ALLEGRO CON BRIO FADES FOR ITALY

Italian banks' cautious approach has distanced them from the risky instruments and products at the heart of the economic crisis, yet prudence is more important than ever if they are to support the country's ailing industries.

WRITER
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Material world: the Italian textiles industry is vulnerable as exports slump and loan facilities contract

As the financial and economic gloom deepens, Charles Kindleberger's *The World Depression 1929-1939* is probably among the books that officials at the Bank of Italy are picking from their shelves. Alessandro Roselli, the Italian central bank's representative in London from 2001 until 2007, was in the front row when Europe's financial capital was struck by the storm and reported back to Rome as the first waves broke over the city. But while Italy's own banks have so far been spared the distress that financial institutions are suffering in the UK, few would bet that the crisis will leave them untouched.

"Italy's banks avoided the first bullets but they need to be worried about the pain the real economy will feel. Some nasty stuff is coming out now," says John Andrew, chairman of Eidos Partners, a boutique investment bank in Milan. During recent months, Eidos Partners has experienced an increasing call on its debt restructuring services. "Foreign banks are getting out of corporate lending in Italy and Italian banks will have to close that gap," says Mr Andrew.

"We have to be honest and admit that it is difficult to forecast at the moment what the future will bring," says Alessandro Profumo, CEO of UniCredit. "It may be that merely surviving is itself a success," he adds.

Not that survival is in question for any of Italy's large banks, although it may be for many of the country's manufacturing firms. Gross domestic product contracted in both the second and third quarters of 2008 and there was a further substantial contraction in the final quarter. The signs suggest a further decline of 2% this year. The Bank of Italy recognises that business confidence has deteriorated to historically low levels and that export orders, a driver for the Italian economy, have slumped.

"The entire system has stopped breathing" says Michele Tronconi, chairman of Sistema Italia Moda, the textiles and clothing association. Textiles sales slumped by 6.5% last year and sales of clothing also fell. Hit by globalisation, the sector has shed 11% of its workforce over the past five years. Even so, it continues to be a huge and crucial contributor to Italian exports and to the economy overall.

ADDED VALUE

"Our added value amounts to almost €19bn, compared to just €8bn from the automobile sector," says Mr Tronconi. But despite its importance, due to the fact that it is made up mainly of small and medium firms, the textiles and clothing sector does not have the negotiating muscle that the automobile sector can flex with the banks. The number of firms making textiles and clothing in Italy has fallen by more than 11,000 during the past five years and more will disappear as the recession bites. "The birth-death cycle is healthy and normal, but now there is a risk that there will be many deaths and no births," says Mr Tronconi.

And business failures will hurt the banks, with loans going sour and liquidations yielding ever-lower values as more stocks, equipment, factories and land are put up for sale in an unreceptive market. "The textiles sector is among the worst in terms of loan quality and that banks should be more restrictive in their lending here is understandable," says Mr Profumo.

"While restructuring has helped firms, it is a sector under stress," says Antonio Vigni, general manager of Monte dei Paschi Siena (MPS). But Mr Vigni, who began his banking career in a branch of MPS in Prato, a textiles town just west of Florence, says that difficulties in the sector should not create difficulties for the bank. "Our loan book is well diversified. Lending to textiles firms takes only 2.5% of the total," he says.

Just as the banks are concerned about the security of their loans, in a situation of declining orderbooks, anxiety about loan facilities and an increasing sense of panic, so the firms that Mr Tronconi represents are worried about relations with their banks. "The small and medium firms that make up a large part of our sector suffer most in a credit squeeze," says Mr Tronconi, "because banks prefer to lend to large companies."

FURTHER AGGRAVATION

And other factors are aggravating the problem for businesses in Italy's textiles and clothing sector. The consolidation that has occurred in Italian banking during the past decade is one of them. Firms that once had accounts with several banks may now find that they have an account with just one bank, and their loan ceilings will be far less than the sum of the facilities that they enjoyed with the various banks where they had accounts previously.

Yet textiles and clothing firms are not the only clients that banks are watching carefully as the economy slumps. The Bank of Italy identified that there has been no halt in the weakness of the construction industry. "We are seeing a deterioration in loan quality to construction firms," says Mr Profumo. And Italian banks are clearly faced with having to deal with clients with worsening prospects across the whole spectrum of business activity, from the extractive industries, to iron, steel and engineering, to food and retailing.

Just how bad matters will get is open to question. "We do not currently think we are going to see the equity being materially

eroded by loan losses in Italian banks in 2009; yet, we believe that it is time to look beyond traditional worst-case scenarios for banks' earnings," says Matteo Ramenghi, banking analyst at UBS. He calculates that UBI Banca, Intesa Sanpaolo and UniCredit could absorb more than 2% of additional cost of credit before core Tier 1 falls to 5%. "MPS would be most exposed to dilution in a stress scenario for asset quality, given its tight capital base."

Mr Vigni recognises that supporting small and medium firms is a challenge but he is optimistic that it can be met. "We can give a message of confidence in the future," he says. Moreover, he is sure that MPS's care in spreading loan risk ensures that the bank is in the best possible condition to deal with the worsening situation. Loans to the iron and steel sector are 3.3% of the total, to engineering 4.6% and to construction 9%, for example, while geographical diversification is also balanced. "There is a crisis but we are equipped to manage it," says Mr Vigni.

CONFIDENT STANCE

Corrado Passera, managing director of Intesa Sanpaolo, also expresses confidence about the ability of Italy's banks to get through the recession without too much trouble. And he is confident that the downturn will not cause too much suffering for the corporate sector. "We will see champions getting stronger. Regarding the weaker firms, we aim to help them through their difficulties," he says. Certainly non-performing loans will increase, as they always do when economies falter.

"We are beefing up the management of troubled loans as sharper management reduces their cost and improves the bottom line," says Mr Passera. And while Intesa Sanpaolo has experienced a slowing of »

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lending to the corporate sector, such a slowing is usual in an economic downturn. "There was still a growth in lending in the final quarter of 2008 and in January," he says.

Complaints that Italy's firms are being squeezed in a credit crunch are out of place, or premature, are confirmed by Victor Massiah, managing director of UBI Banca. "Our policy is that credit should not be restricted unless firms are clearly unable to repay loans," he says, adding that the bank has "the best credit portfolio in Italy". UBI Banca has found that, although interest rates have fallen, demand for medium- and long-term loans has declined. "That's one effect of the recession. Firms are thinking very carefully before investing in new plant," says Mr Massiah.

Notwithstanding the guarded optimism that Italy's top bankers express about the corporate sector, this seems likely to give them problems during the coming year. The dramatic collapse of car sales at Fiat, the sharp falls in orders, production and sales in many related industries, and a huge crisis in the white goods sector are a taste of what is happening. So too is the bumpy, loss-making take-off of the business that took over the busted Alitalia airline, in which Intesa Sanpaolo has taken an important stake.

BRICKS AND MORTAR

But households should prove less of a worry. As in other countries, property mortgages and consumer credit are the areas of banking where attention is focused in Italy. "We've never made loans that are backed by 'houses of cards'. Our policy has been to lend up to 60% of a property's value and the collateral that we hold is very reassuring, three-and-a-half times the residual value of outstanding mortgage debt," says MPS's Mr Vigni.

Mr Massiah at UBI Banca says that Italy has not suffered a housing price bubble whose deflation is badly hurting mortgage-holders as is the case in the UK and Spain. Of course, a recession brings increased unemployment and temporary lay-offs onto Italy's state income support scheme, which provides 80% of normal wages, putting a strain on family budgets. With this in mind, Intesa Sanpaolo is open to renegotiating loan repayments by weaker customers. But according to Mr Passera: "We don't expect major problems and the house market will pick up. With interest rates at their present levels, buying property is once again competitive with renting."

Quite reasonably, difficulties over mortgage repayments are not perceived as a threat. Neither is consumer credit considered a significant risk. Mr Profumo says that consumer credit repayments are stable at UniCredit. Mr Passera of Intesa Sanpaolo says: "Consumer credit has never been a very large component of our portfolio." Italians have traditionally been big savers and cautious about their personal finances. What used to be considered a Protestant virtue of thrift, once practiced in the UK, still hangs on widely as a rule in Catholic Italy. "Consumer credit here is in no way comparable to what it is in Anglo-Saxon economies," says Mr Massiah. And in common with the other large banks, consumer credit is not a problem at MPS.

CAUTIOUS APPROACH

And if the leading Italian banks and Italians themselves have been prudent in matters such as property mortgages and consumer credit, the banks have also been cautious about not venturing into areas of finance where banks of other countries have since found themselves making huge provisions. Prudent oversight by the Bank of Italy has probably helped in this regard.

"We're essentially a retail bank, taking deposits and making loans. We are not bloated with assets and have very little finance," says Mr Vigni. Mr Massiah describes UBI Banca's position as being in the real economy: "More than 98% of our revenues come from core banking. It is all rather basic and boring but it is not because we're unsophisticated as some foreign journalists like to describe us. We simply didn't trust the instruments and products that were being offered."

"Arguably, Italy enters this crisis in a better condition than other countries. Savings are higher, corporate and household debt is lower, the real estate bubble was smaller and the banks are stronger," says Mr Passera. As for suggestions that Italian banks might need to strengthen their capital bases, he says that Intesa Sanpaolo is comfortable with its capital ratios, "consistent with the business we're in and our risk profile".

At UBI Banca, Mr Massiah says that it has the highest core Tier 1 ratio among large Italian banks and that it has no need for fresh capital. UniCredit's capital raising operation in February leaves Mr Profumo's bank in good shape though; like MPS, it will evaluate the possibility of further strengthening using government instruments.

The biggest test for Italian banks will probably come in what happens to the country's real economy. "This year will definitely not be easy. It will be hard and complicated. But it will be manageable," says Mr Vigni. A sentiment with which other leading Italian bankers would seem to agree. TB