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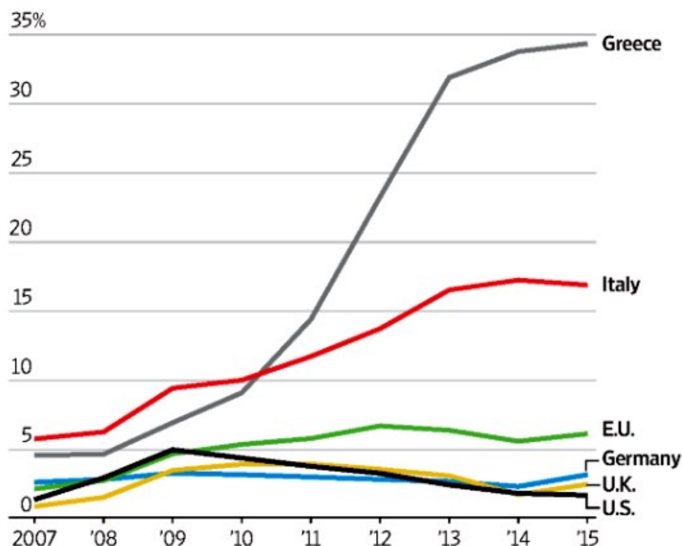
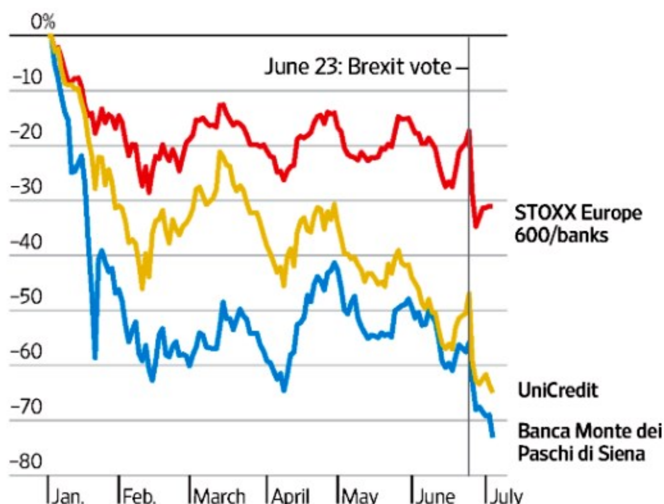
EUROPE'S BANKS FACE RISK IN BREXIT'S WAKE

In Italy, lenders' many bad loans could morph into an EU-wide crisis

Struggles of European Banks





Sources: World Bank; European Banking Authority; FactSet

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Banks' attempts to unload some of the bad loans have largely flopped.

BY GIOVANNI LEGORANO

MILAN—Italy's banks have a problem with bad loans, and that could soon present a problem for the rest of Europe, too.

Here, 17% of banks' loans are sour. That is nearly 10 times the level in the U.S., where, even at the worst of the 2008-09 financial crisis, it was only 5%. Among publicly traded banks in the eurozone, Italian lenders account for nearly half of total bad loans.

Years of lax lending standards left Italian banks ill-prepared when an economic slump sent bankruptcies soaring a few years ago. At one major bank, Banca Monte dei Paschi di Siena SpA, sour loans were so thick it assigned team of 700 to deal with them and created a new unit to house them. Several weeks ago, the bank put the bad-credit unit up for sale, hoping a foreign partner would speed the liquidation process.

The U.K.'s vote to leave the European Union has compounded the strains on Europe's banks in general and Italy's in particular, imperiling the Monte dei Paschi sale and creating fresh uncertainty at a time when lenders are struggling with ultralow and even negative interest rates and sluggish economic growth.

Brexit has many executives concerned that central banks will keep interest rates lower for longer than they might otherwise, in an attempt to counteract the slower growth—in the eurozone as well as Britain. European banks' stocks slid after the vote, with those in Italy especially hurt. Shares in Banca Monte dei Paschi are down roughly a third since the June 23 referendum.

All this threatens to spark a crisis of confidence in Italian banks that, some analysts say, could threaten Italy's stability and, potentially, even that of the EU.

"Brexit could lead to a full-blown banking crisis in Italy," said Lorenzo Codogno, former director general at the Italian Treasury. "The risk of a eurozone meltdown is clearly there if Brexit concerns are not immediately addressed."

Europe's banks were already retrenching before the U.K. vote, and markets appear fearful many don't have thick enough capital buffers. Even

Sulla scia della Brexit, le banche europee a rischio

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da pag. 1
foglio 2 / 3
www.datastampa.it

before the vote, shares were valued at levels that signaled distress. Since June 23, an index of European banks has dropped 17%, bringing total losses from the beginning of the year to 30%.

The pain is greater in Europe's periphery. Portugal's banking system continues to struggle with souring loans, low profitability and little investor appetite. The country received an international bailout in 2011, but given Portugal's high debt, authorities held off on a cleanup of banks' balance sheet through the creation of a systemwide "bad bank." That idea is being discussed now.

In June, Spain's Banco Popular Español SA raised €2.5 billion ($2.79 billion) to tackle continued losses on soured property loans, a sign the country's weakest lenders have struggled to recover from Spain's 2008 real-estate bust and subsequent economic downturn.

The profitability of Italian banks has long been among the worst in Europe weighed down by bloated staffs and too many branches, leaving the banks with little extra capital to cover loans that go bad. Today's low interest rates have hit Italian banks especially hard because of their heavy focus on plain-vanilla lending activities, with relatively little in fee-generating activities such as asset management and investment banking.

When the financial crisis of late 2008 hit, Italian banks tended to roll over loans whose borrowers weren't repaying on time, hoping an economic upswing would take care of the problem, say Italian bank executives.

Italian banks' struggles have led to the first serious test of a model the EU adopted two years ago for handling banking woes. The Italian government has sought EU permission to inject €40 billion into its banks to stabilize the system.

To do so would require bending an anti-bailout rule the bloc adopted in 2014 to force troubled banks' stakeholders—shareholders, bondholders and some of their depositors as well—to pay a financial price before countries' taxpayers must.

Rome argues that bending this rule would be a small price to pay for erecting a firewall against possible bank contagion stemming from Brexit. Italy's EU partners, led by Germany, reject the idea, leaving Rome exposed to a banking crisis that shows no signs of abating.

When the European Central Bank began supervising the eurozone's largest banks in 2014, things got harder. The new supervisor applied tougher criteria than the Bank of Italy did for declaring loans impaired, say bankers. In April, it forced one bank to take bigger write-downs to bad loans before receiving its blessing to merge with another bank.

The result is that impaired loans at Italian banks now exceed €360 billion—quadruple the 2008 level—and they continue to rise.

Banks' attempts to unload some of the bad loans have largely flopped, with the banks and potential investors far apart on valuations. Banks have written down nonperforming loans to about 44% of their face value, but investors believe the true value is closer to 20% or 25%—implying an additional €40 billion in write-downs.

One reason for the low valuations is the enormous difficulty in unwinding a bad loan in Italy. Italy's sclerotic courts take eight years, on average, to clear insolvency procedures. A quarter of cases take 12 years.

Moreover, in many cases, the loan collateral is the family home of the owner of the business, or it is tied up in the business itself.

"There is a desperate need to make collateral liquid," said Andrea Mignanelli, chief executive of Cerved Credit Management Group. "Right now, it gets stuck in auctions and judicial procedures that make cashing the loan very hard."

The Italian government has put forth a series of solutions since last fall, but with little success so far. The proposals include incentives to encourage the creation of an nonperforming-loan market, shorter bankruptcy procedures, and new rules to push Italy's 400-odd cooperative banks to merge.

Brexit has greatly compounded these problems. A slowdown in growth could cause more bad loans to pile up, further depress bank profits and erode already-thin capital cushions. Growth was already slowing before the referendum; on Friday, Italy's business lobby group Confindustria slashed Italy's growth forecast for this year to 0.8% from 1.4%—and to 0.6% from 1.3% for next year—as a result of the Brexit vote.

Another concern is that more pressure on banks' share prices could lead some depositors to pull out their funds. Earlier this year, Banca Monte dei Paschi saw deposit outflows after its share price fell more than a fourth in a few days.

The worse their loans are performing, the more capital banks have to have as a cushion against losses. Now, "Brexit will inevitably push the banks to strengthen their capital situation in order to cope with the volatility of the markets and prevent further damage to their stock prices," said Riccardo Serrini, chief executive of Prelios Credit Servicing, a debt collector.

Strengthening capital is a tall order in post-Brexit markets. UniCredit SpA is a case in point.

The bank—Italy's largest by assets and the only one classified as globally significant under international banking regulations—has already undertaken €74 billion in loan write-downs and capital increases since 2008. With falling profitability and €80 billion in nonperforming loans, its capital cushion barely meets ECB requirements.

With investors pummeling its shares this year, UniCredit ousted its chief executive, Federico Ghizzoni. Last week, with its stock falling, it rushed to appoint a new CEO, Jean-

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Pierre Mustier, its former head of corporate and investment banking. In short order, Mr. Mustier must now present a convincing restructuring plan and raise as much as €9 billion to shore up investor confidence.

The Italian government pushed for a broad solution that would recapitalize banks and draw a line under the bad-loans crisis, when it appealed to the EU for permission to inject €40 billion into the lenders. The Italian government argues that without such a recapitalization move, Italy's banking problems could mushroom into a broader crisis.

"There is an epidemic, and Italy is the patient that is sickest," said Pierpaolo Baretta, an undersecretary at the Italian Economy Ministry. If "we don't stop the epidemic, it will become everybody's problem....The shock of Brexit has created a sense of urgency."

Italian Prime Minister Matteo Renzi pressed the issue in his meeting last week with German Chancellor Angela Merkel.

The European Commission, with strong backing from Berlin, has dismissed the push from the Italians. Some European officials privately expressed annoyance that Rome has been slow to deal with its banking problem and is paying the price in such volatile markets. Now, they say, the Italians are using Brexit to press for permission to bend the rules of a hard-fought banking regime.

"We worked to set down certain rules about bank resolution and bank recapitalization," Ms. Merkel said last week in Brussels. "We can't do everything again every two years. We put a lot of effort into that."

Instead, EU officials say bank supervisors might need to declare some lenders insolvent and impose losses on investors first.

Rome has criticized the EU's new banking regime and doesn't want to use "bail-in" rules that prescribe the order in which stakeholders must bear losses for winding down an ailing bank, in part because of the peculiarities of the Italian banking system. About €187 billion of bank bonds are in the hands of retail investors, who would be wiped out by a bank resolution under the new rules.

Last year, more than 100,000 investors in four small Italian banks that were wound up saw their investments wiped out. Some lost their life savings. The controversy exploded in December after Italian news media reported that a retiree committed suicide after losing €110,000 in savings invested in one of the banks.

Such problems carry little truck in Brussels. "Every grandmother has bought bank shares," said one EU official. "That's how it's presented to us....This work has to be done within the rules, using all the flexibility there is."

Brussels provided a weaker form of support for the Italian banks last week when it authorized Italy to use up to €150 billion in government guarantees to offer liquidity support. Since the Italian banks haven't suffered a lack of liquidity, that provision doesn't help much, say analysts and bankers.

The coming months promise to be tumultuous for Italian banks. The European Banking Authority will conduct stress tests of banks by the end of July and could single out some as having insufficient capital buffers.

In August, an ECB task force looking at bad loans will publish draft guidance on how banks should deal with the problem. While the guidelines will be nonbinding, the supervisors could raise pressure on banks that don't follow them.

In a recent note to investors, Mr. Codogno the former director general at the Italian Treasury, wrote: "The situation may get much worse before it gets better."

—Andrea Thomas, Viktoria Dendrinou, Jeannette Neumann and Patricia Kowsmann contributed to this article.

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