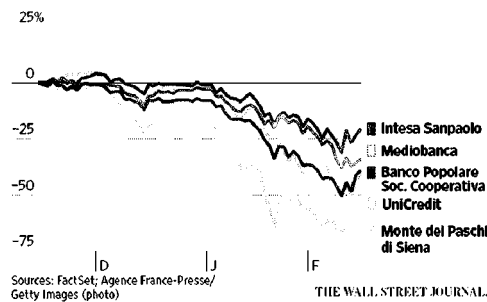


Italian Lenders' Concern

Dragged Down

Share-price performance



UniCredit bank branch in Milan

There is an old saying: If you can't pay a bank back \$1,000, you have a problem; if you can't pay back \$1 million, the bank has a problem.

In Italy, everyone has a problem. The point isn't that every bank has bad loans. They do, but these have at least stopped growing. The point is that the bad loans of the weakest banks may ultimately have to be partly paid for by the rest.

This is a worry even for banks like Intesa Sanpaolo or Mediobanca, which have strong capital ratios and improving or already-low bad-loan positions. The poster child for this concern is the world's oldest bank and Italy's third-biggest by assets, **Monte dei Paschi di Siena**.

Shares of Italian banks, which have slumped this year, rose Monday as markets rallied. But the underlying concerns remain.

Think back to the resolution of four small Italian savings banks last November. They were merged and recapitalized and a bad bank was spun out with €8.5 billion (\$9.6 billion) of bad loans that were valued at just €1.5 billion—a write-down of more than 80%.

Public money wasn't used to fix this problem; other banks had to make special contributions to a resolution fund, while existing equity and bondholders were wiped out. The special contributions cost Intesa almost €380 million, UniCredit almost €280 million and **Banco Popolare** €114 million.

There was a further problem: Ordinary Italian savers hold lots of bank bonds, sometimes quite risky junior bonds, and many lost large amounts. That sparked an outcry and in December the government moved to create an extra €100 million compensation fund, which again will have to be paid for by other banks.

Monte dei Paschi has been working through lots of problems, it aims to sell more than €5.5 billion of bad loans by 2018, and its capital ratio at 11.7% isn't bad. But total nonperforming loans still make up more than one-third of its loan book, or €46.9 billion at face value.

It has taken losses equivalent to almost half this value, but if it is to sell these loans

it will have to take more. Moody's, the credit-rating firm, reckons the sale price of bad Italian loans is about 25% to 30% of face value, even when helped by the new government guarantee program.

For **Monte dei Paschi**, writing down all its bad loans to that level would cost up to €12.5 billion, more than its common Tier 1 equity. That is why its shares trade at just 14% of forward book value.

The bank needs a solution and quickly, given the level of nervousness around all European banks, but especially Italian ones. The bank reported stable funding at its full-year results, and other banks have said deposits aren't shifting from weaker to stronger banks.

A strong merger partner would help. Some say UniCredit might be able to do a deal with a rights issue attached, but UBI Banca is still seen as most likely, especially now that Banco Popolare di Milano looks set to merge with Banco Popolare. However, no partner is likely to take on the bank unless more of its bad loans are dealt with first.

Italy's banks need reform and consolidation, which is coming slowly. But Monte dei Paschi as the focus of market fears is the most pressing problem. Failing to find a solution would cost all Italian banks dearly.

—Paul J. Davies

