

# Watch Italy's referendum for potential banking problems

 [blogs.lse.ac.uk/europpblog/2016/11/22/italy-referendum-banking-problems/](https://blogs.lse.ac.uk/europpblog/2016/11/22/italy-referendum-banking-problems/)

22/11/2016

*Italy's constitutional referendum is fast approaching and financial markets are already jittery. [Lorenzo Codogno](#) and [Mara Monti](#) write that while some observers have pointed to the risk of the Five Star Movement getting into power, or even Italy leaving the euro, these are unlikely developments, at least in the short term. The real issue is not about political instability, but about financial stability: the combination of still modest economic expansion, vulnerability in the public finances and, more importantly, ongoing problems in the banking sector may ultimately lead to a dangerous mix.*



**Interested in other points of view? Check out [EUOPP's full coverage](#) of Italy's constitutional referendum.**



"I rebel — therefore I exist" used to say Albert Camus. There seems to be a wave of populism across the globe, with voters willing to make a statement, rebelling against the establishment and saying 'No'. But isn't that too simplistic an interpretation? It is far too easy to look at the Italian referendum on constitutional change and interpret it as yet another episode of the growing international dissatisfaction with the status quo. The reality is probably much more complex, although admittedly there is an element of that.

With Italy's GDP still running almost 8 percentage points below its pre-crisis peak, it no wonder there is some dissatisfaction and desire to change. However, what would a protest vote look like in Italy? Oddly enough a 'No' vote would be in favour of the status quo and against the reforms proposed by Prime Minister Renzi and his government. The Prime Minister appears isolated in Italy's 'establishment', sometimes even in his own party. So who is the underdog in this case? The opposition to the constitutional changes spans from the extreme right to the extreme left and includes the populist Five Star Movement, and some centrists, such as the former Prime Minister Mario Monti.

Even more odd is the fact that a sizeable number of members of parliament who voted in favour of the reform six times over the past two and a half years are now campaigning for 'No'. The world of Italian politics is upside-down,

as in Alice's Adventures in Wonderland, and thus two weeks ahead of the referendum, opinion polls may well be misleading. And it is not even clear whether Italy will manage to move out of the banking rabbit's hole anytime soon.

### **What is it all about?**

On 4 December Italian voters will be asked whether they approve of amending the Italian Constitution to reform the appointment and powers of the Parliament as well as the partition of powers of State, Regions, and administrative entities. The reform aims to improve the functioning of law making and increase government stability. It is linked to an electoral law, although the electoral law is not part of the reform to the Constitution.

The constitutional bill, proposed by Prime Minister Matteo Renzi and his centre-left Democratic Party in 2014, was approved by an absolute majority of the MPs in both houses of the Italian Parliament. The government first introduced the bill in the Senate on 8 April 2014. The final vote took place in the Lower house on 12 April 2016. As parliamentary approval lacked a qualified majority of two-thirds in each House, it has to pass popular vote as well.

This will be the third constitutional referendum in the history of the Italian Republic (the other two were in 2001 and 2006) and, if approved, the reform would be by far the most extensive constitutional reform in Italy since its approval by the Constitutional Assembly in 1947, which put an end to the monarchy. Opposition parties have criticised the bill, claiming that the reform is badly written and that it will make the government too powerful. The referendum question is clear, but it is likely that Italians will not vote on the basis of the question being asked but rather on a sort of confidence vote on the government and the Prime Minister.

How has the situation changed over the past few weeks? Changes relate to (1) opinion polls, (2) political campaigning, (3) positioning by politicians for possible scenarios after the vote, (4) financial market jitters, (5) development in the complex situation of Italian banks, which is closely linked to politics. Let's take these issues one by one.

### **Why opinion polls should not be trusted?**

Italian laws allow opinion polls to be made public up until two weeks before the referendum, i.e. up to 18 November. Recent opinion polls suggest that the number of undecided has declined but remains rather high, and there is an increasingly wide lead between the 'No' and the 'Yes' camp by about 3 to 6 percentage points or even higher. The trend seems to be sufficiently clear and established. A [recent opinion poll](#) prepared by Cisa-Sole 24 Ore, which can be considered more reliable than similar polls, suggest 'No' at 34%, 'Yes' at 29% and undecided and abstentions at 37%, a still high percentage.

It is striking to see that there is a very high degree of consensus on some aspects of the reform. For instance, 57% of respondents agree that the Lower House only should approve most laws, and 83% are in favour of the provision by which the government can ask Parliament to decide within certain time limits. In other words, there is a much higher support for individual parts of the reform proposal than for the overall package. However, 60% of respondents say they know little of the reform and 61% that they are unsatisfied by government's actions, which seems to have a strong bearing on the overall opinion on the referendum. In fact, at the end of the day, it will be a confidence vote on the government and the Prime Minister.

It is conspicuous that young voters are overwhelmingly in favour of 'No' (and in big numbers vote for the Five Star Movement, the Northern League, SEL-SI, and other parties outside the mainstream). There is an almost 20 percent gap between 'Yes' and 'No' in the lower age groups. In addition, it appears that the majority in favour of 'No' is much larger in the South. Economic stagnation or lack of decent recovery and the high level of unemployment (11.7%), and especially youth unemployment (37.1%), are certainly at the root of the dissatisfaction with the government. Finally, most opinion polls underestimate the importance of votes by Italian citizens abroad and voters abroad tends to be in favour of 'Yes'.

In the referendum on nuclear energy in 2011 the turnout was 57%, and in the previous referendum on constitutional

changes in 2006 it was 54%. Young voters tend to say 'No' to the pollsters, but then they do not show up on the election date. This happened also in the past (elections for the European Parliament). If the turnout this time is close to that recorded in the past, there would be a chance for a 'Yes' victory. If instead the voters who claimed to vote 'No' all go to the polls on 4 December, there would be little chance for a 'Yes' victory, according to current opinion polls. The bottom line is that it will come down to whether voters turn out. The outcome may thus be more evenly balanced than people tend to acknowledge.

### **Campaigning can make the difference**

Campaigning can make the difference in the final two weeks before the vote. Renzi and most of the PD's members are now heavily campaigning. The Five Star Movement is doing the same, but its leader Grillo is mostly absent. Berlusconi's Forza Italia is also campaigning for 'No', but a number of its members are in favour of 'Yes'. Moreover, Berlusconi himself seems to be absent at least up to now.

Matteo Salvini of the Northern League appears to be very active. The political campaign is played also outside of the most important media, where *par conditio*, i.e. equal broadcasting time for both camps, does not apply. In social media there appears to be an outsized support for 'No', while in local media there seems to be a bias for 'Yes'. Being Prime Minister, Renzi also enjoys an oversized exposure to media, although not specifically on the issue of the referendum, which should play in his favour. But this is debatable.

In recent times, the Prime Minister was busy with his international agenda, fiscal matters, and the earthquake. Thus, he has effectively started to push hard on campaigning only very recently, while the opposition seems much lighter in supporting the 'No' camp. This may also play a role in the final outcome of the referendum. At face value, the 'No' camp would have more probability to win, but there is more than an outside chance to see a surprising 'Yes' victory.

### **Financial markets: heading for another turbulent period?**

Government bond yield spreads are again under pressure. The 10-year BTP-Bund spread has moved back to 181bp (18/11) and the spread BTP-Bonos was at 49bp. Stock indices for the Italian banking sector have diverged from those for the rest of the Euro Area. Part of this is due to the sharp steepening of yield curves following the surprising victory of Mr Trump in the US. Another part relates to increasing jitters related to the stability of Italy's political situation, as well as the stability of its banks.

International investors are trying to figure out what this referendum is really all about, but usually, their conclusions are simple or, sometimes, simplistic: first, that 'No' would be a vote against reform; second, that it would be yet another confirmation of the global populist tendencies (Brexit, Trump, etc.) in a country that can hardly afford any deviation from orthodox policies; or third, that 'No' would make existing banking problems very complicated and any capital increase very difficult.

Therefore, in the case of 'No', a period of financial market turmoil may well prevail, at least until a new government is fully in place. The situation of the banks would become very complex to solve anyway and the risks of a new financial crisis cannot be underestimated. However, it could also be argued that it would paradoxically reduce the long-term risk of instability. In fact, a 'No' vote would effectively mean the status quo, i.e. no change in the Constitution. It would also make more likely the possibility of a deep reform of the electoral law (the 'Italicum') which was designed with the new Constitution in mind. This would likely lead toward a more proportional system, and thus the risk of the Five Star Movement getting into power would become lower.

Even the risk of prolonged political instability would be a low probability event as the centre-right Forza Italia, which is steadily declining in opinion polls, would see the opportunity to gain a governmental role and the chance to contribute to redesigning the electoral law by joining a grand coalition. Despite the current official line, this would be too good an opportunity to be missed for them. In any case, it is likely that a government would be in place by year-end or early in January at the latest. So even in the case of a 'No' victory, financial market tensions may well turn out

to be short lived, unless worries about the stability of the banking sector become truly high.

### **What would future political scenarios look like?**

A 'Yes' vote would strengthen Renzi's position, possibly leading to a Congress of the PD ahead of schedule and result in further strengthening of Renzi's grip on his own party. The government would make some changes to the electoral law (possibly allowing for a majority premium to the coalition rather than the leading party or changes in the two-ballot system). Perhaps the problems of the banks would be resolved without government intervention. It would also be a way to pull the sprint for the next political elections in spring 2018, or earlier (although early elections would be very difficult to engineer). Next year would be a lost year anyway for reforms and fiscal consolidation. However, if Renzi were to win the next political elections, there would likely be major changes and reforms.

If 'No' wins, Renzi would likely resign. Recent statements suggest he would not accept being the Prime Minister of a weakened government. By taking a step back, he would effectively start the campaign for the next political elections. The possibility of staying as Prime Minister would also depend on the position that centrist groupings will adopt and the decisions within his own party.

In addition, the NCD-UDC position would become increasingly difficult. If they do not side with the centre-right after the referendum, they would be in danger of disappearing in the next general election. If this happens, however, a grand coalition with Forza Italia would become the only viable solution to get a government. Probably Grasso, Franceschini, or even Padoan could become Prime Minister. Yet, the position could also be offered to Enrico Letta.

The "Grand Coalition" would likely last until the end of the political term in spring 2018 as making a new electoral law would not be straightforward. Such a government would not make any significant reform and economic change. At first glance, this scenario could be a gift for the electoral chances of the Five Star Movement in the next elections, but Renzi would likely stay as leader of his own party and would start behaving like an opposition leader.

Political developments in the aftermath of the referendum are crucial for the stability of financial markets. Nevertheless, it is the combination of risks to political stability and to financial stability, which makes the situation particularly tricky.

### **How high is the systemic risk in the banking sector?**

Italy's banking sector has been under pressure for a long time: the Non-Performing Exposure (NPE) peaked at about 18% of total outstanding loans at the end of 2015, while Non-Performing Loans (NPLs) were at 12%. Even if the stock is now decreasing, the gap between the book and the market value is discouraging banks from taking losses and selling NPLs more quickly.

Monte dei Paschi di Siena (MPS), the oldest Italian bank, was forced to increase capital while also speeding up disposal of NPLs. If the restructuring plan fails, it would hurt the whole banking sector in Italy, and possibly even in Europe. Recently, Bank of Italy underlined that the MPS recovery plan remains exposed to risks that arise mainly from the high volatility of stock markets. MPS restructuring plans could become the catalyst for a full-fledged banking crisis if it fails, or accelerate the solution if it goes well. And this partly depends on a stable political backdrop.

As part of its restructuring plan, MPS has to complete a capital strengthening of up of 5 billion following its performance in EBA's stress tests earlier in 2016. The plan is contemplating several possibilities, including the recently announced voluntary debt-to-equity swap of MPS outstanding 4.3 billion bonds, of which about half in retail hands. Were MPS unable to complete a full capital increase, the only 'Plan B' would be government intervention combined with burden sharing, which would involve bondholders and equity investors.

The valuations offered to bondholders in the voluntary debt-to-equity swap are well above market valuations, with a substantial premium on current bond prices (up to 30%), but no details have been unveiled about the equity price at which the conversion will happen. This uncertainty could be a serious obstacle for some categories of institutional

investors and retail investors alike. For bondholders, both retail and institutional, failure of the swap operation would make the risk of bail-in much higher.

Despite the risk of substantial losses, individual bondholders might still not participate in the hope that other bondholders would do instead, leaving them with a safer bond in a recapitalised bank that still pays a high interest rate. It is a classic prisoner's dilemma. However, failure for MPS would mean widespread losses for a large number of retail investors and additional political fallout. MPS failure would sharply reduce the chances for capital increases by other Italian banks, i.e. UniCredit, Carige, and maybe Veneto Banca and Popolare di Vicenza that are expected to ask for more than 10 billion in fresh capital and sell large tranches of NPLs over the next few months.

Separately, MPS is trying hard to securitise 27 billion of NPLs at a value of 9.2 billion. The government guarantees, GACs, will likely facilitate the sale of the senior tranches to investors, along with the Atlante fund focus on the riskier mezzanine tranches. Were MPS not successful in completing the capital increase, the NPL plan would be equally unsuccessful. This would have an impact on the valuation of NPL portfolios of other Italian banks, such as UniCredit.

### **Is there another 'Plan B' brewing?**

Italian banks' current profitability and earnings prospects are weak, not only because of cyclical factors, such as low interest rates and reduced business volumes affecting banks across Europe, but also due to Italian banks' high cost bases, lack of economies of scale, and modest revenue diversification and a business model that has become obsolete and challenged by ongoing fintech developments. These weaknesses also stem from the fragmentation and overcapacity of the Italian banking sector. Lack of confidence linked to political risk could slow the cleansing process of NPLs from the balance sheets and undermine soon-to-be-announced capital increases.

The rapid growth of NPLs over the past few years largely reflects the weakness in the economy. The quality of lending began to worsen in 2009 and then increased each year through 2014 and especially after the sovereign debt crisis that started in 2011, in step with the contraction of Italy's economy.

With the outbreak of the Lehman crisis, Italian banks adopted a very restrictive credit policy, increasing holding of liquid assets with the lowest risk, investing more in government bonds, reducing exposure to clients with low ratings and overall lending. The perceived higher lending risk translated into higher spreads versus money market rates and prompted banks to ask for increased guarantees and collaterals. The reduction on the supply side and the higher perceived risk increased the cost of credit for borrowers, especially for small and medium enterprises.

A number of other factors have played a role in accounting for the high NPLs. A combination of over-indebted corporates following the sharp crisis-related drop in output, a highly complex legal system of corporate restructuring and insolvency, lengthy judicial processes, and a tax system that until recently discouraged NPL write-offs have all contributed to a rising stock of NPLs. While flows have become marginally negative, their stock remains among the highest as a percentage of total loans in the Euro Area, and the pace of write-offs has not increased significantly.

Many banks are expected to become more profitable as the economy recovers, but economic growth is unlikely to recover at the pace recorded in other countries with a large stock of NPLs such as Spain and Ireland. Moreover, a stronger economic recovery would help to restore private sector creditworthiness, particularly of small and midsize enterprises, which have been most affected by the recent economic downturn. However, some weaker institutions might continue to report increasing NPLs due to past years' poor underwriting standards.

Another challenge is weak profitability. Italian banks face cyclical headwinds, but they are also experiencing structural problems. Italian banks have already cut costs by almost 9% since 2008. However, an improvement in the sector's cost-to-income ratio has not materialised, which, at over 60% as of end-2015, still remains above the average of most other European banking sectors. Cyclical factors, such as low interest rates and reduced business volumes, have weighed on Italian banks' profitability as well, and, in particular, on the net interest income, which represents more than 50% of revenues.

However, there are large differences within the Italian financial sector. The larger banks have reported in the first half of the year significantly stronger net profits and returns on equity than the smaller or financially weaker domestic banks. Larger banks' outperformance stems from a more diversified revenue stream, a higher contribution from wealth management and insurance activities, a lower risk profile, and greater efficiency.

The impediments to consolidation in the Italian banking industry are threefold. First, market conditions remain difficult, with equity valuations well below banks' net asset value. Second, the large stock of NPLs and the uncertainties about their valuations provide further disincentives to merge. Third, increased capital requirements by the regulator, as in the case of the merger between Banca Popolare di Milano and Banco Popolare, on the basis of higher perceived systemic risk.

Although there has been little consolidation among Italian banks recently, the reform of the Popolari banks, which the government approved in 2015, has removed some of the impediments to a process of consolidation and was designed to facilitate the transformation of the Popolari banks.

The approved merger between Banca Popolare di Milano and Banco Popolare, which will create Italy's third-largest domestic bank, is a direct consequence of the reform. Further consolidation is likely to occur over the next two to three years and among midsize regional banks, a key process tackling some of the structural weaknesses of Italian banks. Specifically, consolidation would help correct overcapacity in the sector and generate larger entities, creating greater economies of scale all of which could help put the banks in a more efficient operating position.

### **How would the referendum affect bank stability?**

The healing of the banking sector is conditional on the big MPS operation going smoothly and positively, thereby providing a positive backdrop for all other smaller operations. A positive conclusion needs a stable political environment to provide investors sufficient confidence to invest.

In turn, failure in the MPS operation would trigger government intervention, and this may prove difficult if there is no government in place or the new government is weak and has a limited mandate. In Italy's already upside-down political world, the referendum, as with the Mad Hatter of Alice's Adventures in Wonderland, would sentence Italy's banking sector to death by "murdering the time" needed for its recovery.

*Please read our comments policy before commenting.*

*Note: This article gives the views of the author, and not the position of EUROPP – European Politics and Policy, nor of the London School of Economics. Featured image: Palazzo della Banca d'Italia (Milan). Credits: [Paolobon140](#).*

Shortened URL for this post: <http://bit.ly/2f2ko45>

---

### **About the author**

**Lorenzo Codogno** – LSE, European Institute

Lorenzo Codogno is Visiting Professor in Practice at the LSE's European Institute and founder and chief economist of his own consulting vehicle, LC Macro Advisors Ltd. Prior to joining LSE, Lorenzo Codogno was chief economist and director general at the Treasury Department of the Italian Ministry of Economy and Finance (May 2006-February 2015). Throughout this period, he was head of the Italian delegation at the Economic Policy Committee of the European Union, which he chaired from Jan 2010 to Dec 2011, thus attending Ecofin/Eurogroup meetings with Ministers. He joined the Ministry from Bank of America where he had worked over the previous 11 years. He was managing director, senior economist and co-head of European Economics based in London. Before that, we worked at the research department of Unicredit in Milan.



**Mara Monti** – *LSE, European Institute*

Mara Monti is Visiting Fellow at the LSE's European Institute and a journalist at Il Sole 24 Ore, Italy's leading financial/economic newspaper, based in Milan. She completed an MSc (Econ) in Politics of the World Economy at LSE and graduated in Economics cum laude at Bologna University. She spent her career in journalism, specialising in the financial sector. Over the past 16 years, she has been part of the financial team at Il Sole 24 Ore, writing extensively on financial issues, sovereign crisis and monetary policy issues. Prior to joining Il Sole 24 Ore, Mara worked as editor-in-chief for international news agency Dow Jones Telerate in Milan. She wrote several books investigating the bankruptcy crisis of the past ten years and probing into financial scandals.



-