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Banks and finance after the crisis: Lessons and challenges

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Abstract:

The double-dip recession that hit the Italian economy between 2008 and 2013 has caused severe difficulties for the banking sector in the last few years, which have been aggravated by cases of malfeasance. This speech discusses the response of the Bank of Italy's supervision and the measures adopted to solve the crises that have concerned some banks. It then examines the questions still open regarding the new European financial regulation framework, especially those concerning State aid and bank resolution, as well as its flaws, including the lack of crisis management rules designed to avoid a disorderly exit of banks from the market. Finally, it looks at the main challenges facing Italy's banking sector, i.e. recovering profitability and adjusting to changes in the production system and in technology.

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Banks in Italy, as in other countries, have been seriously weakened by the long and grave economic crisis, which has proved deeper here than elsewhere. The difficulties experienced by some of them have been exacerbated by imprudent or irregular management, which has triggered irreversible crises. The banking sector's problems, and the response of the Government and the supervisory authority, have drawn the attention of analysts, politicians and the media, as well as that of savers. At the centre of the debate lie not only the events surrounding individual banks, but also the increase in non-performing loans (NPLs) and the application of the European regulation on State aid and the new rules on the recovery and resolution of distressed banks.

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Often, the debate has lacked clarity. Inaccuracies and uncertainties have marked discussions on the nature and effective weight of NPLs in banks' balance sheets and on the link between an increase in NPLs and economic performance; the problem of coordinating national and supranational authorities – and the occasional conflicts between them – has been underestimated, at times making it impossible to respond promptly to situations. Italian banks have even been accused of threatening global financial stability.

I have addressed these issues on many occasions, most recently in December of last year before the Parliamentary inquiry into the banking and financial system.[1] I come back to the question now in order to illustrate some of the aspects and analytical elements that I believe may help in assessing recent developments in Italy's banking sector, its present situation and its prospects. I will therefore look at four main topics: how the economic crisis arose and the origins of the problems facing banks; the action taken by the supervisory authority and the measures adopted to solve individual crises; the problems of the European regulatory framework; and the challenges now facing banks and the financial system as a whole.

I will begin – without wishing either to offer justification or to contradict the theories of others – by repeating that the impoverishment of Italy's banks and the state of crisis that some of them are now in are to a very large extent due to the double-dip recession into which our economy was plunged for a long time, starting from the 2007-08 global financial crisis. I will not discuss here the reasons why the recession was so deep and so long – it was certainly aggravated by the Italian productive sector's discouragingly and persistently weak response to the huge global changes of the last twenty-five years – nor will I retrace the steps taken at national and European level to overcome the crisis, first and foremost with the aid of monetary policy. I will, however, make three points.[2]

To begin, after the economic crisis, numerous businesses and households found themselves unable to repay their bank loans. As a result, the share of bad debts and other NPLs in total bank lending tripled between 2007 and 2015. Credit recovery times, which for various reasons are longer in Italy than in other countries, played a major role.

The difficulties of Italy's banking system are not due to delays or negligence on the part of the supervisory authority but to the worst economic crisis our country has ever known. The supervisory authority has intervened continuously with urgent measures, identifying the worst problems, and helping to resolve many critical financial situations. As I have often remarked, because of the profoundly debilitated production system, serious incidences of mismanagement have aggravated the already perilous situation of individual banks.

Troublesome situations and full-blown crises have been managed within a regulatory framework that has undergone dramatic changes in terms of legislation, supervisory action, rules on State aid, and bank resolution. At the same time, macroeconomic conditions and technological developments have made it difficult to sell crisis-ridden banks on the market. Following massive injections of public money in many countries – though not in Italy – to prop up banking systems rocked by the global financial crisis, the recasting of Europe's legislative and regulatory framework has greatly curtailed the scope for public support measures. Under the new system, the response to the grave difficulties in which many banks found themselves after the sovereign debt crisis erupted in 2010 was neither swift nor effective enough.

Nevertheless, as a whole, Italy's banks weathered a particularly adverse economic phase far better than many analysts and commentators had predicted. This prompted the consideration in

[1] See Visco (2017a). See also the recent address by Panetta (2018).
[2] See Bugamelli et al. (2018), and the remarks made in Visco (2015, chapter 4), and in Giunta and Rossi (2017).

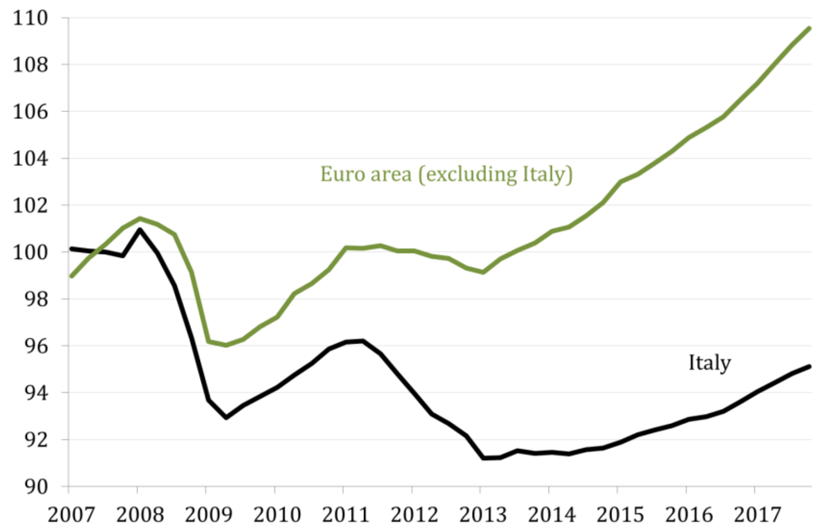
many quarters – including the Bank of Italy, but without neglecting to point out the problems, risks and inefficiencies and suggest remedial action – that the banking system was 'sound overall' though certainly not in each component part. Clearly, there are plenty of challenges ahead and many problems yet to be tackled, against a rapidly evolving backdrop in terms of both regulations and, above all, technology. Yet Italy's banking system is now on the mend, and there is increasing clarity about the path to be taken to overcome the difficulties of the past decade once and for all.

1. How the crisis came about

The global financial crisis, the longest and deepest since the 1930s, began more than ten years ago and culminated in the collapse of the investment banks Bear Stearns and, more notably, Lehman Brothers. It originated in the bursting of the United States housing bubble that had resulted from imprudent lending policies. The effects were amplified by the spread, throughout the US and beyond, of structured finance products based on the securitization of mortgages and other claims whose riskiness had been widely underestimated.

Although the internationally agreed and coordinated economic policy response limited the damage (Visco, 2017b), Italy was hit harder than other European countries: between the first quarter of 2008 and the second quarter of 2009, GDP fell by almost 8 percentage points in Italy, compared with around 5 points in the rest of the Eurozone (fig. 1). The banking sector weathered that shock better in Italy, however, than in other countries, where substantial public intervention was required. At the end of 2011, the impact of this intervention on the public debt amounted to 48 percentage points of GDP in Ireland, 11 points in Germany and 7 points each in the Netherlands and Belgium; in Italy it was barely 0.2 points. Between the end of 2012 and the beginning of 2013, Spain took out a European loan of more than €40 billion, or about 4 per cent of GDP.

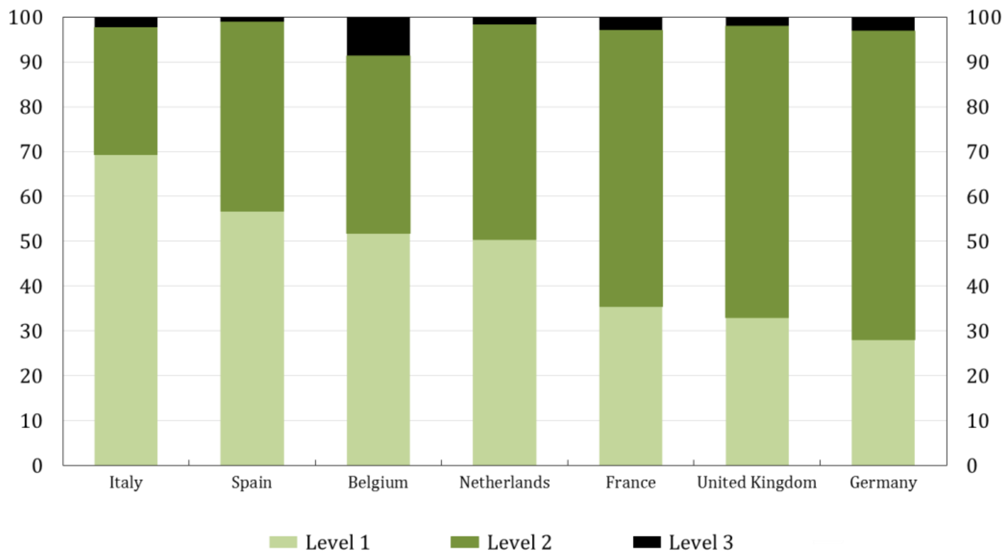
Figure 1 – *GDP* (*2007 = 100*)



Note: GDP at chain-linked prices.
Sources: Istat and Eurostat.

Several factors helped to shelter Italian banks from the direct effects of the global financial crisis. First, the prevalence of a traditional business model based on channelling household savings into the corporate sector: investment banking, which tends to involve derivatives and what are known as Level 2 and Level 3 assets,[3] has always figured only marginally in the balance sheets of Italian banks (fig. 2). Risk-taking was also discouraged by the supervisory authority,[4] while well-established practices of prudent mortgage lending had helped to limit household debt, which to this day remains among the lowest in Europe in relation to both GDP and disposable income.[5]

Figure 2 – *Composition of banks' financial investments in the main European countries*



Note: investments measured at fair value; values as of December 2017.
Source: Bank of Italy.

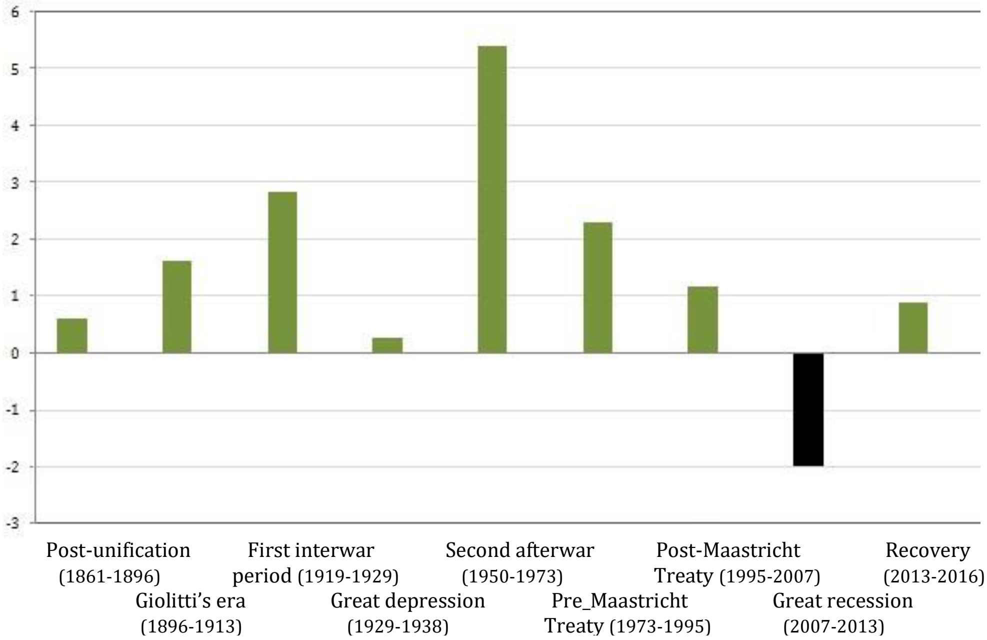
The recovery, which gained momentum worldwide in the second half of 2009, broke off in Europe when the sovereign debt crisis erupted at the end of 2010 with the revelation of the true state of Greece's public finances. This time the political response was slower, partly because of difficulties linked to shortcomings in the Eurozone's economic governance framework. In Italy, this second phase of the crisis had a far more serious impact than on average in the other European countries: between the second quarter of 2011 and the first

[3] Assets classified as Level 2 and Level 3 for accounting purposes, large volumes of which are present in the balance sheets of European banks, are financial instruments not listed directly on active markets and are usually fairly complex, opaque and illiquid. For a full discussion of their risks to financial stability, see Roca et al. (2017).
[4] Some examples include the supervisory inspections of some banks' derivatives trading, the inclusion of structured finance vehicles (such as asset-backed securities) in the perimeter of consolidation of banking groups, and the imposition on the largest non-banks of virtually the same prudential rules as those that apply to banks.
[5] In 2007 the mortgage loan-to-value ratio was 65 per cent in Italy, compared with over 70 per cent in Germany and Spain and over 90 per cent in France and the Netherlands; see the box "The loan-to-value ratio for residential mortgage loans in the euro-area countries", in Banca d'Italia (2013).

quarter of 2013, GDP fell by more than 5 percentage points in Italy, but by just 1 point in the rest of the area (fig. 1).

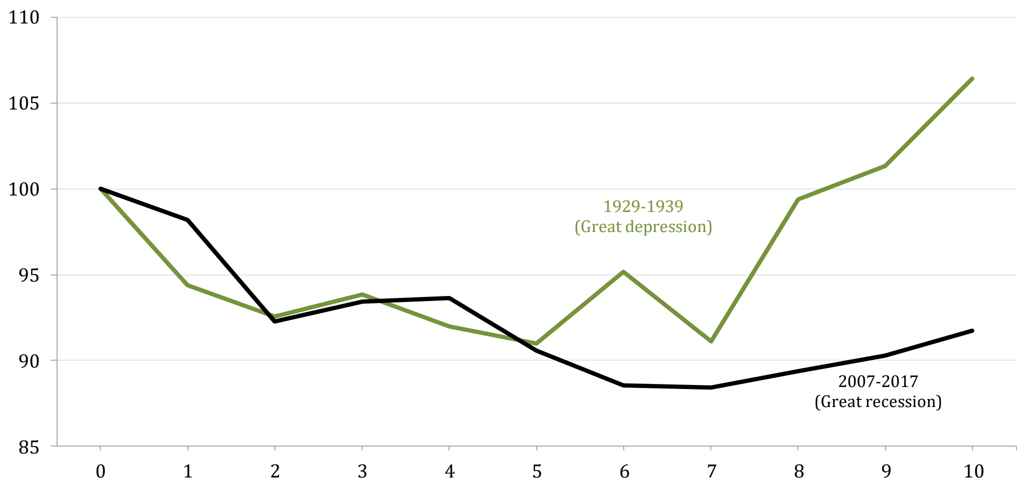
As I pointed out in my "Concluding Remarks" on 31 May last year (Visco, 2017b), the double-dip recession is the worst economic crisis in Italy's history, far worse than the Great Depression (figg. 3 and 4).

Figure 3 – *Changes in per capita GDP in Italy in different historical periods* (*per cent; average annual growth rates*)



Note: GDP at chain-linked prices.
Source: Bank of Italy.

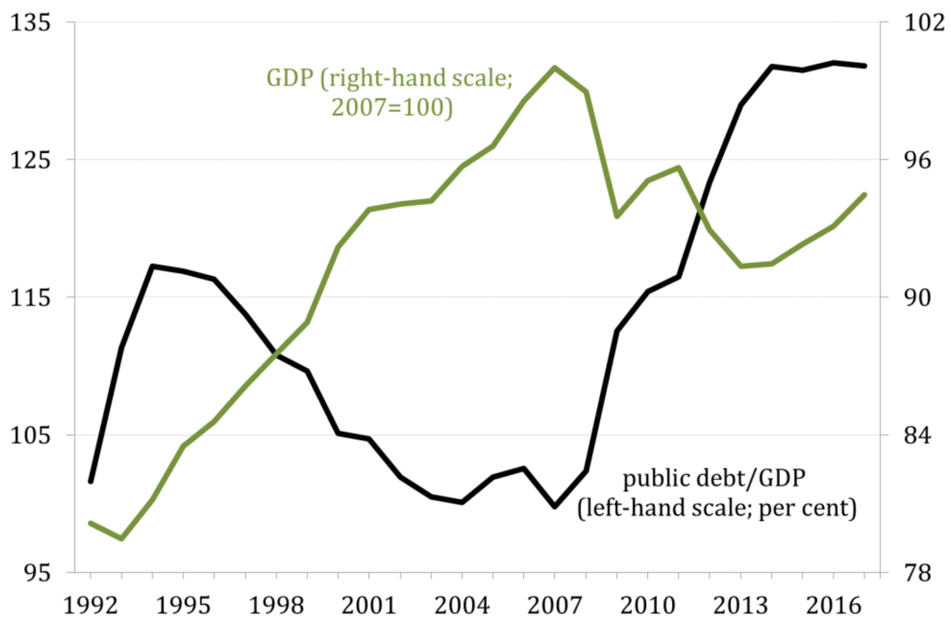
Figure 4 – *Per capita GDP in Italy* (*1929 = 100*; *2007 = 100*)



Note: GDP at chain-linked prices; the horizontal axis measures the number of years since the beginning of the crisis (denoted by "0").
Source: Bank of Italy.

The numbers are well known: from 2007 to 2013 GDP fell by 9 per cent, industrial production by almost a quarter, and investment by almost 30 per cent. In total, more than a million jobs were lost. Despite the measures taken to reduce the deficit, the debt-to-GDP ratio has now surpassed the 130 per cent mark, basically as the automatic effect of lowering the denominator (fig. 5).

Figure 5 – *The financial crisis and the public debt/GDP ratio*

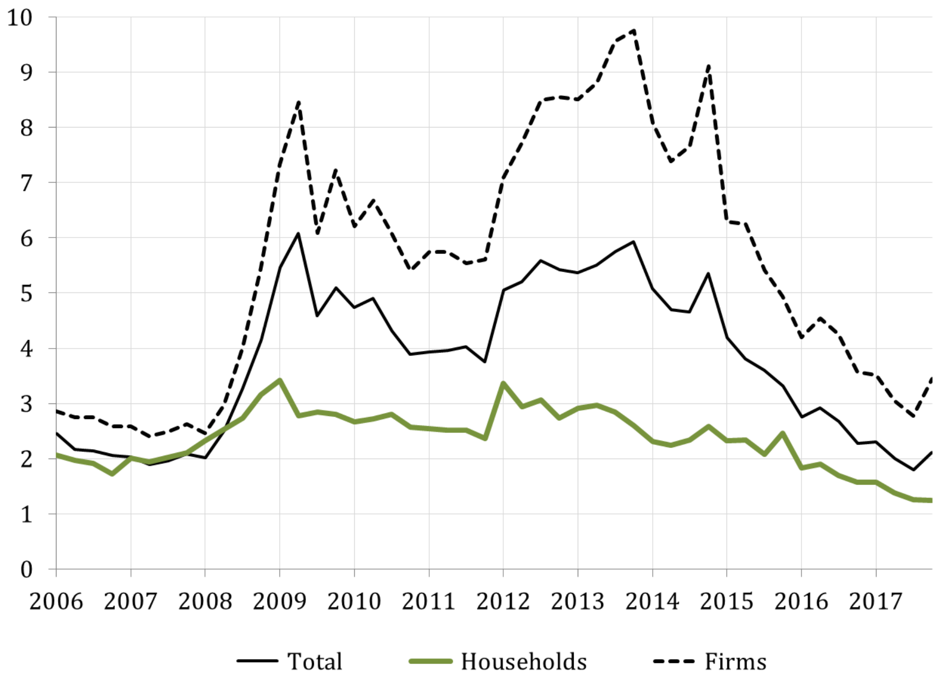


Note: GDP at chain-linked prices.
Sources: Bank of Italy and Istat.

Less than three years later, the second recession brought another large increase in non-performing loan rates for banks. The increase was especially pronounced for firms whose NPL rates neared 10 per cent (fig. 6). Credit quality worsened in all sectors (fig. 7). The stock of NPLs subsequently continued to rise, rather than fall, as it would have done had the economic recovery continued, finally peaking in 2015 at €360 billion gross and about €200 billion (11 per cent of loans) net, i.e. taking account of the loan loss provisions already entered in balance sheets (fig. 8).

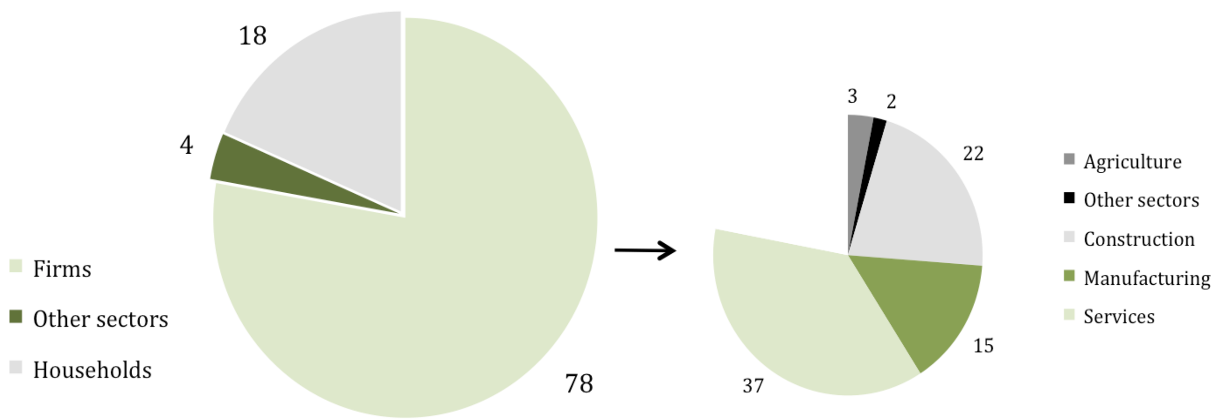
Nearly €90 billion of net NPLs consisted of bad loans, namely exposures to insolvent debtors, €85 billion of which were secured by collateral and about €40 billion by personal guarantees. The remaining share consisted of loans that were unlikely to be repaid or past due, i.e. loans to individuals in temporary difficulty but very likely to ultimately honour their debts.

Figure 6 – *Ratio of new NPLs to outstanding loans* (*quarterly data, annualized and seasonally adjusted; per cent*)



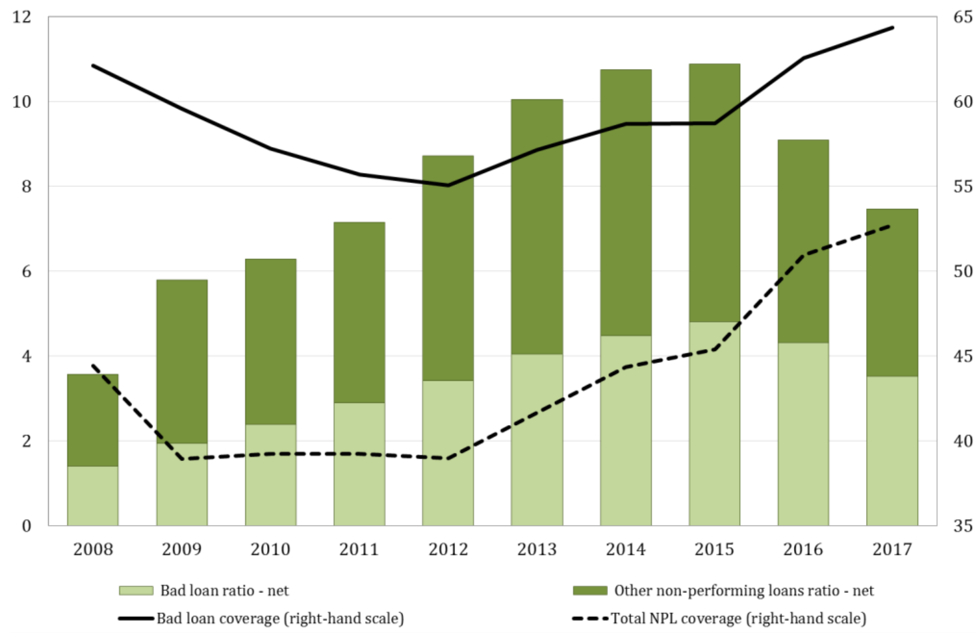
Source: Bank of Italy.

Figure 7 – *Composition of NPLs at December 2017* (*per cent*)



Source: Bank of Italy.

Figure 8 – *Ratio of NPLs to outstanding loans and coverage ratios* (*per cent*)



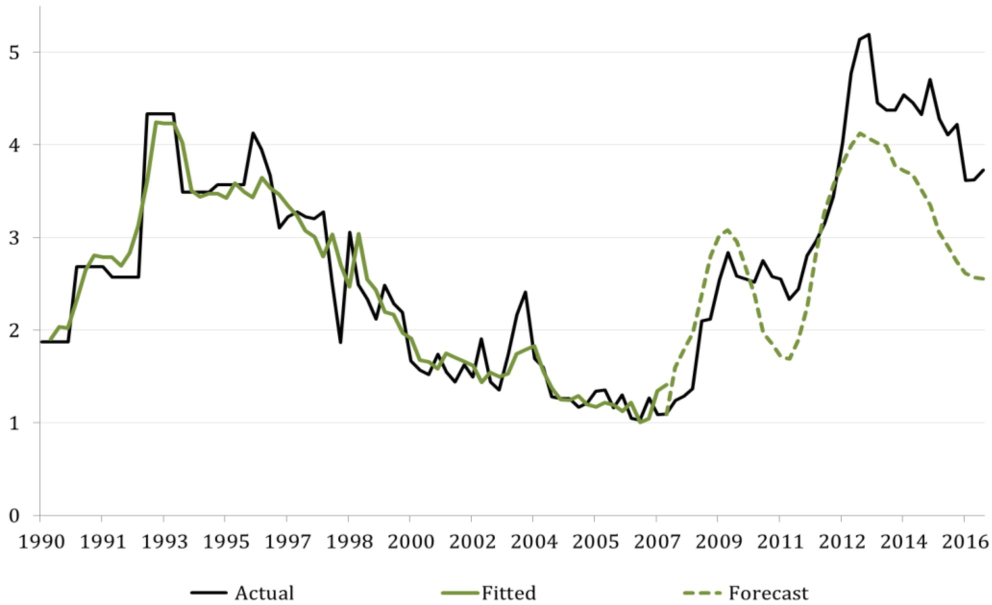
Source: Bank of Italy.

The link between the economic situation and the quality of bank assets is a very strong one. Various studies have shown that the deterioration in credit recorded in both phases of the crisis was for the most part attributable to negative developments in the macroeconomic outlook.[6] With regard to bad loans only, for which we have a homogeneous series of data from the start of the 1990s, the estimated ratio between annual flows from 1991 to 2007 and GDP growth, the unemployment rate, changes in housing prices and gross operating income of firms explains nearly 90 per cent of new bad loans recorded from 2008 to 2016 (fig. 9).

The consequences of the double-dip recession on the financial system could have been far worse. The share of net bad loans in total loans nonetheless remained lower than the levels recorded in the mid-1990s (4.8 per cent in 2015, compared with 5.9 per cent in 1996), after an economic crisis that was far less severe than the one just past (fig. 10).

[6] See Angelini et al. (2017). Similar results were obtained by Notarpietro and Rodano (2016), and Albertazzi et al. (2016).

Figure 9 – *New bad loans ratio* (*as a ratio of outstanding loans; per cent*)



Source: Angelini et al. (2017, p. 49).

Figure 10 – *The financial crisis and bad loans/outstanding loans ratio*

Notes: real GDP with base 2007 = 100; bad loans/outstanding loans ratio in percentage points.
Sources: Bank of Italy and Istat.

The growth in the stock of NPLs and especially their persistently high levels were greatly influenced by the slowness of judicial recovery proceedings and the poorly developed (and largely oligopolistic) secondary market for such assets. In Italy it takes an average of three years to obtain a lower court decision and more than seven years to process a bankruptcy proceeding; in the more virtuous EU countries, it takes less than a year on average in both circumstances. If Italy's recovery times were in line with average Europe times, the ratio of NPLs to total loans would now stand at half the current level.[7] The length of judicial proceedings and the paucity of specialized investors operating in the private NPL market (mostly foreign private equity funds) necessitate very high rates of return (which at times have even exceeded 20 per cent).[8]

2. Supervisory activity during the double-dip recession

Banking crises are nothing new. Banks perform a fundamental role in market economies, but their nature, the structure of their balance sheets and their operations expose them to risks that can give rise to periods of instability, even on a large scale. Crises may sometimes be unavoidable if they are caused by factors that are largely exogenous to the banking system; in any case, the main task of the supervisory authority is to contain risks without compromising the ability of banks to finance households and firms. To this end and to ensure effective crisis management, supervisory authorities must have appropriate tools in place.

The Bank of Italy has taken action on several fronts in response to the various challenges arising over the years. Starting in 2007, when tensions developed on the interbank markets, the Bank of Italy began to closely monitor the liquidity conditions of banks, encouraging them to increase their supply of securities eligible for use as collateral in Eurosystem refinancing operations. In 2011, as the sovereign debt crisis gripped Italy, this monitoring was stepped up, in some cases taking place on an infraday basis. At the end of 2011, a decree was issued allowing the government to provide its own guarantee for bank bonds.

In 2012 the supervisory authority heightened its scrutiny of NPLs. As I have already mentioned, credit quality had worsened significantly but had remained manageable: at the start of the year, NPLs accounted for 7 per cent of total loans (fig. 8). It became readily apparent, however, that a second recession would drastically increase credit risk. In the second half of the year, partly because of a failure to sufficiently raise the NPL coverage ratio (the amount of loan loss provisions in relation to the corresponding gross exposure), the Bank of Italy launched a programme of inspections to verify the adequacy of write-downs, taking account of both aggregate variables (average system values, prospects for the real economy) and individual variables. The move was judged to be severe at the time and naturally met with criticism. Banks with inadequate coverage were asked to take immediate remedial measures. Thanks, first, to our action, and then to the measures taken within the scope of the Single Supervisory Mechanism (SSM) – created at the end of 2014 as the first step towards

[7] See the box "The relationship between the length of credit recovery procedures and volume of bad debts on banks' balance sheets", in Banca d'Italia (2013). See also Marcucci et al. (2015).
[8] See Ciavoliello et al. (2016).

establishing a banking union – the NPL coverage ratio has increased steadily. At the end of 2017, it had reached 52.7 per cent for the banking system as a whole, compared with an average of 44.5 per cent for the main EU banks.

The recession was much longer and deeper than expected. The subsequent recovery, first perceived at the end of 2014, was initially very weak. Credit quality continued to worsen, if more slowly, and loan losses rose so high as to absorb more than 100 per cent of banks' operating profit. Several banks faced difficulties.

During that period, managing bank crises proved particularly complex on account of two factors. On the one hand, the unfavourable economic conditions and the heavy losses incurred by banks made it impossible to resort to solutions involving, as in the past, the acquisition of troubled banks by stronger ones. On the other hand, the European regulatory framework, which was significantly recast as of 2013, rendered it very difficult to use public money.

In the summer of 2013, the European Commission published a *Communication* on State aid for banks (European Commission, 2013) that was more restrictive compared with the previous six issued since 2008, which had been designed to preserve financial stability by substantially easing the rules on aid to the banking sector. The new *Communication* introduced the principle that public funds may only be used if shareholders and subordinated bondholders partake in the losses (burden sharing). In 2015, the Commission issued an opinion to the effect that recourse to the Interbank Deposit Protection Fund (FITD), despite being entirely funded by the banking system, was tantamount to State intervention because contributions made by banks were used for the mandatory reimbursement of deposits of up to €100,000. The same rule applies to the Mutual Bank Depositors Guarantee Fund whose members are mutual banks (*banche di credito cooperativo*, BCCs).

Subsequently, in January 2016, the Bank Recovery and Resolution Directive (BRRD) became fully operational. The Directive envisages only two possible routes for intervention when a bank is deemed "failing or likely to fail" and market solutions are unavailable. The first is liquidation, the winding up of the bank under domestic law and in any case in compliance with the rules on State aid. The second is resolution, which allows the failing bank to continue to operate but only if the resolution authority deems that doing so is in the "public interest".

Resolution involves the application of the bail-in tool, which requires that the funds needed to cover losses and to recapitalize the bank be provided first by shareholders, then subordinated and unsubordinated bondholders, and lastly, by depositors for the portion of their deposits above €100,000. Within the scope of the Single Resolution Mechanism (SRM), recourse to the Single Resolution Fund (SRF), which is financed by the banks of the member states within the banking union, is admissible only if the funds are recovered through the bail-in tool prove insufficient. If, instead, a bank is solvent but is found to have a capital shortfall under a stress test and this poses a threat to financial stability, the member states may intervene by means of a precautionary recapitalization, deemed 'compatible' with the rules on State aid. In this case, the burden sharing requirement nonetheless applies, and a restructuring plan, which is typically very exacting, must be agreed upon between the member state and the European Commission.

During the BRRD negotiations, the Bank of Italy, as consultant to the Italian Government, expressed strong disapproval of the application of the bail-in tool to financial instruments issued prior to the enactment of the legislation. A document presented by the Italian delegation at an official meeting in March 2013 and endorsed by the Ministry of economy and finance (MEF) highlighted the need for an adequate transitional period to allow banks to raise the funds needed to meet the new requirements and savers to reassess their investment decisions in the light of the new rules. It also maintained that the bail-in tool should have a contractual nature and should be limited to newly issued financial instruments containing an explicit clause regarding their reduction in value or conversion into equity upon the activation of a resolution procedure. At European level, however, a different approach prevailed.

Bank crises have therefore been managed with the tools available, selecting on a case by case basis the solution that best safeguarded customers, the supply of credit to the economy and financial stability. Between 2011 and 2015 some 36 banks were placed under special administration. In the 17 cases in which no market solution was found, the banks, representing approximately 0.2 per cent of the banking system's total assets, were liquidated, generally without repercussions on depositors or bondholders.

In November 2015, a few days after the BRRD was implemented in Italy but before the bail-in came into effect, four Italian banks holding 1 per cent overall of system-wide deposits were placed under resolution, with a burden sharing arrangement and the support of the National Resolution Fund. At the end of long and complex discussions between the European Commission (especially the Directorate General for Competition), the European Central Bank, the SSM's decision-making body (especially the Supervisory Board), the SRM (especially the Single Resolution Board) and the MEF, the four banks were sold (at a negative price and relieved of bad debts) to two medium-to-large banks classified as "significant" at single supervisory level (Barbagallo, 2017a).

In July 2017, after the long series of difficulties that began in 2010 had been tackled with private sector capital injections and public sector loans, the European Commission approved the precautionary recapitalization of Banca Monte Paschi di Siena by the MEF. In accordance with European legislation, public support was accompanied by burden sharing measures and by the launch of a complex restructuring plan designed to avoid distorting competition and restore the bank's profitability (Barbagallo, 2017b).

For Veneto Banca and Banca Popolare di Vicenza, the European Commission deemed the private funds that were potentially available insufficient to cover, as required under the BRRD, "the probable losses in the near future" it had estimated; consequently, no precautionary recapitalization was granted. The SSM declared that as a result the two banks were "failing or likely to fail" and the SRB decided that placing them under resolution was not in the public interest. They were therefore wound down in June 2017. Winding them down piecemeal would have entailed risks for uncovered liabilities and have forced banks to call in loans from hundreds of thousands of households and small firms; it would also have jeopardized the jobs of the banks' employees. The Government therefore decided on a block sale of the assets (excluding NPLs) and liabilities of the two banks, following an open and transparent sales procedure. To ensure an orderly winding down and to guarantee the continued provision of financial services, the European Commission authorized State aid to the purchaser, named in the sales procedure as Intesa Sanpaolo. This aid, which serves first and foremost to cover the capital requirement arising from the acquisition and to contribute to restructuring costs, was preceded in this case too by burden sharing measures, as required by the European rules (Barbagallo, 2017c).

In the cases in which burden sharing was applied to subordinated bonds subscribed by retail investors, for the four banks put under resolution in 2015 and for the two Veneto banks wound down in 2017, ex post recovery mechanisms were established subject to certain conditions (including that the holder had purchased the bonds directly at issue prior to June

2014, when the BRRD was approved in Europe). In the case of Banca Monte dei Paschi di Siena, it was decided that shares resulting from the conversion of the subordinated bonds could be sold to the MEF in exchange for the bank's plain vanilla bonds.[9]

Shareholders instead bore the full brunt of the losses, a similar situation to that of shareholders of other listed banks, both in Italy and abroad. During the crisis years, the banking sector share indices fell by up to 90 per cent on average in the main advanced countries compared with prices in 2007. Bank shareholders in Italy suffered fewer losses overall in relation to GDP than those in the United Kingdom, Ireland and Spain.

In the cases I have mentioned, the difficulties were compounded by significant instances of mismanagement, ranging from misconduct to fraudulent behaviour. In such cases, the Bank of Italy has always promptly reported any potential violations of the law to the judicial authorities.[10] It would have been better on more than one occasion to remove individual directors whose conduct had failed to uphold the principle of sound and prudent management, but the Bank was only granted this power in 2015.

Supervisory action preserved the stability of the Italian banking system, at a much lower cost for the State than in other countries. Bearing in mind the steps taken last year, the impact of the financial support given to the banks on Italy's public debt amounted to 1.3 per cent of GDP at the end of 2017,[11] against an average of more than 5 per cent in the rest of the euro area. The Italian banking sector's losses were almost entirely borne by the banks themselves

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[9] The subordinated bonds subscribed by retail investors at the four banks placed under resolution in 2015 were estimated to amount to around €350 million. The FITD disbursed €180 million to those who applied for a flat-rate reimbursement. The National Anti-Corruption Authority (ANAC) received 1,700 reimbursement applications via an arbitration procedure for a total value of €80 million. The arbitration panels met for the first time last March and approved compensation of around €500,000 (upholding 29 of the 32 applications). The subordinated bonds held by retail investors at Banca Monte dei Paschi di Siena came to around €1.7 billion when recapitalization took place. The MEF subsequently purchased 92 per cent of the shares resulting from the conversion of these instruments, issuing plain vanilla bonds for around €1.5 billion; the remaining 8 per cent continued to be held by investors in the form of ordinary shares. For the two Veneto banks, the subordinated bonds subscribed by retail investors eligible for compensation amount to €100 million. The FITD's flat-rate compensation procedure, for which the submission of claims expired on 30 September 2017, is now under way; as in the case of the four banks, it will be joined by the ANAC's arbitration procedure. Finally, the 2017 budget law set up a further relief fund of €25 million a year for the period 2018-2021 to help investors affected by the resolution of the four banks and the winding down of the two Veneto banks.

[10] See, for example, testimony of Governor Ignazio Visco on banking crises and supervision (Visco, 2017a).

[11] This figure includes the impact of the operations carried out in 2017, especially the precautionary recapitalization of Banca Monte dei Paschi di Siena and the winding down of Banca Popolare di Vicenza and of Veneto Banca. According to Eurostat's opinion on the statistical treatment of the latter operation (see European Commission, 2018c), its impact on the public debt is equal to €11.2 billion, of which €4.8 billion for the transfer to Intesa Sanpaolo (already included in the public debt estimates published in February) and €6.4 billion for the reclassification of the losses incurred in winding down the two banks (included in the data revised after Eurostat's opinion and published by the Bank of Italy on Friday 13 April, available at https://www.bancaditalia.it/pubblicazioni/finanza-pubblica/2018-finanza-pubblica/statistiche_FPI_20180413.pdf). It should be noted that the Società di Gestione delle Attività (SGA), to which the NPLs of the liquidated banks were sold, achieved satisfactory results in the past in the recovery of the NPLs of Banco di Napoli; it will take time and patience for it to get the best possible results from these loans. The Eurostat opinion also calculated a higher public budget deficit in 2017 (about 0.3 per cent of GDP) compared with the estimates previously issued by Istat which did not incorporate any impact by the operation. Eurostat recognized that the estimates of recovery rates originally used by the Italian authorities – based on the average recovery rates for NPLs for the banking system as a whole for positions closed out ordinarily in the period 2006-2015 – are consistent with the actual framework for the liquidation, which predicts the recovery of NPLs over a long-term horizon rather than their immediate sale on the market. Nevertheless, Eurostat has established that, for the purposes of a statistical representation of the operation, a more prudent estimate of recovery rates is preferable, one that is considerably lower than that derived from the rates recorded in Italy in the period examined.

and their shareholders. Nevertheless, at the end of last year, common equity tier 1 (CET1) stood at 13.8 per cent of risk-weighted assets, against 7.0 per cent in 2008.

Whether more timely public intervention would have been advisable, let alone possible, and whether the problem of NPLs could have been dealt with by creating a company to manage them with state support, are legitimate questions. At the end of 2011, net bad debts, the most easily sold NPLs, accounted for 2.9 per cent of total loans (see above, fig. 10). The macroeconomic forecasts and those made in 2012 regarding the trend in banks' balance sheets were far more favourable than the actual results. At that time there appeared to be no justification for a system-wide measure supported by a substantial public contribution. Furthermore, as tensions mounted in the sovereign debt market, it was unlikely that a State measure for NPLs would have been compatible with the conditions of the public finances and might have led to concern for their stability.

The situation changed rapidly in the following years. The persistence of the economic crisis well beyond the forecasts fuelled the growth in NPLs: net bad loans exceeded 4 per cent of total loans at the end of 2013, reaching a maximum of 4.8 per cent in 2015. The easing of tensions on the government securities market lifted the pressure on the public finances, whose conditions would now have allowed public support to a bank asset management company, something we actively supported. This solution was, however, prevented by the interpretation of the aforementioned European Commission's *Communication* on State aid.

There is one area where the banks should have acted more quickly. When the amount of NPLs began to be significant, we called on the banks to actively manage them. We urged them to find organizational solutions that could make recovery procedures quicker and more efficient, leaving it up to them to choose, in accordance with the principle of freedom of enterprise, how to proceed and what timeframe to adopt. Subsequently, and in particular after a series of inspections, it emerged that not enough had been done: the banks did not have adequate data on NPLs and used ineffective recovery procedures based almost entirely on recourse to legal action. Following a preparatory phase, in 2016 we therefore started an ad hoc survey on bad loans to obtain useful data for supervisory purposes and to prompt banks to update their databases. Almost two years on from the start of the survey, banks now have a vital tool for actively managing NPLs, deciding which ones to sell on the market and which to keep on balance sheets, and eradicating the information gaps that are partly responsible for making sales prices so low.

The complex procedures required by the new European regulatory framework have also greatly lengthened the time taken to manage and resolve the crises. Steps must be taken to streamline them as much as possible, in part to prevent the assets of the banks concerned from drastically falling in value over time. I will come back to this point later on (Masera, 2017).

3. Open questions in the new European regulatory framework

Europe is struggling to complete banking union and make headway in the reform of its economic governance. There is now a stalemate between the positions of those who think that the priority should be risk reduction in the individual member states and banking systems versus those who instead advocate the rapid creation of shared instruments to protect against these risks, given the constraints on interventions at national level.

The opposition between risk reduction and risk sharing is a sterile one and mainly the result of misunderstandings and scant mutual trust. The result is a system with an incomplete safety net: there is no European backstop for either bank resolution assisted by the Single Resolution Fund (SRF), which is already operative, or for deposit insurance, which is still to come. Meanwhile, at national level it is no longer possible to manage bank crises with the tools and procedures that were used in the past by many EU countries, including in recent years. Stricter rules and common supervision and resolution mechanisms are not enough to prevent crises − even just liquidity crises − nor can they adequately limit their effects. This must be recognized and the necessary adjustments made.

The debate on risk reduction ahead of the completion of banking union centres on two main issues: non-performing loans and banks' sovereign exposures. The stocks of both these assets are especially high in some countries, including in Italy. Several observers believe that there cannot be further progress in risk pooling without a swift reduction in these assets. This viewpoint is debatable.

The proposal to make the prudential treatment of banks' sovereign exposures more restrictive is backed by a single argument: since the crisis has shown that public sector securities are not always devoid of risk (as in the case of Greece), the possibility that banks consider them as such must be eliminated. This issue had already been debated in the mid-1970s by the Basel Committee, which, following an in-depth discussion, introduced the regulatory framework currently in force, which allows a zero risk weighting on these exposures (Goodhart, 2011).

It is worth noting that some of the rules introduced after the crisis already take account of the riskiness of exposures to the public sector. Examples of rules that go in this direction include caps on leverage ratios and the way in which EU authorities conduct stress tests.[12] In any case, it is not obvious that further changes to prudential regulation can lower the probability of a crisis. The main channel tying the fortunes of banks to those of sovereign issuers is the economy, not the fact that banks hold public sector securities. At the end of last year, following two years of debate, the Basel Committee decided not to propose any further changes in this area (Basel Committee on Banking Supervision, 2017).

It is also worth recalling that during a crisis an increase in banks' sovereign exposures can play a stabilizing role, as explicitly recognized by the Basel Committee and as observed in recent years in Italy and Spain.[13] This role of contrarian investor is clearly visible in the data: Italian banks' exposure to the public sector, which climbed from 6 per cent of total assets at end-2011 to a peak of 10 per cent in 2015, has since decreased gradually: it now stands at around 8.5 per cent, following a decrease of over €100 billion, or one quarter of the maximum level reached.

As regards the calls to reduce NPLs advanced in the European debate by those who advocate the need to lower risks, these are understandable and in keeping with our supervisory action, which was intensified in this respect as early as in 2012. In recent years, within the SSM we have contributed pro-actively to the drafting of guidance on NPL management for significant banks, and this year we published similar guidance for the less significant banks (Banca d'Italia, 2018).

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[12] In the latest exercise conducted by the EBA in 2016, owing to sovereign exposures, the loss-absorbing capacity of the participating banks was equal, on average, to more 40 basis point in terms of the CET1 ratio. The absorbing capacity appears proportional to the riskiness of the sovereign debt.

[13] See Lanotte et al. (2016). See also Lanotte and Tommasino (2018), including the references.

In the last two years the share of NPLs in total loans in Italian banks' balance sheets decreased significantly: this is a result that is not always recognized in full. Credit quality improved with respect to both the flow and stock of NPLs, also thanks to some significant sales in the market. The flow of NPLs is now equal to about 2 per cent of total lending, down from a peak of over 5 per cent in 2013 (fig. 6, above). Net of write-downs, the stock decreased to €135 billion, some €62 billion (or about one third) below the peak recorded in 2015. The share in total lending went from 10.8 per cent to 7.5 per cent (fig. 8, above), and is expected to diminish this year as well. The gap with respect to the average for the other EU countries remains wide but is closing rapidly. Measured in terms of the net NPL ratio,[14] the gap decreased to 6 percentage points, down from 11 points in 2015. This trend must continue. The opportunities afforded by the favourable economic situation, which may not last forever, must be seized to continue to strengthen banks' balance sheets.

In the European debate, we have never questioned the need to reduce the stock of NPLs. We have, however, emphasized the issue of the speed at which to proceed in this direction: forcing banks to sell these assets too quickly or at cut or 'close-out' prices could be a source of instability and give rise to an undesirable transfer of value from banks to buyers (Ciavoliello et al., 2016). There is no doubt that NPLs are a significant problem, but one that must be assessed by putting it in the right perspective.

For inexplicable reasons, some have trouble recognizing that to quantify risks one must look at the stock of NPLs net – and not gross – of write-downs. Moreover, the possible negative repercussions of the large stock of NPLs must be analysed in depth: while accepted by many, the idea that they limit banks' ability to grant loans by disrupting the monetary policy transmission mechanism does not appear to rest on solid empirical foundations (Angelini, 2018).

A last important issue in the debate on the completion of banking union and on the reduction of banks' risks is that all risks should be considered, not just a subset of them. The share of Level 2 and Level 3 instruments in EU banks' balance sheets is still very high. At the end of 2016, Level 3 instruments amounted to almost €200 billion on the asset side and Level 2 instruments to €3.4 trillion. The corresponding figures on the liability side were almost €150 billion and over €3 trillion (Roca et al., 2017). The riskiness of these assets is hard to assess. However, the evidence suggests that these instruments are illiquid, opaque and complex. A serious debate on risk reduction cannot overlook them.

Last March the European Commission submitted a legislative proposal addressing NPL write-downs European Commission, 2018a), while the ECB published the final text of the *Addendum* to its Guidance on NPLs (European Central Bank, 2018). The Commission's proposal is a 'Pillar 1' rule, i.e. it is binding for all EU banks. The *Addendum* is instead defined by the ECB as a 'Pillar 2' measure, indicative of the supervisor's 'expectations' with respect to significant banks. Both documents envisage a tight time frame for banks to write off in full new NPLs, be they unsecured (two years) or secured (seven years according to the Addendum, eight years according to the Commission's proposal).[15]

[14] This is the only indicator that permits homogenous cross-country comparisons.

[15] The two documents also differ in that the Commission's proposal only applies to loans granted starting on 14 March 2018 (the date on which the proposal was approved), while the *Addendum* applies, effective from the beginning of this month, to all new NPL flows regardless of the date on which they were granted. Furthermore, the Commission's proposal caps write-downs at 80 per cent for NPLs that are more than 90 days past due.

These measures are designed to diminish uncertainty about the valuation of NPLs (and hence about the soundness of the banks concerned), and to encourage their reduction. However, the effects of these measures differ based on credit recovery times in member states.[16] In most European countries, where the average recovery times are relatively brief, these new rules will only affect a small number of non-performing positions. In Italy and in the few other countries where the average recovery times are much longer, they will instead affect a large volume of positions. Increased write-downs could lead to an unwanted contraction in credit supply owing to higher costs and the unwillingness of banks to make loans, especially unsecured ones. Account must also be taken of the new IFRS 9 on the measurement of financial instruments (International Accounting Standards Board, 2014), introduced at the start of this year, which could have unwelcome consequences for the bank lending market, particularly during downturns.

In any case, to avoid the costs that delays or inefficiencies in the justice system impose on the economic system, including on banks, it is necessary to take swift action to shorten credit recovery times in our country and to align them with those in most of Europe. At the same time, banks must press on with efforts to improve their internal procedures.

The legislative measures addressing credit recovery times introduced in 2015 and 2016 are starting to bear fruit, but further action is needed.[17] Although Parliament has yet to examine the delegated law on bankruptcy reform, it is still possible to move forward even under current legislation. Recently the Consiglio Superiore della Magistratura (2017), Italy's supreme judicial council, published guidelines on real estate foreclosures intended to improve existing trial court practices, which vary widely in terms of response times across the country.

On 14 March the European Commission presented a blueprint on setting up national asset management companies (AMCs) to acquire banks' NPLs (European Commission, 2018b). I have on several occasions pointed out that, if properly designed, the establishment of such companies could be of significant help in overcoming problems that hinder the development of a private market for NPLs. But I have also noted that the transformation of European rules and interpretations on State aid and bank crisis management has made it difficult to carry out these asset transfer schemes in practice and has also made them rather unappealing to banks.

The Commission's proposals do not depart significantly from the current regulatory arrangements. The only innovation – the option of applying to AMCs the framework envisaged for precautionary recapitalization using State aid to support asset transfers at non-market prices – does not introduce any clear incentives, given that precautionary recapitalization is itself subject to strict conditions (including burden sharing measures and the preparation of what is in fact a very severe restructuring plan, to be submitted to the Commission for approval). The lack of clarity on the criteria for estimating market prices (and therefore the dividing line between the presence or absence of State aid), the method's complexity and the need for the mandatory participation of all the banks in the scheme, have effectively neutralized the scope of the proposals. This risks being a missed opportunity.

The issue of rules for bank crisis management is a particularly delicate one. The regulatory reforms of the last few years have radically altered the Bank's role in managing and resolving crises. In Italy there was a phase preceding crisis resolution dedicated to the implementation of measures, defined with discretion and flexibility, to avoid the traumatic exit of banks from the market and to preserve the value of lending relationships. The use of private resources,

[16] The decision to treat bad loans and unlikely-to-pay loans in a similar way is also debateable.
[17] See Marcucci et al. (2017); Brodi et al. (2016); Giacomelli et al. (2017).

such as those provided by deposit guarantee schemes, was permitted, and in exceptional cases, public funds. This phase has since been eliminated. As I mentioned earlier, in the absence of quickly practicable market solutions, the mere statement that a bank is “failing or likely to fail” is enough to trigger a resolution action or, if there is no “public interest”, its liquidation.

Starting the winding up or resolution process involves using valuation criteria that reduce the value of the assets of the failing or even just likely-to-fail bank, in some cases so much so that it becomes insolvent. In both resolutions and liquidations, crisis management is further complicated when there is no buyer to whom the assets and liabilities of the distressed bank can be sold *en masse*; it may even become necessary to sell off the assets one by one at particularly low prices.

Under the current rules the assets of the bank in crisis must be transferred at the time of sale at the ‘market price’, even if this has been rendered excessively low by the illiquidity of the market itself or by the bargaining power of the few purchasers capable of undertaking operations for such enormous sums. These criteria apply both to definitive sales of banks’ assets in the case of a winding up and, for resolution actions, to transfers to bad banks created to sell off the assets over a longer time horizon. The estimated losses, and accordingly the sacrificing of the rights of shareholders and creditors who are bailed in, are therefore greater than what they would be in a system allowing for more flexibility in crisis management.

Without a minimum requirement for own funds and eligible liabilities (MREL) capable of absorbing losses in the event of a crisis – a reserve that the banks have not yet built up – the new European framework could put financial stability at risk, in part owing to the complexity of the rules, their interpretation and the crisis management procedures themselves. The number of authorities involved at European level has grown rapidly; their objectives are not always aligned; there is a dearth of effective coordination, which is essential to ensure that banking crises are managed in an ‘orderly, rapid and efficient manner’; for some operations, such as precautionary recapitalizations under the BRRD, decision-making can take an inordinate amount of time. Furthermore, the conditions being discussed to establish the level and nature of the liabilities that would meet the MREL threaten to be particularly harsh. This must not lead to unsustainable burdens placed on banks, especially small ones (Restoy, 2018).

It is against this backdrop that the regulatory framework must be revised, including at European level, to better guide the transition to the new regulatory system and to make the exit of banks from the market manageable. National authorities should have the power to request public support for ordinary liquidations wherever there are risks to financial stability or to the funding of the economy. More specifically, deposit guarantee schemes should be permitted to intervene in crisis situations.

While it is true that the European Commission can authorize member states to use public funds to support the winding-up process (as in the case of the Veneto banks), this is a rare exception, something to be considered on a case-by-case basis and according to timeframes that might prove incompatible with those needed to ensure an orderly solution. The rules should be changed to facilitate, in particular, the winding up of small banks in order to avoid losses of value, protect retail creditors, and maintain the supply of critical financial services at local level. Progress was made on this front on 13 April with the Commission’s approval of the crisis management scheme for the smallest banks (European Commission, 2018d).

Compliance with market and competition protection rules is, of course, crucial. But in assessing the role of public institutions in preventing and resolving crises, including through deposit guarantee schemes, care should be taken to distinguish between policies designed to encourage market solutions and to avoid potential threats to financial stability, and solutions involving State aid, which in fact distort competition.

4. The challenges ahead

Italy's banking system has made significant progress to date but pockets of vulnerability remain, especially, though not exclusively, among smaller banks. The interventions in corporate governance in recent years – which we have long called for and which have been slowed by resistance, not only on the part of banks – have marked a vital step forward in strengthening the system. The reform of Italy's cooperative banks (*banche popolari*), whose constitutionality was recently confirmed, has removed obstacles to raising capital, thereby creating the conditions for making banks more resilient. Some of the aspects of the 2016 reform of Italy's mutual banks (*banche di credito cooperativo*, BBCs) are highly innovative, also by comparison with the other European countries; it must now be implemented in full. The creation of mutual banking groups will be essential to enable individual BCCs to overcome their size disadvantage and to continue to support the local economy while preserving their cooperative and mutualistic spirit. Work has begun on restructuring this sector. Since 2015 the number of banking groups and stand-alone banks has fallen from about 500 to slightly more than 400 (tab. 1). Following the establishment of the new mutual banking groups, this number will be closer to 120. The reform's importance must be gauged both in terms of the need to repair the malfunctions caused by the crisis and, above all, the challenges posed by the economic, legislative and technological changes under way.

Table 1 – *Number of supervised banks*

	2015		**2016**		**2017**	
	System total	*of which*: BCCs	**System total**	*of which*: BCCs	**System total**	*of which*: BCCs
Total banks	498	365	460	335	410	289
of which: bank groups	75	11	73	9	68	9
of which: stand-alone banks	423	354	387	326	342	280

Source: Bank of Italy.

The first challenge for banks is that of adapting to the new requirements of the productive system, to help make the allocation of resources more efficient and to raise the growth potential of the Italian economy. The financial needs of innovative and internationally active medium-sized and large firms cannot be met by banks alone. In Italy as elsewhere, new financial market segments are developing that allow firms to tap into alternatives to bank credit: bond issuances are increasing and so are stock exchange listings.

This is significant progress but considerable differences remain compared with the other main European countries.[18] Italian firms tend to have less risk capital and much higher bank debt. At the end of last year, 260 non-financial corporations were listed on the stock exchange, less than half the number in France and Germany and just over one quarter of those with listings in the UK. Growth in market finance is needed to make the distribution of risks more efficient and to enhance the resilience of both firms and banks. This requires that banks flank their supply of lending with specialized services designed to facilitate capital strengthening and to diversify sources of finance for firms (Albareto e Marinelli, 2018).

Bank lending will nevertheless continue to be the main source of external funding for small firms, whose financial fragility increased their vulnerability during the long recession; moreover, many of these firms are still struggling to join in the recovery. But there are entire categories of small, competitive firms with strong growth potential. These businesses must be monitored, supported and developed by investing in their future. At the same time, in a context made more difficult by the new regulatory measures on NPLs, banks must respond to the demand for credit and financial support with procedures for assessing creditworthiness based on strict criteria and, insofar as possible, new technologies.

The second challenge is that of strengthening and recouping the profitability of individual banks and of the sector as a whole. Some progress has been made on diversifying income and on keeping costs down but we need to be more ambitious. Much depends on the sustainability of banks' business models and on their ability to attract capital by offering adequate returns, something that has become even more important since the introduction of new prudential regulations requiring much larger stocks of high-quality capital than in the past. Banks must be able to rapidly draw on new resources if conditions deteriorate.

In Italy, as in Europe, banking markets are mature, with strong competitive pressures originating from both inside and outside the industry, partly due to the growth in market finance. The potential to increase earnings from traditional banking activities appears limited overall. Therefore, strengthening the sector requires a marked increase in efficiency levels. For individual banks, this can be done by reorganizing processes and reaping the opportunities afforded by new technologies to raise productivity and to cut costs. At industry level, the current wave of mergers will enable economies of scale to be exploited and spare capacity to be absorbed.

The third, and probably the most important, challenge that lies ahead is technology. Digitalization, which has already transformed many sectors of the economy, is spreading to finance and to activities, which up to now have been exclusive to banks. New technologies have drastically reduced the costs of transmitting, processing and storing information. It is therefore unsurprising that the spread of new digital technologies is associated with strong pressures towards the disintermediation of financial transactions and offers a competitive advantage to those best placed to manage information. Entire production chains within the financial services industry, from payment services to equity trading, are already heavily affected by the digital transformation. In the banking sectors in the United States, the United Kingdom and China the market shares of non-banking entities active on digital platforms are also growing rapidly. Banks are not defenceless in the face of innovation: they can draw on vital resources such as customer data and the trust that comes from being regulated and supervised. The challenge is

[18] See Salvatore Rossi's comments (2017).

to exploit these advantages by having appropriate levels of investment, both in terms of quantity and quality (Panetta, 2017).

5. Conclusions

The severe recession that struck our economy has led to a sea change in the activity of banks. Radical regulatory transformation has rapidly made obsolete arrangements that in the past decades had underpinned the stability of the Italian financial system.

The resolution of the crises at the weakest banks, though encumbered by the new regulatory environment, and the economic recovery, which has gradually gained momentum, have helped to allay the fears surrounding the system's solidity; the markets' assessment of the outlook for Italian banks has improved but weak spots remain. To address them requires first and foremost stability and confidence. Blanket solutions or rushed and procyclical measures are of no assistance. One contribution can come from a review of Europe's institutional and regulatory arrangements for crisis management, whose excessive rigidities must be adjusted.

The favourable current situation provides an opportunity that banks must seize to strengthen their balance sheets further. The Bank of Italy has continued to remind them of the importance of raising profitability, by taking decisive steps to keep total and unit costs down, but also by investing in human capital and exploiting the possibilities offered by technology. Corporate restructurings, measures to raise efficiency and productivity, the pursuit of alliances and mergers to overcome size constraints and achieve the necessary economies of scale and scope, are vital for generating sufficient earnings to achieve the levels of capitalization required to safeguard financial stability. Only then can banks continue to support household consumption and business investment.

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