The recent Asset quality review on non-performing loans conducted by the Bank of Italy: Main features and results

1. Introduction

In the last few years the Italian economy has been under considerable strain. Between 2007 and 2012 GDP fell by a cumulated 7 percentage points in real terms. Industrial production fell by a quarter. This environment has given rise to a large increase in non-performing loans (NPL), whose ratio to total loans went from 4.5% at the end of 2007 to 12.3% in June 2012. Over the same period the level of the related provisions as a ratio to total loans (the so-called coverage ratio) fell by 12 percentage points, from 49.4% to 37.7%.[1]

For a proper assessment of the current levels of NPL and of the coverage ratio characterizing Italian banks, over time as well as in the cross-country dimension, several facts must be taken into account.

1. The definitions of non-performing loans in the EU are highly heterogeneous, and the one adopted by Italian banks is particularly ample.[2] In particular, over the last few years Italian banks have called for more collateral and reduced loan-to-value ratios. Applying the definition of non-performing loans adopted by leading European banks, which excludes fully collateralized positions, the coverage ratio of the Italian banking system would be much higher, and increasing over the last three years.[3]
2. Four of the twelve percentage points decline in the coverage ratio recorded between 2007 and 2012 reflect a composition effect.[4]
3. Italy is characterized by long judicial procedures for credit recovery actions. This induces banks to build the outstanding amount of provisions gradually; it also entails a relatively high steady state level of the NPL ratio.[5]

The Bank of Italy constantly monitors the evolution of credit risk and banks' provision policies. Asset quality reviews (AQR) are carried out on a regular basis, as a part of the

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[1] These data are from Bank of Italy, *Financial Stability Report*, No. 4, November 2012, and do not consider loan write-offs. In this note, in accordance with supervisory practice, reference is made instead to data gross of write-offs.

[2] See S. Barisitz, "Nonperforming Loans in Western Europe – A Selective Comparison of Countries and National Definitions", Oesterreichische Nationalbank, Focus on European Economic Integration, Q1/13, http://www.oenb.at/de/img/feei_2013_q1_studies_barisitz_tcm14-253775.pdf.

[3] See Bank of Italy, *Financial Stability Report*, no. 5, pp. 27-28.

[4] In keeping with past experience, the slump in economic activity has increased the portion of non-performing loans other than bad debts, typically characterized by lower coverage ratios: for bad debts the coverage ratio is 54.7 per cent, compared, for example, to 20.6 per cent for e.g. substandard loans. In turn, the differences between coverage ratios reflect differences between loss ratios: for bad debts they are generally more than two times those for substandard loans. See Bank of Italy, *Financial Stability Report*, no. 4, p. 32.

[5] See Bank of Italy, *Financial Stability Report*, no. 5, pp. 28-29.

Supervisory Review and Evaluation Process (SREP), in order to assess the current and perspective exposure to credit risk of each institution, according to the reference framework provided by the Bank's Supervisory activities guidelines.

This note presents the main methodological aspects and the key results of an initiative focused on coverage ratios and provisioning policies launched by the Bank in 2012. To this end, the next section briefly illustrates the general approach adopted by the Bank in its supervisory activity focused on asset quality. Section 3 describes the specific features and the results of the AQR carried out in 2012-13. The forthcoming supervisory actions are described in Section 4.

2. Key principles of supervisory controls on asset quality at the Bank of Italy

AQR are performed off and on-site with the support of a Risk Assessment System, a set of models developed by the Bank of Italy to evaluate the different risk profiles.

Off-site controls are based on the analysis of a large number of data and indicators drawn from the prudential reports collected by the Bank of Italy, which are wider than the minimum standard required at international level (COREP), and from the Italian Central Credit register. The latter, in particular, provides the supervision officers with detailed, high frequency information on credit exposures, provisioning, default rates, collateral etc. at the level of the single counterparty. In addition, where needed and according to the proportionality principle, ad-hoc operational data are requested from banks. Banks with validated IRB models also have to provide data, at the single counterparty level, on EAD, PD and LGD. Supervisory off-site checks are carried out at least on a yearly basis; for problematic institutions and/or specific portfolios, the frequency may be higher.

On-site inspections are planned according to an annual process that takes into account the intermediaries' features and the need for possible in-depth controls suggested by the off-site supervisory activity. Assessments can also be undertaken independently of the planned process, whenever urgent needs arise, also in view of possible corrective actions. Inspections are carried out by a dedicated Inspectorate Department within the Supervision Area. For these tasks Bank of Italy does not rely upon external auditors.

Reviews of individual credit files are systematically undertaken in on-site AQR. To define the size of the sample of files to be examined, the Inspectors may use a judgmental approach or a statistical methodology, generally relying on detailed supervisory information (Central Credit register data and prudential reports).

The largest banking groups are examined on a continuous basis, through a turnover of targeted on-site inspections. Adding up the time of these targeted visits, in the period 2009-2011 the two main Italian banking groups in terms of total assets have been under inspection for 85% of the time, the next three groups for 58% of the time; the time spent on inspections focused on AQR has been about 60% of the total. For the other banks, AQR are usually carried out within the framework of periodic on-site full-scope inspections. For regional and local banks the time between full-scope inspections is on average 3.5 years. For medium/small sized banking groups the frequency of inspections depends on individual

situations; priority is given to banks signaled by the off-site analysis as having significant weaknesses.

3. The 2012-13 Asset Quality Review

In 2012 a specific AQR was launched, aimed at assessing the adequacy of the provisioning on non-performing loans.

3.1 Banks selection

First, an off-site analysis was conducted on the basis of statistical methods to identify banks with potentially inadequate levels of provisioning. For each banking group the review focused on homogeneous portfolios in terms of type of impairment (bad debts and substandard and restructured loans)[6], collateral, and the borrower's sector of activity.

This analysis allowed to identify 20 large and medium-sized banking groups whose coverage ratios either were lower than average or had decreased significantly. For these banks the off-site analysis was followed, in the Autumn of 2012, by on-site inspections, whose aim was to assess in detail the adequacy of the provisions and to examine policies and practices in this field.[7] These groups account for about 40% of the banking system's total domestic non-performing loans.[8]

3.2. Methodology and phases of the on-site examinations

For each of the 20 banking groups inspected, an analysis of the qualitative aspects of provisioning against NPL (adequacy of banks' policies and practices) was conducted. The guidelines set out in the Supervision Handbook were revised to take into account the present exceptional cyclical conditions, providing the inspectors with more stringent criteria for assessing collateral, recovery period and discount rates.

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[6] The Italian classification of NPL includes four sub-categories (see Annex 1). Past-due items were excluded from the analysis owing to recent changes in the regulations and their relatively small share over total non-performing loans.

[7] For 18 groups the on-site inspections focused on provisioning, while at 2 intermediaries these checks were part of a full-scope inspection.

[8] For the two largest groups (Unicredit and Intesa) the bad debts component was verified on an off-site basis in accordance with the principles and methods used for inspections based on statistical samples. The smaller banks were not involved in the specific AQR, as they are subject to frequent full scope examinations by the decentralized inspection units operated by the Bank.

Table 1 – KEY STATISTICS OF THE INSPECTIONS
(consolidated data; June 2012)

	LOANS INSPECTED	
	TARGETED SAMPLES	STATISTICAL SAMPLES
number of groups inspected	20	19
non-performing loans examined (bad loans + substandard loans + restructured loans)		
Number	5,182	5,803
Amount (€ bn)	24.2	-
% of 20 groups' total non-performing loans	27%	-
of which:		
portfolio of bad loans examined (€ bn)	11.0	3.4
% of groups' total bad loans	21%	8.5% (1)
portfolio of substandard loans examined (€ bn)	8.5	-
% of 20 groups' total substandard loans	29%	-
portfolio of restructured loans examined (€ bn)	4.7	-
% of 20 groups' total restructured loans	55%	-

(1) The percentage is calculated on the stock of bad loans net of those in the targeted samples.

At the same time, work on individual borrowers was carried out. The same methodology was applied for all the inspected banking groups; a dedicated coordination team ensured harmonization. Specifically, for each of the 20 groups considered, this part of the analysis involved two separate steps:

a) examination of a targeted sample of individual credit files. These borrowers were selected from each group's portfolio of bad debts and substandard and restructured loans of high unit value. The choice fell on those characterized by a lower coverage ratio and collateral level. About 260 borrowers for each group were examined, totaling nearly 5,200 files, for a value of about €24 billion (27% of these groups' stock of NPL; Table 1). A check was also made on the classification of these borrowers adopted by the banks.
b) verification of a statistical sample of individual borrowers, representative of the overall portfolio of bad debts[9] of each bank, divided into 4 clusters (firms, for loans with/without collateral; households, for loans with/without collateral). About 300 individual borrowers for each group were examined, for a total of 5,800 credit files and a value of €3.4 billion.[10] In view of the tight time limits set for the analyses, work on the statistical samples was carried out by the banks' internal audit and risk management units using

9 Taking into account the time constraints on the checks, the statistical sample focused on the bad debts, which represent the largest (60%) and riskiest component of the non-performing loan portfolio.

10 The examination involved 19 of the 20 groups inspected; for one group the scope of the analytical checks made the statistical analysis superfluous.

guidelines provided by the inspection teams. The results were verified by the inspection teams.

The large number of individual files included in each bank sample and the granularity of the analysis carried out required a major organizational effort. Ninety inspectors were involved for an average of 4 months each and a total of 6,700 FTE days.

3.3 Main results

The inspections revealed deficiencies in provisioning policies and practices at several banks, in matters such as methods for valuing collateral and the definition of discounting parameters (recovery period and discount rates). In addition, activity in these fields by the risk management and internal audit units was in some cases found to be inadequate. Groups were invited to take immediate steps to overcome these organizational shortcomings; a call was also made for more homogeneous valuations within banking groups.

After an initial debate on the criteria proposed by the inspectors, the banks mostly showed a satisfactory level of cooperation, reformulating their policies and revising their valuation methods in accordance with the inspectors' prudential guidelines. The banks also launched a reassessment of their entire portfolios of non-performing loans on the basis of the new indications.

The increase in forecast losses produced by the work on the targeted sample (step a) above) amounted to €3.4 billion, against €7.4 billion of provisions already made by the 20 groups. As a consequence, the coverage ratio for this sample of non-performing loans, including write-offs (see footnote 1), rose from 31% at 30 September 2012 to 43.5% at 31 December 2012 (Table 2).[11]

This increase does not necessarily imply an analogous need for more provisions for the rest of the 20 groups' NPL, or the rest of the Italian banking system, due to the selection criteria illustrated above (low or declining coverage ratio for the banks, low coverage and collateral for the individual borrowers).

[11] In more detail, the above data reflect the following components. The bad debts examined accounted for €11 billion (21% of the 20 groups' total bad debts). As a consequence of the inspections, the average coverage ratio for bad debts of the sample rose from 44% in September 2012 to 58% in December. The substandard credit files examined amounted to €8.5 billion (29% of the 20 groups' total substandard loans); for restructured loans the corresponding figures were €4.7 billion and 55%. Between September and December the coverage ratio rose from 19% to 36% for substandard loans and from 12% to 19% for restructured loans. The above figures take into account the fact that many of the credit files examined were reclassified in a higher risk category (35% of the substandard loans were reclassified as bad loans and 50% of the restructured loans were reclassified as substandard loans or bad loans).

Table 2 – MAIN RESULTS FROM THE "TARGETED SAMPLES" ANALYTICALLY EXAMINED DURING THE INSPECTIONS (1)

	Amount examined		Banks' estimated losses (€ mln)	Coverage ratio 30.9.2012 (pre-inspection)	Additional provisions resulting from inspections	Total estimated losses	Coverage ratio 31.12.2012 (post-inspection) (2)
	€ mln	% of the 20 groups' total					
Bad loans	11.021	21%	5.259	44%	1.586	6.845	58%
Substandard loans	8.496	29%	1.583	19%	1.509	3.092	36%
Restructured loans	4.684	55%	561	12%	350	911	19%
Total non-performing loans (1)	24.201	27%	7.403	31%	3.449	10.852	43.5%

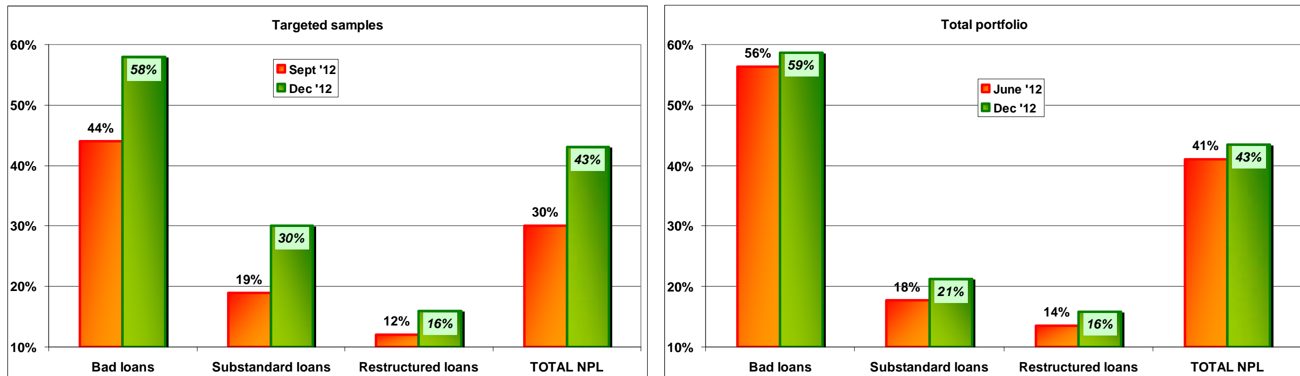
(1) Total non-performing loans do not include past due items. The column "Amounts examined" reports values net of write-offs. The column "Banks' estimated losses" is gross of write-offs. The coverage ratios are computed by re-attributing write-offs to the denominator (column "Amounts examined"). Write-offs are concentrated in the bad loans item. (2) The increase with respect to September is also influenced by the increase in the denominator of the ratio over the quarter.

Work on the statistical sample (step b) above) led banks' internal audit and risk management units to estimate additional losses for the bad loans samples amounting in the aggregate to €0.3 billion, against provisions of €1.65 billion. The results of this step of the analysis, verified by the inspectors, provided the data for an inferential exercise regarding the groups' total bad loans. On the basis of this exercise, additional losses amounting to €4.3 billion were estimated by the Bank of Italy. Duly taking into account the limits inherent in the statistical nature of their derivation, these estimates will be used for the application of second-pillar capital add-ons in the Supervisory Review and Evaluation Process (SREP). The SREP will also make use of the results gathered from the inspection of banks' provisioning policies and practices.

While the samples examined by the inspectors were selected as of September 2012, in the following months banks also continued to provision for inflowing NPL. Provisions made on the portfolios of NPL (old and new) not covered by the targeted and statistical samples amounted to €3.8 billion, thereby bringing the increase in total additional provisions between September and December 2012 to €7.5 billion.

Overall, the coverage ratio for the entire portfolio of NPL (bad loans, substandard and restructured loans) of the 20 groups in question, including write-offs, rose from 41% as at 30 June 2012 to 43% as at 31 December 2012 (Figure 1). The relatively small growth in the coverage ratio is due to the strong increase in NPL (the denominator) observed during the second half of 2012.

Fig. 1 - NPL COVERAGE RATIOS FOR THE 20 BANKING GROUPS INVOLVED IN THE ON-SITE INSPECTIONS (1)
(percentage values)



(1) Left panel: solo data. Right panel: consolidated data, available only twice a year. Coverage ratios are computed gross of write-offs. The targeted samples comprise individual files accounting for about 27% of these groups' total portfolio of NPL as of June 2012.

4. Next steps

The Bank of Italy will closely follow the implementation of additional corrective measures that the banking groups inspected were invited to adopt; for 8 of the 20 groups examined the checks were extended to the entire loan portfolio, in some cases turning the inspection into a full-scope examination of the entire operational activity of the group. For these cases, on-site supervisory work is still ongoing.

Specific instructions will be sent out to the entire banking system on procedures and governance issues concerning provisioning risk. Moreover the internal Supervision Handbook is under review to include the criteria adopted and the experience gathered during the on-site inspections.

The monitoring of banks' assets quality and provisioning levels is still ongoing and has been extended to other groups through ordinary inspections. This action will be co-ordinated with similar exercises that will be carried out at the international level.

To minimize the procyclical effects of the interventions, the Bank of Italy has called on the banks to increase their internally generated resources by further curbing operating costs, dividends and executives' and directors' compensation, consistently with banks' profitability and capital adequacy. For banks that will have to undertake more far-reaching adjustments, a contribution should come from the sale of non-strategic assets. To face the risk of unfavourable developments over the next few years, consideration should be given to measures, even temporary ones, to reduce staff costs in relation to revenue.

ANNEX 1

NON-PERFORMING LOANS – CLASSIFICATION ACCORDING TO THE ITALIAN REGULATION

Bad loans: exposures to an insolvent counterparty (even if insolvency is not legally ascertained) or in equivalent situations, regardless of any loss estimate made by the bank and irrespective of any possible collateral or guarantee.

Substandard loans: exposures to counterparty facing temporary difficulties – defined on the basis of objective factors - that is expected to be overcome within a reasonable period of time.

Restructured loans: exposures in which a pool of banks or an individual bank, as a result of the deterioration of the borrower's financial situation, agree to change the original conditions (rescheduling deadlines; reduction of interest rate), giving rise to a loss.

Past due: exposures other than those classified as bad loans, substandard or restructured exposure that are past due for more than 90 days on a continuous basis.