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The banking and financial system: recurring crises and structural changes

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Introduction

The banking and financial system is going through a phase of intense transformation, in a macroeconomic situation that is increasingly highlighting its role of primary importance in the local and global economy.

The World Economic Forum, in its report on global risks published last February, defined the current scenario as a 'polycrisis', identifying some of the main challenges facing the world economy and society: inflation, the post-pandemic environment, the energy crisis, geopolitical conflicts, cyber risks, and the acceleration of climate change. We are facing a complex combination of critical issues and an environment where global risk exceeds the mere sum of individual weaknesses.

This complexity increases the uncertainty of the environment in which we operate, potentially jeopardizing the progress achieved in certain areas. This is not the first time that the financial system has faced periods of instability but, over time, large-scale events have shaken the economic environment and triggered a series of responses. These are complex times, from which, however, we can emerge even stronger.

The most notable example is the crisis of 2007, when a series of interconnected risks led to the consequences we know all too well. The period that followed was marked by great progress on many fronts, as a result of the lessons learned during that time. The regulatory framework has been significantly strengthened by updating the rules; the range of tools has increased and supervisory practices have been intensified. The development of the banking union has helped to guide the evolution of the financial system towards greater resilience in the face of external shocks.

As in the past, therefore, it is important that we learn from our first-hand experiences to strengthen and improve what we have.

The recent banking crises in the United States and Switzerland have once again drawn attention to the robustness and consistency of the supervisory framework and practices, and are currently being analysed by the authorities involved as well.

Recent crisis events

In the case of the United States, we have witnessed sudden crises due to banks' individual shocks and to shortcomings in regulation and supervision. Specifically, these events were marked by an unprecedented outflow of liquidity over a very limited period of time, partly owing to the use of digital channels and the role played by social media.

With regard to the regulatory framework, the current discussions are focusing on finding corrective measures for the most problematic risk profiles in light of recent events, without disrupting its overall structure. I am referring in particular to the interest rate risk management, taking into account the new monetary policy stance aimed at countering the increase in the inflation rate; the calibration of liquidity indicators, in terms of scenarios, time horizons, the assessment of instruments included among the liquid assets; and the actual loss-absorbing capacity of additional tier 1 (AT1) capital instruments.

The recent crises also confirm, once again, the central role played by internal control systems and risk governance. At the same time, they demonstrate that the supervisory authorities must be able – in terms of expertise, resources and intrusiveness – to identify risks in a timely manner, properly catching their signals and responding with tangible supervisory measures.

They also confirm the need to reassess the issue of proportionality in regulation, which has so far largely been based on the criterion of intermediaries' size. Interconnectedness has instead become an increasingly important criterion, as it also increases the risk of contagion in the event of crises involving small intermediaries with significant business and/or market relations. The criterion of analogy has also come to the fore, whereby crisis situations can spread on the basis of real or merely perceived similarities between business models.

Of course, the focus of prudential supervision on assessing, above all, the actual idiosyncratic risk profile of intermediaries and the system in which they operate remains unchanged. The speed at which crises spread, even if they affect one or more smaller intermediaries, and the system's high degree of interconnectedness force us to keep our guard up on all components of the financial environment.

We must therefore preserve a certain continuity in the supervision of both large banks and smaller intermediaries, including in terms of the application of international regulations, while taking into account the importance of stability in local markets too.

The situation of the Italian financial system

The Italian financial system is in a more favourable situation than when it had to face past crises, showing improvements in income, credit, assets and liquidity. It stands out for its heterogeneity, with large, medium-sized and small intermediaries and various business models reacting differently to the changing environment.

In the banking sector directly supervised by the Bank of Italy there are still some weak areas which we will continue to address as we have done in recent years. We have progressively stepped up action with respect to the less significant institutions, as also recognized by the International Monetary Fund in recent discussions. Our approach has been based on different lines of action, aimed at strengthening banks' business models, the long-term sustainability of sources of income, governance safeguards, including against novel risks (in particular digital and climate transition risks), and the levels of capitalization. In this regard, in recent years we have worked on our convergence with the supervisory methodologies adopted by the Single Supervisory Mechanism (SSM), which has allowed, among other things, the requirements for smaller banks to be increased, thereby narrowing the gap with the significant banks; in particular, we have assigned greater importance to interest rate risk, which explains a significant proportion of the requirements addressing Pillar 2 risks.

We often stress that the degree of interconnectedness – between banks and non-bank intermediaries, and between financial operators and non-financial entities – is an important factor for the financial system. This growing integration reflects the evolution of operations in different business areas: asset management, including non-performing loans (NPLs); the rationalization of costs, including through outsourcing, not only on the IT risk side; and the strengthening of the sustainability of business models, which has long been a key part of our action, including for smaller intermediaries.

With this in mind, today I would like to focus on two main topics: the progressive digitalization of the system and the impact of the interconnectedness between banks and the non-bank sector on risk profiles, especially the credit risk profile.

The path to digitalization

The digitalization process of the financial system has now reached a level of maturity that has irreversibly changed the business model of supervised banks and financial intermediaries, since traditional and digital finance are now inseparably intertwined and the increasingly dense network of interconnections between banks and non-banks is a stable feature of the system, including for smaller intermediaries.

Specifically, I would like to address three aspects: the implications of Fintech, crypto-asset operations and outsourcing.

Digitalization is not a recent phenomenon, but in the last decade there has been an increase in the frequency and speed with which new subjects (e.g. Fintech, Bigtech) enter typical segments of the banking business or create new realities that do not fall into the traditional paradigms. In addition, most of the initiatives proposed by banks are carried out by acquiring shareholdings of or partnering with Fintech companies, often also with the involvement of consulting companies. In many cases, technology leverage is used to provide traditional services, but in an innovative way, thus introducing new risks into already mature segments.

The Bank of Italy obviously welcomes this process, bearing in mind that it can in principle increase the sustainability of business models and be a success factor, for smaller banks as well. The Bank tries to play a leading role in the assessment of risks and opportunities, including through its own innovation facilitators, as was also underlined at the recent Milano Hub event held on 17 May.

The daily challenge of supervision is therefore to maintain a balance between the need to facilitate system innovation and to ensure adequate risk control. We therefore monitor the system through various initiatives, for example periodic surveys, questionnaires on IT risks, surveys on innovative segments, but above all through direct contact with the market and supervised entities, with already known operators and any other entity seeking to start up in the Italian system.

At the current level of maturity of the system, in addition to recognizing the opportunities, we cannot shy away from considering the evidence that comes from operational supervision, especially for some of the projects that were submitted but turned out to be hardly sustainable, while realizing that these are natural steps in a phase of transition to new modes of operation and more stable progress.

Many operators, including some smaller banks, are aware of the importance of adopting a digital transformation strategy, even if the expenditure on technological innovation, while growing, is concentrated among a limited number of operators. Recent analyses show that these strategies are essentially aimed at increasing business volumes; however, the monitoring and management mechanisms in place are not always adequate to achieve the objectives set, partly due to the lack of specialized expertise, in particular for smaller intermediaries.

For example, cases of potential criticality arising from the overestimation of the benefits of Fintech projects and the underestimation of their risks (e.g. due to the lack of specific metrics in the definition of risk appetite, an inadequate risk culture and weaknesses in control systems, partly owing to the abovementioned limitations in the number and expertise of the available resources) are highlighted.

The increased exposure to strategic risk (sometimes due to plans that are unrealistic and inconsistent with existing constraints and thus to difficulties in achieving the planned objectives) should also be assessed, together with the operational risks relating to fraud and lack of transparency and the reputational risks linked to a potentially reduced knowledge of customers and direct contact with them, which have been replaced by a social media/ digital reputation, something which spreads faster but is more unstable.

In some cases, there is a growing use of advanced risk assessment techniques, including through the use of artificial intelligence. As we highlighted when publishing the results of our in-depth studies, this development should be regarded as positive insofar as adequate risk monitoring and rigorous and reliable data governance are ensured, with the aim of limiting unexpected consequences.

With regard to projects relating to transactions in crypto-assets and the development of decentralized finance, the most widespread activities are trading in crypto derivatives, the reception and transmission of orders, and custody, although the volumes are still small. The Bank of Italy took action before the European regulation (Micar) was completed and issued a communication to the public in June 2022, outlining its expectations for the financial system and for the operators concerned, and pointing out the need to ensure adequate safeguards, also in light of the current rules. Although the regulatory framework is still being defined, we are aware that we must intervene as a supervisory authority, where necessary, relying on the principles and rules that our legal system already has.

The content of the aforementioned 2022 communication is at the heart of our dialogue with intermediaries, when we evaluate new innovative projects or operations already under way. This discussion has often led to the revision of projects, the reshaping of initiatives or, in some cases, even to their withdrawal. For example, we asked intermediaries to adequately frame such initiatives in their strategic plans and to provide detailed evidence on the crypto-asset transactions carried out for customers or in the pipeline, on any anomalies detected and on the related contribution to the income statement. Important work has been carried out on the content of disclosures to the public, especially with regard to the lack of protection.

We welcome all initiatives backed by accurate internal analysis – also carried out by internal control functions – and with adequate safeguards for the mitigation of risks, including legal and reputational ones (for example by limiting operations for customers with constraints on wallet-to-wallet transfers), in compliance, of course, with existing legislation (e.g. on e-money and the pursuit of sound and prudent management). Particular attention should be paid to the custody of digital assets, which is one of the potentially risky links between traditional and digital finance.

The Bank of Italy took specific measures on outsourcing before the approval of the DORA Regulation: in addition to mapping service providers, which revealed about 3,000 outsourcers, of which 1,800 offer critical or important functions, and after examining hundreds of outsourcing contracts relating to non-bank intermediaries, we recently issued the final provisions for reporting on outsourcing, which will allow up-to-date information to be obtained on this subject.

In addition, inspections on service providers are continuing and this year we have extended them to entities to which intermediaries outsource internal control functions; the aim is to strengthen the supervision of intermediaries, including by engaging directly with the most important suppliers. The results of these first experiences – despite relating to suppliers active in specific financial intermediation sectors – show the need for more monitoring of the quality assessments of the service offered and of the adequacy regarding the specificity of their business models.

Interconnectedness and risk transformation

The Bank of Italy has always focused on the interconnection between banks and non-bank intermediaries, given the operational links that are instrumental to the development and diversification of revenues. With this in mind, a supervisory model for non-bank intermediation has been built over the years, inspired by the principles of equivalence and uniformity of supervisory practices in the banking sector.

This approach, which has also been promoted internationally, has allowed the Bank of Italy to gain a broader and more integrated view of the phenomena of risk transfer and propagation and to swiftly refocus its supervisory strategies through targeted interventions in the most vulnerable sectors. Our lines of action are consistently shaped over time by the need to monitor risk in its various forms.

The Italian banking system has been engaged for years in asset restructuring, by reducing the non-performing loans (NPLs) accumulated over the past years. The share of non-performing loans in our system has fallen sharply and is currently in line with European averages. Looking ahead, we could face a slowdown in the economic cycle and less favourable financing conditions, with a consequent impact on risk levels and the cost of credit, which is currently low.

At the same time, the numerous de-risking initiatives of Italian banks have increased the areas of interconnection in recent years. The disposals of non-performing loans (more than €210 billion since 2016), partly driven by the opportunities offered by the State Guarantee (GACS) on securitizations of bad loans, have led to forms of transfer and/or sharing of credit risk on the assets transferred, which in recent years have increased the number of entities in this sector. Disposals aimed at carrying out securitization transactions are the predominant component. For NPL securitizations, the use of GACS covered almost all transactions.

The developments in this sector have made supervision more complex, which assesses and monitors the links between the two components of the financial system in order to identify and limit any forms of risk spill-over. In this regard, supervisory actions have been carried out on non-bank intermediaries operating in the secondary market for non-performing loans, with the aim of monitoring the potentially systemic implications arising from the risks underlying the assets and, at the same time, of promoting progress on the internal safeguards of supervised intermediaries.

In November 2021, we published a communication for the system to reiterate the central role of master servicers, as supervised entities, in securitization operations, and to draw the industry's attention to the liability and risk profiles arising from the management of securitization processes. With this communication, we launched a more precise monitoring of recoveries through the acquisition of half-yearly templates referring to operations with and without a public guarantee, and we carried out targeted supervisory investigations.

In general, we note the importance of structural and cyclical profiles in performance trends that depend, respectively, on the quality of the original business plans and on the exceptional nature of the situation caused by the pandemic crisis, which mainly affected the recoveries of 2020 and 2021. Our supervisory action focused in particular on identifying the critical profiles that emerged, also on the basis of data on the monitoring of recoveries, for example governance and control arrangements, asset valuation methodologies and recovery projections, the monitoring of recovery performance, and the disclosure of the performance of transactions for the benefit of all stakeholders (e.g. investors, government and so on).

In 2022, we carried out specific supervisory actions and organized frequent discussions with financial intermediaries. The findings highlight the need to strengthen organizational structures, governance, operational processes and the efficiency of control and risk management functions. The deficiencies identified concern, among other things, the checks on the preparation of recovery plans, their continuous updating (with possible effects on the forward-looking performance indicators of operations), and the monitoring of the recovery strategies put in place by the entities who may have been delegated to carry out this type of activity.

Finally, the use of asset divestments increased operations with Alternative Investment Funds (AIFs) and other specialized non-bank operators, confirming the gradual shift of some risks across different segments of the financial ecosystem. In general, banks may retain certain exposures, such as shares or loans, to support their operations, often achieving more advantageous conditions than they would with simple cash transfers.

At the end of 2021, the Bank of Italy launched a survey on credit funds in order to increase the information on their asset contribution and direct lending operations, and on the characteristics of asset managers. We noted that the adoption of the main business models (turnaround and collection) depends on the confidence in the ability of asset managers to achieve greater recoveries than direct management by banks or direct sale can.

The results of the in-depth analysis highlighted some issues relating, for example, to the ability of managers to select targeted companies with truly remediable difficulties and to put advanced investment processes in place to actively influence restructuring, as they do with equity investments. In the case of collection funds, they should reach an adequate size for the performance of core processes, adapting the internal controls when they rely on outsourcers. In both business models, the ability to prudently verify the value of the underlying assets and the consequent valuation of the shares is particularly important. Finally, reflections are under way on whether to reduce the scope of discretion in assessments, thus avoiding regulatory arbitrage.

Finally, I would like to point out that recent regulatory innovations have led to the assignment of new tasks to supervisory authorities, such as those relating to crowdfunding and to the issue of covered bonds, making our portfolio of responsibilities more complex but also complete, and confirming the need to maintain as integrated an overview as possible of the overall risk profile of supervised intermediaries and of the financial system.

Conclusions

Over the years, the system has undergone profound changes that have partly increased its ability to withstand adverse events, but have also significantly increased the overall risk profile and the interconnectedness between the various sectors of the financial ecosystem. The recent crises confirm the existence of a structural situation of uncertainty and the need to prudently and consciously explore the lessons we can learn to further improve the resilience of the system, regulation and supervisory activity.

The ongoing reflections show that the crises that have occurred are the result of a combination of idiosyncratic and institutional factors. Authorities and economic operators alike must continue to investigate the causes and implications of these events. These failures show that we live in a context of recurrent crises which, however, should not call into question all the progress made over the years. There is no need to reinvent the wheel, but we should rather assess the real need to change regulatory and supervisory practices, carefully weighing up the action to be taken in order to prevent hasty moves that increase rather than reduce overall risks.

It is clear that even relatively small banks can cause significant stress in the financial markets. The application of the principle of proportionality must therefore necessarily take account of what has happened, bearing in mind the limits imposed by idiosyncratic risks and system interconnections.

We also need to reiterate the importance of applying the rules in a uniform manner, given that gaps and inconsistencies in the implementation of internationally agreed rules, especially those of Basel, can lead to crisis situations with global consequences. It is therefore crucial to address these challenges with an overall vision, ensuring a consistent and comprehensive application of the rules to limit potential turbulence.

It is also clear that supervision plays a crucial role: a well-designed rule system may not be enough if its practical application is weak. At the same time, the experience that supervision brings to the table is crucial to drawing up appropriate supervisory rules and policies properly, in order to feed a virtuous supervisory circle that strengthens the resilience of the system and reduces risks to overall stability as much as possible.

The innovations to which the system reacts and adapts are reflected in new business model configurations, whose sustainability is at the heart of supervisory assessments, and confirm that the market is growing towards its full maturity. The governance of technology is key, due to the effects it may have on different fronts, from the provision of services to the effective management of the data available to intermediaries.

Risks must be monitored, even if they take on new forms. Understanding and, if possible, anticipating these trends, gearing up to address them, and intervening when necessary, is both a challenge and a responsibility for supervisory authorities, even if principles and rules adapt more slowly to ongoing developments. It is not enough to analyse phenomena thoroughly; we must also be willing to act and take the necessary measures to preserve the risk safeguards.

Crises cannot be avoided, but we must work on managing them better, maintaining a preventive and forward-looking approach to risks, promoting strong collaboration between the different areas involved, both within and between national and international authorities, and increasingly adopting a logic based on functions rather than actors. Technical analysis must remain robust, comprehensive and internally consistent, in order to consider all the relevant aspects, identify risks correctly and assess the actions to be taken.

Addressing these challenges in a complex system and a challenging geopolitical context requires a serious commitment to containing and mitigating risks, creating a virtuous circle between the authorities and the financial system, which is called upon to build up on these experiences.

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