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Quo vadis banking union? Italian banking crisis

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The real estate bubble started to burst in the USA roughly ten years ago, tossing the global economy into a severe recession mainly on the back of contagion effects in the financial sector.

In order to avoid a bad situation from getting worse, many financial institutes had to be bailed out by governments and thus ultimately by the taxpayers. One of the learning points of the financial crisis is to prevent taxpayer-funded bank bail outs in the future.

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Homogeneous framework within the banking union?

Much has happened in bank regulation since 2009: standardised, stepped-up requirements for capital ratios, a central supervisory body for system-relevant banks plus regular stress tests, and a regulatory framework for bank liquidation. The latter even requires not only shareholders and junior creditors, but also senior creditors to make contributions (bail in) in the event of an imminent bankruptcy. This means it looked like the right framework for the prevention of bail outs was in place.

However, discrepancies have become evident on a national level when it comes to senior bonds and the question of which ones should be affected by a bail-in and thus contribute to the ratio prescribed by the banking union for capital eligible for bail-ins ("*Minimum Requirements for Own Funds and Eligible Liabilities*" (MREL)). This implies that even the third pillar of the banking union has not been set up in a standardised fashion yet. This is perfectly illustrated by current events in the Italian banking market.

Italian banking sector in focus

Financial institutes in Italy have been under pressure due to numerous bad loans for almost a year. Whereas the biggest banks such as Unicredit, Intesa Sanpaolo and Banca Monte dei Paschi are currently experiencing low spreads, the two regional banks Banca Popolare di Vicenza and Veneto Banca have now been unable to avoid liquidation.

On 23 June, the ECB decided that the two financial institutions were "failing or likely to fail"; as a result, the Single Resolution Board (SRB) concluded that a liquidation as pursuant to the Bank Recovery and Resolution Directive (BRRD) was not of public interest. This was based on the assessment according to which neither Banca Popolare di Vicenza nor Veneto Banca were systemically relevant, and it paved the way to a liquidation according domestic (i.e. Italian) insolvency law. Although we doubt the likelihood of a cross-border systemic shock, the Italian authorities did point out the risk of contagion for national banks and underlined the importance of the government getting involved in the process.

Damage to EU's regime for failing banks?

However, in contrast to the actual intention of the BRRD, the Italian government is providing EUR 17bn (including guarantees), with the investors of the two banks only having to foot part of the bill. This is legally possible due to the liberties granted by national legislation, but the new bail out questions the regulatory framework of this pillar of the banking union, not the least as it required consent from the EU, which came promptly.

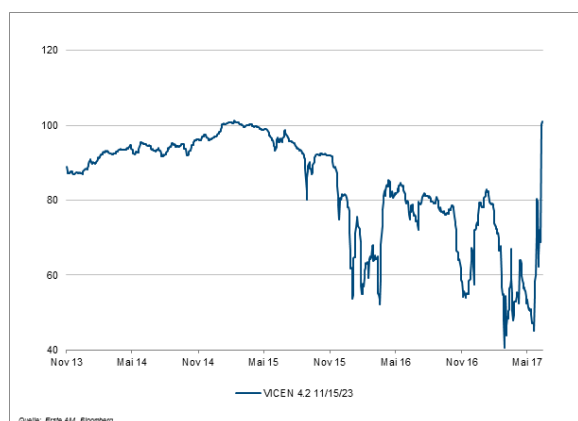
In the rest of Europe, the bail out decision has garnered less approval. Experts have pointed out the disservice the decision does to the idea of bank liquidation within the banking union, and rightly so. German politicians have been particularly disillusioned by the decision and have remarked that the credibility of the EU regulatory framework is being eroded by circumventing it at the first sign of difficulty. The German economic expert Schnabel has pointed out the loopholes in the liquidation regime that have to be plugged before the banking union could stand any chance of completion. A common deposit guarantee scheme has thus presumably been postponed indefinitely.

Relief among senior bank bonds

For the Italian banking sector and the economy, on the other hand, the solution has significantly more upsides. First of all, a systemic shock to the Italian banks has been prevented, since a total of about EUR 25bn worth of senior bonds would probably have been called on for the bail in. And further down the line, the financing costs for banks would have sky-rocketed. Ultimately, there would have been a significant risk of a bank run.

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Price chart of a senior bond of Banca Popolare de Vincenzo since inception (11/2013-06/2017)



Source: Erste AM; Bloomberg; as of 29.6.2017

Please note: Past performance is not a reliable indicator for future developments.

With the decision for the Bail-Out the price of the senior bond of Banca Vincenzo maturing on 26. June 2023 jumped above the initial offering price of 100.

Questions on bail-in of senior bonds remain unanswered

The case of the two Italian banks confirms our perception of the banking union and the mechanism of the bail in scenario associated with it: while banks are required to hold sufficient amounts of senior capital for it to be used for restructuring in the event of a bail in where equity and junior debt do not suffice, there are still too many loopholes for political decisions on a national and European level that thwart the idea of the no-bail-out-scenario for taxpayers. Also, the European map is a patchwork of regulations instead of one concise, standardised regulatory framework. The question is whether the existing framework should not be amended or specified to facilitate a functioning and unified liquidation mechanism in the banking union.

The example of the Italian banks questions the likelihood of a bail in of senior bonds from a fundamental point of view, which is causing pricing shifts for spreads across senior and junior bonds.

As the example of the Spanish Banco Popular showed, where the ECB stated on 6 June that the Spanish bank would default or was likely to default, it never works in the favour of a financial institute when the necessity of a capital injection is being discussed publicly over an extensive period of time. This does not only hamper new business from coming through, but it also leads to a withdrawal of liquidity. This is also why the market needs swift clarity on the recapitalisation of Banca Monte dei Paschi.

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