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## Italy's Big Banking Mystery

The country's financial institutions are regaining their health, yet they're hardly increasing corporate lending.

By *Marcello Minenna*

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Most eyes are on Italy's upcoming election, but economists also are focusing on an Italian mystery. The country has made considerable progress cleaning up the problems in the financial system that seemed to be holding back the economy, and the economy is growing again. Yet that growth seems to have little relationship to the newfound health of the banks, and no one can quite say what the breaking of this link means for the future.

The year is opening with much-needed good news for Italian banks. The volume of nonperforming loans on bank balance sheets has fallen to €173 billion gross, or €66 billion net excluding collateral or other provisions covering possible losses. That's a decline of 30% year-on-year to the net figure.



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Italian banks also have decreased their holdings of Italian government bonds, a link between the sovereign and the financial system identified by the European Central Bank and the European Commission as another soft spot in the financial system. Italian banks now hold “only” €336 billion in Italian

government debt, an appreciable decline of nearly €47 billion during 2017.

In one respect this banking cleanup is having the expected effect. Banks are lending to households again, with credit to households increasing by 2.9% year-on-year in November 2017. That's low compared with France, where the rate was 5.8%, but better than Spain or Portugal, where household credit still is contracting.

The puzzle is that credit to enterprises is not enjoying a similar upward momentum. Growth in corporate credit in Italy has been stuck at around zero since November 2015, according to the most recent ECB data, while it's accelerating in the rest of Europe—5.8% in France and 4.7% in Germany. This is happening despite an increase in Italian industrial activity (2.2%) and business investment (3.2%) in that span. Those trends should be increasing companies' demand for credit, yet the banks aren't satisfying that demand.

Several factors explain this. One is that the banking cleanup still has a way to run. Roughly 60% of the reduction in nonperforming loans is attributable to only six banks—the two largest lenders, Unicredit and Intesa San Paolo, which are now well into turnaround plans, and four smaller banks that were bailed out in late 2016. That suggests that despite healthy economywide figures, many banks may not yet be in a position to lend more.

There's also less than meets the eye to the reduction in reliance on sovereign bonds. The main factor has been bond purchases by the Bank of Italy, the country's central bank, as part of the ECB's eurozone-wide quantitative-easing program. Rather than a virtuous "recomposition" of bank balance sheets in which banks use the proceeds of bond sales to the central bank to extend other forms of credit, banks mostly seem to be absorbing the new cash and unwilling or unable to lend it out again.

There's a bigger factor, however: regulatory pressure. Italian banks still live under the threat that the ECB will approve a new regulation on nonperforming loans that could dramatically increase the amount of capital banks must hold to protect against potential losses. This addendum to existing regulations currently is under review. Italian banks, like all European institutions, face a new battery of stress tests in May 2018 that could expose them to additional capital requirements. These two looming challenges have kept Italian banks in deleveraging mode, prioritizing risk reduction over any other goal.

Their solution is to ration corporate credit. The ECB's negative interest rates and quantitative easing have suppressed borrowing costs in Italy as everywhere else in the eurozone. The average interest rate for a loan to an Italian nonfinancial company is now 1.74%, only 0.03 point more than in Germany—essentially a zero spread. But those Italian loans are going only to the healthiest companies that can offer substantial collateral or other guarantees.

Ample evidence of a capital hunger not satisfied by traditional banks can be found in the explosion of new Individual Savings Plans. This investment instrument, introduced in 2017, amounts to a conduit to feed ample household savings into enterprises. This has provided more than €10 billion in financing to small and medium-size enterprises in the first 12 months of the program. That's equal to 50% of the bank loans extended to all companies in 2017. Capital scarcity also is driving traditionally conservative Italian managers into the stock market, with a 118% increase in new listings on the small-company board of the Italian Stock Exchange in 2017.

The current "bankless" economic recovery is unprecedented in Italy. The question is how much longer it can continue if banks don't get back in the lending game soon.

*Mr. Minenna is a doctoral lecturer at the London Graduate School of Mathematical Finance.*