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Summary of Unicredit SpA: out of the frying pan?

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Lyddon Consulting Services Limited has published the above paper about the "recapitalization" of Unicredit S.p.A., examining the bank's capital in the light of:

I. the accounting of its 13-for-5 rights issue in February/March 2017 in an amount of €13.0 billion;
II. its level of provisioning for Non-Performing Loans ("NPLs"); and
III. the accounting of its investments in its banking subsidiaries outside Italy.

The rights issue is the main funding for the "recapitalisation" plan. It was used to cover provisions of €12.2 billion taken in the final quarter of 2016, broken down as €3.6 billion to increase write-downs on a portfolio of NPLs which were to be sold off (the FINO project), €4.5 billion to increase write-downs on the remaining portfolio of NPLs being retained (the PORTO project), and €4.1 billion of other provisions. In addition, Reserves reduced in Q4 2016 by a further €2.1 billion, bringing them to -€2.5 billion at 31/12/16.

The bank continues to skate on very thin ice:

- The European Central Bank is examining the FINO project to see if the sale price of the portfolio was not manipulated in a way that allowed Unicredit to escape making a further write-down;
- Regulatory capital is made to appear adequate because Unicredit's Internal Risk-Based Approach ("IRB") to calculating its ratios permits it to shrink its assets by 58% before setting its capital against them;
- Unicredit's capital is also being used twice: to support Unicredit SpA's own business in Italy and also that of its foreign banking subsidiaries. Under Basel II the capital owned by Unicredit SpA in the latter should be backed out of the capital available to support Unicredit SpA's own business.

Unicredit SpA has a major capital deficit if Basel II is applied as commonly understood. In addition, a bank that has allowed 21.37% of its loans in Italy to become NPLs should arguably not be allowed to run an IRB Approach to credit assessment at all. The Italian loan book is still held at a value that appears optimistic, for the same reasons that investors have valued the FINO portfolio below the level of 12.96% of nominal which Unicredit must achieve in order not to take a further write-down.

The rights issue was paid in in Q1 2017; the provisions and charges disclosed in the Prospectus were taken in Q4 2016.

In between Unicredit was out of compliance with its regulatory capital ratios.

Even now the compliance of the stock-exchange listed bank – Unicredit SpA - with regulatory capital ratios is contingent upon:

1. The acceptance that the bank's IRB Approach adequately assesses the credit risk on its performing loans, when the same methodology has allowed 21.37% of its total customer loans to become NPLs;
2. The reduction – under IRB – of gross assets by 58% to determine the risk-weighted assets, against which the capital ratios are calculated;
3. The final completion of the FINO project for a net sale price for the portfolio of at least 12.96% of nominal value and its refinancing through the European Central Bank;
4. The bank's ability to realise at least 43.43% of nominal value from the remaining NPL portfolio, the PORTO project having reduced the "carrying value" down to this level;
5. The continued agreement of regulators to allow Unicredit SpA to assess the capital needed to hold shares in its major banking subsidiaries in Germany, Austria and Central&Eastern Europe as if it were a loan asset, instead of deducting the investment 1-for-1 against Unicredit SpA's capital, as Basel II dictates;
6. An absence of significant NPL problems in the loan books of these foreign banking subsidiaries.

These are major contingencies and the bank lacks buffers of resources to deal with further difficulties in its loan book, other assets and off-balance sheet business.

The final completion of the FINO project looks some way off as well. Unicredit has removed the FINO portfolio of €17 billion from its own balance sheet, and exchanged it for notes issued by the companies it sold the portfolio off to. The first securitization transaction related to FINO is for only €5.3 billion of that, and it has achieved one of the two public credit ratings needed for Unicredit to borrow against the notes from the ECB.

However the ECB is investigating the details of the sale of the FINO portfolio by Unicredit, as to whether the valuation is lower than the amount of notes that Unicredit wants to borrow against, and whether Unicredit paid a cash subsidy in order not to take a further loan write-down.

If the difference in valuation was material, then Unicredit should arguably have made a statement to the stock exchange, or at least made a representation that the difference in valuation was within the range implied by its caveat on page 130 of the prospectus for the rights issue.

That prospectus was already uninformative enough about the status of Unicredit's reserves as at the date of its publication, about the impact on reserves of the loan write-downs and other provisions that were disclosed in the prospectus (of €12.1 billion), about the nature of the €4.1 billion portion of this €12.2 billion that was not about NPL write-downs, and about the extra €2.1 billion of charges that were in the end taken in Q4 2016, over above the €12.2 billion. Reserves were actually negative at the time the prospectus was issued (by €400 million) based on charges in Q4 2016 of €12.2 billion, and were disclosed in the annual report as having been -€2.5 billion at 31/12/16, a materially worse situation than a retail investor will have appreciated from reading the prospectus, and one that will have eluded all investors because charges were supposed to have been €12.2 billion and not €14.3 billion.

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