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Banks face double challenge of capital and funding

MILAN, 4 October (Reuters) - the jump in the yields of Italian government bonds has increased pressure on banks and the risk of a capital shortfall, while some challenges lie ahead for funding.

Government bonds make up 10% of Italian banks' assets. Analysts have estimated that the increase in sovereign yields equated to about 40 basis points of CET 1 lost on average by banks in the second quarter. In the third quarter, it's thought that eight basis points have gone up in smoke.

After the dramatic widening of the spread, analysts are now developing scenarios that see the gap reaching 400. A spread of that size would force some banks to seek new liquidity from investors, according to a comment last week by the president of Assiom Forex, Luigi Belluti.

One of the most badly hit banks is Banco BPM. In the second quarter it lost valuable capital that it needs if it's to offload non-performing loans. The erosion of capital also complicates matters in the restructuring of Montepaschi.

And in the meantime, the tense situation on the markets has led to an increased cost of funding.

In March Intesa Sanpaolo issued a 10-year bond paying 1.83%, which was traded yesterday at 3.12%.

Only Intesa issued unsecured securities between May and August, with a 5-year bond priced at 2.15%.

According to traders, however, the market has again frozen.

For the time being, the problem only concerns banks like Montepaschi and Carige, which need to fund tier two capital using hybrid debt.

Thanks to the 240 billion euro in long-term funding provided by the European Central Bank, Italian banks won't have liquidity problems in the immediate future.

There have been no runs on deposits, so banks could easily continue to protect their net interest yields and reach year-end without issuing bonds.

In any case, access to the markets is vital.

"If the lack of new issuances were to continue for another 3-6 months it would become a real problem. Regulators want banks to be able to access the markets at any time", comments Francesco Castelli, Head of Fixed Income at Banor Capital.

Italian banks' average liquidity coverage ratio - one of the two indicators monitored by the regulators - was 171% at the end of 2017, well above the minimum level of 100%, according to figures from Banca d'Italia.

In Castelli's opinion, higher-than-average liquidity buffers are a result of pressure from the regulators. He adds that the supervisory authorities' hope is to keep those reserves intact until the time comes when the ECB's funding needs to be replaced by ordinary debt.

Refinancing requirements will become more urgent next year.

Starting from mid-2019, banks will need to exclude from their net stable funding ratio the other liquidity indicator considered by the regulators, 140 billion euro in long-term debt reaching maturity in June 2020.

Even before the increase in sovereign bond yields, Moody's rating agency was warning that Italian banks would see the cost of funding rise with the repayment of ECB funding, with margins squeezed accordingly.

By the end of 2020 about half of the 267 billion euro in circulating bank bonds will also reach maturity.

The stricter financial regulations introduced after the 2008 crisis and changes in Italy's tax system since 2012 also make the classic funding methods used by Italian banks, which have traditionally relied on retail customers, more difficult.

Banks will also need to deal with new European regulations (minimum requirement for own funds and eligible liabilities (MREL)) on debt and capital that can be removed from financial statements to absorb potential losses.

"There's a transition period starting in January 2019, but if banks don't start to issue bonds next year they'll find it difficult to meet the requirements", comments Cristiano Tommasi, partner at Allen & Overy.

UniCredit, which, as a systemically important financial institution, has specific requirements to meet, has managed to complete just one third of its refinancing plan for 2018.

Credit institutions have transferred to customers just one fifth of the 100 basis points that the increased yield premium is worth. It's possible, however, that in the near future they will need to begin sharing more of the costs with customers.

"If the bond spread continues to widen, sooner or later we'll need to increase the cost of credit", concludes an executive from an Italian bank.

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