# Monte Dei Paschi Recapitalization

### *Introduction*

On October 17th 2022 Banca Monte dei Paschi di Siena, the world's oldest bank, started its seventh capital raise in 14 years raising concerns among its shareholders. The bank encountered difficulties to secure large-scale commitments from investors with the Italian Treasury contributing 64% to the capital increase in an attempt to lay the foundations for a future privatization. If successful, the plan will add €2.5bn to the bank's equity which will allow it to support a costly restructuring plan including an early retirement plan for around 4,000 employees. Moreover, the recapitalization could finally be the chance for Monte dei Paschi to regain trust from investors and international institutions, after emerging as Europe's weakest lender just over a year ago. With pressure from central banks, a failed sale attempt to UniCredit as well as a negative current market environment, many investors are doubtful of the recapitalization success.

### *About Monte Dei Paschi Di Siena*

Italy-based Banca Monte dei Paschi di Siena is the oldest operating bank in the world and provides banking, financial and insurance products, as well as investment banking services offered by its subsidiary MPS Capital Services. It operates through three business segments: Retail Banking, Corporate Banking and Corporate Center. Retail banking encompasses consumer lending, insurance, financial and non-financial products for retail customers, tax planning, financial advisory and planning for private customers. Corporate Banking covers business strategies aimed at small and medium enterprises, institutions and large corporations, as well as offering lending and financial products, leasing and factoring. Finally, the Corporate Center is concerned, among others, with governance and support services as well as treasury and intergroup entries. The Bank currently has over 21,000 employees across approximately 1,400 branches and almost 4m customers in Italy. Moreover, it is considered the 5th largest bank in Italy as measured by assets.

Banca Monte dei Paschi di Siena was founded in 1472 and is considered the oldest operating bank in the world. It was constituted by the Republic of Siena to carry out the foreclosure in favor of the population's most disadvantaged classes in a particularly difficult moment for the local economy. Because of its history and its stability for over 5 centuries, the business is closely intertwined with its community. It remains Siena's largest private employer and the foundation Fondazione Monte dei Paschi di Siena, which owned the bank, donated the profits for kindergartens, ambulance services and even contributed to cultural celebrations like the city's Palio. For this reason the Italian government as well as the bank itself have been trying to keep Monte dei Paschi afloat.

### *A History of Financial Struggles*

After suffering a €1.7bn loss in FY2020, the bank was finally profitable in FY2021 with €2.7bn in revenue and is now looking at its seventh capital increase in 14 years. As a matter of fact, since the start of the European sovereign-debt crisis in 2008, Monte dei Paschi has raised over €23bn of equity through share issuing and the intervention of the Italian government's Bank of Italy. Monte dei Paschi's issues began in 2007 when, just months before the 2008 financial crisis, the lender paid €9bn cash, which was more than it could afford, to acquire Padua-based Antonveneta and become the third-largest bank in Italy, after Intesa Sanpaolo and UniCredit. In 2009, two derivative contracts from the bank's recent past, operations Santorini and Alexandria, began creating losses. In order to hide the damage the bank's top management chose to enter into alternative derivative contracts with Deutsche Bank and Nomura. In 2012, during the European sovereign-debt crisis, with declining valuations on Italian government debt, Monte dei Paschi lost almost €2bn in just half a year and had to recapitalize. During the same year, the derivatives contracts were made public to the new board of the bank and to Bank of Italy. In January 2013, they were revealed to the public, causing Monte dei Paschi to lose 20% of its value on the stock exchange in three days. Six years later, over a dozen executives from Monte dei Paschi, Deutsche Bank and Nomura were convicted. The scandals of 2013 led to a new capital increase, as well as the first bailout by Bank of Italy for €3.9bn. At the end of the same year, plans to issue €3bn worth of new shares were made but postponed to mid-2014. Together with the new recapitalization, Monte dei Paschi had to manage skepticism from the ECB, which declared it unable of withstanding a financial catastrophe.

Furthermore, between 2014 and 2016, the bank failed two ECB stress tests, leading to a plan for recapitalization for €5bn, which later failed. The ECB's stress tests are assessments of how well banks are able to cope with financial shocks. They identify vulnerabilities and can be conducted annually or as large-scale financial health checks of banks, but they can also be conducted on individual banks if necessary. In 2016, the risk types considered in the stress test included credit risk, inclusive of securitizations, market risk and counterparty credit risk, as well as operational risk. In addition, banks were requested to project the effect of the scenarios on net interest income and to stress P&L and capital items not covered by other risk types. The failure of two stress tests in three years caused a crisis for the bank, which requested a precautionary recapitalization by Bank of Italy, leading to its second €3.9bn bailout.

Since 2017, the Italian Ministry of Economy and Finance has been the majority shareholder of Monte dei Paschi. However, with the establishment of Mario Draghi's government in 2021, there have been attempts to re-privatize the bank. The most remarkable of all has been the proposed deal with UniCredit, failed due to a valuation gap between the parties. As a matter of fact, Italy's largest lender put forward requests for a €7bn recapitalization package, as well as planning 5,000 job cuts. Nonetheless, Italy remains determined to let Monte dei Paschi stand alone, and this €2.5bn capital increase could be the chance that it needed.

## *Deal Structure*

After months of negotiations and an agreement from a group of banks to underwrite the capital raise, Monte Dei Paschi di Siena launched its €2.5bn rights issue on October 17th. Out of the total, €1.6bn will be supplied by the Italian Treasury and €857m will be collected from a group of investors, including banks and asset managers. The fundraising initiative will last two weeks and end on October 31st.

Monte Dei Paschi will issue a maximum of 1,249,665,648 new shares at €2 each and 374 new shares will be sold for every three existing shares. The proposed price amounts to a 7.9% discount on the bank's ex-rights price calculated from MPS's closing share price on October 11th. In 2017, after the bank faced several scandals and significant losses the Italian government acquired a majority stake in MPS and currently holds 64.23% of the bank. Although the Italian treasury can participate in the capital raise, regulations state that the government can contribute as long as it does not increase its ownership percentage. Therefore, at the end of the fundraising initiative, the government will still own 64.23% of the bank.

The pool of banks that will engage in the capital raise includes Mediobanca, Bank of America, Citigroup and Credit Suisse and their total investment in MPS amounts to €807m. Milan-based alternative investments fund Algebris will provide €50m and additional €37m will be raised from third-party investors. Monte Dei Paschi has agreed to pay €125m in fees to the major financial institutions backstopping the issue.

## *Deal Rationale*

After losing approximately €22bn over the last 14 years, over the summer Monte Dei Paschi started searching for alternatives to raise additional capital. MPS considered a debt-to-equity swap or the potential sale of business units but eventually decided to undertake a rights issue. The bank has not disclosed how these new funds will be implemented, but several reasons explain why the additional capital is essential for MPS's restoration and success.

Financial institutions are required to hold, in addition to other minimum capital requirements, a capital buffer designed to reduce the pro-cyclical nature of lending. According to the European Systemic Risk Board, the capital buffer of European banks must amount to 2.5% of their total exposures and must be made up of Common Equity Tier 1 capital. If the buffer falls below 2.5%, the bank faces limitations regarding dividend and bonus payments. CEO Luigi Lovaglio stated that part of the new funds will be used to restore the bank's capital buffers that were negatively affected by the financial challenges MPS faced.

In June, Monte Dei Paschi's board of directors approved the new business plan for the years 2022-2026 entitled "A Clear and Simple Commercial Bank". The majority of the funds coming from the capital raise will be employed for the realisation of the plan and to boost credibility in the bank and its future initiatives. The plan aims to achieve a solid and resilient balanced sheet and reach a sustainable profitability level. One of the cost-saving strategies the bank is planning to implement is a voluntary exit plan, which will see more than 4,000 employees leave MPS. This is expected to result in MPS saving €270m every year starting from 2023.

Furthermore, finance minister Daniele Franco told parliament that the capital raise is a prelude to the future bank's privatisation. After saving the bank from bankruptcy in 2017 by acquiring a majority stake, the Italian government has been urged to privatise the bank by the European Union. Last year, Italy missed the deadline for MPS's privatisation because a deal with UniCredit fell through at the last minute. Although it asked for a delay, the government must show steps to the European Commission that it is serious about privatising the bank.

## *Future Outlook*

Although on October 25th the European Central Bank approved Monte Dei Paschi's rights issue, there are still several doubts and concerns regarding the legitimacy and transparency of the fundraising activity that might lead to an authorisation withdrawal. Brussels officials are worried that the capital raise would constitute illegal state aid. This is because the eight major underwriters, including Citigroup, Bank of America, Credit Suisse, Mediobanca, and Algebris will share a €125m payment for contributing to the capital increase. Also the other third-party investors will receive "commission fees" to reduce their risk exposure. Investors argue that these fees do not reflect the bank's current market capitalisation and are "off-market". The Italian treasury appears to be the only party contributing to the fundraising that will be fully exposed to the risk and will not receive any fee as collateral. The European Commission is closely monitoring the transaction and has not released new comments after the approval.

On October 14th, three days before the fundraising starting date, MPS share price decreased by 42%. The drop reflects investors' uncertainty regarding the success of the transaction. During the two fundraising weeks, the bank's share price is expected to experience high volatility. The capital raise is, in fact, classified as "highly dilutive" as three shares will result in 374 new shares. Furthermore, some factors might harm the success of the 2022-2026 plan developed by the bank. First, the €125m MPS will have to pay the eight major investors represent 14.6% of the capital obtained by the investors themselves, and 5% of the total capital raised. As a result, part of the new funds will already be gone.

 

Another factor that might negatively affect MPS's success is the macroeconomic environment characterised by high interest rates and low GDP expectations. Moreover, the results of the cost-saving strategies the bank is planning to implement are likely to be outweighed by rising inflation. Therefore, the costs faced by the bank will be the same as the current ones. Finally, the success of the plan will depend on the ability of the management to overcome Monte Dei Paschi's structural weaknesses and their efficient employment of the newly available funds.

TAGS: Bank, Regulation, Recapitalization, Bank of Italy, Monte dei Paschi, European Central Bank