LUISS SCHOOL OF EUROPEAN POLITICAL ECONOMY

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THE ROLE OF BANKS IN THE RECENT ITALO-GERMAN DISPUTE

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THE DEBATE between the Italian President and other European representatives (the European Commission President and German Chancellor in particular) has recently raised a number of disagreements, aided by multiple factors that, while impacting the entire euro area, have gained peculiar prominence in Italy. Although they have political and institutional components, these factors find their roots in economics. For this reason, it is worth focusing on the economics problems (specifically on the banking sector problems) that have shaped the Italian negotiating position in the euro area.

1. Normative and Factual Aspects

The problems that have weighed on the Italian banking sector in recent months, and that have been strengthened by the European process of creating a Banking Union, are too well-known to be worth repeating in great detail. Here, it suffices to recall four facts:

First, the transition from the international financial crisis to European crises transformed Italian banks from a virtuous case, which had not needed significant government assistance when compared to the banks in the rest of the European Union, into repositories for non-performing loans (NPLs). These NPLs have now exceeded €350 billion and are severely impeding the flow of credit to the 'real' economy.

After having rejected the opportunity to finance a "bad bank" with European funds in June 2012, a move that would have worsened Italy's debt-to-GDP ratio, the Italian government ran out of time to create one or several special vehicles to acquire NPLs at prices directly sustained by government guarantees. Thus, Italy is now subject to new European rules, put in place three years ago (see European Commission Communication C216, known as the "Banking Communication," published 30 July 2013), which prohibit direct state aid to banks in difficulty outside the resolution processes centered on the bail in. Only at the end of January 2016 is a compromise being worked out, one that risks not actually solving the problem since it does not reduce (or insufficiently reduces) the difference between the average values of NPLs as recorded in the balance sheets of banks and their average values if liquidated on the market.

Second, in mid-November 2015, the Italian government gave in to new EU rules on state aid that prevented it from using its national interbank fund to save three regional or small savings banks—*Banca Marche, Cassa di risparmio di Ferrara,* and *Cassa di risparmio di Chieti*—and a mid-size cooperative bank—*Banca popolare dell'Etruria*—that were all in deep trouble. The national interbank fund is financed by private resources made available on an *ad hoc* basis by

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the remainder of the Italian banking system and had been utilized in a previous and controversial bailout of *Banca Tercas*. However, this fund requires a public actor to set it in motion, which is enough to make it incompatible with the previously mentioned new European rules.

The Italian government had to pursue a different solution. It spun off the non-performing loans of Banca Marche, Carife, CariChieti, and Etruria into a single "bad bank," cleaning up the balance sheet of the newly formed four banks, which were born from the ashes of the old one. This process wiped out the value of shares and subordinated bonds that the four failing banks had previously issued. Making matters worse was the fact that, in recent years, the Italian banking sector had placed an abnormal amount of different types of bank bonds (including subordinated bonds) in the portfolios of small investors, as opposed to directing them only to institutional investors. Hence, the obliteration of the value of subordinated bank bonds resulted in social alarm.

Third, this rescue was hastily implemented in order to take advantage of the shrinking window between the Italian Parliament's tardy adoption of new European rules on banking resolution processes and the beginning of 2016. Had Italian authorities waited until January 1 of this year, the second pillar of the Banking Union would have fully gone into effect, implying that the restructuring of each failing bank and the potential utilization of the Single Resolution Fund would first require loss coverage by private shareholders and bondholders (up to 8% of bank liabilities) through the so-called bail in. More precisely, the latter implies that, in sequence, stocks, all types of non-guaranteed bonds, and deposits over €100,000 would face value reductions or nullification in order to trigger the resolution process for banks in trouble. Had this applied to the four above-mentioned banks, the new bail in procedure would have embroiled also holders of 'plain vanilla' bonds and, at least in principle, depositors with over €100,000 in their deposit accounts. The aftermath would have increased the burden and concern of all savers.

Fourth, the bail in and other components of the bank resolution mechanism, approved by the European Council between June and December 2013, would have to be completed alongside the third pillar of the Banking Union: the European Deposit Insurance Scheme, which is based on the creation of a single fund for deposit guarantees. At the end of last year, following up on previous agreements by member states, the European Commission proposed the gradual constitution of this fund, which met with a resonating German veto.

On this issue, Germany argued that the actual creation of a common fund for deposit guarantees should be contingent upon the banking sector of more fragile countries bringing their exposure to their own country's sovereign debt under control. This can be done either by lowering the proportion of these sovereign bonds with respect to their total assets under a certain threshold, or by no longer classifying these liabilities as risk free, forcing them to have appropriate capital coverage. The German argument is that, if these requirements were not satisfied, a common deposit insurance scheme would weaken the link between the banks' acquisition of sovereign bonds and the private assumption of related risks, distorting market rules to an extent that there would be an indirect but automatic *bail out* of more fragile countries.

2. The Dispute

When combined with other European issues (the impact of non-conventional monetary policy, lackluster economic growth of more fragile countries, and the use of the flexibility clause with respect to required adjustments in public balances), these four above-mentioned factors have at least three implications. Above all, the Italian banking sector, an essential player in the possible recovery of the Italian economy, risks finding itself weighed down by various factors: the excessive amount of non-performing loans and its own country's sovereign bonds, which puts constraints on credit allocation; the excessive issuing of bank bonds in the past that, aside from making it difficult to find effective gross substitutes, increases vulnerability in the case of a bail in and reduces the potential for new financing. Consequently, the Italian banking sector would benefit from cooperation between member states on financial matters and the completion of the Banking Union. The first move would facilitate the identification of effective solutions for the gradual liquidation of non-performing loans and Italy's sovereign bonds; the second move would provide a counterweight against the potential destabilizing effects of the bail in. Finally, Germany pursues opposite options. Reacting to the Italian decision to fully exploit the flexibility clauses and to other internal tensions in the EU, the German government has apparently chosen to use the banking sector to experiment with decentralized solutions that would shift the burden of adjustments to individual countries.

These three implications, which illustrate part of the economic dispute between Italy and European institutions, make it clear that ambitious initiatives lacking a detailed and positive foundation tend to stray from cooperative European solutions in the direction of decentralized ones. As mentioned above, this threatens the ability of the Italian banking sector to support output growth. From a purely economic point of view, one would be tempted to conclude that Italy's stance is appropriate if one expects increased flexibility in public balances to have enough of a positive impact on economic growth to make up for the negative effects due to tighter constraints on the banking sector. However, I believe that such a conclusion is, at the very least, a hasty one since it would have to be based on more accurate findings.

3. A Possible Point of Attack

My previous assertion demands additional elaboration. The first is very general: the link between increased flexibility in public balance sheets and additional economic growth depends on the anticipated and effective use of said flexibility. In this regard, the economic policy initiatives the Italian government settled on, which resulted in the decision to pursue a 1% increase in public deficit for 2016, raise several questions. In particular, the choice to stimulate private consumption in order to improve collective expectations does not seem to set our productive activities on a path toward robust growth. The second elaboration is linked to previously raised concerns about the banking sector. At closer scrutiny, the Italian criticism regarding new European rules on state aid in banking resolutions and on bail in shares common ground with the German objection to the European Deposit Insurance Scheme: the inefficient management of pre-existing factors or, more precisely, of legacy and stocks.

It is not possible to further develop the first theme since it is too general. I will instead focus on the second. The Italian government criticizes new European rules on banking resolution because these rules neglect two elements. Firstly, the fact that the amount of state aid provided to the Italian banking sector between 2008 and 2013 was so limited as to have a negligible impact on Italian public debt. Secondly, the fact that bank bonds issued before December 2013 or 1 January 2016, i.e., issued before the approval or implementation of the bail in, originally incorporated lower risks than they do now, seeing as how the new banking resolution mechanisms also apply to them. Analogously, the German government finds it unacceptable that the European Commission would propose a common deposit insurance fund prior to "cleaning" the balance sheets of the banks located in more fragile member states. In fact, these balances incorporate high and specific inherited risks. In other words, Germany opposes the choice to approve the third pillar of the Banking Union prior to an offloading of the negative legacy, which is hidden in the composition of bank assets in the most fragile EMU countries.

This confirms my prior assertion: Germany and Italy's criticisms of the Banking Union are both based on inefficient management of legacy problems. The implication is quite obvious. The Italian challenging of European institutions and Germany would have a higher degree of credibility if it raised the following issue: why should Italy accept a legacy of suddenly riskier bank bonds and the 2008-13 state aids to non-Italian banks in trouble if Germany is not forced to accept the legacy of risk incorporated into sovereign bonds held by each of the EMU banking sectors.

The best answer is not to revise and weaken the implementation of bail in but to quickly approve and launch a single deposit guarantee fund at the EMU level. I continue to maintain that it has been a significant and negative imposition to enforce a new rule that altered the risk profiles of pre-existing financial portfolios of savers in a number of EMU member states. I am nevertheless aware that the request to not apply the bail in to bank bonds issued prior to December 2013 would put the very structure of the Banking Union back under discussion (the Single Resolution Fund in particular), as well as other European institutions pivotal to the area's stability (such as the European Stability Mechanism and the Outright Monetary Transactions). Conversely, Germany needs to admit that not respecting the agreements relating to the completion of the Banking Union would also be a dangerous step in the wrong direction. Without the creation of a common fund for deposit guarantees, the resolution mechanisms for banks in crisis would be neither effective nor efficient. These mechanisms would increase the likelihood that national funds for deposit guarantees would prove quantitatively inadequate, thus introducing an additional threat to EMU financial stability.