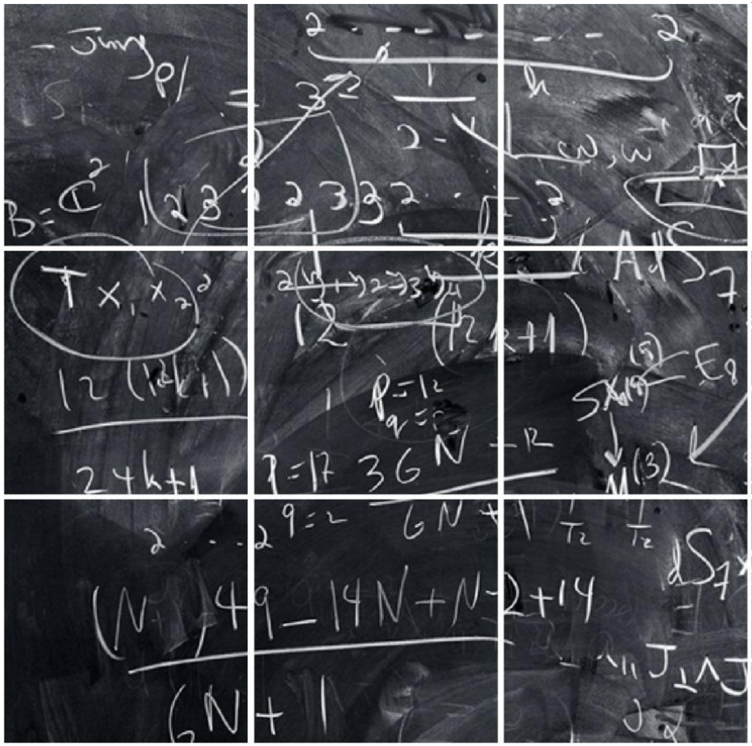

Q1 2017

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NOTES No. 24

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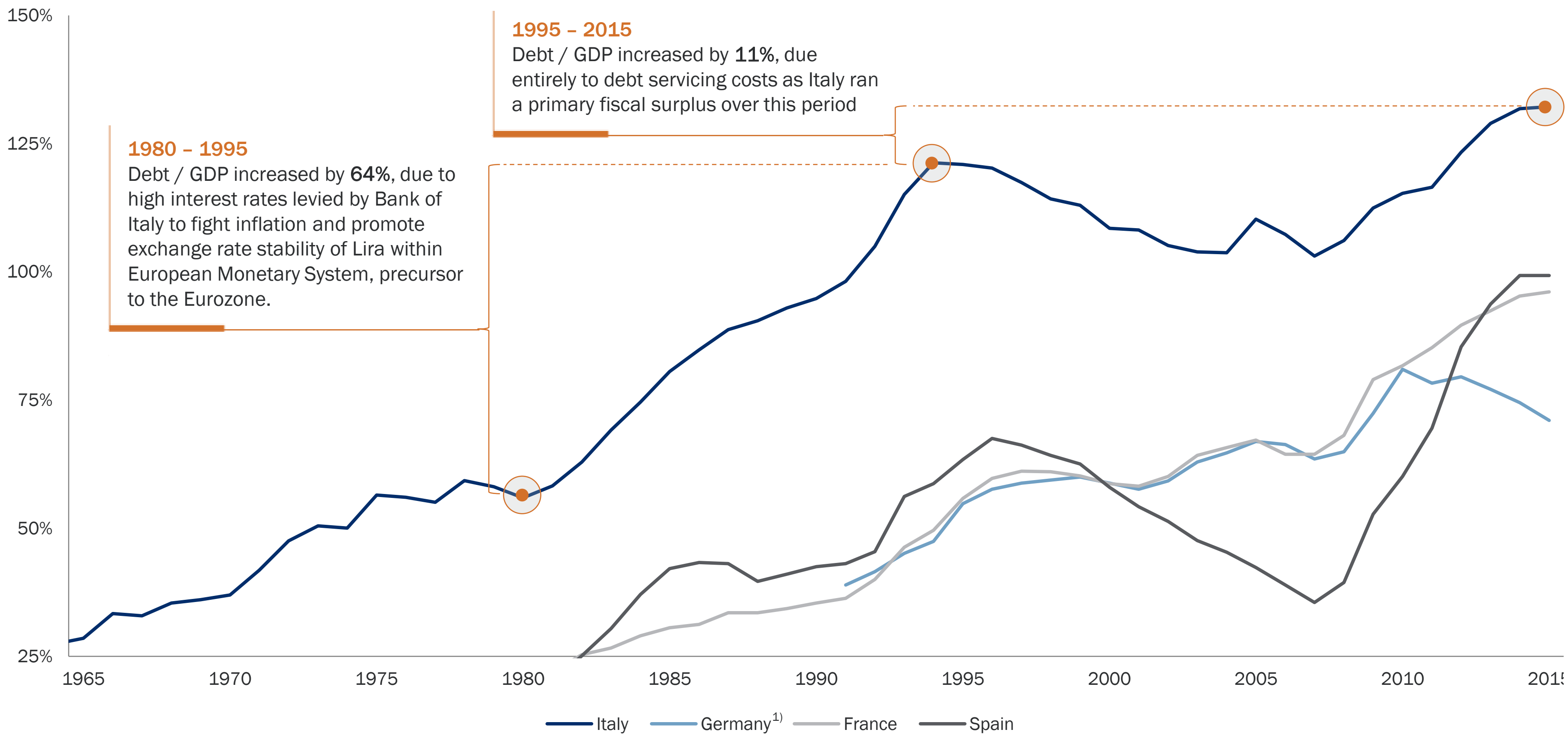
An orderly restructuring of Italian debt

ITALY'S DEBT CRISIS IS A 30-YEAR OLD PROBLEM

Key source of Italian debt issue (gross government debt / GDP) between 1970 and 1995 and since GFC

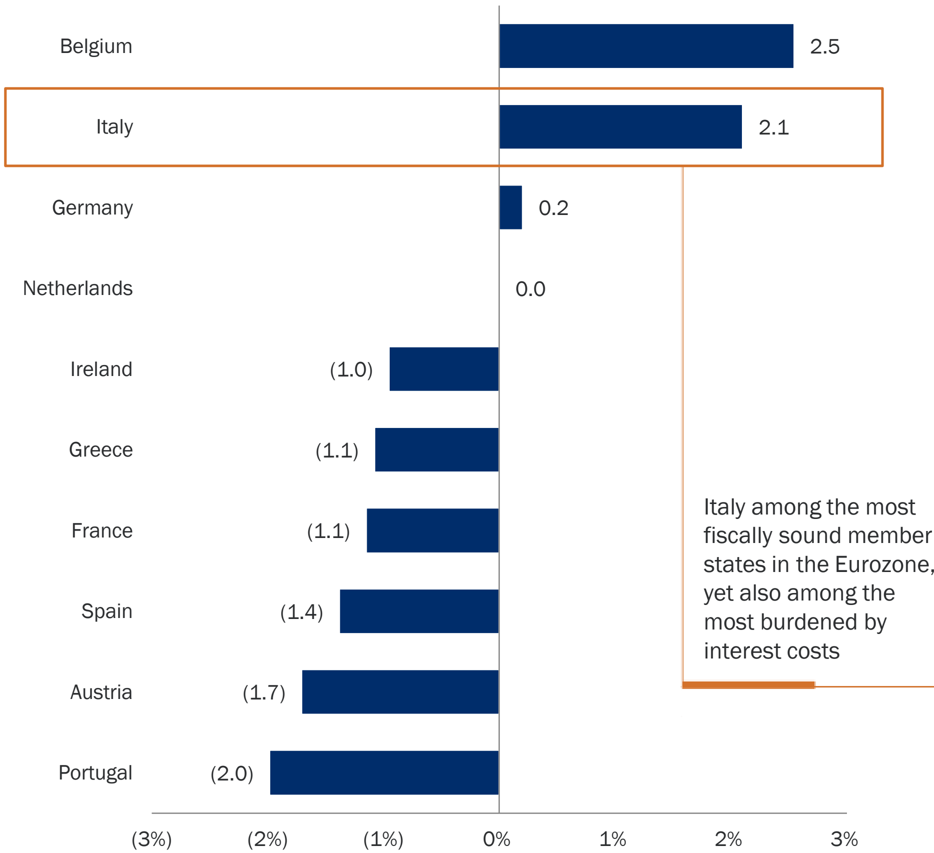


Source: IMF

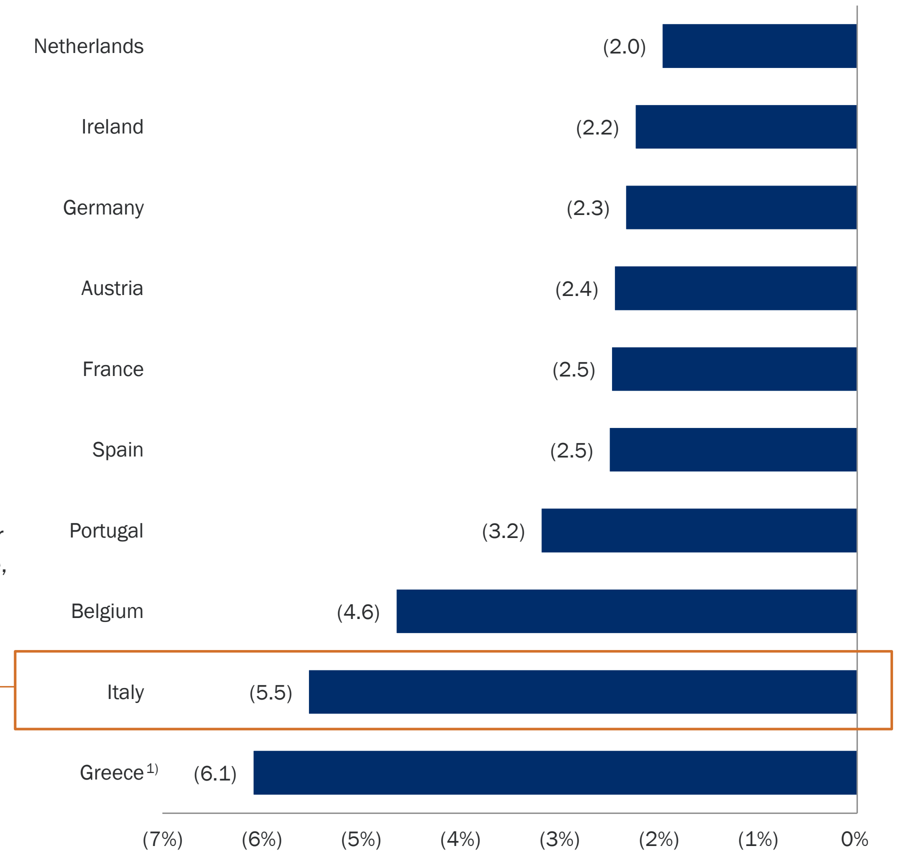
1) Germany since unification

ITALY DESERVES A BREAK: FISCAL RESTRAINT MATCHES GERMANY FOR 20 YEARS

Average primary balance as % of GDP since 1995



Average interest costs as % of GDP since 1995

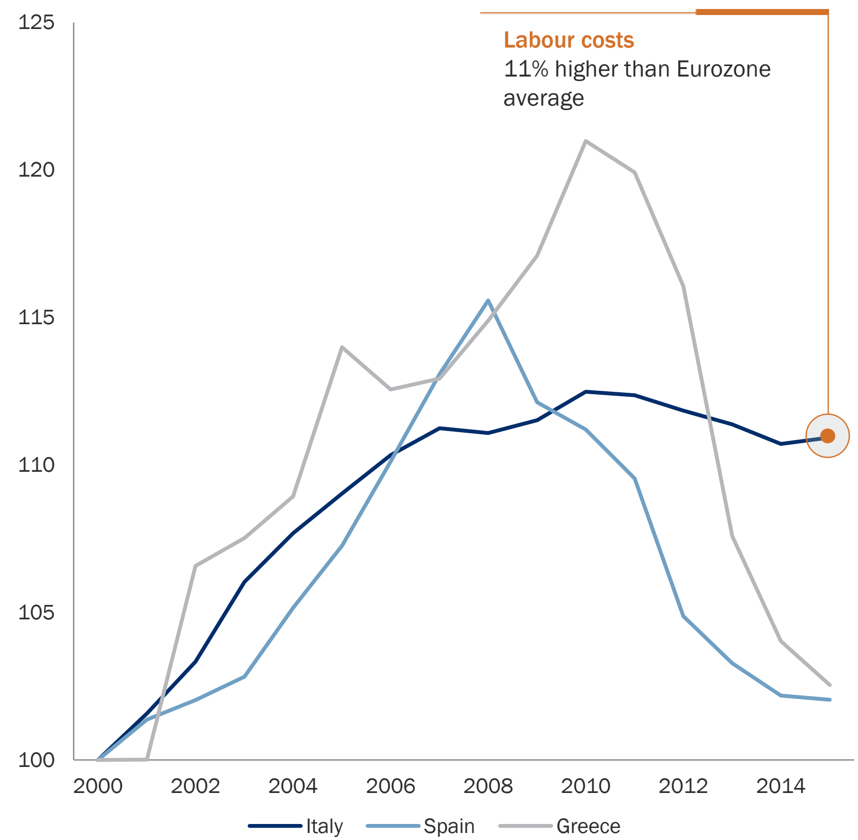


Source: IMF, Astellon calculations

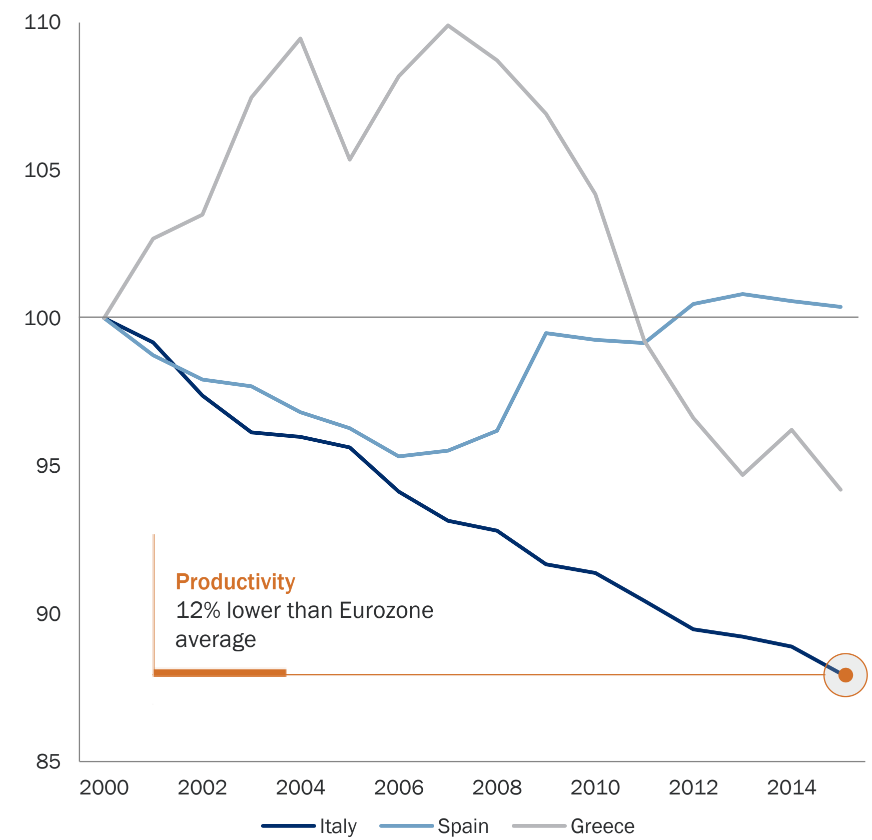
1) *Average cost of debt for Greece reduced to 5.1% post debt restructuring in 2012. These figures are sourced from official IMF statistics but are not inclusive of the refunded interest payments made to bonds held by the ECB due to the conditional nature of the refunds.*

HOWEVER, ITALY STILL NEEDS TO DELIVER ON STRUCTURAL REFORMS...

Unit labour costs relative to Eurozone average



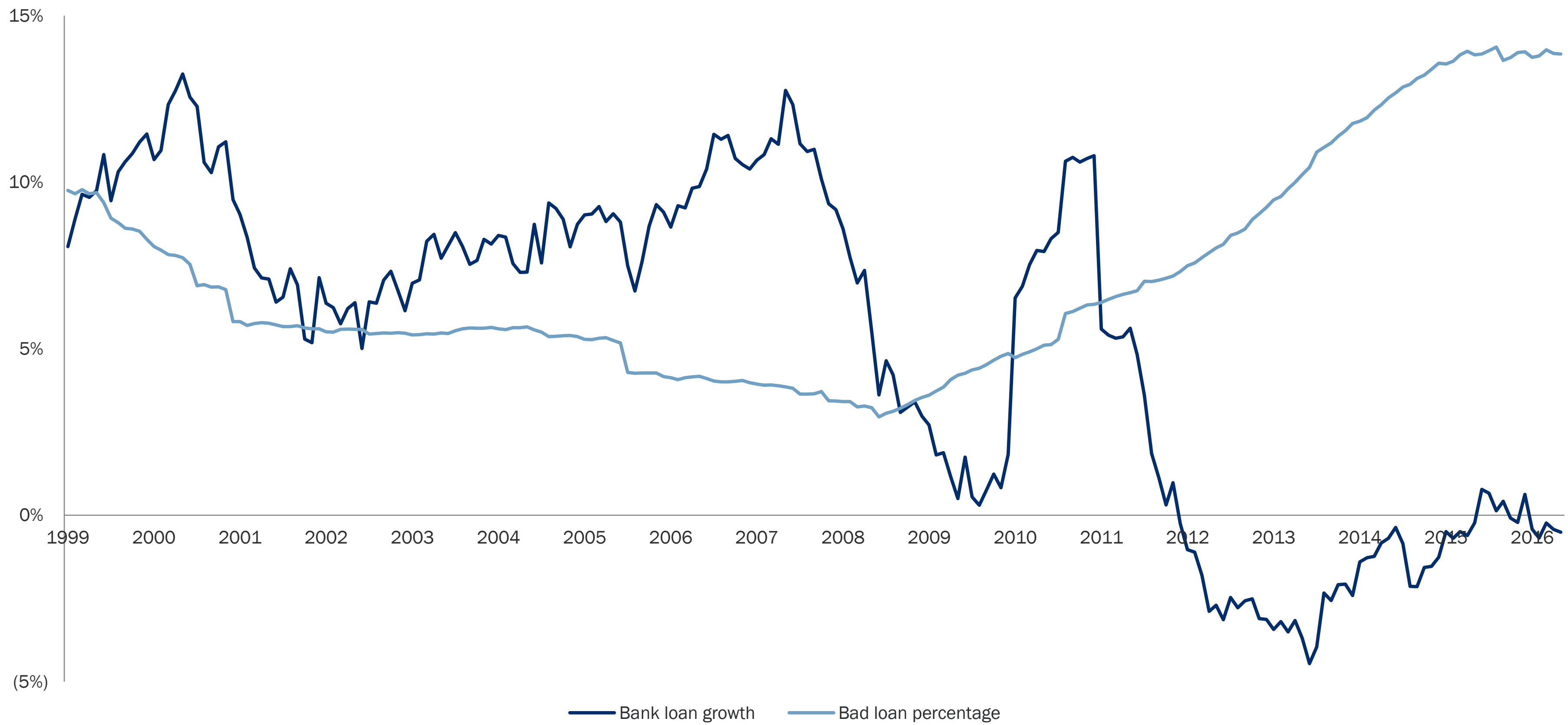
Labour productivity relative to Eurozone average



Source: OECD, Astellon calculations

...AND THE OBVIOUS CLEAN-UP OF ITS BANKING SYSTEM

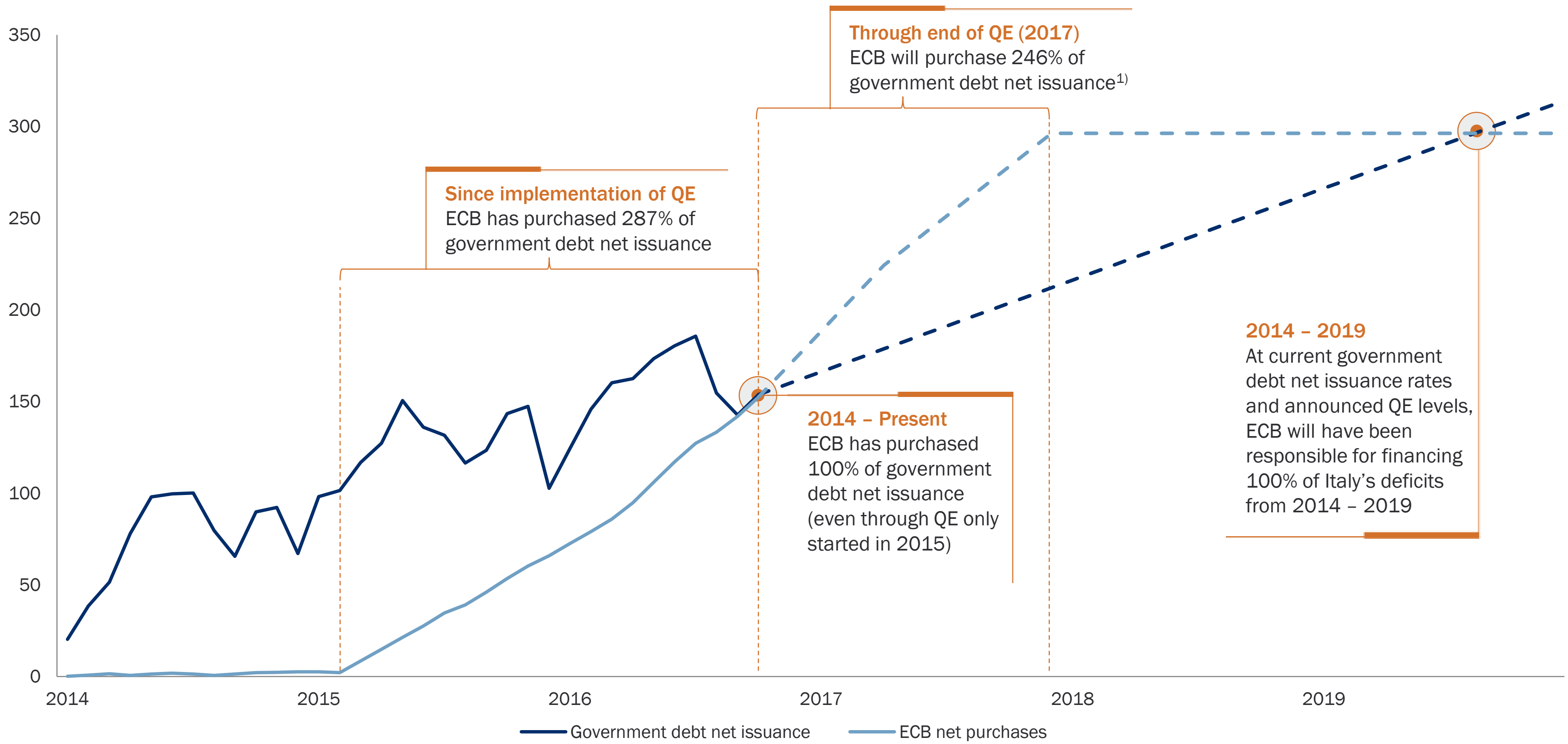
Debt deflation feedback loop since 2012 – elevated bad loans reduce bank lending which further reduces aggregate demand



Source: Bank of Italy

ECB ONLY NET BUYER OF BTPS LEFT

Cumulative change in government debt levels since 2014 (€ bn)

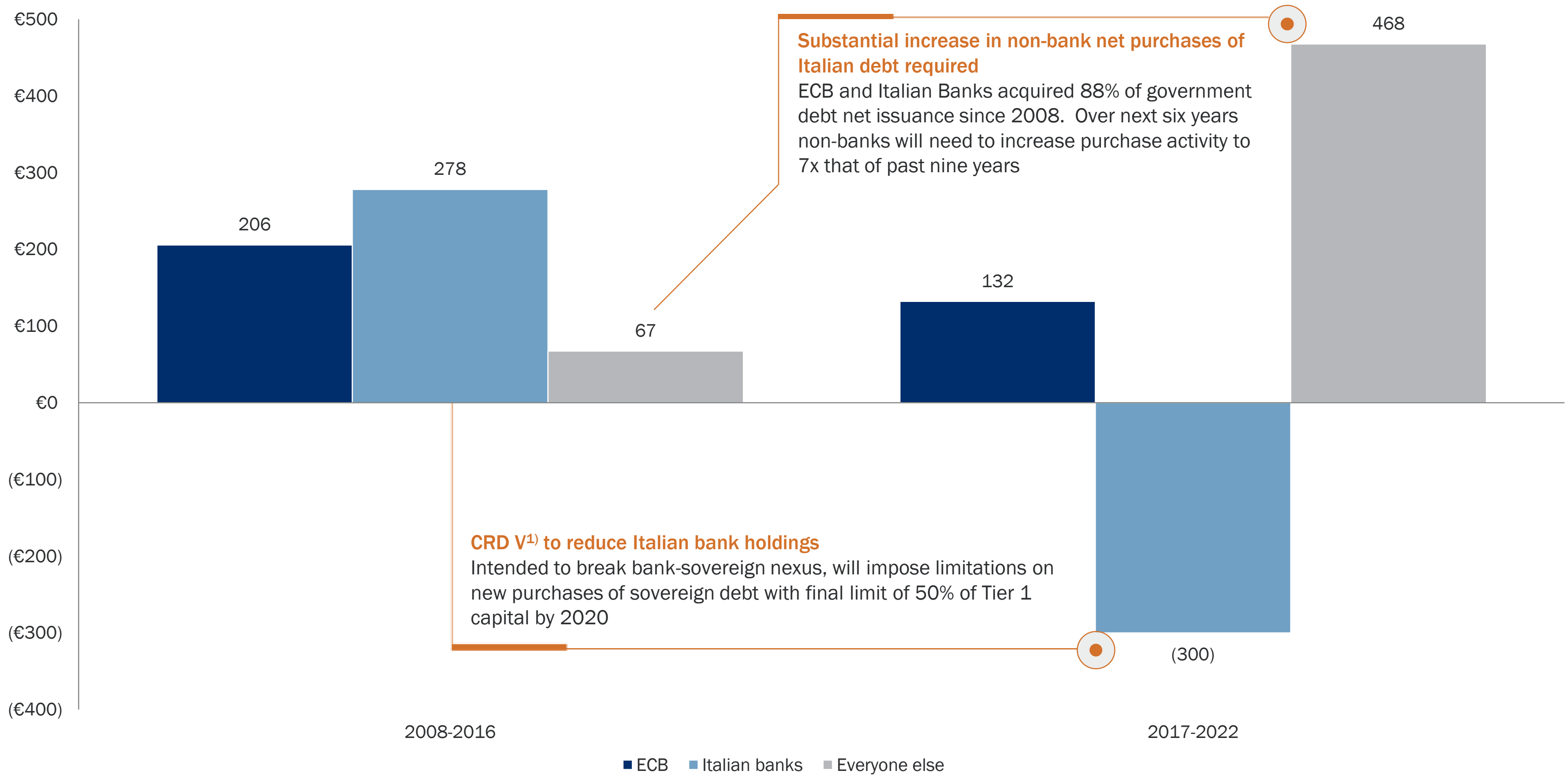


Source: Bank of Italy, Astellon calculations

1) Assumes €50bn annual run-rate of government net debt issuance

REG. OF SOVEREIGN-BANK NEXUS[1)] COULD TURN ITALIAN BANKS INTO SELLERS

Net purchases/sales of Italian government debt (€ bn)

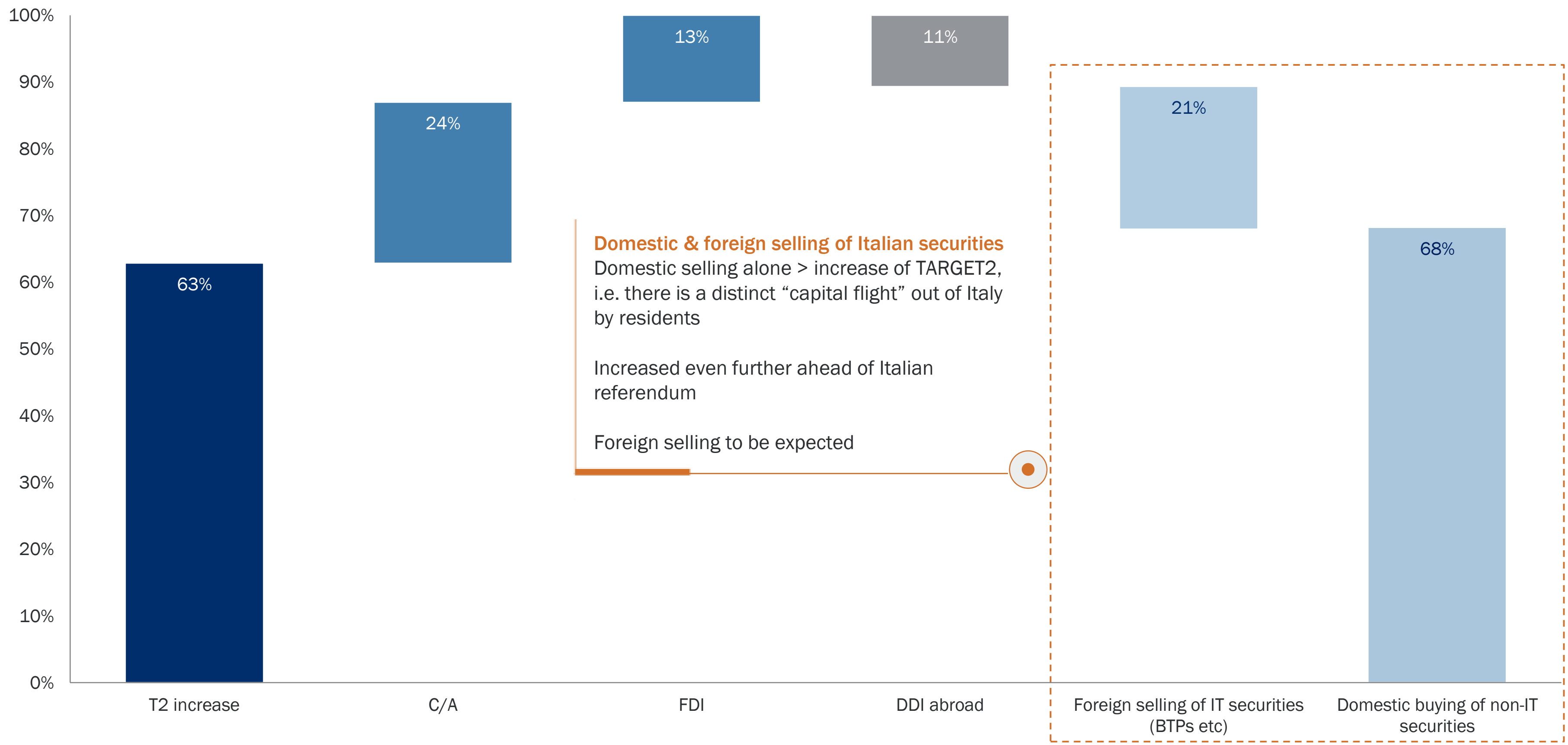


Source: Bank of Italy, ECB, Bloomberg, Autonomous Research, Astellon calculations

1) EU draft proposal (CRD V) contains provisions to curb sovereign exposures initiated after Nov 22, 2016: 100% of Tier 1 by 2018, 75% by 2019, 50% by 2020

QE TECHNICALLY INCREASES TARGET2 BUT ALSO FACILITATED CAPITAL FLIGHT

Cumulative flows of balance of payments of Italy in % since QE was rumoured to start (08/2014) until 08/2016

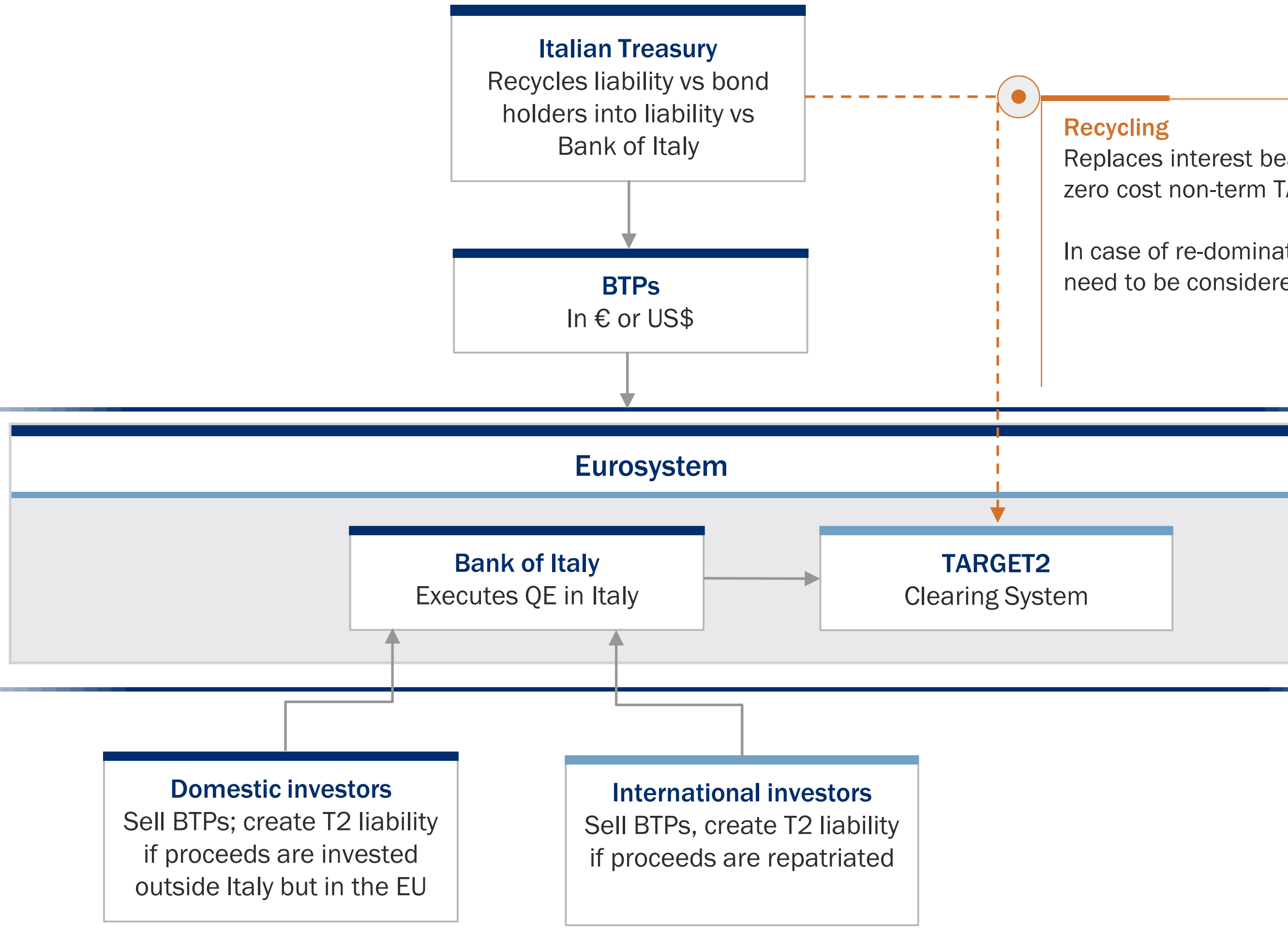


Source: IESEG School of Management, October 2016, Astellon calculations

1) Target 2 increased by €224bn over this time horizon and reached a new record of €354bn in September 2016 and €359bn by November 2016

MACHIAVELLIAN THINKING: THE QE COUNTER-PARTY RECYCLING MECHANISM

Simplified overview of QE: liabilities vs bondholders are replaced as liabilities vs Bank of Italy and ultimately Eurosystem



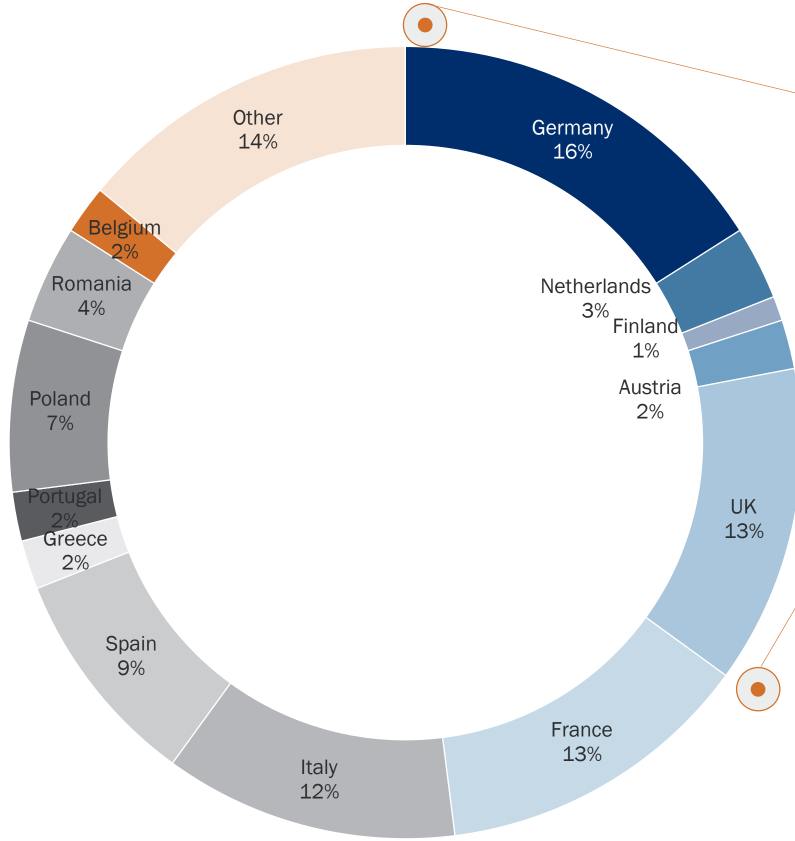
Recycling

Replaces interest bearing term liabilities with zero cost non-term TARGET2 liabilities

In case of re-domination/default those balances need to be considered as losses

GERMANY IS NOW VULNERABLE: NO BLOCKING MINORITY IN THE EU POST BREXIT

Blocking minorities[1] in the EU Council: Germany's position will weaken significantly



Blocking minority[1)]
Incl. the UK, the former Deutsche Mark bloc has a blocking minority of >35%

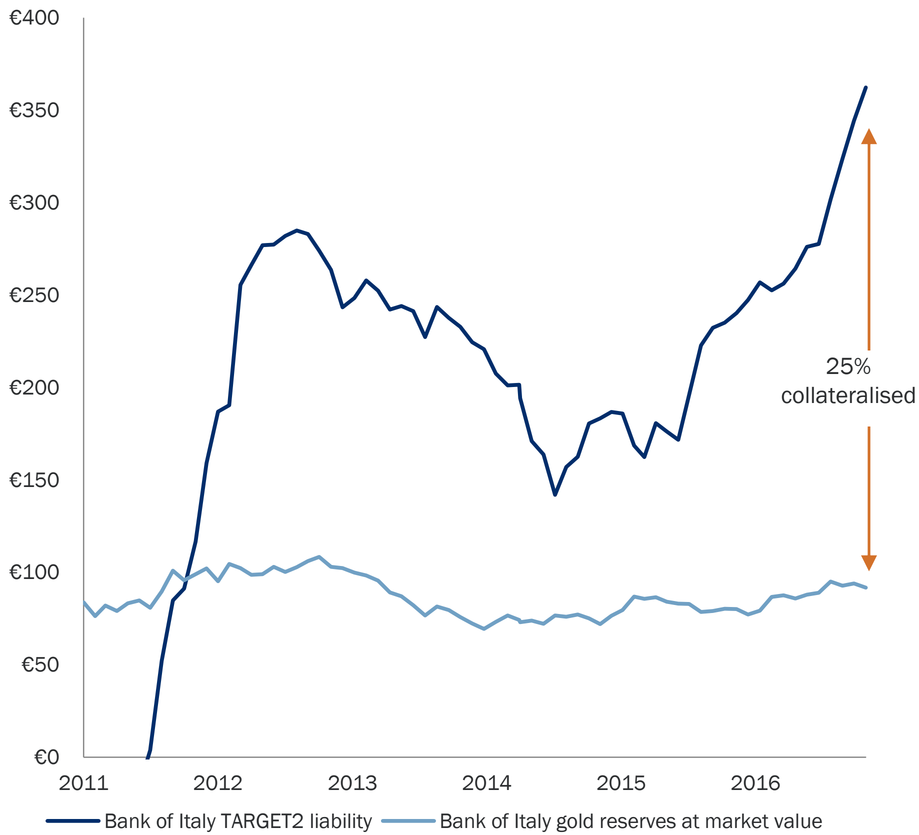
Excl. the UK, the former Deutsche Mark bloc falls to 25%

Source: H.W. Sinn: Der schwarze Juni, September 2016, Astellon calculations

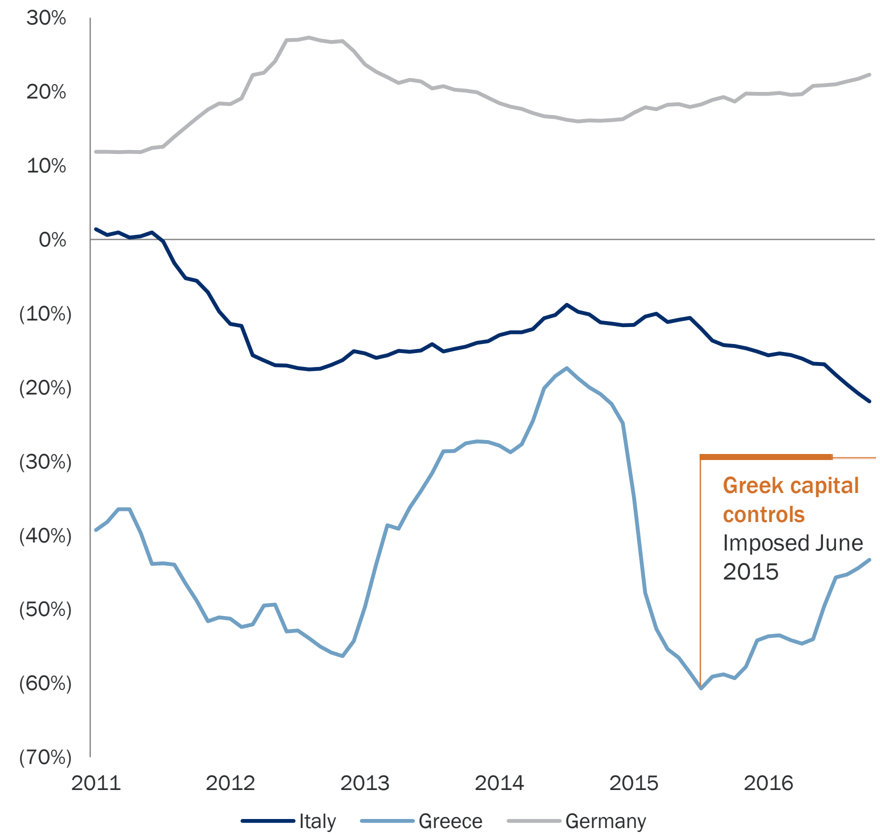
1) *Since 2014, decisions are made either unanimously (decisions that impact budgetary decisions of each country), with a simple minority or with a qualified majority (majority of decisions). A qualified majority requires >55% of countries and 65% of the population of such countries. At least 4 countries are required. This implies that 45% of the number of countries and 35% of the population can form a blocking minority*

AT A MINIMUM, TARGET2 IMBALANCES SHOULD BE COLLATERALISED[1)]

Italy TARGET2 liability vs market value of gold reserves (€ bn)



TARGET2 asset/(liability) as % of GDP

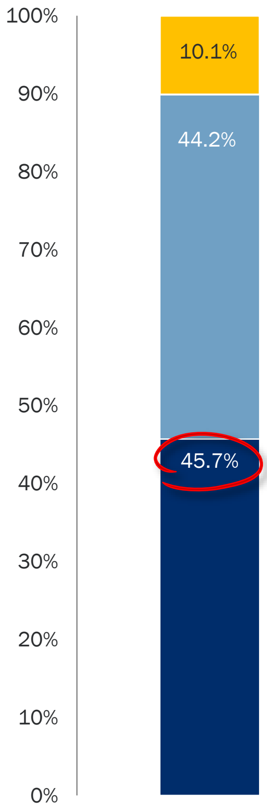


Source: Bank of Italy, ECB, IMF, Bloomberg, Astellon calculations

1) *This has historical precedent - gold reserves were used by the Bank of Italy in 1976 to guarantee a loan from the Bundesbank*

RISK OF UNILATERAL RE-PROFILING OF BTPS IS A CLEAR & LEGAL POSSIBILITY…

Distribution of stock of publicly-traded Italian sovereign debt by legal framework as of 2016



- Decree bills based on Italian law
- International bonds – issued with contract provisions (includes NY law and non-CAC Italian law)

- CAC bonds[1)]

  Includes aggregation features, i.e. not series by series

  Allow a proposed modification to be made binding on all holders if approved by relevant quorum to avoid hold-outs

  Based on commonly used CACs in the UK and US after the G10 report of 09/2002

- Decree bonds based on Italian law

  Very few if any contract provisions

  Even easier to restructure than Greek govies as they don't require retroactive CAC inclusions

  Ministry of Economy and Finance can restructure the bonds if deemed necessary by way of issuing framework decrees that allow it to reimburse before maturity, transform maturities etc.

  Unlikely to trigger cross-default provisions for NY-law bonds

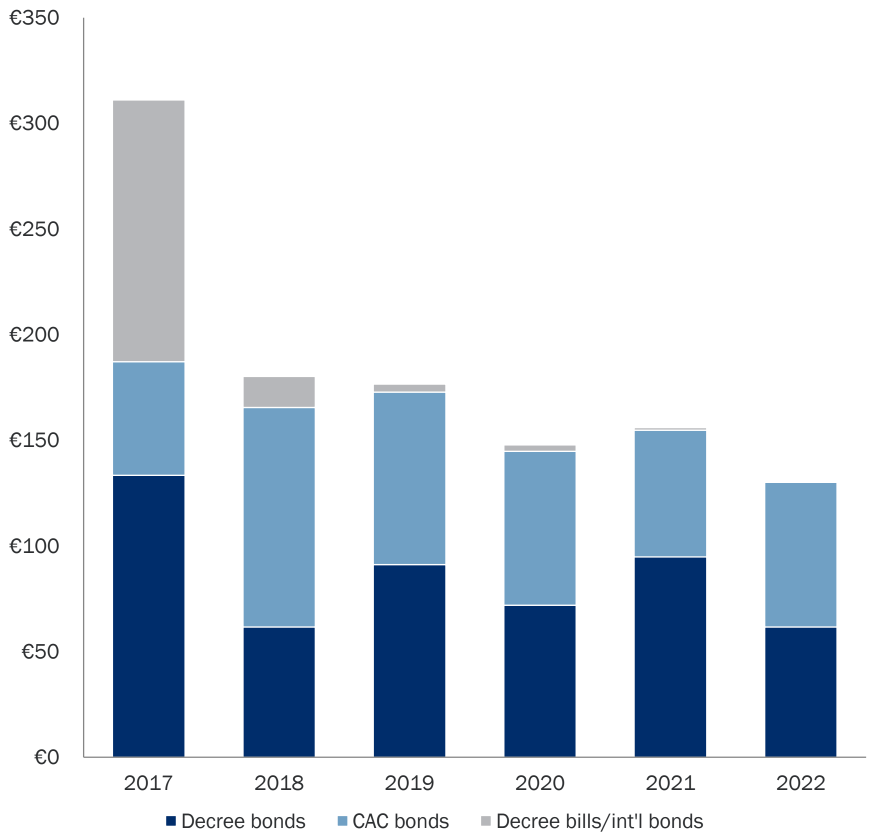
  Lower Court of the regional administrative tribunal provides exclusive jurisdiction and Council of State on appeal

Source: A Edelen et al. A mature approach: using a unilateral or voluntary extension of maturities to restructure Italian debt, November 2012

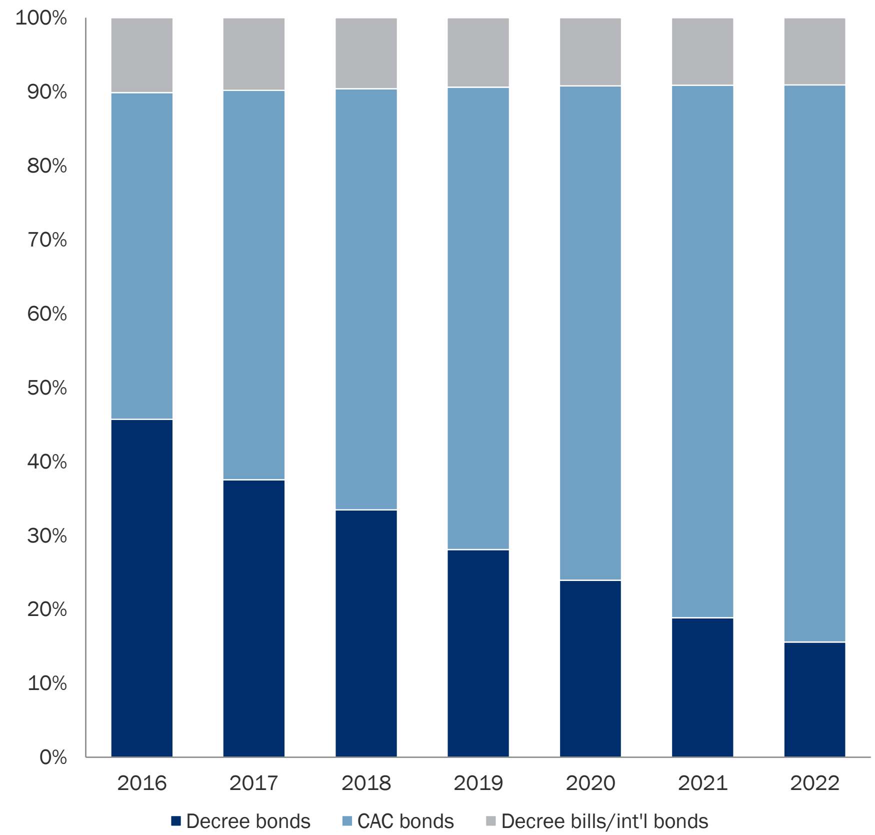
1) Collective Action Clauses became mandatory since 2013 in accordance with the ESM Treaty

...AND WILL EXIST FOR YEARS TO COME

Maturity schedule (€ bn)



Projected debt composition[1)]



Source: Bloomberg, Astellon calculations

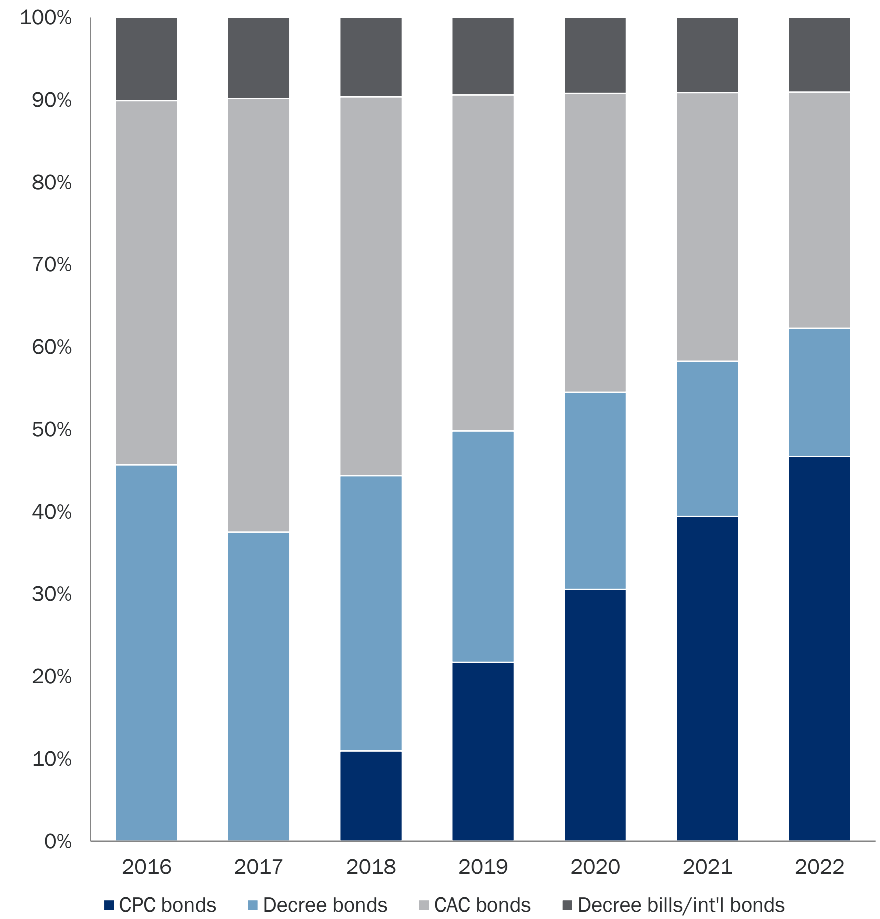
1) Assumes €50bn annual net increase in government debt, constant 8% financing with decree bills, and no new international bonds

GERMAN PROPOSAL[1] ALLOWS ORDERLY SOV DEBT RESTRUCTURING/BAIL-IN

Proposal by German Council of Economic Experts

- Mechanism to be applied as part of ESM assistance
  - Requires independent assessment of debt sustainability
- 2 stage decision framework
  - 1st stage: a fast and simple decision determines whether ESM requires creditors to agree to a standstill at the start of the ESM programme
    - Maturity extension is required if debt/DGP >60% - 90%
    - Refinancing volumes exceed 15% - 20% of GDP
    - 2 – 3 violations of fiscal rules in last 5 yrs
  - 2nd stage a comprehensive set of considerations determines deeper restructuring requirement, debt relief
- New class of bonds to be issues with **Creditor Participation Clauses (CPC)** with 3 key changes vs CACs
  - Single limb voting for CAC to avoid hold-outs (75% majority) and amendment to pari passu clauses (to avoid “Argentina case”)
  - An enforcement moratorium anchored in the ESM Treaty
  - Phase-out of privileges for sov debt in banking regulation

However, penetration of debt stock with CPCs takes time[2]



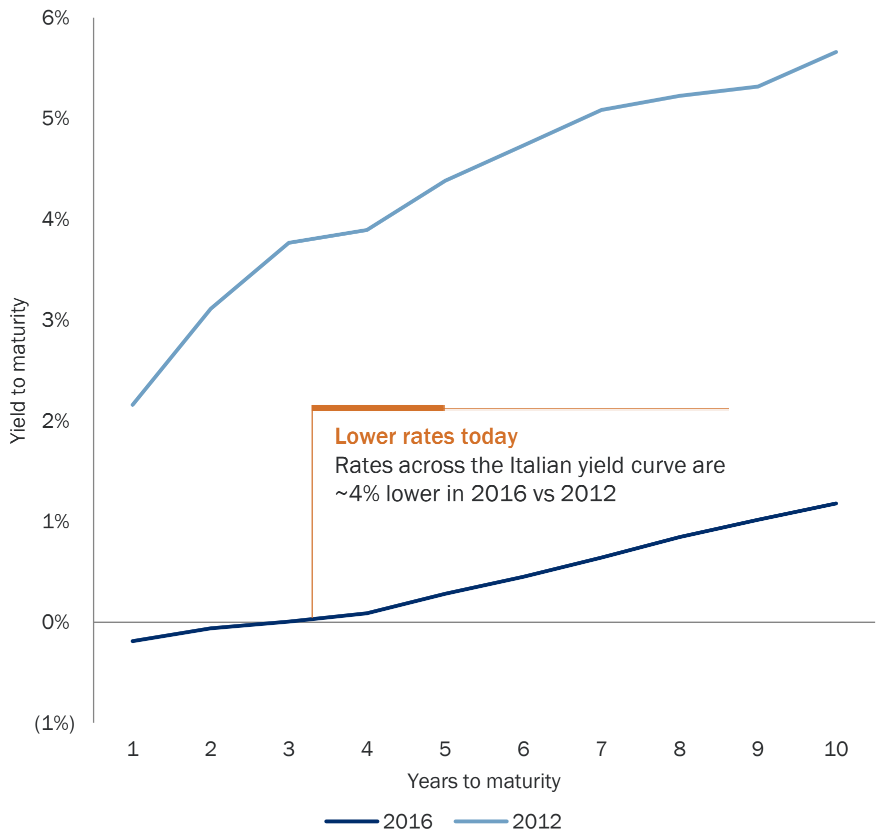
Source: Bloomberg, Astellon calculations

1) *Sachverständigenrat 11/2016: an analysis of Euro area bond maturities and simulation of the introduction of new CACs*

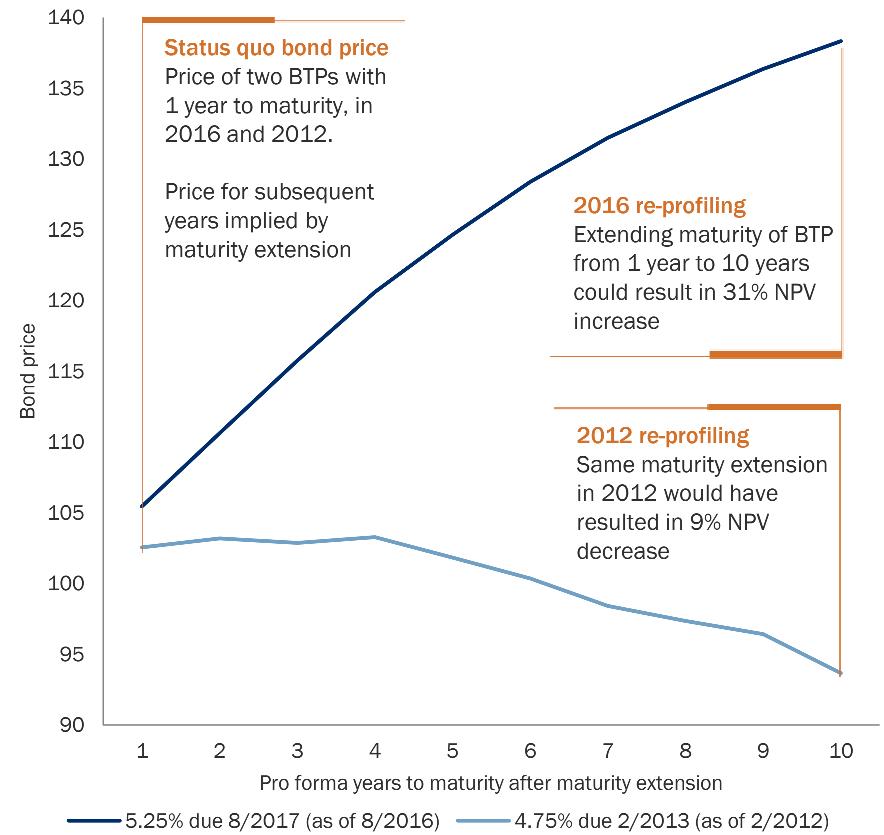
2) *Penetration of Italian sovereign debt including CPCs assuming they become effective as of 2018*

MATURITY EXTENSION BY ITSELF IS NOT A PANACEA

Italian sovereign yield curve – 2016 vs 2012



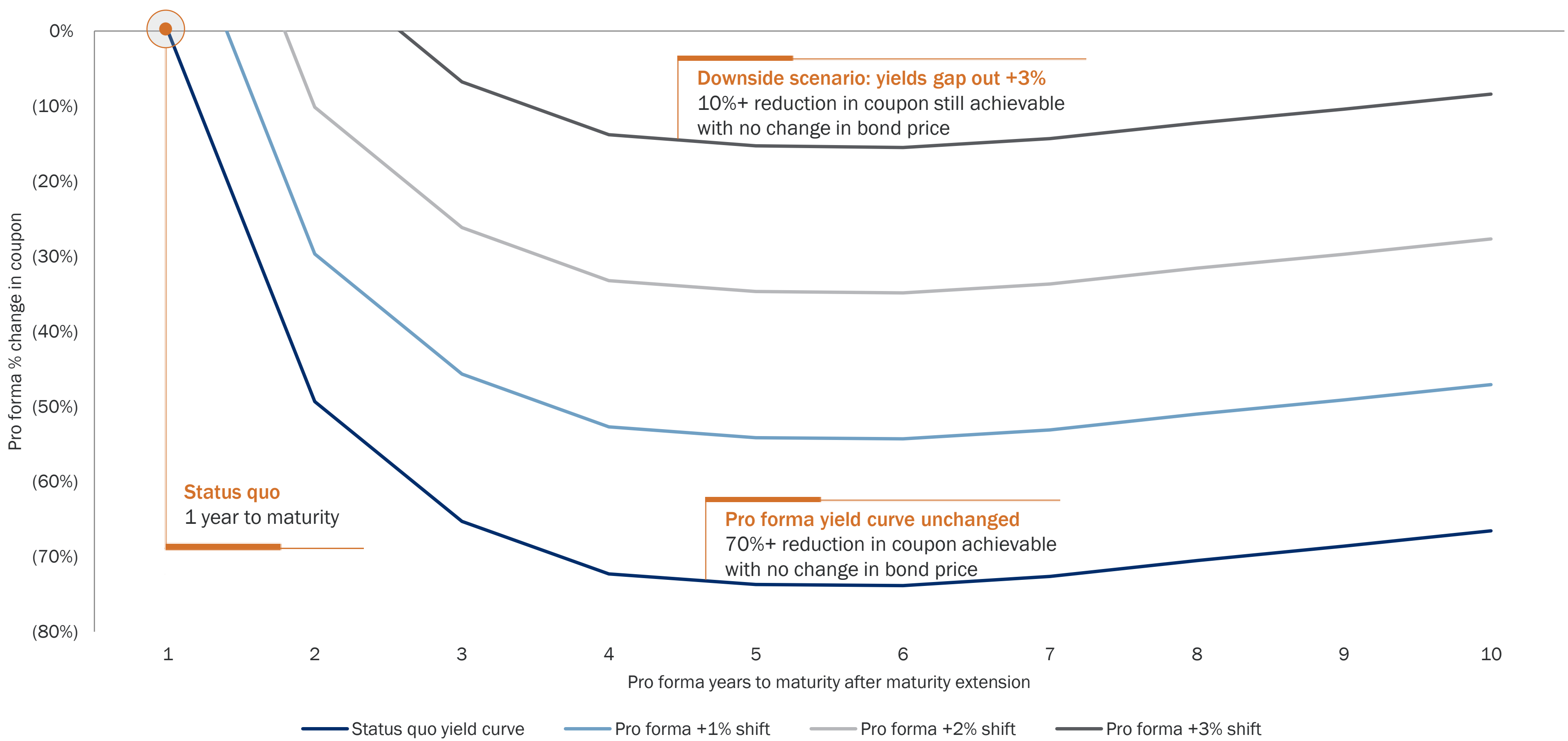
Maturity extension today could lead to *increase* in bond prices



Source: Bloomberg, Astellon calculations

CUTTING COUPON AND MATURITY EXTENSION CAN BE VALUE NEUTRAL

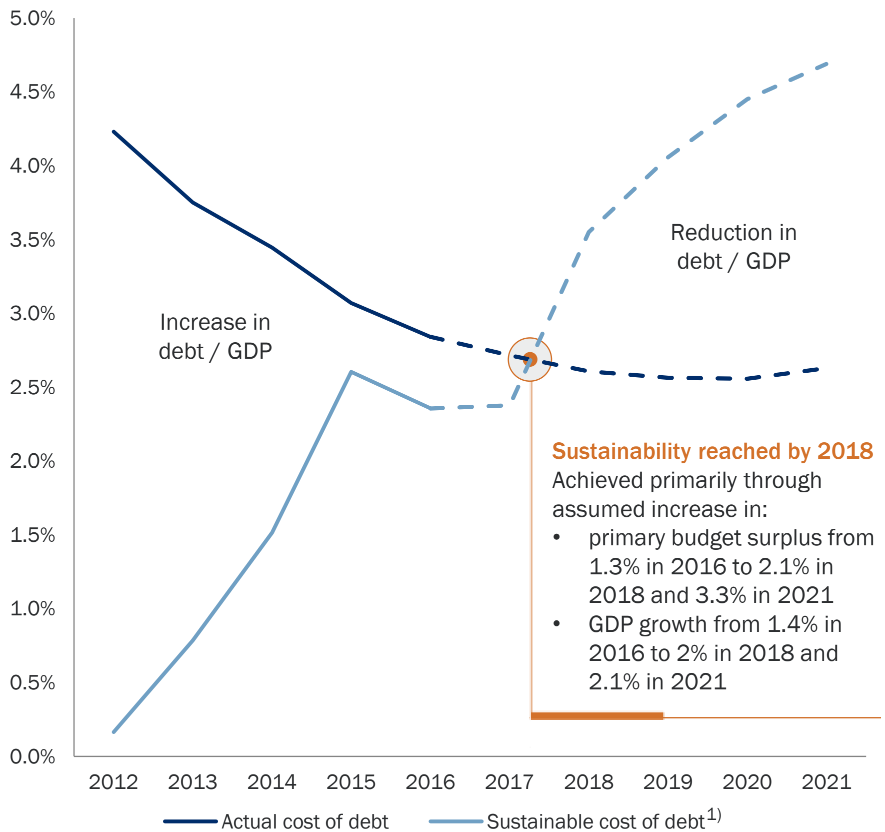
Value neutral % coupon reduction implied by maturity extension and shift in yield curve for 5.25% due 8/2017 BTP



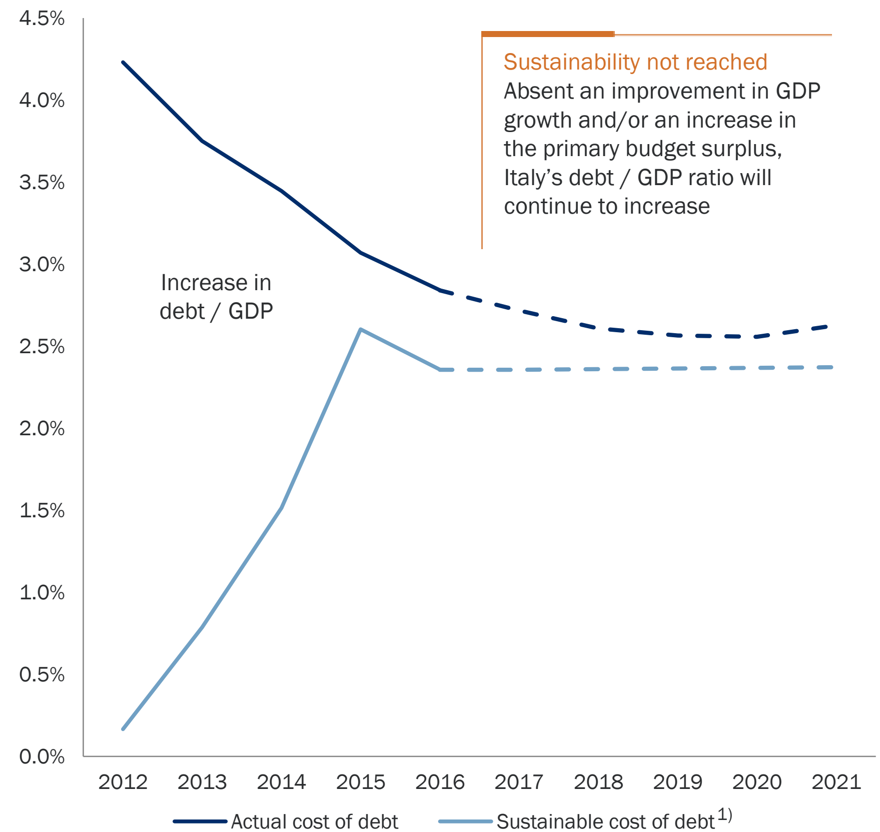
Source: Bloomberg, Astellon calculations

COUPON REDUCTION MOST IMMEDIATE AND REALISTIC PATH TO SUSTAINABILITY

IMF projections require substantial economic improvement



2016 run-rate carry forward



Source: IMF, Astellon calculations

1) Sustainable cost of debt defined as implied cost of debt level required in a given year for debt / GDP ratio to remain unchanged over prior year. Formula driven by existing debt / GDP ratio and assumptions on nominal GDP growth and primary budget balance level.

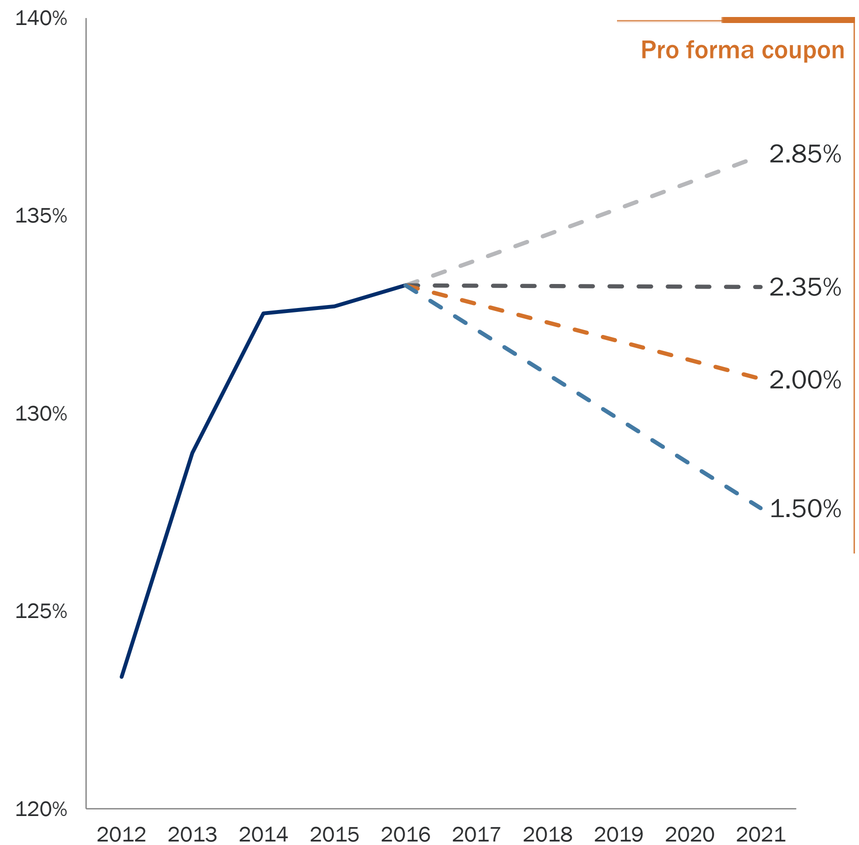
VOLUNTARY EXCHANGE OFFER COULD FIX DEBT SUSTAINABILITY ISSUE

Lower coupon & maturity extensions vs credit enhancements

- **Benefits for Republic of Italy**
  - Orderly debt exchange process
  - Maturity extension by ≥ 5 years
  - Reduction of weighted average coupon of currently 2.85% to 2.35%, i.e. a reduction of at least 17%
    - Approximately equal in size to the aggregate reduction in debt costs that has been achieved since QE began
  - Sufficient time to enact structural reforms without dependency on international capital markets

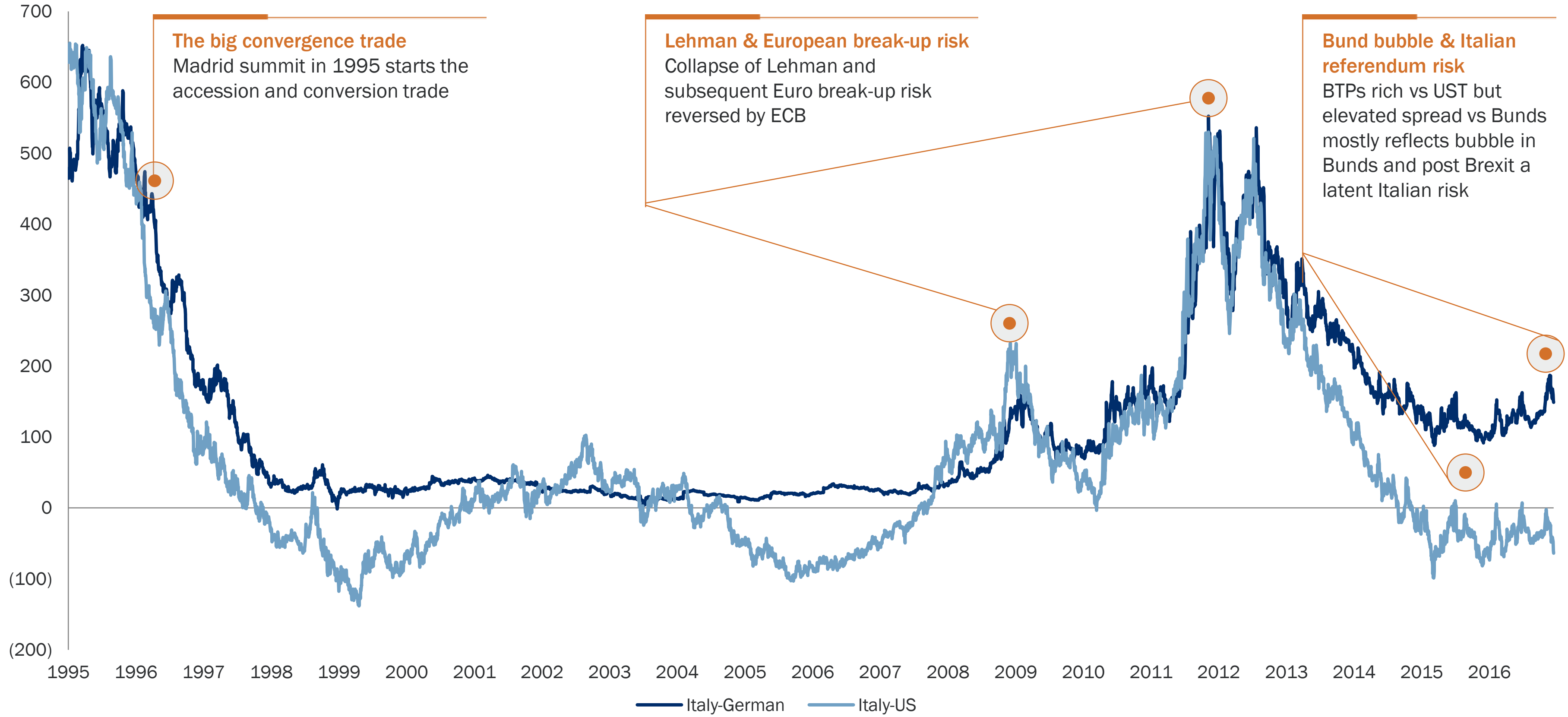
- **Benefits for investors**
  - Improves risk-reward of owning BTPs as downside risk is removed or substantially mitigated
  - Credit enhancement features should include
    - All new bonds should have CPCs
    - International law applicable
    - € as base currency, defaults to US$ in case of Italy exit from Eurozone or break-up of Eurozone
  - Ring-fencing with no/limited contagion to other European holdings

Debt / GDP (carry forward of 2016 economic performance)



MEANWHILE, BTPS ARE STILL RICH DESPITE SPREAD WIDENING VS BUNDS…

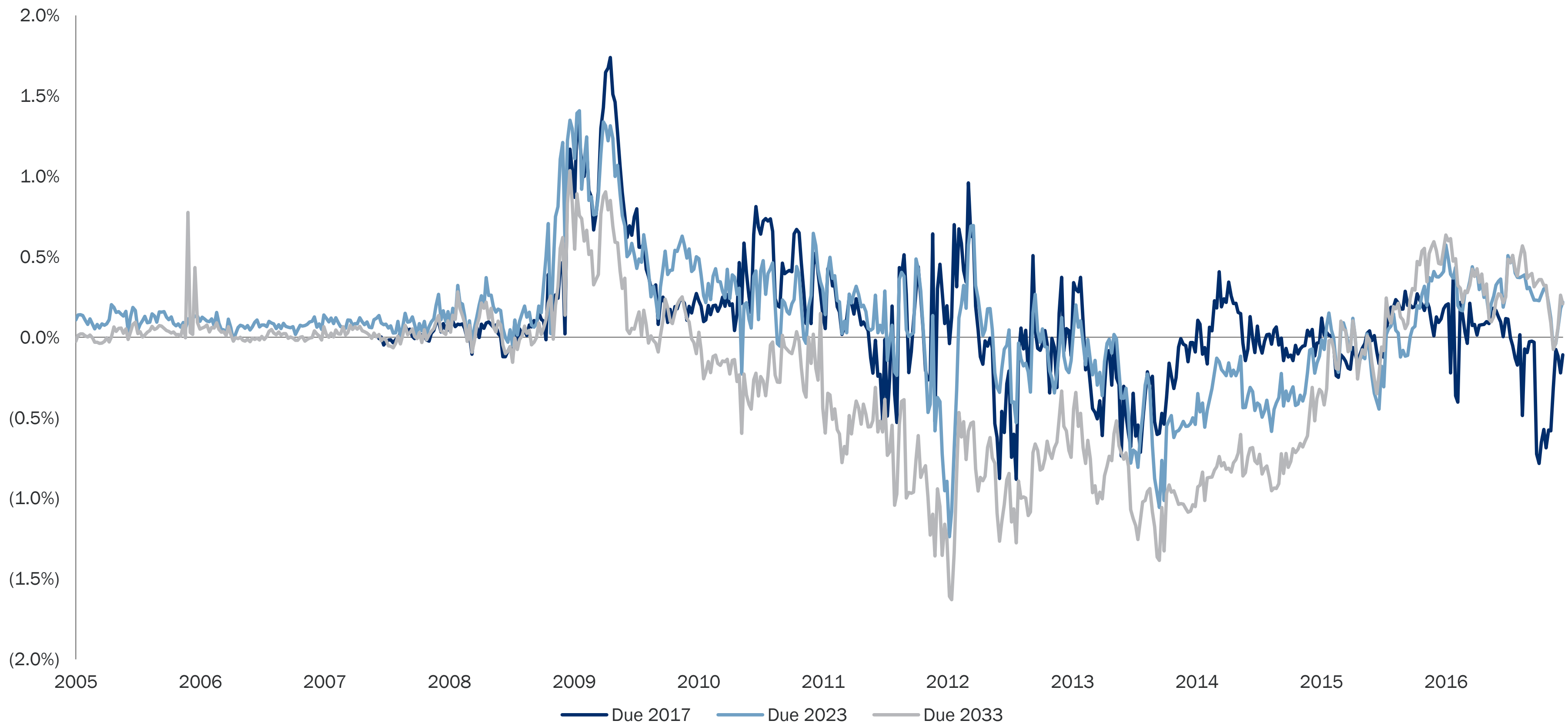
10yr spread differentials Italian BTPs vs German Bunds and vs US treasuries



Source: Bloomberg, Astellon calculations

SUPERIOR US$ NY LAW INVESTOR PROTECTION CURRENTLY NOT VALUED

€ equivalent spread of US$ NY law bonds[1)] vs decree bonds: between 2011 and 2014 negative spread up to 150bps



Source: Bloomberg, Astellon calculations

1) US$ denominated bond swapped into €

SPREADS AT RISK OF GETTING RICHER STILL

Key short-term and mid-term event risks

Duration hedge

Outright or as spread

Back up in UST to impact BTP yields as well

2016/17

QE Tapering

ECB to (further) reduce or end QE as of 2018

ECB is only marginal buyer of BTPs

2018

CRD V

Bank-sovereign nexus to be softened

Italian Banks could become net sellers

2016/17

Re-profiling or re-domination risk

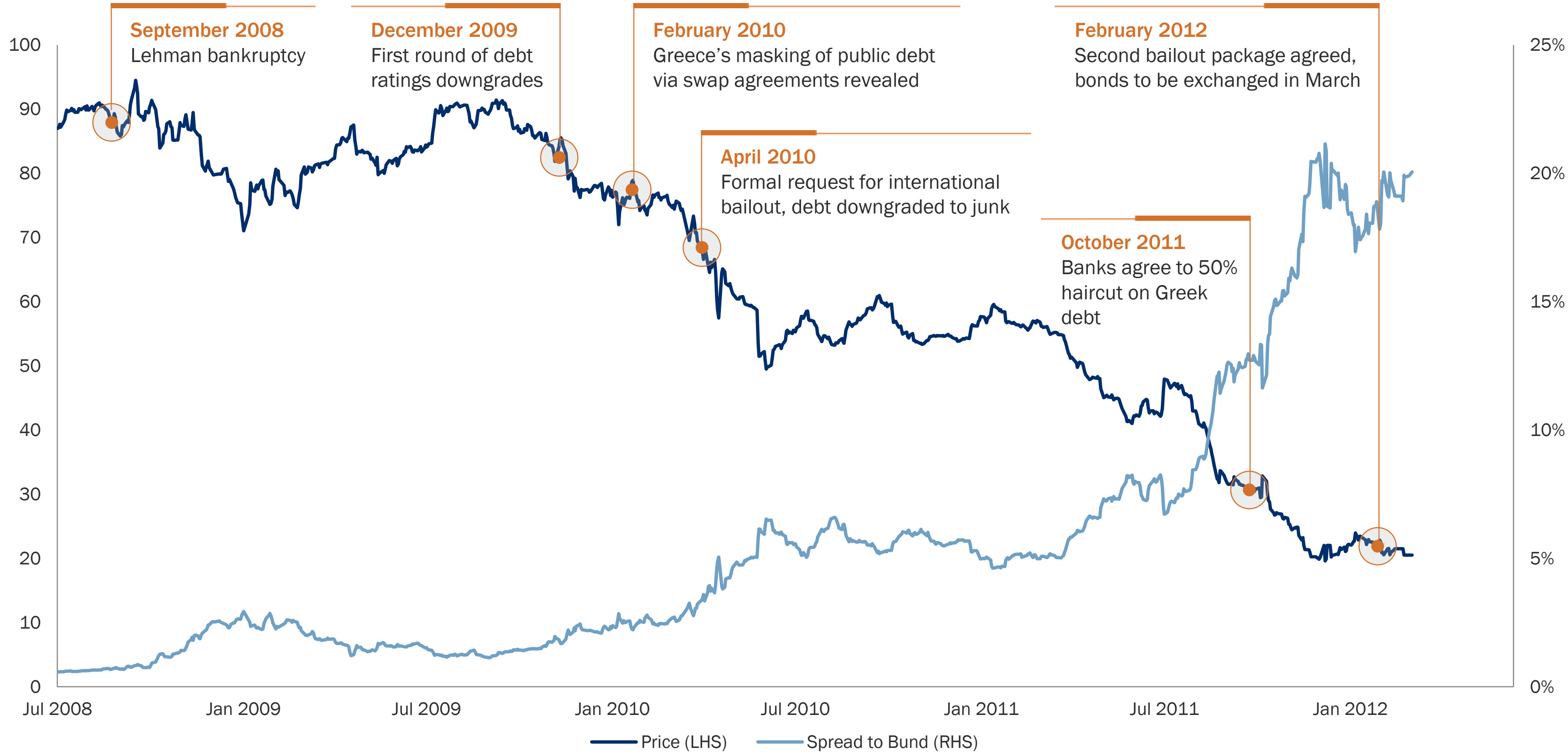
Orderly or disorderly

Unilateral re-profiling or re-domination or some form of (orderly) Greek-style haircuts

2018/19

EXAMPLE GREECE: THE DAMAGE WAS DONE WAY AHEAD OF THE RISK EVENT

Case study: Greece 4.60% bonds due 2040, price and spread to Bund



Source: Bloomberg, Astellon calculations

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