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Markit Recap – 4/11/2016

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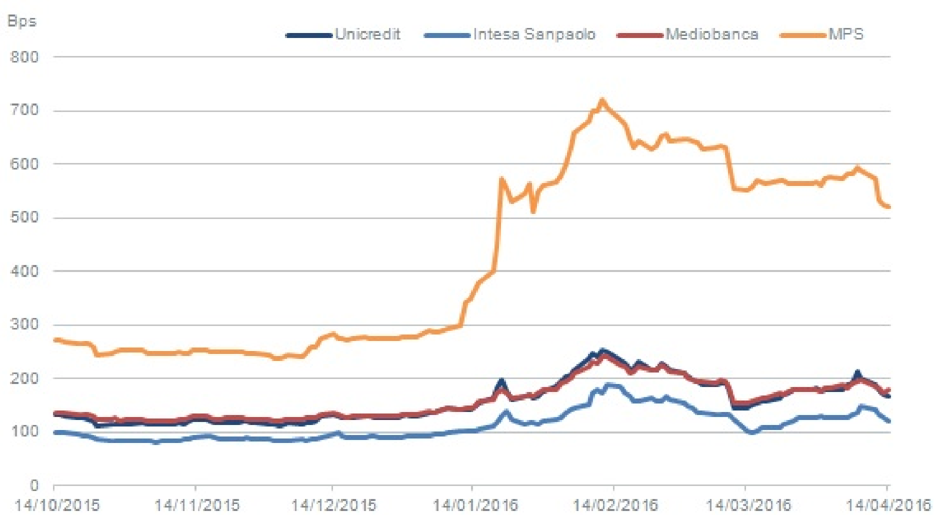
When it comes to the Italian banks, pessimists are not in short supply. Indeed, to be bullish on this sector could be considered contrarian, or even foolhardy, given its parlous state. Asset quality is the overriding problem – Italy's banks have €360bn of non-performing loans on their balance sheet, about a third of the eurozone's total.

Nonetheless, there were tentative signs this week that optimism is returning as markets reacted positively to new supportive measures announced by the government. A €5bn fund called "Atlante" will be created, with funding provided by the country's strongest financial institutions. It is being presented as a private sector initiative, though the state-owned lender Casa Depositi e Prestiti is also contributing. EU laws on state aid have proved to be a stumbling block in the past, but the Italian government must be confident that their small stake in the fund will be overlooked by Brussels.



The fund will be used to underwrite banks raising equity capital, as well as buy junior tranches of NPLs under the government-backed scheme launched earlier this year. In addition, measures to accelerate the foreclosure process – a major impediment to NPL valuation – and plans for a well overdue consolidation in cooperative banks rounded out the government's efforts to fix Italian banking.

The big question is: will it work? The initial market reaction suggests that it may be a step in the right direction. CDS spreads in Monte dei Paschi Siena (MPS), the country's most troubled bank with over 30% of loans non-performing, tightened from 590bps to 520bps. Unicredit and Intesa Sanpaolo, Italy's largest banks, also rallied.

The latter move is somewhat surprising given that both banks are the largest contributors to Atlante – about €1bn each. It increases their exposure to the weakest borrowers in Italy at a difficult point in the credit cycle. However, the scenario of possibly multiple bank failures if clearly the most damaging for the whole sector, and if the latest measures help stave off such an outcome then it is beneficial for financial institutions both large and small.

It is easy to be cynical about Italy’s banks, and it is not hard to fund reasons why this latest effort to revitalise the sector could fail. The size of the fund is dwarfed by the scale of NPLs, and the considerable difference in the book value of the loans and their market value could create more holes in banks’ capital positions. But, for now at least, the optimists are having their day in the sun.

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