Italian banks

A bailout of Monte dei Paschi is not enough

So long as structural problems fester, more rescues will be needed

FT View

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There is a difference between preventing a crisis and solving a problem. Italy has taken a step towards the former by setting the framework for a state bailout (http://next.ft.com/content/a018e818-c831-11e6-9043-7e34c07b46ef) of struggling bank Monte dei Paschi di Siena (http://markets.ft.com/data/equities/tearsheet/summary?s=it:BMPS). The plan is sensible in outline. The European Commission and the European Central Bank should allow some version of it to proceed. If, however, they do not want a repeat of this exercise — with MPS or another bank — the European authorities and Italy must work together on the underlying problem: the flawed structure of the Italian banking system (https://www.ft.com/topics/themes/Italian_banks).

MPS (http://next.ft.com/content/b2118cf0-c836-11e6-9043-7e34c07b46ef), Italy's third-largest bank with €160bn in assets, is under significant stress. It had net nonperforming assets of €23bn at the end of the third quarter, as compared to €9bn in equity. A bailout of at least €5bn is needed, and soon. Depositors have been pulling money out of the bank all year and the pace of the flight picked up this month. Efforts to raise the money from private sources fell short by half, leaving the state little choice but to propose a bailout.

Under the Italian proposal, MPS shareholders will be wiped out. Institutional holders of the junior bonds will be converted into equity owners, implying that they will lose the lion's share of their capital. Retail holders of the junior bonds will be compensated with grants of senior bonds. Depositors will be protected. The state will put in capital — of an amount still to be determined — and provide emergency liquidity as needed, receiving full control of the bank in return.

It is to be hoped that the European Commission will allow a plan of this sort to go ahead as a "precautionary recapitalisation" of the kind permitted under EU rules from 2014. The guidelines were designed for banks that are solvent but undercapitalised. The other, much harsher option would be to insist on a full bail-in under the EU's Bank Recovery and Resolution Directive, which are rules for the dismantling of failed banks. In a resolution, senior creditors, and even depositors, could face steep losses. Happily, the commission has signalled willingness to consider a precautionary recapitalisation of MPS. Some German lawmakers are voicing dissent (http://next.ft.com/content/b407a570-c918-11e6-8f29-9445cac8966f), however.

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The Italian authorities may be keen to inject as much capital as they can under European rules. The key to any bank restructuring is to create a strong sense of finality. The impression that more capital might be needed increases the chance that it will be. Indeed, a muscular state contribution makes sense at this point. True finality, however, will remain out of reach as long as the underlying problems of Italian banking go unsolved.

Italy has too many banks and too many bank branches, which has led to chronic unprofitability. Costs need to be taken out and headcounts cut. Failing banks need to be shut. Consolidation has barely begun. Along the way, a robust market for impaired assets must be developed. This may require more aggressive markdowns than have occurred to this point.

Finally, governance at small- and medium-sized banks needs to be made stronger and more transparent. Bank boards, local governments and local businesses are too closely intertwined. Too many people serve on the boards of multiple banks. And the judicial system needs reform so it can handle bankruptcies more efficiently.

This will be slow, painful and politically sensitive work. All the more reason to start now. Given the persistent sluggishness of Italy's economy, banks will continue to require periodic state bailouts if they cannot be run profitably. It is time to move from preventing crises to solving the problem.

Letter in response to this editorial:

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