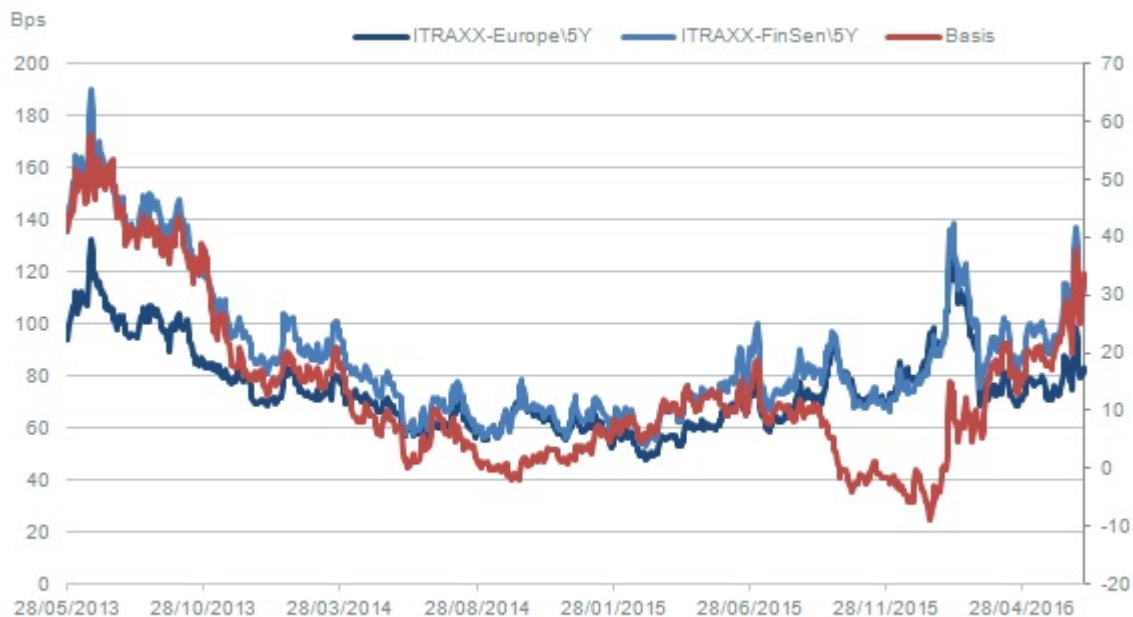


# Markit Recap – 7/4/2016

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The parlous condition of the European banking system keeps coming back to haunt the global economy, with the latest attack of lurgy coming from Brexit. The UK electorate's vote to leave the EU has laid bare the weak credit quality of lenders, a state of affairs that needed little revealing.

Markit's iTraxx Senior Financials index, which indicates credit risk on banks and insurers (banks have a higher weighting) in Europe, was trading at 95bps prior to the referendum. Just two business days later it closed at 137bps, close to the wides reached in February. Unlike the bout of credit deterioration earlier this year, however, non-financial and financial investment grade names have not moved in tandem. When the Markit iTraxx Senior Financial index hit 138bps in February, the Markit iTraxx Europe was only 13bs tighter. Post-Brexit, the basis had stretched to 38bps. This is the highest difference since October 2013.



Technical factors may partially explain why the Main index outperformed (though it still widened 23bps following Brexit!). Payer options on the Main were a popular way of hedging the tail risk of Brexit, and the activity related to this useful strategy is probably contributing to the rally.

But fundamental drivers of spread widening in banks shouldn't be underplayed. Italian banks are the most conspicuous representation of Europe's failure to implement a wholesale recapitalisation programme akin to the US TARP. Monte dei Paschi di Siena, Italy's most beleaguered financial institution, has non-performing loans that make up about 35% of its assets. The ECB has ordered MPS to reduce its NPLs, which will require a fresh

injection of capital. As MPS trades at 10% of its book value, this won't be forthcoming from the private sector.

Unfortunately, the obvious solution – Italy's government coming to the rescue – is not as easy to implement as it once was a few years ago. The EU's BRRD (Bank Recovery and Resolution Directive) states that a public recapitalisation may only come after participation of shareholders and creditors. Such a bail-in would be politically toxic in Italy due to the upcoming referendum on constitutional change, a vote the government may struggle to win.

But there may be a convenient get out clause. As MPS is not yet considered failing or likely to fail (some may debate this) a precautionary recapitalisation may be permitted, with the impending stress test providing the justification. Such a compromise may give some temporary relief, but the endemic credit quality problems in Italy (and banks elsewhere in Europe) won't go away unless a more radical solution is implemented. MPS subordinated CDS was trading at 37 points upfront on July 7, a level indicating high probability of default and the threat of bail-in. This won't be the last Brexit-inspired distress story over the coming months.

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