Discussion of
“The Origins of Italian NPLs”

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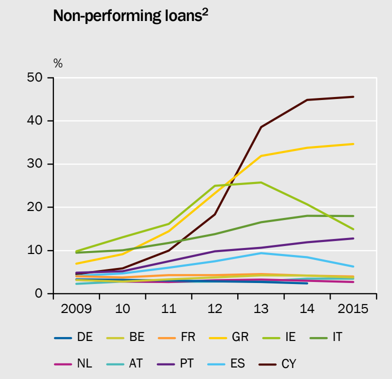
Overview

Comments

Conclusion

Overview of the paper

- Legacy from the financial and eurozone crisis: High levels of non-performing loans in former crisis countries, including Italy
- Important questions:
  - What caused the rise in NPLs?
  - Could this rise have been prevented by a more prudent lending behavior by banks?



Potential reasons for the rise in NPLs

(1) Macroeconomic conditions ("exogenous")
(2) High risk-taking
(3) Other bank-specific factors (e. g., poor lending practices, outright fraud)

- While (2) and (3) can be blamed on the banks themselves, (1) is "unavoidable"

Main results

1. **Macroeconomic analysis**: Macroeconomic conditions (*"exogenous"*) explain the overwhelming part (90%) of NPL flows
2. **Microeconomic analysis**: At least 50% of defaults are due to *"bad luck"* (= failure of ex-ante sound loans)
3. **Microeconomic analysis**: High risk-taking explains very little variation in default rates across banks, *"banking residual"* has highest explanatory power

- Conclusion: A large share of the rise in NPLs was *"unavoidable"*, i. e., outside of the control of banks themselves

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Interesting and important paper

- First-order topic, not only for Italy
- Fantastic micro-level dataset
- Interesting results with potentially huge policy implications

Macroeconomic vs. microeconomic analysis

- **Macroeconomic analysis** captures differences *across countries*: Why have some countries experienced a much sharper increase in NPLs than others?
- **Microeconomic analysis** captures differences across banks *within Italy*, i. e., differences from the Italian mean

- Since NPLs are a widespread problem in the Italian banking sector and Italy appears to be different from other countries, the mean is at least as interesting as deviations from it

Are macroeconomic conditions **exogenous**?

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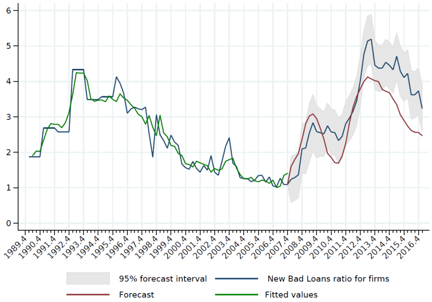
- *Clearly not!*
- The depth of the financial and eurozone crisis was related to the *amplification of crises* through the financial sector
- Nevertheless, the paper treats macroeconomic developments like natural disasters

- NPLs themselves are likely to have exacerbated the recession, especially in Italy
- Without high levels of NPLs, *sound loans may not have failed* to the same extent

Are macroeconomic conditions **exogenous**?

- *"This suggests that the surge in Italian bad debt in the 2008-2016 period is largely (though not entirely) explained by the dynamics of macroeconomic fundamentals..."*



- Naturally, risks (excessive or not) materialize in a recession
- Alternative explanation of the figure: Model fails to predict the persistently high level of NPLs once a crisis hits
- This persistence could be a consequence of the **endogeneity of macroeconomic conditions** (and hence NPLs)

Is the exposure to macroeconomic risk **unavoidable**?

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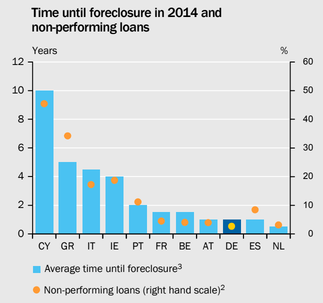
- *No!*
- Banks *choose* their exposure to macroeconomic risk (example: interest rate exposure)
- Macroeconomic (undiversifiable) risks are attractive from a bank's perspective because taking such risks yields a *high return*
- Taking macroeconomic risks may be an instance of **excessive risk-taking**: It makes banks *too correlated to fail*
- Exposure of financial institutions to macroeconomic risk is **not unavoidable**
- Results rather point towards the *failure of risk management systems (and supervisors) to deal with tail risks*

Why is Italy different?

- Striking empirical finding is the difference between Italy and other countries experiencing similar macroeconomic shocks
- What explains these differences?
- Conjecture: High **stocks** of NPLs give rise to *stronger persistence of downturns* because they lead to zombie banking, reduced lending etc.
- Then it is of utmost importance to reduce the **stock** of NPLs



Low explanatory power of "risk attitude"

- **Z score** may not capture risk in a satisfactory way because it only measures risks that are observable from *balance sheet data* (while banks have an advantage in dealing with risks that are not so easily observable → **soft information**)
- Methodology first purges data from "exogenous" factors, therefore the effect of risk is *underestimated* if it is correlated with these factors
- High-risk lending may be an adequate business strategy if backed by sufficient capital: normalize NPLs by *capital* instead of loans?

High explanatory power of “bank residual”

- **Residual** comprises everything that we have not included explicitly, hence it captures our *ignorance* (including unmeasured risk-taking)
- Fraud, ROE, capital ratio, “sophistication” appear to matter but a large part of the cross-sectional variation remains unexplained
- Does this imply that most of the residual is *random*?
- Not necessarily! Need for further research

Policy implications

- Paper refrains from formulating **policy implications**
- But the wording could suggest that...
  - Banks cannot be blamed for the high level of NPLs (and hence they should not be "punished" for it?)
  - Excessive risk-taking was not an issue (so neither banks' risk management nor banking supervision failed?)
  - The government should step in to help banks to deal with the NPL issue?
- Such an interpretation would set an incentive for banks to expose themselves even more to macroeconomic risks in the future and would *raise the risks for financial stability*

Further comments

- How reliable is NPL data before the Asset Quality Review/for non-SSM banks? Recognition of NPLs?
- Data selection (restriction to firms with balance sheet data) throws out an important part of the data: Left-out firms have higher NPLs, in absolute and relative terms
- Provide exact calculation of Z score

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- Interpretation of the paper could be inverted:
  - Evidence is consistent with the view that *banks exposed themselves strongly to macroeconomic risk*, which materialized in the crisis
  - In combination with the *high stocks of NPLs* in Italy, this may explain why the recession in Italy was so persistent
- Policy implications:
  - Banking supervision should focus not only on idiosyncratic risk-taking but on *macroeconomic risk-taking*
  - Capital regulation should also be adjusted to properly take into account macroeconomic risk-taking
  - The reduction in the *stock of NPLs* should have a high priority on the agenda of policymakers to break the vicious circle between weak banks and a weak economy
- Broader question: Who should bear macroeconomic risks?

Thank you very much for your attention!