Italian banking crisis incubated by EU—another 'bail-in' horror story

By Elisa Barwick

On 19 March the European Court of Justice ruled that the European Commission (EC) acted illegally in 2014 when it blocked Italy from bailing out a regional bank. This had set off a chain of events which forced a "bail-in" of Italian banks, sparking contagion throughout the banking system. The EC's actions, during what was a contained crisis, "unleashed systemic contamination", insisted Italian Banker Roberto Nicastro.

Concocted after the 2008 financial crisis, bail-in is the alternative to taxpayer funded bailouts, and mandates the conversion of bonds and deposits into equity to keep banks afloat. Following the test case of Cyprus in 2013—the first use of bail-in which saw its banking system and economy seize up for many months—Italy fell victim to bail-in in 2015, before the EU's bail-in regime, the Bank Recovery and Resolution Directive (BRRD), came into force EU-wide on 1 January 2016. This 2015 Italian bail-in was triggered when the European Union (EU) in 2014 refused to allow Italy to conduct a bailout of Abruzzi bank, Tercas. The basis for the decision was that under EU competition rules, "state aid" is illegal and Italy's Interbank Deposit Insurance Fund (FITD) was considered to be acting with a public mandate to protect depositors, interpreted as state aid despite the fact that it is a private fund contributed to by Italian banks. Hence, when four regional banks collapsed in December 2015 (Banca Etruria, Nuova Carife, Banca Marche and Carichieti), Italy was forced to bail them in, leading to a significant loss of consumer savings, a bond crisis and a 60 per cent collapse in capital value across the Italian banking system.

Nicastro, who was caretaker of the four rescued banks, elaborated in a 22 March interview with *Corriere della Sera*: "The depreciation of the non-performing loans of the four banks down to 17 per cent of their nominal value put pressure on the entire system, accelerating the crises of other financial institutions: from the Veneto banks to Monte dei Paschi. ... The four banks", he continued, "were worth less than 1 per cent of the entire banking sector in Italy. And yet, that episode blocked the issue of bonds for the entire system in the following period."

President of the Economic and Monetary Affairs Committee of the EU Parliament, Roberto Gualtieri, said that the EC decision produced very serious economic and political damage for which someone will have to account. The Italian Banking Association will seek €13 billion in damages, and the Italian government may do the same. Nicastro observed that the EU's actions have damaged the principle that private individuals, not just the state, are responsible for bank failures—the supposed premise of bail-in.

Where is the 'bail-in' silver bullet?

The functionality of bail-in is being questioned elsewhere. Leading bankers in charge of financial stability are again warning they have no tools to fight a new global crisis, despite the bail-in solution having been hailed as the ultimate means of preventing a bank collapse from spilling over into the rest of the system. In reality, bail-in was designed not to preserve the function of banks, but to prevent the quadrillion dollar-plus financial derivatives bubble unravelling. Now there is little confidence it will save anything at all.

Second in charge at the IMF, David Lipton, citing slowing global growth, trade instability, and political uncertainties such as Brexit, warned in a 25 March speech in Portugal that we are ill-equipped to deal with the coming downturn. The IMF's First Deputy Managing Director said that the bottom line in the effort to "prevent another system shock" is that "the tools used to confront the Global Financial Crisis may not be available or may not be as potent next time. The space for additional monetary policy accommodation will surely be more constrained; fiscal resources may not be as available in many countries; and political resistance to bailouts may be greater because many people feel that those who brought about the last crisis did not shoulder their share of the burden."

While citing progress in the implementation of bail-in mechanisms, Lipton warned that "fragmentation along national lines ... limits the potential for cross-border risk sharing" and a full, supranational, banking union. The "severe downturn" awaiting us over the horizon, he said, means each nation doing its own thing will not suffice.

"All countries need to renew their commitment to the reforms" that the IMF is pushing, Lipton declared. He singled out Italy for not being prepared, but if anything it is the most prepared—for the reality that bail-in will not work. Leading Italians have spoken out against bail-in, from Finance Minister Giovanni Tria, to Italian Banking Association head Antonio Patuelli, and the Bank of Italy's banking supervision chief Carmelo Barbagallo. They have demand the EU bail-in regime be repealed as it is unenforceable and will only undermine trust in banks and generate instability. ("Italy demands EU abolish 'bail-in' rules", *AAS*, 13 Mar. 2019.)

This was affirmed, from the standpoint of the banks themselves, in a 25 March article in the London *Financial Times*. Author David Crow observed that "there are concerns that bail-in debt, which has been proven to be more expensive to issue than many bank executives had hoped, could weigh on profitability". The process of selling high interest rate bail-in (hybrid) bonds, he said, "in fact threatens to weaken the viability of some lenders". European banks are under pressure to issue some €450 billion of bail-in debt this year, to reinforce their balance sheets. Crow cites Barclays analysts suggesting it could wipe 2-8 per cent off their pre-tax profits in the next few years. "Nor is there any guarantee that bail-in debt will work as planned in the event of the next global financial crisis", concluded Crow.

The IMF told Australia in no uncertain terms to finish the job of erecting a full statutory bail-in regime in its February 2019 Financial System Stability Assessment. Instead of the bail-in flop, Australia needs a policy that will prevent commercial banks making speculative losses by banning them from speculating. The Banking System Reform (Separation of Banks) Bill 2019, which the Senate Economics Legislation Committee is currently examining, is the only effective method of crisis prevention. Make your submission in favour of this alternative to bail-in, if you haven't already.