THE ITALIAN BANKING SYSTEM

Monte dei Paschi's Scandal and the Euro Area's Sovereign Debt Crisis

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The Monte dei Paschi di Siena (MPS) is the world's oldest bank. In January 2013, amid financial difficulties and a mounting scandal, it received a state bailout of 3.9 billion euros. Subsequently, other smaller Italian banks, namely, Carige and Banca Marche, were requested by the Bank of Italy to raise significant new capital, and Banca Marche was put into special administration. The financial woes experienced by these Italian banks, in which foundations played a prominent role, offer an opportunity to reflect on three inter-related topics, according to which this chapter is structured.¹

The first issue is the evolution of the Italian banking system and banking legislation over the past few decades, which is instrumental to explain the governance structure of the MPS, Carige, Banca Marche, and other banks in which foundations have a prominent role. The second issue is the sovereign debt crisis in the euro area, which set the broader context in which the MPS scandal and the ensuing financial troubles of Carige and Banca Marche took place. The development of the sovereign debt crisis had implications for Italian banks that hold a large quantity of public debt. Hence, the sovereign debt crisis risked turning into a banking crisis. The third issue is the principal response of the European Union (EU) and euro area to the sovereign debt crisis—that is, the proposal for the creation of an EU banking union. This

proposal resulted in strong supervisory actions taken by the Bank of Italy to prepare for the handover of banking supervision to the European Central Bank (ECB).

From the “Petrified Forest” to a Modern Banking System

To understand the financial woes experienced by the MPS and by other banks such as Carige and Banca Marche, it is important to understand the evolution of banking regulation in Italy since the late 1980s, when Treasury Minister Giuliano Amato described the Italian banking system as a “petrified forest” that had changed little since the 1930s.² The banking sector was largely state-owned, as a result of government rescue operations during the Great Depression. Moreover, the Italian banking system was “segmented” as it included public long-term credit institutions (*istituti di credito speciale*) and short-term credit institutions (*istituti di credito ordinario*), with few private banks and many public savings banks, as well as cooperative banks (which constituted a small minority). The savings banks had a variety of (non-profit) objectives, including the promotion of social and cultural activities at the local level. They were mainly owned by public bodies, especially local authorities, who favored the practice of distributing top positions according to party-political affinity (*lottizzazione*). Each of these categories of banks was also subject to geographical constraints that restricted their activity and limited competition in the sector.³

The EU’s Second Banking Directive of 1989, which established a single passport for banks that enabled them to operate across the EU, introduced the all-purpose “universal bank” model.⁴ According to this German-inspired model, banks were potentially able to perform a variety of financial activities, such as securities trading, in addition to loans and deposits/withdrawals. The universal bank model contrasted sharply with the existing segmented banking model in Italy at that time. Moreover, Italian banks, most of which were state-owned, were not very efficient or profitable by European standards; hence, they would have been unable to compete efficiently with foreign banks in the single market. Consequently, the Italian authorities were worried that the EU’s 1992 single market program, in particular, the Second Banking Directive, would raise the presence of foreign credit institutions in Italy. A major reform was therefore needed in order to raise the efficiency and profitability of Italian banks with a view to preserving strong national champions in an integrated, more competitive European banking market. Furthermore, the exchange rate crisis in 1992, which resulted in the lira’s exit from the European Exchange

Rate Mechanism and the near default on the Italian public debt that accompanied it, called for budgetary restraints and gave momentum to privatization, both within and without the banking sector in Italy.

In 1990, the so-called Amato-Carli law, named after the two Treasury ministers who worked on it (Giuliano Amato and Guido Carli), established that banks were profit-making enterprises.⁵ This had not been the case before because a vast part of the banking system was state-owned. The new legislation prescribed a clear separation of the dual objectives previously pursued by the savings banks: public interest activities, on the one hand, and banking business, on the other. The savings banks, which had previously functioned as associations or foundations under public law, were required to turn into public limited companies.⁶ These continued to conduct banking operations, while the capital of savings banks was transferred to foundations that had to be newly established under private law. Thus, the foundations were initially the sole owners of the respective savings bank companies. The foundations were mandated to provide social and public services in the common interest. The reform enabled the savings banks to raise capital in the financial market and dismantled the regional constraints on banks' activities. It opened the door to the injection of competition into the system and to the privatization of the numerous public banks, which was pursued throughout the 1990s.

The Consolidated Law on Banking of 1993 brought Italian legislation into line with EU legislation (to be precise, the Second Banking Directive of 1989), by introducing two major innovations that aimed to establish universal banking in Italy. It allowed banks to hold shares in industrial concerns and eliminated the distinction between banks and special credit institutions, thus allowing all banks to perform operations previously limited to specific types of intermediaries. The specific savings bank legislation was abolished in 1993, so from that point onward the main distinction was between commercial banks and cooperative banks. By the end of 1992, the 83 savings banks that existed when the Amato-Carli law was passed had separated their banking operations from their social mandate, setting themselves up as public limited companies.⁷ Despite this formal privatization, the foundations continued to hold substantial stakes in the bank companies. The Consolidated Law on Finance, which laid the groundwork for *de facto* privatization, changed this in 1998.

The Consolidated Law of 1998 is also known as the Ciampi law because Carlo Azeglio Ciampi, the former governor of the Bank of Italy, was the Treasury minister who proposed it. It is also known as the Draghi law, named after the director-general of the Treasury at that time, Mario Draghi, who masterminded it. The Ciampi-Draghi law

established that all the (majority) stakes in savings banks held by the private law foundations were to be sold by 2003, ending the foundations' control over banks. The foundations were offered tax incentives to encourage them to sell their stakes to private investors. The law established new rules on corporate governance and company takeovers by facilitating the issuing and trading of securities. It also increased the protection of minority shareholders and the transparency of corporate governance.⁸

The extensive public sector was partly dismantled in the 1990s in the industrial sector and in the banking sector. After the transformation of the savings banks into limited liabilities companies, privatization gained momentum in Italy. By the mid-2000s, there were no state-owned banks in Italy, unlike, for example, Germany and Spain.⁹ The abolition of the regional principle, the transformation of the savings banks into public limited companies, the elimination of the savings bank legislation, and the *de facto* integration of the savings banks into stock market-listed banking groups enabled the former public sector banks to act as regular commercial banks.¹⁰

Privatization of Italy's savings banks went hand in hand with consolidation in the banking sector, which led to the formation of universal banks—to be precise, banking groups.¹¹ Mergers and acquisitions redistributed market shares, amounting to a third of total banking assets. The main banking groups were formed through mergers and acquisitions that involved commercial banks, savings banks, and, in some cases, cooperative banks.¹² The mergers between savings and commercial banks reduced the ability of local and regional governments to exert political influence on banks, although the governments continued to hold stakes in banks via the foundations. The big banks, which saving banks became part of, operated according to international standards in terms of corporate governance and business model.

Domestic consolidation was a deliberate strategy to deal with increasing cross-border competition in Europe. It promoted the formation of Italian banks that were outwardly competitive and limited the penetration of foreign banks in Italy. Indeed, until the early 2000s, the penetration of foreign banks and financial institutions in Italy was relatively limited for a variety of reasons, most notably the lukewarm attitude toward foreign ownership of Italian banks by the Bank of Italy under the governorship of Antonio Fazio (1993–2005).¹³ Fazio had a dirigiste approach to banking policy, seeking to modernize and reshape the banking system in Italy by orchestrating the domestic concentration of banking activities and by protecting it from foreign penetration.

The cases that made the headlines across Europe because they involved foreign banks related to two proposed takeovers of Italian

banks in 2004–2005: one by a Spanish group, Banca Bilbao Vizcaya Argentaria, of Banca Nazionale del Lavoro, and the other by ABN Amro of Banca Antoniana Popolare Veneta (Antonveneta). In both cases, Governor Fazio intervened to block the foreign takeover bid while endorsing counter-bids launched by two Italian banks, Banca Popolare di Lodi and Unipol, respectively. Both foreign banks involved in the attempted takeovers complained to the European Commission (EC), which had given its authorization on the grounds that the bids did not jeopardize competition in the banking sector. An anti-trust inquiry launched by the EC's commissioner for competition, Neelie Kroes, was dropped on the grounds of lack of conclusive evidence. The EC's commissioner for internal market and services, Charlie McCreevy, also expressed his concern in a letter to Fazio in 2005.¹⁴

Italian magistrates began to gather evidence of wrongdoing (insider trading and abuse of office) by Fazio and subsequently investigated the Antonveneta case. It also emerged that the governor and some close collaborators had overturned the negative opinion given by the Supervisory Department of the Bank of Italy, which had refused to authorize Lodi's acquisition of the Antonveneta share. After the appointment of Mario Draghi as the Bank of Italy's governor in 2006, foreign banks acquired major Italian banks, including the Banca Nazionale del Lavoro (acquired by BNP Paribas), and Antonveneta (acquired by the Dutch ABN AMRO, although it was subsequently sold to the Italian bank MPS in 2008).¹⁵

The MPS Scandal and the Financial Difficulties of Carige and Banca Marche

The origin of the MPS's financial problems was its (overpriced) acquisition of Banca Antonveneta for 9 billion euros in late 2007.¹⁶ Santander, which had sold Antonveneta to the MPS, had valued Antonveneta, minus a subsidiary which it kept, at 5.6 billion euros. This acquisition gave the MPS the largest corporate loan book relative to its size in Italy and substantially weakened its capital base at a time when the financial crisis was gaining momentum. The bank's share price dropped 11 percent to 3.72 euros on the day following the announcement of the takeover, valuing the entire group at less than the value of its acquisition target.¹⁷

After the acquisition, the MPS had to rebuild capital. In March 2009, it received 1.9 billion euros of state capital injection in the form of Tremonti bonds, discussed below. Afterward, the MPS did several (non-public) derivatives deals with Deutsche Bank and Nomura in

order to keep huge losses off its balance sheet.¹⁸ The intention was to spread the losses over a 30-year period by repurchasing agreements based on Italian sovereign debt. At the same time, the bank was building a huge portfolio of Italian sovereign bonds, while the Eurozone sovereign crisis was building up.¹⁹

Following pressure from the Bank of Italy, the MPS raised 2.5 billion euros additional capital in April 2011. In order to maintain its control of the bank, the main MPS shareholder, namely, the Monte dei Paschi di Siena Foundation, discussed below, decided to call on Goldman Sachs and JPMorgan to borrow 1 billion euros. In October 2011, with dividends from the bank drying up as its profits fell, the Foundation was forced to ask for a standstill from its creditors on its debt.²⁰ As a consequence of moral suasion applied by the Bank of Italy, the top management of the MPS was replaced in April 2012 and was subsequently subjected to judicial investigations.

The new management of the MPS immediately made public the huge losses suffered by the bank, making it clear that state financial assistance was needed. The second bailout, worth 3.9 billion euros (the so-called Monti bonds), was decided on in January 2013.²¹ It was subjected to scrutiny by the ECB and especially the EC's Directorate-General for Competition. In July 2013, EC Commissioner Joaquín Almunia argued that the proposed restructuring plan was too lenient on executive pay, cost-cutting, and treatment of creditors. He warned that unless the plan incorporated "urgent" changes, he would launch a full-blown investigation.²²

The MPS's downfall discredited the bank's former management and exposed the close ties between politicians and banks. Indeed, the bank's largest shareholder was the Monte dei Paschi di Siena Foundation, which controlled more than 50 percent of the bank's share. The Foundation, which was mainly composed of local politicians, used its profits to finance a variety of (non-bank-related) local activities, such as hospitals, museums, and low-cost housing, but also the local soccer team and even the Palio.²³ It also appointed the management of the MPS, with the assertion that in so doing it dispensed patronage and jobs. After the scandal, the Foundation's stake in the MPS dropped to 33 percent and is set to drop further in 2014.²⁴ In July 2013, the MPS changed its governance structure with a view to making its shares more attractive to investors, paving the way for the issuance of 1 billion euros in new shares by the end of 2014. The change was also a consequence of the pressure exerted by the Bank of Italy and the EC, whose approval was needed for the bank to receive state aid.

The MPS scandal was followed by serious financial difficulties experienced by two smaller Italian banks, Carige and Banca Marche,

in which foundations played an important role. In February 2013, Carige's Core Tier 1 capital adequacy ratio, which is a key measure of financial soundness, was 6.2 percent, one of the weakest among Italian banks. Carige, which in the past had underestimated the amount of write-downs on non-performing loans, was forced by the Bank of Italy to revise its practices. Its balance sheets in 2012 reported an increase of write-downs from 118 million euros to 447 million euros, and the previous 200 million euros profit of the bank became a net loss of 62 million euros.²⁵ Consequently, Carige was required by the Bank of Italy to hire a new chairman and board and to devise a capital-strengthening plan of 800 million euros, to be achieved partly through non-core asset sales and partly through a rights issue. Carige sought to sell assets to avoid a capital increase that would reduce the influence of its main shareholder, the Carige Foundation, a charitable entity with close ties to local politicians, which owned 46.6 percent of the bank. After an inspection in August 2013, the Bank of Italy stressed widespread inadequacies in Carige's management and control systems, which had an impact on its risk-taking policies, and demanded that the bank's new management revise its lending practices.²⁶

Banca Marche posted a net loss of 232 million euros in the first half of 2013 due to write-downs on loans for 451.8 million euros, an increase of 373 million euros compared to the same period in 2012. The write-downs were 170 million euros higher than what the bank had forecast as a result of an "extraordinary review" of the bank's loan portfolio requested by the Bank of Italy. In the summer of 2013, Banca Marche was subject to an extended inspection by the Bank of Italy because it had one of the lowest Core Tier 1 capital ratios among Italian banks—4.2 percent.²⁷ In order to increase its capital base, the bank had approved a 300 million euros share issue to be carried out by the end of 2013. Yet one of its main shareholders, the Banca Marche Foundation, was unwilling to see its stakes in the bank diluted. In September 2013, the Bank of Italy temporarily suspended Banca Marche's board of directors and internal auditors from their functions and appointed two special administrators tasked with increasing the bank's weak capital base.

In 2013, the Bank of Italy, which initially had carried out an inspection of bad loans at 20 of the country's banks, extended its checks to the entire loan portfolio of eight smaller lenders, including Carige and Banca Marche. These supervisory actions were part of a broader plan by the Bank of Italy to encourage smaller Italian banks to tidy up their balance sheets in preparation for the functioning of the Single Supervisory Mechanism (SSM). The SSM was to be a key component of the EU banking union, which, as will be discussed below, was the main response to the euro area sovereign debt crisis.

The Italian Banking System and the Sovereign Debt Crisis

Except for the massive financial losses experienced by the MPS, the Italian banking system was marginally affected by the banking crisis that hit most developed countries between late 2007 and 2009. This was partly due to the limited size of the Italian financial sector, to the rather “conservative” business models of Italian banks, and to the effective supervision of the Bank of Italy. The Italian banking system also is relatively small: total balance sheet assets are about 2.5 times the country’s GDP, compared with 3.3 times in Germany and Spain and 4.1 times in France. The Italian financial system as a whole, of which the banking system is part, is also smaller than in other countries. In proportion to GDP, stock market capitalization in Italy is 28 percent, compared to 42 percent in Germany, 44 percent in Spain, and 67 percent in France.²⁸ Moreover, insurance companies and pension funds are less developed in Italy than elsewhere.

The concentration of the banking system is relatively limited in Italy, which has a comparatively high number of banks. The five largest Italian banks have over one-third of all bank assets. The market shares of limited liability companies, savings banks, and cooperative banks is respectively 80 percent, 9 percent, and 7 percent of customer deposits, with branches of foreign banks holding the remaining 5 percent.²⁹ Foreign banks operating in Italy, through branches or subsidiaries, account for over 13 percent of total Italian banking system assets, a proportion higher than in France or Germany. Banks in Italy provide most of the credit to the real economy. Bank lending to firms is equal to 57 percent of GDP, compared with 43 percent in France and 36 percent in Germany. Fewer than 300 companies are listed on the stock exchange, compared with 760 in Germany and 630 in France.³⁰

Despite the privatization, the modernization, the consolidation, and the opening up of the Italian banking system, Italian banks have a rather traditional business model and a limited degree of internationalization. In the run-up to the global financial crisis that began in late 2007, the majority of assets of Italian banks were loans to customers, with only a small component of derivatives, approximately 3 percent of banks’ assets. A great percentage of the assets of Italian banks were national government securities. Hence, Italian banks had a relatively large exposure to the government, which proved to be a significant weakness when the sovereign debt crisis worsened, as will be explained below.

Italian banks did not fuel a property bubble: they lent to households far less than, for example, either Spanish or Greek banks. Data from the Bank of Italy suggest that Italian banks were predominantly

lending to non-financial companies and that, among non-financial companies, the bulk of the loans went to services and industry, not building.³¹ Obviously, a property bubble can also come from residential mortgage lending, but there was no significant rise in consumer lending in the years preceding the crisis.³²

As far as liabilities are concerned, Italian banks had a broad and stable funding base, even though they collected funding on the wholesale market. However, they tended to lend mostly to each other in the wholesale market. The average home bias for Italy was the highest in the euro area's national banking systems.³³ At the height of the crisis, banks cut their lending to banks in other countries far more than their lending to banks in their own country, so the fact that Italian banks lent to each other suggests that inter-bank borrowing was more stable than in those systems (as in Spain) where inter-bank funding was largely from abroad. Second, although Italian banks have high levels of wholesale funding, this is relatively longer term.³⁴ From early 2011, the difficulties that Italian banks faced in providing credit, due to the cost and availability of funding, owed to the spike in bond yields fed principally by market concerns over Italian sovereign debt and the relatively high dependence of banks on bond sales to fund lending. Third, several of the debt securities issued by Italian banks were sold to their customers, which made this sort of funding less subject to the vagaries of the financial markets. Italian banks have greater access to retail investors for their bond issues than elsewhere in Europe.³⁵

Last but not least, the Bank of Italy provided effective supervision.³⁶ Indeed, both explicit regulation and supervisory practices seem to have played an important role in ensuring that the Italian banking system did not increase its risk exposure or leverage excessively. World Bank indicators give Italy high scores as far as capital requirements are concerned, as well as for "restrictions" imposed on banks' activities.³⁷ Hence, unlike Ireland and Spain, where the banking crisis then became a sovereign debt crisis, Italy did not experience a banking crisis. Instead, the country suffered from chronic fiscal imbalances, especially a large public debt, whose sustainability was challenged by a persistently low growth rate over more than a decade and by rising interest rates following the global financial crisis.

Italy had been suffering from chronic fiscal imbalances well before the crisis, with a public debt above 100 GDP for the last three decades. On the positive side, Italy has run a primary surplus from 1992 onward except for primary deficits in 2009 and 2010, which were mainly due to a falling growth rate. On the negative side, following the entry of the country into Economic and Monetary Union (EMU) in 1999, the Italian government failed to take advantage of the low interest rates

that would have substantially reduced its outstanding public debt. Unlike in Spain and Greece, a large proportion of the public debt is held domestically by banks and small investors/families. The limited degree of Italy's external indebtedness was the consequence of the relatively small current account deficits that Italy suffered during the first decade of EMU membership and the high saving rate in the country.

The main problem in the Italian case was not so much the high level of public debt, especially taking into account the relatively low level of private debt and the fact that the public debt is mostly held abroad. It was the very low growth rate that raised serious issues about the sustainability of the public debt.³⁸ Italy has been suffering from low economic growth for more than a decade: 0.54 percent annual average real GDP growth between 2000 and 2010 versus 1.37 percent for the euro area. Since the beginning of the crisis, the low or negative economic growth and rising unemployment in Italy have worsened the state of the public finance.

Moreover, Italy has suffered from a loss of competitiveness since joining EMU. Between its adoption of the euro in 1999 and 2008, unit labor costs in the manufacturing sector—the strongest indicator of economic competitiveness—continued increasing more rapidly in Italy than the EU10 average. During that period, the countries' productivity marginally increased. According to the World Economic Forum's annual 2012 competitiveness ranking, "one of the shared features of the current situation in all these [Southern European] economies is their persistent lack of competitiveness ... Over all, low levels of productivity and competitiveness do not warrant the salaries that workers in Southern Europe enjoy and have led to unsustainable imbalances, followed by high and rising unemployment."³⁹

On the positive side, Italy had limited external indebtedness and did not experience high level of capital inflows prior to the crisis. This was the consequence of the relatively small current account deficits that Italy saw during the first decade of EMU membership and the high savings rate in the country. Italy has the second-largest manufacturing and industrial base in Europe, after Germany, and is one of the biggest export-oriented economies in the euro area. "Made in Italy" is still a valuable brand around the world. Furthermore, Italian banks did not channel capital inflows into a property bubble. Most Italian bank lending was to manufacturing and service sectors.

When the sovereign debt crisis broke out in Greece in 2009–2010, Italy was initially unaffected, as suggested by the 10-year spreads on government bonds for Italy versus the German bunds. Italy began to face serious problems in the bond market in the summer of 2011: the spread between Italian 10-year bonds and their German counterparts

widened; Italian sovereign debt yields moved above those charged to Spain; and rating agencies downgraded the creditworthiness of the Italian government and consequently of Italian banks. Stock prices fell in the banking sector because of the banks' increased borrowing costs resulting from Italy's downgrading and because of the concerns about their exposure to sovereign risk, as in the case of the MPS. Moreover, as the conditions of the Italian economy deteriorated, high levels of non-performing loans hit Italian banks, such as Carige and Banca Marche, because a number of their customers were struggling to repay their debt.

Despite the limited external imbalances prior to the crisis, a massive sell-off of Italian sovereign debt and Italian bank stocks precipitated a balance-of-payments crisis in Italy in January 2011. In addition, there was evidence of a drain on bank deposits as well. Italy experienced significant capital outflows during the summer of 2011. The liquidation of Italian public debt held by foreign investors contributed to the outflows. Italian bonds were sold in large quantities because they were no longer considered risk-free assets. In the TARGET2 system, the real-time gross settlement system of the euro area, the Bank of Italy, previously a creditor, became a net debtor after late 2007.

In the summer of 2011, the ECB intensified its purchase of Italian (and Spanish) bonds in the secondary markets in an attempt to reduce borrowing costs. In December 2011, the ECB launched a program titled Long-Term Refinancing Operations (LTROs). It issued loans at an interest rate of 1 percent for a period of three years to European banks while accepting government bonds, mortgage securities, and other commercial papers in the portfolio of the banks as collateral. At the same time, the ECB changed its rules on collateral, accepting lower-quality collateral in return for its loans. Under this program, the ECB loaned 489 billion euros to 523 banks, mainly in Greece, Ireland, Italy, and Spain. Indeed, Italian and Spanish banks took about 60 percent of all the net new loans from the ECB.⁴⁰ The banks used these funds to buy government bonds, effectively easing the debt crisis. In February 2012, the ECB held a second three-year auction of 529 billion euros to 800 European banks. Although the ECB program did not target Italy specifically, the country benefited through a temporary reduction of its borrowing costs. The ECB lent to euro area banks, which in turn lent to euro area governments and then used the government debt they bought as collateral for yet more loans from the ECB.

Market instability in the euro area and unsustainable borrowing costs for countries such as Italy led to the ECB's decision, announced on 6 September 2012, to purchase euro area countries' short-term bonds in the secondary markets as part of a new program dubbed Outright

Monetary Transactions (OMTs). However, governments of the participating countries were required to apply for aid from the euro area rescue funds and to comply with conditions in exchange for the support. The Italian government repeatedly ruled out the possibility of requesting EU financial assistance, pointing out that the economic situation of Italy was different from that of the countries that had requested EU financial assistance. The Italian authorities often highlighted the “permanent risk of contagion,” portraying Italy as a bystander in the crisis, and argued that “strengthening the euro zone is of collective interest.”⁴¹

The Plan for an EU Banking Union

After several firefighting measures, the EU—or, to be the precise, the euro area—eventually put forward a bold initiative to deal with the sovereign debt crisis: a banking union. In June 2012, the European Council, which brings together the heads of states and governments, agreed to deepen EMU by creating a banking union that was to be based on five components: (1) a single rule book on bank capital and liquidity; (2) a single framework for banking supervision; (3) a single framework for the managed resolution of banks and financial institutions; (4) a common deposit guarantee scheme; and (5) a common backstop for temporary financial support. The proposals for the banking union amounted to a radical initiative to rebuild financial market confidence in both banks and governments—especially in the euro area periphery. The banking union would be designed to stabilize the national banking systems exposed directly to a vicious circle between the international financial crisis and the euro area’s sovereign debt crisis and to reverse the fragmentation of European financial markets.

Since June 2012, the various elements of such a banking union have been discussed and mostly agreed upon, with a couple of exceptions. In September 2012, the European Commission proposed a regulation for the establishment of a Single Supervisory Mechanism (SSM), which was approved by the EU’s Council of Ministers in December 2012 and is currently in the process of being set up. The adoption of EU capital requirements legislation in early 2013 reinforced the single rule book, although many lacuna remained. A directive on Banks’ Recovery and Resolution was agreed upon by the Council of Ministers in May 2013. In July 2013, the EC proposed a regulation for the setting up of the Single Resolution Mechanism (SRM), currently under negotiation. The EC had previously proposed a directive on Deposit Guarantee Schemes (DGS), which was stalled. The European Stability Mechanism (ESM) began operation in September 2012 with the goal

of eventually replacing the temporary European Financial Stability Facility (EFSF). It was envisaged that, subject to certain conditions, the ESM could provide financial support to ailing banks.

One of the key features of the banking union, which has direct implications for Italian banks, is that the SSM applies only to the euro area countries and to the non-euro area countries that decide to join it. In the SSM, responsibility for banking supervision is basically assigned to the ECB.⁴² During the negotiations, the main issue has been the scope of ECB supervision, that is, whether the ECB should directly supervise all banks in the euro area (plus the opt-in countries) or only the main (cross-border) banks and the relationship with non-euro area member states—in particular, those that would not opt in. In the end, the agreement reached at the December 2012 European Council foresaw that the ECB would be “responsible for the overall effective functioning of the SSM” and would have “direct oversight of the euro area banks.” This supervision however would be “differentiated,” and the ECB would carry it out in “close cooperation with national supervisory authorities.”⁴³ Direct ECB supervision was to cover those banks with assets exceeding 30 billion euros or those whose assets represent at least 20 percent of their home country’s annual GDP. This direct supervision would concern approximately 200 euro area banks. However, the agreement also permits the ECB to step in, if necessary, and supervise any of the 6,000 banks in the euro area to bring about the eventual restructuring or closure of banks that find themselves in difficulties.

As for the relationship with non-euro area members, some euro-outsiders were interested in participating in the SSM and therefore opposed the regulation proposed by the EC in September, which placed the ECB at the center of the mechanism. The European Council eventually decided that non-euro area member states could opt in into the SSM and that opt-in countries should be able to sit on a new ECB supervisory board with equal voting powers but not on the decision-making Governing Council.⁴⁴ The majority of non-euro member states either sought to enter the banking union or adopted a “wait and see” policy.⁴⁵

In July 2013, the EC proposed the establishment of an SRM,⁴⁶ designed to complement the SSM. The EC’s draft regulation envisages the establishment of a Single Resolution Board, consisting of representatives from the ECB, the EC, and the national resolution authorities of the countries where the bank has its headquarters, as well as branches and/or subsidiaries. A Single Bank Resolution Fund would be set up under the control of the Single Resolution Board to provide financial support during the restructuring process. The fund is to be subsidized by the banking sector. The proposal gave the ultimate decision-making power to the EC, which would decide whether and when to place a

bank into resolution and would set out a framework for the use of resolution tools and the fund.

The main issues in the negotiations on the SRM concern the centralization of decision-making power, the sources of funding, and the legal basis of the new mechanism. The EC's initial proposal envisaged that decision-making power would be in the hands of the Commission itself. Some member states, first and foremost Germany, argue that decision-making power should rest with national resolution authorities. As for the funding of the new mechanism, the EC has proposed the creation of a Common Resolution Fund, to be funded by industry, but some member states, first and foremost Germany, oppose this. A third issue concerns the legal bases of the SRM, in particular, whether it would require the revision of EU treaties, as suggested by German policy-makers, or not, as argued by the EC, the ECB, France, Italy, and Spain, which are keen to speed up the establishment of the SRM.

The negotiations on the various elements of the banking union are ongoing. The main issues that have not been settled yet are the creation of a common DGS and the use of the ESM as a common fiscal backstop. To diminish the likelihood of moral hazard, creditor countries (notably Germany) have sought to establish clear limits to their financial assistance to ailing banks and governments in debtor countries hit by the sovereign debt crisis. This has accounted for the limited scope of the SRM, the difficulty in agreeing on a common DGS, and the limited amount of ESM funds and their conditional use. By contrast, countries that have had ailing banking systems, such as Spain or potentially Italy because of the fragile position of its government, tend to support a full banking union with a common fiscal backstop.

Conclusion

The MPS's huge losses and its need for public financial support made the headlines in Italy in 2013 and was followed by serious financial difficulties in other small Italian banks, such as Carige and Banca Marche. Nonetheless, the Italian banking system coped reasonably well with the global financial crisis that began in late 2007 and reached its peak in October 2008. The Italian banking system was also relatively unaffected by the euro area's sovereign debt crisis until the contagion extended to Italy. Italian banks, such as the MPS, held a large share of (depreciating) government debt: the risk was turning a public debt crisis into a banking crisis. When the sovereign debt crisis developed, Italian banks were negatively affected by their respective country risk.

These events in 2013 provided the opportunity to reflect on the reform of the Italian banking system that had been set in motion by the Amato-Carli law in 1990 and was followed through by subsequent pieces of legislation. The reform had been successful in modernizing, privatizing, and consolidating the Italian banking sector, increasing its competitiveness and enabling Italian banks to withstand foreign competition on the domestic market as well as expanding abroad. Yet the reform had left some unresolved issues, such as the residual influence of foundations on banking business and governance structure.

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Notes

1. This chapter was partly written while the author was a research fellow at the Hanse-Wissenschaftskolleg.
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