MARKET FLASH

LA FRANÇAISE – 29 May 2018

ITALIAN TURBULENCE:
THE CONTAGION BETWEEN COUNTRY RISK AND THE FINANCIAL SECTOR

Tensions on Italian government bond yields have rapidly affected the debt issued by the country's private sector. Despite the recent progress of the Italian banking sector in terms of solvency and reduction of outstanding bad loans, it is mainly financial sector debt, and in particular subordinated debt, which has been impacted. Finally, the historical link between the financial sector and government debt remains significant, which is understandable.

As at 29 May, the credit spreads of the Markit indices “iBoxx EUR Financials Italy” and “Germany” have risen respectively by 102 bp and 20 bp since the beginning of the month. The average spread of the “Iboxx Contingent Convertible Developed Market” index (benchmark corresponding to CoCos additional Tier 1 debt) edged up from 335 bp to 472 bp with a performance of -4.9% for the index over the period.

The contagion between country risk and the financial sector can be seen at various levels.

Firstly, the rating agencies assess the credit quality of a financial institution based in part on country risk. **Moody's has just placed Italy’s rating under negative watch, which could have an impact on the rating of certain financial institutions in the event of a downgrading of the government rating.**

In addition, **banks and insurance companies generally hold local public debt, which links them financially to its performance**. Thus, UniCredit holds around €51bn in Italian government securities for a CET1 (Common Equity Tier 1) equity base of €47bn. This gives the UniCredit group a capital buffer of €13.9bn compared to the regulatory requirements. In other words, the bank could theoretically suffer a net loss of more than €13bn (i.e. a 27% loss on the €51bn held) without this jeopardising its compliance with the ECB's regulatory requirements or calling into question coupon payments on Additional Tier 1 CoCo bonds.
Similarly, at the end of March, Intesa Sanpaolo held €29.9bn in Italian sovereign securities (excluding securities held within its insurance subsidiary), and a capital buffer of €14.6bn in excess of regulatory requirements. **The Italian issuers on which we are positioned are therefore sufficiently capitalised to absorb a much larger shock on Italian government debt than that which we have just experienced.**

Today, the **capital buffers of the main Italian banks and insurance companies are significant**, especially in view of regulatory requirements and previous crises. Indeed, excluding the scenario of a restructuring of Italian public debt, these buffers are largely sufficient to absorb a significant decline in the valuations of the country’s sovereign securities. In addition, the latest results published are reassuring and for several quarters have followed a positive operating trend for banks (disposals of non-performing assets and improved profitability), while Generali continues to improve its solvency margin (211% at the end of March 2018). Lastly, **a significant portion of this outstanding public debt is recorded as "Held to maturity” in the banks' portfolios and therefore does not affect their income**

statement or their equity. The volatility of Italian sovereign securities may therefore weigh on the profitability of the banks, as this has an impact on their financing costs, and therefore on their net interest margin, but this does not currently produce a significant balance sheet effect.

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