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Monte dei Paschi is only the tip of the iceberg

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- Monte dei Paschi has a preliminary deal to get rid of its toxic loans and to strengthen its capital position. The step is seen as a crucial move to solve the Italian banking crisis.
- Although a deep restructuring of the Italian banking system is needed, the strategy so far is more like emptying a rubbish bin without asking where the rubbish came from.
- This note gives a detailed picture of the underlying regional and sectoral weaknesses and argues for a two-dimensional approach to solve the problems.

After months of negotiations over Monte dei Paschi di Siena (MPS) with its EUR 10.8 billion of (net) bad credits, an agreement "in principle" with the European Commission has been eventually reached.[1] Most importantly, the agreement involves a cap on senior staff pay equal to 10 times the wage of an average MPS employee and compensation of "retail junior bondholders who were mis-sold by converting these bonds into equity and buying those shares from the retail investors".[2] After the solution of the case of MPS, a deal for other two troubled banks – Banca Popolare di Vicenza and Veneto Banca – is now on the agenda.

Have Italy's banking problems now been solved? Not at all. It is true that the nation-wide stock of bad debt – the worst category of nonperforming loans – would be considerably slashed if the plan to write off most of MPS's

[1] "Mps, intesa Ue-Italia. Coinvolti azionisti e obbligazionisti junior", Il Sole 24 Ore, June 1, 2017. This is not the final agreement though, as some important details and declarations on the side of the bank have still to be provided.

[2] "Statement on Agreement in principle between Commissioner Vestager and Italian authorities on Monte dei Paschi di Siena (MPS)", European Commission DG Competition, June 1, 2017.

bad debt came through.[3] But MPS is only the tip of the iceberg. Although it is commonly agreed that the fixing of the Italian banking crisis should be followed by a structural policy plan for the economy as a whole, not much has been done yet to develop a strategy in this sense.

In this paper, we take a closer look at the evolution as well as the regional and sectoral distribution of bad loans of Italian banks. We find a reduction of the disparity of bad debt ratios among the regions, with the formerly better performing North catching up with the weaker performing South. Moreover, we find that the corporate sector accounts for an over-proportional share of bad bank credits across all regions. Italy's banking problems will not be solved as long as the performance of the economy remains as poor as it has been for the last two decades.

Italian bad debt under the microscope

Regional dimension

Looking at the bad debt ratios, there is not only a considerable cross-regional variability, but also some important changes in the intertemporal pattern.

Before the crisis, Italy's bad debt landscape was showing its typical North-South divide (Figure 1). Specifically, North-West and North-East were experiencing low and stable bad debt ratios (as a percentage of total loans) and remained under the nation-wide average during the entire pre-crisis period (represented in Figure 1 by a positive gap between the national average and regional bad debt ratios). On the other extreme, the South and the Italian Islands started the millennium at high and above-average levels of bad debt ratios but managed to reduce significantly their gaps in the years 2000-2008. The Center region stayed in between and almost perfectly mimicked the nation-wide development, with only a small but nearly constant negative gap towards the national average.

The tide turned after the crisis. Both northern regions worsened remarkably and decoupled from their previous patterns of stability. Especially the North-East saw a relatively strong rise of the bad debt ratios and moved into a negative-gap territory. To the contrary, although the bad debt ratio in the Center increased again from 2.9% in the third quarter of 2008 to 8.5% at the end of 2016, the speed of this increase was slower than in the national average. Consequently, the region moved from a negative to positive gap. Finally, both southern regions saw their bad debt ratios rise again after the crisis, although they have not yet reached the all-time highs from the pre-crisis period.

Sectoral dimension

Along with the regional diversity, there is also sectoral dimension of the Italian banking crisis. Figure 2 illustrates this. Across all regions and almost over the entire period 2000-2016, the corporate sector's bad debt ratios were above the regional average. But whereas before the crisis the gap was still contained – or almost inexistent in the northern regions – this changed significantly after the crisis, with bad debt ratios especially in the southern regions on a very fast increasing track.

[3] Discussed is securitization of EUR 26 billion of gross non-performing loans held by MPS. See "Mps, esclusiva ad Atlante per la cessione delle sofferenze", Il Sole 24 Ore, May 29, 2017.

Figure 1. Regional bad debt ratios as a percentage of total loans and the gap towards the national average (in percentage points; positive gap means a bad debt ratio under the national average).

North-West

Gap (right) Bad debt ratio

North-East

Gap (right) Bad debt ratio

South

Gap (right) Bad debt ratio

Islands

Gap (right) Bad debt ratio

Center

Gap (right) Bad debt ratio

Note: **North-West** includes Piedmont, Valle d'Aosta, Liguria, Lombardy; **North-East** – Provincia Autonoma di Bolzano, Provincia Autonoma di Trento, Veneto, Friuli-Venezia Giulia, Emilia-Romagna; **Center** – Tuscany, Umbria, Marche, Lazio; **South** – Abruzzo, Campania, Puglia, Basilicata, Calabria; **Islands** – Sicily, Sardinia.

Source: Own elaborations (Flossbach von Storch Research Institute) based on data from the Statistical Bulletin of the Banca d’Italia 1999-2017.

Figure 2. Sectoral bad debt ratios as a percentage of total loans in the Italian regions.

North-West

30 25 20 15 10 5 0

Non-financial companies
Regional average
Consumer households

Q1 2000 Q1 2001 Q1 2002 Q1 2003 Q1 2004 Q1 2005 Q1 2006 Q1 2007 Q1 2008 Q1 2009 Q1 2010 Q1 2011 Q1 2012 Q1 2013 Q1 2014 Q1 2015 Q1 2016

North-East

30 25 20 15 10 5 0

Non-financial companies
Regional average
Consumer households

Q1 2000 Q1 2001 Q1 2002 Q1 2003 Q1 2004 Q1 2005 Q1 2006 Q1 2007 Q1 2008 Q1 2009 Q1 2010 Q1 2011 Q1 2012 Q1 2013 Q1 2014 Q1 2015 Q1 2016

South

30 25 20 15 10 5 0

Non-financial companies
Regional average
Consumer households

Q1 2000 Q1 2001 Q1 2002 Q1 2003 Q1 2004 Q1 2005 Q1 2006 Q1 2007 Q1 2008 Q1 2009 Q1 2010 Q1 2011 Q1 2012 Q1 2013 Q1 2014 Q1 2015 Q1 2016

Islands

30 25 20 15 10 5 0

Non-financial companies
Regional average
Consumer households

Q1 2000 Q1 2001 Q1 2002 Q1 2003 Q1 2004 Q1 2005 Q1 2006 Q1 2007 Q1 2008 Q1 2009 Q1 2010 Q1 2011 Q1 2012 Q1 2013 Q1 2014 Q1 2015 Q1 2016

Center

30 25 20 15 10 5 0

Non-financial companies
Regional average
Consumer households

Q1 2000 Q1 2001 Q1 2002 Q1 2003 Q1 2004 Q1 2005 Q1 2006 Q1 2007 Q1 2008 Q1 2009 Q1 2010 Q1 2011 Q1 2012 Q1 2013 Q1 2014 Q1 2015 Q1 2016

Note: **North-West** includes Piedmont, Valle d'Aosta, Liguria, Lombardy; **North-East** – Provincia Autonoma di Bolzano, Provincia Autonoma di Trento, Veneto, Friuli-Venezia Giulia, Emilia-Romagna; **Center** – Tuscany, Umbria, Marche, Lazio; **South** – Abruzzo, Campania, Puglia, Basilicata, Calabria; **Islands** – Sicily, Sardinia.

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This development is alarming for two reasons. First, the stock of bad debt of non-financial corporations accounts for over 70% of the total amount of bad debt (without considerable differences between regions). Second and more importantly, the debt problems in the corporate sector stand in the way of higher growth in the near future.

Good therapy needs the right diagnosis

Is it enough to slash bad debt from banks' balance sheets? Most probably not. Even if affected enterprises were forgiven their debt, this would not be sufficient to bring Italy back on track. As shown in Figure 3, there is a strong positive correlation between the level of unemployment (which is a symptom of past weak economic performance) and the bad debt ratio in each of the Italian regions. In a previous note, we showed empirically that weak economic performance and thus unemployment lead to the accumulation of bad debts.[4]

Italy's future

Back in 2013 Matteo Renzi launched an ambitious plan to set "a new paradigm of growth". Among others, he aimed at reforming the labor market, revitalizing the South, strengthening public finances and improving the electoral system. However, in two and a half years at the government (from February 2014 to December 2016) he failed to implement more than half of his 12-point program. After losing the referendum on a new electoral law in December 2016 he left it to the others to move on with reforms.

Now Renzi is back again on the political stage and prepares for the election to be held in the first half of 2018. If his political calculation adds up, a pro-European and pro-growth coalition between Renzi's Partito Democratico and Berlusconi's Forza Italia could be formed. However, the circumstances to enforce the overdue reforms are worse now than in 2013, with the populists on the rise and Italian public debt on all-time highs.

[4] See Agnieszka Gehringer (2016), „Non-performing loans in the euro periphery were not build in a day", Flossbach von Storch Research Institute, Economic Policy Note 28/10/2016.

Figure 3. Scatter plots of regional unemployment rates and bad debt ratios.

North-West
$R^2 = 0,8909$

North-East
$R^2 = 0,864$

South
$R^2 = 0,8924$

Islands
$R^2 = 0,8855$

Center
$R^2 = 0,8028$

bad debt ratio

unemployment rate

Note: **North-West** includes Piedmont, Valle d'Aosta, Liguria, Lombardy; **North-East** – Provincia Autonoma di Bolzano, Provincia Autonoma di Trento, Veneto, Friuli-Venezia Giulia, Emilia-Romagna; **Center** – Tuscany, Umbria, Marche, Lazio; **South** – Abruzzo, Campania, Puglia, Basilicata, Calabria; **Islands** – Sicily, Sardinia.

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