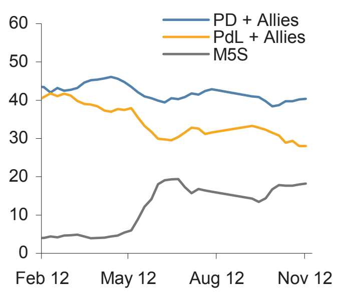
Italy: Short-term volatility, but Monti stays

We are long Italian corporates (Fiat) and banks (Intesa, UniCredit, Monte Paschi).

Lack of continuity in its reform agenda is threat for Italy. Italy has a multi-decade history of delegating structural reforms to technical governments. The current Monti government is carrying out a mix of austerity and structural reforms in a short period of time. The reform plan is ambitious and gives Italy a chance to save itself, as we wrote earlier in the year (The Revolver | Italy: A chance to save itself, 27 March 2012). However, we cannot expect a technical government to restructure the country in only one year: Italy needs more time to heal itself. Therefore, it is critical to ensure Monti's reforms are carried through by the next government even after March 2013 elections. So far, Monti has not entered the running for next election, but he has said he is open to staying if he is asked to do so by the next parliament.

With Monti, Italy is unlikely to need to enter an IMF program, in our view, and it will also not need a bad bank, like Spain.

Italian politics: more fragmented
Poll data, % vote



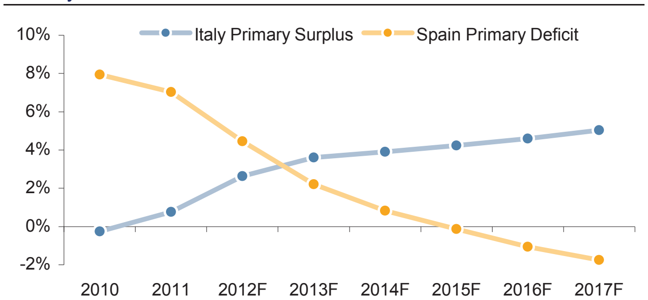
Source: RBS Credit Strategy, EMG

Sicilian elections show increasing abstention, political fragmentation. Elections in Sicily in October showed increasing voter alienation, with a low turnout of just 47%, down from 67% in 2008. There was a large swing away from the centre-right People of Liberty Party (PdL) towards the centre-left Democratic Party (PD), which won with 30.5% of the vote. The results also showed the rise of the wildcard 5-Star Movement (M5S), a new party formed in 2009, which gained 18% of the vote. In the run-up to the next election in April 2013, wider national polls from Ipsos, EMG, IPR and SWG put the PD in the lead with 28-30% of the vote (from 33.2% at the 2008 election), and the PdL on 15-17% (much reduced from 37.4% in 2008), with M5S also on around 16-20%. Including the main parties' allies, the centre-left PD coalition has around 40% of the vote, compared to just under 30% for the centre-right PdL coalition.

Changes to electoral law can increase parliamentary fragmentation. Pier Luigi Bersani, leader of the PD, is calling for a 10-12.5% majority premium in number of seats to be awarded to the leading party. Centre-right parties, which are seeing declining consensus, are strongly rejecting this – proposing a more proportional electoral system, with lower majority bonuses and lower thresholds to enter parliament.

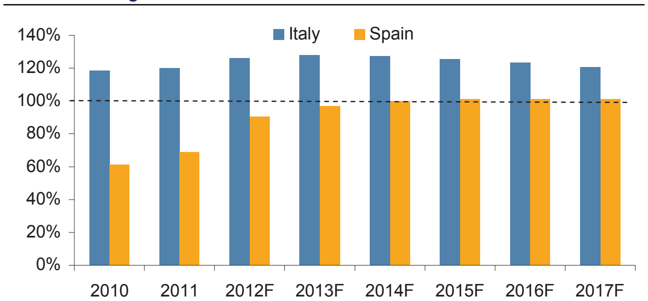
Fragmentation means short-term volatility, but more likely return for Monti. Increasing fragmentation will likely mean no clear parliamentary majority at the next election. This makes it more likely that the new parliament will ask Monti's technical government to renew its term. This is eventually a positive as it will allow Monti to continue with his reforms, enhancing competitiveness and ensuring debt sustainability in the long-run. However, it is in the run up to the next election, throughout Q1 2013, that political risk and uncertainty can re-emerge, likely resulting in some short term volatility in spreads.

Italy benefits from a primary surplus
Primary balance, % GDP



Source: RBS Credit Strategy, IMF

Italy's debt is increasing less rapidly than Spain's
Government gross debt, % GDP

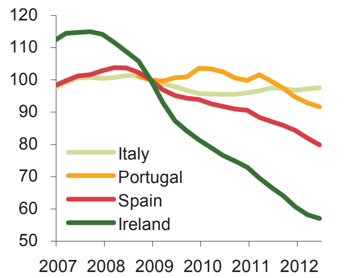


Source: RBS Credit Strategy, IMF

Banks: NPLs are high, but on shallower trend

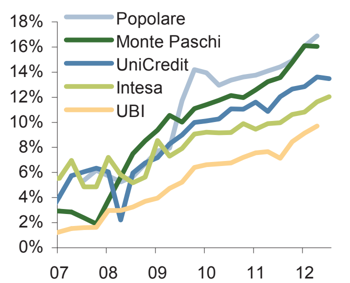
We are long Intesa, UniCredit and Monte Paschi senior.

House price correction was muted
House price index, 100 = FYE 2008



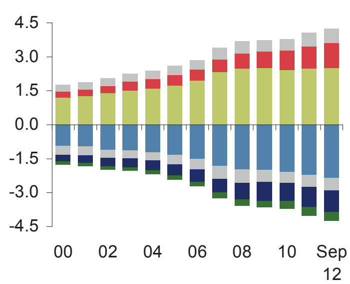
Source: RBS Credit Strategy, ECB

NPLs are high but rising slower
Non-performing loan ratio, %



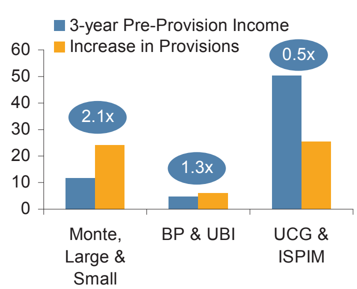
Source: RBS Credit Strategy, Bloomberg

Italian banks are smaller
Italian banks balance sheets, €tn



Source: RBS Credit Strategy, ECB

No bad bank: provisions moderate
Capital needs vs earnings, €bn



Source: RBS Credit Strategy, Bloomberg

Italy is a low-leverage economy. Italy has a public debt problem, but its total debt is among the lowest in Europe, including household, corporate and bank debt. Italian households have not stretched their balance sheets as much as other countries within Europe. Italian mortgage debt is just 19% GDP – among the lowest in Europe – vs 63% in Spain and around 40% in France and Germany. Similarly, banks in Italy did not grow as fast and are now 258% of GDP, vs 340% across the Eurozone and 400% in the periphery. Consequently, Italian banks are under less pressure to deleverage.

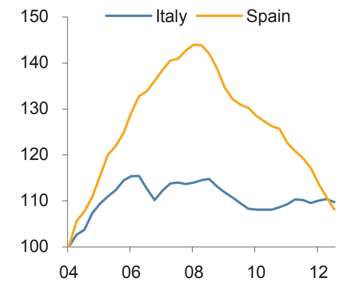
Stable real estate means asset quality is better, but coverage ratios are declining. In contrast to other periphery countries like Greece, Ireland and Spain, house price growth in Italy over the past decade has been modest. Consequently, prices have been fairly stagnant since 2006, compared to a 25% fall in Spain and 50% in Ireland. NPLs have always been relatively high in Italy, given that Italian banks use broader definitions when referring to NPLs (including some loans more than 30 days past due, rather than 90 days for most other Eurozone banks). However, NPLs are rising at a much slower rate at around 10-20bp per month for UniCredit and Intesa, compared to around 30-40bp per month in Spain. Declining coverage ratios are also a concern: the average for the Italian banking system is 37.7% as of June 2012, down from 49.4% in 2007, according to the Bank of Italy's latest Financial Stability Report. However, this is in part due to a shift in the make-up of non-performing loans away from doubtful ("sofferenze") loans and towards substandard, restructured and past due loans, which require fewer provisions. In addition, coverage ratios are lowest among the smaller banks (those with fewer than €3.6bn of assets), at just 25.1%, compared to 40.3% at the top 5 banks.

Monte Paschi is the weak link among the large banks. Most of the Italian banks are well-capitalised, with CT1 ratios well above 10%, despite the deterioration in asset quality. NPLs are still rising, but at a much shallower pace when compared to Spain. As a result, even though asset quality is deteriorating, the Italian banks are generally still able to retain sufficient earnings to continue rebuilding capital. The exception is Monte Paschi. As at Q3 2012, the bank has a CT1 ratio of 10.8%, albeit this includes €1.9bn of capital (the Tremonti bonds) from the state. Monte was the only Italian bank to be identified as having a capital shortfall at the EBA stress tests in Q2. Monte also faces a far more rapid deterioration in asset quality than other Italian banks, with NPLs (including watchlist and past due) up €1.4bn (+1.2%) QoQ in Q3.

State support for Monte will continue. The Italian government will likely continue to support Monte Paschi, given as much as anything the cultural and historical capital the bank has (it is the oldest bank in the world, founded in 1472). Monte is around the same size as Bankia, with around €230bn in total assets vs around €290bn for Bankia, but is much smaller as a proportion of GDP (around 13% for Monte vs 27% for Bankia), so it is less costly for the government on a relative basis.

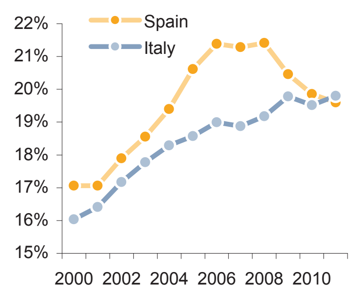
Does Italy need a bad bank? We think not. While NPLs continue to increase, overall the pace is slower (+10-20bp per month) than faced by the Greek, Irish or Spanish banks (+30-40bp per month). We stress test the Italian banks with a 40% increase in NPL ratios over the next 3 years and increasing coverage ratios to 60% for doubtful, 30% for substandard, 20% for restructured and 12% for past-due loans. The total increase in provisions is €64bn. However, Intesa and UniCredit could more than twice cover any rise in provisions from increasing NPLs or coverage ratios through earnings alone. This results in combined provisions for Monte Paschi, the Large (€21.5bn+ assets) and Small (€3.6-€21.5bn) banks of around €24bn (the Minor banks and non-banks we assume would not be rescued by a bad bank), half of which would be covered by earnings, assuming a conservative Pre-Provision Income-to-Total Assets ratio (in line with the worst-performing banks). As a result, uncovered provisions of €12bn (around 0.5% of GDP) over 3 years do not require a bad bank, in our view.

Drastic house price falls in Spain
House prices, 2004 = 100



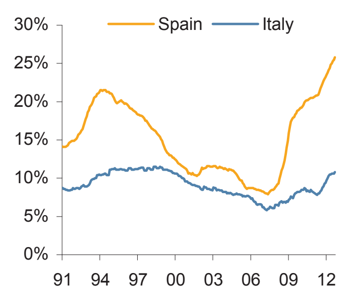
Source: RBS Credit Strategy, Bloomberg

Spanish construction shrank
Construction and real estate, % GDP



Source: RBS Credit Strategy, INE, Istat

Spain unemployment: more severe
Unemployment rate, % labour force



Source: RBS Credit Strategy, Eurostat

Spain vs Italy: Spain needs surgery, Italy therapy

Italy and Spain both face a deep recession and need structural reforms. Both countries will likely experience a continued recession throughout 2013, but Spain's will likely be deeper next year. The IMF forecasts Italy to contract -2.3% in 2012 and -0.7% in 2013, compared to -1.5% this year for Spain and -1.3% in 2013 (IMF | World Economic Outlook, October 2012).

Lack of competitiveness and high funding costs hurting firms in both countries. Industrial production in both countries has declined over the past decade due to lack of competitiveness, as real labour costs increased relative to core European countries. Funding costs are hurting firms in both countries, which rely on loans for around 80-90% of credit and are paying interest rates around 2-2.5% higher than firms in core Europe. As a result, bankruptcies for SMEs are rising, feeding into higher bank NPLs.

However, the structural challenges Italy and Spain face are different:

- Italy benefits from a primary surplus, a more diversified and less levered economy, but faces increasing political risk as it approaches new elections in April 2013.
- Spain's economic problems are deeper: it needs to refocus its economy away from real estate, reform its banks and control increasing regional debt.

We expect the recession to last longer in Spain. Unlike Italy, Spain experienced a far more severe property bubble, which it is still suffering from. Property prices have fallen 25% from peak, and Spanish property consultancy firm R. R. de Acuña & Asociados forecasts prices to fall another 12% in 2013, even with an optimistic GDP growth forecast of +1.4%. Structural weakness from the housing and construction sectors will compound the cyclical downturn and mean the recession is much deeper and longer in Spain than in Italy, in our view. Pre-crisis these two sectors together accounted for over 21% of GVA, but this has now shrunk to around 19%. The adjustment process has left the Spanish economy with significant spare capacity (capacity utilisation: 72%) and high unemployment (25.8%), which will weigh on domestic demand and growth for several years, as well as on Spanish banks.

Fiscal challenges are more urgent in Spain

Primary surplus allows Italy more flexibility on timing of austerity. Italy is running a primary surplus of around 0.8% of GDP, which the IMF forecasts to rise to 2.6% in 2012 and 3.6% in 2013. Public debt is higher in Italy, at 120% of GDP in 2011, and as a result interest payments drag the budget into an overall deficit of -3.8%. However, its primary surplus gives Italy more time and flexibility to make fiscal adjustments relative to Spain, which must reduce its 2011 -8.9% deficit to within -3% by 2014. The EC Autumn Forecast estimates Spain's 2014 budget deficit at 6.4% GDP, while the IMF forecasts Spain's total public debt to rise to over 100% by 2014.

Regional debt weighs more on Spain. Spain's central government debt (€618bn) is around 58% of GDP, compared with 120% in Italy. However, adding regional (€151bn) and local authority debt (€36bn), public debt rises to around 75%. The regions account for around a third of Spain's 2011 public deficit and add nearly 20 points to Spain's Debt/GDP ratio, compared to around 7 points in Italy. The Spanish government continues to support the regions. For example, the €18bn Regional Liquidity Mechanism (FLA) guarantees regional debt issuance (Spain Regional Liquidity Mechanism, 13 July 2012). As a result, uncontrolled regional deficits and spiralling debts are a much more significant problem for Spain than for Italy, given their size.