Who will rescue the World's Oldest Bank?

(Duccio da Boninsegna, La Maestá, ca 1308-1311. Siena, Museo dell'Opera Metropolitana)

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Monte dei Paschi di Siena is the world's oldest surviving bank. It traces its roots to the Tuscany's early prosperity - the wool trade - and the time when the grazing lands of Maremma to its immediate South were placed as a guarantee for the bank's early depositors: in those days, the bank did not have equity capital in the modern sense of the term, (Paschi means "pastures" in the local dialect). When Monte dei Paschi was founded, in 1472, Siena was still had a hundred years ahead of it as an independent Republic, Lorenzo de Medici "the Magnificent" ruled in Florence, and the Yorkist Edward IV in England, where the embers of the Wars of the Roses were still glowing. France was still healing from the wounds of the Hundred Years' War. "Spain" as such did not exist, still divided between Castile and Aragon and other splinter statelets. Germany, nominally united under the Empire, was in fact a loose assembly of hundreds of independent polities. The states of Central and Northern Italy were the powerhouses of the European economy.

From these auspicious beginnings, Monte dei Paschi went on to centuries of success and a dominating influence in the life of Siena and the entire region. In the latest chapter of its history, straddling the 1990's and the early 2000's, it became a veritable modern day Lorenzo de Medici as a patron of the arts and the culture of Siena, including its football team, the "Palio" horse race and as the financier of large enterprises and local entrepreneurs and households. There were few business or charities in Siena that were not recipients of Monte dei Paschi's Medici-like munificence.

Unfortunately, a series of daring (but some would say foolhardy) strategic decisions in the last 15 years, and the overextension of its munificence into politically-driven rather than economically sound lending decisions, have made Monte dei Paschi The Sick Lady of Italian and European banking. The bank has had to be twice rescued by the Italian government and its non-performing loan portfolio is the largest of any Eurozone systemically significant bank.

This essay traces the story of the latest attempts to recapitalize and restructure the bank in the context of recent developments in Italian financial affairs. How these efforts may or may not succeed. And what else may be needed to achieve a stable and final restoration to health not only of MPS, but also of Italian banking.

Introduction

The last few weeks have seen a series of extraordinary events at Monte dei Paschi. First, the bank spectacularly failed the European Banking Authority's stress tests on July 29th. Almost simultaneously, its management announced an extremely ambitious restructuring and recapitalization plan. More recently, following rumours of disagreements between the bank's management and its advisors, the bank's CEO, Fabrizio Viola, was summarily dismissed by the Treasury Minister (the Italian Treasury is MPS's largest shareholder). A search for a new CEO was launched and closed within less than a week, the winning candidate being Marco Morelli, currently at Merryll Lynch BoA but a former CFO of the bank and JP Morgan banker. The same day when the Board appointed Morelli, the Bank's Chairman, Massimo Tononi, resigned, ostensibly in disagreement with the management reshuffle.

All this amongst conflicting statements by Prime Minister Matteo Renzi and Economy Minister Pier Carlo Padoan, delivered in high-profile venues on national television, about the likely timing of the bank's recapitalization. Finally, the press is awash with stories about the need to restructure the July 29 plan by extending it to some form of "burden sharing" by junior bond holders, something which had been repeatedly ruled out by all sides in the plan's early days. A Reuters story on September 22 suggested that unnamed EU officials "now expected the Italian government to have to use public funds to rescue MPS". Unsurprisingly, MPS shares and junior bonds are trading at all-time lows.

How did a bank rescue of such strategic importance for Italy and its banking system come to result in such chaos?

Despite much cheerleading from the Italian press, and some premature triumphalism from Italian bank CEOs, presidents, and politicians, the stock market had been somewhat sceptical of the recapitalization plan from the very beginning. However, this was by no means just an Italian problem. Several banks in the Eurozone and elsewhere in Europe were pummelled by the market in the two days following the plan's publication, which also coincided with the release of the European Banking Authority (EBA) stress test results.

There were probably several reasons behind this reaction, but two stand out.

One was that the market woke up, perhaps belatedly, to the difference between "passing the stress tests" and "passing the stress tests without a significant drawdown in capital". "Passing the stress tests" with a CET1 ratio above a presumed minimum "threshold" (since the ECB has not published a threshold for the 2016 STs, the market has to guess what it may be; estimates seem to centre around 6%) simply means that a bank would not be declared insolvent in the event of the 2018 adverse scenario. It does not mean that it will not need additional capital.

This was most likely the situation of Unicredit Group (UCG) which, although it showed a CET1 ratio deterioration of only 350 basis points in the adverse scenario, had a starting level of just 10.59% and so would find itself, in such a scenario, just above 7%, 200 basis points below the average for the cohort of banks involved in the tests. After months of rumours and official denials, the Group's president, Giuseppe Vita, told the press on July 14 that he did not believe the capital strengthening UCG had achieved would be enough to satisfy regulators[1]. The amounts of additionally required capital mentioned in press and analyst reports were (and are) in the range of 7-9 billion euros. Other Eurozone banks that "passed" the tests with significant deterioration in CET1 (under the adverse scenario), such as Allied Irish Bank, Royal Bank of Scotland and Bayerische Landesbank, Landesbank Baden-Württemberg and NRW Bank are probably in a similar situation of needing additional capital.

Another factor was concerns about profitability. The Commerzbank earnings warning in early August probably played the biggest role in this respect, especially given that Commerzbank is not a bank plagued by large NPLs or huge derivatives portfolios. And the warning was explicit in tying the expected fall in profits to the ECB's negative interest rate policy. It was only natural that investors should immediately project similar expectations onto other banks. Again, this is not new. However, one thing is to speculate about worries on margin compression from the NIRP. Quite another is to see it as a black-on-white warning from the second largest bank in the Eurozone's top economy.

Finally, there were the terms of the proposed MPS plan itself, how it could contribute to settling down months of uncertainty about the Italian banking system, and what it meant for the valuations of the rest of Italian banks. Before looking at these terms in detail, it is worth taking a step back and considering how we got to where we are today, since that history is in itself germane to the current predicament and to possible future developments.

The NPL problem and the search for capital

The MPS plan itself was the culminating point of a list of attempts by the Italian authorities to resolve the problem of bank NPLs. This problem arose from the combination of two factors. The long years of recession in the aftermath of the financial crisis followed a period of already very low

[1] The WSJ Europe, July 14 2016.

growth, lasting since Italy's entry into the Eurozone, and thus have resulted in fifteen years of quasi-stagnation and pro-capita GDP contraction. This has left a long trail of non-performing loans on the books of Italian banks. Italian bankruptcy and asset repossession legislation also make it very hard and time-consuming for banks to take full title to collateral and to liquidate it.

In addition, as numerous court cases have revealed, alliances between local business and political interest centred on some regional and super-regional banks, including MPS, lead to weak governance and questionable lending practices, resulting in uncommonly large bad loan exposures, even when compared to the national average.

In January of this year, after a reportedly year-long negotiation, Italian Finance Minister Padoan apparently failed to convince his Euro-Group peers and Commissioner Margarethe Vestager that Italy should be allowed to establish a state-backed "bad bank" to dispose of Italian banks' NPLs on terms that Italy would find acceptable. As a back-up plan, he decided, with the agreement of the European Commission ("EC"), for a scheme based on a priced-at-market but government-provided guarantee for the most senior tranches of securitised NPLs (called GACS). However, that programme was a far cry from the "systemic solution" that a nation-wide bad bank would have provided. Indeed, despite initial announcements that tens of billions of programs of GACS-supported NPL sales would soon materialize, not a single disposal program of note has been launched to date.

The GACS did not solve the NPL problem. Instead, they drew investors' attention to the fact that the real problem was one of capital shortfall in several banks, including MPS. The Italian banks' book values at which they carry their NPLs range from 37-45% of face value, whereas the market is typically not prepared to pay more than 20-25%. Even the Bank of Italy, in a transaction from late 2015 to rescue four small insolvent banks, had indicated that their NPLs should be valued at 22.5%.[2]

Thus, the disposal of NPL portfolios at anywhere near market value, even with the support of the GACS, would create large losses for the selling banks. Since none of these banks had surplus regulatory capital, correspondingly large capital injections would be needed. In addition, as the recent stress tests have also shown, some of the banks need to raise additional capital regardless of NPLs.

Recent experiences with attempting to raise equity in the Italian market had also shown the risks of tapping private investors under unfavourable circumstances, even when backed by strong hands. Saipem, formerly the engineering arm of ENI, launched a 3.5 billion capital call at the end of October, to enable it to deconsolidate from ENI's balance sheet and reduce its debt. Cassa Depositi e Prestiti (CDP), the Italian State main holding company and recipient of all postal deposits, as the major shareholder of ENI, simultaneously paid 465 million for a 12.5% stake in Saipem, and agreed to take up another 12.5% of the company in the coming rights issue. Unfortunately, the company went from being valued at slightly more than 3.5 billion (then 103% of book value) the day the new issue was approved, to being valued at *less* than 3.5 billion shortly after it was completed. In other words, incumbent shareholders, including CDP, initially suffered a mark-to-market loss of 100% of their pre-rights issue valuation. The price of Saipem shares has since recovered somewhat and currently sits about 3% above the rights' issue price.

Whilst the Saipem mishap could be put down to the woes of the oil sector, the banking sector was not sailing in particularly safe waters either at the time (and, of course, it has only become less so

[2] The value of these portfolios had initially been fixed at 17.5% in the process of resolving the four banks and transferring the assets to an SPV. In a subsequent revision, the Bank of Italy determined that the portfolios should have been transferred at a value of 22.5% instead.

since). Therefore, any prospects of a secondary offering to private investors came to be seen as increasingly hazardous alternative by banks and their boards.

The only alternative to these expensive private capital calls would be for the government to inject money into the banking system using public funds, analogous to what the United States did with the TARP-2 programme in 2008-2009. However, under the new EU-wide Bank Recovery and Resolution Directive (BRRD) rules, which had come fully into effect on January 1st 2016, almost all forms of state capital injection would require a “bailing-in” of private bank bondholders, most of which are retail savers in Italy. Alternatively, an injection of public moneys would have to take place under an ESM program like the one adopted in Spain, with the signing by Italy of a memorandum of understanding with the “Institutions” in exchange for permission to resort to state aid. Neither of these options was deemed politically viable, at least not in a scenario that also included the survival of the Renzi government. The implications for private bondholders is probably the main reason why the negotiations between Italy and the Commission on a nation-wide bad bank had stalled.

Atlante

In April the government managed to assemble a private-sector solution with some public funds from Cassa Depositi e Prestiti to inject capital into two banks that had earlier been mandated by the ECB to raise additional equity, Banca Popolare di Vicenza (BPVI) and Veneto Banca (VB).

The government-sponsored Atlante fund managed to corral a “coalition of the willing” amongst banks and other institutional investors into providing a multi-billion contribution to backstop these capital calls. The intention was that Atlante would also be used to buy NPLs from the lenders with excessive exposures. Unfortunately, two things happened. First, several private institutional investors that had initially agreed to participate into Atlante backed out of the project after taking a closer look. Instead of launching with the expected six billion euros endowment, Atlante only raised 4.25 billion. Secondly, since private investors subscribed less than 0.5% of the BPVI and VB issues, Atlante’s backstop was used for 100% of both rights issues (Atlante is now the owner of >99% of the capital of both banks).

It may also be that CDP’s recent track record with the Saipem transaction was on investors’ minds when considering Atlante. It is possible that the presence of CDP amongst its backers telegraphed to those approached for an investment that Atlante was in fact just a government-engineered “rescue”, no matter the cost to subscribers, instead of an attractive investment opportunity.

Following its purchase of BPVI and VB, Atlante’s ammunition was thus reduced to 1.7 billion, still a material amount, but way too small to play the expected role in a system-wide settlement of the NPL problem.

Another ECB-mandated capital increase for Banco Popolare succeeded in raising the required 1 billion euros from investors, but only at a huge discount. Ever since the capital raise was completed, the bank’s share price has traded above the already heavily discounted level at which investors subscribed the new shares for just four days. The more that time passed and investors observed the results of these extremely costly capital calls, the more equity issuance became, understandably, a bogeyman for bank CEOs, their boards, and their shareholders.

The authorities’ efforts to address the NPL problem had a legislative coda in early May. The government passed a law decree to facilitate collateral repossessions by banks and other measures aimed at strengthening the value of lenders’ collateral. This was heralded as a major step to alleviate the NPL problem since it is well known that collateral repossession and credit recovery in Italy are the slowest in the EU. It was hoped that, together with the GACS, these legislative changes could significantly improve the market price for NPL sales, thus relieving banks from the NPL-capital shortfall nexus. Unfortunately, even before the decree was published on May 3rd, it transpired that, apparently due to political pressures and other considerations, the government had decided[3] to modify the decree to cover only new loans. But of course the only way to improve the market valuation of current NPLs was to change the laws applicable to *existing* loans. The official estimates for how much the May 3rd decree could reduce the length of credit recovery procedures for existing NPLs were reduced from the initially optimistic "several years" to six months, and eventually dropped altogether. Bank share prices, which had enjoyed a brief bounce on the expectations of relief provided by the new laws, peaked the day before the cabinet approved the decree, and then resumed their decline. Another attempt by the authorities, another disappointment!

Enter Brexit, enter ECB

Around the end of June, two events precipitated the need to find a solution for MPS, which had the largest NPL problem of all Italian banks.

The first was the unexpected result of the Brexit referendum, with the accelerated price declines and increased volatility that it initially caused for all European banks. The second was the leaking of a letter from the ECB to MPS's management, instructing the bank to cut its non-performing exposure (NPE) by 26 billion by 2018, a disposal rate twice what the bank had included in its business plan.

MPS currently has 47 billion total gross NPE, reduced to 26 billion after provisions. In the highest risk category of "bad loans" (which, in a Freudian give-away of a Catholic heritage, are called in Italian *sofferenze*, or "sufferings") the gross exposure is 26 billion and the net is 9.7 (coverage ratio of 63.1or, conversely, a book value of 37% for the bad loans). This represents something like 50 % in excess of their plausible market value, and an implied capital shortfall of over 3.7 billion in the event of their disposal at market prices.

The need to find a solution for the MPS NPL problem *and* capital shortfall thus became pressing, with market attention focusing on the date of July 29, when the EBA/ECB 2016 stress test results would be announced.

For several weeks the media had been rife with rumours and stories about negotiations between the Italian government and the EC (and, more informally, with German chancellor Angela Merkel) on finding a compromise whereby Italy could inject capital pre-emptively into MPS, but crucially *without* any burden-sharing or haircuts for the bank's subordinate debt, which would be mandated under even the most benign interpretation of the BRRD rules.

Given the very large share of retail investors amongst these debtholders (many of whom may not have been fully aware, to put it mildly, of the risks involved when subscribing), the issue was – and remains - intensely political in Italy. Following the partial debacle of Renzi's PD in the June local elections, and with a constitutional referendum looming in October-November, it was felt that it would be a political suicide for Renzi even to contemplate imposing haircuts on retail investors.

Then, on July 3rd, in a televised interview, Renzi suddenly announced that he favoured a "market solution" for the problems of Monte dei Paschi, stressing also that his government had been the first to "get politicians out of the banks".

Whilst no one quite knows what happened behind the scenes, it seems clear that all sides felt that they could not go into a showdown from which one of them would emerge severely weakened and

[3] Federico Fubini, Corriere della Sera, 2 May 2016.

for which a typical EU-style fudge was not available. The Commission was not prepared to compromise its already weakening post-Brexit influence by allowing for a loosening of the just-introduced BRRD rules. Renzi was not about, by agreeing to even a “soft version” of burden sharing, to hand his domestic rivals in the Eurosceptic 5-Star movement and within his own PD an easy target with which to attack him during the referendum campaign. And Merkel was not ready to hand Allianz für Deutschland an equally easy target by giving her support to spendthrift and rule-dodging Southern Europeans, as they would no doubt be depicted in the German debate, on something as visible and as delicate as BRRD.

Whether because of a deliberate evaluation of these unpalatable options or otherwise, the *political* outcome was to simply ignore, or postpone, the question of whether public funds should be used for MPS, or for other Italian lenders. The *practical* outcome was the MPS NPL disposal and recapitalization plan that the bank’s board eventually presented at 8:45 pm on July 29, with less than two hours to go before the announcement of the EBA stress tests.

The Plan, as announced

The terms of this plan are now well known, so only its essential elements need be mentioned here:

- MPS will establish an SPV, endowing it with a capital of 1.6 billion euros and transferring this equity tranche to its current shareholders, who will thus enjoy all residual gains from the NPL recoveries, once the senior and mezzanine tranches are repaid. MPS will take a 1.6 billion charge to fund this initial step.
- MPS will mark down its entire bad loan (“sofferenze”) portfolio, a nominal amount of 27.7 billion euros, to a price of 33% of face value, creating a 1.02 billion euros loss. .
- MPS will then sell to the SPV the NPLs at price of also 33% of face, for MPS with a transaction value of 9.2 billion euros. However, including the impact of the 1.6 billion junior tranche effectively transferred to the current shareholders “for free”, the net resulting price that the SPV will have paid for all of the NPLs will be 27.5% of face.
- MPS will also mark down the remaining “unlikely to pay” and past due NPE still on its books by ca. 2.18 billion euros, taking a further loss for this amount.
- The resulting capital shortfall of approximately 4.8 billion euros will be covered via an issue of new equity (press reports mention “up to 5 billion” as the amount, thus the net equity change will be negligible), initially covered by a pre-underwriting agreement from a consortium of international banks led by JP Morgan.
- In turn, the SPV will finance the acquisition of the NPLs via the issuance of two tranches of debt:
    - A 6 billion euros senior tranche to be placed with private investors. The portion of this tranche that qualifies for investment grade (IG) rating will be eligible for GACS protection. No one has any precise figures for the amount that is expected to be IG, but a figure as low as 2 billion euros has been mentioned. That would leave 4 billion euros of a nominally senior, but still junk-rated tranche, to be sold without guarantees (even if the figure is lower, it will still leave a residual amount to be sold without guarantees).
    - JP Morgan has indicated that it will provide the SPV with a bridge loan for the entire 6 billion euros so that it can acquire the NPLs immediately, allowing the bank to deconsolidate the loans.
    - Atlante 2, a fund receiving investments from some the residual moneys in the original Atlante as well as a new “coalition of the willing” from Italian banks, institutional investors, and CDP, will purchase the mezzanine tranche for a price of 1.6 billion euros.

- Atlante 2 will also receive a 5-year option to purchase up to 7% of the capital of MPS at strike price equal to the sum of the issue price for the new shares plus the market value of the rights issue warrants (details will presumably be confirmed once the rights issue is approved by the board later this year).

The Plan, reconsidered

A brief analysis of the details of this transaction can perhaps reveal why the market initially met the plan with scant enthusiasm and why so many doubts and possible adjustments are now being raised. Three specific questions come to mind.

1. The transaction, as initially proposed, will not affect the bank's CET1 capital. All the new capital will be used to compensate for the various write-downs and the transfer of the junior tranche to the present equity holders. The strengthening of the balance sheet will come exclusively from a reduction in risk-weighted assets, mostly NPLs[4]. The CET1 capital and net book equity of the bank will thus remain at 8.2 and 9.9 billion euros respectively (based on 2016 first half levels) and the tangible net equity will presumably remain at 9.6 billion euros.

   Even assuming that the discount to theoretical parity offered to new investors in the rights issue is in line with the relatively high 30-40% that has been used in recent cases (Banco Popolare's was at 37%), investors in the 5 billion euros equity issue will thus be asked to subscribe MPS shares at a multiple of 0.57 times tangible net equity (TNE), or 0.55 times net equity (NE).[5] At the moment, the market capitalisation of MPS, at just over 550 million euros, corresponds to about 5.75% of the bank's net equity. Evidently, the still large NPE portfolio and investors' apprehensions over the coming rights issue and its dilutive effects heavily influence the current valuation.

   The bank also stated that, again after completion of the transaction, the ratio of its net NPE to book equity (the so-called "Texas ratio") would be ca 120%, significantly reduced from the present level of 265%.[6]

   Looking briefly at comparables among Italian banks, this seems like an optimistic target, to say the least. Italian (and European) banks trading at above half of tangible book value are a rarity, except for the group of banks that focus mainly on advisory or asset management. Intesa San Paolo trades at close to 0.80 times TNE but, arguably, its dominant position in the retail market, its robust governance, high capitalization and low NPL exposure place it in a category of its own. The other top two banks in Italy, Unicredit (UCG) and Unione di Banche Italiane (UBI), trade at multiples of respectively 0.30 and 0.2 5 times TNE. UBI's Texas ratio is 117%, in line with MPS's expected ratio of 120%. UCG's is significantly lower at 87%. Banca Popolare di Milano (BPM), the Italian bank with the lowest NPL exposure (amongst listed banks of a significant size), has a Texas ratio of 80% and trades at a multiple of 0.35 times TNE. [7]

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[4] Monte dei Paschi di Siena – Investor Relations Website "Structural and definitive solution to bad loan legacy", presentation released 29 July 2016. https://www.mps.it/investors/investor-relations/risultati_di_gruppo_e_presentazioni/Presentazione%20risultati/MPS-2Q16-Results.pdf Page 7

[5] MPS financials, author's calculations.

[6] See footnote 4.

[7] All figures in this section are author's calculations based on 2016 Q2 financials for balance sheet data, Bloomberg data for expected future earnings, and September 22 closing prices obtained from Borsa Italiana's website).

Performing a similar comparison from an earnings perspective produces similar results. MPS's earnings, which have returned to modest profitability after losses totalling 15 billion in the previous four years[8], have not only been plagued by NPLs write-downs: net interest margins have fallen considerably and costs have remained high, mainly due to a very large branch network (the second largest in Italy, with 2133 branches, according to 2015 company data) . Bloomberg reports that the aggregate/average analyst forecast expects the company to report 2017 adjusted net earnings of 0.72€ per share, or 210 million. The investors in the capital call would thus be buying MPS shares at a price-to-earnings (PE) multiple of at about 25 times 2017 earnings.

It is possible that several of these estimates are still influenced by the legacy of the bank's NPEs, with its attending need for high ongoing write-downs and provisions, and their depressing impact on earnings. However, even considering the average of the five highest estimates reported by Bloomberg, almost all of them updated after July 29 (and thus presumably including the beneficial effects of the plan on future earnings), we obtain an average of 0.18€/share for 2017 earnings, or 540 million euros. In this case, the PE ratio implied in the plausible price for the rights issue will be 10.2 times 2017 estimates.

Looking again at some comparables, UBI trades at a PE multiple to 2017 adjusted earnings of 6.4 times, UCG at 5.0 and BPM at 7.4. Intesa, the Italian bank with the highest valuation, trades at a 9.0 times expected 2017 earnings.[9]

One can legitimately wonder how the authors of the plan could ever have expected that investors would take up 5 billion euros of MPS common stock, at a multiple over 50% higher than its most direct competitors' on a Price/Book basis and, even in the more optimistic estimates, at an average premium of 58% on a PE basis. Such questions may be particularly pertinent considering also that, as we mentioned on page 3 and according to recent press reports, Unicredit Group may also be tapping the market, at or around the same time, for an estimated 7 billion or larger capital call.

2. On the SPV side of the transactions, at least one major question remains. The mezzanine tranche will be safely in Atlante 2's hands. The junior tranches will be "gifted" to the existing shareholders of MPS. The placement of the senior tranche could be more problematic. As discussed above, only the portion of this tranche eligible for investment-grade rating will benefit from GACS insurance. Investors will have to be found who are willing to buy this tranche without the government guarantee.

   Once again, the issue is price. The assumptions built into the SPV's plan for asset recovery and cash flow projections presumably will have to reflect the ca 23% premium (an effective price of 27.5%, as against the market levels of 20-22% used in previous transactions) at which the SPV is acquiring the NPLs. This will mean aggressive estimates on recovery rates and possibly lower expected yields.

   Will investors be willing to subscribe this tranche, uncovered by the government's guarantee, at such higher prices and for amounts that could run to several billions? This question may never be tested in practice: a newspaper report in mid-September suggested that the price for the disposal of the NPL portfolio might have to be revised down after all.[10]

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[8] MPS 2011-2015 annual statements, 1st quarter and 1st half 2016 statements

[9] See footnote 7.

[10] Gianluca Paolucci, La Stampa, 17 settembre 2016.

3. A third, related question, concerns the bridge loan. Given that it is possible that a large portion of the senior tranche will not be GACS-eligible, who or what will guarantee the bridge loan issued by JP Morgan? In other words, what will happen if some of the senior tranche has not been sold once the bridge loan comes due? Will JP Morgan buy them itself? If not, who will? Will the SPV be able to refinance the loan?

It is of course possible that, in the coming weeks and months until the completion of the bank's restructuring, these questions find more than satisfactory answers (even though, as we have seen, in the weeks following the initial announcement and enthusiasm, if anything the questions are intensifying and, for now, not finding answers). Nevertheless, a plan that even raises these kinds of questions can hardly be be the definitive solution to allay market fears about MPS's future, or serve as a blueprint for other banks). When one considers these elements in full, it is perhaps not surprising that the market had an adverse reaction.

In order to track the market's reception of the proposed plan, the media have focused on the sharp fall in the price of MPS common stock in the days immediately following the announcement and its subsequent further decline (as of its September 23 close, MPS shares are down almost 39% since July 29). Nevertheless, that price is largely irrelevant. The dilution that current MPS investors will face even in the rosiest outcome is so vast that the price of MPS common stock represents at best a small optionality value. It seems that the only source of value to those investors is likely to be the equity tranche of the NPLs that they are receiving. Even this, given the levels at which the senior and mezzanine tranches are being bought will require an extremely favourable concatenation of circumstances, some would say a near-miracle, to produce any returns. Therefore, the most that we can say about the fluctuations of the stock price between now and completion is that they will represent the market's perceptions of the probability of such a miracle.

On the other hand, a better way to assess the market reaction is to look at the price behaviour of MPS's subordinated debt. For starters, the amounts at stake are much larger. The entire market capitalisation of MPS is currently just over 550 million euros (September 22nd closing price). The outstanding subordinated bonds, on the other hand, have a nominal value in excess of 5.2 billion euros and a market value of about 3.3 billion[11]. Whilst their prices are less visible that those of the MPS common stock, the fate of these bond holdings will have a much bigger impact on MPS investors than whatever amount MPS current shareholders manage to retain after the transaction.

If the market had felt that the plan's chances of success were high, one would have expected the value of the subordinated debt to increase well above the levels observed since before the announcement and since when the ECB letter surfaced. A credible plan would have finally removed the sword of Damocles hanging over sub investors' heads these last few months, namely the uncertainly as to whether, through a bail-in, a haircut, or a voluntary liability management exercise, part or all of their holdings may be cancelled or converted into equity.

The initial market reaction in the price of MPS junior debt was better than that of the stock. Subordinated debt prices climbed by approximately 5 percentage points in the days leading up to the announcement of the plan (taking the relatively liquid April 2020 maturity as a reference), and another 5 points on Monday August 1st, to reach a high of 85. However, already by the close of business on August 3rd, the 2020 subs were trading below the price before the announcement; they then hovered around the same levels, and have recently started falling again, with an acceleration of

[11] Bloomberg, EuroTLX, Bourse de Luxembourg, MPS Capital Services. Closing prices on 22 September 2016 and author's calculations. These figures include both the bank's "Tier 2" subordinated bonds and the so-called Additional Tier 1 Capital (AT1) instruments, such as perpetual notes and contingent convertibles.

the decline following rumours in late August[12] about the addition to the plan of some "burden sharing" by the junior bondholders. This was apparently due to growing doubts, based on initial investor feedback, about the possibility of raising the required amount all through new equity. The closing price of the April 2002 issue was 63.1 on September 22nd, close to the lows last seen right after the publication of the ECB letter in late June[13]. Prior to that letter and Renzi's announcement of a preference for a "market solutions", these securities were trading around 90-91.

It is difficult to overestimate the effects of this continuing uncertainty. A well-structured debt equity swap, giving bondholders a share in the restructured banks' equity *pari passu* with the new investors in the rights issue, would have introduced certainty into what they could expect. By converting some of the debt to equity, it would have reduced the amount of equity to be raised in the market and improved the overall prospects of success for the plan. If, as was the case in the Greek banks in 2015, this was done by converting into equity only part of the junior debt, the remaining debt could actually have benefited from the overall strengthening of the bank's balance sheet.

The very fact that, only a month after the announcement of the original plan, with its triumphal announcements that "bondholders will be protected", rumours started circulating about their forced involvement in the restructuring, rumours which no one has even bothered to deny, cannot but generate uncertainty in the confidence of the plan's success by its own authors. The rest of the subordinated bank debt market continues and will continue to suffer from the volatility associated with this uncertainty. The situation could have been very different, and the perception of a more well thought-out plan communicated to the market, if a debt-equity swap had been included amongst its components from the start. Of course, the same thing could be said, with even greater cause for concern, about the decisions that lead to the removal and replacement of the bank's most senior managers over a month after the plan was announced but long before it was completed.

Conspiracy theories and other explanations

The proposed terms of the transaction were in some respects so aggressive and optimistic that some local commentators, indulging in one of Italy's favourite national pastimes, conspiracy theories, started speculating that some dark and unspeakable promises were exchanged between the bankers and the Italian Treasury or CDP[14]. Others, perhaps more cynically but more down-to-earth, simply suggested that this is not a real plan at all, that there never was a real expectation that investors will pay such multiples for MPS equity. And instead that the very announcement of the "rescue plan" was a sham, a way to kick the can down the road for a few more months, and crucially to beyond the autumn constitutional referendum, when another solution will be found and adopted.

A more nuanced view is perhaps appropriate. It is certainly true that the terms of the proposed plan strained credulity. But it is also true that Matteo Renzi's government, bank CEOs and directors, the management of CDP, but also a large chunk of the Italian business community were and *are* trying in earnest to find a solution to Italy's banking problems within the boundaries of existing regulations. *Il Sole 24 Ore*, owned by Italy's Confindustria has strongly supported the plan (even though the tone of its articles has, it seems to this writer, been oddly moralistic and exhibited a curious mix of nationalism and victimhood). The Confindustria does usually take a pro-government line on big systemic issues, but it is rarely kind toward banks. And, in this case, its support for the plan seems to have been genuine.

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[12] [12]Andrea Fontana, Il Sole 24 Ore, 29 August 2016.
13 Closing prices on September 22nd from Euro-Tlx Fixed Income exchange.
[14] See for example Massimo Mucchetti, "Etruria e MPS, I miracoli mancati di Matteo", Il Foglio online edition, 8 August 2016.

Prime Minister Renzi himself, in a series of high-profile statements on the Monte dei Paschi situation, has continued to defend the validity of the proposed plan vigorously. It is true that these statements can be seen as perfunctory and even as a form of propaganda. And also that, as noted above, some statements by Economy minister Padoan have gone in the opposite direction, causing some confusion. Nevertheless, Renzi's vigorous statements represent a reaffirmation of the of the government's commitment to stand by its plans and to ensure that the "case of MPS" finds a valid and definitive solution.

The government, however, is also simultaneously involved in trying to juggle multiple political and economic crises. The internal strife of Renzi's own PD, the repercussions of the Brexit crisis and upcoming negotiations, the fear of a renewed acceleration of migrant inflows, the concerns about terrorist attacks and the need to continue supporting growth in the short term in the context of a still-dismal domestic and international outlook, are all squarely on Renzi's plate at the moment.

The political capital that Mr Renzi and his cabinet can bank on is not infinite. Additionally, the multiple challenges he faces place competing demands on his bandwidth and that of his team. In the real world, no one has the gift of ubiquity, neither in the physical, nor in the intellectual domain. And those challenges are possibly making it difficult for Renzi's cabinet to dedicate to Italy's banking problem the focus and the political capital that it deserves and requires.

The real problem – and why a real solution is impossible – for now

Achieving a solution to this problem will prove to be a complex task, both politically and technically, even under the best of circumstances.

A spate of recent criminal cases have implicated senior officers, directors and even board chairmen of a group of regional and supra-regional banks in offenses as diverse as falsification of accounts, forged prospectuses, fraudulent bankruptcy, transactions created for the sole purpose of concealing losses, stock manipulation, obstruction of statutory supervision and money laundering.

The details emerging from these cases have created a widespread impression that, in much of the past fifteen years, bank governance and management in Italy were plagued by multiple derelictions. In addition to the falsification of financial statements and prospectuses (often in conjunction with new rights or bond issues), the banks involved were shown to have been affected by client favouritism, routine lending to directors and related counterparties, and at best loose practices for managing conflicts of interest. [15]

As a separate, but related matter, it is well known that Italian law allows the selling of ordinary bonds and other securities directly by banks to their retail clientele. This practice, which has existed for decades, while vulnerable to abuse, also had its positive for both banks and their clients: many regional banks were able to leverage the long-term trusted relationship with their clients to achieve cheaper long-term finance, also benefiting from the fact that bank bonds were held to be on par with government bonds in terms of their certainty of repayment. The banks would in turn partly plough back the benefits from this cheap finance into the local communities in the form of loans to

[15] A detailed report on malfeasance by certain banks was delivered to the Italian Senate's Finance Committee on September 15 by Dr Luigi Orsi, the deputy chief prosecutor of Milan's Court of Cassation, titled "Fact-finding investigation on the conditions of Italain banking and financial system and the safeguards of savers, also with reference to prudential supervision, and European crisis resolution and deposit guarantee". See: http://www.senato.it/leg/17/BGT/Schede/ProcANL/ProcANLscheda36086.htm. The text of the report does not appear to be yet available to general readership. A summary is available in Francesco de Dominics "Il capo ordina, la banca ti ruba i soldi". Libero quotidiano, 24 settembre 2016.

local entrepreneurs and families[16]. (Of course, the same result could have been achieved, with more diversification for investors, with well-functioning capital markets and specialised funds).

Whatever the merits and flaws of this regulatory set-up, the system worked reasonably well on this basis for many long years.

However, the details emerging from some of the investigations mentioned above, and others beyond them, have shown a systematic abuse of the regulatory set up, for two reasons.

First, because the coming into force of BRRD had meant that the old rule of thumb whereby, in practice if not in law, a bank bond was as safe as government one was no longer valid (and, nonetheless, several banks continued to market their bonds as if BRRD did not exist). Second because some of the banks involved in the recent judicial cases, did not simply continue selling ordinary (senior) bonds to their retail clients, but they developed elaborate mechanism, including a mix of incentives and threats for client advisors, to induce savers to buy subordinate bonds, contingent convertibles and even shares at artificially high valuations (hence the charges of market manipulations). Some investors were even made to sign waivers in which they accepted that they were "buying securities outside of the guidelines of MIFID rules"[17]. Most of them were sold bonds and shares with no consideration for even basic investor profile or suitability, and no diversification.

Monte dei Paschi itself, for example, went so far as to make the minimum denomination of a 2.1 billion euros subordinate issue as low as 1,000 euros (all of MPS's nine other subordinate issues have a minimum denomination of 50 thousand euros), reportedly so that it could be more easily sold to retail savers. Local press reports suggest that between 50 and 60 thousand investors may hold this security alone. The number of investors who, either in the bail-in that followed the rescue of four small banks in late 2015 or in the recent rights issues for Veneto Banca and Popolare di Vicenza, have lost 100% or nearly so of their investments, exceeds 200 thousand. Two pensioners who had lost over 99% of their liquid assets, invested respectively in a Banca Etruria subordinate bond and Popolare Vicenza stocks, committed suicide.

Securities and banking regulators, while respecting the letter of their mandates with punctilious formality, only managed to intervene after much damage had been done to the banks' finances or to retail investors (in several cases, the public prosecutor's office was in fact brought in at the initiative of the Bank of Italy). It is a matter of record that a widespread and prolonged abuse of savers' trust in their banks has been carried out, certainly not intentionally but as a de facto outcome, under the present framework for prudential supervision and inspection by the banking and stock exchange regulators.

Such lamentable mishaps have been widely reported and commented on in Italy. They have contributed to creating a diffuse perception that the financial sector was just like any other industrial sector and thus not subject to the forms of protection and vigilance that it instead requires (since the banking sector has a duty of care toward systemic stability and investor confidence as "public goods"). The resulting loss of confidence is a price that Italy's bank-centric economy call ill afford, especially at a time of still-precarious recovery.

[16] On the perception of the near absolute "safety" of bank bonds as an investment, see for example Donato Masciandaro, "Due passi avanti verso il risparmio consapevole", Il Sole 24 Ore, 16 novembre 2003.

[17] This writer has personally seen one such "waiver", scribbled by hand on the subscription documents for a reverse convertible that had been sold to a terminally ill, 89 year-old pensioner. The waiver was presumably obtained with friendly verbal assurances that "it was just a formality".

Meanwhile, governments of the centre-right, the centre-left, and bipartisan coalitions, instead of playing their institutional role as rule- setters and, where necessary, reformers, have played at best the part of an impotent spectator and, at worst, of a complicit participant in abusing the weak governance of the banking system to favour allies, associates and friends with loans, jobs, and favourite projects, on both a local and a national scale.

As is made increasingly apparent by judicial and other investigations, one locus of these links between politicians and banks was Monte dei Paschi itself.

> "Concerning MPS, let us not kid ourselves: the responsibilities of a section of the political left, in Siena and in Rome, are enormous." [18]

This sentence was not uttered by an investigative magistrate or a 5-Star politician: it was a comment made by Matteo Renzi himself, following the publication of an internal report by the regional branch of his PD on the links between Monte dei Paschi and politicians at the local and national level.[19]

In 2007, Monte dei Paschi acquired Banca Antonveneta from Santander for a price of 9 billion Euros, only a few days after Santander had itself purchased it for 6.7 billion as part of the break-up on ABN-Amro. Between late 2012 and early 2013, that acquisition became the object of a broad judicial investigation that has so far resulted in multiple indictment of MPS officers and some of its investment banking advisors, for charges as diverse as market manipulation, balance sheet fraud and obstruction of regulators, as well as the conviction in the first level of criminal justice of its former chairman and former general manager.

The press coverage of these investigations and the attendant disclosures also drew attention to the fact that, because of a specific demand of Santander Chairman Emilio Botin, MPS acquired Antonveneta, without performing a full due diligence[20]. The price paid by MPS corresponded to a multiple of almost twenty-two times the most recent available net earnings at the time of the acquisition.[21] Many sector analysts and journalists have identified the Antonveneta acquisition as the beginning of the present dire financial troubles for MPS.

The investigations also produced a vast body of revelations from bankers, local politicians and other witnesses about the intricate webs and alliances that existed between the bank, its then controlling shareholder, the MPS Foundation (which in turn was controlled by the centre-left-dominated Commune of Siena), and national politicians. The Foundation, the majority of whose board was appointed by the Commune of Siena, in turn picked half of the bank's board.[22] This led to an active involvement of national bosses of the PD and its predecessor parties in influencing the bank's governance and its strategic priorities (a former mayor of Siena told investigators that "a big push" for a greater involvement of MPS on a national scale, which led to the ill-fated Antonveneta acquisition, "came from Rome"[23]).

This intricate background is essential to an understanding of why the "Monte dei Paschi problem" is so politically charged. In all probability, many of the taxpayers and arguably-misled retail savers and other investors who might have to pay for an eventual public rescue of the bank would believe, rightly or wrongly, that they were paying for past misdeeds of the PD and its predecessors on the centre-left and for the beneficences received by its friends.

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[18] Matteo Renzi, quoted in *La Repubblica*, 30 July 2016.
[19] *Il Giornale*, "MPS il PD si sveglia tardi. La crisi? Colpa nostra. Basta politica in banca", 24 August 2016
[20] Federico De Rosa, "Interview to Alessandro Daffina", Correre della Sera, 28 January 2013.
[21] Banca Antonveneta, 2006 financial statements; author's calculations.
[22] *The Guardian*, "Italy rocked by Scandal at the World's oldest bank", 1 February 2013.
[23] Franco Ceccuzzi, Quoted by Guido Ruotolo, La Stampa, 1 August 2013

Matteo Renzi and his young PD associates had nothing to do with these abuses. Moreover, it is quite true that Renzi and his team are the ones who have tried to "get politicians out of banks", as Renzi stated in his interview of July 3rd. Even so, it is questionable whether any PD government could survive a broad-based "bail-in" of MPS retail bond investors.

All of these issues will have to be tackled as part of a broad-reaching solution for Italy's banking problems. It is almost certain that Renzi and his cabinet know this and that Confindustria knows it. It is very likely that the European Commission knows it as well.

This writer holds the belief that such a definitive solution will need to involve, in one form or another, the use of public funds. In order to reach an agreement between Italy and its EU partners on this point, the dominant question will not be about whether retail investors need to suffer a "soft bail in" or a draconian one, or the extent to which the Italian government will be allowed to compensate them for their losses (in principle and in precedent, the Commission has already agreed on this). Rather, the Commission and Italy's Eurozone partners will in all likelihood demand that the lapses in governance, poor investor protection, and only partly effective prudential supervision that have allowed this however narrow cohort of banks and bank officers to wreak havoc on confidence in *all* the Italian banking system become the object of a thorough and transparent review and reform. With the simply stated and unequivocal goal of ensuring that these abuses cannot be repeated in the future.

Whatever one thinks of the plans for a European banking Union, it is simply naive to expect that Italy can regain the trust of its Eurozone partners necessary to proceed to an area-wide deposit guarantee, or any other forms of risk-sharing and mutualisation, without undertaking this review and the adoption of revamped supervisory and governance best practices. It is of course also something that is deeply in the interest of Italy itself and, as Nicolas Veron noted in a recent paper for Bruegel [24] it is slightly perplexing that this has not already been noted or undertaken domestically.

Nor is the lamentable history of Italy's weakness in bank governance and prudential supervision the only problem affecting the banking system. As is the case in the rest of Europe, Italy's banks are suffering from poor profitability. ECB Governing Council President Draghi himself discussed this at length in his press conference on July 21st and in a subsequent address [25]. Bank margins have been declining for years, fees are under pressure from competitive pressures and other sources of revenues, such as the selling to investors of structured securities, have largely dried up. In addition, Italian banks have, with lower earnings, larger branch networks than their Eurozone peers and thus significantly higher costs. And, just like elsewhere in the Eurozone, there are still too many banks.

Consolidation, branch closures (and thus personnel reductions), other cost rationalizations and the new laws on credit recovery, will all help, in time. However, once again, much of this will present a political as well as an economic problem. Recent estimates of the amounts of redundancies expected from Italian banks' 300 thousand strong payrolls are, at between 16 and 30 thousand, probably too timid. The process of returning Italian banks to profitability will require a combination of time, political skills and political capital, and the overturning of huge vested interests.

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[24] Nicolas Veron, Italy's banking problem is large but can be fixed. The Bruegel, blog published on 14 July 2016. http://bruegel.org/2016/07/italys-banking-problem-is-serious-but-can-be-fixed/

[25] Mario Draghi, Welcome address to the 1st Annual Conference of the European Systemic Risk Board, Frankfurt am Main, 22 September 2016. ECB website: http://www.ecb.europa.eu/press/key/date/2016/html/sp160922.en.html

However, precisely because of the magnitude of the task, it is perhaps not surprising that the government has decided not to tackle it now and that it has chosen instead to try to find, misguidedly or not, other short-term solutions at least to the biggest problems, such as MPS.

This paper has presented a perhaps more benevolent interpretation of the motives of the Renzi government and the other actors in this year's Eurozone summer drama than many commentators in Italy and elsewhere would agree with, but it seems to this writer to be the one that best fits the available information.

The price of confusion

Having said all this, and despite a lucid and vigorous defence of the government's strategy by the Prime Minister in his public utterances, it is difficult to escape the impression of at least some hesitation in the government's intentions and a lack of clarity in its communication strategy. The latest confusing messages around the timing of the MPS rescue plan, the firing and resignations of senior officers and board members, the rumours about the changing shape of the plan, are only the latest example of an unfortunately long series of poorly thought through initiatives and communications mishaps.

It is quite safe to say that this latest chapter in Italy's banking saga started with the entry into force of BBRD.

This EU directive, independently of the "Etruria *affaire*" and the case of the rescued four small regional banks, represents an important watershed, among other matters, in the regulation of the relationship between banks and savers. Regardless of the abuses by some banks, the implicit rule whereby "a bank bond is as safe as a government one", was all of a sudden no longer valid. Following the enactment of BRRD, in case of a bank failure, savers could lose 100% of their investment in subordinate bonds but also in ordinary ones and, in some cases, even of deposits.

The European Council and Parliament had introduced BRRD, by common agreement, in December 2013. Members of the Italian government and of its political parties, with the contribution of the bank supervisory authorities (Bank of Italy), had participated in its negotiation and approval. Yet, even after its partial entry into force on 1 January 2015, or even after its adoption into Italian legislation on 2 July 2015, no one thought it necessary to inform the public of this major novelty in regulation. The vast majority of savers and citizens first heard about BRRD and of its impact on the new riskiness of bank investments when the government and the supervisory authorities, in agreement with the European Commission, announced the resolution of Banca Etruria, Banca delle Marche, Cassa di Risparmio di Ferrara and Cassa di Risparmio di Chieti on November 22nd 2015.

It is clear that responsibility for this failure to inform the public adequately does not rest exclusively on the present government, which is the one that actually caused the BRRD to be incorporated in Italian law and that intervened to rescue the four small banks with the least possible financial damage for small savers. Nevertheless, the lack of an appropriate communication strategy up to that point contributed significantly to increase investors' nervousness and uncertainty following the cold shower of the "Etruria *affaire*". If it had been possible to inform the market and investors in a more gradual, thorough and pre-emptive manner about BRRD and its impact, it is possible that some of the most destabilising aspects of that episode and of the subsequent repercussions and alarms over the solidity of other banks (including many unfounded ones) could have been avoided.

This episode was followed, as we have seen in the preceding pages, by the slightly awkward "Bad bank" and GACS "switch"; by Atlante and the hurried rescue of BPVI and VB; by the misdirected focus of the decree of May 3rd on bank collateral repossession; and by other minor episodes. Culminating finally in Atlante 2 and the MPS rescue plan.

One final source of confusion came from an unexpected source. With less than 24 hours to go before the release of the stress tests and the announcement of the plan by the MPS board, Corrado Passera, a former CEO of the Postal Savings Bank and of Intesa, as well as a senior minister in the Monti government, announced that he had teamed up with UBS to present a competing plan. This reportedly included a number of attractive and sensible features, such as a much smaller equity rights issue than the one proposed by JP Morgan, a debt-equity swap at least for at least institutional junior bond holders, and a "strong signal of discontinuity in governance" (code word for major changes at the board level). It thus showed that Mr. Passera possibly had a better understanding of the elements that the market would consider essential in a capital plan than the authorities and MPS's own management. Perhaps unsurprisingly, the plan never really saw the light of day. The Board of MPS rejected it without even inviting Mr Passera and his UBS allies to present it in detail.

The sudden appearance and then disappearance of this plan, however, coming after weeks of mutating rumours about exactly what plan would be adopted, helped create an "anything goes" atmosphere, and the impression that the process of rescuing MPS was run in by the authorities in a haphazard, almost lackadaisical manner, with no one really in control and with no overall direction.

These ante-facts are worth retelling because they help describe the perception of the trial-and-error approach that had developed in the weeks before the July 29 announcements. An approach that, in the impression that an outside observers could form, is even more grating when compared with the authoritative, clear and well-argued public utterances of Prime Minister Renzi himself. Or even, it must be said, with some of the reforms, long-delayed by previous governments and finally enacted by the Renzi cabinet, such as those of the *banche popolari* or of the rural cooperative banks, that actually go in the direction of strengthening the institutional and governance framework for the national banking system. (The May 3rd law decree does the same for collateral repossession and enhancement of lenders' security. Even though the decree unfortunately does little to nothing for the current NPL problem, it could strongly help NPL work-outs and bank profitability in the future).

Unfortunately, the complexity and the delicacy of the restoration of the banking system to full health, a goal that requires, as an indispensable element of success, almost blind trust in the courses of action chosen by the authorities, mean that the coherence and the transparency of the messages from the government and the other authorities involved are essential.

Thus, the most worrisome aspect of these episodes, with their public relations fiascos and the repeated promises followed by underwhelming results is the apparent lack of clarity of the goals being pursued.

This lack of clarity contributes to the perception that the government still lacks a coherent plan for the return to health of the banking system by intervening vigorously and with determination on its weakest link, such as of Monte dei Paschi. Or, rather, than such a plan does exist, but that this plan involves the use of public funds without having to accept the implications for small investors that the BRRD dictates, a seeming contradiction in terms under the present regulatory architecture. And thus that, not being yet ready to challenge the Commission or the Union on this point, the government prefers a fragmentary approach of individual steps designed simply to gain time and to or to put out the brush fires that flare up from time to time. In the next few months, this could contribute, unfortunately, to push up the bar of the market threshold of trust that will eventually have to be vaulted once a definitive solution is adopted. With a growing risk, in the meantime, of incidents, including serious ones, in the market.

ECB to the rescue – Again?

The situation of confusion and apparent lack of clear strategic plans for a timely resolution of the Italian NPL problems, or at least a ring fencing of the worst cases, thus seems destined to continue. Perhaps until the Constitutional referendum later this year, perhaps until new elections can be held under the new institutional arrangements that a victory for the referendum would introduce.

The Italian NPL problem is not taking place in a vacuum and it is most certainly not an isolated eyesore in the Continental banking and economic landscape. As mentioned at the outset of this essay, European banks are suffering for a variety of reasons, which also include NPLs (even outside Italy), but are by no means limited to it. Negative interest rates, weak profitability, concerns about changes in viable business models, opaque derivatives portfolios and the increasing perceived costs of regulatory constraints are all putting pressure on banks and on bank equity prices. Banks that used to dominate EZ-wide indices are dropping out of them.

As in the case of Italy and its NPL problem, politicians and regulators could, if they had the vision, the political will and the political capital, resolve many if not all of these issues. BRRD rules on state recapitalizations in the periphery could be suspended in exchange for governance changes and national programs of "supervisory house-cleaning". A bolder move toward the completion of banking union could bring a fresh wave of confidence and stimulus toward new credit formation; but such a move is unlikely to be politically unacceptable in Germany unless there are first radical changes in governance and supervision and a significant de-risking of the periphery's banking exposures. Or they could inject much-needed capital into the banking system.

It seems to be a consensus opinion, supported by the most recent ECB stress test results, that EZ banks need additional capital. A continent-wide TARP-like programme could change the picture overnight and mobilize public sector surpluses into high-multiplier programmes for strengthening bank capital. This in turn could lead, in short periods, to high-multiplier effects in stimulating loan growth, with obvious benefits for all Eurozone members. Professor Luigi Zingales has proposed one such initiative, although in an Italy-only approach[26]. While an EZ-wide plan might take more time to put together, it would have clear benefits over a national solution. But of course, any Eurozone-wide plans for state aid would require a collective decision to at least suspend BRRD rules.

With elections in the countries of all of the EZ's major economies looming next year (possibly including Italy), none of this seems likely to happen.

This political stasis does not only produce a tough problem for Italy and the Eurozone economy but also a difficult predicament for the ECB. The ECB is already under pressure to bring inflation back toward its statutory goal of below, but close to, 2%. In the absence of new and massive forms of economic stimulus from domestic consumption, government investment or external demand, employment is going to remain sluggish and second-order inflation dynamics will remain contained, or be absent altogether. Unless there is a boost from a massive euro devaluation or a renewed commodity rally, it will be very difficult to elevate overall inflation toward the 2% level – and either of those contingencies would in any case create problems of a different sort, and potentially even more serious, for the cohesion of the Eurozone.

In his July 21 press conference, President Mario Draghi spoke at length about the need to restore bank profitability. ("We no longer have a solvency problem amongst EZ banks" – he said - "But now

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[26] Luigi Zingales, "A TARP for Italian banks", Il Sole 24 Ore, 28 June 2016. http://www.italy24.ilsole24ore.com/art/business-and-economy/2016-06-28/analisi-131922.php?uuid=ADp6iZk

we need to worry about bank profitability"). His entire line of argument, in the discussion of these relationships, was to suggest that weak profitability, along with other factors (amongst which, in his remarks, NPLs featured prominently) are ultimately what drive banks' lending standards. If lending standards become too tight, an essential link, in consensus thinking, between monetary policy and the real economy can become compromised.

But President Draghi went beyond this. In a passage at the beginning of the Q & A section, in addressing a question about the effect of Brexit on Eurozone banks and bank stock prices, he said:

> **Question: So far banks have suffered most from Brexit, it seems. They are very important for the transmission of monetary policy, so do you see maybe there's some need to act? (…)**
>
> Draghi: (…) You're right, banks are important. Especially important for the eurozone, which is basically a bank-based economy, where the credit intermediation goes mostly through the bank lending channel. Bank equities in the aftermath of the Brexit were especially hit, and especially in the eurozone, and especially those banks with a high share of NPLs, of non-performing loans. Bank equity prices are of some significance for policymakers, because if they drop in the way they did, one would assume, *if this is to stay,* cost of capital would increase, and therefore the net return on lending would decrease and would suggest on the banking side a more conservative lending behaviour. ***That's why we do care about bank equity prices for the transmission of our monetary policy***[27]

The last sentence is critical. Interfering with the transmission of "our" monetary policy is an ultimate anathema for the ECB. It is the justification that was used by Trichet, in May 2010, when he surprised the market by announcing the Securities Market Programme (SMP) whereby the ECB bought government bonds of Eurozone countries that were under attack by markets, two weeks after intimating that "no further measures were necessary" to tackle the developing Eurozone government debt crisis. Most importantly, it is also the one used by President Draghi himself to justify the introduction of the Outright Monetary Transactions (OMT) program of potentially unlimited purchases of bonds from certain Eurozone countries, in the famous "whatever it takes" speech, just over four years ago:

> "{OMT} is aimed at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy".[28]

Things that "interfere" with monetary policy transmission (or that tend to compromise its singleness or homogeneity – and it is clear that a fragmentation of credit standards can lead to different monetary policy transmission speeds across different countries) have a long history of justifying extraordinary and unprecedented action by the ECB.

In this case, President Draghi did not say that bank equity prices or, for that matter, bank profitability, are interfering with monetary policy transmission *today* (he did say that about NPLs and said it repeatedly). But he did place a stake in the ground to the effect that the ECB may see it as part of its mandate to correct bank equity prices "if they drop in the way they did, (…) if this is to stay", in other words, if sharp post-Brexit-like drops in these prices endured. Because they might, on his line of argument, interfere with monetary policy transmission.

The present environment is one in which politicians may be unable or unwilling to take the action that they alone could (and should) take to revamp lending, investment and consumption. If this state

[27] ECB Governing Council President Mario Draghi, ECB Press Conference of 21 July 2016. Transcript available at: http://www.ecb.europa.eu/press/pressconf/2016/html/is160721.en.html#qa. Author's italics, underlining and bolds.

[28] ECB Governing Council President Mario Draghi, ECB Press Conference of 2 August 2012. Transcript available at: http://www.ecb.europa.eu/press/pressconf/2012/html/is120802.en.html

of affairs does not change radically, how long is it going to be before the ECB goes the next step and either announces, or hints at, that it is looking at more direct ways to affect bank equity valuations?

Of course it may be a long time before the ECB even thinks about going as far as the HKMA in August 1998 and BOJ since April 2013 and announces a programme of purchases of bank shares. But buying common stocks directly is not the only way to influence bank equity valuations. The ECB could be just as effective, both through capital instruments arbitrage and via the sheer impact of the signals sent by such a move, if it announced a programme of buying senior or junior bank bonds.

There is nothing in the ECB statute that prevents it from doing this. Such a move would directly address *both* its stated goal of improving bank profitability *and* remove a possible obstacle to monetary policy transmission. Some may warn of moral hazard. But the ECB, with the same aim of oiling all of the monetary policy transmission channels, is buying billions in corporate bonds, including bonds from issuers whose direct contribution to Eurozone prosperity may be at least questionable. If the ECB can find its way to rationalize or mitigate the moral hazard in buying corporate bonds, why not add bank bonds to its QE programme?

President Draghi is not a man known to use a comma or capitalization without a reason. Those sentences about bank profitability and bank equity valuations were there for a reason in his July 21st comments. It only remains to be seen if the reason is along the lines that we have suggested here. If it is, how long can it be he shows us his cards?

Of course, aside from the moral hazard of transferring public resources directly to the benefit of bank shareholders, a move such as this would take the ECB one more step down the path of a complete blurring of the boundaries between private and public sector. Between fiscal and monetary policy. And between credit-formation by the private sector and the decisions of a dominant public agency. That process, however, has been well underway for a while in other areas of interference by central banks in the life of the principal economies. So long as politicians do not act, even in areas where it is their prerogative and their duty to act, what is to prevent the ECB, never shy about stretching its authority and increasing its political influence, from stepping into the void once more time to fill the gap?

In 1494 the Medici Bank failed. Its decline had been accelerated by bad loans to defaulting European monarchs, by foreign branch-managers who failed to distinguish between their private and their corporate priorities, and by a general neglect by the Medici family, whose then head, Lorenzo "the Magnificent" was concentrating more on his patronage of the arts and politics than on the bank. In the final stages of decline Lorenzo, who died in 1492, had tried to save the bank by raiding various public pools of funds, including the Florentine treasury and the Monte della Dote, a charitable institution. *Plus ça change*…

The following year the Medici family were expelled from Florence in the much-changed social and economic context that favoured the rise to power of the radical preacher Gerolamo Savonarola[29]. They returned, this time as a puppet government under imperial suzerainty, only several decades later. Some might hope that an intervention by the ECB would l bring better fortunes to Monte dei Paschi this time.

[29] Raymond de Roover: "The Rise and Decline of the Medici Bank, 1397-1494". Harvard University Press, Cambridge, Massachusetts, 1963.