The Eurozone's Hidden Debt - Dubious Measures, Lacking Transparency

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This piece discusses the main accounting issues that have been used to keep two major Italian banks both afloat and apparently compliant with the globally-agreed standards that were supposed to assure the resilience and stability of the financial system after the 2007-8 crisis.

These two banks now propose to merge, a sure sign that one or both are running out of steam: talks are in full swing between UniCredit and Banca Monte dei Paschi di Siena (Monte dei Paschi). This will prompt the fudging of the two banks' accounts and capitalisation positions, questions which were discussed in the 2020 publication, *Managing Euro Risk*.[1]

UniCredit is a Black Knight, not a White one: UniCredit has been cast in the role of White Knight in this transaction – the solvent bank taking over a failing one. The White Knight role has previously been adopted by Santander towards Banco Popular Espanol, and by Intesa Sanpaolo towards Veneto Banca and Banca Popolare di Vicenza.[2] UniCredit's position is almost as problematic as that of Monte dei Paschi, though. UniCredit has a network of foreign subsidiaries that hold 51% of the group's assets. UniCredit SpA - the Italian bank and the group parent – does not 'deduct back from its own capital the capital it holds in other banks'.[3] This flouts the international Basel rules, applicable to banks, which the EU purports to apply.[4] The equity value of UniCredit is leveraged up through special treatment given to the parent and to its subsidiaries.

There are a number of other problems which have not been made transparent. These include:

Misleading share valuation. The treatment allows the UniCredit parent bank to value its shares in its subsidiaries at €33.7 bn, whilst excluding €16.6 bn of Reserves sitting in subsidiary banks.[5] This amount should be added to both the parent's equity and to the value of the shares: equity should stand at €66.1 bn instead of €49.5 bn, and the value of the shares at €50.3 bn instead of €33.7 bn. The key point is that the value of the shares of €50.3 bn should then be deducted back from the equity of €66.1 bn to isolate the parent's own equity, upon which it can base its own business. This is just €15.8 bn and not the €49.5 bn that its balance sheet states.

Equity of €15.8 bn scarcely meets key regulatory ratios: €15.8 bn is 3.4% of the parent's nominal assets of €452.1 bn, barely meeting the Basel Leverage Ratio of 3%. €15.8 bn is at the same time 8.6% of the parent's Risk-Weighted Assets (RWAs) of €183.1 bn.[6] The ratio of Risk-Weighted Assets to core capital is the CET1 Ratio, and is the main measure used by global regulators for a bank's financial stability and resilience. The denominator is RWAs as opposed to nominal assets and the numerator is Common Equity Tier 1, or CET1.[7] As UniCredit is a Global Systemically Important Bank (GSIB), its

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[1] 'Managing Euro Risk', Barnabas Reynolds, David Blake and Bob Lyddon, Politeia, February 2020.

[2] 'Managing Euro Risk' pp. 123-4

[3] 'Managing Euro Risk' p. 100

[4] Basel rules are the global standards for bank capitalisation issued by the Bank for International Settlements in Basel; their strengthening was a key response to the Global Financial Crisis. The outlawing of this 'double leverage', the Leverage Ratio and the CET1 Ratio are main components of these rules

[5] UniCredit SpA "Company" accounts in the UniCredit 2020 annual report p. 525 and p. 535

[6] Risk-Weighted Asset or RWA – the supposed maximum loss a bank can suffer under a piece of business after its nominal amount, the characteristics of the counterparty and the characteristics of the transaction and any collateral have been processed through a bank's Internal Ratings-Based methodology

[7] Common Equity Tier 1 or CET1 – equity or capital that meets criteria laid down in Basel rules and which is meant to be of the highest quality, and definitely available to a bank as a loss buffer. It must be at least 8-10% of the bank's Risk-Weighted Assets, depending upon how important the bank is to the national or global financial system. UniCredit is both

CET1 Ratio should be at the higher end of the range of 8-10%. The UniCredit parent bank has a CET1 Ratio of 8.6% which may not just be below its threshold: it is also far below UniCredit Group's claimed CET1 Ratio of 15.5%.[8] This disparity proves that the same CET1 amount is being used twice, to support €452.1 bn of assets owned by the parent, and again to support €479.3 bn of assets owned by its foreign subsidiaries.

It is not certain that the Risk-Weighted Asset figures are correct: one of the problems here is that the procedures used by both banks lack transparency and the upshot is that risk is not sufficiently accounted for or covered. This is perfectly exemplified in the banks' treatment of loans that have gone into default. Both UniCredit and Monte dei Paschi have substantial bad lending and have employed techniques sanctioned by the European Banking Authority (EBA) for reducing their Non-Performing Loans (NPLs).[9] These include techniques called 'forbearance' and 'restructuring' under which the borrower makes no payments to cure its default but the loan can be returned to 'Performing' status. They include securitisations of NPLs where the selling bank provides the vast majority of the funds for the transaction and remains exposed to the risk of the same bad loans but at one step removed. These techniques paper the cracks.[10] The market-to-book ratio of Monte dei Paschi is 20%.[11] This demonstrates a belief amongst the investor market that Monte dei Paschi's assets are misvalued by around €5 bn: its retained NPLs and the bonds it owns based on the securitisation of its NPLs. Share investors can see through these techniques but financial regulators apparently cannot, possibly because they have connived in their creation.

Stress Tests, Risk-Weighted Assets and Internal Ratings-Based Methodologies which enable banks to understate their risks and pass their Stress Tests: the final problem is the biggest, and it impacts both these banks and the UK banks. It is the relationship between Stress Tests, used for supposedly verifying banks' stability and resilience, and the Internal Ratings-Based (IRB) methodologies that are employed for calculating banks' Risk-Weighted Assets.[12]

As stated in the footnote 12 above, an IRB methodology captures the characteristics of a transaction and of the transaction counterparty, and of any collateral, and re-expresses the nominal amount of the transaction into its Risk-Weighted Asset equivalent, and the RWA is almost always lower than the nominal amount. The RWA is meant to represent the maximum possible loss that the bank can suffer on that transaction in normal, unstressed market conditions.

Stress Tests, whether applied by the EBA or the UK's Prudential Regulatory Authority, base themselves on these RWAs and on the bank's statement of its CET1 as the principal buffer for swallowing any loss while remaining solvent itself. The Stress Tests then apply scenarios of increasing economic gravity under which the RWAs expand, causing the CET1 to fall below the bank's Basel threshold or even disappear. This last outcome would indicate that a bank's core capital was not adequate to swallow the losses it would experience in that scenario and remain solvent itself.

In the most recent EBA Stress Test Monte dei Paschi was shown to have negative CET1 under the most adverse scenario.[13] In other words Monte dei Paschi's buffer is inadequate to swallow losses from the risks it is running.

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a GSIB and a national systemically important institution in Italy and other EU member states, and subject to supplementary CET1 percentages set by the global Financial Stability Board and by the respective national supervisor

[8] p. 9 of UniCredit 1H21 and 2Q21 Results

[9] 'Managing Euro Risk' p. 128

[10] https://en.irefeurope.org/Publications/IREF-Newsletter/article/The-Italian-Non-Performing-Loan-Story-how-the-2016-Securitisation-Laws-have-led-to-Permanent

[11] Based on a share price of €1.15 when Capital per Share is €6 and BMPS' nominal capital is €6 bn

[12] 'Managing Euro Risk' p. 117-8

[13] https://www.reuters.com/business/finance/eu-banks-move-closer-dividend-payouts-after-strong-stress-test-showing-2021-07-30/

Dubious starting point: the problem is whether the start-point is even correct i.e. do the bank's RWAs reflect the risks it is running in unstressed market conditions? The answer to that is probably not, and certainly not if the Archegos case is indicative of the true scale of losses that banks can experience.

The Internal Ratings-Based Approach - the Basel formula - customarily shrinks the nominal value of a transaction into a much lower Risk-Weighted Asset. The fact that the Leverage Ratio at 3%, based on nominal value, is so far below the CET1 Ratio of 8-10% indicates that financial supervisors expect a 60-70% shrinkage. Why?

The Internal Ratings-Based Approach is functioning the wrong way round: IRB methodologies have developed into a technique to misvalue assets in order to justify a bank's continued operation and indeed growth, and to enable a pretence by supervisors towards the wider world that the financial system is now stable and resilient.

The Archegos bankruptcy is a case in point. Its banks converted their trades with Archegos into RWAs – the maximum possible loss the banks could experience – and took collateral against the RWA amount. Archegos had US$10 bn 'of funds under management', and put the entirety of this amount up as collateral. The trades went bad and in general market conditions that were unstressed, even if the prices of the reference assets of the trades did themselves fall dramatically. The banks were left with credit losses of US$10 bn after all the collateral had been applied. This means that the gross losses were US$20 bn and were reduced to US$10 bn by the application of the collateral. The RWA calculations on the trades themselves should have given a maximum possible loss of US$20 bn, not US$10 bn: an error in a magnitude of 100%. This mirrors the situation at the UniCredit parent, which shelters under a claimed Group-wide CET1 ratio of 15.5% when its own individual CET1 ratio is 8.6%.

Monte dei Paschi's RWA calculations show it as well-capitalized when the market considers it bankrupt: Monte dei Paschi's consolidated interim report of 31st March 2021 showed it had CET1 of €5.96 bn, when its nominal assets were €146.66 bn: a Leverage Ratio of 4%. However, its RWAs were only €48.90 bn, 33% of their nominal value. Based on its RWAs, Monte dei Paschi could claim a CET1 ratio of 12.2%, a healthy surplus over a threshold of 8%. Investors, ascribing it a market-to-book ratio of 20%, viewed it as near-insolvent.

Banks have not recapitalised since the financial crisis: a merger of UniCredit and Monte dei Paschi would fudge all this over for a time, and distract attention from the bigger issue: banks have not recapitalised since the Global Financial Crisis. Under the auspices of their supervisors, they have optimised IRB methodologies, a chewing gum that justifies the industry's small, fixed capital to its expanding business volume and risk profile. Mergers are needed whenever the chewing gum threatens to snap.

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