

Economics Group

Special Commentary

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Do Italian Banks Pose a Global Systemic Risk?¹

Executive Summary

Italian banks have faced a challenging operating environment since the advent of the global financial crisis, and their share prices have lurched lower in recent weeks. Non-performing loans have mushroomed in recent years, and some analysts worry that individual banks are now seriously undercapitalized. The stress test analysis that is scheduled for release on July 29 may shed some light on the capitalization needs of Italian banks.

A stress test analysis that is critical of some Italian banks could lead to renewed volatility in Italian financial markets, if not in financial markets in other countries as well. The need for bank recapitalization in Italy should not ignite a global banking crisis because banking systems in most other countries do not have an inordinate amount of exposure to the Italian economy. That said, a banking crisis in Italy could potentially bring banking systems in other Eurozone countries under the spotlight.

Deep-Seated Banking System Woes in Italy

While most of the world's attention has been focused on Brexit over the past few weeks, there has been another potential crisis brewing in Europe that has largely escaped unnoticed. As shown in Figure 1, an index of share prices of Italian banks has nosedived in recent weeks. Not only is the index approaching the lows that were set at the height of the European sovereign debt crisis in summer 2012, but it is more than 60 percent below its level in January 2009. What is going on in the Italian banking system? And should we be worried?

Share prices of Italian banks have been hammered recently.

Figure 1

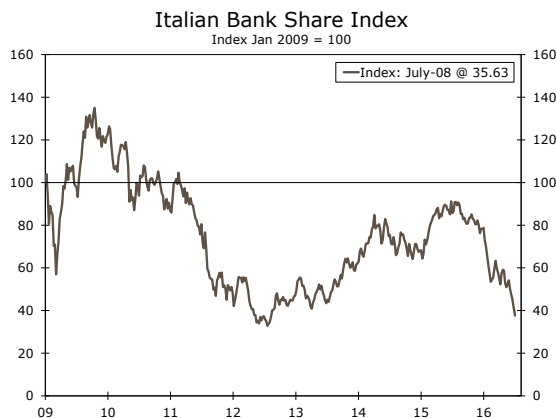
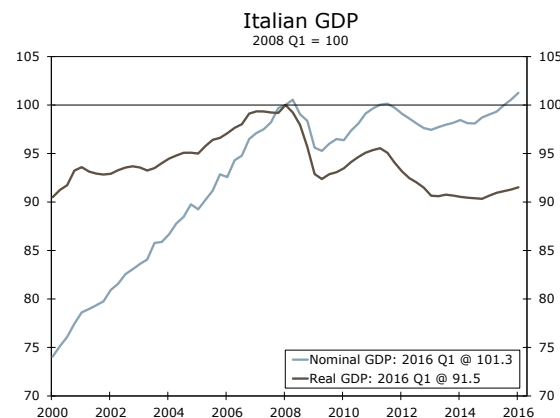


Figure 2



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities

¹ I would like to thank Hank Calenti of Wells Fargo Securities for helpful comments and advice.

Together we'll go far



There is a serious NPL problem in Italy.

Let us start with the first question. The trend decline in the Italian bank share price index since 2009 reflects some long term challenges facing the Italian banking system. First, economic growth in Italy has been anemic since the global financial crisis. Nominal GDP in Italy is more or less flat on balance relative to its peak in Q1-2008 and real GDP is down more than 8 percent over that period (Figure 2). Indeed, real GDP in Italy is no higher today than it was 15 years ago. It is hard for banks to increase profits when the economy is not growing.

Speaking of profits, non-financial businesses in Italy have struggled in the slow growth environment. There are about €200 billion worth of non-performing loans (NPLs) in Italy, which represent about 8 percent of the loans in the Italian banking system (Figure 3), and non-financial businesses account for about 70 percent of these NPLs.² However, some analysts estimate that up to €160 billion more loans could eventually turn into non-performing status, which would push up the overall NPL ratio to an eye-popping 15 percent.³

More recently, the outlook for the profitability of Italian banks has been hammered further by the sharp decline in interest rates. Not only are short-term interest rates in negative territory at present, but the yield on the 10-year Italian government bond has plunged to an all-time low (Figure 4). Italian banks own more than €400 billion worth of Italian government bonds, which account for about 10 percent of their assets. If yields on Italian government bonds remain near their current levels, it will hurt the profitability of Italian banks. In addition, the decline in interest rates will also weigh on the interest income that banks make from their lending operations.

Figure 3

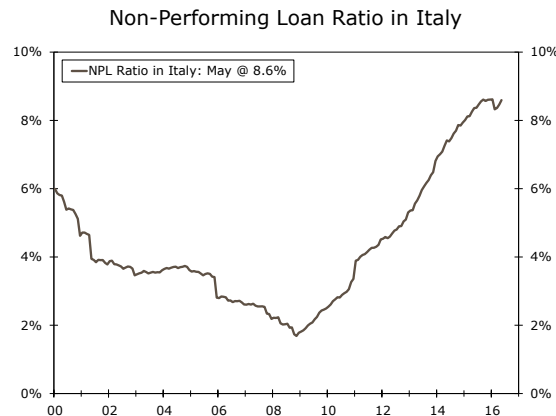
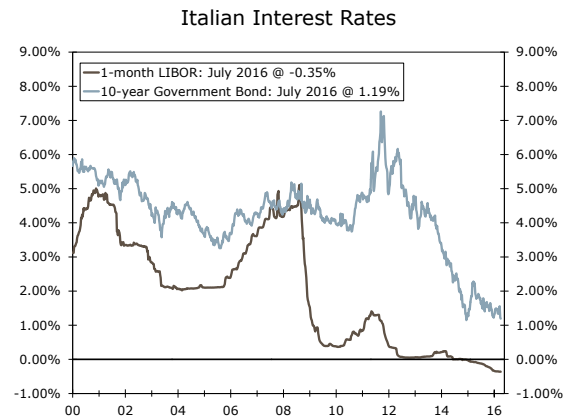


Figure 4



Source: Bloomberg LP, IHS Global Insight and Wells Fargo Securities

Could a banking crisis in Italy have global implications?

If Italy were a tiny economy, we really would not care much about the problems in its banking system. Banking problems in Italy clearly would have negative implications for Italian residents and the broader Italian economy, but they really would not have any implications for most foreign economies. However, Italy is one of the ten largest economies in the world, and the country's banking system assets, which total nearly €4 trillion, make it among the world's largest. Could a train wreck in the Italian banking system have systemic implications for the global financial system?

Most Foreign Banks Have Limited Exposure to the Italian Economy

One piece of good news is that the loans that Italian banks have extended have been generally financed by deposits of domestic residents, which tend to be a low-cost and stable source of

² Due to the slow process of bankruptcy proceedings in Italy there is a fair degree of inertia with respect to NPLs.

³ *The Economist*, July 9-15, 2016, p. 9 and Elie Darwish and Nelson Ribeirinho, "Italian Banks: Is Atlante going to get some steroids?!", Natixis Credit Research, July 4, 2016.

financing.⁴ If Italian banks relied on wholesale financing via short-term loans and deposits by sophisticated foreign investors, then those banks could face a liquidity crisis if those investors quickly yanked their money out of the Italian banking system. But because bank deposits are generally guaranteed by the government, most depositors do not pull their money out of banks at the first whiff of trouble. In other words, a destabilizing “run” on Italian banks does not seem likely anytime soon.

Another piece of good news is that foreigners do not have an immense amount of exposure to Italian banks, which should limit the ability for any banking crisis in Italy to spread around the world. Foreigners hold almost €300 billion worth of cash and checking accounts in Italian banks and they have nearly an identical amount of “other” deposits in the Italian banking system (Figure 5). Foreigners also have roughly €170 billion worth of lending exposure to Italian banks, either via direct bank loans (*e.g.*, foreign banks lending directly to Italian banks) or via the ownership of bonds that have been issued by Italian banks. That said, Figure 5 highlights that Italian residents hold the vast majority of the exposure to the Italian banking system.⁵

Foreigners do not have an immense amount of exposure to Italian banks.

Of course, the implosion of the Italian banking system, should it occur, would lead to the collapse of the Italian economy. In that event, foreign banks could suffer losses not only on their exposure to Italian banks, but also on any exposure they have to Italian companies and individuals. A banking crisis that started in Italy could quickly spread around the world. So how exposed are foreign banks to the Italian economy?

Figure 5

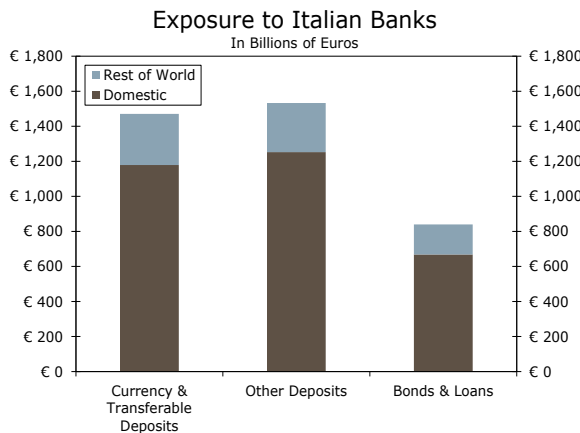
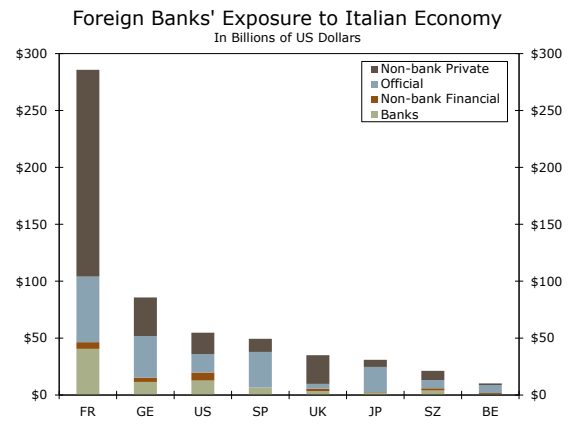


Figure 6



Source: Bank of Italy, Bank for International Settlements and Wells Fargo Securities

At nearly \$300 billion of total exposure, France has the most on the hook to the Italian economy among foreign banking systems (Figure 6). About two-thirds of this overall exposure by French banks is to the Italian non-bank private sector (mainly the Italian corporate sector). That said, the exposure to the Italian economy accounts for less than 5 percent of the assets in the \$6 trillion French banking system. Rounding out the top five foreign banking systems with exposure to the Italian economy are Germany (\$86 billion, 1.4 percent of assets), the United States (\$55 billion, 0.4 percent of assets), Spain (\$49 billion, 1.5 percent of assets) and the United Kingdom (\$35 billion, 0.4 percent of assets). In other words, a banking crisis in Italy probably would not lead to a global banking crisis *à la* 2008.

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⁴ The loan-to-deposit ratio of the Italian banking system is 0.98 at present.

⁵ Many of the bonds that banks have issued are owned by Italian retail accounts. Some analysts have noted that it would be political suicide for the Italian government to “bail in” bondholders (*i.e.*, turn their debt securities into equity securities) due to the large retail ownership of those bonds.

Does the Italian Banking System Need to be Recapitalized?

Many of the problems that the Italian banking system faces at present would dissipate if the Italian economy were to grow at a stronger pace. However, with challenging demographics—the World Bank projects that the working-age population (i.e., individuals between 15 and 64 years of age) will decline 4 percent over the next 10 years—and with weak productivity growth, a significant increase in the rate of Italian economic growth does not look likely anytime soon.

As noted above, there could be as much as €360 billion worth of NPLs in the Italian banking system. According to the Bank of Italy, the “estimated realizable value” of the €200 billion worth of acknowledged NPLs is about €85 billion (43 percent). If a similar ratio applies to the other €160 billion of potential NPLs, then Italian banks may be able to recover about €150 billion of their total NPLs. If the other €210 billion or so of NPLs need to be eventually written off, then the €440 billion of capital and reserves that the Italian banking system has on its collective balance sheet would be seriously impacted.

The Italian government recently backed a private fund that has £5 billion of equity that can be levered up to buy NPLs. But even if the fund is wildly successful—the jury is still out on that score—it probably would still leave the banking system woefully short of the amount of capital that it needs. Some answers to the amount of potential capital shortfall in the Italian banking system may be forthcoming on July 29. On that day, the results of the stress tests that are currently being conducted by the European Banking Authority (EBA) are slated for release. Although the EBA will not grade banks on a pass/fail basis, the analysis may shed some light on their capital needs. If the EBA analysis confirms what many observers already fear, namely, that some Italian banks need higher capital buffers, then share prices of Italian banks could slide even further. In that event, volatility could return to financial markets, not only in Italy but potentially in many other countries as well.

Conclusion

The marked decline in share prices of Italian banks over the past few years speaks to the difficulty these institutions have faced. Indeed, the NPL ratio for the banking system could be as high as 15 percent, and some individual banks could be severely undercapitalized. Confirmation of undercapitalization in the soon-to-be-released stress test analysis could lead to further downward pressure on share prices of Italian banks.

Although the Italian economy is among the largest in the world, banking systems in most countries do not have an inordinate amount of exposure to it. The French banking system has nearly €300 billion worth of total exposure to Italian companies, banks, individuals and government, but this amount represents only 5 percent of French banking system assets. Exposure to the Italian economy accounts for less than 2 percent of banking system assets in other major economies. A stress test analysis that is critical of some Italian banks could lead to renewed volatility in Italian financial markets, if not in financial markets in other countries as well.

In that regard, a banking crisis in Italy could potentially bring banking systems in other Eurozone countries under the spotlight. For example, the NPL ratio in Spain is around 10 percent at present, although it has trended down from nearly 14 percent a few years ago. Any tightening in financial conditions that resulted from renewed financial market volatility could weaken economic activity across the Eurozone, thereby making bank recapitalization in other countries more likely. A banking crisis that was confined solely to Italy should not ignite a global banking crisis. But any potential contagion effects emanating from Italy would certainly warrant watching. Stay tuned.

Stress test results should be released on July 29.

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