Italian banks' future at stake in the referendum

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The international community, and especially the rest of Europe, is holding its breath over the referendum to be held in Italy on 4 December. Ratification of the constitutional reform seeking among other things to curtail the powers of the Senate, is crucial if a new period of political and financial instability is to be avoided. If the "no" vote wins, prime minister Mateo Renzi may well resign, which would lead to increased volatility in the financial markets. The political vacuum would add to doubts about the policies to be implemented to solve the problems of the Italian banking system.

Public and private financing would become more expensive, due to the increased pressures on the yields on Italian public debt. A "no" vote would also negatively affect the likelihood of success of the capital increases announced by major Italian banks, notably Monte dei Paschi, and possibly UniCredit, as well as the situation of other small- and medium-sized banks which already received state aid some time ago.

As well as the need for more drastic adjustment of capacity and above all greater consolidation, in a system with 635 entities in mid-2016, Italian banks' main problem is the more than €360 billion in impaired exposures on their balance sheets, 18% of total lending. These exposures are not concentrated in any particular sector, such as the construction and property development sector as in the case of Spain, which makes the problem difficult to solve since the measures cannot be focused on a single portfolio. In any case sooner or later the losses will have to be recognised.

Although both the private initiatives and the institutional reforms undertaken in the banking area in the past few years are going in the right direction, they are lagging behind the actions taken in other countries with similar problems. Among other things, the concept of impaired exposure has been brought into line with international standards, the governance of the "popular" banks and the co-operative credit banks has been improved, the banking foundations have been reformed, seeking to diversify risks and measures have been introduced to speed up debt recovery. Also, in an attempt to promote the transfer of impaired assets from the banks to external vehicles the government has approved the 'GACS' or Treasury guarantee on the senior part of impaired securitised assets, providing they are rated at least investment grade by one of the major rating agencies. It has also established the Atlante Fund, which has already used €2.5 billion for capital increases of two banks in difficulties, and which has undertaken to help reduce the heavy impaired exposures of Monte dei Paschi. Even so, the operating capacity of this fund is limited in the face of a problem of these dimensions.

In the case of Monte dei Paschi, complete implementation of the new business plan presented at the end of October would substantially relieve its situation. For this, both the €5 billion capital increase and the sale of a portfolio of more than €27 billion of impaired assets (the worst quality ones, the so-called sofferenze) would need to be carried out successfully. However, there are execution risks involved in this transaction, and the capital increase will be very difficult to carry out if the "no" vote wins the referendum. If the plan were to fail, there would be various alternatives for recapitalising it, which are envisaged in the new EU regulatory framework (BRRD), and which could negatively affect even retail investors, even if they were to be compensated subsequently through some mechanism or other. The success of Monte dei Paschi is essential for the creation of a dynamic market for impaired exposures in Italy, and it would be an example for other banks to emulate.

In the final analysis, the reforms of the Italian banking system will succeed only if the substantial impaired exposures in the balance sheets are reduced. For this, two things are necessary: that these reforms be accompanied by other structural reforms contributing to boost the low growth rate of the euro zone's third biggest economy; and financial stability. And financial stability is a large part of what is at stake in the referendum.