The Precarious State of Italian Banks

An update on the serious financial problems facing Italy.

It has been just over a month since an Italian pensioner committed suicide after he lost his life’s savings due to the Italian government rescuing four small banks in danger of failure. The pensioner was not the only person who lost money as a result—thousands of small investors lost significant sums in the rescue. Since then, the European Union’s Bank Recovery and Resolution Directive (BRRD) came into effect Jan. 1. The directive imposes losses incurred from future bank failures on shareholders, subordinated creditors and potentially depositors, which has come to be called a “bail-in.” Italy’s banking problems are a critical part of our 2016 forecast and have already brought Italy into direct disagreement with Germany over the EU’s role in banking crises. While there have been some positive indicators in the Italian economy recently, the situation overall is still tinder waiting for a spark.

First, the good news: bank loans to both the private sector and to non-financial corporations rose in November for the first time since April 2012, increasing by 0.6 percent and 0.2 percent respectively, according to data released by the Bank of Italy. Loans to households have continued to rise since June, increasing in November by 0.8 percent. Since these are the latest statistics available, it remains to be seen whether the global tremors emanating from China’s economic woes will affect this development. But rising corporate loans in Italy is certainly a good sign.

Unfortunately, therein ends the positive. First of all, while corporate loans have increased, non-performing loans have continued to rise, so far reaching $216 billion. That is around 17 percent of Italy’s gross domestic product according to the European Banking Authority. Secondly, across the board, there are worrying signals that confidence in the Italian banking sector is extremely low. The new EU
rules in the BRRD lay out a hierarchy of who is liable in a case of insolvency. First it is shareholders, followed by subordinated debt holders and senior debt holders. The last group to take losses before a bank can have recourse to taxpayer money is small or medium enterprise and individual depositors with more than 100,000 euros. It is important to note that in Italy, it is not uncommon for bank bonds to be sold to retail investors.

According to the Bank of Italy, at the end of 2014, 237.5 billion euros worth of domestic bank debt was held by Italian households. Some Italians who lost money when Italy rescued Banca Marche, Banca Etruria, CariChieti and CariFe at the end of November were unaware that the new BRRD rules meant their investments were liable. Ultimately, 130,000 shareholders holding approximately 790 million euros worth of junior debt saw their investments disappear. And in that case, the four banks held just 1 percent of Italian bank deposits.

BRRD guidelines insist that deposits up to 100,000 euros are protected. And since May 2011, Italy's Interbank Deposit Protection Fund (FITD) has guaranteed bank deposits of up to 100,000 euros. Considering that, according to MutuiOnline, the average bank account in Italy held about 13,200 euros in the first half of 2015, superficially it appears that much of the Italian population will not be susceptible to losing funds should more banks be rescued. However, this is little assurance to those with deposits up to 100,000 euros. First, if deposits over 100,000 euros were lost, it would hurt businesses, and Italy already struggles with an unemployment problem, particularly in the south.

Second, it is unclear whether the FITD actually has the funds necessary to save these deposits in the event of additional and potentially larger banks failing. The FITD protected 500.7 billion euros in June 2013, and the funds available for interventions totaled about 2 billion euros in 2014. For some perspective, in the first quarter of 2015 in the United States, the Federal Deposit Insurance
Corporation insured $6.3 trillion worth of deposits and had $62.7 billion on hand in its insurance fund. The issue is not the low ratio of reserves to bank deposits, it is that the FITD has not released new figures since 2013, so there is no way to know how much capital it still has available to cover the losses of struggling banks.

To save the previously mentioned four small savings banks, Italy formed a National Resolution Fund, into which Italy’s healthy banks contributed $3.6 billion euros—well more than FITD had on hand in 2014. Furthermore, Italy’s healthy banks are only required to make annual contributions of around 600 million euros to this fund. To raise the necessary $3.6 billion, healthy banks essentially had to give the National Resolution Fund a three-year advance, which they did by borrowing the money from UniCredit, Intesa Sanpaolo and UBI Banca.

To complicate matters further, the Italian state cannot get involved in the situation. Italy is the eighth largest economy in the world and the fourth largest in Europe, but EU state aid rules now preclude Italy from using public funds to rescue these banks until shareholders and depositors have borne the brunt of the losses. Nor can the European Central Bank (ECB) give Italy euros for this purpose. This has brought Italy into direct conflict with Germany. On Nov. 23, Germany harshly criticized a European Commission proposal to create a European Deposit Insurance Scheme meant to provide EU guarantees for depositors in the event of a banking crisis, which Italy supports for obvious reasons.

Add to this uncertainty the fact that the interest rate on deposits is very low (less than 1 percent for households and non-financial corporations) and the real problem begins to come into focus. Because interest rates are so low, security is the only reason for Italians to keep their money in banks. If that security is gone—and there are ample reasons for the everyday depositor to doubt it—there is little gained from keeping one’s money in an Italian bank. Many may think it would be better to withdraw the money than to gamble that the money will still be in the bank a year
According to data from the Bank of Italy, private sector deposits have not yet been affected by this. But other symptoms of this lack of confidence are apparent. Investors trying to sell Italian bonds are not readily finding willing customers. After the bank rescue, many Italians tried to sell back their bank bonds, but there was no market for them and prices continued to drop. The Bank of Italy also has released data showing that in November the percentage change in bonds issued was -15.6, and the percentage change has been in the negative double digits for at least 14 months. Private investors are also increasingly reluctant to invest in Italian debt in general. It certainly helps that the ECB extended its monthly bond-buying program to March 2017, but that extension cannot solve this problem alone.

Another troubling indicator is Italy’s TARGET2 balance. TARGET stands for Trans-European Automated Real-Time Gross Settlement Express Transfer System, which is the interbank payment system used for transactions that occur among eurozone members. There is a great deal of academic disagreement about how to interpret TARGET data, but it is telling that Italy has its worst TARGET2 balance ever at -229.6 billion euros and Germany has its highest since 2012 at 592.5 billion euros, according to the ECB. Some of Italy’s balance is a result of its negative trade balance with Germany, which was about -$5.5 million in 2014. But the majority of it may very well be capital flight—Italians moving their money to German banks due to a lack of confidence in Italian banks. And because the recipient banks have little interest in Italian bonds, the result is a positive outflow of capital registered by TARGET2.

To sum up: while the Italian banking system is not yet in crisis, there have been a number of developments that continue to erode confidence in Italian banks. Depositors cannot be sure what to expect should their bank need to be rescued, and there are legitimate doubts as to whether there is enough money available to
guarantee deposits of less than 100,000 euros. EU rules on state aid, which constrain government options, have made investors, shareholders and large depositors liable for bank losses. Germany and Italy have come into conflict over those very rules, and over whether the EU should play a role in guaranteeing deposits across its member states. Investors are increasingly reluctant to buy Italian bonds, and Italian depositors are increasingly reluctant to hold bank bonds after what happened to bondholders in the four banks that were rescued in November. And it appears that capital may be flowing out of Italy towards Germany and other safe havens.

Italy is not yet in crisis, but it faces serious banking problems, and how serious those problems become will depend on whether the rest of Europe recognizes the issue and is able to forge a solution. Thus far, Europe’s sense of urgency does not correspond to the depth of Italy’s challenges.