TROUBLES OF THE ITALIAN BANKING SYSTEM AND THE SMOTHERED HOPES OF EUROPE

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ABSTRACT

The crisis of many Italian banks, be them large commercial banks or small local mutual banks, is adversely affecting the European banking system. Confidence in Italian banking firms has decreased substantially in Italy and abroad. Financial intermediaries have specific shortcomings and specific problems to solve. Necessary improvements include better management of costs and risks, less influence by political parties on banks, improved selection mechanisms of managers, and more productive allocation of credit. Bank balance sheets should be improved in order to facilitate lending and thereby strengthen the real economy. This will take time since it is not easy to repair bank balance sheets and update the governance of banks. Rehabilitation of banks should essentially be matched by a proper cultural twist in the mindset of Italian citizens. On the other hand, the ability to secure a healthier banking sector is very much dependent on the recovery of the real economy and, therefore, on the ability for corporations to have access also to capital markets. Without such improvements, however, Italy may pose a serious challenge to the idea of a competitive European Union as advocated in the past for instance by former President of the European Commission Romano Prodi (1999).

Keywords:
Non-performing loans; Distressed Italian banks; Eurozone; Italian banking system; Crisis in Europe

1. INTRODUCTION

Italy is still in the midst of a severe banking crisis. Given the dimensions of the country's financial system, such a crisis, if not properly managed, could adversely affect the European banking system. To prevent this, it is important to understand the origins of the problems and, thereby, avoid a prolonged period of crisis. Despite market improvements, consolidation process, privatisation of Italian financial intermediaries and regulatory changes, which took place during the 1990s (Angelini and Cetorelli, 2003; Ciocca, 2005; De Bonis et al., 2012), the system as a whole still requires substantial improvements, including: a better management of risks and costs; more appropriate mechanisms of selection of top managers; less political influence on banks' lending strategies. At the outset of the global financial crisis, both commercial and mutual Italian banks seemed to be solid enough to withstand the crisis adequately. Back then, finance minister Giulio Tremonti used reassuring arguments about the assumed resilience of Italian financial intermediaries, expressing confidence in their future success. However, things gradually changed and the overall situation became increasingly difficult to manage as problems started to pile up, particularly as the crisis spread to the real economy and, subsequently, an increasing number of enterprises and households stopped paying back their loans. Moreover, credit provided to Italian enterprises has not been allocated efficiently enough.

The aim of this paper is to inform the reader about the challenges currently faced by Italian banks. These problems are not limited to Italy. Instead, they are affecting the European banking system at large (Reichlin and Valleé, 2016), casting doubts on the credibility of the European Union as well (Bandulet, 2011; Guerrieri, 2012; Tosun et al., 2014; Fabbrini, 2015). The remaining parts of this paper are structured as follows. Chapter 2 investigates the origins of the problems of Italian banking firms. Chapter 3 asks whether there are any solutions to solve the Italian crisis. Chapter 4 provides a critical discussion on the fact that the economic and political framework of a common European union may no longer be as safe and appealing as it used to be twenty years ago. Chapter 5 provides some final remarks.

Ideally, the present paper should be of interest to economists, experts in banking, policy makers and, more in general, to those concerned about the future of Europe - a Europe that, unfortunately, could soon 'fall apart' (Laibach, 2014). Despite keeping the style descriptive and as simple as possible, at the end the reader should be able to get a proper flavour of the complexity of the Italian banking crisis and of the kind of reforms/changes currently needed.

2. THE DEEP TROUBLES OF ITALIAN BANKS

Banks play a pivotal role in the Italian financial system (Messori, 2011; European Commission, 2015; Accornero et al., 2017). This chapter aims to answer the following question: What are the main issues of Italian banks? To start with, it is often argued that Italian financial intermediaries suffer from somewhat low profitability. As in many other European economies, small banks in Italy face profitability pressure and the need for a better management of costs. On average, Italian banks tend to be exposed to cost challenges, seemingly having among the highest structural costs in western Europe (e.g. Iona et al., 2015; Albertazzi et al., 2016; Garrido et al., 2016; IMF, 2016).

High costs originate, for instance, from operating costs related to bank business models as well as relatively high number of branches per capita compared to EU standards. It should be mentioned the fact that the number of bank branches increased just before the introduction of digital banking: arguably, the resulting mismatch between technological progress in financial intermediation and the human resources employed by banks lead the entire banking system to a loss in competitiveness. It comes as no surprise that after a fall in the number of banking employees since year 2013, further reduction of staff is planned until 2020.

In Italy, selection of top managers in the banking sector remains somewhat inefficient. In Italian banks, the more connected the bank managers are, the lower the probability of their turnover. As showed by Battistin, Graziano and Parigi (2012), banks with highly connected managers seem to suffer from lower profitability, particularly in the case of mutual and cooperative bank groups. The authors therefore conclude that connections in Italian banks function as 'collusion devices' to maintain rents at the expense of bank performance. Otherwise stated, the disciplining of top managers serving Italian banks do not function properly at all. Furthermore, a recent investigation by D'Amato and Gallo (2017) finds that in Italian banks (and particularly in cooperative banks), directors sitting on boards for too long develop close relationships with managers: as a result, the effectiveness of their monitoring is substantially weakened.

A third problem originates from the rather negative influence of politics on bank firms. In general, Italian banks, even the largest among them, often operate under the influence of political parties and local governments, particularly when it comes to deciding about their business strategies and development policies. This, in turn, negatively affects the quality of lending policies and can prevent an adequate assessment of risks: 'most of Italy's banks, many of which are small and local, have politicized governance features that blur commercial incentives. As a consequence, they were unable to rein in their lending during the downturn of the late 2000s … Many of these loans turned sour in subsequent years and local connections prevented the banks from working them out, so they kept supporting borrowers in a pattern of pretend and extend' (Véron, 2017).

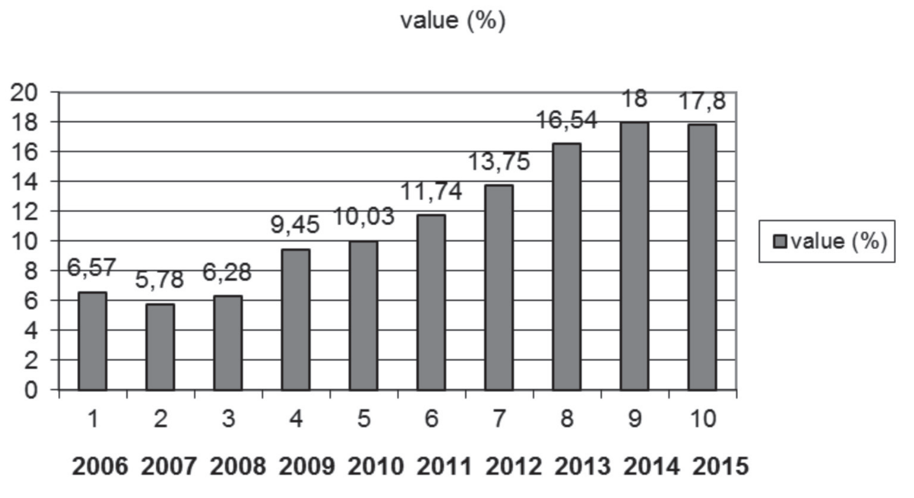
Inefficient selection of top managers and the relatively high influence of politics on both bank credit policy and decision making processes were paired with insufficient diversification of risks in the risk management policy, as well as with a decrease in the credit portfolio quality of the Italian banks. The negative repercussions on the banking sector in the light of non-performing loans called for more stringent policies for banks in issuing loans, leading to a credit crunch.

The problem of non-performing loans was furtherly exacerbated by some external factors, such as:

- a decline in industrial production due to the credit crunch, lower demand for products, and increased market pressure from global players, in part explaining for the low performance and scarce profitability of the Italian firms (with increased difficulties in repaying their loans); and
- occasional difficulties of some households to timely repay their loans (for instance, due to rising unemployment in most industries);
- The result has been a strong increase in non-performing loans with a deterioration in banks' balance sheets with negative repercussions on the ability of some banks to attract new capital. So the Italian banking sector became remarkably unhealthy at the moment.

Non-performing loans in Italian banks totalled €360 billion in 2016 - approximating to roughly 22% of Italy's GDP, even though this number does not account for some of the losses already registered in banks' balance sheets. Most of them are piled up in large commercial banks. Counterfactual analyses and related exercises for a reassessment of non-performing debt (e.g. Notarpietro and Rodano, 2016) are not very convincing. Moreover, the Governor of the Bank of Italy Ignazio Visco recently acknowledged that banks' difficulties in Italy have been exacerbated by 'fraudulent conduct and imprudent lending policies' (Visco, 2017, 12).

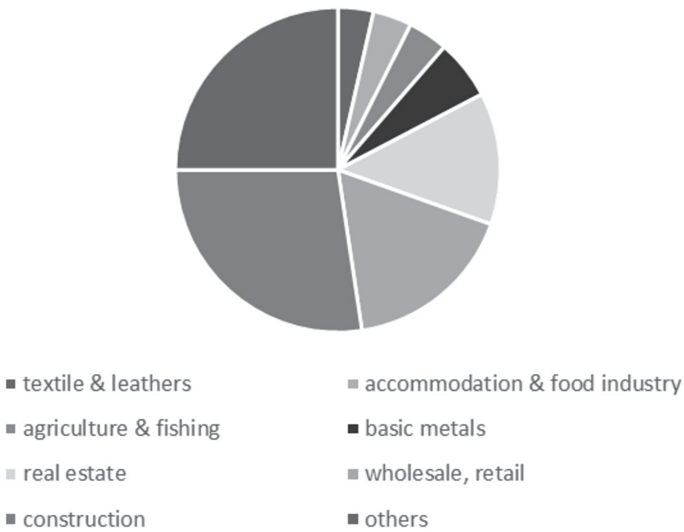
Figure 1.: Evolution of Non-performing debts in Italy



Source: World Bank, 2016.

Analysis based on data from the Bank of Italy shows that non-performing debts in the corporate sector originated mostly in the construction industry, manufacturing and real estate - all industries that have played a role in the spread of the crisis (De Lucia and Ubovic, 2016). For example, in the Friuli Venezia Giulia region in the North-East of Italy, more than 500 enterprises operating in the construction industry have ceased their activity over the period 2008-2016. In most other regions the situation has not been any better. In addition to that, one should recognise that another important source of such debts are large Italian corporations that have lost their competitiveness on the market over the last years, particularly those that are under extraordinary administration procedures - for instance, the Italian flag carrier Alitalia (discussed later).

Figure 2.: Non-performing debts in Italian companies by sector



Source: Bank of Italy, 2016 and De Lucia and Ubovic, 2016.

It is useful to look at different types of banks in order to understand how they are being affected by the crisis.

2.1. Monte dei Paschi bank: the oldest operating European bank in distress

At the beginning of 2016 the Italian government decided for the rescue of four small regional lenders (Banca Marche, Popolare Etruria, CariFerrara and CariChieti). Now, it is time for Italy to have a proper check up on its large for-profit banks.

A dramatic story is that of the Monte dei Paschi bank, Italy's third largest bank and the oldest lender in Europe. One element that is striking about this bank, but rarely noticed by foreign analysts is that, despite operating nationally, it retains a remarkably "local" outlook - something that can be noticed by looking at its control mechanism and business culture (Conti, 2013; Stefancic, 2017a; Stefancic, 2017b).

The bank has been capitalised a number of times during the last few years, but nevertheless performed poorly during the EBA stress tests in 2014 and 2016 (e.g. EBA, 2016), thus failing to attract large investors at the end of 2016. As suggested by De Groen (2016), Monte dei Paschi failed or nearly failed all the EU-wide supervisory exercises that have been undertaken in the past years. The bank has only managed to raise just enough capital, including public funds, to close the capital shortfalls or meet the threshold. The fact that the bank was allowed to live on the edge proved to be costly to the Italian society.

At the beginning of 2017, the Italian government decided on the nationalisation of the bank, at least until its outlook improves and becomes enough attractive for institutional investors. The bail-out of Monte dei Paschi can be understood as a measure for preventing the risk of contagion to other financial intermediaries. It remains questionable, however, whether the losses registered by the bank due to speculation on financial derivatives, risky and overpriced acquisitions such as that of the Banca Antonveneta in mid-2000s (Lemma, 2011; Boeri and Guiso, 2013; Stefancic, 2016), and a number of underperforming investments, are to be covered with injection of money raised by tax-payers.

One cannot exclude the possibility of other Italian banks - both commercial, cooperative and mutual banks - applying for government aid in the coming months.

2.2. Mutual banks: *banche popolari* from the Veneto region in distress

Looking at a different typology of banks, we can argue that Italian cooperative banks are not immune from failure either. For instance, some of the largest mutual banks (the so-called "banche popolari") suffered from an increase in non-performing debts during the past years, particularly since year 2010. This has attracted unprecedented attention from professional analysts and journalists alike.

Two telling examples are those of the Banca Popolare di Vicenza and the Veneto Banca, both located in the Veneto region, that is, the region of the "Italian miracle" in the 1960s and '70s, and still one of the most competitive and entrepreneurial regions in Europe. In terms of assets, both banks figured among the largest banks in Italy.

It is reported that retail investors had at least €5bn wiped out as the share prices in the banks crashed to 10 cents in 2016 (Sanderson, 2016). Both of them have been recapitalised by the Atlante fund, a sort of bad bank that is apparently participated in mainly by commercial banks and insurance companies, and managed by a private fund manager. As of June 2017, troubles for these banks are, however, far from being over.

Indeed, as recently commented by the Financial Times, 'the two banks, which are in talks to merge, were taken over last year by Atlante, Italy's government sponsored, privately backed rescue fund. But the lenders have continued to leak deposits, further eroding their capital base, say people with direct knowledge of the events. A person familiar with the plan being prepared for the European Commission said it was seeking approval to start recapitalisation procedures for the two banks for "about €5bn", a figure far higher than estimates a year ago and a sign of the banks' worsening capital position' (Sanderson, Barker and Jones, 2017).

2.3. A quick comparison with other countries

According to experts at the IMF, it is high time to repair Italian bank balance sheets in order to facilitate lending and to strengthen recovery of the real economy (Jobst and Weber, 2016). Challenges faced by many Italian banks are similar to those experienced by the Portuguese and the Irish banks, but the dimensions of the Italian banking sector are much larger. Italian financial intermediaries have specific shortcomings and specific problems to solve, which are quite different compared to those of large German commercial banks.

While Italian for-profit banks are struggling with non-performing debt, troubles in the largest German counterparts are mainly the direct consequence of losses on financial derivatives, as is the case of Deutsche Bank and some other German banks (Hardie and Howarth, 2009; Münnich, 2016). Generally speaking, despite the harmonisation of the banking regulation, the level of integration of the European banking system remains low. At the same time, the fragmentation of the European banking markets seems to be increasing rather than decreasing. Otherwise stated, if solutions are sought at a European level, these key distinctions need to be encapsulated into strategies aimed at preventing further crises and reducing current problems.

Needless to say, better coordination in the design of crisis-prevention mechanisms at the EU level would be welcome. As suggested by Ligon and Fedirka (2016), the banking crisis in Italy could negatively affect the eurozone: 'uncertainty in the Italian market could lead risk-averse investors to stay away from Italian assets, and thus the euro, impacting its value. Additionally, should MPS [Monte dei Paschi bank] or other large Italian financial institutions fail, Italy would sink into a domestic crisis that would have significant systemic effects on the value of the euro. This would have negative repercussions for other economies in the eurozone' (Ligon and Fedirka, 2016, 2).

A similar conclusion on Italy is reached also by Reichlin and Valleé (2016) who describe Italian banks as 'dysfunctional': 'not only is its dysfunctional banking sector undermining economic recovery and inhibiting investment; the sector's troubles are the sharp end of a problem that affects the entire eurozone'.

3. ARE THERE ANY SOLUTIONS?

Arguably, one of the key solutions for Italy would be to secure economic growth in the years to come. Banks would indeed benefit very much from it. Without recovery of the real economy, improvements in the banking sector are quite difficult to achieve - if possible at all. Luckily, the real economy in Italy is still healthy in many regions. The Italian economy is still largely based on SMEs, many of which showed resilience to the crisis, thereby managing to survive competition despite all of the difficulties experienced.

Notably, SMEs can restructure more easily compared to large companies with an aim to increase their competitiveness. This is a strong point which Italian (and European) policy makers should properly account for in their agendas. Additionally, major efforts should be directed to increasing the size of at least a percentage of such firms due to the fact that, on average, Italian enterprises tend to be small, undercapitalised and are heavily dependent on bank loans. Another fundamental point that still needs to be properly addressed is the current lack of new economic policies - essential for Italy to properly solve the crisis (see, for instance, De Cecco, 2007; Di Quirico, 2010; Lucchese et al., 2016).

Perhaps the most pressing issue remains, however, the essential restructuring of a number of large corporations based in Italy, which appear to be unable to pay back their loans to banks due to registered losses, in some cases resulting in the risk of insolvency. Indeed, several large Italian corporations are in a critical position right now. Some of them operate under extraordinary administration procedures. A dramatic example is that of Alitalia, the flag carrier of Italy. The company has been registering losses since its very establishment, but over the last decade the situation has become so critical that the corporation now faces either nationalisation or bankruptcy. Despite occasionally benefitting from financial aid from the government, it has not been able to adequately compete on the market, losing millions of passengers over the last years. Major creditors of Alitalia - banks such as Intesa Sanpaolo and Unicredit - currently face the risk of losing considerable sums of money in either case.

Another telling story is that of the Eutelia-Agile group - an Italian telecommunications services provider based in Arezzo, Tuscany, specialised in offering data services, voice services and cloud services to Italian small and medium-sized enterprises. The group failed some years ago, and was subsequently restructured by another corporation specialised in cloud computing. Losses for the company's creditors have been nevertheless important. Furthermore, about 2 thousand people have been dismissed by the company.

Other examples of large corporations based in Italy that are at risk of bankruptcy, have just managed to prevent a crisis, or are yet to be restructured in order not to exit the markets, include Ilva (steel industry), Fincantieri (shipbuilding), the Italian branch of Electrolux (appliances manufacturing), Stefanel (clothing and fashion industry) and some large call centres that employ hundreds of people who risk losing their jobs. The inability of such corporations to pay back their loans (entirely or in part) all adds up to the large amount of non-performing loans that have been piling up in the Italian banking sector since the onset of the financial crisis, followed by the economic downturn. It should also be observed that the problems of large enterprises generally have damaging effects on subcontractors and suppliers, most of which classify as SMEs.

Financial intermediaries play a key role in providing financial support to Italian firms and in servicing households. One could thus argue that saving banking problems is a condition for the Italian industrial sectors to perform well. The problem with this argument is that Italy currently lacks a strong industrial policy that could possibly pave the way to long term improvements. Or, at least, the latter needs to be improved and better communicated. Having recognised that, it therefore becomes essential to critically discuss whether the allocation of credit by Italian banks is really productive at the moment.

At least two examples cast substantial doubts on the efficiency of banks' credit allocation to the real economy. First is the case of the Stefanel company, a famous fashion and clothing producer based at Ponte di Piave in the Veneto region, which had to ask for extraordinary administration procedure at the end of 2016 in order to avoid failure due to high indebtedness. The company listed as its main creditors various Italian banks such as Unicredit, Intesa Sanpaolo, Bnl, Banco Popolare and the Mediocredito del Friuli Venezia Giulia. Despite all the troubles, in June 2017 the company was provided with new fresh credit and financial help for restructuring.

Second, the case of the Feltrinelli publishing group based in Milano - a chain of books and music stores serving customers in Italy. Despite turning to being highly indebted, the company continued to receive loans over the last years at interest rates below the market average. Feltrinelli was even granted a new line of credit amounting to some 50 million euros so to be able to restructure and make new investments e.g. in electronic publishing and in online sales. These two examples provide an idea of how Italian banks often tend to keep existing relationships by privileging servicing large companies - even those that face critical problems or even bankruptcy - rather than looking for new opportunities that may translate into more efficient credit allocation policies.

Said that, Italian banks would need to achieve improvements as quickly as possible so to be able to attract institutional investments, particularly those from foreign investors. In order to achieve this goal, not only Italy has to clean up its banking-sector problems, but the country as a whole should get back a decent level of credibility through a number of much needed political, social and economic reforms. Developments in the banking sector, including the design of strategies aimed at reducing the level of non-performing loans, should figure among the priorities of such a package of reforms. Nevertheless, one can safely conclude that there will be no concrete reduction of the problem of non-performing loans unless this will be matched by a restructuring process of several Italian corporations. In this respect, a key challenge for Italy would be to develop capital markets and help large corporations to get adequate access to them, as is the case in contemporary well-functioning financial system.

4. SMOTHERED VISIONS OF EUROPE

The present section concludes by critically taking into account the arguments once advanced by well-regarded Italian economist and politician Romano Prodi about a united Europe as described in his pamphlet *Un'idea dell'Europa* (1999). In the above mentioned book, the former Prime Minister of Italy and former President of the European Commission sketches both the main issues and the potentials for the European Union. Prodi considered the Italian membership in the EU as a unique opportunity for the country to modernize and improve its economic outlook. The Italian banking crisis is just an example of how things moved away from the desired outcomes.

Let me briefly summarise the main arguments provided by Prodi (1999). On the one hand, Prodi lists declining population, mass migrations, structural unemployment and declining welfare-state protection as the main challenges for Europe. On the other hand, he also recognizes benefits deriving from the consolidation of universal principles of freedom and democracy (Prodi, 1999: 7). All in all, benefits should be able to outnumber the potential problems, Prodi suggested at the turn of the Century.

By reviewing Prodi's ideas of a 'new' Europe, I wish to put forward a rather strong argument: Italy is currently representing a challenge to the ideal vision of a united Europe, an economic and political project which is gradually departing from the idea advocated in the past by Adenauer, De Gasperi, Monnet and Schuman. The problems in the Italian banking system represent but an example of such a risk.

One could indeed list a whole set of things that have gone wrong in Italy during the last decade: high levels of youth unemployment, approximating to 40 percent at the beginning of 2017 (Pizzin, 2017); excessive public debt (approximating to 130 percent of GDP in 2016 - see also Table 1.); stagnating growth; democratically elected political representatives unable to address the real problems of citizens; the divide between Northern and Southern regions of the country. Furthermore, some scholars suggest that there are significant institutional causes which can explain for some of the above mentioned difficulties, for instance: a legal framework that needs to be updated; heavy bureaucracy; widespread disinformation (Calingaert, 2008; Vincenti, 2013).

Table 1.: Baseline scenario: public debt in 2010 and 2020 (selected countries)

Country	Debt (%Gdp) 2010	Debt (%Gdp) 2020
Denmark	49	39
France	92	114
Germany	82	97
Great Britain	83	124
Italy	127	131
Portugal	91	132
Spain	68	93
Sweden	55	39

Source: Deutsche Bank Research and Bandulet (2011)

Back in 1999 Prodi called for reforms that would help the Italian country to gradually get closer to the 'European standards' (1999: 15). Not only Italy has not been able to adjust to the (best) European standards in several ways. Its political and economic elites showed inability to manage the crisis and are still unable to design a proper strategy for effectively solving the problems mentioned above - similarly as they were twenty or thirty years ago. For this reason, one could go as far as to claim that Italy is representing a potential threat to the larger eurozone.

I am not blaming Romano Prodi for Italy's political and economic decay. I am instead suggesting that a certain idea of Europe simply did not materialize. Expectations for countries such as Italy have proved too high to be met in reality, leaving the entire project of a united Europe very shaky at the moment. It can be suggested that the EU shall be properly rediscussed in the years to come. Active membership of Italy in the eurozone should no longer be taken for granted. Back in 2011, Nouriel Roubini argued that, in order to solve the problems, Italy may have 'to exit the monetary union and go back to a national currency, thus triggering an effective break-up of the eurozone' (Roubini, 2011). It seems that such a moment is getting closer despite some sensibly reassuring arguments recently advanced by Bank of Italy's Governor Visco (2017) at the ordinary meeting of shareholders.

5. FINAL REMARKS

Whatever their importance, consolidation of the Italian banking sector and improvements in bank governance structures are not sufficient to put banks on the right track. Indeed, the fact that Italian banks had played a (rather negative) role in the impairment of industrial districts or entire regional economies, as was showed by the Veneto example, comes at a price. This was shown particularly by the rise in the number of non-performing loans in the period 2009-2015. As a result, confidence in Italian banking firms has decreased substantially both in Italy and abroad. Even worse, there is a substantial risk that no significant changes will take place in Italy earlier than in year 2025.

The rescue of a number of small banks in 2016 and, more importantly, the temporary nationalisation of Monte dei Paschi bank in 2017, proved to be costly for society. Rehabilitation of banks and an attempt to restore trust in banking will be essential for achieving substantial improvements in the Italian economic outlook. This has a flavour of a proper cultural twist in the mindset of citizens, which will not be easy to achieve. As I suggested elsewhere, it takes much more than to simply repair bank balance sheets and improve the governance of banks (Stefancic, 2016). While political parties should be discouraged from participating in banks' strategies since they tend to blur their commercial incentives, Italian citizens should, on the other hand, find new ways to exert stronger control over banks.

Strategic thinking would be essential to solve some of the problems mentioned in the present paper. Policy makers should properly address the social factors shaping change and innovation in banking - such as social networks, power, cultural settings and the kind of information being used by banks in their lending processes (e.g. D'Aurizio et al., 2015) so to put emphasis on best practices and, on the other hand, contribute towards stabilising the system by discouraging imprudent lending policies. They should also plan a proper reorganisation of the banks' branch networks as a result of the fact that, arguably, too many employees have been hired by the Italian banks just before the application of digital banking and new technologies. Many employees will have to be either relocated or repositioned on the job market. If Italian top bank managers would have been better acquainted with new trends in financial intermediation in the past, such mistakes might have been avoided.

Bearing in mind that banks need to operate both ethically and efficiently, general improvements should include reduction in costs (e.g. operating costs), a better diversification of risks, improved mechanisms for the selection of managers, stronger limitations to prevent political interest from influencing bank firms' strategies and policies. These improvements may, however, not suffice. A key challenge for Italy is to improve its capital market which appears to be underdeveloped at the moment. The lack of proper capital markets casts doubts on Italy's ability to solve its financial problems. In fact, in order to find long-term solutions, Italian corporations and large businesses should have better access to efficient capital markets.

On the other hand, I argue that small innovative enterprises - which can help in securing growth - should have access to venture capital, as is the case in most advanced economies. Otherwise stated, it is very much questionable whether the 'venture capital' should continue to be granted by the Italian commercial banks and state agencies since they lack both the know-how and the kind of incentives that are essential for this market segment.

By contrast, should Italy prove to be unable to solve its domestic troubles with banks, that would certainly have massive repercussions on the euro and, subsequently, on other European economies. Failure could lead to radical changes, and both freedom and democracy could be at stake.

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