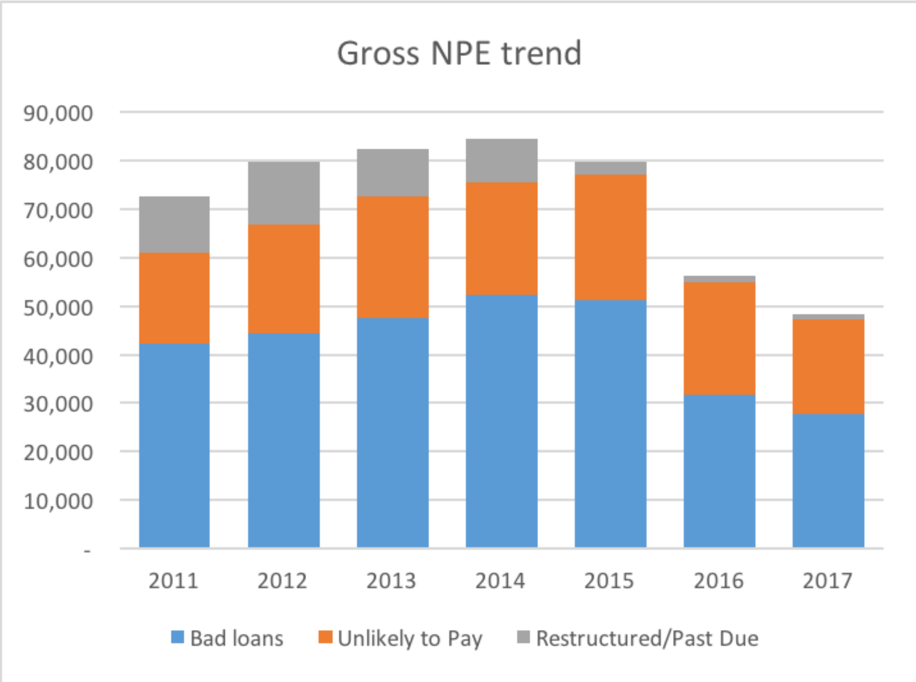

Exhibit 3: Goss NPEs trend (2011-2017). Source: UniCredit's annual reports and personal elaboration

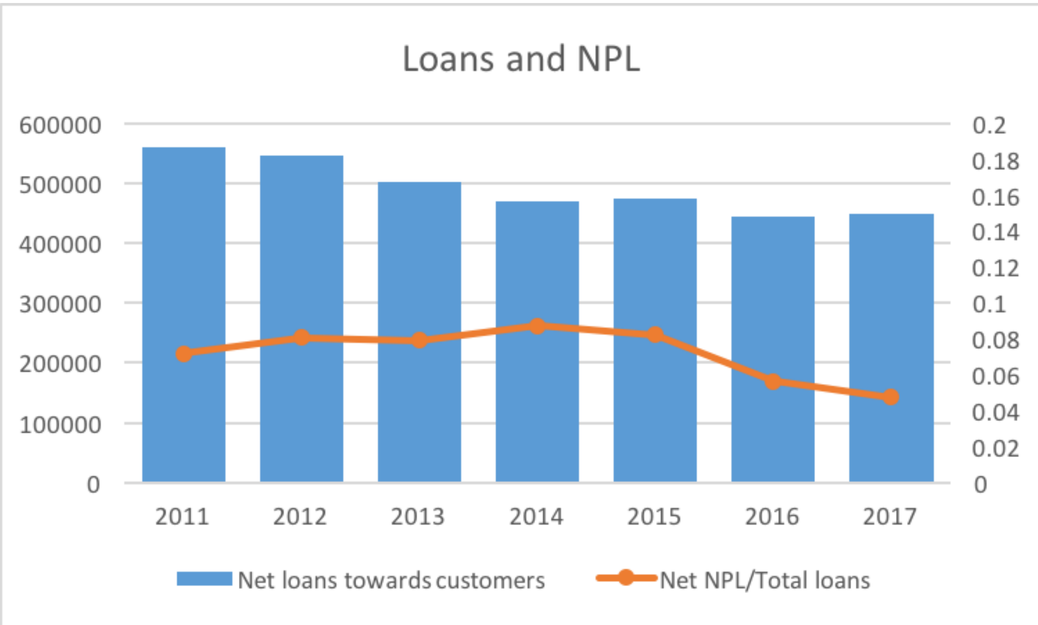

Exhibit 4: Net loans and NPL ratio (2011-2017). Source: UniCredit's annual reports and personal elaboration

UniCredit NPE data (in millions)	2011	2012	2013	2014	2015	2016	2017
Net loans towards customers	559.553	547.144	503.142	470.569	473.999	444.607	447.727
% growth		*-2,22%*	*-8,04%*	*-6,47%*	*0,73%*	*-6,20%*	*0,70%*
Net performing loans	519.369	503.086	463.327	429.477	435.079	419.612	426.536
% growth		*-3,14%*	*-7,90%*	*-7,31%*	*1,30%*	*-3,55%*	*1,65%*
Gross NPE	72.531	79.787	82.360	84.359	79.760	56.342	48.432
% growth		*10,00%*	*3,22%*	*2,43%*	*-5,45%*	*-29,36%*	*-14,04%*
Bad loans	42.245	44.377	47.592	52.143	51.089	31.799	27.805
Unlikely to Pay	18.735	22.516	25.051	23.301	26.054	23.165	19.522
Restructured/Past Due	11.551	12.894	9.717	8.915	2.617	1.378	1.105
Net NPE	40.184	44.058	39.815	41.092	38.920	24.995	21.191
% growth		9,64%	-9,63%	3,21%	-5,29%	-35,78%	-15,22%
Bad loans	18.118	19.360	18.058	19.701	19.924	10.945	9.499
Unlikely to Pay	13.031	15.142	15.069	15.199	17.086	13.144	11.028
Restructured/Past Due	9.035	9.556	6.688	6.192	1.910	906	664
Impaired loans	32.347	35.729	42.545	43.267	40.840	31.347	27.241
Impairment losses on loans with clients	(5.664)	(8.989)	(13.808)	(4.171)	(4.061)	(11.966)	(2.097)
Coverage ratio*	44,40%	44,80%	51,70%	51,30%	51,20%	55,60%	56,20%
Net NPL/Total loans	7,18%	8,05%	7,91%	8,73%	8,21%	5,62%	4,73%
Bad loans/total loans	3,24%	3,54%	3,59%	4,19%	4,20%	2,46%	2,12%
Shareholders' equity	54.797	66.453	46.841	49.390	50.087	39.336	59.331
Net Bad Loans/Equity ratio	33,06%	29,13%	38,55%	39,89%	39,78%	27,82%	16,01%
Core Tier 1**	8,40%	10,84%	9,60%	10,26%	10,59%	8,15%	13,73%
Net profit (loss)	(8.841)	1.222	(13.965)	2.008	1.694	(11.790)	5.473

*NPE

**Transitional pro-forma

Exhibit 5: UniCredit's Non-performing exposures (2011-2017). Source: UniCredit's annual reports

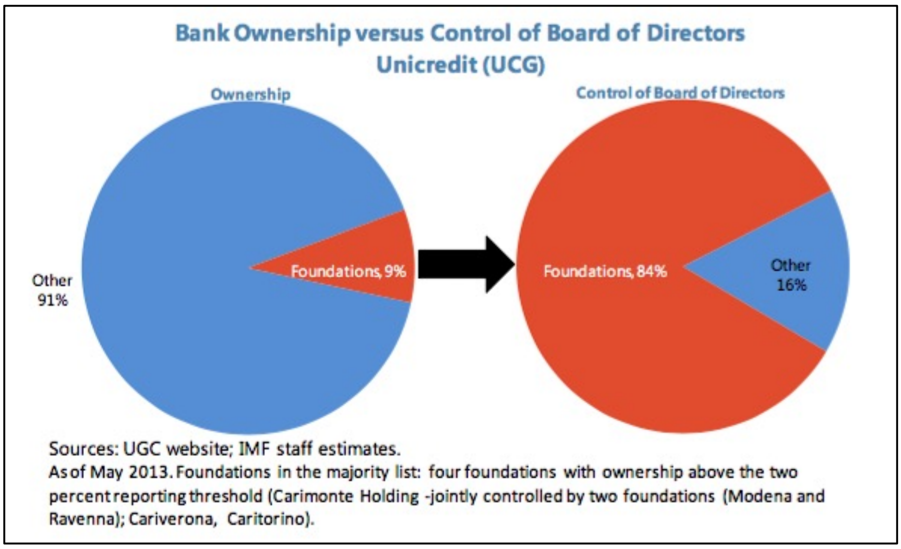

Exhibit 6: Bank ownership and control of BoD by foundations. Source: Jassaud, 2014.

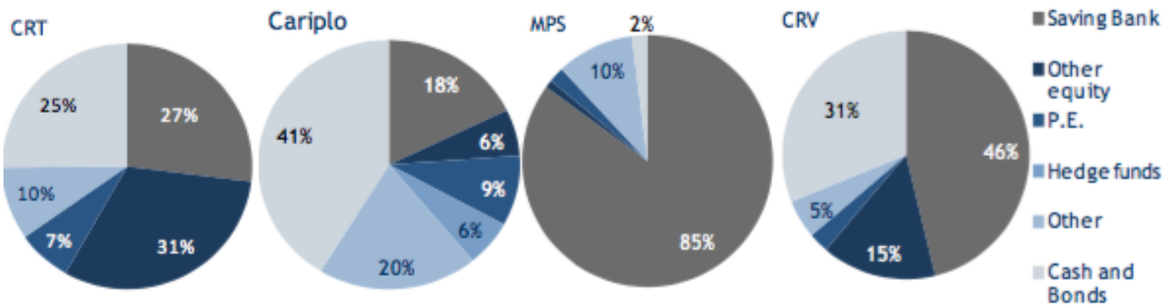

Exhibit 7: Foundations and portfolio composition. Source: Filtri and Guglielmi, 2012.

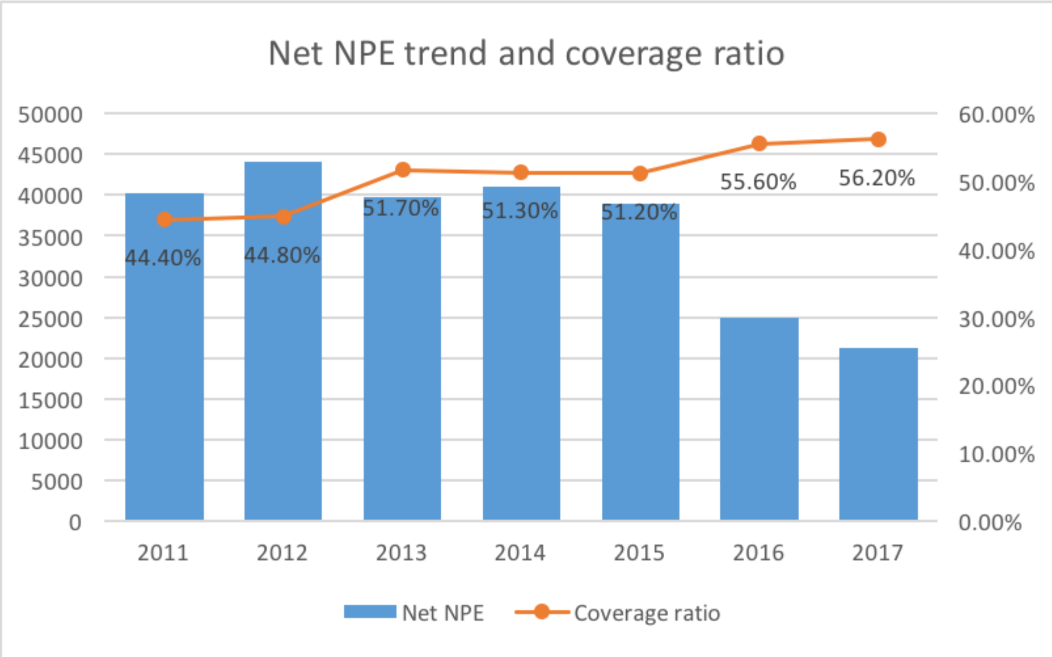

Exhibit 8: Net NPE and Coverage ratio. Source: UniCredit's annual reports and personal elaboration

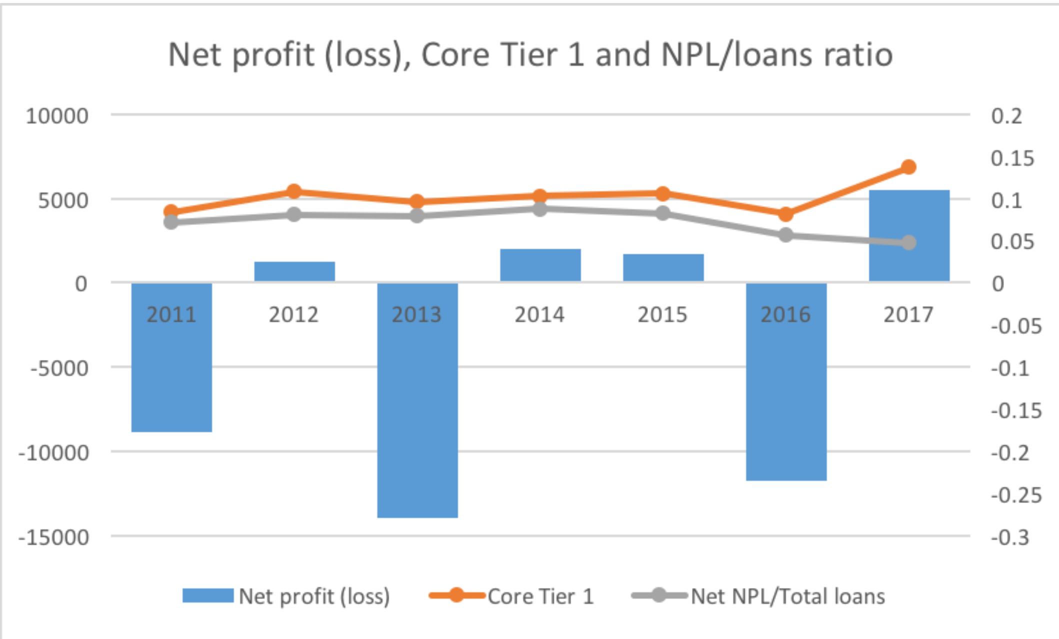

Exhibit 9: Net profit (loss), Core Tier 1 evolution and NPL ratio. Source: UniCredit's annual reports and personal elaboration

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