Precautionary Recapitalisation, Resolution, Liquidation: Navigating the Maze

On June 25, Italy passed a Decree Law to place Veneto Banca (not rated) and Banco Popolare di Vicenza (not rated) in liquidation. Less than three weeks before, Spanish Banco Popular (not rated) had been placed into resolution and sold to Banco Santander (AA-, Stable). Meanwhile, details of the precautionary recapitalisation for Monte dei Paschi (not rated) are being ironed out. In this report, we summarise these three recent cases and point to some takeaways for credit investors.

What did the four banks have in common?

All four banks were dogged by poor fundamentals, including low or negative profitability and very significant asset quality issues. In fact, the weak asset quality was also the driver of the weak earnings and capital deterioration, as operating profit was simply not enough to cover the credit losses. For the four banks, non-performing assets typically amounted to close to a third of the total balance sheet, and to multiples of the capital base.

What was the main difference between the Venetian banks and Monte dei Paschi Di Siena (MPS)?

There were two key differences: first and foremost, while the case for public interest was easy to make for MPS, given its size, it was more dubious in the case of the Venetian banks. The second difference was that MPS had posted a negative CET1 ratio in the adverse scenario of the 2016 stress test, meeting a key criterion for a precautionary recapitalisation.

What was the main difference between the Venetian banks and the Popular failure?

The main difference to us was the speed at which the situation deteriorated. For the Venetian banks, trouble had more or less quietly been breeding for some time, and some sort of loss for junior creditors was widely anticipated by the market. In the case of Popular, the institution was negotiating a private-sector solution weeks before being placed into resolution. The key catalyst for the resolution was the reported run on Popular's liquidity, which led the supervisors to conclude that the bank was failing or likely to fail.

What has been the role of Intesa and Santander?

The role played by Intesa and Santander in taking over the Veneto banks and Popular, respectively, for a token price is important. In terms of size, the acquired franchises' operations are comparable. However there are some key differences:

- While Santander acquired the whole of Banco Popular, including its bad loans and potential downside from future lawsuits, Intesa was able to select the good assets of the Veneto banks, materially limiting the downside risks.
- In order to protect its capital ratios, Santander will tap the market for EUR 7bn in equity, while one of Intesa's conditions was the neutrality of the deal on its CET1 ratio, meaning that the acquired perimeter was fully capitalised at transfer, with equity of EUR 3.5bn.
- Restructuring costs would be borne by Santander in one case, and by the Italian government in the other.

Analysts

Marco Troiano, CFA
m.troiano@scoperatings.com

Team leader

Sam Theodore
s.theodore@scoperatings.com

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Investor Outreach

Michael Pinkus
m.pinkus@scoperatings.com

Scope Ratings AG

Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 20 3457 04524

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

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What were the consequence for investors?

In all cases, shareholders were completely written down. Similarly, the adopted solutions made senior debtholders whole. However, the payoff for subordinated debtholders were quite different. In the case of Popular's resolution, AT1 and Tier 2 holders lost everything. In the MPS recapitalisation, the burden-sharing requirement would result in capital securities being converted into equity prior to the government's equity injection (Tier 1 notes would be converted at 75% of their face value; Tier 2 at 100%).

In the liquidation of the Venetian banks, AT1 and Tier 2 securities were written down to zero, with the proviso that retail investors would get compensation from the Italian 'solidarity fund', which is funded by the banking system via the national deposit guarantee fund.

Why was liquidity not an immediate issue in Italy?

In our view, the proactive attitude of the Italian government played a role. The Venetian banks and MPS were able to issue senior bonds with a state guarantee, which kept them afloat. Moreover, the Italian Ministry of Finance has repeatedly reassured both senior bondholders and depositors that the buck would stop with subordinated debt.

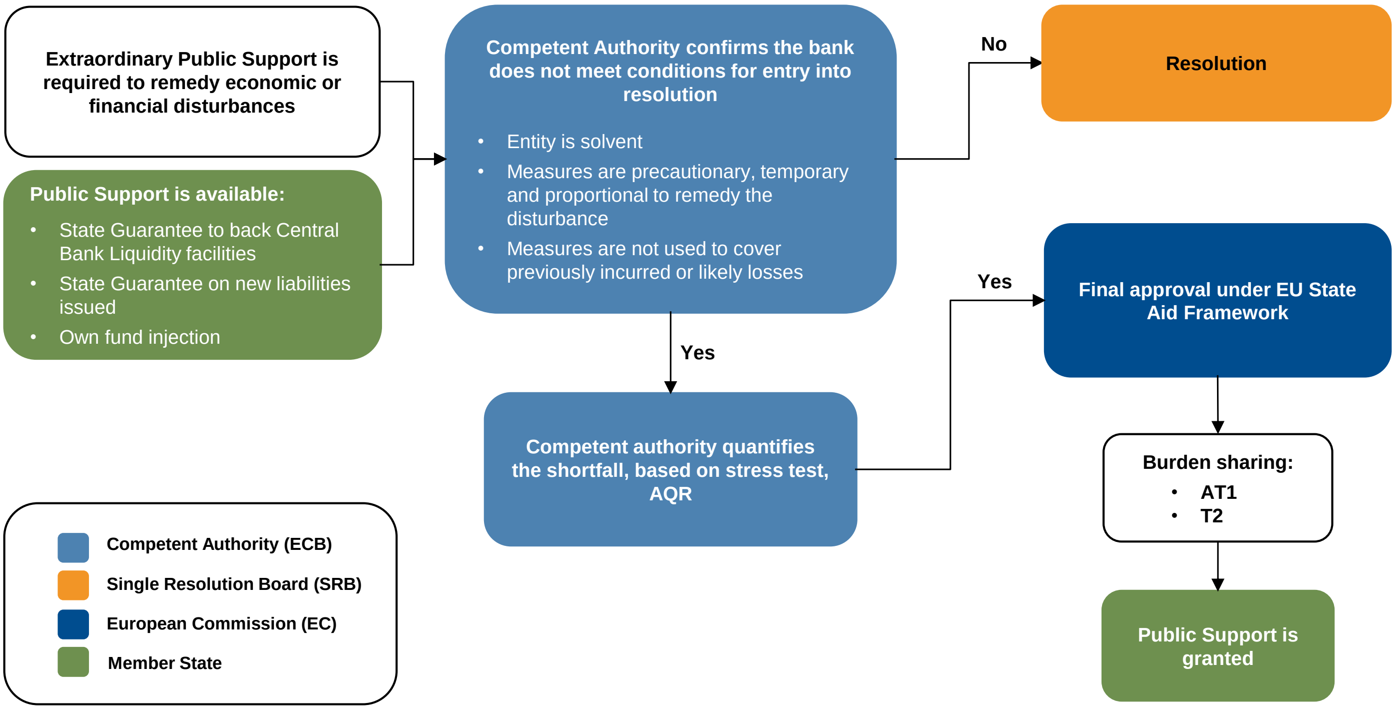
In contrast, public-liquidity guarantees for Popular were not made available (not publicly discussed, to our knowledge). Ironically, the relative strength of the Spanish banking system may have played against Popular in that specific situation: a large segment of the Spanish system had been bailed out and restructured during the crisis, resulting in a healthier system; that has not been the case in Italy. The scope for contagion was thus perceivably lower in Spain than in Italy, thus limiting the government's incentives to intervene and undermining the grounds for extraordinary public support (which has to be aimed at preserving financial stability or remedy a serious economic disturbance).

Figure 1: Selected key ratio comparison between the Venetian banks, MPS and Popular

Selected financial ratios	MPS (Q3 2016)	Banco Popular (Q12017)	Veneto Banca (Q4 2016)	Banco Popolare di Vicenza (Q4 2016)
Total assets (EUR m)	160,129	147,114	28,078	34,424
CET 1 (EUR m)	7,848	6,100	1,218	1,605
CET1 ratio (phase-in, %)	11.5%	10%	6.39%	7.47%
Total capital ratio (phase-in, %)	14.29%	11.91%	8.27%	8.88%
LCR (%)	153.2%	146.0%	128.0%	37.9%
Total gross NPAs (EUR m)	45,584	36,839	9,020	9,800
Total provisions (EUR m)	23,075	16,657	3,924	4,639
Total net NPAs (EUR m)	22,509	20,182	5,096	5,160
Total NPAs coverage (%)	50.6%	45.2%	43.5%	47.3%
Net NPAs/CET1 (%)	287%	331%	418%	321%
Gross NPAs/CET1+provisions (%)	147.4%	161.9%	175.4%	156.9%
Total gross NPAs/total assets (%)	28.5%	25%	32%	28%

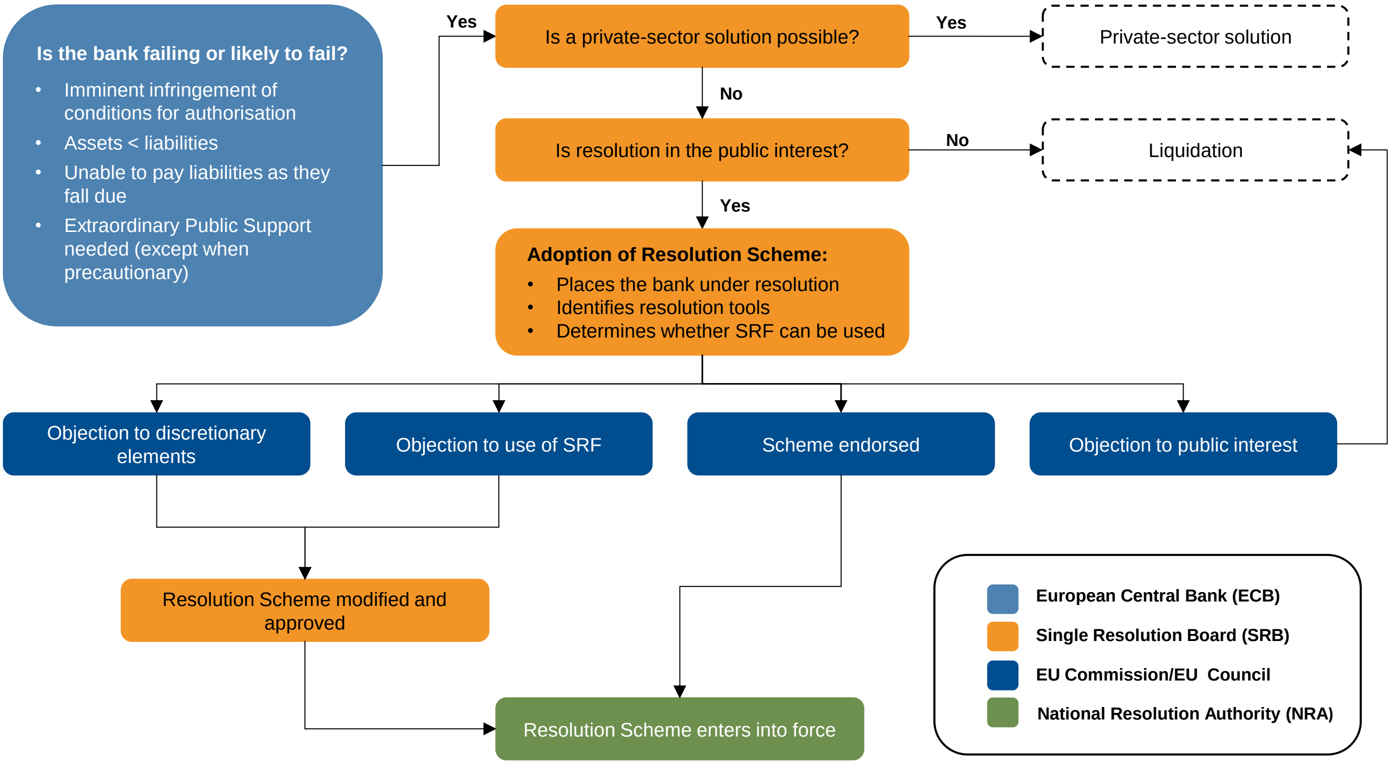
Source: SNL, Company data, Scope Ratings

Figure 2: Precautionary recapitalisation flowchart



Source: Scope Ratings

Figure 3: Resolution: process and main actors



Source: Scope Ratings

Scope Ratings AG

Headquarters Berlin
Lennéstraße 5
D-10785 Berlin

Phone +49 30 27891 0

Frankfurt am Main
Neue Mainzer Straße 66-68
D-60311 Frankfurt am Main

Phone +49 69 66 77 389-0

Paris
21 Boulevard Haussmann
F-75009 Paris

Phone +33 1 53 43 29 89

London
Suite 301
2 Angel Square
London EC1V 1NY

Phone +44 203-457 0 4444

Madrid
Paseo de la Castellana 95
Edificio Torre Europa
E-28046 Madrid

Phone +34 914 186 973

Milan
Via Paleocapa 7
IT-20121 Milan

Phone +39 02 30315 814

Oslo
Haakon VII's gate 6
N-0161 Oslo

Phone +47 21 62 31 42

info@scoperatings.com
www.scoperatings.com