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Italian banks on the ropes after Basel III

BANKS

News analysis

New regulations see lenders struggling to raise capital, say **Patrick Jenkins and Rachel Sanderson**

Italian bankers are in a fix.

During the financial crisis, Italy's banks fared far better than their peers in Europe and the US, owing to a culture of conservative lending and wariness of complex financial instruments. But as their peers in Europe and US now recover, it is Italian bankers who face tough decisions.

Their banks, among the lowest capitalised in Europe, need a boost. Moreover, in the wake of new global capital rules, they are under mounting market pressure to show where that will come from. Yet their routes to it are blocked for many of the reasons that helped them weather the crisis.

Their historical shareholders registers - filled even today with prudent, and increasingly illiquid, provincial banking foundations - make further rights issues hard to do. The alternative, of a gradual build-up by retaining profits, is stymied by the banks' anaemic growth prospects in an economy forecast to grow 1 per cent this year.

The result is that while banks around the world gradually recover their valuations, having raised capital and seen profits recover, and European groups as a whole boast market capitalisations that are in line

with their tangible book value, Italy is left behind.

"Italian banks are trading at a 20 per cent discount to tangible book value when many others are above tangible book," says a senior analyst at a US investment bank, who declined to speak on the record. "They're being penalised for their lower capital and their very low level of earnings."

In the past 12 months, Italian banks - including the big three of UniCredit, Intesa Sanpaolo and Monte dei Paschi di Siena - have underperformed the FTSE top bank index by 13.2 per cent. It is a stark reversal from the previous 12 months when they outperformed the European average.

Analysts and investors say that markets are jittery about their profitability, but, more crucially, about the banks' relatively low capitalisation in the light of Basel III capital rules.

The Italians' lightweight capital has come to the fore as international regulators, under the auspices of the Basel Committee on Banking Supervision, have come up with a new capital framework for banks. The rules oblige all banks to hold the equivalent of at least 7 per cent of their risk-weighted assets in equity capital, with an as yet undefined supplement, likely to be as much as 2 percentage points more, for big banks such as UniCredit and Intesa Sanpaolo.

UniCredit, which underwent a €6.6bn recapitalisation in 2009, had a core tier 1 ratio of 8.45 per cent at the end of March. Intesa Sanpaolo, the only big bank

to not undergo some form of recapitalisation, has a core tier 1 ratio of 7.2 per cent. The core tier 1 ratio at Monte dei Paschi, which took €1.9bn in bail-out bonds from the state, is 5.8 per cent, according to people close to the bank.

Banks have a staggered timetable, extending until 2019, to hit the new capital levels, which is why, for the time being, Italy's bankers are keen to insist that if conditions remain benign they can rebuild their capital by holding on to profits over the years ahead.

But it is here that the benefits that the banks had in the financial crisis (from being only marginally involved in investment banking) turn against them. With such a focus on retail banking - and within that on deposits more than lending - the low interest-rate environment has squeezed margins so much that profits are under real pressure.

Only in the past quarter did Italian banks show their first pick-up since 2008 in net interest income, as well as slowing rates of loan impairments. But profitability still remains weak and is far below pre-crisis levels, heavily affected by depressed margins and a high cost of credit.

"That's the weakness of the sector here," says one top Italian bank executive. "There is no diversification of the revenue model."

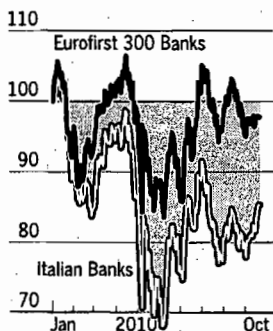
Italian banks might also find it harder than European peers to hit the new 7 per cent capital ratio, because the definition of what they can count as capital is being tightened. Deferred tax assets, out-

lawed under Basel III, have traditionally been a rich source of capital for Italian banks. They are lobbying hard about the clampdown, which they say penalises them for the Italian government's policy of, in effect, taxing loan-loss provisions. But few expect Romè to back any carve-out of the new rules.

As a consequence, investors and bank regulators say that it would not be a surprise if Monte dei Paschi and Banco Popolare, the two banks that received bail-out bonds from the government, ended up seeking new capital, although Antonio Vigni, chief executive of the former, has denied this will be the case.

The bigger question is whether UniCredit and Intesa Sanpaolo will be able to hold out against mounting market pressure for beefed-up core capital, experts say. Providing a clear presentation of the impact of Basel III on their balance sheets may go some way to calm market jitters. But, in a worsening market environment, it is unlikely to be enough.

Italian banks
FTSE indices (rebased)



Source: Thomson Reuters Datastream



Italian banks to slash pay-outs

Lenders eager to meet Basel capital standards

Dividend cuts likely to be sensitive politically

By Patrick Jenkins and Rachel Sanderson in Milan

Italy's big banks are shaping up to cut dividends sharply as they try to avoid joining the fledgling trend among European peers to raise fresh equity.

In spite of being among the weakest capitalised banks in Europe, UniCredit, Intesa San-

paolo and Monte dei Paschi are adamant they will not launch rights issues to meet new global capital standards. "Dividend policy will be the real point of decision and flexibility instead," said one senior bank executive.

Another bank director said: "To beef up capital, halving the historic dividend pay-out ratio is perfectly possible."

Italian banks have historically distributed close to half their net profits as dividends. But that tradition has been thrown into doubt by the decision by international regulators at the Basel Committee on Banking

Supervision to increase the minimum level of top-notch core tier one capital from 2 per cent of risk-weighted assets to 7 per cent by 2019.

Cutting the dividend will be politically sensitive in Italy, where provincial banking foun-

dations continue to hold large stakes in even the biggest banks. These foundations, run by local grandees, have long relied on the banks' dividend pay-outs to fund social ventures.

In spite of the extended phase-in period for the new Basel rules, many banks believe that the markets will favour

institutions that meet the new requirements early, prompting them to consider how they can top up capital quickly.

Some, such as Standard Chartered in the UK and Germany's Deutsche Bank, have already launched rights issues. Others have begun shrinking their risk-weighted assets.

But Italy's banks believe they can be compliant by 2013 with both the 7 per cent Basel III ratio and an expected "systemic buffer" for big banks of up to 2 per cent more, largely by cutting dividends. UniCredit had a core tier one ratio - the key

measure of capital strength - of 8.3 per cent at the end of June, but that is likely to fall below 8 per cent as a result of a tighter definition of core capital and tougher risk weightings.

Intesa is set to announce that its 7.9 per cent core tier one ratio will fall below 7 per cent and Monte dei Paschi, with the weakest ratio of 5.8 per cent, has ruled out a rights issue.

But like the big two, people close to the bank say it will consider dividend cuts as a key means to rebuild capital.

