The total direct and contingent costs of EU membership that explains why the UK must extricate itself from EU institutions
THE TRUE COST OF EU MEMBERSHIP

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Bob Lyddon & Gordon Kerr

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Bob Lyddon

The direct and contingent financial costs of continued EU membership

Mainstream media coverage of the costs of UK membership of the EU has concentrated heavily on the Brexit battlebus figure of £350 million per week. The actual present direct cost of net UK membership fees plus other direct membership costs is approximately three times this figure. In addition, the UK (along with other ‘wealthy’ EU nations), is exposed to contingent liabilities of over £1 trillion.

The author recognises that however the actual shape of Brexit turns out, the benefits of the changed arrangements should be assessed against the costs of the changes and the costs of doing nothing. The narrow purpose of this paper is merely to itemise the costs, direct and contingent, of the UK’s present EU membership.

Broadly the analysis below takes into account explicit EU membership fees, cost to the Exchequer of economic migration, certain other directly attributable tax costs, plus the UK’s contingent liabilities that arise by virtue of its shareholdings in various EU financial institutions which themselves appear to have exposure to further ‘one off’ expenditures such as ripples in the Italian banking millpond. The author recognises that this is a cost-only analysis; there may be benefits from the array of proposed transitional arrangements which may compare favourably - when combined with tariff and trade consequences - with these costs, but the author believes it is important to calibrate these costs.
Direct costs of EU membership borne presently by the UK are £51 billion per annum as tabulated below:

<table>
<thead>
<tr>
<th>Source</th>
<th>Annual Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>EU Member State Net Cash Contribution</td>
<td>£9 bn</td>
</tr>
<tr>
<td>EU economic migration</td>
<td>£30 bn</td>
</tr>
<tr>
<td>EU tax efficient business models</td>
<td>£10 bn</td>
</tr>
<tr>
<td>Dutch tax practices</td>
<td>£2 bn</td>
</tr>
</tbody>
</table>

For more detail... http://globalbritain.co.uk/brexit-papers/

Onshoring of EU tax efficient business models after Brexit will, in addition, cause £10 billion more to be spent in the UK by the same multinationals who have adopted them. These models are where UK-derived profits are sucked into Member States like the Netherlands, Ireland and Luxembourg via aggressive intercompany charging, royalties, loan payments and so on, leaving a large but low-paid UK workforce with minimal spending power, and many graduate-level jobs and the associated investments and expenditure in the other Member States.

Furthermore, if the UK ceases to be bound by the Treaty on the Functioning of the European Union, it will cease to be liable for the debts of any of the 3 ECLFs (EU Contingent Liability Funds):

- responsible for the EU Budget;
- a shareholder in the European Central Bank;
- a shareholder in the European Investment Bank.

The EU Budget is legally established on a ‘joint and several’ liability basis, meaning that (albeit highly unlikely) in extremis the UK (or a narrow group of, say, the UK, Sweden, Netherlands and Germany) could be billed for the entire Budget, and for the entirety of the duration of the Multiannual Financial Framework. Even where the UK has a limitation of liability on paper – as with the European Investment Bank - international creditors look to the UK as one of the countries able and willing to render “extraordinary support” – beyond the contractual limit.

Should the UK terminate its membership of the EU and cancel its shareholdings in the ECB and EIB, UK taxpayers will be relieved of €1.3 trillion of liabilities, less approximately €40 billion of loans that the European Investment Bank has made into the UK, responsibility for which
the UK would have to assume. These figures are of course based on an extreme case whereby all other EU parties default on their joint and several commitments. Nonetheless, the UK’s maximum exposure is truly €1.3 trillion less the €0.04 trillion of loans made by EIB to UK entities.

**Deteriorating risk profile of the European Institutions**

The risk-profile of the EU’s financial engagement is far from static. Through the European Fund for Strategic Investment (the “EFSI”), the EU has started lending into Greece again, notwithstanding that country’s ongoing difficulties. Such loans are underwritten by all solvent EU Member States (not just Eurozone members who are parties to the two bailout funds from which Greece has received money – the EFSF and the ESM.)

The EFSI is actually not a fund at all but the European Investment Bank lending more money, in this case partially under the guarantee of the European Union. This means that, if the Greek borrowers do not repay EFSI loans, the EFSI’s losses are debited to the EU Budget and credited to the European Investment Bank to make it whole. The EU Budget thus absorbs any future losses on these Greek loans and, since the EU Budget is a joint-and-several liability of all the Member States, the UK has, through this mechanism, exposure to the Greek bailout and these fresh loans. The UK was in a similar fashion a party to the bailout of Ireland and Portugal through the European Financial Stabilisation Mechanism.

New financial threats should be considered in this analysis. We can today observe the problems of the Italian banking industry which will inevitably increase the size and triggering likelihood of UK exposures to all three ECLFs (EU Contingent Liability Funds).

**Subsidising the welfare bills of other EU Member States**

The main use of UK cash payments to the EU, and of the loans taken up by other EU Member States supported by UK guarantees, is essentially to subsidise government expenditure, such as infrastructure and welfare bills, in those other Member States. This has two components:

- Funding or guaranteeing public spending that neither the Member State’s own tax base nor its borrowing capacity will sustain;
- Causing public spending to be correspondingly reduced here.
At the same time, 3 million citizens of other Member States are presently living in the UK, and predominantly at earnings levels not high enough to deliver the tax revenues needed to cover the cost of the UK public services supporting them. In a sense some EU Member States could be said to have exported the net welfare cost of outward migration to the UK, less the costs they suffer supporting inwards migration from the UK to their countries.

The UK is thus exposed to the net cost of inward migration in two ways:

1. Increased public spending bill in the UK thanks to increased demand from net inwards migration from EU member states;
2. Funding or guaranteeing these same EU Member States’ domestic public services, the cost of which has already been reduced to the extent of their net outward migration.

**Authority and control over UK Financial Liabilities**

There is an issue with the role of unelected EU officials. The way in which Greece has been authorised to access EFSI money is a prime example of how the system presently works. In effect, EU officials whilst probably genuinely trying to help Greece recover are, wittingly or otherwise, increasing the financial liabilities of the UK, Germany and the small number of other large and supposedly solvent EU member states. Safeguards may have been agreed to limit Greece’s access to new EU money, but EU officials have oftentimes circumvented safeguards.

**Insulating the UK from further bailouts**

It may be some time before Greece, Ireland and Portugal visibly again default. In the meantime, the UK remains at risk of having calls for cash imposed via EU decisions governed by Qualified Majority Voting procedures. Under such a system the UK has in effect no power to resist such new liabilities.

The UK remains an attractive source of financing for the other EU Member States. The UK is the second largest EU net contributor and is regarded, alongside Germany, as the most prosperous of Member States.
Insulation from potential new problems, for example Italy

Outside of the calculations above, all solvent EU member states risk new financial exposures, which we believe are likely to stem from latest developments concerning Italian banks. Italy’s government is committed to a path that they term “recapitalisation” of the Italian banking system. Up until the recent problems at Banca Monte dei Paschi di Siena (“BMPS”), the Italian banking industry had stated that it planned to fund this recapitalisation from its own resources and via “market-based” transactions. Now the Republic of Italy has stated that it plans to borrow an extra €20 billion itself, partly to shore up the books of BMPS, the rest to be used to support “market-based” recapitalisations of several other banks.

As at the date of writing it is uncertain whether the €20 billion will be sufficient to solve the problems of BMPS and, if it is, how much will be left over to “recapitalise” other banks.

Unicredit – another bank that had been identified by banking regulators as having weaknesses in its profitability, capital buffers and provisions for bad loans – recently completed a large rights issue, raising over €12 billion. At the same time it may not have been at all clear to investors that this entire amount had already been written off by the bank in the context of two projects named in the Rights Issue Prospectus, namely the “Porto” and “Fino” projects.

Under these projects Unicredit achieved two things:

1. Sold off a portfolio of Non-performing loans but required to write them down further from the value at which they were being held in the accounts of Unicredit prior to the sale, in order to meet the terms set by the buyer i.e. the buyer considered the value of the loans to be well below their “carrying value” in Unicredit’s accounts;
2. Reduced the “carrying value” of another portfolio of Non-performing loans that it has retained on its books. Now Unicredit has written the value of the loans down to less than their earlier “carrying value”.

Whether these measures truly cleanse Unicredit of poor loans is uncertain:

• Over 22% of their entire loan book in Italy is classed as “Non-performing and past due” or worse;
• There may be further loans that are already “past due” but not yet reaching the further trigger for them to be classed as “Non-performing” as well;
• There may be further loans that are classed as Performing because measures like grace periods and capitalisation of interest have been used;
• The above only applies to the loan book in Italy: if the credit process was so poor in Italy, there can be no certainty that a better credit process was in place in its group banks in Germany, Austria and Central & Eastern Europe.

These are big banks that it owns, and the way in which the parent bank accounts for its ownership is by showing the share capital of those other banks as an asset in the Unicredit S.p.A. balance sheet, in an amount of €112 billion, whereas Unicredit S.p.A.’s capital is only €46 billion, and it has a further €250 billion of customer assets as well: normally a bank should deduct the value of its holdings in other banks from its own capital and only have the remnant available to it to support customer assets of its own. However if this rule – agreed upon in the second Basel capital accord – were applied to Unicredit S.p.A., it would have a capital deficit of €66 billion from its holdings in other banks alone, with absolutely no capital available to support customer loans of its own.

The rights issue does little to improve the financial status of Unicredit S.p.A. other than to bring the “carrying value” of its loans down towards their realistic value. The issue does nothing at all to improve the status of its banks outside Italy.

“Recapitalisation” of banks does not alleviate underlying situation

Italy is over-indebted at every level. New money flowing into Italy since 2011 has almost without exception come from one of the ECLFs (EU Contingent Liability Funds), as listed on page 1 above, and it is not unreasonable to suppose that the cost of recapitalising Italy’s banks will eventually fall on these three ECLFs. The actual cost of any general “recapitalisation” will likely thus ultimately fall on the shoulders of the large solvent member states such as UK, Netherlands and Germany, absent action to preclude this. The specific plans of which we have recently become aware appear to target the ECB and therefore holders of euros in the first instance as the source of new money.
The Italian banking system is uniquely insolvent. Operating in an economy that has been consistently static or shrinking, it is highly fragmented and poorly governed, and notably very reluctant to write off non-performing loans.

Italian banks admit to holding €360 billion of “non-performing loans”, equivalent to 17% of their balance sheets. According to the European Banking Authority, as of June 2016 Italian banks were 97% leveraged, i.e. only 3% of their balance sheets were funded with capital. Even applying an optimistic 50% recovery rate to the 17% of assets classified as non-performing would infer that a realistic valuation of these NPLs was in June 2016 equal to 8.5% of Italian bank balance sheets.

Given that it is 97% funded by debt, this national banking system is deeply insolvent, with a capital shortfall of 5.5% of total assets in respect just of non-performing loans.

In addition, under global Basel rules it needs further capital to support the performing loans. The Basel rules dictate that this must be the higher of (a) 12% x the “Risk Weighted” (adjusted downwards) figure, or (b) (under the Leverage ratio) 3% x the gross 83% of asset figure. We do not know the risk weights, but under the Leverage Ratio this means a minimum additional capital injection of 3% x 83% = 2.79% of the assets classified as performing.

So the system has a deficit of 5.5% regarding non-performing loans, and a further 2.79% regarding performing loans, meaning an overall deficit of 8.29% of the system’s assets. In other words it requires new capital of 8.29% of total system assets to return to solvency.

Even this calculation makes a major assumption – that the performing loans merit treatment as such, and merit the banks having only 2.79% of capital compared to the nominal value of the loans. That is a very big assumption.

“Recapitalisation” of the Italian banking system

Gordon Kerr of Cobden Partners has contributed below a detailed analysis of the Italian banking regulators’ and the political elite’s “market based recapitalisation solution” which has been carefully structured over the last two years.
This solution involves new laws and a brilliant understanding by this Italian supervisory elite of the global bank regulatory capital rules as well as of the ECB bank support rules. The reader will see that it is perhaps validly described as the strongest evidence of the insolvency of Europe’s banking system since the 2008 failures triggered by the collapse of Lehman Brothers. One point on causality; the Lehman collapse did not cause the banking failures in Europe, it revealed the insolvency of Europe’s banks.

**Italy’s Solution to the problem of non-performing Loans: recapitalisation of Banca Popolare di Bari S.c.p.A. – by Gordon Kerr of Cobden Partners**

**a) The Context**

Italian financial and government authorities have been aware for some time that many of its banks are not only insolvent, but also have loss-making business models. Few of these banks have any credible hope of generating sufficient profit to offset the losses they are carrying and obviously the bulk should be put through a bail-in and then bankruptcy process as stipulated by current European banking rules.

The Italian banking authorities admit that the sector is carrying €360 billion of non-performing loans, and, as stated above, this is 17% of total system assets. No developed country’s system has ever recovered from such a level of losses, and Italy’s economy will remain in the doldrums until Joseph Schumpeter’s entreaties to submit these failed banks to creative destruction are embraced.

The ‘recovery’ plans recently published in the Rights Issue prospecti of both Unicredit and Monti Dei Paschi (MPS) are very similar and contain three main elements:

a) Sell NPLs to ‘cleanse fully’ (see below) their balance sheets;
b) Increase profits from high net worth customers whilst reducing services to other customers who will have to undertake more self-service for routine banking needs;
c) Close branches and dismiss staff.

The template now presented is the model for implementing (a) above, and has been prepared from analysis of Italy’s first NPL securitisation, for Banca Popolare di Bari S.c.p.A., (together with two banks that were merged into
it: Banca Tercas S.p.A. and Banca Caripe S.p.A.). This template is now hardwired and is highly likely to be replicated by any banks which the Italian financial authorities select for continued existence. It is also highly likely that, to maintain the appearance of sound governance, a small number of banks will be ‘let go’ by these authorities.

b) Banca Popolare di Bari (BPB) – structuring details

The first step is that BPB sells its portfolio of “non-performing loans” to a Special Purpose Company, and the SPC pledges the portfolio to raise the money to buy it.

The loans are “non-performing” in the extreme; not a single euro of cashflow has been generated by any of the portfolio of loans for between 1 and 16 years. All of the loans are in foreclosure but collection efforts have been so tardy that only 29% have reached even the first stage of Italy’s glacier paced legal recovery process.

Moody’s warn that this 29% number is a “negative” ratings feature. 36% of the loans are unsecured, and a fair proportion of them are to insolvent companies which enjoy limited liability status. Such loans are therefore entirely worthless. The precise percentage of unsecured loans to limited liability companies is not specified in publicly available documents, but 81% of all the borrowers are companies.

If, as a rough measure, we assume that the secured / unsecured ratio applies across all of the collateral, then 81% x 36%, equal to 29% of the portfolio (not to be confused with the 29% figure for slow enforcement above) is entirely worthless and should have been written off long ago. These loans should not have been included in this securitisation transaction because there is no hope of any recovery, and no serious accountant or finance director of a bank would regard them as assets.

The Special Purpose Company (SPC) finances 94% of its costs including the purchase price of these toxic assets from BPB by selling a bond back to BPB and also drawing down other funds from BPB.

This bond that BPB buys back from the SPC is then guaranteed by the Republic of Italy. Italy’s sovereign credit rating is actually one notch lower than the rating of the bond. Therefore, although market investors might
derive some extra comfort it would not be much. We say “would”, because investors are unlikely ever to be offered any of these senior ranking bonds. That would defeat the purpose of the securitisation “recapitalisation” plan for Italy’s banks. The purpose of this buy back is, as disclosed in BPB’s 2015 Annual Report, to - under the global bank regulatory capital (Basel) rules - transform the asset from “complete write-off” to “top quality” in the books of BPB such that it can be refinanced with freshly printed ECB cash. The structure is described as a ‘market transaction’ because:

i. it bears the hallmarks of a classic securitisation, with the SPC’s liabilities being tranched into four slices; and
ii. the subordinate tranche, or “B bond”, is purchased by genuine arm’s-length market investors. The ‘B’ bond is analysed below.

To repeat, the bond BPB buys back is the senior or ‘A’ tranche. Its terms are not market-based. The ‘B’ bond ranks junior to it, and is the only tranche that is market-based. Then, ranking junior to the ‘B’ bond are two further classes of capital, neither of which are “market” transactions either:

1. Italy’s Atlante fund puts in a sliver of junior debt, the “J note”, which ranks below the ‘B’ note. This is about 6.5% of the SPV’s financing.
2. BPB itself donates €8.8m, or about 6% of the SPC’s financing. This is described as “collections”. Being the most junior tranche, it should be called equity – but then BPB would be the owner of the SPC and would not be able to reverse the non-performing loans out of its balance sheet.

Despite the presence of a 10% mezzanine or ‘B’ bond, it is absurd to describe as a “market recapitalisation” a transaction displaying the following features:

a) the NPLs are not sold at a market price. The EU “approves” the price at a level sufficiently close to the already written-down level on BPB’s books such that any further reduction in BPB’s regulatory capital caused by the further write-down is more than offset by the regulatory capital kickback (see below);
b) the NPLs are sold by BPB essentially to itself. BPB provides 94% of the SPC’s financing requirements and retains 85% of the risk; the 9% difference represents frictional costs such as fees. Such frictional costs are extremely high for debt deals, a further burden on these struggling banks;
c) the reason that the regulatory capital benefits apply is because Italy has passed a law allowing the state to guarantee senior ranking securitisation...
bonds ONLY where the underlying collateral is comprised entirely of non-performing loans;

d) the ratings agencies, whose reputations were wrecked in the subprime CDO markets 2008-2010, then asked for forgiveness having taken “mea culpa pleas” and were given a second chance by European authorities, are up to their old tricks. They have based their ratings on recovery rate projections substantially more optimistic than actual recovery rate data suggests, according to independent experts in Italian bankruptcy judicial and voluntary recovery processes;

e) the market activity solely relates to the ‘B’ bond – some 10% of the transaction. However, the bargaining power is so heavily in the investors’ hands that they have been able effectively to siphon off the lion’s share of the cashflow that these toxic assets are likely to generate; i.e. the ‘B’ bonds are effectively structurally superior to the ‘A’ bonds.

So, although the structure is primarily a sham, a circular transaction, there is some genuine market involvement to the extent of the 10% ‘B’ bond.

c) Banca Popolare di Bari (BPB) – siphoning value to Mezzanine (B bond) investors

The basic appeal of the ‘B’ bond is straightforward. The judicial enforcement process and the third-party collateral recovery process is generating, for now, a recovery rate of (we estimate) around 7% - 10% per annum of the written down value of the outstanding debt. Despite the ratings agencies’ confidence that such a recovery rate will be maintained for 20 years, the authors consider it quite likely that the rate will reduce over time.

The ‘B’ bond, also a floating rate note, bears a coupon of Euribor plus 6% p.a. on 10% of the SPC’s liabilities. Nearly all hedge funds invest with leverage. Any hedge fund taking the view (not unreasonably) that the Italian and ECB monetary authorities (i) are willing to do whatever it takes to prevent the systemic collapse of Italian banking (on the grounds that that would in turn destabilise the euro itself); and (ii) therefore they will furtively support the BPB template, will see the appeal of such a coupon, particularly if the fund can leverage its investment.

If the hedge fund is able to fund 70% of its investment via the burgeoning prime brokerage market at a cost of 1% p.a., and provided that the transaction survives even for just under 6 years, the investor will have
received coupons equivalent to all its risked capital. Every coupon beyond that is pure profit. If ECB life-support operations keep the mezzanine tranche still breathing at eleven years, the leveraged hedge fund investors will just about have doubled their money (see cashflows below, for simplicity we assume Euribor is zero, rather than minus 0.2%).

Nobody expects the ‘B’ bond ever to receive any repayments of bond principal, because for any such payments to be made the ‘A’ bond would have to be fully redeemed at par - which the market regards as extremely improbable. But this does not matter much to the incentives for the investor in the ‘B’ bond. If the SPC collapses after say only 8 years, the ‘B’ bond investor - a leveraged hedge fund investor in this example (assuming the coupons are always 6% for simplicity) – will have received returns equal to 140% of its equity invested:

<table>
<thead>
<tr>
<th>B Bond Leveraged Investment; Total</th>
<th>100</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equity</td>
<td>30</td>
</tr>
<tr>
<td>Borrowing</td>
<td>70</td>
</tr>
</tbody>
</table>


<table>
<thead>
<tr>
<th>Year</th>
<th>Coupon</th>
<th>Debt Cost</th>
<th>Net cash</th>
<th>Cumulative</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>5.3</td>
</tr>
<tr>
<td>2</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>10.6</td>
</tr>
<tr>
<td>3</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>15.9</td>
</tr>
<tr>
<td>4</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>21.2</td>
</tr>
<tr>
<td>5</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>26.5</td>
</tr>
<tr>
<td>6</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>31.8</td>
</tr>
<tr>
<td>7</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>37.1</td>
</tr>
<tr>
<td>8</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>42.4</td>
</tr>
<tr>
<td>9</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
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<tr>
<td>10</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>53.0</td>
</tr>
<tr>
<td>11</td>
<td>6</td>
<td>0.7</td>
<td>5.3</td>
<td>58.3</td>
</tr>
</tbody>
</table>

Although conventional bond terminology and properly-drawn structure diagrams correctly label the ‘B’ bond as ranking junior to the claim of the ‘A’ bond in the event of the SPC’s insolvency, this subordination will bite the ‘B’ bondholder only in the event of a sharp change in the expected pattern of collections.

For example, if the collection rate falls below a performance trigger,
payments of interest to the ‘B’ bond are suspended. However, for so long as the collection process progresses more or less at its present rate, and because the coupons of the A and ‘B’ bonds are paid simultaneously, the ‘B’ bondholder enjoys de facto superiority over the claims of the supposedly senior ‘A’ bondholder.

Let us explain. The ‘B’ bond pays a coupon of Euribor plus 6% per annum (first coupon believed to be 5.8%). This is nineteen times the 0.3% coupon presently being paid on the ‘A’ bond. Even when we look at the absolute cashflows in the chart below, and even though the ‘B’ tranche is sized at only 10/85 of the (A+ B) total bond issuance, ‘B’ bondholders receive 2.27 times the amount of total cash disbursed - by way of periodic interest payments - to ‘A’ bondholders.

In this way, the reader can understand why there is strong appetite among market investors for the B bonds. ‘B’ bondholder’s interest payment claims are so large not only in pro-rated, but also in absolute, terms with respect to the ‘A’ bond, that B bondholders will hoover up the bulk of the total amount of cashflow that the collection process can reasonably be expected to generate in the median (in probability terms) range of expected circumstances.

<table>
<thead>
<tr>
<th>Financing size</th>
<th>€100 m total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pro Rata Entitlement to cash Ignoring Legal Subordination</td>
<td>Total Annual Coupon Cash to all</td>
</tr>
<tr>
<td>B Bond 10%</td>
<td>€600,000</td>
</tr>
<tr>
<td>A Bond 85%</td>
<td>€255,000</td>
</tr>
</tbody>
</table>

The ‘A’ bondholder only receives repayment of principal, on any coupon date, when the collections exceed the combination of this €835,000 figure PLUS all the ongoing operating costs of the SPC (which in these NPL transactions are exceptionally high). What they actually add up to is detail that does not matter. The central expectation is that some ‘A’ bond principal payment will likely take place, but it will be modest. Even the optimistic rating agencies expect only 5% per annum. Furthermore, to the extent that ‘A’ bond principal is repaid, so the differential between ‘A’ and ‘B’ coupon payments widens, thus increasing the de facto seniority of the ‘B’ bondholders claims to future current cashflow.
Whenever the structure collapses, the ‘B’ bondholder’s return, even on an unleveraged investment basis, is in the vast majority of reasonably predictable circumstances likely to exceed the return to ‘A’ bondholders. The ‘B’ bond investment analysis is thus a play both on the timing of the collapse of the structure, and on the ‘shape’ of the collections mapped over time.

d) ‘B’ bondholders’ risks

The ‘B’ bond’s payout is exposed primarily to changes in the collection “shape”:

a) ‘B’ bond’s worst case is if collections drop almost immediately below the trigger level of 90% of the undisclosed “base case scenario”. In this event ‘B’ bond coupons will be suspended and the ‘B’ bond will genuinely be subordinate;

b) Conversely, if for example, the authors are proved completely wrong and Italy’s banks spectacularly return to rude health overnight because all of the borrowers quickly establish successful small businesses, restore their personal and corporate financial health and speedily repay these loans at the written down price of the collateral pool, we might expect the collection rate to be 33% in each of the next three years. In such circumstances the ‘B’ bond investor would earn a total return for only three years of (ignoring NPV calculations for simplicity) 18% plus the return of principal, an IRR of 6% (unleveraged), but only over three years. Still, not a bad – even if short lived - investment in today’s challenging low yielding environment.

c) However, if collections chug along at more or less the present rate for, say, 8 years and then tail off rapidly and stop altogether, generating massive losses for the ‘A’ bondholder, the ‘B’ bondholder does rather well and for about twice the duration in the case set out above at b). If, for example, the investor was leveraged 70% debt and 30% equity (as per the first chart above), the ‘B’ bondholder receives a total return of 140% of his investment. But of course the B bondholder will almost certainly never receive a cent of cashflow classified as “repayment of principal”. For that to happen, the A bond will have to be fully repaid. But the B bondholder does not care about that; despite technically losing all his principal, in the 8 year collapse scenario, he will have received cashflows equivalent to the return of all of his principal plus interest equivalent to an IRR of about 8%.
e) Why are ‘B’ bondholders So Advantaged? None of the Italian Transaction Parties Care About Losing Nearly All of their Money

How has this structure, so heavily skewed to the benefit of ‘B’ bondholders, been agreed by all the parties? Well, quite simply, none of the three Italian parties to the transaction, BPB, the Italian government, and the Atlante II Fund, care about losing nearly all their money. BPB as sole ‘A’ bondholder does not care: it is not motivated to do this transaction for any normal banking reason such as funding or discounting of receivables. All it seeks to do is to window-dress its balance sheet for now and hope that, at some point soon, the ECB will allow these highly-rated ‘A’ notes to qualify under its collateral rules for repurchase agreement.

We understand that NPL Asset-Backed Securities (aka NPL ABS) are not part of the ECB’s current programme of buying Asset-Backed Securities (also known as QE). However, NPL ABS will qualify as eligible collateral for ECB repurchase agreement funding as long as the second best rating accorded to them by a Credit Rating Agency is “single A”. This is not applicable to BPB’s ‘A’ bond since the rating is only Baa1 but may apply to Unicredit and others if the senior note is rated single A or better. If and when this happens, the Italian financial elite will enjoy a Eureka moment as the NPL problem will be transferred directly onto the printing press of the ECB and hence will be borne by solvent holders of euros throughout the Eurozone (including solvent Italians).

Neither does the ‘J’ note holder - Atlante - care about either losing all its money or the structural superiority of the hedge funds holding the ‘B’ bonds (as explained in next section).
The only party to the entire structure that can legitimately be termed a market participant is the ‘B’ bondholder. This piece of the puzzle was created purely for the “market solution” spin to pass muster with easily-duped mainstream media.

Although ‘B’ bondholders will receive no payments of principal until the ‘A’ bond has been fully repaid, ‘B’ bondholders don’t care much about that either. Nobody in the financial markets, including all prospective investors in the expected future swathe of replica ‘B’ bonds for Monte dei Paschi, Unicredit and so forth, expects more than a modest proportion of any of the principal of the ‘A’ bond to be repaid because the collateral quality is so poor.

To a far greater extent - now that interest rates are close to zero - than with sub-prime CDOs a few years ago, this new wave of Italian NPL securitisations will demonstrate that the combination of ratings agencies, bank regulatory capital rules, near zero interest rates and derivatives will divert all of the government and central bank cash support for poor mortgage borrowers/ailing Italian banks very quickly into the pockets of hedge funds, their prime brokers (investment banks) and the professional firms (lawyers and accountants – remember the 9% frictional costs) and new issuance investment banking firms associated with these heavily engineered and lawyered structures. And the rush is about to start.

No serious participant in the global capital markets believes that either Banca Popolare di Bari or Banca Monte Dei Paschi have any prospect at all of returning to solvency; the market activity represented by this 10% voluntary investment in the mezzanine securitisation tranche is additionally a play on the probability of governments and central banks supporting structures such as these by maintaining and probably increasing the provision of liquidity support to banks irrespective of their insolvency. If this support dries up and the Italian banking system suffers a ‘reset’ it is highly probable that asset prices will fall which will reduce expected collections on the collateral below even our modest present expectations.

The “Rule Gaming” Engineering Behind the Two Bonds

Now we will look at the transaction diagrammatically and step-by-step.
Recapitalisation – Step 1

The first step in the “recapitalisation” is to establish the Special Purpose Company – the “SPC” – to purchase the collateral and issue the new debt which effectively replaces BPB’s present funding. BPB transfers to the SPC:

- The non-performing loans, valued at €148.2 million, the same amount as they are valued in BPB’s books;
- The €8.8 million of “collections”;
- A liquidity loan of €4.2 million.

It is false to describe the €8.8 million as “collections”; these are sums of money that BPB has managed to realise from the borrowers and the security through its own efforts of debt collection. If the loans were being sold off for €148.2 million in a genuine “market”, arm’s-length transaction, BPB would already have booked the “collections” amount to its own profit & loss account as “Amounts recovered on non-performing loans”.

This €8.8 million is, in truth, simply an injection of equity, sized by the optimistic models recently created by the ratings agencies as sufficient to generate the desired ratings on the ‘A’ and ‘B’ notes. Had the ‘A’ note not achieved at least the rating level actually awarded, it would not have qualified for the Italian sovereign guarantee essential to cleanse BPB’s balance sheet.
The €8.8 million is not a debt owed to anyone; as a result it functions as equity, the first-loss cushion should the assets of the SPC prove inadequate to meet its liabilities. If the reality of BPB’s 100% equity injection into the SPC was recognised by its accountants, BPB would be treated as owning the SPC and should consolidate the SPC into its accounts – but that would reverse the rationale of the transaction. To avoid this undesirable outcome the dishonest pretence is maintained that for some reason these prior “collections” belong to the SPC. But that interpretation lacks any shred of credibility.

Likewise, it is unclear why BPB has to make the loan of €4.2 million to the SPC, other than to create a larger equity cushion beneath the other tranches of capitalisation, so that those other tranches receive better credit ratings: BPB is injecting this loan into the SPC at a level junior to the bond that the SPC issues back to it, in order that the bond get a better rating itself, have the Republic of Italy guarantee attached to it, and eventually qualify for ECB funding.

**Recapitalisation – Step 2**

Having taken on an asset – the NPLs of €148.2 million – and contracted a liability of €4.2 million and a first-loss cash deposit of €8.8 million, the SPC has to make its balance sheet balance. This it does by issuing three bonds, totalling €150.5 million and all ranking senior to the first-loss cash deposit and to the BPB loan:

<table>
<thead>
<tr>
<th>Bond type</th>
<th>Amount</th>
<th>Investor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Senior ranking ‘A’ Floating Rate Note</td>
<td>€126.5 million</td>
<td>BPB itself</td>
</tr>
<tr>
<td>Mezzanine ranking ‘B’ Note (FRN also)</td>
<td>€14.0 million</td>
<td>Hedge Funds</td>
</tr>
<tr>
<td>Junior ranking ‘J’ Note</td>
<td>€10.0 million</td>
<td>Atlante II</td>
</tr>
<tr>
<td>BPB loans</td>
<td>€4.2 million</td>
<td>BPB</td>
</tr>
<tr>
<td>First-loss equity</td>
<td>€8.8 million</td>
<td>BPB</td>
</tr>
<tr>
<td>Total liabilities of the SPC</td>
<td>€163.5 million</td>
<td></td>
</tr>
</tbody>
</table>
Many of the Italian banks have subscribed to it, and their thinking is simple:

- If enough of them put something into the pot, none has a majority interest, so that they can each account for their stake in Atlante II as if it were a Trade Investment, and on the equity method: they can record their shares at the price they paid for them, without worrying about Atlanta II’s assets and other liabilities;
- The shares in Atlante II are unquoted so there is no market price at which they would have to be valued at in their holders’ annual accounts;
- Even if the capital ratio on the Trade Investment turns out to be 100%, their share investment is for a relatively small amount in terms of their overall balance sheet: this side of it is immaterial to them.

The important point is that, if €10.0 million can be used (as in the BPB transaction) to eliminate Non-performing loans with a “market value” of €148.2 million and a nominal value (or Gross Book Value) of €471 million, the industry has developed a model for eliminating balance sheet items on a ratio of 15:1 on Market Value and 47:1 on Gross Book Value, items that are tying up the capital base of the banking system - €148.2 million of capital in BPB’s case. With €100 million of funds in Atlante II there can be an extinguishing of Non-performing loans to a Market Value of €1.5 billion and a Gross Book Value of €5 billion, freeing up €1.5 billion of capital.

With €20 billion of funds – the amount that the Italian government has authorised itself to borrow to recapitalise the Italian banking sector - there could
be an extinguishing of Non-performing loans to a Market Value of €300 billion, and a Gross Book Value of €1 trillion and a release of €300 billion of capital. It is understood that a part of this €20 billion will be injected directly into BMPS and not made available through an Atlante II-style structure, so these figures are given as an illustration of what could be achieved. The precise purpose to which the Italian government €20 billion will be put remains unclear.

Atlante II will almost certainly lose all of its money. Not a single euro even of interest will be paid to J bondholders until the B Bond principal is repaid in full. As explained above, B bond investors expect to lose all their “principal”.. Since the contributing Italian banks’ stakes in Atlante II are Trade Investments and not loans, these cannot become non-performing loans.

If twenty banks each put €5 million into Atlante II and it has €100 million of funds, and that is used up in the “recapitalisation” of 15 banks, not all of the transactions will go bad and certainly not all at once. Atlante II can be kept alive for 25 years without its owners having to adjust the value of their stakes – which are small compared to their own balance sheet footings anyway - and so any present problems have been tucked away until 2041, while the benefits of the appearance of enhanced Risk Weighted Asset metrics for each supported bank are immediate.

Recapitalisation – Step 3

The final elements of the transaction both protect the SPC and enable this magical change of capital treatment for BPB:

Banca Popolare di Bari – Recapitalisation (3)

Lastly, the Republic of Italy guarantees the ‘A’ FRN and JPMorgan provides an Interest rate “Cap” to the SPC, protecting it against any rise in interest rates...
Since all of the bonds issued by the SPC are on a floating rate of interest, JPMorgan will pay out to the SPC in every period where the floating rate (LIBOR) exceeds the figure agreed in the contract. That is commercially prudent. This protection has been purchased to protect only the ‘A’ and the ‘B’ bonds: there is no illusion that the SPC will ever have the money to service the ‘J’ bonds, so there is no need to protect the SPC from a cost escalation in servicing them.

Then the Republic of Italy adds its guarantee to the ‘A’ Floating Rate Note owned by BPB. In effect this means that BPB can now regard the ‘A’ bond as a “sovereign risk” obligation, and ascribe capital to it in the same proportion as it would have ascribed to the “Collections” when they were held by BPB in cash, which means held putatively in an account at the Banca d’Italia. When a bank has “cash” in the sense of a credit balance in an account in its own name, it is normally held in its account at the central bank, and the capital adequacy treatment will be the same as on:

- physical cash (which is an obligation of the central bank);
- bonds issued by or guaranteed by the government of the same country.

The ‘A’ bond – like physical cash and a balance on a central bank account – counts as “central bank money” because it is an obligation of the Republic of Italy or of its agency (the central bank) and definitionally it is one denominated in its own currency. “Central bank money” assets are regarded as risk-free and therefore meriting a capital adequacy of less than 1% of their nominal value.

### BPB Asset and Capital position BEFORE:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Nominal</th>
<th>Capital quotient</th>
<th>Capital needed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-performing loans</td>
<td>€148.2 million</td>
<td>100%</td>
<td>€148.2 million</td>
</tr>
<tr>
<td>“Collections” at Banca d’Italia</td>
<td>€8.8 million</td>
<td>0.09%</td>
<td>€0.007 million</td>
</tr>
<tr>
<td>Totals</td>
<td>€157.0 million</td>
<td>n/a</td>
<td>€148.2 million</td>
</tr>
</tbody>
</table>

### BPB Asset and Capital position AFTER:

<table>
<thead>
<tr>
<th>Asset</th>
<th>Nominal</th>
<th>Capital quotient</th>
<th>Capital needed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Floating Rate Note</td>
<td>€126.5 million</td>
<td>0.09%</td>
<td>€0.108 million</td>
</tr>
<tr>
<td>Loan to SPC</td>
<td>€4.2 million</td>
<td>8.5%</td>
<td>€0.357 million</td>
</tr>
<tr>
<td>Totals</td>
<td>€130.7 million</td>
<td>n/a</td>
<td>€0.465 million</td>
</tr>
</tbody>
</table>
BPB must charge off an extra €26.3 million as a loss, since its Assets reduced from €157.0 million to €130.7 million. But that is a small price to pay compared to the nub of the transaction, which is the amendment of the Basel Risk Weighted Asset metrics primarily used to assess the capital adequacy of each bank.

The quantum of capital needed to demonstrate solvency under Basel Rules reduces by €147.7 million. Whatever the actual quantum of capital that BP Bari claims to use in its present liability funding mix will post transaction appear to be sufficient to support its assets, making the bank now appear solvent when it was not before.

Naturally this is a complete sham, a series of accounting tricks to delude the European Central Bank, the European Banking Authority, the media, political and financial leaders in multiple other EU member states, and probably the banks themselves. The prime movers are the stakeholders in Atlante – the Italian banks themselves acting in a concert party. They can achieve a capital relief in a proportion of 147.7/10, a relief unavailable from normal sources (i) recoveries on the debts; (ii) realisation and sale of security held; (iii) profits after tax on other banking business; (iv) issuance of new shares. The non-performing loans remain non-performing and are not improved upon by anything in this transaction.

**Capital adequacy treatment of the A Bond with a guarantee from the Republic of Italy**

These transactions hinge on the subject banks being able to view the Senior floating rate note guaranteed by the Republic of Italy as risk-free, but this is clearly not the case when Standard & Poor rate the Republic as a BBB- credit, meaning containing “Moderate credit risk”.

As we explain below, the correct capital quotient against an asset rated BBB- would be nearer 8.5%, and not the 0.09% used in these transactions.

The Republic of Italy is doing the same here in an economic sense as buying the ‘A’ bond itself: it is taking the credit risk on the assets underlying the note. But the Republic of Italy cannot buy the FRN firstly because it has no cash itself, and secondly because it would have to borrow the money and then go even further out of compliance with its commitments under the EU Fiscal Stability Treaty – so it issues a guarantee instead.
This template will be valid for all the recapitalisations: the Republic of Italy would guarantee the written-down, or net book, value of the assets, but its funding of the deals will be less than 10% of that amount because:

- All funding will have to first be borrowed;
- All such borrowings impact their compliance with the Fiscal Stability Treaty;
- They can get away with borrowings below 10% of the whole, but not of 90%.

Just to recap (excuse the pun!)

The situation before this “recapitalisation” was that Banca Popolare di Bari (“BPB”) owned, in gross value terms, €471 million of non-performing loans. Definitionally that means loans where it is 90 days or more since the non-payment of a scheduled loan instalment and/or of interest.

In the case of BPB these are loans which in some cases have been non-performing for many years, and which have been made to borrowers across southern Italy and Sicily. Supposedly 63.4% of the loans are secured, and on real estate, and the DBRS credit rating report on the transaction p3 states that “The property portfolio securing the loans is diversified in terms of property type. The largest property type concentrations include: residential properties (approximately 45.1% of open market value - OMV), industrial (27.0% of OMV), commercial (9.5% of OMV) and hotel (6.3% of OMV).”

The question arises as to why, if the security is so good, BPB did not foreclose on it years ago and sell it to pay off the written-down loans. The truth may lie in three places (i) the slow pace of Italian bankruptcy proceedings means that even a first mortgage does not constitute readily forecloseable security; and (ii) foreclosing and selling the security would either drive its value down, or else there is no market for the security at close to the valuation ascribed to it by BPB; and (iii) the banks would be shown overtly to be deeply insolvent if they did this.

BPB has recognised that these loans are non-performing. They have written them down from their gross value to a 32% value in their accounts; €471 million has been written down to the €148.2 million “market” price at which the loans are sold to the securitisation Single Purpose Company (SPC), however it is highly unlikely that these loans could have been sold
for this 32% price. If that were possible, why go to these convoluted lengths and incur all these external securitisation costs?

One main purpose of the securitisation is to game the regulatory capital rules. The non-performing loans tie up capital to the same value at which they are held in the books of BPB: €148.2 million. This contrasts with the average capital that banks should hold against a Performing loan of 8.5% of its nominal amount. The aim of the securitisation is to ‘release’ the bulk of that €148.2 million capital in order to feign solvency.

Rather than recapitalise, this transaction actually decapitalises – the capital allocated to the bonds is much less than that allocated to the NPLs. BPB is free to spend that capital in wages or on anything else – like making further loss-making loans. This “securitisation” is not a market transaction. It is simply an accounting trick to fiddle the bank’s official measure of solvency: its ratio of capital to assets.

**BPS as a ‘carcass bank’**

The term ‘zombie bank’ was used after the 2008 crisis for banks whose situation was such that they could not attract deposits, could not raise new capital and so could not make new loans: the banks were in a stasis.

However, as moviegoers know, ‘zombies’ move. BPB is a ‘carcass bank’, in existence because terminating it is politically inconvenient, so it is allowed to persist as a burnt-out hulk. Within the carcass a certain proportion of its loans are still accounted for as ‘performing’. But the bank is lifeless and motionless. The borrowers’ position remains unchanged. Much creativity has been required for BPB’s non-performing loans to be restructured so that BPB does not have to be liquidated. The question next to be posed is how much creativity is needed in order to keep the ‘performing loans’ accounted as such within the carcass, and this is explored later.

**Response of the European authorities**

As stated, the Republic of Italy’s plan to borrow a further €20 billion will see it go even further out of compliance with the EU’s Fiscal Stability Treaty.

If not BPB, then the other, larger banks involved (like Monte dei Paschi) will attempt to offer the ‘A’ Floating Rate Notes – which are guaranteed by
the Republic of Italy – as collateral to the European Central Bank for new
funding.

Perhaps these plans will be foiled by the European authorities at some
point, European authorities’ disquiet being driven by objections from the
German Finance Minister, Dr Schaueble. This problem is just too big and
too public for a conjuring trick to be the solution to it. Perhaps the plans
will succeed despite these objections.

What happens if these plans are foiled by the European authorities?

If Germany/ the Bundesbank successfully object, then the house falls
down. The fear of this outcome will be the main driving force behind
any decision of the European authorities yet again to turn a blind eye. If
the plans are allowed through we will expect rapid euro debasement and
eventual currency collapse a la Argentina within two or three years.

If the European authorities block the plan the collapse will be more or less
immediate. As and when the house falls down the European Central Bank
will see the value of its current collateral against all of its loans to Italy
collapse, and the loans of the European Investment Bank into Italy will
default:

• The ones to SMEs made through the main Italian banks will default
  because those banks will have defaulted on other obligations, and the
  EIB loan documents contain a cross-default clause;
  • The EIB and EFSI loans to Italian borrowers and projects will either
cross-default at once or default over time as the borrowers cease to be
  able to pay.

The EIB will call the guarantees it has from the EU regarding the EFSI, and
those calls will be paid out of the EU Budget.

Both the ECB and the EIB will experience losses that they do not have the
capacity to absorb – both being highly leveraged on their capital already.

So we are looking at an impasse, and then a collapse, and the necessity
for a proper write-down of the value of claims on borrowers: not just a
re-shuffle and re-accounting, but a new contract under which the borrower
has to pay back a lot less than under the current contract. It is then the
trading counterparties and lenders who have to write off what is owed to them.

The knock-on inference of that is that any country with an exposure to Italy – either commercial through trade, direct financial by holding Italian securities, or indirect financial by having banks with exposures there and by being a shareholder in institutions with exposures there – is at risk of catching a very bad cold when it becomes clear what the size of the problem is and that it is too gargantuan for the Italian government to deal with, or to be dealt with behind the closed doors of the ECB and the European Commission.

Bills will be issued to the Member States to recapitalise the ECB and EIB. Extra bills will be sent to Member States by the EU to cover the calls on the EIB guarantees out of the EU Budget.

Sources of the UK’s existing exposure to Italy

The UK’s existing exposure to Italy arises from several sources.

The first is commercial: British companies trading there, owning trade debts or relying on sales into Italy under Single Market access.

The second is through our banks, which will have exposures to Italian banks and other borrowers.

The third is through our reliance on banks for the functioning of our own financial markets – like Deutsche Bank or BNP-Paribas – who have substantial Italian businesses, BNP-Paribas’ being through their subsidiary Banca Nazionale del Lavoro.

Then we have the UK’s exposure to Italy through the EU financial mechanisms.

The European Central Bank, in which the UK is a shareholder, is funding the Italian central bank through various money-market operations and through the TARGET2 intra-central bank settlement system, thus permitting the Italian central bank to fund the Italian private banks through money-market operations:
• All money-market operations are collateralised;
• ECB operations with the Italian central bank are collateralised with Italian government bonds, a form of security which encapsulates “correlation risk”, namely that the borrower and the security they offer have the same credit risk;
• Operations with private banks are secured on collateral with credit ratings as low as BBB-, but since the bonds of several EU Member States are BBB- or lower, why should the European Central Bank not accept bank or corporate bonds better rated than ones it counts as risk-free on the grounds that they are government bonds of Eurozone Member States?

The European Investment Bank has ratcheted up its lending into Italy since the first Eurozone crisis, as well as into Spain. Over the period from the Eurozone crisis until 2014, these countries were the biggest EIB borrowers, despite the reduced access that the sovereign borrowers in the same countries had to the capital markets. The loan amounts are in € billions:

<table>
<thead>
<tr>
<th>Nr</th>
<th>Country</th>
<th>% 11-15</th>
<th>2014</th>
<th>% 2013</th>
<th>% 2012</th>
<th>% 2011</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Spain</td>
<td>+20%</td>
<td>€86.7</td>
<td>+8%</td>
<td>€80.6</td>
<td>+7%</td>
</tr>
<tr>
<td>2</td>
<td>Italy</td>
<td>+13%</td>
<td>€67.5</td>
<td>+3%</td>
<td>€65.6</td>
<td>+7%</td>
</tr>
</tbody>
</table>

The figures for new loans signed in 2015 were:

<table>
<thead>
<tr>
<th>Nr</th>
<th>Country</th>
<th>New signed loans in 2015</th>
<th>% of EIB total</th>
<th>2014</th>
<th>% of EIB total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Spain</td>
<td>€11.9 billion</td>
<td>+15%</td>
<td>€11.9 billion</td>
<td>+15%</td>
</tr>
<tr>
<td>2</td>
<td>Italy</td>
<td>€10.9 billion</td>
<td>+14%</td>
<td>€10.9 billion</td>
<td>+14%</td>
</tr>
</tbody>
</table>

These loans, whilst they are mainly public sector debt, are not lent to the sovereign borrower, such as the Republic of Italy or the Kingdom of Spain. Instead they are advanced to regional or municipal authorities, or to limited liability companies that are owned by one or more such authorities, or they are made to commercial banks for on-lending to SMEs. Thus the UK, by being a shareholder in the EIB, has an exposure to the Italian banking system via the EIB’s SME loans, and to the Italian economy as a whole.

On top of this we have the EIB’s increasing lending in the context of the European Fund for Strategic Investments (“the EFSI”). The EFSI’s most recent report on its new lending had:
- Numerous projects where the destination of funds was stated as “EU countries”, which could be Italy – or Greece – or anywhere;
- A long list of projects specifically in Italy, such as:

<table>
<thead>
<tr>
<th>Project name</th>
<th>EFSI funding (€ million)</th>
<th>Total funding (€ million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arvedi Modernisation Programme</td>
<td>100</td>
<td>194</td>
</tr>
<tr>
<td>Trenitalia Regional Rolling Stock</td>
<td>300</td>
<td>617</td>
</tr>
<tr>
<td>2I Rete Gas Smart Metering</td>
<td>200</td>
<td>415</td>
</tr>
<tr>
<td>Novamont Renewable Chemistry</td>
<td>15</td>
<td>93</td>
</tr>
<tr>
<td>Raffineria di Milazzo</td>
<td>30</td>
<td>225</td>
</tr>
<tr>
<td>Societá Gasdotti Italia - Gas transmission</td>
<td>44</td>
<td>88</td>
</tr>
<tr>
<td>Toscana energia gas Network &amp; Metering</td>
<td>90</td>
<td>151</td>
</tr>
<tr>
<td>Autovie Venete A4 widening</td>
<td>120</td>
<td>887</td>
</tr>
<tr>
<td>Euromed RORO</td>
<td>200</td>
<td>501</td>
</tr>
<tr>
<td>ISP Risk Sharing Initiative for SMEs &amp; Mid-caps</td>
<td>100</td>
<td>280</td>
</tr>
<tr>
<td>Aimag settore idrico e ambiente</td>
<td>59</td>
<td>119</td>
</tr>
<tr>
<td>Banca del Mezzogiorno Loan for SMEs &amp; Mid-caps</td>
<td>50</td>
<td>140</td>
</tr>
<tr>
<td>Dolomiti Energia Networks &amp; Hydro II</td>
<td>100</td>
<td>171</td>
</tr>
<tr>
<td>MM Water Infrastructure Upgrade</td>
<td>70</td>
<td>246</td>
</tr>
<tr>
<td>Italian Green Bond Fund</td>
<td>40</td>
<td>Undisclosed</td>
</tr>
</tbody>
</table>

What is wrong with the European authorities stepping in where the markets have failed?

The private Italian banking system is clearly not able to provide this funding:

- They cannot raise the money themselves because of investor concerns about the banks’ ability to repay;
- The private Italian banks cannot take the loans on their books because they have inadequate capital to support them: 8.5% of the loan amount in Tier 1 capital and 2% of it in Tier 2 capital, under Basel rules;
- In other words the private Italian banks do not have either the 10.5% of capital or the remaining 89.5% in deposits, so as to make the loans.

The Republic of Italy cannot fund these loans, because of its own poor credit rating, and it is limited in increasing its own direct borrowings because of the EU Fiscal Stability Treaty. They are supposed to be reducing debt – to 60% of GDP by 2030 – and not increasing it.
The only source of new money is the EU, but the EU has no money of its own. The only source is the as-yet unexhausted credit of the major EU countries that have good credit ratings (like Germany, Netherlands, the UK, and Bulgaria) who have been made to stand behind the financial mechanisms of the EU and enable them to borrow from international investors and on-lend to Italy, Greece and so on.

Have the Markets Failed?

The EU authorities regard the lack of access of Italian banks and borrowers to new loans as a “market failure”, whereas actually it is a market success, in precluding the growth of risk in the organisations that might otherwise have expanded their lending into Italian banks and borrowers.

The real failure is the lack of recognition of the reason for the €360 billion of non-performing loans that exist in the Italian banks: it is called the non-performing Italian economy. Both private individuals and businesses are generally over-indebted, meaning they cannot:

1. Pay back their own loans, contracted directly; or
2. Pay increased national taxes so that the Republic of Italy can reduce its debts to 60% of GDP;
3. Pay increased municipal and regional taxes so that the EIB’s loans outside the context of the EFSI can be repaid;
4. Pay the fares, levies and charges so that the EIB’s loans within the context of the EFSI can be repaid:
   a. More journeys and higher train fares to pay for “Trenitalia Regional Rolling Stock”;
   b. More gas usage and higher prices to pay for “Societá Gasdotti Italia - Gas transmission”;
   c. More driving and higher motorway tolls to pay for “Autovie Venete A4 widening”.

The meaning of €360 billion of non-performing loans is that the economy cannot sustain the current loan volume, let alone more.

Losses of “assets” for providers of funds

The current recapitalisation plans for the Italian banks do not provide a relief of the debt burden on the economy: they are an accounting trick for
the banks to feign compliance with Basel rules and get more funding from the ECB.

In the situation as it exists on the ground, a genuine “recapitalising” of the private banks would have to mean real losses booked by providers of funds. In the first instance one should look to:

- Depositors having more than €100,000 in the bank;
- Suppliers of levels of capitalisation in the form of Tier 2 capital;
- Shareholders (like the ones who have been gulled into making new investment in the Unicredit rights issue).

These investors would lose all or part of an asset. In other words if the asset is part of a pension fund and is written down by 40%, the fund’s asset is now worth €150,000 and not €250,000, and can sustain annual drawings of €5,000 and not €9,000: the investor just had their pension cut in half.

If that is politically unacceptable, one has to look to public authorities to take the loss on behalf of their citizens:

- The Republic of Italy, by buying new shares, or compensating depositors above the €100,000 limit – but where do they get the money from without breaking the Fiscal Stability Treaty or other EU Directives, and can they get the money anyway?
- The EU mechanisms themselves: the ESM by providing new money, or the ECB, EIB or EFSI by taking a write-off on their current loans?

The Italian crisis is much larger than the Greek one, and the Italian economy is not capable of full repayment with interest on existing loans, as the Greek economy is not. €360 billion of non-performing loans is probably an optimistic number, given the way in which banks calculate the capital adequacy on their loans.

The question is whether the UK needs still to be in the room when the contributions are demanded.

**Who will be first to the court house?**

In a situation where a loan goes bad, banks use the phrase “first to the court house”, meaning being the first bank to call the loan in default and to
initiate legal action for recovery, the first to foreclose on security and to get free possession of it.

Where there is a loan facility available, calling it in default at least means that the undrawn amount cannot be borrowed. These are the basics of limiting risk. The UK’s situation in the EU is just this one: the UK could be called upon to make a financial contribution simply because it is party to a treaty, but there is an exit clause in the treaty which makes no reference to residual liabilities. A lending banker would trigger the exit clause immediately and put a stop on the liability.

The losses on Italy could be booked at the European level, in the EU Budget, in the ECB or in the EIB. Global investors are not going to take a hit on funds they have lent to the EU or the EIB, so losses made at the EU or the EIB can only be allocated to one place: the EU Member States. The ECB has the right to allocate losses it makes back to its shareholders: the EU central banks and through them to the Member States.

Why €360 billion of non-performing loans will not be the bottom line

One of the fallacies of the last 8 years has been the recapitalisation of the European banking system. The rules of the central bankers – issued through their own bank called the BIS based in Basel – have certainly been tightened:

- Extra tests on banks’ liquidity, by making them hold higher amounts of “High-Quality Liquid Assets” (the BIS defines what constitute these types of asset, but not what constitutes their degree of liquidity);
- Larger percentages of each type of risk the bank takes on, to be visible on the bank’s balance sheet as either Tier 1 capital (meaning shareholders’ funds and similar first-loss funding) and Tier 2 capital (meaning second-loss funds, like subordinated debt).

The new quotients for this latter test – so-called “capital adequacy” – are that a bank must use at least 10.5% of capital in its liability funding mix, and that at least 8.5% of this capital should be in the form of Tier 1 capital, and no more than 2% as Tier 2 capital.

The residual problem lies in what was not changed, namely that most Western banks are permitted to “risk-weight” their assets according to formulae that they have designed themselves:
• This is applied to all forms of risk: credit risk, market risk and operational risk;
• Banks have to show a methodology to their own auditor and to their supervising institution;
• Its effect is universally to under-weight every risk position, to show it as being less risky than the Basel ‘standard’ treatment, which is not risk-weighted;
• The bank in question is thus enabled to hold less capital and looks more profitable.

In any bank there is a natural tension between the Business Development teams and the Credit Assessment teams that “support” them:

• Business Development comes up with a loan opportunity, and does an initial write-up: they rate the loan a ‘7’ and propose a loan margin of 1.05% - the interest margin stated in the Loan Pricing Manual to pay for the capital needed to support the loan;
• Credit Assessment do their work, rate the loan a ‘10’ and say the loan margin should be 2.21% because that is what the Loans Pricing Manual says;
• There is a discussion, the loan is approved as an ‘8’ and the loan margin agreed with the borrower as 1.05% (instead of the 1.30% that the Loan Pricing Manual says should be charged on an ‘8’).

In this way and repeated over hundreds of loan applications, the average quality of the loan portfolio is compromised, as is its profitability.

Facility Risk Rating and Credit Conversion Factor

The example given above of a Business Development team and a Credit Assessment team negotiating, is based around the processes of Facility Risk Rating (“FRR”) and Credit Conversion Factor (“CCF”) in action.

Banks run a methodology where each loan is assigned an FRR, and in the illustration below it is an FRR on a scale between 1 and 23, because each one corresponds to a notch in the Standard & Poor credit rating system, from lowest credit risk to highest.

The FRR represents the likelihood of the bank making a loss on the loan, derived from:
1. An assessment of the strength of the borrower in isolation;
2. An assessment of the risk in the loan security, terms and structure.

Each FRR delivers a CCF, which is the factor by which the nominal amount of an asset is multiplied to deliver its amount as a Risk-Weighted Asset, or RWA. The RWA is then multiplied by 8.5% to determine the Tier 1 capital that must be held. The CCF can be as low as 1% (it is very rarely zero),

There is a strong economic incentive for banks to under-rate the risks they are taking:

- It then appears that they have enough capital and even a surplus;
- They can get more new business because the loan margin they have to charge is lower;
- They appear to be profitable;
- Loans are rated between 12 and 15 even when the borrower is teetering on the edge of bankruptcy, because, until the loan goes “Past Due”, it remains the bank’s judgement call as to what the credit risk and capital adequacy are, as opposed to the bank’s Accounting Policy.

<table>
<thead>
<tr>
<th>FRR</th>
<th>CCF</th>
<th>Status</th>
<th>S&amp;P long-term</th>
<th>S&amp;P narrative</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1%</td>
<td>Performing</td>
<td>AAA</td>
<td>Minimal credit risk</td>
</tr>
<tr>
<td>2</td>
<td>4%</td>
<td>Performing</td>
<td>AA+</td>
<td>Very low credit risk</td>
</tr>
<tr>
<td>3</td>
<td>8%</td>
<td>Performing</td>
<td>AA</td>
<td>Very low credit risk</td>
</tr>
<tr>
<td>4</td>
<td>13%</td>
<td>Performing</td>
<td>AA-</td>
<td>Very low credit risk</td>
</tr>
<tr>
<td>5</td>
<td>20%</td>
<td>Performing</td>
<td>A+</td>
<td>Low credit risk</td>
</tr>
<tr>
<td>6</td>
<td>29%</td>
<td>Performing</td>
<td>A</td>
<td>Low credit risk</td>
</tr>
<tr>
<td>7</td>
<td>43%</td>
<td>Performing</td>
<td>A-</td>
<td>Low credit risk</td>
</tr>
<tr>
<td>8</td>
<td>59%</td>
<td>Performing</td>
<td>BBB+</td>
<td>Moderate credit risk</td>
</tr>
<tr>
<td>9</td>
<td>78%</td>
<td>Performing</td>
<td>BBB</td>
<td>Moderate credit risk</td>
</tr>
<tr>
<td>10</td>
<td>100%</td>
<td>Performing</td>
<td>BBB-</td>
<td>Moderate credit risk</td>
</tr>
<tr>
<td>11</td>
<td>130%</td>
<td>Performing</td>
<td>BB+</td>
<td>Substantial credit risk</td>
</tr>
<tr>
<td>12</td>
<td>165%</td>
<td>Performing</td>
<td>BB</td>
<td>Substantial credit risk</td>
</tr>
<tr>
<td>13</td>
<td>205%</td>
<td>Performing</td>
<td>BB-</td>
<td>Substantial credit risk</td>
</tr>
<tr>
<td>14</td>
<td>255%</td>
<td>Performing</td>
<td>B+</td>
<td>High credit risk</td>
</tr>
<tr>
<td>15</td>
<td>305%</td>
<td>Performing</td>
<td>B</td>
<td>High credit risk</td>
</tr>
<tr>
<td>16</td>
<td>365%</td>
<td>Past Due/secured</td>
<td>B-</td>
<td>High credit risk</td>
</tr>
<tr>
<td>17</td>
<td>430%</td>
<td>Non-accrual/secured</td>
<td>CCC+</td>
<td>Very high credit risk</td>
</tr>
<tr>
<td>18</td>
<td>505%</td>
<td>Past Due/unsecured</td>
<td>CCC</td>
<td>Very high credit risk</td>
</tr>
<tr>
<td>19</td>
<td>585%</td>
<td>Non-accrual unsecured</td>
<td>CCC-</td>
<td>Very high credit risk</td>
</tr>
<tr>
<td>20</td>
<td>600%</td>
<td>Chapter 11/secured</td>
<td>CC</td>
<td>In or near default, with possibility of recovery</td>
</tr>
<tr>
<td>21</td>
<td>775%</td>
<td>Chapter 7/secured</td>
<td>C</td>
<td>In or near default, with possibility of recovery</td>
</tr>
<tr>
<td>22</td>
<td>955%</td>
<td>Chapter 11/unsecured</td>
<td>SD</td>
<td>In default, with little chance of recovery</td>
</tr>
<tr>
<td>23</td>
<td>1176%</td>
<td>Chapter 7/unsecured</td>
<td>D</td>
<td>In default, with little chance of recovery</td>
</tr>
</tbody>
</table>
If these are the FRRs and CCFs associated with different risk-ratings in the Standard & Poor’s system, the outcome of the FRRs and CCFs is found in the loan margin that banks have to charge in order to hit their Return on Capital target (“ROC target”). A Loan Pricing Manual shows the loan margin to be charged on the nominal amount of the loan, so that the desired ROC target is achieved on the capital to be held against the risk-weighted amount of the loan.

How a Return on Capital (RoC) target is set

A RoC target is derived from the Basel III rules on bank capitalisation and what each type of capital costs. Basel rules require at least 10.5% capital as a percentage of Risk-Weighted Assets, and this is to be composed of:

- At least 7% of common equity
- Another 1.5% of capitalisation qualifying as Tier 1
- At least 8.5% of Tier 1 capitalisation
- No more than 2% of capitalisation qualifying as Tier 2

Since Tier 2 instruments are generally subordinated debt or preference shares, and attract an interest coupon that is a spread over LIBOR, banks will express their targets in terms of returns on Tier 1 capital – which is normally an absolute number such as 25% per annum.

Tier 2 instruments bear interest on the same basis as much of the deposit base: LIBOR. The extra yield to be paid on Tier 2 capital compared to ordinary deposits is factored into the return target on Tier 1 capital, as follows:

<table>
<thead>
<tr>
<th>Factor</th>
<th>Computation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yield paid to investors on Tier 2 capital</td>
<td>LIBOR plus 4%</td>
</tr>
<tr>
<td>Yield paid on ordinary wholesale deposits</td>
<td>LIBOR</td>
</tr>
<tr>
<td>Percentage of loan funded with Tier 2 capital</td>
<td>2% x Nominal x CCF</td>
</tr>
<tr>
<td>Profit on loan needed to pay for Tier 2 capital</td>
<td>4% x 2% x Nominal x CCF = Nominal x CCF x 8 basis points</td>
</tr>
<tr>
<td>Loan pricing basis</td>
<td>LIBOR plus margin</td>
</tr>
<tr>
<td>Profit on loan needed to pay for Tier 1 capital</td>
<td>25% x 8.5% x Nominal x CCF = Nominal x CCF x 212.5 basis points</td>
</tr>
<tr>
<td>Add in profit needed on Tier 2 capital as above</td>
<td>Nominal x CCF x 8 basis points</td>
</tr>
<tr>
<td>Combined profit needed on loan to pay for capital</td>
<td>Nominal x CCF x 220.5 basis points</td>
</tr>
<tr>
<td>Loan interest where CCF is 100%</td>
<td>LIBOR plus 220.5 basis points</td>
</tr>
</tbody>
</table>
With this one can extrapolate an example Loan Pricing Manual, with the 23 FRR grades in it, the CCF corresponding to each one, the Risk-Weighted Asset amount if the nominal amount of the loan is 100, and then:

- The Tier 1 capital needed to support the loan as a percentage of the nominal amount of the loan;
- The number of basis points of margin that are needed on the nominal amount of the loan in order to meet the RoC target:

<table>
<thead>
<tr>
<th>FRR</th>
<th>CCF</th>
<th>RWA if nominal = 100</th>
<th>Capital as % of nominal</th>
<th>Loan margin needed to hit RoC ‘hurdle’</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>1%</td>
<td>1</td>
<td>0.09%</td>
<td>2.21</td>
</tr>
<tr>
<td>2</td>
<td>4%</td>
<td>4</td>
<td>0.34%</td>
<td>8.82</td>
</tr>
<tr>
<td>3</td>
<td>8%</td>
<td>8</td>
<td>0.68%</td>
<td>17.64</td>
</tr>
<tr>
<td>4</td>
<td>13%</td>
<td>13</td>
<td>1.11%</td>
<td>28.67</td>
</tr>
<tr>
<td>5</td>
<td>20%</td>
<td>20</td>
<td>1.70%</td>
<td>44.10</td>
</tr>
<tr>
<td>6</td>
<td>29%</td>
<td>29</td>
<td>2.47%</td>
<td>63.95</td>
</tr>
<tr>
<td>7</td>
<td>43%</td>
<td>43</td>
<td>3.66%</td>
<td>94.82</td>
</tr>
<tr>
<td>8</td>
<td>59%</td>
<td>59</td>
<td>5.02%</td>
<td>130.10</td>
</tr>
<tr>
<td>9</td>
<td>78%</td>
<td>78</td>
<td>6.63%</td>
<td>171.99</td>
</tr>
<tr>
<td>10</td>
<td>100%</td>
<td>100</td>
<td>8.50%</td>
<td>220.50</td>
</tr>
<tr>
<td>11</td>
<td>130%</td>
<td>130</td>
<td>11.05%</td>
<td>286.65</td>
</tr>
<tr>
<td>12</td>
<td>165%</td>
<td>165</td>
<td>14.03%</td>
<td>363.83</td>
</tr>
<tr>
<td>13</td>
<td>205%</td>
<td>205</td>
<td>17.43%</td>
<td>452.03</td>
</tr>
<tr>
<td>14</td>
<td>255%</td>
<td>255</td>
<td>21.68%</td>
<td>562.28</td>
</tr>
<tr>
<td>15</td>
<td>305%</td>
<td>355</td>
<td>25.93%</td>
<td>672.53</td>
</tr>
<tr>
<td>16</td>
<td>365%</td>
<td>365</td>
<td>31.03%</td>
<td>804.83</td>
</tr>
<tr>
<td>17</td>
<td>430%</td>
<td>430</td>
<td>36.55%</td>
<td>948.15</td>
</tr>
<tr>
<td>18</td>
<td>505%</td>
<td>505</td>
<td>42.93%</td>
<td>1,113.53</td>
</tr>
<tr>
<td>19</td>
<td>585%</td>
<td>585</td>
<td>49.73%</td>
<td>1,289.93</td>
</tr>
<tr>
<td>20</td>
<td>600%</td>
<td>600</td>
<td>51.00%</td>
<td>1,323.00</td>
</tr>
<tr>
<td>21</td>
<td>775%</td>
<td>775</td>
<td>65.88%</td>
<td>1,708.88</td>
</tr>
<tr>
<td>22</td>
<td>955%</td>
<td>955</td>
<td>81.18%</td>
<td>2,105.78</td>
</tr>
<tr>
<td>23</td>
<td>1176%</td>
<td>1,176</td>
<td>100.00%</td>
<td>2,594.12</td>
</tr>
</tbody>
</table>

The key objective is to try and develop new business that is rated 1-9, because then the Risk-Weighted Asset is smaller than the nominal asset.

At an FRR of ‘10’, the Risk-Weighted Asset is the same as the nominal asset: this equates to the risk on a security rated BBB- in the Standard & Poor system, which would be one issued by the Republic of Italy.
The average FRR should not be higher than 10 under any circumstances, and there should be great efforts exerted to ensure that no asset falls down to FRR of 18 or worse. The problem with that is that the status of a loan can no longer be disputed if it falls as low as 16 – because it is “Past Due”: http://www.investopedia.com/terms/p/past-due.asp

“Past due is a loan payment that has not been made as of its due date. A borrower who is past due may be subject to late fees, unless the borrower is still within a grace period”.

However, there is some leeway because “Past Due” is not yet “non-performing”: http://www.investopedia.com/terms/n/nonperformingloan.asp

“A non-performing loan (NPL) is the sum of borrowed money upon which the debtor has not made his scheduled payments for at least 90 days. A nonperforming loan is either in default or close to being in default”.

There is some leeway in that a three-month rollover loan where the last payment was received on 30/9/16 only goes “Past Due” on 1/1/17 and only goes onto “non-performing” on 1/4/17, 180 days after the last payment:

<table>
<thead>
<tr>
<th>Date</th>
<th>Status</th>
<th>Days since last payment</th>
</tr>
</thead>
<tbody>
<tr>
<td>30/9/16</td>
<td>Performing</td>
<td>0 days since last payment</td>
</tr>
<tr>
<td>31/12/16 – 31/3/17</td>
<td>Past due</td>
<td>90 days since last payment</td>
</tr>
<tr>
<td>1/4/17 &gt;&gt;</td>
<td>Non-accrual aka</td>
<td>180 days since last payment</td>
</tr>
</tbody>
</table>

And how does one avoid putting a loan into these last two accounting statuses:

- Agree a grace period;
- Lend the borrower the interest;
- Re-schedule the payments;
- Anything credible that stops the loan dropping into these accounting categories, because the CCF skyrockets when it goes to 16 or worse.

At FRR 23 the borrower is bankrupt and the bank has no security and no chance of making a recovery. The CCF goes to 1,176% or in other words 100/8.5: the bank has either to hold capital for the entire nominal amount of the loan or to write the loan off to zero and take a loss against
the bank’s capital of the entire loan. This was where BPB was before its “recapitalisation” transaction.

**What banks will do to avoid this accounting treatment accounting gymnastics**

The inference of this paper is that the Italian banking sector has had no choice but to account for €360 billion of loans as non-performing, but then:

- What other loans are Past-due and accounted for as such?
- What loans are kept as “Performing” by grace periods and by capitalising interest i.e. lending the borrower more in order to collect the interest from them?
- What further loans are importantly impaired as to the likely non-receipt of interest and only partial repayment of capital?
- What loans are rated 2 or even 3 FRR grades higher than the equivalent external credit rating of the loan would be?
- What is the bank’s capital deficiency after all of those adjustments?

Indeed, the BPB transaction shows an asset – a security guaranteed by The Republic of Italy – being ascribed an FRR of ‘1’ when its S&P public credit rating of BBB- merits an FRR of ‘10’. There we have an asset rated 9 FRR grades higher than justified by its external credit rating. How much more of that is there across the performing loans of Italian banks?

We have recent and very negative evidence of Italian accounting practices, and this is in the case of British Telecom. The interesting point is that the unveiling of the losses followed a well-known pattern: the bottom line is four times higher than the amount that was initially admitted to.

The loss was originally put at £140 million, but during the week of 23.1.17 the figure was revised upwards to £530 million.

**Write-offs of Italian assets owned by EU mechanisms and by Italian banks**

There are €360bn of NPLs currently admitted to as existing in Italian banks, of which €210billion are in foreclosure. The Italian government estimates that these €210billion will yield €87 billion of ‘net proceeds’, leaving a write-off of €123 billion. The Italian government also hopes that the balance of €150 billion might be coaxed back to life and could avoid the foreclosure/write-off process.
€123 billion is admitted as lost; a further €237 billion is questionable. Total sector assets are €2.1 trillion, of which the official June 2016 NPL share are 17% (360 billion / 17%) and of which 83% are classed as performing - €1.8 trillion.

Given the way in which the “recapitalisation” transactions transforms NPLs into not only performing, but completely risk free assets, and seeing how the Risk-Weighted Assets methodology is applied to replace what should be a ‘10’ on the riskiness scale with a bond guaranteed by the Republic of Italy that is classified as a ‘1’, there must be a fear that other discomforting banking practices, such as capitalising interest payments to avoid classifying loans as in default, are in use, which simply mask other asset quality problems.

The EU mechanisms have loans to Italian banks, through their SME financing programmes, and they also have direct loans to Italian borrowers. Supposedly all these loans are “performing” at present.

It is foolish to pretend that full value exists in the Italian economy against the loans extended by EU mechanisms and against the current book value of loans made by Italian banks, when Italy’s GDP is still lower than it was before the crisis, when it comes out of recession and back in again, when unemployment is 11% and youth unemployment is 39%, and when it has benefited from years or near-zero and now negative interest rates. It is a poor show when loans become “Past due” in such environment, because the loan interest is unlikely to be above 1% per annum and still the borrower cannot produce it.

And this is just for Italy. The same base situation exists in Greece (still), Malta, Cyprus, Portugal, Ireland and Spain, and can be expected to be a quantum that corresponds closely to the relationship of the debt to be written off in Italy to the size of Italy’s GDP.

We accept for this purpose that the write-down of assets in Italy is the same as the current expectations of the Italian authorities, namely €123 billion:

- This figure assumes the recoveries on NPLs do come in as the authorities expect;
- This figure does not include impairments of “performing” loans, which would increase it;
• Or losses by EU mechanisms on their lending and collateral, which would also increase it;
• And we set aside our fear that the losses could follow the pattern of British Telecom’s Italian subsidiary and be three and a half times the amount initially admitted to.

€123 billion can thus be taken as a conservative figure for the overall losses, but still it represents 6.4% of Italy’s GDP, and we can extrapolate from that the write-downs needed across the other Member States:

<table>
<thead>
<tr>
<th>Country</th>
<th>GDP in €billions</th>
<th>Quotient</th>
<th>Write-off in €billions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>1,927</td>
<td>6.4%</td>
<td>123</td>
</tr>
<tr>
<td>Spain</td>
<td>1,243</td>
<td>6.4%</td>
<td>79</td>
</tr>
<tr>
<td>Ireland</td>
<td>226</td>
<td>6.4%</td>
<td>14</td>
</tr>
<tr>
<td>Greece</td>
<td>212</td>
<td>6.4%</td>
<td>14</td>
</tr>
<tr>
<td>Portugal</td>
<td>207</td>
<td>6.4%</td>
<td>13</td>
</tr>
<tr>
<td>Cyprus</td>
<td>21</td>
<td>6.4%</td>
<td>1</td>
</tr>
<tr>
<td>Malta</td>
<td>9</td>
<td>6.4%</td>
<td>1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>245</strong></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The citizens of these countries are unlikely to enthuse about the authorities’ plans for these amounts to be written off at taxpayers’ expense.

The countries themselves cannot write these debts off because they would have to produce an amount of cash that is beyond their borrowing capacity and because of the rules of the March 2012 Fiscal Stability Treaty.

Nor will global investors who hold AAA-rated bonds of the European Union and the European Investment Bank accept a haircut on their holdings.

So where will the buck stop?

The only place where these amounts can be written off is within the European mechanisms themselves - the European Union, the European Central Bank and the European Investment Bank – because then the losses can be comfortably collectivised across all the Member States – Eurozone and non-Eurozone, Northern and Southern.
The UK’s pro-rated contribution

Since the UK represents about 16% of EU GDP and since 65% of the EU GDP counts as the EU-North GDP (i.e. the only source of funding for such EU institutional recapitalisation), the UK could be asked for a contribution 16% x 65% = 25% of the total loss, or €61 billion.

The question than arises as to whether such a contribution would diminish our other contingent liabilities of €1.3 trillion, and the answer to that is probably not.

The two entities that would be the initial place-of-booking of the losses would be the European Central Bank and the European Investment Bank. The losses would cause a call-up of the entire subscribed-but-not-called capital of both institutions, and also wipe-out the subscribed-and-called capital.

What would be needed then would be an operation to restore the capital situation of both institutions to their status quo ante, as well as to top off the difference between the losses and this amount. Both would require what Standard & Poor’s term “extraordinary support” i.e. injections of funds from the owners beyond any limitations imposed by a liability structure that is several-but-not-joint.

Initially the losses would result in the UK paying in its subscribed-but-not-called capital into both the ECB and EIB:

- ECB: €1.4 billion
- EIB: €35.7 billion
- Total: €37.1 billion

Then we would be asked to write off that amount and our subscribed-and-called capital in both:

- ECB: €0.1 billion
- EIB: €3.5 billion
- Sub-total: €3.6 billion
- Total write-off of capital: €40.7 billion
Next we would be asked, under the heading of “extraordinary support”, to reinstate our capital in the ECB and the EIB by subscribing to capital as follows:

- ECB: €1.5 billion
- EIB: €36.2 billion

But we would only be asked to pay in the same portion as before:

- ECB: €0.1 billion
- EIB: €3.5 billion
- Total: €3.6 billion

The remainder would re-instate our subscribed-but-not-called capital:

- ECB: €1.4 billion
- EIB: €35.7 billion
- Total: €37.1 billion

This amount of €37.1 billion would not be funded but would remain as a contingent liability – part of our €1.3 trillion of contingent liabilities which would remain at this figure.

Our cash contribution so far would be:

- Pay-in of current subscribed-but-not-called capital: €37.1 billion
- Pay-in of new subscribed-and-called capital: €3.6 billion
- Total: €40.7 billion

This does not fill the hole: there needs to be a €20.6 billion top-up. But the losses inside the ECB and EIB would be far deeper than would be covered by this contribution, noting also that only the solvent countries would be asked to pay in, because the insolvent countries are the cause of the insolvency of the ECB and EIB.

To plug the gap between the amount needed from the UK (€61.3 billion) and the amount the UK subscribes through the above operations (€40.7 billion), the UK would simply be asked to make a payment in against which there would be no asset or hope of a recovery.
It would be a payment demand for €20.6 billion, which might or might not go through the EU Budget. Either way the UK’s contingent liabilities under the 2013-2020 Multiannual Financial Framework would be as they were before, because the EU needs its annual budget amounts in order to continue to function. In consequence our contingent liabilities of €1.3 trillion to the EU financial mechanisms would remain as before.

Whether the amounts have to be contributed directly to the ECB and EIB – or indirectly through the EU Budget – is unimportant, because the amounts would be over-and-above current contractual commitments.

What the UK would have done is to render “extraordinary support” to the EU, ECB and EIB as Standard & Poor’s expects us to do, meaning paying in of cash and issuing of guarantees over and above what we are legally liable for now:

- Contractual - pay-in of current subscribed-but-not-called capital: €37.1 billion
- “Extraordinary support” rendered in cash and represented by Share Capital: €3.6 billion
- “Extraordinary support” rendered in the form of the reinstatement of contingent liability for subscribed-but-not-called capital: €37.1 billion
- “Extraordinary support” rendered in cash and represented by nothing: €20.6 billion
- Total cash outlay: €61.3 billion
- Remaining contingent liability: €37.1 billion

**Total costs and contingent liabilities of EU membership**

We can sum these up as:

1. Direct costs attributable to EU membership: £51,000,000,000.00 per annum (see page 2)
2. Contractual contingent liabilities to EU financial mechanisms: €1,300,000,000,000.00 (see page 2)
3. Possible amount of “extraordinary support” required to absorb Eurozone bank losses within the ECB and EIB: €61,300,000,000.00

This last figure is stated with little confidence that €245 billion represents the total impairment to the book value of Eurozone loans. It is based on
Italy’s admitted-to stock of €360 billion of non-performing loans in the books of Italian banks, the authorities’ expectations that only €123 billion will not be recovered, and does not include:

- Bad loans into Italy by the ECB and EIB in their direct operations with Italian borrowers, and in the EIB’s indirect loans to Italian SMEs made across the books of Italian banks;
- Bad loans into Italy made cross-border by other Eurozone lending organisations;
- Value impairments in loans that are currently held in the books of the Italian banks at levels above “non-performing”;
- Recoveries on the €360 billion of non-performing loans undershooting the expected €237 billion.

If the British Telecom experience is anything to go by, the total value impairment on all loans in Italy made by ECB, EIB, Italian banks and other Eurozone lenders might even exceed the €360 billion of NPLs accounted for as such in the books of Italian banks now.

Were this to be the case, the total amount of “extraordinary support” for Italy and the other Eurozone periphery countries would rise above the €245 billion extrapolated here, and the call on the UK would escalate beyond €61.3 billion.

This is not a risk that the UK should be willing to take and this is why it is the right thing to do to withdraw from the EU and insulate ourselves as best we can from these enormous liabilities, as well as from a cash cost of £51 billion per annum.

Bob Lyddon 11 April 2017
Summary of
the true cost of EU membership
The total direct and contingent costs of EU membership that explains why the
UK must extricate itself from EU institutions

- The total direct, cash costs of EU membership are far higher than the
  £350-million-a-week - £18 billion per annum - that has become common
  currency
- They are nearer to £51 billion per annum – or £980-million-a-week - if one
  counts in the cost of EU economic migration and the losses of tax revenues
  caused by the predatory tax practices of other Member States
- But far bigger liabilities for the UK are associated with our guaranteeing the
  EU Budget, and with our being shareholders in the European Central Bank and
  European Investment Bank
- These liabilities total €1.3 trillion and the likelihood of their materialising as a
  call for cash is rising
- It is rising because of the large amounts being lent out by the ECB and the
  EIB, and to deteriorating credit risks, including Greece: the UK has become
  responsible for Greece’s new debts contracted through the European Fund for
  Strategic Investments
- The main worry, though, is Italy. Not only is it receiving huge amounts direct
  from the ECB and EIB, but its banks are already struggling under an admitted
  €360 billion of Non-performing Loans (“NPLs”)
- UniCredit has announced a rights issue to raise more capital to help it deal
  with this problem, and Monte de Paschi di Siena is being bailed out with more
  borrowings taken on at the level of the Republic of Italy – which puts Italy even
  further out-of-compliance with the EU Fiscal Stability Treaty
- These home-grown efforts are unlikely to succeed in solving a problem of this
  magnitude, without further assistance from the European institutions
- That is unless the template for “market-based bank recapitalisations”, used in
  connection with Banco Popolare di Bari, can be rolled out across the industry
- This template is not market-based, it is a series of accounting tricks that
  convert NPLs into sovereign risk debt, or, put another way, convert NPLs that
  have to be matched Euro-for-Euro with capital on the bank’s balance sheet, to
  a security against which the bank has to hold almost no capital
- This alchemy is achieved by ‘gaming’ the definition of sovereign-risk debt
  against the guidelines for bank capital adequacy laid down through the Bank
  for International Settlements in Basel, known as the Basel Accords
- A security carrying the guarantee of the Republic of Italy was awarded to
  Banco Popolare di Bari in exchange for the surrender of its NPLs. The security
– which would qualify for a rating of BBB- from Standard and Poor’s and necessitate the holding of 8.5% of its value as capital – is instead held in the balance sheet as if it were risk-free (because the guarantor is a sovereign) and capital is held against it is well below 1%

• The problem is that this subterfuge will soon be seen through by other Member States as a devaluation of the euro
• At that point Italy and its banks will become insolvent and require a colossal rescue operation and one that makes no claim to retain the value of the assets held by Italy’s creditors: they will have to take a substantial haircut
• It will be politically unacceptable for Italian consumers to take that haircut, the Italian state and the Italian banks cannot afford to take the haircut, and investors in the securities of the EU and EIB will be exempted from a haircut by the guarantees their securities enjoy from the EU Member States collectively
• Instead the losses will be crystallised within the books of the EU, ECB and EIB, expunging the current capital of the ECB and EIB and rendering them insolvent: these are exactly the circumstances in which Standard and Poor’s assures investors that Member States will render “extraordinary support”
• In this case this support would result in Member States allowing their current shareholdings in the ECB and EIB to be written off and then completely re-instated with new capital subscribed and paid in
• This is unlikely to fill the hole, and there would be an extra gap to be filled. Given the parlous financial state of a majority of the EU Member States, few of them would be able to render “extraordinary support” in the quantity required, which is why the burden would fall upon the Northern Member States, in proportion to their GDP: the UK represents 25% of the GDP of EU-North
• Even if the losses in the Italian banking system are as low as the €123 billion predicted by the Italian authorities at present, out of €360 billion of NPLs currently, the Italian situation is replicated across Spain, Portugal, Ireland, Greece, and Cyprus, such that a total value impairment of €245 billion would not be unrealistic
• The UK’s share of that loss would be €61 billion
• One cannot be completely sure of either the recovery of €237 billion out of €360 billion of current NPLs that the Italian authorities predict nor, given Italian accounting practices, that €360 billion is the correct amount of bad debts
• The UK’s share of the loss could easily escalate beyond €61 billion, without reducing either our cash costs of £51 billion per annum or our contingent liabilities of €1.3 trillion, and this is why we need to leave the EU and do our best, before and after Article 50 is triggered, to insulate ourselves from the consequences of these losses
About the author...

**Bob Lyddon**

Bob Lyddon is an experienced management consultant both privately and with PwC. Recent engagements include running an international banking alliance, advising small payment providers how to access UK payment systems, and advising a major player in global payments as to the opportunities and threats arising from the establishment the UK’s Payment Systems Regulator.

With PwC Bob managed several Euro implementation programmes. Prior to that, he had a diverse 17-year career in international banking, encompassing Transaction Banking, syndicated loans, export finance and derivatives.

Bob holds a First Class degree in Modern Languages from the University of Cambridge.

**Gordon Kerr**

Gordon Kerr has a law degree from the University of Warwick and a 25 year track record in the black arts of banking; with particular focus on derivatives, securitisation, tax and regulatory capital arbitrage; together with intra-bank exposure structuring in order to exploit accounting loopholes and keep such exposures off the books of all parties to the transactions.

In 2011 Kerr set up Cobden Partners Limited in order to work commercially on the coming financial ‘reset’. Using this brand, Kerr has undertaken education and training assignments, and presented at a range of public and private events and business schools in an endeavour to promote awareness that European banking is such poor shape that it now threatens to fracture the euro itself.

Kerr is a regular lecturer at the Sofia Business School, and also a senior fellow with IREF Europe and the lead author of their monthly Newsletter on banking and central banking; http://en.irefeurope.org/-IREF-Newsletter,r0022-
Global Britain was founded twenty years ago to provide the positive business case for the UK to leave the European Union and published a wealth of research briefs and papers to that end.

Now that the argument for an outward-facing, sovereign, democratic UK has been won Global Britain is committed to ensuring that our politicians do not betray the 17.4 million that voted for it.

The Brexit Papers is a series of detailed essays designed to ask questions and provoke debate about the policies and strategies required to ensure the UK enjoys as optimal and clean a Brexit as possible. In this, the sixth, Bob Lyddon exposes the fiscal cost of EU migration and how we need to leave the Single Market to have any prospect of reducing it.

Other Brexit Papers available from Global Britain:
- Our liabilities to the EU: The biggest risk of all
  Why leaving the Single Market is the only way to avoid the huge risk from financial gambling by EU institutions
- The Single Market’s Dutch auction
  How the EU’s Single Market fosters corporate tax avoidance schemes that costs the UK billions
- The UK’s lost GDP and tax revenues
  How Single Market tax dodges cost the UK £10bn a year and make us all the poorer
- The EU’s payments paradox
  Fifteen years of incoherent legislation and value destruction – that now facilitates the financing of terrorism
- The Euro currency cul-de-sac
  Seventeen Years of broken promises – and now a dead end
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  How much could the demise of Deutsche Bank damage the UK and EU as a whole?

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  Approaches to negotiating a better use of development aid
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  Leading the world to tariff-free trade
- Why our financial services need a clean Brexit
  Only leaving the Single Market can deliver greater opportunity for UK financial services

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