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A Monte of trouble

Italian bank Monte dei Paschi emerges as the loser after ECB stress tests

- Monte dei Paschi's spreads extremely volatile while capital plans are uncertain
- Tests won't be a panacea for eurozone's malaise
- ISDA 2014 basis has changed significantly over the past month

Earnings season is well underway and the Federal Reserve ended its bond purchase programme, but in Europe all eyes were on the results of the ECB's asset quality review and stress tests.

A total of 25 banks out of 130 failed the tests, though only 13 banks have capital shortfalls once prudential actions this year are taken into account. Overall, the eurozone's banks need to find €9.5bn (approximately 0.1% of eurozone GDP) to fill the capital hole.

Italian bank Monte dei Paschi emerged as the biggest failure, with a capital shortfall of €2.11bn. A look at the company's CDS spreads shows that this was no great surprise to the credit markets. Prior to the introduction of ISDA 2014 definitions on September 22, the subordinated 5-year spread was trading at 260bps. It then widened sharply due to the new definitions increasing the value of subordinated CDS protection (the changes affected all European banks).

But Monte dei Paschi's spreads continued to widen in the following weeks and underperformed European peers. On the eve of the stress test results, they were trading at 627bps, 185bps wider than the September 22 levels.

After the announcement of the results, Monte's sub spreads gave up a further 50bps to trade at 677bps. But only two days later they had recovered to 610bps, an improvement from the pre-result levels. On the face of it, this seems surprising given that subordinated bondholders are in the firing line if government intervention forces a bail-in (an eventuality that the new definitions explicitly cover through an additional credit event). But the Italian authorities were quick to deny that public money would be used to prop up the country's ailing banking sector (three other institutions require capital injections).

Monte dei Paschi has already received €4bn in public aid, some of which has been paid back, and other alternatives are likely to be considered before that route is taken again. It can sell assets or raise funds through a rights issue, both of which should be positive for credit investors. Or it could sell itself to another, larger institution, which would also benefit bondholders.

However, Intesa Sanpaolo described a merger of the two institutions as "unimaginable". The reaction of the credit markets showed that investors had expected a larger Italian bank to rescue the ailing bank – Monte dei Paschi's subordinated spreads widened 154bps to 800bps. MPS has a little over a week to come up with a capital raising plan, and we can expect further volatility in the interim.

The dust is still settling from the results, but it seems clear that the catharsis EU officials hoped for hasn't materialised. The AQR, in particular, was worthwhile and bank balance sheets are more transparent. But it doesn't follow that Europe's banks will now embark on a lending spree – lack of demand remains the underlying problem. And deflation looms, a scenario, incidentally, that the stress tests didn't consider.

Nonetheless, the credit markets ended the week on a high, thanks to an unexpected intervention from the Bank of Japan. The Japanese central bank announced that it was expanding its asset purchase programme, a decision that shocked the markets. It was a timely move given that the Fed stopped its own bond buying programme earlier this week (though the size of its balance sheet is still accommodative). If the ECB (and Germany) can manage to overcome its conservatism and follow suit, then there might be some hope for the eurozone.

ISDA 2014 basis – one month on

Name	5Y 2003	5Y 2014	Basis	% Basis	% Basis 1M ago
UBS	67	187	121	181%	225%
Credit Suisse	77	197	120	156%	187%
Deutsche Bk	101	187	86	86%	77%
HSBC Bk	70	129	59	84%	53%
Monte Dei Paschi	357	649	292	82%	75%
Societe Generale	106	190	83	78%	67%
UniCredit	135	238	103	76%	81%
Santander	99	172	73	74%	95%
BBVA	101	175	74	73%	95%
Std Chartered	118	200	82	69%	74%
Intesa Sanpaolo	112	184	72	64%	88%
Barclays Bk	100	161	61	61%	72%
Commerzbank	147	236	89	61%	94%
BNP Paribas	89	140	51	58%	55%
LLOYDS BK	95	149	54	57%	55%
RBS	102	159	57	55%	93%
Cr Agricole	97	149	52	54%	62%

We analysed the basis caused by the introduction of the ISDA 2014 definitions last month. One month on from the roll, we can see that there have been some changes in the subordinated basis as the market acclimatised to the new rules. The Swiss banks still have the widest basis due to the inclusion of the coco supplement as standard.

Elsewhere, we have seen the basis in some banks, such as HSBC and Deutsche Bank, increase significantly. Others, particularly RBS and Commerzbank, have seen their basis shrink by a considerable amount. The size of the basis changes and the lack of a discernible pattern perhaps shows the challenges faced by the CDS market in adjusting to the 2014 definitions.

Name	5Y 2003	5Y 2014	Basis	% Basis	% Basis 1M ago
Italy	117	139	22	18%	16%
Spain	93	106	13	14%	11%
UK	19	21	2	12%	7%
Ireland	57	64	7	12%	2%
Portugal	194	216	22	11%	10%
Sweden	14	16	1	10%	6%
Belgium	52	57	5	10%	4%
Austria	26	28	3	10%	8%
Denmark	24	26	2	9%	4%
France	50	54	4	9%	6%
Netherlands	24	26	2	9%	7%
Germany	19	20	1	7%	6%
Norway	14	14	0	1%	3%
Finland	28	28	0	0%	2%

In sovereigns, however, there is a clear shift in the basis. The vast majority of western European names saw their basis increase over the past month, with Italy's 2014 spreads trading as much as 18% wider than 2003 equivalents.

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