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All roads lead to Siena

Summary

The Asset Quality Review ("AQR") will provide the first reliable stress test of European banks. It will improve the transmission mechanisms of monetary policy and will be a key positive macro trigger for Europe in 2014. But it comes with a cost: the risk of bail-in for large European banks.

Among the true systemic institutions, the one we believe it the most at risk is Monte dei Paschi ("MPS"): high non-performing loans ("NPL") ratio, large book of Italian govies, capital base of low quality, no asset relief measures, etc.

MPS is currently trying to raise 2.5bn€ with a capital increase. We believe this transaction will succeed (probably next January) in the bullish environment.

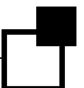
However, this might not be enough. In order to have a more accurate view of MPS, we performed our own stress test of MPS based on the full Pillar 3 disclosure of the bank and the transition period on Basel 3 CET1 definition. Our stress exercise is based on the (rather robust) methodology developed by Oliver Wyman ("OW") on Spanish banks, as OW will also be in charge of the AQR.

Our test uses the new harmonized definition of NPLs recently proposed by the EBA. This leads, we believe, to a large increase of NPLs at MPS. Based on a 6% CET1 threshold, we estimate a 1.8bn€ shortfall, rising to 2.5bn€ with a 7% CET1.

MPS could fill the gap by simply not reimbursing its hybrid capital purchased by the government (4.1bn€ of "New Financial Instruments"- "NFIs"). This could lead to new state aid investigations, and possibly bail-in, if the European Commission imposes strict conditions on NFI reimbursement as it did with SNS. The EC's full decision on MPS, including the expected reimbursement schedule, should be known in December.

However, on the short term, we are positive on MPS' Tier 1 bonds as the risks are tilted to the upside. A successful capital increase would be a great catalyst for the bonds whereas the bank has clarified on its investor call that any shortfall (vs. 2.5bn€) would only be matched by a conversion of the NFI, with no further state aid impact (no new investigation, bail-in, etc.)

In the longer term, it will all be about the final AQR-Stress test number. MPS could raise approximately 1bn€ of capital through LME on hybrid debt. If the AQR-Stress tests shortfall is significantly higher, nationalization will not be far away. Investors should pay attention to the details of the state aid decision and to the technical features of the AQR-Stress test methodology.



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Before taking over the supervision of European banks (the SSM "Single Supervision Mechanism"), the ECB has asked for a comprehensive asset quality of review, i.e. a forensic analysis of the loan books of large institutions. This will be complemented by a full stress test. The most cynical way to understand to goal of the ECB, is probably to say that the central is only willing to implement the new supervision mechanism with a clean sheet. Any failure should not be its responsibility.

But there is more at stake. It is well known that one of the key feature of the current crisis is that the usual monetary transmission mechanisms do not work well. Loan growth in Europe is still sluggish, to say the least, and the inflation of the central bank's balance sheet has not led to comparable increase in the monetary base. It is very hard to assess whether this is more an issue of offer or demand for loans, but one thing is certain: the rising numbers of non-performing loans and the reluctance of banks to handle these quickly does not help credit.

This is why we believe that, in 2014, the whole process launched by the ECB will be a key positive factor for the Eurozone.

However, it might come with a cost. The market is likely to view the credibility of a stress test only by the number of banks failing it. This might appear as preempting the outcome of the tests, but it makes sense: if tests are necessary, it must be because something is going wrong, somewhere. For a bank, failing the test is not necessarily bad news: it could simply lead to further recapitalizations, "upfronting" loan loss provisions and improved efficiency of the balance sheet. Real trouble will only happen for banks that are unable to raise the amount of equity required by the regulators. This is where a new concept invented by regulators could be actually used: bail-in. Although the ECB and the European Commission appear to be at odd on the exact conditions in which bail-in should be used, for some banks this is a true risk.

Among the true systemic banks, we believe Monte Dei Paschi is the one to watch. The other banks that could be subject to bail-in following the AQR are small and their failure would have no widespread impact on markets. But MPS is the third largest bank in Italy, with very large sovereign exposure, growing NPLs and a large retail franchise. Its ultimate fate will be one of the key event of 2014.

Previously on…"The Monte Saga"

A brief recap of the Monte Dei Paschi ("MPS") saga is probably useful. MPS is not only the oldest bank in the world, with arguably the most beautiful headquarters, it is also the epitome of finance gone wrong before the explosion of the credit bubble.

On the surface, MPS's problems seem similar to the ones faced by other banks: public recapitalizations in the aftermath of Lehman's bankruptcy, large sovereign exposures fueling the bank - sovereign negative feedback loop and growing NPLs following the Eurozone's recessionary economic policy.

But the truth is much more complex. At the end of 2012, press reports started to leak the news of undisclosed derivatives losses at MPS, right in the middle of a fierce electoral campaign. Following strong political and popular pressure, the management was eventually forced to acknowledge that

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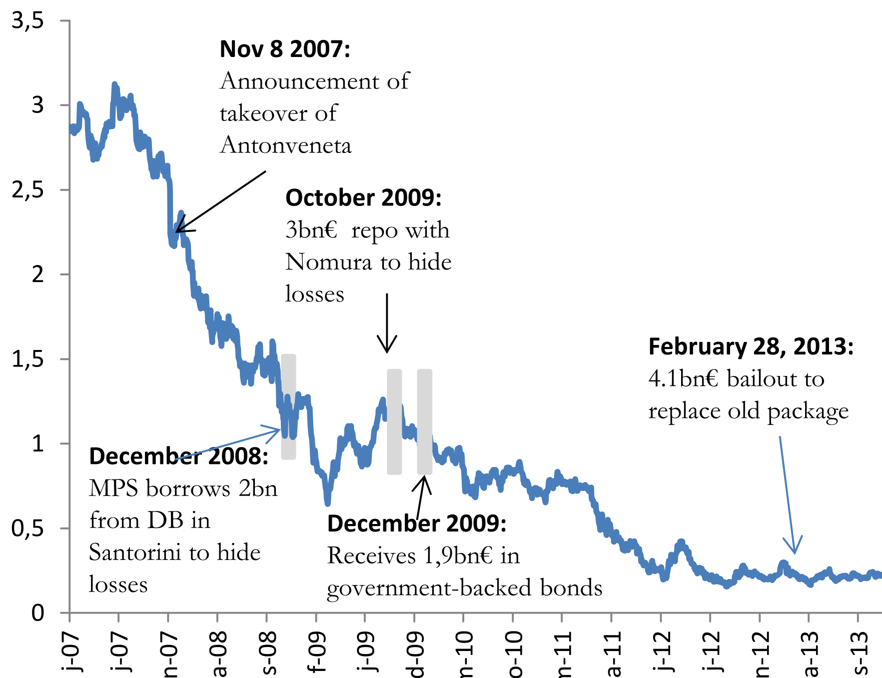
three transactions had not been properly booked and that 730M€ of losses should have been included in its former annual accounts. This increased the size of the bailout required from the government and created public outrage.

It all started with three deals: Alexandria (-273M€) was a CDO investment gone sour and restructured into a long term repo to hide losses. Santorini (-305M€) was a holding strategy of Intesa shares, designed to improve the regulatory capital treatment of the investment and to put the risks off-balance sheet. That deal was subsequently transformed into an Italian government debt investment, again to hide losses. Nota Italia (-152M€) is a weird structured credit linked note with an incorrect booking of a sale of protection on Italian sovereign risk. These trades were the key reason for the huge increase in BTP exposure at MPS, with a very long maturity. They partly explain why MPS suffered so much in the 2011 EBA stress-tests. Because the trades were entered into when the credit spread of Italy was very tight, they are also the main reason for the huge negative AFS reserve at MPS ; e.g. on Alexandria the restructuring trades were closed when 10-year CDS was roughly at 75bps.

Why did MPS's management felt they absolutely need to enter into such terrible transactions (personal interests aside?) One possible reason is the November 2007 9bn€ all cash Antonveneta acquisition, just four weeks after Santander had purchased it for 6.6bn€ from ABN Amro, within the context of the mega takeover bid on ABN that triggered so many bankruptcies. Of course, the timing and price paid were disastrous. The stretch on MPS's regulatory capital was enormous and that is most certainly why they decided to hide further losses on the derivatives transactions.



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What doesn't kill me makes me stronger (or does it really?)

The newly appointed MPS's management finds itself in an incredibly complex situation due to the combination of two potentially conflicting constraints: the current state aid investigations and the upcoming Asset Quality Review.

EBA Stress tests and State aid investigations

At the beginning of the crisis, like most large Italian banks, MPS received state aid in the form of hybrid bonds purchased by the Italian state. These "Tremonti bonds" had bespoke characteristics (including very deep subordination) that allowed them to be booked as Core Tier 1 for Basel 2 purposes. At the time, since the aid was not designed solely for MPS, the state aid investigations where rather soft and the EC did not request any harsh "behavioral measures" (as the EC likes to call them) such as asset sales or burden sharing on subordinated debts (no calls, coupon skip, etc.). In a rather bold and unprecedented move, MPS decided not to call its hybrid Tier 1 in 2011 but increased the coupons after the first call dates from Euribor + 390, 562.5 and 465bps to Euribor + 630, in an attempt to show "investor friendliness".

However, things started to go sour with the EBA stress tests that included a specific analysis of holdings of sovereign bonds (the so-called "sovereign shock"). MPS had a very substantial Italian bond portfolio and it was only thanks to a first capital increase (1.8bn€) and to a public backstop that the bank was able to reach a 8.8% Core Tier ratio in the adverse stress scenario.

This backstop took the form of new hybrid bonds, the NFI (for "New Financial Instruments") that had equity conversion features and were consistent with the EBA's new definition of eligible Core Tier 1 securities.

When MPS disclosed the true losses of its three derivatives trades (see above) the government realized that the nominal amount of NFIs had to be raised to 4.07bn€. This triggered new state aid investigations.

These investigations are expected to be finalized very soon. Their main terms should be very much in line with the EC's blueprints: coupon deferral on Tier 1 and Upper Tier 2 securities, no call, asset sales, deleverage, etc., until the state aid is fully reimbursed. MPS also took the commitment to raise 2.5bn€ of equity through a share sale before the end of 2014, in order to (partially) reimburse the NFI (3bn€ in 2014).

Things got even more complex last July when the EC modified its guidelines on state aid in the financial sector. The purpose of the modifications was to adjust these guidelines to the upcoming SSM and SRM ("Single Resolution Mechanism", i.e. the implementation of various tools to handle failing banks, including bail-in). In practice, it implied that any state aid investigation launched after August 1st 2013 would apply these guidelines, leading to possible massive dilution for shareholders and bail-in on hybrid debt.

Despite the launching of the state aid investigations prior to August 2013, this decision had potential consequences for MPS due to the fact that the recapitalization plan provides that if the share sale is not successful, the NFIs will have to be converted into shares (at a contractually agreed price). The question, then, was to know if this conversion would be considered as a new state aid,

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triggering new investigations with the application of the new guidelines (effectively wiping out existing shareholders).

According to the management of MPS (this has not yet been confirmed by the EC) the potential conversion is already envisioned in the current investigation and would not trigger any new measure. This is a key information for hybrid debt holders and shareholders of MPS.

Still, the main short term issue for MPS is the success of this 2. 5bn€ share sale. It is challenging for at least three reasons:

- The current market capitalization of the bank is only 2.2bn€ so it would entail a massive dilution;

- The largest shareholder of MPS, a Foundation established in Sienna, is also seeking to sell its holding in the market in order to repay its debts[1]. The Foundation has expressed its willingness to block the capital increase, although they will most likely succumb to political pressure.

- There are very significant risks attached to the bank and similar deals in the past (e.g. Bankia) have not been very successful. You always want to be the "shareholder of last resort", not the one just before that. Investors will want the certainty that, on the medium term, this is the "last recap".

- Time is playing against MPS: as the deadline looms, they will be more and more desperate to sell, at a lower price. Greedy investors might prefer to wait.

This being said, the market for European shares, especially in financial companies and in the periphery, is buoyant, so there is a true chance that they manage to pull it out.

The AQR

At first glance, we would tend to have a rather positive stance on MPS' hybrid debts: if they manage the capital increase, bonds will soar. If they fail, the downside is limited: any shortfall will be matched by a conversion of the NFI, hurting equity investors, not debt investors.

But there is a problem.

All this works if and only if the recap is truly the final one. Will it?

Unlike previous stress tests, this one should include a major change: banks will need to harmonize their definitions of NPLs and, possibly, of coverage ratios. This has been the one area of banking

[1] We understand the Foundation has pledged its shares to a pool of banks, so, in any case, even if the Foundation did not sell, the banks would also be willing to sell.

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regulations where European harmonization was truly lagging: currently, there is no way to effectively compare NPLs in Italy, Spain, France, Germany, etc. Definitions are simply too different. For the first time, the ECB will compute (or rather ask Oliver Wyman to compute) expected losses in adverse scenarios with harmonized definitions of troubled assets and provisioning policies. This could lead to massive capital needs in countries where provisioning / NPL policies are lax as compared to new guidelines published by the EBA last October.

It was explicitly stated by MPS on its investor calls that the current EC investigation does not take into account the AQR (though obviously they would argue that state aid investigations are based on true economic terms and should not impacted by "accounting policies". Hum.) The true risk is thus the following: the capital increase could be successful but the AQR could show that MPS needs an additional recapitalization. Having already tapped the market just a few months earlier, they could be unable to raise the cash. This scenario would most probably lead to bail-in / nationalization of the bank.

So we believe the key issue for investors in MPS securities right now is to try to "reverse engineer" the outcome of the AQR in order to estimate any future potential capital requirement.

Best estimates of the AQR's outcome

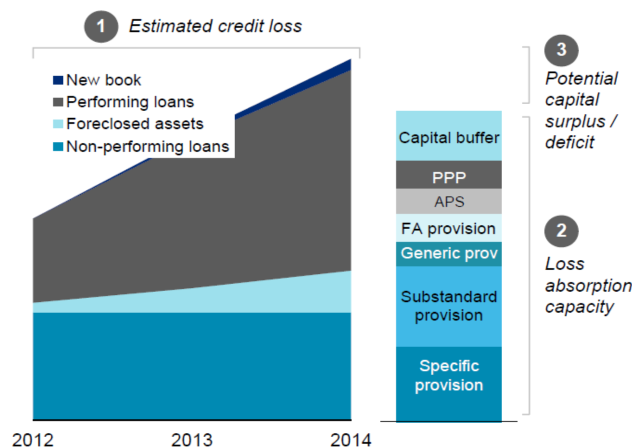
The ECB has selected Oliver Wyman ("OW") to perform the AQR and corresponding stress tests. Interestingly, OW was already in charge of the rather robust Spanish stress tests. Hence, the OW report on Spain, along with new EBA guidelines and the ECB's presentation of the AQR process, are probably the best sources available to understand what the AQR is going to look like. The name of the report is very telling: "ASSET QUALITY REVIEW AND BOTTOM-UP STRESS TEST EXERCISE" (our emphasis.)

The OW Methodology (AKA Spanish Stress Tests)

The OW approach is a bottom-up approach. Its purpose is to assess loss projections on the loan book of each bank and to compare these losses to current and future capital buffers.

This is best explained in Figure 4 of the OW report:

Figure 4: Bottom-up stress testing framework



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The chart shows that main drivers of the stress tests are:

- Loan Losses estimates on non-performing loans including foreclosed assets (for which the
- market price of collateral has to be estimated)
- Loan Losses estimates on the performing book
- Loan Losses estimates on the new book
- Capital estimates

Regarding capital, the following important points should be stressed:

- Obviously existing provisions are taken into account
- Asset protection schemes are included (not relevant for MPS)
- Estimated pre-provisioning profit is included, thus requiring a full business plan of the bank
- Deferred tax assets are estimated and treated "in accordance with current and anticipated legislation". This is a key issue for MPS with its 4.2bn€ deferred tax assets.

Regarding loan losses, the key assumption is that three modules are used: foreclosed asset loss forecasts, performing loan book loss forecasts, non-performing loan book loss forecasts. In practice this means that different methodologies are applied to the three modules.

1. Regarding foreclosed assets, the value of the collateral is a blend of historical prices and third party appraisals.

2. Regarding the performing loan book, the methodology uses Probability of Default (PD) and Loss Given Defaults (LGD) estimates, with a macroeconomic overlay to account for a degradation of PD/LGD ratings. This is entirely consistent with the standard regulatory framework which relies on internal estimates of PD/LGD, backtested on a yearly basis to check that the numbers are conservative enough.

3. Last but not least, the non-performing book is assessed only through LGD (i.e. default has already occurred). LGD are mainly estimated using single estimates taken from 2011 downturn data, with an additional time effect: projected cures decrease over time.

The key information is thus that foreclosed assets will be estimated using collateral values (mainly real estate for MPS), performing loans using a rating based approach and non-performing loans using coverage (or LGD) ratios.

The report gives the following indications to assess the impact of the macroeconomic overlay on the actual PDs of the performing book in the adverse stress scenario:

Asset Class	PD Multiple (compared to 2011)
Real Estate Developer	x3.8
Retail Mortgage	x4.4
Corporate	x3
Retail	x2.7

LGD are also estimated for each asset class (see tables in the OW report).

Impact of the New EBA Guidelines

The EBA recently published guidelines regarding the classifications of NPL or problem exposures. We believe this is of outmost importance for the upcoming AQR as we think banks will be required to split their loan books in the three categories outlined above. The new rules will imply important changes in the classification of existing loans:

1. Objective definition of NPLs: past due exposure after 90 days will always be classified as NPL;

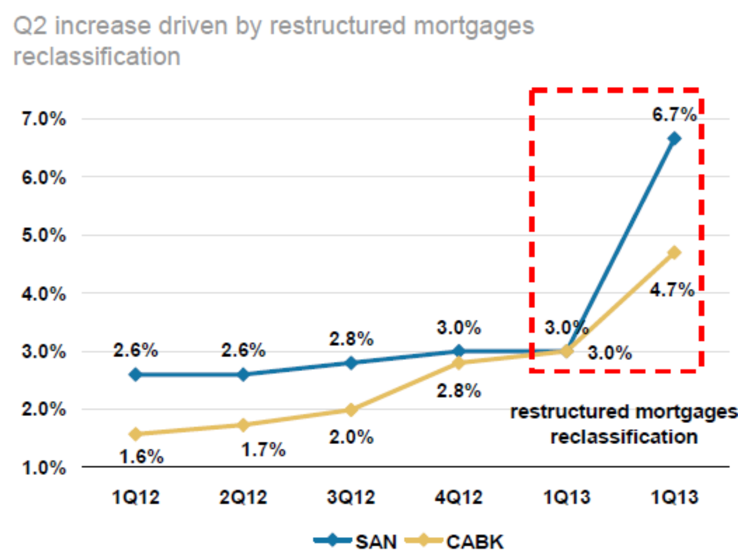
2. Pull effects are harmonized: pull effects is a highly technical but extremely important concept. It relates to the fact that an exposure on a given entity can be classified as non-performing if other exposures of the same group are non-performing. Tests are usually based on a % of nominal exposure within a group which is past due or as a % of discounted cash-flows which are past due.

3. Entry and exit points (cure periods, etc.) are harmonized.

4. Forbearance definitions (i.e. cases where a financial advantage is given to a distressed debtor, also known as restructuring) are harmonized.

Based on the existing and future rules applicable in each country (rules vary all over Europe) we have developed a model designed to estimate future NPLs based solely on the impact of EBA reclassification.

The following chart, applied to Spanish banks, show that the actual, reported, impact can be huge.



Source: Morgan Stanley

On top of that, the ECB added one important clarification: the minimum Core Tier 1 ratio will be set at 8% using Basel 3 phasing rules (i.e. not fully phased-in).

Some important issues remain to be clarified: the treatment of sovereign bonds (we do not expect a harsh treatment as the ECB has just announced its OMT program and will hardly be able to justify haircuts apart from MtM variations through the AFS reserve) and the actual macroeconomic scenarios that are used.

The rest of the OW methodology will be applied in the European AQR, we believe.

Application to MPS

We have developed a full stress test model applicable to MPS that takes into account:MPS's business plan that was recently presented to the market. We believe these forecasts will be used as they are the ones used by the EC in the state aid review process.

- MPS's business plan that was recently presented to the market. We believe these forecasts will be used as they are the ones used by the EC in the state aid review process.
- MPS full description of its loan book portfolio, as detailed in its Pillar 3 reports, with details on the internal rating of the book.
- A reverse calculation of the PD of the loans using the regulatory RW formulas. This is done on every regulatory category of the loan book with each applicable PD formula as defined in Basel 2 regulations. A macro overlay is then applied to the PD in order to be consistent with the Spanish numbers estimated by OW. We believe the economic cycle is not in the same phase as it was in 2011 so PD multiple should probably be lower in 2014 (the actual date of the AQR). We use a 175% multiple in the base case scenario, 250% in the adverse scenario and 300% in the "true stress" scenario, almost identical to Spanish numbers used in 2012. (Italian banks in general and MPS in particular are much more exposed to Corporate / Retail risk than to RE risk, unlike Spanish banks.)
- A stress scenario on the reclassification in NPLs of existing performing exposures. The main impact stems for forbearances and performing loans with past due over 90 days. Our model produces an estimate total forbearance of ≈4.2% of the loan book, consistent with the slightly higher number estimated in Spain (5.3%), due to higher RE exposures in Spain.
- The OW report did not integrate an increase in RWA resulting from the macroeconomic environment. In theory this does not impact losses but certainly impacts Core Tier 1 ratios. We have the option to include it in the model but chose not to do it.
- Target coverage ratios are set at a level which, we believe, is consistent with the findings of the OW report (bearing in mind that Spanish estimates are certainly highly conservative estimates for Italy, especially in the real estate sector). Each coverage ratio is applied to the various IRB and Standard portfolio of MPS. We make no difference between the different types of NPL (doubtful / subjective / forbearance / watch list) which is certainly a conservative assumption.

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- A full calculation of the phase-in behavior of the capital of MPS, taking into account the specific and highly complex treatment of DTA in Italy, following the 2011 law and the various grandfathering buckets applicable to DTAs (with or without temporary differences, after or before cut-off dates). All major grandfathering items are modeled: AFS reserve, EL surplus, equity investments deductions, etc.

- We also integrated a -5% shock on all Level 3 assets as suggested by the ECB.
  Finally, we integrate a 5% stress on the value of the sovereign bond portfolio for the calculation of AFS reserves (bearing in mind the likely amortization period of the BTP book of MPS).

- We also integrated a 228M€ impairment on the stake of MPS in Banca d'Italia.

How is the ECB going to judge if banks fail or pass the tests? We believe the ECB will actually combine two tests:

1. In the first one, the ECB will use the numbers calculated after the effect of AQR reclassification, combine these with current P&L and balance sheet numbers (i.e. FY 2013 or HY 2014) and check for the 8% CET1 trigger. We believe that, on that short term horizon, MPS will pass the test rather easily with an excess capital close to 1.5bn€. This is mostly due to the DTA that will be almost entirely kept in regulatory capital. This estimates takes into account a 2.5bn€ capital increase and a reimbursement of 3bn€ of NFI.

2. The ECB will also look at a stress scenario with an adverse macro shock and a time horizon set at the end of 2016. As a minimum capital ratio, the ECB is likely to use either 7% (a number consistent with Basel 3 regulatory minimum including the capital conservation buffer of 2.5%) or 6%, a number consistent with previous stress test and with the fact that the whole concept of a capital conservation buffer should be that a bank is allowed to use the buffer in periods of stress. The final assumptions should be disclosed in January.

This is how we believe the numbers will look like for MPS over that horizon:

Comment	CET1/Macro shock	No shock	Base	Adverse	True stress
AQR Level	8,0%	- 668	- 1 394	- 3 213	- 4 333
Possible stress test levels	7,0%	54	**- 682**	- 2 518	- 3 650
	6,0%	777	31	**- 1 823**	- 2 966
Regulatory minimum	4,5%	1 860	1 100	- 780	**- 1 941**

In any case, MPS would exhibit a severe capital shortfall, in the 2bn range.

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However, it should be stressed that this shortfall could be covered in a very simple way: postponing the reimbursement of the 4.1bn€ NFI that is scheduled to happen over the 2014-2017 period.

End game scenarios and trade ideas: timing is everything

What are the possible end game scenarios for MPS and the likely timing? Broadly speaking there are three possible outcomes.

- MPS is taken over by a large Italian bank. Intesa is the most obvious candidate as Intesa's main shareholder seems interested, but a consortium of Italian investors is also a possibility. This would be a typical Italian approach to handle large distressed companies.

- MPS manages to raise enough equity in the market, on its own.

- MPS is unable to raise enough equity; the bank is bailed out or bailed-in (most probably both.)

Let us first deal with the two "easy" outcomes. If anyone is truly interested in MPS, they will surely wait: wait for the capital increase to succeed or, more cynically, to fail and wait for the AQR to reveal any capital shortfall and then assess whether the shortfall is manageable. To put it simply, any buyer will remain silent until the very last minute to pay a very cheap price. If you want to bet on that outcome, you will need nerves of steel and no liquidity constraint.

For MPS to be able to raise enough equity on its own, we believe the scenario has to look like this: first the capital increase is a success. Ideally, the capital increase should be done in January, when markets are generally buoyant, and before the EBA announces the details of the stress-test exercise to avoid any negative news, e.g. on the CET1 threshold. If possible, the capital increase should go beyond the initial 2.5bn€ and the news that the board has approved a 3bn€ increase is a good sign in that direction. Then, the AQR should reveal only limited capital needs, maybe around 1bn€. This could be covered by a LME on hybrid bonds, some asset sales, increased cost-cuttings, deleveraging, *etc*. This scenario would be highly positive for credit (Senior, LT2 and Tier 1, with obviously the highest impact on the Tier 1 bonds).

The third scenario is the most complex. In practice, it would go like this: the capital raising will have been successful, totally or only partly, and existing shareholders will have been diluted to some extent. Then the AQR results are published and MPS is unable to raise enough equity to meet the shortfall. However, MPS will always have enough equity (at least under the scenarios we assessed) to meet the AQR targets provided it does not fully reimburse the NFI. This means that the AQR will possibly imply that the NFI cannot be reimbursed as initially expected.

This is extremely important and it is where things are starting to get really tricky. The total amount of NFI to be reimbursed will depend on whether the capital increase has been successful or not and on the amount of capital required in the AQR. The state aid investigations will certainly set a time schedule for the reimbursement of the state aid. Recall that it was the incapacity of SNS to reimburse the state aid on time that triggered its very harsh bail-in. This is something the EC will monitor closely. However, one can expect the EC to be a little bit more lenient in the case of MPS

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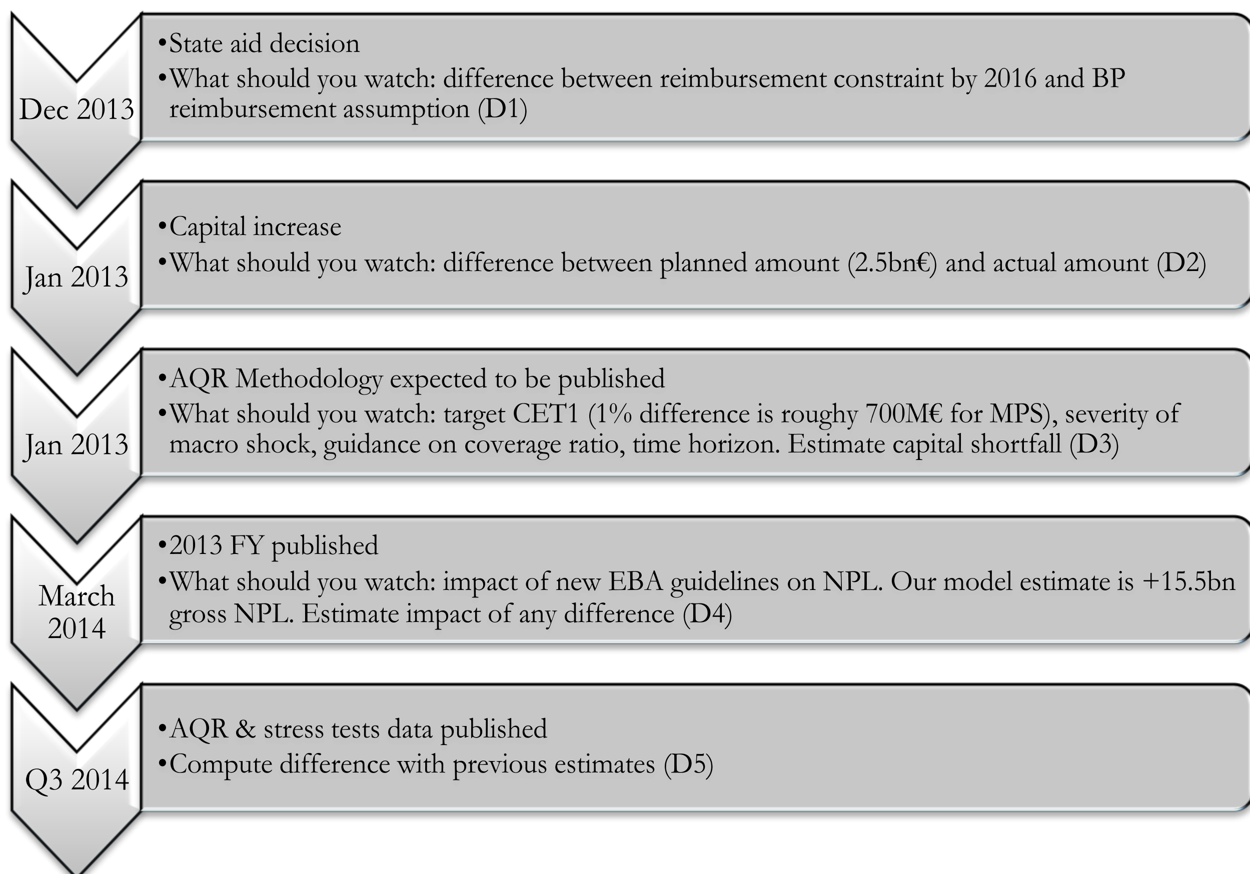
if, (arguably) unlike SNS, the extra capital requirement does not come from a more distressed situation but purely from a new capital requirement exercise imposed on the bank by regulators.

One should also stress that there is an important caveat in the new State aid guidelines, namely cases where systemic stability has to be taken into account. Interestingly enough, in all previous state aid cases, the systemic stability issue has always been left to the appreciation of the Central Bank. This effectively transfers large powers to the ECB as future regulator. In that respect, it is important to note that the ECB wrote to the EC last summer to give its views on the new guidelines and expressed the strong opinion that no bail-in should occur when minimum capital ratios are met. Based on the ECB's importance in the entire process, not to mention its role as only assessor of financial stability, this opinion cannot be discarded entirely and bail-in should be no means been viewed as entirely automatic.

Still, we believe that the key metric will not be the capital requirement in itself but the difference between the expected total NFI reimbursements set in the state aid plan and the actual reimbursements that would allow the bank to meet its AQR capital requirements. If the difference is huge, shareholders and subordinated investors will be bailed in. If the difference is minor, they will escape bail-in.

How is it possible to trade such a complex situation? It's all about the timing and it is best summarized in the following chart.



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Our current estimate for the capital shortfall in a stress test is 1.8bn€ with a 6% CET1 target. If the sum of all adjustments mentioned above are enough to bring that number below 1bn€, or more prudently 500M€, then the bank will probably make it. Otherwise it is going to be a full nationalization. Our guess on the acceptable shortfall relies on three factors: the amount MPS could get from a LME on subordinated debt, the fact that MPS seems to have already optimized its RWA quite a lot and does not have further room of improvement there, and the fact that large asset sales seem quite unlikely for the time being (especially Antonveneta which is heavily loss making and has a very small book value). So it's pretty much LME only and our estimates are based on (i) a 50% discount on Tier 1 debt, (ii) a 35% discount on UT2 debt, (iii) a 25% discount on LT2 debt and (iv) a conservative tax rate at 35%. Considering the actual capital structure of MPS this would lead to a CET1 gain of 1.1bn€, to be adjusted with a 80% participation rate, i.e. 931M€. Recall that in very distressed situations (such as Coop) participation rates can be very high, as the risk of losing everything is material. The transaction could also be structured in a tax and regulatory efficient way in order to improve the capital numbers (e.g. with some of the price being paid in shares, *à la* Bankia or Coop) but, for the time being, we stick to our conservative assumption.

We believe that over the next few weeks the market will mostly deliver good news for MPS. At the current *Price To Book* value of less than 33% (with the sector trading now close to 80%) there is enough potential upside on MPS to attract equity investors[2]. The capital increase could be successful and this would certainly push bond prices upwards. On the other side, a partial failure of the capital increase would only trigger a partial conversion of the NFI with no immediate consequences for bondholders. The risks seem tilted to the upside and we would be buyers of MPS Tier 1, until we have further clarifications on the AQR & Stress Test methodology and on the state aid decision.

[2] We are aware that the Price to Tangible Book ratio is much less attractive (close to 1x actually) but Italian DTAs have a true economic and regulatory value and cannot be fully discarded.

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