Social Europe

The Italian Non-Performing Loans Problem And Europe

by Marcello Minenna on 30 September 2016

The narrative about Eurozone problems is often – and rightly – focused on the Italian banks' troubles, burdened as they are by €338 billion of non-performing loans (NPLs) with little or no chance of recovery owing to the persistent crisis of the Italian manufacturing sector. The Monte dei Paschi drama is just the tip of the iceberg: a problem too obvious to be ignored, but certainly not the only one.

In all honesty, the problem has not come out of nowhere: NPLs have grown steadily since the financial crisis of 2008-2009 at the astonishing rate of €50bn per year, reflecting the reluctance of banks to record losses and an overall attitude of postponing the problem (the *wait and see* strategy). Italian banks have been waiting for a robust recovery in economic activity that has simply not materialized. The austerity policies coordinated at the European level through the reform of the Stability and Growth Pact have certainly had a role in this non-recovery.

Billions of new capital (up to €80bn, with MPS accounting for the lion's share with €10bn) have been periodically injected onto banks' balance sheets, but their effect has quickly waned, owing to the low profitability of a fragmented banking system in a zero interest rates environment. With the European recession of 2013-2014 and the stricter rules of supervision at European level imposed by the *Single Supervisory Mechanism* (SSM) which imposed recognition of NPLs as losses at a faster rate, cracks in the system have begun to surface.

A number of structural factors, such as the economic cycle and austerity policies, have been shared with other Eurozone countries. In order to progress the political debate, the NPL problem needs therefore to be properly framed in a broader European perspective.

According to the latest available data from the European Central Bank CBD2 database(Consolidated Banking Data), in April 2016 the Eurozone banks were overloaded

with €1014bn of NPLs. A significant amount, even ifa slight reduction from the € 1114 peak reached in April 2015.

The gradual economic recovery that gained traction at the beginning of 2015 has had a clear positive impact – even if moderate – on impaired loans but with differentiated outcomes. A breakdown of loans by country of origin confirms that the NPL problem is structurally worse in Italy: the incidence of NPLs on the balance sheets of Italian banks remains substantially unchanged at just over 30% with respect to the total in a period of 16 months of analysis, despite the downwards trend at European level.

In France the absolute value of NPLs is high but the phenomenon can be considered contained since the proportion of impaired loans to the total is around 4% (when in Italy it hovers around 18%). The good recovery in the Spanish economy and the unexpected boom of new loans have reduced the impact of bad loans, whose percentage is gradually decreasing over time (from 9.38% in 2013 to 6.26 % in 2015). The dire situation of Greece completes the bleak panorama in Southern Europe. The endless Greek recession, exacerbated by an enduring deflation, does not allow the banks to dispose of the huge mass of distressed loans, accounting for over 35% of the total amount of Greek bank lending.

The German Exception

The trend in Germany has been different and worthy of attention. The German banking system has benefited from a reduction of over €30bnNPLs, more than a third of the overall compression registered for the entire Eurozone, thus reducing the NPL weight to a negligible percentage of the total (2.34%). It is a plausible explanation for this that the stronger GDP growth experienced in Germany after the 2008-2009 crisis has enabled enterprises and households to resume debt payments that had been suspended.

The German experience shows that a "*wait and see*" policy of banks in the disposal of bad loans could well be a viable strategy, if the weight of impaired loans is not excessive and a recovery of the economic cycle can be reasonably expected. However, when the ratio of NPLs is too high, it quickly becomes in itself an obstacle to growth. In order to restore falling profitability banks reduce their support for the real economy, forcing the businesses that depend upon bank loans out of the market. In this way the banking system is self-sabotaging its "*wait and see*" strategy.

When classified by economic sector of origin, the NPLs data describe a dichotomy between *core*and *peripheral* countries. In Germany and France the picture is balanced, with about

50% of NPLs attributable to the manufacturing sector and the other half shared by households and the banking sector.

In sharp contrast, the decline of the industrial sector is driving NPL growth in peripheral economies, especially in Greece and Italy. Almost three-quarters of NPLs were granted to Italian and Greek small-medium enterprises that have now probably disappeared from the market. Hence these loans are deadweight losses despite their optimistic accounting, not recoverable even in the presence of strong GDP growth. This interpretation explains the low evaluation of these loans made by the market (around 20% of their nominal value).

In summary, we cannot but acknowledge the peculiarity of the Italian case: the country can hardly get out of the NPL quagmire without a structural intervention under the direction of the European authorities. A massive purchase of securitized NPLs would be required, several orders of magnitude higher (at least € 500bn) than the current ECB *Asset Backed Securities Purchase Program* accompanied by forced recapitalizations with government funds given on precise, restrictive conditions.

Whatever the technical implementations, losses are inevitable and need to be mutualized among the different actors of the economic system. Preferably in a coordinated manner; buffer-type or one-off interventions, carried out at national level (such as in the MPS case), would not help.