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CEPS POLICY BRIEF
Thinking ahead for Europe

A closer look at Banca Monte dei Paschi: Living on the edge

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Key Points

The Italian bank Monte dei Paschi di Siena (MPS) is expected to fail the 2016 EU-wide stress test conducted by the European Banking Authority (EBA), whose results are due to be presented Friday, 29 July 2016. When taking a closer look at the bank, it becomes apparent that the bank has so far failed or nearly failed all the EU-wide supervisory exercises that have been undertaken in the past six years. Almost every time the bank has managed to raise just enough capital, including public funds already contributed twice by the Italian government, to close the capital shortfalls or meet the threshold. This allowed the bank to live on the edge, which is costly to society. Supervisory, resolution and competition authorities should therefore discourage banks from following in MPS' path of doing the minimum required, by imposing extensive recapitalisation requirements with a proper resolution.

Policy Recommendations

- Supervisors should subject banks that perform poorly in several consecutive supervisory exercises to additional scrutiny.
- The stress test is unlikely to be very helpful in the case of MPS since it looks at the impact of an adverse scenario on earnings, and not the true value of existing non-performing loans, which constitute the real issue. Accordingly, the supervisor should use its discretionary powers to undertake a detailed assessment to determine the current market value of the bank's loan book.
- Bail-in of retail investors in subordinated debt also seems feasible since most of the instruments are held by the wealthiest families. Moreover, in the event that the instruments were mis-sold, the government could compensate them. The conduct-of-business supervisors should closely follow the sales practices of bail-inable instruments to avoid further mis-selling and ensure that banks now inform their clients, take the risk-profile into account and diversify their portfolios.
- The supervisory, resolution and competition authorities should impose the standard procedure as foreseen in the resolution scheme with bail-in to cover the losses and arrange the recapitalisation. If the resolution authority faces some obstacles in the execution of the bail-in, it could use its discretionary powers to prioritise certain creditors.
- The authorities should use their experience to correct the weaknesses in the resolution framework (e.g. cross-holding of bail-in instruments, exclusion of politically sensitive exposures), improve ongoing work (e.g. recovery and resolution plans, setting MREL-levels) and prepare for future resolution cases (e.g. sufficiently high recapitalisation).

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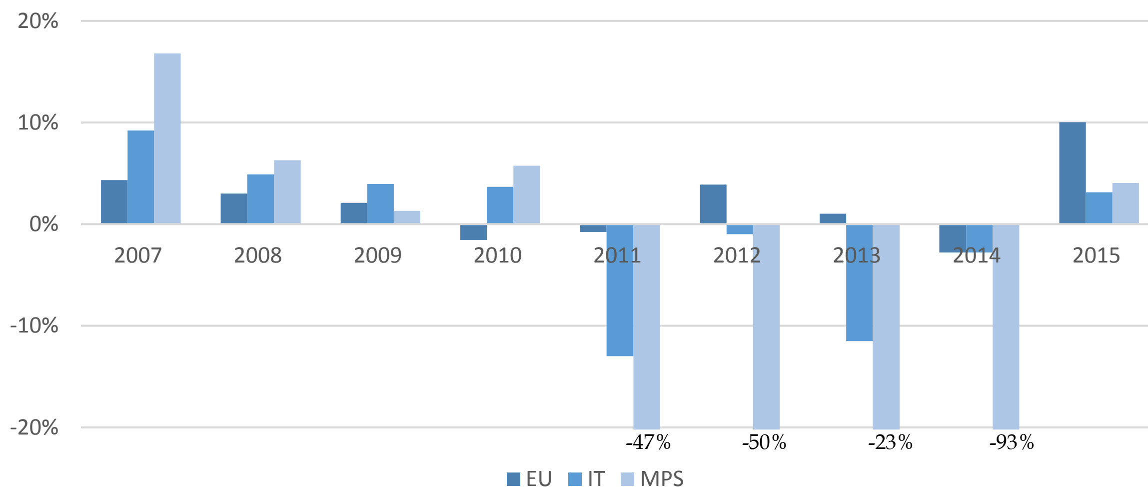
Despite raising the capital required to cover the shortfalls in previous exercises, the capital cushions of Banca Monte dei Paschi di Siena (MPS) have remained relatively thin. This makes the bank more vulnerable for new setbacks, such as the large losses it is likely to face on its portfolio of non-performing loans (NPLs). Although it has been clear for some time that MPS is unlikely to be able to solve the issues with its NPLs on its own, the authorities are reluctant to intervene and are presumably waiting for the results of the stress test before officially intervening. These authorities should eschew taking semi-soft measures again, which are likely to prolong MPS' struggle.

Acquisition of Banca Antonveneta

Looking more closely at MPS, it is clear that the Italian bank has been living on the edge for years now. It was traditionally a foundation-owned savings bank, but was converted to a listed bank in 1995. Afterwards the bank rapidly expanded its activities both through new autonomous initiatives and acquisitions, most notably Banca Antonveneta just before the Great Financial Crisis hit in 2007. The acquisition price of €9 billion (of which approximately €5.9 billion goodwill) was more or less similar to MPS' total equity at the time the deal was announced. The acquisition was not particular successful. MPS had, for example, to write-down almost all of the goodwill that was created through the acquisition in recent years. The write-downs of €4.3 billion and €1.5 billion in 2011 and 2012, respectively, contributed to the large negative returns on equity posted by MPS in recent years (see Figure 1), but they had a limited impact on the bank's capital position due to an exemption of goodwill from regulatory capital.[1]

Figure 1. Return on equity in the EU, Italy and MPS, 2007-15 (%)

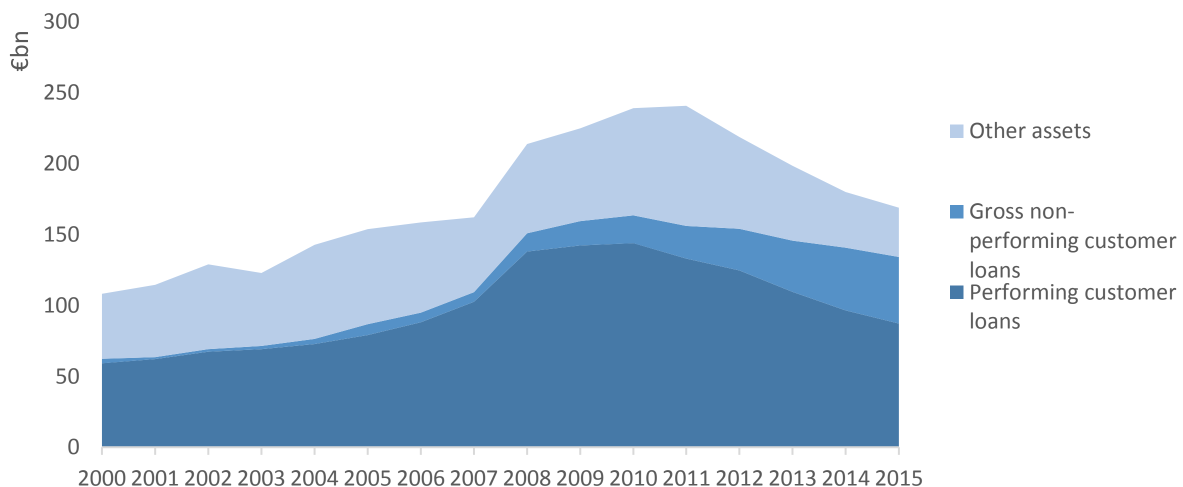


Note: The figure shows the return on equity for the European Union (EU), Italy (IT) and Banca Monte dei Paschi di Siena (MPS).
Source: Author's elaboration based on ECB consolidated banking data and financial statements of Banca Monte dei Paschi.

[1] The write-down of goodwill can even improve the regulatory capital position of Italian banks by up to 30% of the write-down because of a reduction in the taxation of the profits or tax credits that are being created. When the tax credits are not directly claimable, they are exempted from the regulatory capital.

In turn, the acquisition itself had an impact on the capital position of MPS. Although the bank, among others, issued new capital and increased the leverage to finance the deal, the capital cushions of the bank were thin and of a weaker quality after the completion of the acquisition. The total capital of the bank was 9.3% at the end of 2008, whereas 8.0% was required. Moreover, the acquisition was paid for by the issuance of €6 billion ordinary shares (core equity Tier I) and €2.2 billion new subordinated capital instruments (Tier II regulatory capital) as well as retained earnings. In order to strengthen its capital position, the bank applied for (voluntary) capital support from the Italian government. MPS issued €1.9 billion so-called Tremonti-bonds to the government in 2009. The conditions for this intervention were relatively light. The support was only granted to improve the capitalisation of banks that at least appeared on paper to be solvent and not to absorb losses. Whether MPS was actually solvent at that time is questionable. The bank had, for instance, been involved in a derivative construction that hid some losses. This derivative contract was not to the auditor or the supervisor in 2009, and was only uncovered in 2013.

Figure 2. Balance sheet structure of MPS, 2000-15 (€bn)



Note: The financial statements up to 2003 are based on IT GAAP, whereas IFRS has been applied since. The gross non-performing customer loans are estimated based on the net non-performing customer loans and the provision ratios.
Source: Author's elaboration based on financial statements of Banca Monte dei Paschi.

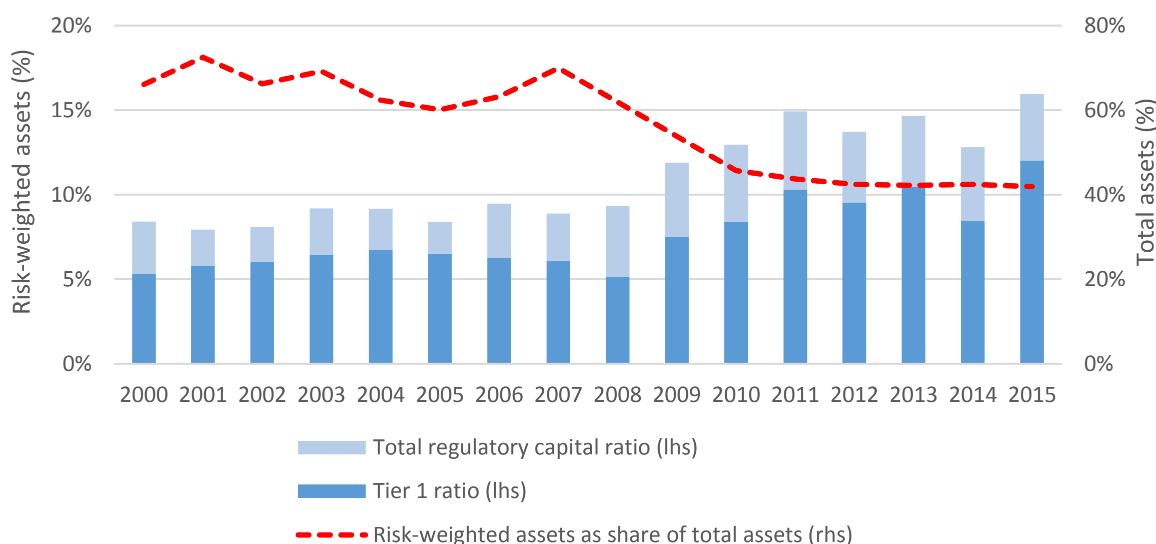
Stress tests and capital exercises

The government's support to MPS and the bank's hiding of losses via the derivative transaction appeared to be essential to allow the bank to just barely pass the stress test undertaken by the Committee of European Banking Supervisors (CEBS) in 2010 (see Annex Table **1** in the Annex). Hence, without the €1.9 billion in government support, it would have noted a capital shortfall of €1.7 billion. In all the four EU-wide stress tests and capital exercises that followed afterwards, MPS failed or tricks were used to pass. In 2011, the bank was subject to both a stress test and capital exercise of the EBA. It narrowly passed the stress test (surplus €1.4 billion) through the issuance of new capital instruments (€1.8 billion) while the exercise was undertaken. But it failed the capital exercise in which MPS noted a capital shortfall of €3.3 billion due to a sovereign portfolio whose market value was below the book value. By the cut-

off date, the bank had a very concentrated government debt portfolio that consisted almost exclusively of Italian government debt and was about twice the regulatory capital. MPS had a total gross exposure to all EEA governments of €30.9 billion, of which €0.5 billion was to other governments than the Italian. It was also the Italian government that covered most of the losses with a new capital injection of €2 billion[2] and approximately €1 bn through deleveraging. The effort, however, was insufficient to meet the capital threshold when the capital exercise was finalised in June 2012, due to large loan losses in the meantime.

MPS also failed the combination of the EBA-EU wide stress test and ECB's asset quality review in 2014, i.e. the stress test and asset quality review ahead of the start of the Single Supervisory Mechanism (SSM). It noted a capital shortfall of €4.3 billion. In response, the bank reduced its exposure and issued new capital instruments, which it also used to repay the government funds. The Italian government currently only has 4% of the ordinary share capital remaining in the bank.[3] In 2014 and 2015, the bank issued in total about €8 billion in new ordinary shares and reduced the capital requirement with another €1 billion through deleveraging in terms of both assets and risk-weighted assets.

Figure 3. Regulatory capital ratios of MPS, 2000-15 (€bn)



Note: The total assets up to 2003 are based on IT GAAP, while afterwards IFRS has been applied.
Source: Author's elaboration based on financial statements of Banca Monte dei Paschi.

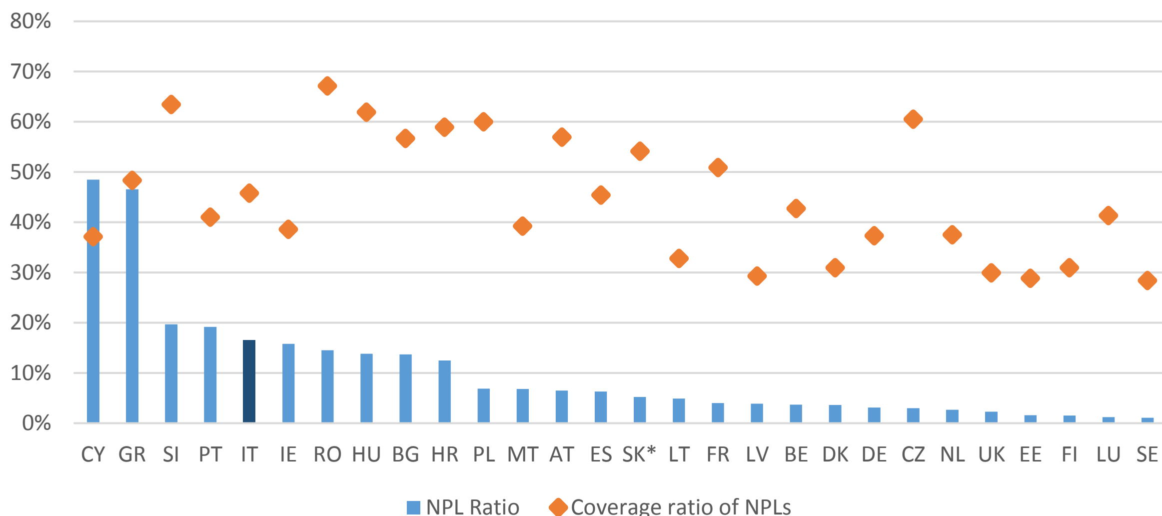
Overall, the total assets of MPS declined about 30% from €241 billion in 2011 to €169 billion in 2015 (see Figure 2). The main deleveraging in terms of risk-weighted assets had at that time already taken place. Hence, the average risk-weight decreased from 70.0% in 2007 to 45.7% in 2010 (see Figure 3). Afterwards the risk-weight decreased to 41.9% in 2015. In order to make the deleveraging possible, the bank had to *de facto* stop lending to the real economy. Customer loans decreased by about a quarter from €147 billion in 2010 to €111 billion in 2015.

[2] MPS received in total € 3.9 billion capital support from the Italian government, but €1.9 billion was used to repay the Tremonti bonds.
[3] The Italian government obtained the share capital in exchange for the accrued interest on the capital instruments.

Non-performing loans

Despite the measures to increase the regulatory capital, the margins remained thin, making MPS more vulnerable for issues with the NPLs. MPS is not the only bank dealing with a sizeable NPL portfolio. In fact, NPLs constitute an important threat to banking-sector stability in several European countries. Based on the harmonised definition for NPLs by the European Banking Authority in 2013,[4] Italy, together with Cyprus, Greece, Slovenia, Portugal and Ireland, are among the countries where many banks have already been resolved with the highest level of NPLs in the EU (see Figure 4). The NPLs are in particular concentrated in the loan portfolios of small- and medium-sized enterprises and to a lesser extent of households. The NPLs to large corporates are in general the least numerous among the non-financial corporations and households. The differences between the countries are due to differences in economic structure and situation, bank lending policies as well as effectiveness in nudging payments and dealing with distressed debt, but also more structural differences in legal systems, court procedures and tax regimes (EBA, 2016).

Figure 4. NPL ratio & coverage ratio, March 2016 (weighted average)



*Data for December 2015.
Source: Author's elaboration based on EBA (2015).

More specifically for Italy, the stock of NPLs has according to the Italian central bank increased rapidly in recent years to €360 billion or 18% gross NPLs at the end of 2015 (Banca d'Italia, 2016). Besides the economic headwinds, the NPLs in Italy are relatively high due to the inefficient court proceedings, limited outside court options and disincentives in the tax system to write-down loan losses, and no deep secondary market. The Italian government has recently taken some measures aimed at improving the NPL market. These include reforming the insolvency and foreclosure proceedings, reducing the time in which loan-losses can be deducted for tax purposes and the tax that needs to be paid on the acquisition of fore-closed

[4] Based on this harmonised definition, a loan is qualified as non-performing when it is 90 days past-due or unlikely to be paid without collateral realisation. Moreover, all exposures to a debtor should be considered non-performing when 20% of the exposures to a debtor are 90 days past-due.

real estate and initiating a scheme to facilitate the securitisation of NPLs. The impact of these measures that partially only apply to new NPLs remains to be seen, but they will definitely require some time before becoming effective. The value of the NPLs therefore remains uncertain.

In recent years the main issue was that the number of NPLs surged; the current issue is that the value of the NPLs is decreasing as a result of the increasing NPLs in the Italian banking sector. MPS is suffering more from this also relative to other Italian banks, since the NPL portfolio is about twice the size of other Italian banks or one-third of its customer loan portfolio. The overrepresentation of NPLs at MPS seems to be primarily due to lax lending policies, more SME customers (who are responsible for most of the bad loans) and less-efficient capacity to handle bad debts than other banks in the past. Formally, most loans are secured through collateral, which consists for most SMEs of machinery and industrial buildings, which have very limited value at the moment that the enterprise goes bust.

The gross value of the NPLs is currently about €50 billion, which is taking the provisions into account valued at around 40% in the books of MPS. The market value, according to various estimations, is somewhere between 20-40%. The difference is created through the fact that book values (IAS/IFRS) are based on cash-flows, while the market values are based on the investors' expected rate of return. MPS has been summoned by the ECB to accelerate the unwinding of its NPL portfolio. The sales of the NPLs will urge MPS to accept the difference between the book and the currently lower uncertain market values.

In addition, the supervisor might impose additional capital charges in response to the 2016 stress test results. Contrary to the previous stress tests, the results of this year's stress test will not be expressed in a shortfall but will be used to inform the Supervisory Review and Evaluation Process (SREP). Based on the SREP, supervisors may decide to require some individual banks to hold additional capital. For MPS, the ECB as direct supervisor needs to determine whether the bank needs to hold additional capital. The stress test itself, however, is not the appropriate tool to determine legacy losses, since it looks at the impact of a hypothetical stress scenario on future earnings. The additional capital required for MPS should therefore be determined differently.

Extensive recapitalisation

The competent authorities should compel MPS to stop living on the edge, which is very costly for the society. Hence, as the example of MPS has shown, banks that are closer to failing are prone to take more risk, attempt to hide or postpone losses and are less likely to function as a financer of the real economy. Moreover, these banks are more likely to need public funds and form a threat to financial stability. The supervisory authority should therefore insist that banks like MPS that are performing poorly in multiple stress tests or close to the capital thresholds when applied are subject to a more thorough review. In addition, more supervisory scrutiny is also required when the bank is over exposed to certain activities or risks that are not well captured in the stress test, such as legacy losses. In the case of MPS, for example, the supervisor could use its discretionary powers to undertake a detailed assessment to determine the current market value of the loan book in combination with a stress test to create a large degree of certainty that the bank will survive without support in case the situation deteriorates.

The Italian solution

MPS might, however, not be able to raise sufficient private funds through the ordinary channels (e.g. issue shares, sell assets, etc.). Based on various recent media reports, the European Commission will accept the call from the Italian authorities to consider the current situation an 'exceptional circumstance' based on the post-Brexit referendum market turmoil. This will allow the Italian government to avoid a bail-in and open the door to a bail-out of MPS, as it did in 2009 and 2012. The Italian authorities seems to want this solution to avoid a politically sensitive bail-in of creditors, including Italian households, which would be required under the resolution procedure. The proposal that the Italian government and the banking association seem to be pushing foresees a limited bail-in of only subordinated debt holders and some asset-relief measures that will be potentially 'government'-sponsored using the publicly initiated and bank-funded Atlante fund. The fund would then be used, for example, to acquire the NPLs from MPS. For this scenario to unfold, the government would have to provide a guarantee to allow the fund to leverage to a size sufficient to acquire the NPLs.

Bail-in

The concerns of the Italian government and others about the bail-in of retail customers might be exaggerated due to the focus on the exceptions. A closer look at the households' holdings of Italian bank bonds shows that the large majority of the bail-inable instruments are held by the wealthiest Italian households, which should have been able to assess the risks of such instruments and absorb the losses, if any. Hence, according to a survey by the Italian central bank, about 6% of Italian households hold non-equity instruments eligible for bail-in. More than 85% of the bail-in instruments are held by the 10% wealthiest Italian households. Accounting for around 40% of total financial assets, bank bonds form with an important part of the wealth of these households. Looking at all households, the share of subordinated bonds (0.7% of household wealth) and senior unsecured bonds (4.3%) is responsible for only about 5% of household wealth. Deposits above €100,000, representing 5.6% of total assets, form the largest share of household wealth that could potentially be subject to bail-in (Banca d'Italia, 2015; D'Alessio & Faiella, 2002).

Moreover, one should not forget that bail-in does not necessarily mean that debt-investors lose their money. The bailed-in debt-investors will receive shares in the resolved MPS in return for the debt instruments that are converted from debt into equity. The book value of these instruments should be equal to the value of the debt instrument at the moment of issuance, as long as the losses are not larger than the pre-bail in equity. The latter would mean that the debt-investors that are being bailed-in are not only providing capital, but are also bearing part of the losses. The price of the securities might drop straight after the issuance, due to uncertainty about the performance of the bank and also in most cases unfavourable market conditions, but it might afterwards recover and even end up above the notional value of the converted securities once the performance of the bank improves and the markets calm down.

Notwithstanding that there might be no loss, some of the bail-in instruments have been sold to customers that were not made aware of the riskiness of the instruments. In these cases of mis-selling, the customers should in the first instance be compensated by either the issuing or

the selling party. Since these parties will in many cases be unable to provide the required funds because they lack sufficient funds or are already bankrupt/resolved at the moment that the claim is made, it is important that conduct-of-business supervisors closely follow the sales practises of the bail-inable instruments of banks. In particular, the supervisors should ensure that clients are well informed, take the risk-profile into account and are encouraged to diversify their portfolios. It might already be too late in the case of MPS, and if so, the resolution authority could exempt these investors from bail-in or the government might chose to compensate some of the smaller investors itself.

The European solution

The Italian solution would mean that taxpayers' money would again be exposed to the banking sector, whereas recovering and resolving distressed banks without resort to taxpayers' money is one of the main objectives of the new European recovery and resolution scheme. Moreover, the use of a fund like Atlante, which is funded by other banks, is also not recommended owing to its heightened systemic risk. In the short-run the public-private solution through the Atlante fund might reduce the uncertainty on the sustainability of MPS and other Italian banks that reduce their NPLs, but it might also distort the level-playing field, i.e. Italian banks seem to get a preferential treatment compared to banks in other countries. In the longer run it might further lead to extra risk-taking and prolong the bank-government embrace, which could trigger a future crisis. The supervisory, resolution and competition authorities should therefore impose the standard procedure as foreseen in the resolution scheme with a bail-in to cover the losses and arrange the recapitalisation. In case it faces some obstacles in the execution of the bail-in (e.g. cross-holdings of bail-in instruments by banks, mis-selling of subordinated debt instruments to retail customers, unclear marking of bail-in instruments), the resolution authority could use its discretionary powers to prioritise certain creditors in resolution to ensure a smooth execution of the bail-in, with the precondition that no-creditor is worse off than in case of liquidation. Finally, the authorities should use these experiences to correct the weaknesses in the resolution framework (e.g. cross-holding of bail-in instruments, excluding politically sensitive exposures), improve ongoing work (e.g. recovery and resolution plans, setting MREL-levels) and to prepare for future resolution cases (e.g. sufficiently high recapitalisation).

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Annex Table 1. Overview of results MPS' in cross-border stress tests, 2009-2016

Name	EU-Wide Stress Testing Exercise	2010 EU-Wide Stress Testing Exercise	2011 EU-wide stress test	EU Capital exercise 2011	EU Capital exercise 2011 final results	2014 EU-wide stress test	Comprehensive assessment	2016 EU-wide stress test
Leading supervisor	CEBS	CEBS	EBA	EBA	EBA	EBA	ECB	EBA
Disclosure date results	01/10/2009	23/07/2010	15/07/2011	08/12/2011	03/10/2012	26/10/2014	26/10/2014	29/07/2016
Type	Stress test	Stress test	Stress test	Capital exercise	Capital exercise	Stress test	(Stress test)/ Asset quality review	Stress test
Scope of exercise								
Cut-off date	Dec-2008	Dec-2009	Dec-2010	Sept-2011	June-2012	Dec-2013	Dec-2013	Dec-2015
Stress years	2009-2010	2010-2011	2011-2012	..	..	2014-2016	..	2016-2018
Capital threshold (adverse)	4% Tier 1	6% Tier 1	5% Core Tier 1	9% Core Tier 1	9% Core Tier 1	5.5% Core Tier 1	5.5% Core Tier 1	..
Stresses	Macro-economic	Macro-economic	Macro-economic	Sovereign exposures	Sovereign exposures	Macro-economic	..	Macro-economic
Results Monte Dei Paschi di Siena								
Capital at cut-off date	N/A	7.5% [€ 9.1 bn]	5.8% [€ 6.3 bn]	9.2% [€ 10.0 bn]	10.8% [€ 10.4 bn]	7.0%** [€ 5.7 bn]	10.2% [€ 8.5 bn]	12.8% [€ 8.5 bn CET1]
Impact baseline scenario	N/A	+0.1%	+0.3%	-3.2%	-3.6%	+0.6%	-4.2%	+0.0%
Impact adverse scenario	N/A	-1.3%*	-1.1%			-7.1%	-10.3%	-14.2%
Shortfall	**N/A**	**+0.2% [€ +0.2 bn]**	**+1.3% [€ +1.4 bn]*** **	**-3.0% [€ -3.3 bn]**	**-1.8% [€ -1.7 bn]**	**-5.6% [€ -4.3 bn]**		**..********

* Including sovereign shock.
** The capital at cut-off date for the EBA's 2014 stress test included already the value adjustments of the asset quality review of the ECB.
*** Despite 0.3% [€ -0.4 bn] shortfall, not reported as such because of 1.6% [€ 1.8 bn] capital raised during course of exercise.
**** Since there is no official threshold in the 2016 stress test, there was also no capital shortfall reported.
Sources: Author's elaboration on CEBS (2009), ECB (2014), EBA (2010-16), and Ayadi & De Groen (2014).