European Central Bank rejects request by Italy for more time to rescue ailing lender

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The European Central Bank has rejected a request to delay the deadline on a private-sector-led deal to rescue the Monte dei Paschi di Siena (MPS) bank, Italy's third largest, making more likely a government bailout that would impose major losses on small investors and bondholders.

MPS had sent a request to the ECB's supervisory board to extend the deadline on the deal to January 20 to allow more time for the €5 billion rescue operation to be put in place.

The deal, which hinged on an injection of funds from Qatar's sovereign wealth fund of up to €2 billion and a series of complex debt for equity swaps, was to have been settled this week. But the overwhelming "No" vote in the Italian referendum last Sunday and the subsequent resignation of Prime Minister Matteo Renzi threw the rescue plan into disarray with the Qatari fund saying it would not make an investment until it received clarity on the formation of a new government.

According to a report in Reuters and subsequent reports in the *Financial Times* and the *Guardian*, the board of the ECB's Single Supervisory Mechanism, charged with European banking regulation, turned down the request for a delay at a meeting yesterday.

The ECB and the Italian Treasury have so far refused to comment but trading in MPS shares was suspended, after losing a further 10 percent of their value. According to the Italian media, MPS held an emergency board meeting and will be engaged in talks with the government over the weekend.

Citing "people briefed on the deliberations," the *Financial Times* said the supervisory board had turned down the request fearing that "if MPS's troubles were left unresolved, it could lead to a systemic crisis across Italy's banking system."

The ECB decision makes it almost certain that the government will have to organise a bailout in some form. However, under European Union rules, which came into force this year, any injection of state funds would have to be preceded by the imposition of losses on creditors, in particular small retail investors and households.

Such a move will be politically explosive. Small investors, who often hold deposits, account for a large share of junior bond holders. It is estimated that there are some 40,000 households which own €2 billion worth of bonds in MPS. They were lured into making such investments following the European banking crisis of 2011 with the assurance that their investments were as safe as deposits.

A "bail-in" of such bondholders in four small banks which went broke late last year caused a political uproar, with one small investor taking his own life. Any such operation involving MPS, taking place on a much larger scale, would become a major campaign issue in Italian elections following the fall of the Renzi government and could lead to a movement to quit the EU.

A statement issued by Members of the European Parliament belonging to the right-wing populist Five Star Movement, issued on the blog of the organisation's founder Beppe Grillo, said MPS could only be saved by state aid in order to avoid bail in-rules that hurt smaller savers as happened a year ago.

"This is not the time to fear the European Union and a possible infraction procedure. The consequences of a disordered bail-in would be disastrous to say the least. Almost apocalyptic if one considers the size of MPS."

The statement, which was reported in the *Guardian*, said it was "time to slam our fists at the table in Brussels … while not giving a damn about the deficit."

The talks between MPS and the government may

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result in a last-ditch effort to come up with a rescue plan, but the political uncertainty about the composition of the new government and its policies make its achievement unlikely.

Mujtaba Rahman, head of European issues for the Eurasia Group risk consultancy, told the *Financial Times* that European institutions had always been "sceptical" about the private-sector plan. "Not only does it imply a less ambitious restructuring plan but the ability to secure an anchor investor has become much less likely in light of Renzi's resignation and the ongoing political instability in Rome," he said.

It appears that the ECB decisions may be part of a wider plan to force the Italian government and the country's financial authorities to impose a restructuring of the country's entire banking system, which is weighed down by an estimated €360 billion worth of bad loans.

Reuters reported that ECB officials had expressed the hope that the "precautionary recapitalisation" of MPS by the Italian state—that is, a recapitalisation of an institution still considered to be solvent—would pave the way for similar injections of government funds into other Italian banks plagued by bad loans.

According to one anonymous ECB official, cited by the news agency, there was a consensus that MPS needed a recapitalisation. "Once that is done, it could serve as a template for other banks."

But as the Reuters report noted, such a state intervention became a "political taboo" this year when new EU rules stipulated that it could only be carried out after all private investors, including small holders, took losses first.

Whatever the outcome of the talks and negotiations over the next few days, it will have far-reaching implications for the entire Italian banking system. The next potential crisis centres on UniCredit, Italy's largest bank, and its only significant global banking institution.

UniCredit is set to announce a plan to raise €13 billion in capital next Tuesday as part of an effort to stabilise its financial position. But if the government does decide to undertake a bailout of MPS under the terms dictated by the ECB, those plans could be jeopardised. According to the *Financial Times*, senior bankers said they were fearful that a "precautionary recapitalisation" of MPS could jeopardise efforts to raise capital by UniCredit.

So far, European financial markets have remained stable in the face of the MPS crisis. But there is potential for so-called "contagion" because of the interconnections in the banking system. For example, UniCredit owns Hypovereinsbank, which is Germany's fourth largest bank, while Banca Nazionale del Lavro, Italy's eighth largest lender, is owned by BNP Paribas, France's largest bank, and Cariparma, Italy's eleventh largest lender, is owned by Credit Agricole, a major French bank.

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