Ifo Viewpoint

Munich, 27 July 2016

No. 176
Italian Banks Should Not Be Allowed to Sidestep Investor Bail-In*

Should Italian banks crippled by non-performing loans be bailed out at the taxpayers' expense? For a long time this kind of bank bail-out was common practice. Germany is no exception to this rule. One of the lessons of the financial crisis was that bank losses must no longer be passed onto taxpayers. That is why the European banking union rules strictly limit state funding for ailing banks. It is only allowed after private investors have sustained losses amounting to at least eight percent of the balance sheet total. Exceptions are possible in a crisis, for instance, that poses a threat to the banking system of the Eurozone as a whole. This is not, however, the case with the Italian banking system.

The precarious situation of Italian banks is the first major challenge facing the European banking union since the new bank resolution rules took effect as of 1 January 2016. However, as is so often the case in the Eurozone, there is very little willingness to comply with jointly agreed rules. The Italian government wishes to prevent the banks' private investors from being held liable.

National governments did actually have enough time to prepare for the new banking union rules. The fact that Italian banks have a lot of bad loans on their books became clear with the Asset Quality Review of 2014 at the very latest. This test obviously wasn't taken seriously by Italy, as it was supposed to ensure that credit institutions were prepared for the banking union. It has also been clear for years that banks could no longer be bailed out with taxpayers' money after 1 January 2016. All EU member states are obliged to ensure that their banks hold enough capital that can be bailed in and that this capital is held by investors who can absorb losses.

Now there are loud complaints that the bondholders of these bad banks also include retail investors. Several banks have sold bonds that are not covered by deposit protection funds. These retail investors are now being cited as a reason to blatantly disregard the banking union rules barely six months after they come into force. The fact that the bank's creditors also include shareholders and large investors seems to have been conveniently forgotten.

The rule that private investors accept liability first doesn't only exist to protect taxpayers. The liability of investors for eventual losses is one of the basic rules of a market economy. It is the counterpart to their right to a share in the profits. In principle, not just eight percent but a hundred percent of the creditors of banks should be held liable, as is the case with any other company. The fact that small investors should be protected by deposit guarantee funds does not change this principle. The deposit guarantee fund is a form of insurance that banks pay premiums for. State guarantees encourage banks to take excessive risks, as was clearly shown by the financial crisis. Moreover, such guarantees distort competition in the European internal market if banks' refinancing costs depend on the financial strength of the home state that will absorb their losses in a crisis. In addition, there is now a considerable amount of joint liability for government debt in the Eurozone via bail-out funds, the OMT programme and the ECB's current government bond purchases. That is just one reason why other member states cannot accept that Italy further increases its public debt by bailing out the banks.

ECB President Mario Draghi is calling for state aid for Italian banks to prevent them from having to sell non-performing loans for less than their value. That would be a convincing argument if the sale of such distressed loans were to threaten the stability of the financial sector in the Eurozone as a whole. But this simply is not the case. Any company that needs cash fast may be forced to sell assets at a low price. This does not justify state intervention. The bad loans don't have to be thrown onto the market either. Recapitalising the banks by converting bank creditors' claims into equity would go far enough. These interests could also be shares in a new bad bank that commercialises the non-performing loans.

Advocates of public bail-out funding also argue that the retail investors in question will vote "no" in the constitutional referendum in autumn if funding is not forthcoming. This argument, however, can be used to throw all rules on limiting subsidies and restricting state debt overboard. Elections are always just about to happen somewhere.

This is not just about Italy. The question of whether banks possess enough capital to absorb losses in the case of a crisis should also be raised in Germany. For the future of the Eurozone as a whole it is absolutely crucial that the rules on the liability of private creditors are respected. Allowing Italy to bend the rules just as they face their first major test would undermine their credibility. The banking rules would share the fate of the fiscal rules enshrined of the Maastricht Treaty. Such a scenario would make it impossible to supplement the banking union with a deposit protection fund once and for all. The European disease of systematically breaking rules that were jointly agreed upon must be contained.

* Published in German under the title “Fataler Regelbruch” (Fatal Regulation), *Handelsblatt*, 27 July 2016, p. 48.

Clemens Fuest
Professor for Economics and Public Finance
President of the Ifo Institute