COMMENTARY
Thinking ahead for Europe

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The Italian Banking Saga: Symptom of a deeper underlying problem?

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The abrupt end to the saga of the two smallish banks from the Veneto Region shows what really motivates policy-makers. For months, if not years, the official narrative had been that these banks were undeniably still carrying problems from the past, but that they could be perfectly viable if only the Italian government would be allowed to provide them with support. But a combination of European rules and institutions severely limit this kind of 'state aid'.

This is why the last few months have witnessed a complicated game between the Italian government and various European instances (the European Commission, the Single Resolution Board and the Single Supervisory Mechanism (aka the European Central Bank)). The Italian government was constantly trying to find ways to inject public funds into its most troubled banks, whereas the European institutions were trying to find a way to apply their rules that would be politically acceptable to the Italian government.

The solution for the two Venetian banks found over a recent weekend was technically elegant and might even have been 'least cost', or rather 'least political' cost for both sides: the banks are officially liquidated with the healthy part of their business (the good bank) going for a symbolic sum (plus some hefty guarantees) to a domestic competitor. The remainder, i.e. all doubtful assets, stay in a different entity, the 'bad bank'. Given that the 'bad bank' will not be doing any new business, the Commission decided that it did not have to be too severe on state aid rules, apparently using as a pretext the argument that state aid to an entity that no longer competes does not distort competition.

Both sides can thus declare victory. The European side can claim that finally two medium-sized banks that were losing deposits and for which no private investor could be found have been forced to exit the market. The Italian authorities have also achieved their main aim, which apparently was not to save the banks, but to ensure that the investors in the senior bonds of the banks would not be affected and that retail investors in the subordinated bonds can be reimbursed by the government for most of their losses.

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But this is a pyrrhic victory on both sides.

The Commission has shown once more that it is really ‘political’. To appease the government of an important member country, it has de facto undermined one of the central aims of the new banking rules (called the Bank Recovery and Resolution Directive or BRRD), namely that governments should not pay for private losses.

But the pyrrhic nature of the ‘victory’ on the Italian side is more important. What is really noteworthy is the absence of any reaction in the Italian political system against another increase in an already-high public debt just to avoid losses for a few thousand, regionally concentrated investors.

The contrast with the resolution of a much larger Spanish bank only a few weeks earlier is instructive. In the case of Banco Popular, hundreds of thousands of holders of subordinated debt saw their bonds being converted into capital without any intervention by the Spanish government.

One of the reasons why the risk premium on Spanish government bonds has gone markedly below than that on Italian debt might be that investors do not look only at government debt-to-GDP ratios, but also at the way in which different political systems deal with adjustment and losses. In weak systems, the public debt is high because the government is willing to pay for the losses of small, well-organised, groups.

High levels of public debt should thus be seen as the outcome of a political system in which the interests of beneficiaries of public spending too often outweigh the collective interests of taxpayers. The opposite example can be found in Denmark, which some years ago even forced senior bond holders to accept losses. That decision was heavily criticised at the time since it led to higher risk premia for the banks. The Danish government has little debt and would certainly have been able to pay off all senior bond holders. But the reason why Denmark has little public debt is that the political system makes it much more difficult to use public funds to pay for private-sector losses.

Paying off the investors of the two Venetian banks thus represents just the tip of an iceberg, of a larger underlying systemic problem. One of the key reason why the Italian economy has not grown over the last few decades is that adjustment has been so difficult. Adjustment is always accompanied by losses in the sectors that must downsize. The Italian political system seems to have problems in accepting this adjustment. The banking system is now the most visible sector in need of adjustment, but the same problem could be seen in other sectors beforehand, like the case of the largest steel producer whose fate is still to be decided. The repeated rescues of the national carrier Alitalia represents another emblematic case of using public funds to cover private losses.

The Italian banking sector does not face a systemic crisis. There is enough capital in the banks and enough savings in the country to keep the banks afloat. But a country in which a few thousand disgruntled investors in subordinated bonds have a greater political weight than millions of taxpayers faces a fundamental problem. Instead of claiming victory, the government should explain that rescuing investors does not constitute a free lunch. Italy can get its public finances under control only if its political system stops pretending that there are free lunches.