LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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WAYS FORWARD: SOLVING THE PROBLEM OF ITALIAN BANKS

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1. Introduction

The phase of Quantitative Easing (QE3) announced last March by the European Central Bank (ECB), and the linked new series of targeted longer-term refinancing operations (T-LTRO II), have reduced liquidity risks for euro area banks. Vice versa, the Italian banking sector has gross non-performing loans (NPL) exceeding €360bn, and the book values of these loans–on average–are more than double the corresponding market prices potential international buyers are willing to pay in the short term. Moreover, the Italian banks declaring higher incidences of NPL are often those with capital-to-asset ratios close to the minimum required by European regulatory authorities; therefore, if they offload a significant proportion of their NPL at short-term market prices, they would record losses at a level requiring significant recapitalization, a difficult market challenge at this time. This is hindering the launch of an efficient market for securitizations in Italy.

At the end of June 2016, the European Commission approved the Italian government's request to guarantee some types of new bonds issued by solvent national banks and ECB's liquidity provision for these banks. As also shown by the reaction of the stock market in the following days, this agreement is not an adequate solution for the ongoing problems of the Italian banking sector since it only covers liquidity risks. It does, however, send important signals and opens up the possibility for progress.

2. Problems and Ineffective Solutions

As a result of the UK referendum on Brexit, the Italian banking sector risks becoming both the catalyst and amplifier for negative macroeconomic shocks in the euro area. Hence, it is crucial to find an efficient and time-consistent solution to the main weaknesses that affected this

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sector since 2012. With its public guarantee scheme, the Italian government signaled that the abnormal amount of NPL held by Italian banks cannot be gradually re-absorbed through long-term debt management processes. These processes, left to the initiative of Italian banks, would be distorted by the constraint of minimizing recapitalization needs. On the other hand, by accepting this scheme, the institutions of the European Economic and Monetary Union (EMU) signaled their willingness to recognize that a number of Italian banks are facing a crisis that could have a systemic impact on the Italian and European financial market. This is an important issue since the European legislation maintains that the actual threat of systemic instability allows for the implementation of state-aid without first triggering a resolution process and, hence, the application of *bail-in*.

The Italian banking sector's situation shows that the creation of the Atlas Fund in April 2016 and the state guarantees on the senior tranches of securitized NPLs, agreed upon by the Italian government and the European Commission in January 2016, are inadequate for launching a market liquidation of Italian NPL and the subsequent recapitalization of banks. These measures were and still could be useful tools for avoiding the resolution process for small- and medium-sized Italian banks unable to satisfy European capital requirements through market operations.

Guarantees on senior tranches cannot significantly reduce the gap between the average book value and the market values of Italian banks' NPL. Additionally, purchases of more risky tranches by the Atlas Fund, even if they were not limited by the availability of funds (sitting at €1.7bn after the recapitalizations of Banca Popolare di Vicenza and Veneto Banca), thanks to new capital inflows, could not set credible market prices and thus create an efficient Italian market for securitizations. These prices would be, in fact, distorted by the overlap of the buyer and sellers. The main portion of the NPL's Italian suppliers would be banks that also hold a large majority of Atlas shares; hence, the Fund would play the role of monopolistic purchaser, under the control and in the interest of the suppliers-owners. This distortion could not be overcome by increasing the property role of the *Cassa Depositi e Prestiti* (CDP), either in an enlarged Atlas Fund or in a new twin Fund of Atlas. The private shareholders of CDP are also important shareholders of the largest part of Italian banks with NPL to sell.

3. New Opportunities

The fact that the previous initiatives of the Italian government are not effective in combatting the crucial problems of the Italian banking sector and that these problems do not mainly relate to liquidity risk does not contradict the statement above that the most recent agreement on public guarantees opens up the possibility for new progress. Public aid without the application of the resolution mechanism—and specifically of *bail in*—would be legitimized by potential systemic instability in the Italian banking sector. Hence, this most recent agreement can be interpreted as proof that European institutions are ready to recognize that the problems of a number of Italian banks may lead to an actual threat of systemic instability. As a consequence, at least two new avenues for exploration open up: 1) recapitalization, using public funds, of all Italian banks ready to undertake a rapid, albeit gradual, offloading of NPL, at a level sufficient to reduce their NPL-to-assets ratio to a figure in line with the average of other European banks; and 2) the creation of one or more "bad banks" to buy up the aforementioned NPL.

These two new options nonetheless come with difficulties. The main obstacle to the first lies in the fact that, if the recapitalization of Italian banks were financed by the national budget, the country's debt-to-GDP ratio would increase, at least temporarily, by about 3%. On the other hand, if the Italian government turns to the European Stability Mechanism (ESM) for help, based on decisions adopted by the European Council in June 2012 and implemented in July of that year by the Eurogroup, Italy would need to sign a Memorandum of Understanding (MOU) accepting a “light” form of a European aid program.

Obstacles to the second option coincide, to a lesser degree, with those of the first. The new bad banks would need to be capitalized, and the same selling banks may request recapitalization down the road, due to the recorded losses resulting from the offloading their NPL to these bad banks. The latter requiring liquidity would not, conversely, be a relevant problem: the emission of bonds and access to ECB financing would be covered by the new public guarantee scheme.

Solving the Italian banking conundrum is a long and arduous road. However, the recent agreement between the Italian government and the European Commission has opened practical avenues for moving forward. We cannot lose the opportunity: one of the necessary, even if not sufficient, condition to restarting a path of economic growth is re-building a strong and fully operative banking sector capable of contributing to a transition to more articulated Italian and European financial markets.