The Real Cause of the Italian Bank Bailouts and Euro Banking Troubles

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How a Banking Union Has Created Deep Divisions that Undermine the Eurozone's Stability

> *Has the European banking union worsened rather than solved the credit and financial market conditions in the area? In a recent speech at the European Parliament re-edited for this blog, Vladimiro Giacché, President of Centro Europa Ricerche, clarifies many obscure and misunderstood aspects of the story: the economic and political interests involved and the peculiar case of the Italian banks.*

The European banking union was born with the declared objective to reduce the "financial balkanization" of the Eurozone. Balkanization—the breakdown of cross-border banking when anxious lenders retreat to domestic safe havens—was rightly perceived as one of the main threats to the stability and the very existence of the common currency.

In fact, in the aftermath of the financial crisis, most available analyses showed how a system—that until 2008/2009 was so deeply interconnected it seemingly could never be disentangled—has since then been redefining itself along national lines. Eurozone cross-border lending has fallen to almost half of its pre-crisis levels, and many investors and banks have returned to core countries (Germany and France). Lending in so-called peripheral countries (Greece, Ireland, Spain, Portugal and Italy), meanwhile, has reverted to being essentially domestic. This was politically embarrassing but also dangerous, since it made an end to the common currency technically feasible.

What's worse, this new situation created an additional problem just as dangerous: a vicious and potentially catastrophic feedback loop between bank credit risk and sovereign credit risk—i.e., the risk that a nation could be pushed into default.

One Goal, Three Pillars

The original idea was that a banking union would re-establish an integrated banking and financial market through three main pillars: 1) a common banking oversight system 2) procedures that limit the risk of contagion in the event of a crisis, and 3) an European-wide insurance on deposits that could break the link between country risk and bank risk.

This was the theory. In practice, the banking union generated huge asymmetries and unfair competitive conditions across the Eurozone. Such asymmetries affected the Italian banking system in particular in a way that contributes to explaining today's events.

As far as the first pillar is concerned, the common banking supervision system covers various national banking systems very unevenly. It ignores high systemic risk from some of the larger countries in the area and therefore, at least in the short term, favors them.

As to the second pillar, the procedures for rescue or resolution of the banks in crisis—with a basic prohibition of public bailouts—have themselves heavily asymmetric effects that damage some national systems, starting with Italy. Notably, these rules were established only after many European countries had extended unprecedented financial support to their national banks. Those huge financial transfers had de facto suspended the European regulation of state aid—that is, of public nation-based interventions—in the wake of an emergency. Doing so significantly distorted the competitive playing field for banks across different countries in Europe.

Abolishing the possibility of a timely public bailout today penalizes those countries, like Italy, that had not massively supported their national banking system in the earlier phase. For them, the bailout option is now subordinate to very stringent criteria and postponed for so-called "bail-ins,"—that is, schemes that hold stock, bond and deposit holders liable for bank losses—all while leaving open the option of a bank default.

As to public transfers to banks, an article published by M. Frühauf on Frankfurter Allgemeine of August 16th 2013—a few months before the approval of single supervisory mechanism for banking by the Council of the European Union—provides rather impressive data. Just one example of the many bailouts in Germany in the aftermath of the financial crisis was the guarantee the government gave the insurance company Hypo-Re, which amounted to up to 145 billion euro. The cost thus far to German taxpayers of this rescue is 20 billion euro. Other sources provide slightly different overall numbers on public bailouts, but what clearly emerges is the peculiarity of the Italian banking situation, which until now involved far less public help than those of the other European countries.

The negative effect of the first two pillars of the banking union then became destructive because of the absence of the third pillar: European-wide insurance on deposits. This mechanism was essential to the declared objective of the banking union: arresting the process of "financial balkanization." In fact, the absence of European-wide insurance kept the burden of (partially) protecting savers on the shoulders of the nation-state. It also, once again, contradicted the European solidarity that should be the basis of the institutional architecture of the EU and in particular of the Eurozone.

The effect of the banking union's set of norms—the two existing pillars and the non-existent one—has been catastrophic, especially for the Italian banking system. For which the new rules have changed substantially and without any transitory phasing in from the pre-existing system. The banking union rules also contradict two articles of the Italian Constitution (art. 43 and 47).

In spite of the intentions, the new normative context heavily penalized the savers, especially those who held so-called subordinated bonds, which suddenly became more risky with the new regime.

And, as it was easy to predict, the absence of a public backstop for crisis situations as well as the absence of a system of European insurance triggered a bank run against banks perceived as the most fragile, or that were facing some company crisis that would have been easily manageable in the previous normative system. In this way, as a self-fulfilling prophecy, the liquidity problems of some institutes triggered a bank run which put their solvency at further risk.

Another major asymmetry, and danger, derives from the treatment in the new regime of market risk. Already in the stress tests and Asset Quality Review managed by the European Central Bank, the weight of this risk—which is linked to financial activity, and includes derivatives transactions—was significantly underestimated. The new system put a much greater emphasis on credit risk – thus penalizing systems like the Italian one that are relatively less financialized but in which credit risk is a relatively more important factor.

There's more: market risk, as opposed to credit risk, does not even appear in the five priorities of the European banking vigilance activity of the European Central Bank, as evidenced by its 2015, 2016, and 2017 annual reports (see the last one).

The upshot is that under the current system, the type of risk that caused the 2008 crisis and the ensuing Great Recession is insufficiently monitored. What's especially insufficiently monitored is the market risk run by some big German and French banks and in particular that of a colossus such as Deutsche Bank. Knowing the effective value of Deutsche Bank's Level 3 assets (derivatives) is more an exercise of divination than a scientific estimation: indeed, the team of the ECB that recently conducted an inspection by the Frankfurt Bank "was not even asked to price the value of the derivatives in the portfolio." The European Supervisory Authority had given up on it with a peculiar justification: It is unrealistic to evaluate the adequacy of derivative pricing in the portfolio of Deutsche Bank and other big banks, due to the discretion given to banks and reviewers (see L. Davi, BCE, 68 banche sotto ispezione. Fuori i Level 3 dalle verifiche, "Il Sole 24 Ore," 25 January 2017).

And the Winner is…

The clear winner of the banking union has been the German banking system: All German banks, but especially the small and medium ones, who benefitted from the establishment of a 30 billion euro balance sheet floor for banks to be subjected to ECB supervision. To obtain such condition as part of the first pillar, German minister of Finance Wolfgang Schäuble threatened to veto the banking union project as a whole, and it is no mystery that he was thinking precisely about banks such as the relative small Sparkassen (savings banks).

Of the 417 Sparkassen, only one is under the supervision of the ECB today; we are talking about banks that count for the 22.3% of the loans in that country for a total of 1000 billion euro.

But this is not the only way these public banks, traditionally tied to the German ruling party CDU, were protected. At least two other ways deserve mention.

The first is how the so-called Institutional Protection Schemes (IPS) were kept outside the European regulation. IPS are systems of mutual protection and guarantees of the associate banks, regulated via a contract. They exist in Germany (Sparkassen and Volksbanken), Austria (Raiffeisen banks) and Spain (saving banks). IPS aren‘t banking groups, nor banks networks. Hence, they are not directly under the European discipline—the European Directive on capital requirements [CRD IV] does not even mention them—nor the Basel Accords. This is how Thomas Stern, expert for banking regulation at the Austrian Financial Markets Authorities, characterized the situation: “The decision of the European legislator to not extend the regulation about capital and liquidity to the IPS is remarkable and hard to understand from a prudential point of view.” Stern wrote these lines in 2014, but the situation is hardly improved since then.

Being member of an IPS confers significant privileges. Needless to say, the Italian banks that resemble the Sparkassen and Volksbanken—the Banche di Credito Cooperativo (cooperative banks) —are fully subject to the European regulation, including the standard capital and liquidity requirements.

The second way in which the German government helped the Sparkassen is very interesting but not well known: It postponed the system of mutual guarantee and deposit insurance between European banks indefinitely.

The link here may not appear straightforward. In 2013, the banking union started with two out of the three pillars only. It was a huge mistake for Italy to accept this asymmetry, which made the banking union inconsistent with respect to its own declared goals.

In 2015, however, the negotiations for the mutual guarantee proceeded. Sparkassen and Volkbanken did not want to participate for two reasons: first, because they mistakenly believed that they could protect themselves thanks to their special IPS status; and second, because they feared that doing so would mean a step toward the need to fully comply to the general regulations, without benefitting any longer from regulatory exceptions.

The first opposing statements by the *Sparkassen* go back to the summer of 2015. Subsequently, Schäuble threatened to block the norm in the Council, with the official excuse that Germany refused to pay for other countries’ banking problems. Various attempts to compromise were unsuccessful, because all implied some sort of European supervision on the German banks – disclosing thus the real nature of the problem: the German government‘s desire to hinder any form of European supervision over German Sparkassen and other minor banks.

In early December 2015, even Schäuble appeared forced to concede to pressure from the European Commission and the main States of the Eurozone. The economics-focused newspaper, Deutsche Wirtschafts Nachrichten, underscored how such a decision could pave the way to a hard conflict between German banking sector and the government.

Then, on December 8th, the bombshell. Schäuble’s counter-attack plan consisted of first delegitimizing the ECB for its alleged conflict of interest in being the monetary authority and the supervisory authority at once—a condition that European leaders, Schäuble included, had recently decided. He then announced his opposition to the mutual guarantee proposal unless all states transposed the bail-in regulation in their own law and, crucially,

unless the risks of the banking systems were previously reduced. He later clarified that European banks must reduce the amount of their own nation's sovereign bonds in their portfolio. This tactical move not only postponed the discussion indefinitely, but also shifted attention from bank risk to individual nations' (sovereign) risk, a field in which Germany has nothing to be afraid of. It was in fact Italy, under Prime Minister Renzi, that was forced to veto the discussion on sovereign bonds in banks' balance sheets, thus blocking discussion on the third pillar.

In the meantime the other two pillars were activated, skipping over entirely the transitory period for smoothing out the regulatory shift that had originally been proposed. The result can readily be seen: The German Sparkassen can continue to benefit from softer capital requirements and from an almost exclusively domestic vigilance. It's an explosive mix that could eventually lead to a banking crisis.

A crisis of the banking sector in Germany today would have nothing to envy, in its effects, by comparison with the US Saving & Loans Banks crisis in the 1980s. A positive German economic cycle and the fact that the major risk areas are currently different combine to temporarily the threat it poses. In the meantime, the Sparkassen defend to death their autonomy and the right not to be supervised by any European authority (see "Deutsche Banken sehen EU-Aufsicht kritisch", Frankfurter Allgemeine Zeitung, 1 June 2017).

The Fallout

Understanding this context, the roots of the troubled Italian banking system become clearer. The burden of non-performing loans (NPLs) grew out of the worst economic crisis in peacetime since 1861. The problem also emerged because no bank bailout was undertaken after 2008. If we look at the stock prices of the banking sector in the last years, it is easy to spot a very negative trend. However, on a closer look, the price drops were not due to generically "bad" news, but rather to news related to European regulations or interventions of the European regulator aimed at one specific bank or situation. These latter include letters sent by the European supervisory agency sent to one or another bank or banks, for instance asking to sell immediately—and therefore at a very low price—problematic loans.

From the end of 2015—when the European Commission stopped the intervention of the Italian interbank guarantee fund to save four local banks in troubles—to February 2016, after the bail-in regulation entered into force without a transition period and without any European-wide deposit insurance, 46 billion Euro out of 134.6 of Italian banking sector capitalization were burned. That's a drop of 35%.

In all the cases of banking troubles or crises occurring in Italy from the end of 2015 onward, a dominant element was the flight from deposits, which would have not occurred with the national regulation in place before the banking union. In all those cases, the absence of a public backstop in the form of a bailout was crucial. It's no exaggeration to say that for the Italian banking sector the new regulation has brought only additional risk and not stabilization, the stated intention.

What to do? At the beginning of 2016 in Italy there was a debate about whether to suspend the bail-in regulation. At that time, many member states of the European Union were in favor of suspending the Schengen Treaty—the EU free movement deal that took effect in 1995. Suspending Schengen is in place de facto, but the bail-in never was. This is astonishing—especially given the bail-in regulation's contradiction with the Italian Constitution, and given the asymmetries inherent in the strange wobbly table with two legs that we kindly call "banking union." But it's never too late to reverse wrong policies and negotiation mistakes, provided you understand them.