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Atlante Fund Offers Italian Banks Support, But There's A Sting In The Tail

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Atlante Fund Offers Italian Banks Support, But There's A Sting In The Tail

Quaestio Capital Management SGR SpA (Quaestio SGR), an Italian asset management company, announced on April 12, 2016, the creation of a privately owned investment fund, Atlante SpA, which is intended to support Italian banks in their ongoing efforts to enhance their capital and clean up their credit portfolios. Full details have yet to emerge, but the fund is expected to be backed by large, privately owned Italian banks including UniCredit SpA (BBB-/Stable/A-3), Intesa Sanpaolo SpA (BBB-/Stable/A-3), and Unione di Banche Italiane Scpa (UBI, BBB-/Stable/A-3); institutional investors; insurance companies; and banking foundations. State involvement will be limited to a minority participation by Cassa Depositi e Prestiti (CDP, BBB-/Stable/A-3), a government-related entity in charge of implementing the government's financial policy.

By encouraging the creation of this fund, the government and regulatory authorities hope to restore investors' confidence in the Italian financial system and reduce market turmoil. The fund is expected to act as a backstop facility for Italian banks' rights issues and could also acquire the most junior tranches of securitizations of nonperforming loans (NPLs).

Overview

- The creation of a privately owned investment fund to support Italian banks entails short-term benefits and some longer-term risks.
- It will backstop capital increases by a few Italian banks and potentially support credit portfolio clean up in the system.
- However, banks participating in the fund are exposed to potential losses and, in the long term, mutualization of problems in the system may erode stronger entities' financial profiles.

Combined with the measures already launched by the Italian government and, even more importantly, with the potential for further reform of Italian bankruptcy law, the fund's acquisition of junior tranches of NPL securitizations is intended to foster the disposal of problematic assets and broaden the secondary market for NPLs in Italy. Recent government measures aimed at supporting this market include the GACS mechanism, under which the state would guarantee certain tranches of bonds issued by special-purpose vehicles (SPVs) on behalf of individual Italian banks for the purpose of transferring, managing, and structuring a portion of those banks' NPLs.

Standard & Poor's Ratings Services views the Atlante initiative as positive for the Italian banking system in the short term. We anticipate that its potential participation could reduce the execution risk associated with capital increases for a few Italian banks, and support the underwriters that guarantee these rights issues. However, in the long term, we consider that the participation of Italian banks in the vehicle leaves them exposed to the risk of potential losses on their investment, as well as to some tail risk, depending on Atlante's final financing structure. Additionally, the initial size of the facility seems relatively small to produce significant benefits for the whole system. For this reason, we believe that banks investing in the vehicle could be asked to increase their participation in the future and, thus, their exposure

toward weaker financial institutions. A progressive mutualization of problems within the financial system could end up impairing the financial profile of Italian banks with stronger creditworthiness.

We don't anticipate that the fund will affect our ratings on Italian banks. Veneto Banca SpA (B/Negative/B) is the only rated bank that is currently undergoing a capital increase exercise, and we already factor the potential benefit from the successful completion of its rights issue into our rating on the bank. We do not anticipate a rating impact for banks investing in the vehicle, as we estimate the initial investment will be relatively contained.

A Fund To Back Italian Banks' Capital Increases

Quaestio SGR will manage Atlante as an alternative investment fund. The fund should ensure that Italian banks can successfully complete the capital increases currently in progress by acting as a backstop facility to cover potential shortfalls in the initial offering of right issues. It will also focus on supporting Italian banks' efforts to clean up their deteriorated credits portfolio, by potentially acquiring the most junior tranches of NPL securitizations. This will increase the attractiveness of the senior tranches, which could benefit from a guarantee under the GACS mechanism (see "Italy's Plan To Reduce Banks' Nonperforming Loans: Why It Isn't A Cure-All," published on Feb. 2, 2016, on RatingsDirect).

Quaestio SGR considers that the current market prices of Italian banks shares are highly penalized by their high stock of NPLs, the lengthy defaulted loans recovery processes, and lack of certainty regarding some banks' capacity to complete the sizable capital increases required by regulators. In its investment strategy, Quaestio SGR expects Atlante to purchase assets in the coming weeks and months, and then benefit from future value recovery in both the equity and the real estate market. Quaestio SGR has not disclosed any additional information on Atlante, particularly on its governance and its financing structure.

More Information Is Still Needed

Although detailed information on the fund's underlying mechanism, its governance, and its financing structure has not yet been set out, based on currently available information, we expect the total equity injected in Atlante to be relatively small. The €5 billion-€6 billion estimated size of the facility would be more than sufficient to cover potential shortfalls in the capital increases three Italian banks--Veneto Banca, Banca Popolare di Vicenza SpA, and Banco Popolare Societa Cooperativa SCRL--have already announced.

We do not know all the entities that will participate, nor the size of their initial investments in the fund. We estimate that rated Italian banks could each invest an amount equivalent to 10-15 basis points (bps) of our risk-adjusted capital (RAC). If this estimate is correct, the first equity disbursement is likely to be manageable and would not affect banks' credit profiles. However, in most stressed scenarios, we consider a similar capital structure limits the capacity of the fund to backstop potential future capital increases of other Italian banks and at the same time acquire tranches of securitized NPLs. In this scenario, financially stronger banks could be asked to increase their exposure to the fund and, indirectly, to weaker institutions.

The Creation Of The Fund Could Benefit Weaker Banks In The Short Term

Atlante offers increased certainty on successful completion of capital increases by a few Italian banks, at a time when confidence has been sorely lacking, and the short-term benefits are likely to be significant. Turmoil in the wholesale markets has affected Italian banks since the beginning of the year and we consider that it has increased execution risk for some rights issues. Although some deals were postponed to minimize this risk, market volatility has been prolonged and concerns regarding banks' capacity to meet regulatory requirements have resurfaced in recent weeks. The capital increases Banca Popolare di Vicenza and Veneto Banca are due to complete by June this year are fully guaranteed by other banks. However, we saw a significant risk that current market conditions could have led underwriters to end up with higher holdings of the newly issued shares than they originally estimated. This could have eroded their capital ratios, to various degrees. The creation of Atlante reduces this risk significantly.

The presence of the Atlante facility should also help restore investors' confidence in banks' capacity to complete capital-enhancing actions required by regulatory authorities. If institutional investors' sentiment improves, it could encourage them to subscribe to more of the newly issued shares, which could lower the need to use Atlante as a backstop facility. This would leave it with higher capacity to support future capital increases of other Italian banks and to acquire the most junior tranches of Italian banks' NPL securitizations.

Opening Up The Secondary Market For NPLs In Italy Will Help All Banks

In turn, this could help open up the secondary market for NPL securitizations, and thus benefit the whole system. If market conditions improve, entities with large stocks of NPLs could dispose a higher portion of their defaulted loans and deconsolidate these problematic assets from their balance sheets. The GACS scheme enables those who participate to issue securitizations where the senior tranches benefit from a government guarantee; the Atlante fund could give them an opportunity to sell junior tranches at terms that could be more favorable than those offered in the current market.

We understand that the government may augment this positive effect by considering further reforms to bankruptcy law. At present, we estimate it takes much longer to recover the remaining value in Italian NPLs than in the rest of Europe. If the government can significantly reduce the time required to recover NPLs, particularly the time needed to repossess collateral attached to defaulted loans, it could increase the implicit value of Italian NPLs. Ultimately, such measures could foster the creation of a more effective secondary market for NPLs in Italy.

Atlante Entails More Risks In The Long Term

Italian banks had accumulated a total of about €196 billion in gross bad loans (sofferenze) by February 2016. Set against this amount, the estimated €5 billion-€6 billion total size of the Atlante backstop facility appears relatively small. In the most stressed scenario, the fund would be barely sufficient to cover potential shortfalls arising from the capital increases already announced by three Italian banks. Banca Vicenza, Veneto Banca, and Banco Popolare are due to raise about €3.75 billion in total over the next few months. In this scenario, Atlante's remaining capacity to

support potential future rights issue of other Italian banks and at the same time acquire NPLs securitizations would be fairly limited. Even though we don't know yet the vehicle financing strategy, the proposed capital structure could reduce the effectiveness of this measure to support the whole system in the future.

Moreover, the participation of Italian banks in Atlante's equity leaves them exposed to potential losses on their investment in the vehicle. We don't yet know how much each institution will initially contribute to the fund. However, even if the first disbursement of individual investors were to be overall manageable for their size and their credit profiles, they remain exposed to the risk that Atlante could require additional capital if it were to incur losses on its investment portfolios. If the fund consumes most of the initial resources in the next few months, its investors could also be asked to increase their participation to support Atlante's future investments in the system. Ultimately, we consider that participation in this scheme could increase other Italian banks' vulnerability to the further deterioration of weaker domestic peers' creditworthiness and financial fundamentals. A progressive mutualization of problems within the financial system could end up impairing the financial profile of Italian banks with stronger creditworthiness.

Ratings Are Unaffected At Present

We do not expect the creation of Atlante to have a material effect on our ratings on Italian banks.

Veneto is the only rated entity currently undergoing a capital increase required by regulatory authorities, following large credit losses incurred by the bank in past few years. However, our ratings on Veneto already incorporate the potential benefit from the successful completion of the capital increase. If our view of the domestic operating environment improves further, this will likely lead to Veneto achieving a RAC ratio sustainably above 5%.

We estimate that participation in the vehicle will not affect the ratings on the other banks that we consider likely to invest in Atlante (based on publicly available information). We estimate their initial investment as being contained and therefore neutral to our current assessment of their financial profiles. That said, we will monitor these investments, and our views may change, particularly if banks were to further increase their participation in the fund to a point where it could impair their solvency or other features of their financial profiles.

Only a rating committee may determine a rating action and this report does not constitute a rating action.

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