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Banks-State: the incest goes on (and without Draghi and QE, there's trouble ahead)

After the decline in May and June, in July the BTPs held by Italian banks picked up again. All that was needed was the prospect of the end of QE looking a little further off. But Draghi, in the ECB, is nearing the end of his term and in Germany the liberals of the FDP will soon be entering government.

by Fabrizio Patti

Mario Draghi, on the left, and Pier Carlo Padoan, at an ECOFIN summit in Brussels in 2014 - GEORGES GOBET / AFP

Some commentators describe it as a dog chasing its tail, others as an incestuous relationship. We're talking about **Italian banks' exposure to public debt**, which since the crisis of 2011 has continued to rise. A dangerous embrace, because while it has produced advantages both for the banking institutions and for the State, it has also increased systemic risk in the event of new crises. The peak was reached in June 2016, after which a slow descent began. This reduction, however, has been by no means unimpeded, as the latest data on the stock of Treasury Bonds (BTPs) held by Italian banks show. **July saw a rise of €5 billion,**

following a notable fall in May and June, of €9.4 billion and €20 billion respectively.

The fact that this stock remains high (€370 billion) means that, with **the end of quantitative easing (QE)** - and the loss of a sure buyer like the European Central Bank (ECB) - approaching, the banks would once again be under pressure in the face of a **possible increase in the spread**. An increase that would occur both for purely economic reasons and as a result of the political uncertainty that could emerge in 2018, in Italy (**elections** with an uncertain winner), in Europe (the situation in **Catalonia**) and elsewhere in the world (**North Korea**). We should also bear in mind that the elections in Germany will probably see the liberals of the Free Democratic Party (**FDP**) party enter the government. One consequence is that the conditions to be met in the event of reforms in the euro area could become more rigid. One such reform is the single deposit guarantee scheme (the last pillar of banking union) and one of the demands reiterated by the Germans (especially by Angela Merkel's Council of Economic Experts, led by Lars Feld) is the need to place a limit on banks' exposure to the government bonds of their own country.

But let's try to understand what's happening. According to **Angelo Drusiani**, asset management expert at Banca Albertini Syz, **the fall in May and June was linked to the possibility that the end of QE is in sight**. The markets had picked up on this, given not just the improving performance of all the economies but also the signals coming from Mario Draghi, president of the ECB. After the explanations following the Sintra conference in Portugal in late June, which kept pace with the strengthening of the euro, the understanding was that the reduction in purchases would only begin at the start of 2018 and would be gradual. In addition, interest rates in the euro area shouldn't increase for all of 2018. We'll need to see if the effects of the German elections in September will bring a change of climate in the following months. "My prediction is that the proportion of BTPs held by Italian banks will slowly decline and this will be linked to the expectations of the market and the banks regarding the ECB's moves", comments **Nicola Borri**, Assistant Professor of Economics at the Luiss university in Rome. According to Drusiani, the latest moves should be interpreted as temporary trends, and BTPs are ready for disinvestment when yields rise. "We should also bear in mind", adds Drusiani, "that **even before the general rise in rates, something else will happen: there will be another person leading the ECB, after Draghi**. It will depend on that person's decisions; let's not forget the Trichet precedent", which should be remembered for the restrictive policies he put in place.

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in Italy (elections with an uncertain winner), in Europe (the situation in Catalonia) and elsewhere in the world (North Korea)".

"In any case, we need to bear in mind that when interest rates rise, the price of BTPs will fall and so their value in banks' balance sheets will decrease too", adds Borri. What consequences will this loss of value have? The reply isn't immediate, and the reason for that is that government securities are considered to be zero-risk: they're calculated at their par value and not at their real value. Thinking that there's no effect on banks' financial statements, however, is an illusion. As **Francesco Castelli**, Head of Fixed Income at Banor Capital Ltd, explains, the consequences would be linked to the liquidity that the ECB would provide in exchange for depositing securities with it as collateral. In other words, with the price of BTPs decreasing (if yields were high, i.e. if the spread widened again), the liquidity arriving from the central bank would also decrease and the ECB would ask banks for a partial redemption of loans. This remaining liquidity would be obtained on the markets, at rising rates. "Irrespective of how they're entered in balance sheets, for banks to have BTPs that are worth less increases their cash requirement and the cost of funding". Moreover, "the banking laws no longer make it possible to ignore the mark-to-market and this would produce a loss in the financial statements".

In short, **there would be problems for the banks even if it didn't come to a Greek default scenario**, in which the value of sovereign bonds, and with that the banks, would collapse. And yet it is to the Greek crisis, and more specifically to 2013, that we need to return, because it was that experience that brought home to us the very real risks of banks' excessive exposure to the public debt of their country of reference. Indeed, **before 2013 it was, paradoxically, the funding mechanism put in place by the ECB that led Italian and Spanish banks to stock up with sovereigns**. In the middle of the Italian crisis of late 2011, with Mario Monti's government already in power, the other Mario, Draghi, envisaged that the range of accepted collateral could be widened. Italian banks could issue their own bonds, place them under the state guarantee just introduced by the Monti government, take them to the ECB, obtain liquidity in exchange and with that liquidity buy BTPs. This prevented the system from collapsing once the flight of foreign buyers began (starting with Deutsche Bank). This resulted in the banks making truly advantageous deals, with yields peaking at 7%, then falling to 5%, against a risk limited by the guarantees, as Castelli recalls.

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> reiterated by the Germans is the need to place a limit on banks' exposure to the government bonds of their own country".

Now the situation has, of course, changed. **Two-year BTP yields are negative** (-0.25%), albeit not as low as Bunds (-0.75%). **Why are there still so many bonds in credit institutions' portfolios?** For two reasons, as Castelli explains. One, the backlog of transactions carried out between 2011 and 2013 that have not yet reached maturity. And then the **obligation for banks to hold higher levels of liquid reserves than were required some years ago**. In fact, those liquid reserves are government bonds and the decision banks have to take is more about which type of bonds to keep. The Head of Fixed Income at Banor Capital adds that the leading Italian banks, Intesa Sanpaolo, Unicredit and Banco Bpm, have, in effect, already changed the composition of their sovereign portfolios. They've reduced their BTPs in percentage terms and increased the amounts of German bunds and French bonds held (with the last two accounting for about 25% each). This apparently happened on the **"advice" of the ECB,** which, it should be noted, today has a supervisory role: i.e., it performs stress tests. "For banks, holding a German bond means accepting the fact that you'll have a yield of less than 0.30-0.40%. They accept this from a perspective of equilibria with the ECB". At the same time, Castelli underscores, it's healthy for banks to hold a certain amount securities because it prevents the need, as seen in the emerging countries, to call on international investors who demand much higher returns given the lack of alternatives.

For banks, the issue today is above all to shift attention from increasingly meagre bond yields to credit, i.e. to once again perform their original role. As Nicola Borri points out, the signals are positive, as regards both the economy and the banks. We have the stabilisation of the stock of non-performing loans (NPLs), the rescue of MPS and the Veneto banks (which does, admittedly, complicate the European reforms) and a number of capital increases, starting with Unicredit's successful operation. "Now", he adds, "the problem is to see to what extent the banks manage to inject the ECB liquidity into the economy". If they succeed, that'll be advantageous for them. If they fail, it will be hard, because there are no alternatives to obtain good returns. Much will depend on the commercial ability of individual banks".

> "For banks, the cost of funding would rise and they would have to show the losses resulting from lower BTP values in their financial statements". In short, there would be problems for the credit institutions even if things didn't go so far as a Greek default scenario, in which the value of government bonds, and with it the banks, would collapse".

As regards the risk that the question might be put all too brutally to Italian banks by European reforms hingeing on the axis between Paris and Germany (a Germany with the liberals in government), opinions differ. Nicola Borri doesn't hide his scepticism as to whether reforms like banking union can be carried out, after the exceptions to the BRRD [translator's note: Bank Recovery and Resolution Directive, or bail-in directive] rules with the cases of MPS and the Veneto banks. In Angelo Drusiani's view, we could see **stronger pressure for limits to be placed on the amounts of BTPs held**. "However, we need to remember that there has been a similar precedent, with the Deauville agreement between Sarkozy and Angela Merkel, and the effects would certainly be negative". For this reason, underscores Castelli, it is essential for Italian politicians to have a greater presence in the European debates, to ensure that situations like the BRRD being approved without Italy being fully aware of the consequences, are not repeated". Just as, he adds, "**the politicians need to realise that with the end of QE the price on the market of political stances such as a demand for a referendum on the euro would be an increase not of 20 basis points on the spread, but of 200**".

While all of this may be true, a perceptive economist like **Giorgio Arfaras**, editor of Centro Einaudi's Lettera Economica, suggests that we shouldn't exaggerate our concerns over the effects of the ending of QE on the banking system and on the public accounts. The first reason, he explains, is that, while the ECB is beginning to find that certain countries' securities are in short supply for its purchases, there are still Italian BTPs available to buy. So purchases would still be possible in an emergency. We should also consider **the key variable of debt duration: while it used to be short, at two to three years, it has now risen to seven years**. So, "if a crisis that echoed that of 2011 were to occur, it would have less of an effect on companies' accounts, because they would be paying one seventh of the debt per year". And there are another two aspects to consider: while there may be a political risk in Italy in 2018, one probable scenario would be a broad coalition. Lastly, "although the Germans, as depicted by the media, are the country obsessed by the government bonds held by Italian banks, asset managers are more pragmatic and are buying them, because they have a higher yield". The risks, therefore, "have been fictionalised. Commentators pick up on situations such as the end of QE and take them to the limit. I personally would place my bets on an intermediate - or, if you like, mediocre - scenario".

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