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Italy's Political Woes Spell 'Nightmare' for BNP, Agricole

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(Updates with Italy's post-Berlusconi scenario in fifth paragraph. For more on Europe's debt crisis, see {EXT4 <GO>.})

Nov. 9 (Bloomberg) -- BNP Paribas SA and Credit Agricole SA, France's largest banks by assets, are finding that their pursuit of growth in neighboring Italy in the past decade has a downside: political risk.

As the world's biggest foreign holders of Italian public and private borrowings -- with $416.4 billion of such debt at the end of June -- French lenders face collateral damage from the political turmoil that sent Italy's bond yields to euro-era records. Austerity measures to balance Italy's budget are also threatening growth in an economy that has lagged behind the European average for more than a decade, and may hurt the French banks' consumer businesses.

"Italy was a dream investment for French banks," said Christophe Nijdam, a bank analyst at AlphaValue in Paris. "Nobody could have imagined a sovereign crisis touching a G-7 economy at that time. But the political deadlock is turning the dream into a nightmare."

Prime Minister Silvio Berlusconi, who failed to muster an absolute majority in a routine ballot in Rome yesterday, agreed to resign after parliament approves the country's austerity plans next week. Berlusconi's move forces Italy to seek a new regime stable enough to convince investors the country can fund itself and implement painful budget-cutting measures.

'Gorilla in the Room'

Italy's ability to refinance is critical to French financial institutions, which held $106.8 billion of government borrowings and $309.6 billion of private debt at the end of June, according to data from the Bank for International Settlements.

Italy's 1.9 trillion euros ($2.6 trillion) of debt is the world's fourth-largest, behind the U.S., Japan and Germany, and more than that of Greece, Spain, Portugal and Ireland combined. Relative to gross domestic product, it is the highest in Europe after Greece, standing at about 120 percent.

"Italy has always been the gorilla in the room for French banks," said Julian Chillingworth, who helps manage 15 billion pounds ($24 billion) at London's Rathbone Brothers Plc and holds BNP shares. "Sovereign-debt investments in the euro zone are turning out to be like George Orwell's Animal Farm: 'All animals are equal but some are more equal than others.' Italy is not as low risk as Germany or France. The immediate issue for Italy is refinancing."

French AAA Rating

Italy's political woes pushed the yield on its 10-year bond to a euro-area record on Nov. 7, increasing the premium investors demand to hold the securities instead of benchmark German bunds to the highest since the currency's introduction in 1999. The yield approached the 7 percent level that drove Greece, Ireland and Portugal to seek bailouts.

Concern about French banks' debt holdings in Europe's troubled countries -- Greece, Portugal, Ireland, Spain and Italy -- has weighed on their stocks. Before today, the shares of BNP Paribas had fallen 41 percent since early July. Credit Agricole tumbled 50 percent, more than the 27 percent drop in the 46- member Bloomberg Europe Banks and Financial Services Index.

A BNP spokeswoman declined to comment on the impact of the political turmoil in Italy as did a Credit Agricole spokeswoman.

French banks carried about 50 percent of the total private and public claims at European banks related to Italy at the end of June, according to BIS data. The French lenders' holdings threaten to channel risk toward France, whose own AAA rating is threatened as the European crisis deepens.

Umbilical Cord

Between the French and Italian financial systems "there's a kind of umbilical cord," said Jacques-Pascal Porta, who helps manage 500 million euros at Ofi Gestion Privee in Paris, and holds shares in BNP Paribas and Credit Agricole. "If things turn sour in Italy, clearly it's going to be a problem for the two banks. And given that these are two big French banks, it's going to weigh on France's rating too."

BNP Paribas, based in Paris, held more Italian than French sovereign debt at the end of 2010. It has since cut back on its Italian sovereign holdings. France's two biggest banks hold about 20 billion euros of Italian government debt.

"French banks' Italian sovereign exposure in itself isn't very systemic," said Pierre Flabbee, a Paris-based analyst at Kepler Capital Markets. "Even in the unrealistic case of an Italian default, their level of exposure per se isn't systemic for France. Italy is too big to fail because the consequences of a sovereign default on private debt would be incalculable."

Disengagement Effort

French banks, like their European counterparts, are cutting Italian sovereign holdings. The banks' participation in the government-debt flight is lowering the value of their remaining holdings and threatens to exacerbate the region's crisis.

BNP Paribas last week said it cut those holdings by 40 percent, to 12.2 billion euros between July and the end of October. The move was part of an attempt to shrink its total sovereign debt holdings by 23 percent to 81.5 billion euros.

“We incurred losses” from the sales, BNP Paribas Chief Executive Officer Baudouin Prot said in a Bloomberg Television interview last week.

Credit Agricole’s net banking-book Italian debt holdings at the end of June were at 7.8 billion euros, it said Aug. 25.

Meanwhile, Italy’s austerity plan threatens to dampen economic activity and hurt the banks’ main business there. Over the last decade, BNP Paribas and Credit Agricole bought two of Italy’s 10 largest lenders.

“Italy has a strong economy; it just needs to be well managed,” BNP Paribas’s Prot said.

Consumer Banking

Berlusconi’s government has announced austerity measures amounting to more than 100 billion euros since July in an attempt to stem contagion from the euro-area debt crisis.

Italy’s government cut its growth forecast to 0.7 percent this year and 0.6 percent in 2012, from the 1.1 percent and 1.3 percent estimated in April. The unemployment rate rose to 8.3 percent in September from 8 percent in the previous month.

Drawn by one of Europe’s most lucrative consumer banking markets, French financial companies spent at least 20 billion euros since 2006 buying Italian banking and insurance assets.

“The pure retail banking exposure of the French banks in Italy is fully legitimate,” said AlphaValue’s Nijdam. “It was difficult to penetrate, no country really wants its neighbor to buy its domestic banks.”

BNP Paribas, which acquired Rome-based Banca Nazionale del Lavoro SpA in 2006 for 9 billion euros, has about 950 outlets in Italy. Credit Agricole operates about 960 branches in the country. BNP’s 19,100 and Credit Agricole’s 12,000 employees in Italy are the most outside their home market.

‘Image Liability’

“If there was a slow growth or a recession in Italy, maybe the profitability would be impacted, but I do believe that BNL would remain profitable,” Prot said.

In the third quarter, pretax profit at BNL, which was founded in 1913, rose 18 percent from a year earlier to 135 million euros.

BNP Paribas had 73.3 billion euros of loans at its BNL unit at the end of September, compared with BNL’s 32.2 billion euros of deposits, according to its website. The Italian retail- banking unit of Credit Agricole, which will report third-quarter results tomorrow, had 33.2 billion euros of loans and 32.8 billion euros of deposits at the end of June, company data show.

For now, the best option for French banks may be to hunker down and ride out the storm, said AlphaValue’s Nijdam.

“Italy is suffering from some political image liability,” he said. “It’s a solid economy and it makes sense for banks that have taken strategic industrial positions to remain there.”

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