Italy's Coming Banking Crisis

The rest of Europe is losing patience.

By Lorenzo Codogno

There are lessons that the European Union has learned about banking crises, but it is still not clear how it can avoid the next one in Italy. Economic and political developments in the European Union and the still-unfinished banking union make any effort all the more complicated, and leave open the issue of how Italian banks can adequately be backstopped.

The end of quantitative easing by the European Central Bank, the spread of populism and Euroskepticism, the fresh fall into recession in the second half of 2018, the deterioration in debt dynamics, and the related renewed pressure on government bond yields may mark the start of a new wave of banking problems. Italy's banking sector may be hit before it adequately addresses remaining vulnerabilities and leftovers of the previous crisis.

What has been the policy and banking response since the previous crisis?

In 2011, Italy experienced a quasi-credit crunch. The debt crisis touched Italy's specific weaknesses, with poor economic performance in the years preceding the crisis and a very high debt-to-GDP ratio. Banking problems were the direct consequence of the government debt crisis and the downturn in the economy. Italian banks suffered

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from a *de facto* closure of the eurozone interbank market and the related difficulties in funding their financing gap. The perceived higher lending risk translated into higher spreads versus money market rates and prompted banks to ask for increased guarantees and collaterals to clients. The reduced supply of credit and the higher perceived risk increased the cost for borrowers, especially for small- and medium-sized enterprises. The negative loop, in turn, affected the quality of the credit portfolio of banks. Italy quickly became the focus of financial markets' attention and a threat to the stability of the whole eurozone, given the size of its economy and public debt.

Addressing banking problems in earnest was a plus for the EU countries that did it. Government intervention to support the banking sector in the initial stage of the crisis was indeed massive across Europe, and it appears it reduced the negative economic impact of the crisis and allowed a quicker recovery in credit.

Italy missed that opportunity. Policymakers and banks did not recognize promptly enough the fast deterioration in non-performing loans, and their effect on lending and the broader economy. Moreover, the high debt-to-GDP ratio constrained any possible government intervention. As a result, market worries remained elevated until 2016, despite underlying improvement in the economy and the banking sector. Banking problems in Italy required substantially less public money than in other countries, but the smaller and delayed intervention came at a price for the economy. At the end of 2016, the Italian government allotted €20 billion to set up a fund for intervention in favor of banks through different instruments. *De facto,* this injection of public funds provided confidence in financial markets and stabilized the situation.

Other European countries are preparing for Italy's default.

In March 2018, the populist anti-establishment Five Star Movement and the League won Italy's general elections and, in early June, formed a government together. Italy's growth was still at the lower end of the range of euro-area countries before elections, although it was steadily recovering. Since then, concerns about fiscal and structural policies of the new government, on top of a slowdown in euro-area growth, have spread another bout of tensions in Italy's government debt, with major banks' credit default swaps following suit. The transmission channel of a possible new crisis remains the banking sector, partly due to the sovereign-bank doom loop that has remained in place since the 2011 crisis.

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A Bank of Italy study, based on the years of the crisis, shows that a 100-basis-point increase in the ten-year government bond yield spread increases fixed-term deposit and repo rates by 40 basis points, rates on new corporate bonds by 100 basis points, rates on loans to non-financial corporations by 70 basis points, and mortgage rates by 30 basis points within a quarter, while it reduces the Common Equity Tier 1 capital of banks by 50 basis points. However, the situation this time looks different. It is no longer a liquidity crisis. In fact, the interbank market has never recovered since the 2011 crisis and remains effectively closed, but banks have received stable funding from the ECB. While banks are far better capitalized, bank regulation is much tighter, and thus bank capital constraints may emerge sooner. On balance, it appears likely that the negative impact on banks stemming from the widening of spreads will be milder and delayed relative to 2011. The widening of yield spreads started in late May 2018 and produced its first effects on supply and cost of credit at the end of 2018.

There are still leftovers from the previous crisis, as the recent case of Banca Carige suggests. Moreover, there are a few other smaller troubled banks, which may require additional intervention. Still, these banks represent a tiny part of the Italian banking sector and, although sometimes systemic in some areas, they indeed do not pose a widespread stability issue. With the economy expanding moderately, these cases could have easily been absorbed. However, the issue now is the impact

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that the new downturn in the economy and widening spreads may have on the banks over time, while many unresolved issues both domestically and at the European level remain.

In the context of an incomplete Union and ahead of the May 2019 European parliamentary elections, European politicians do not call for "more Europe" and speedier completion of the banking union. Instead, there is almost a sense of dizziness and rejection. The crisis has left scars in the relations among European Union member states, and especially among those in the euro area, and there is a sense of mutual distrust that is blocking any initiative towards further integration and sharing of policies and common institutions.

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At the December 14, 2018, Euro Summit, there was not much progress in completing the banking union. European leaders decided that the European Stability Mechanism will take on the role of backstop in bank resolutions. The backstop will be activated when the resources of the Single Resolution Fund are insufficient, effectively doubling them, but the provision will become fully operational only by 2024. Moreover, the SRF is not aimed at addressing systemic and widespread issues, but only isolated bank problems.

Broader problems in the banking sector of a single country should be addressed by using different financial assistance instruments at the disposal of the ESM to support countries, which in turn would help their banking sector, as it happened for Spain in the past. However, it seems the initiatives undertaken recently were mainly aimed at ring-fencing Italy, to prevent its problems from affecting the rest of the European Union, rather than addressing them directly.

With the blessing of the Italian government and with the almost complete silence of the media, European leaders approved initiatives that could impinge on Italy's ability to address future banking crises without a full-fledged ESM program. That Italy was too big to be helped by other European countries was known; that the other European countries would have demanded a full program for Italy, before any aid or funding, including the possible one of the ECB in the context of the Outright Monetary Transactions, was also well known. However, the December decisions have made clear what many suspected, namely that other European countries are preparing for Italy's default.

First, it was decided to introduce a precautionary funding line, without strict conditionality, for those countries that fully comply with European fiscal rules. These are mainly aimed at the so-called "innocent bystanders," that is, those countries like Ireland that could be affected by the contagion of a financial crisis that starts from another country, say Italy. Second, another type of financial assistance with limited conditionality was not approved, which could have helped Italy in case of need. Furthermore, a technical change (single-limb collective action clause) was approved that facilitates debt restructuring with private creditors. Finally—and perhaps the most important change—it passed the principle that before any financial assistance, the country's debt must be declared sustainable by the ESM and the European Commission. It should also be noted that the possibility of introducing a modest and symbolic European fiscal capacity was quickly dismissed. In a more or less explicit way, all this means that if Italy loses market access and asks for European financial aid, the restructuring of its public debt would be the first requirement from other countries, before even starting any discussion.

Many unresolved issues both domestically and at the European level remain.

With a still incomplete European banking union and no significant progress in economic and financial integration, Italy's misguided domestic policies may well lead to another banking crisis over time, with little desire in the European Union to find, or even seek, a backstop for the country, let alone its banks. ◆