Italy | Economics

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Italy's bad bank(s): not enough, but it helps

This is a summary of the Special Report on Italian banks – 'State guarantee on NPL securitization: not enough, but it helps' published on 02 February 2016.

Italy's bad bank scheme

Last week, after a year-long negotiation, the Italian government reached an agreement with the European Commission on a bad bank scheme that does not infringe state aid rules. According to the Italian Finance Minister there will be no impact on Italy's large public debt. The final scheme is centered on a state guarantee applied to the securitization of non-performing loans (NPL). The Italian acronym of the scheme is GACS.

The main technicalities

GACS is a tool that banks and NPL buyers can use to reduce the funding costs of an NPL securitization. Each bank can transfer some of its NPLs to a bank specific vehicle, obtain a rating from one of the ECB recognized agencies, buy the GACS guarantee on the senior notes, and then sell the equity/junior notes to deconsolidate the vehicle (improving its balance sheet quality).

While the natural buyers of equity/junior notes will be private equity investors or hedge funds, the GACS guaranteed senior notes could be offered to a wider spectrum of investors, or they could be repurchased by the selling bank (especially if GACS guaranteed senior notes are eligible assets to obtain funding from the ECB). The cost of the GACS will be based on the CDS of Italian issuers (financial and non-financial entities with an underlying level of risk in line with the rating of the senior notes). The cost will increase over time, creating an incentive to accelerate the NPL recoveries. We calculate a cost of c.90bps for the first three years, moving up to c.120bps from the fourth year.

What could be the impact of the GACS on the NPL market?

All in all, the GACS reduces the funding cost of the NPL securitization. However, we estimate the GACS benefit to be modest, increasing NPL prices of 3-5%. This does not seem enough to close the gap between NPLs' current market pricing and carrying value in banks' books (>20ppt on average).

We think that banks will tend to sell only a part of their NPL portfolios (of higher quality/more covered). The process will be gradual. In this way, banks will be able to limit or avoid losses.

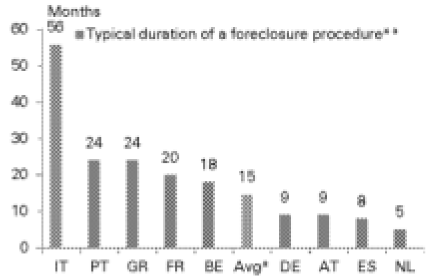
Overall, the scheme is a marginal help but it does not represent a final solution to the EUR 200bn (~12% of GDP) NPL problem of the Italian banking system.

Macro implication of the GACS: a marginal help

From a macro perspective the GACS is unlikely to change lending dynamics, although it could be part of the solution. The GACS scheme, an effective implementation of last summer's bankruptcy reform which reduces foreclosure times (Figure 1) and additional measures for easier collateral repossession could have a more visible macro impact.

On a less positive note, rising concerns about Italian banks could hinder the credit recovery (Figure 2) – see also *Special Report "You cannot ignore Italy"* from 22 January. We believe these concerns are overstated.

Figure 1: Italy's too long average foreclosure time hinders growth



*Average excluding Italy
** As of Feb 2014
Source: ECB, Deutsche Bank

Figure 2: Stuttering credit impulse

Source: ECB, Eurostat, Haver Analytics LP, Deutsche Bank