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Weekly Credit Brief Jun 05 - Jun 11

Italian banks' recovery path may be derailed by proposed government policies

by Liu Hanlei

At the height of the Italian banking crisis in 2016, non-performing loans by Italian banks went up to almost 20% of total lending and EUR 138bn of debt were forced to be written down. Fast forward to 2018 Q1, a return to profit by Banca Monte dei Paschi di Siena in its latest earnings report, an Italian bank bailed out by the government last year, may signify early signs of recovery for Italian banks. In line with the better financial earnings by Monte Paschi, the median financial ratios for 11 Italian banks have seen improvement over the past 4 quarters. Non-performing loans (NPLs) ratio have been falling alongside with improving return on equity (ROE) and cost/income ratio which are some of the commonly used financial metrics to determine the performance of a bank (see Table 1). The RMI-CRI 1-year aggregate Probability of Default (PD), a median of PD for 11 Italian banks, fell with the recovery in financials of the banks since the start of 2018 until May 2018 (see Figure 1).

Italian banks	2017 Q2	2017 Q3	2017 Q4	2018 Q1
Cost/income ratio (%)	70.82	67.68	69.12	63.90
Non-performing loans ratio (%)	16.96	16.25	15.40	14.40
Return on equity (%)	3.45	2.72	4.30	7.51

Table 1: Median financial ratios for 11 Italian banks. *Source: Bloomberg*

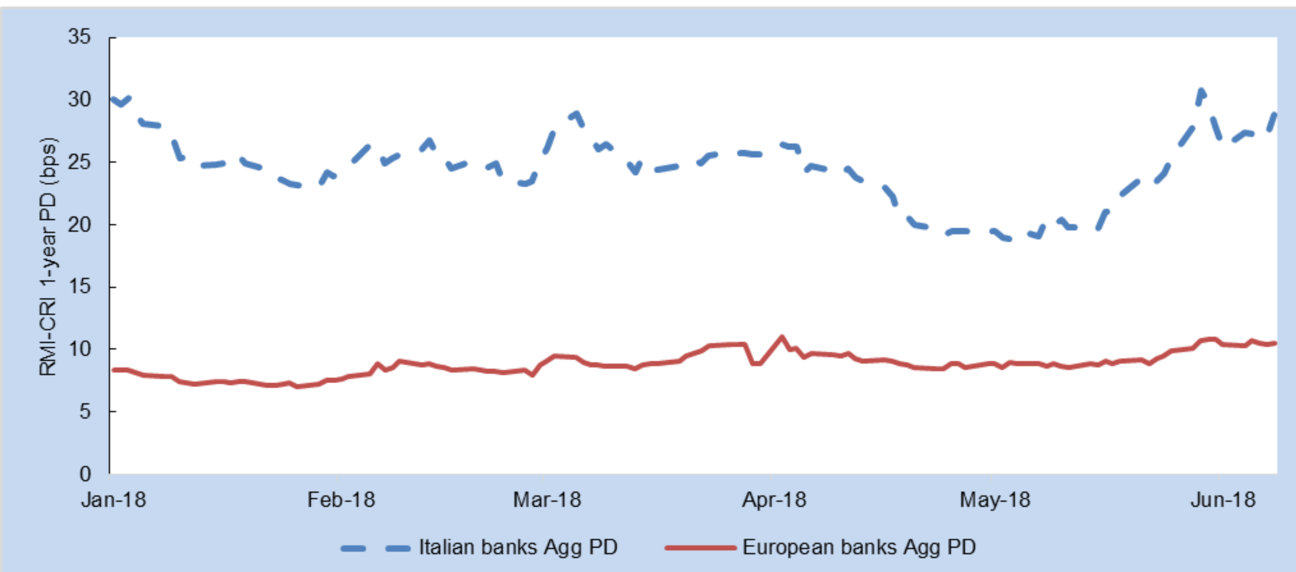

Figure 1: RMI-CRI 1-year aggregate PD for Italian banks and European banks (median of 34 European banks excluding Italian banks). *Source: RMI-CRI*

After a hung parliament since March 2018, the populist coalition of the anti-establishment party Five Star Movement and the far-right Northern League formed the new Italy government in May. A series of political events caused jitters among investors. At first, it was due to the President of Italy rejecting the parties' choice of a Eurosceptic economist, Paolo Savona, as finance minister. Eventually, Giovanni Tria, a pro-euro political economy professor, was sworn in as finance minister on 1 June. Next was when Italy's Prime Minister, Giuseppe Conte, gave a speech on 5 June highlighting the new programs of the government, by implementing radical tax cuts and anti-austerity measures such as providing basic monthly income for the poor. These new programs have left investors puzzled given that Italy is experiencing slow growth amid high public debt, 132% of GDP, which is the second highest ratio in the Eurozone after Greece. The political uncertainty and proposed economic programs have caused Italy's government 10-year bond to suffer a sell down and the yield has since shot up to 3.13% on 8 June from 1.80% about a month ago.

According to the Bank of Italy, Italian banks are heavily exposed to its own country sovereign bonds, accounting for almost 10% of assets and this is higher than most other European banks at about 4%. The top two Italian banks, Intesa Sanpaolo and UniCredit had EUR 54.5bn and EUR 76bn worth of Italian sovereign bonds at the end of 2017 respectively and their exposure exceeded the size of their capital buffers. The third largest bank, Monte Paschi, had more than 90% of its EUR 21.7bn sovereign debt in Italian government bonds as at the end of June 2017. Shares of Italian banks suffered a sell-off, led by the top three Italian banks, along with Italian's government bonds. The RMI-CRI 1-year aggregate PD for Italian banks also rose in mid May 2018. Analysts labelled the linkage between the country's creditworthiness and the banking system as the doom loop which was also what happened to Greece in 2015.

There are also concerns about the recovery plan by Italian banks, namely its non-performing loans disposal programs, as the coalition has discussed repealing laws that allow banks to recover debts from Italian citizens without judicial approval. Italian banks' average NPLs ratio of 14.4% still remains above the Eurozone average at 2.46% as of 2018 Q1 (see Table 2 below). For Italy's largest banks, the NPLs ratio of UniCredit stands at 9.5% and Intensa Sanpaolo at 11.7% as of March 2018. For Monte dei Paschi, it stands the worst at 38.1% but after concluding its government-backed securitization to remove EUR 24bn of NPLs, this would be brought down to 19.7%. The Italian government has also brought up the idea of rolling back recent bankruptcy reforms which may derail banks' plan to clean up its balance sheets given that the government is a key pillar of the securitization scheme. The current scheme will end in September and uncertainty looms whether the new government will renew it with the European Commission.

European banks	2017 Q2	2017 Q3	2017 Q4	2018 Q1
Cost/income ratio (%)	61.08	58.44	69.87	60.25
Non-performing loans ratio (%)	2.54	2.47	2.10	2.46
Return on equity (%)	9.50	9.20	8.30	10.10

Table 2: Median financial ratios for 34 European banks excluding Italian banks. *Source: Bloomberg*

Despite the improvement in financial standings of Italian banks, they still pale in comparison to its European peers. Italian banks' NPLs ratio remains much higher and ROE still lags behind. Figure 2 below exhibits the term structures of the RMI-CRI Forward 1-year Probability of Default (Forward PD) for Italian and European banks. The starting point of the curve, month 0, represents the RMI-CRI 1-year PD on 8 June, 2018. The PD shows that Italian banks' credit profiles are worse than the credit profiles of European banks, which is also evidenced by the weaker Italian banks' financial ratios. In addition, the shape of the term structure shows that, based on the market information on 8 June, 2018, the credit profile for Italian banks could deteriorate further and peak in the following 12 months. The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months.

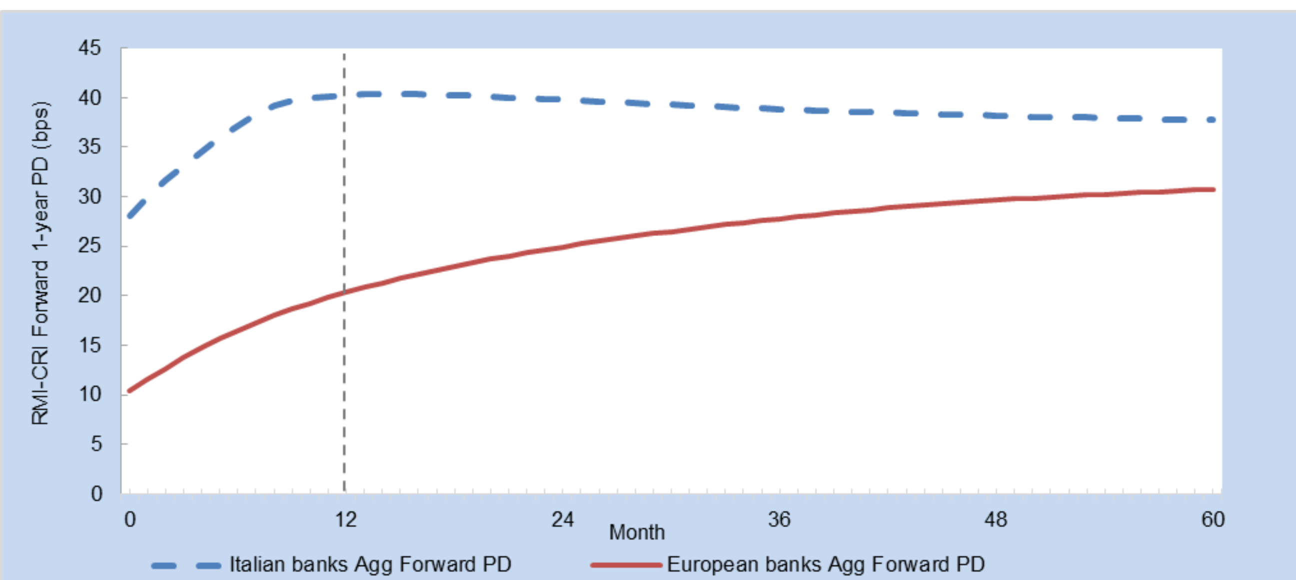

Figure 2: RMI-CRI Aggregate Forward 1-year PD term structures for Italian Banks (median) and European banks (median) on 8 June, 2018. *Source: RMI-CRI*

Though Italian banks still remain weak as compared to its European peers, they have achieved a better standing as compared to its 2016 crisis level. However, given that the populist coalition has won a confidence vote in the lower house of parliament on 5 June, this may set the stage for the coalition to implement its economic programs and proposed policies. The uncertainty of the NPLs disposal program and anti-austerity programs may very well derail Italian banks' recovery path.

Credit News

A China credit channel sees longest drop since stock crash

Jun 11. Chinese companies' room for raising cash is narrowing as policy makers increase liquidity scrutiny. The number of outstanding loans held by listed companies has contracted for four straight months to CNY 1.53tn in May 2018, marking the longest run of declines since the 2015 stock market collapse. Following the regulators' deleveraging effort, new rules about putting limits on the number of shares that can be pledged and accepted in share-back lending were released in March. The rules lead brokerages to avoid share-pledging deals, which involves market volatility risks. The narrowing funding channel has increased the cost of refinancing. Yields on 3-year Chinese AA- corporate bonds have climbed 61bps from the year's low in April, to 7% on June 8, 2018. (Bloomberg)

Top investment bank profits at pre-crisis levels

Jun 11. According to research conducted by Financial Times, nine of the world's top 10 investment banks have marked a total net income of USD 78.4bn in 2017, higher than USD 75.4bn in the year before the 2007 crisis. The solid profitability shows that investment banks have emerged from a decade of change in much better shape than many would have predicted, highlighting the industry's strong resilience amidst tougher regulation and severe competition. However, return on equity is still well below the pre-crisis level mainly due to post-crisis regulations on capital levels. Fixed-income revenues were more resilient only because 2007 was already a low watermark. Even with the market pressure, most banks are still expected to improve profitability over the next years. (FT)

Debt fears are mounting for the Euro Zone's only Nordic member

Jun 10. According to Bloomberg, Finland's debt has nearly doubled to USD 125bn over the past ten years and the Finance minister has expressed concern about the nation's debt burden. Finland intends to pay down its debt while economic growth and employment remains strong. As the fastest aging nation in the EU, Finland's escalating elderly care costs and pension payments are expected to place an upward pressure on a shrinking population of taxpayers. However, Finland's sovereign bonds have been given the second highest rating by credit rating agencies and carry one of the lowest yields in Europe. (Bloomberg)

Money markets see biggest inflows since 2013 in run for cash

Jun 8. Following trade tensions and turmoil in developing economies, cash inflows in global money market reached its highest record since October 2013. According to EPFR Global, an amount of USD 55bn equivalent flowed into the money market in the week through June 6, among which USD funds play the biggest role with USD 45bn being rolled in. While US funds were the biggest beneficiaries, European equity and emerging-market fixed income were the big losers. In addition to the surging cash influx in money market, money managers in US and China can obtain positive real returns on cash-like instruments in the US since the crisis. US equity funds extended their longest inflow streak since the fourth quarter of 2017, taking in about $1 billion overall and Chinese bond funds saw the highest allocation in over 17 months. (Bloomberg)

Franklin Templeton sheds Bahraini bonds and warns of crisis

Jun 7. One of the largest fund managers in the world has cut exposure to Bahrain and predicts an economic crisis if the country does not receive financial aid soon. Unlike other Gulf nations, Bahrain has been slow to implement economic reform and the country's public finances have dwindled even though crude oil prices have rebounded this year. The IMF estimates that Bahrain needs oil prices to climb beyond USD 100 a barrel in order to balance its fiscal budget. Five year credit default swaps on Bahrain's sovereign debt have risen to the highest level since June 2016 as investors remain skeptical of the country's ability to replenish its foreign reserves. (Bloomberg)

Dubai gold retailer held for loans default is released (Reuters)

Greece submits reforms to parliament, aiming to unlock last bailout loans (Reuters)

S&P confirms Estonia's rating at AA- with stable outlook (ERR)

Regulatory Updates

Turkey's central bank raises rates again, says ready to tighten further

June 7. Turkey's central bank raised its benchmark interest rate again by 125bps to 17.75% on June 7, 2018, 2 weeks after the previous emergency interest rate hike. Previously, increase in doubts over whether the central bank can rein in double-digit inflation and President Erdogan's growing influence on monetary policy before election has made the lira to fall 16% in 2018. President Erdogan has increased pressure on central bank before the presidential polls to lower borrowing costs and spur credit growth and construction. The central bank has raised rates by 4.25pps since late May when it announced a dramatic 3 percentage-point increase to stem the rout in the lira. Despite the mild outlook for demand conditions, elevated levels of inflation and inflation expectations continue to pose risks on the pricing behavior. (Reuters)

India's central bank tightens rules around state bond valuations in blow to banks

Jun 6. According to RBI, India's central bank, the investors would now have to value their investments in the state government bonds at the market prices, and not a fixed mark-up of 25bps above the corresponding central government security, which has been followed for years. In an already brutal fiscal year for state government bonds, which has seen a rise of 50 basis points in yields since April, this move could attenuate the demand for government debt and further increase the bond yields as the banks have used the existing method to mask their actual trading losses. According to Ashish Vaidya, Head of DBS Bank Mumbai, India's benchmark 10-year bond yield can rise above 8% in the upcoming weeks. Though, as a cushion for the losses, RBI allowed the banks to spread the bond trading losses for the April-June quarter over the next four quarters and also loosen the rules to allow a larger share of their bond holdings towards liquidity coverage ratios. (Reuters)

Indonesian central bank says no plan for capital controls (Business Times)

MAS partners IFC to spur green bond market in Asia (Business Times)

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