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The Italian banking system and the exit from the crisis

Speech by the Deputy Governor of the Bank of Italy

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The economic situation and outlook

Growth in the euro area is firming up, driven by the accommodative monetary policy stance and increased international trade. In Italy the recovery has been under way for more than two years and is taking hold. Recently released data from Istat indicate that in the first quarter of this year GDP grew by 0.4 per cent, pushed up by household consumption and firms' inventories. Investment, which had been accelerating strongly since the start of 2016, slowed, but this should only be temporary. Our analyses suggest that firms will expand their production capacity once again in 2017. After the sharp increase at the end of last year, exports are continuing to grow in parallel with world trade.

The recent positive performances are partly unexpected and must be analysed carefully; they will have to be confirmed in the months to come. They are, however, consistent with improvements in the labour market. Although excess labour supply depresses wage growth, the number of people in employment continues to increase, with an acceleration in April, and this despite the termination of the incentives for hiring new employees on permanent contracts.

Inflation is rising but its core component remains weak. Similar developments can be seen in the euro area. Although the risks of deflation have declined, upward pressures on prices have not emerged to the extent that they are self-sustained in the medium term or that justify a revision of the monetary policy stance.

The outlook for the Italian economy is favourable. In the forecasts published last week, we calculated that GDP could grow by 1.0 per cent in the current year and by 1.2 per cent in the two following years. The national accounts data released a few days ago (and not included in our forecasts) suggest higher growth at the end of the first quarter, which would raise GDP growth, other things equal, to 1.3 per cent on average in 2017. The gap between Italy and the other euro-area economies should continue to narrow.

The banking system has almost completely adapted to the new economic environment and to the comprehensive regulatory reform that followed the crisis. There are important open issues that require the banks and the authorities to be fully committed. After going through an unprecedented recession and setting out on a path of capital strengthening under very difficult conditions, the positive performance of the real economy has now created the pre-conditions for Italian banks to move out of the stage where they are just reacting to the crisis.

Regulatory developments and supervisory action

Banking regulations introduced in response to the financial crisis are having a profound effects on prudential and accounting rules and on supervision. The new regulations are compressing the size of the banking sector. The Basel III rules raised capital requirements, limited leverage, and established stringent liquidity requirements. Additional capital requirements are envisaged for systemically important banks. Several countries have introduced measures to separate lending from the financial activities that banks carry out on their own account. Other capital measures, of which I will comment today, are in the final stages of preparation as part of the completion of Basel III.

Looking ahead, these regulatory changes will make banks less risky, increasing their capital and liquidity and lowering their leverage. However, banks' profitability and the development of the lending market will be under pressure, with potential repercussions on the availability of credit for the real economy. In the euro area these developments are coupled with a limited role of capital markets in financing business.

Most of the new regulations have been implemented and are already producing effects. A pause is now desirable to allow time to adapt to the new system and to prevent the continuous introduction of new rules from itself becoming a source of uncertainty. Outstanding issues must be solved rapidly.

The first important issue is that of internal models. The measures currently under discussion would reduce latitude in calculating risk parameters and limit the unjustified variability of risk-weighted assets, which are the denominator in capital ratios. Differences among countries have emerged in capital requirements measured with internal models. This issue is less important for Italian banks, which have so far made limited use of such models. However, it is essential to reach an agreement on the matter to ensure a level playing field with foreign banks, which have made broad use of internal models for a long time. By taking steps to develop internal models, even within a consortium and subject to verification by the supervisory authorities, the Italian banking system could align itself with those of the other main European countries on this issue.

The Targeted Review of Internal Models (TRIM) project recently launched by the Single Supervisory Mechanism (SSM) assesses the compliance of significant banks' internal models and ensures uniform supervisory practices. The review covers models for credit risk as well as for market and counterparty risk. Over 100 assessments are scheduled in 2017, in which Bank of Italy staff will be actively involved. The goal is to swiftly eliminate any deviation from the regulations;

misalignments with the practices set out in the TRIM Guide will be assessed at a later stage.[1] Italian banks must plan in advance any adjustments to their risk measurement systems, anticipating potential consequences on capital. They have already made significant progress, but much more remains to be done.

A second important issue to ensure more effective supervision and a level playing field at European level is the removal of uncertainty in the valuation of bank assets. The assets and liabilities recorded in banks' balance sheets as Level 2 (L2) and Level 3 (L3) instruments play a key role, as their evaluation is particularly complex. Their value is not directly inferable from market prices but must be estimated using complicated techniques. Coupled with the difficulty of distinguishing between L2 and L3 contracts, this can lead banks to make valuations whose goal is to keep down capital requirements through accounting and regulatory arbitrage.

Classifying a contract as L2 instead of L3 has several advantages. First, it is possible from the outset to book profits equal to the entire difference between the actual transaction price and the fair value estimated through internal models (known as the day-1 profit). Second, it limits the 'stigma' associated with holding large amounts of L3 instruments, which analysts regard as highly risky assets.

Because of their high degree of complexity and low level of standardization, L2 and L3 instruments are illiquid; their quick sale would likely entail a substantial discount on their fair value. When the high risks embedded in these financial instruments emerged in the United States in 2008, the value of L2 assets decreased by 15 per cent and that of L3 assets by 21 per cent, with troughs of 31 per cent and 57 per cent respectively.[2] If not properly accounted for in the valuations, illiquidity could give rise to fictitious profits representative of hidden risks. Moreover, the actual value of L2 and L3 portfolios is difficult to assess, as it cannot be inferred from the prices recorded in the markets but is instead estimated using models based on variables whose liquidity is also low or nil.

The total value of the complex instruments held by euro-area banks is very high. L3 and L2 assets total €162 billion and €3.3 trillion respectively; L3 and L2 liabilities amount to €143 billion and €3.1 trillion. The total amount of these instruments is twelve times greater than that of net non-performing loans. Two national banking systems hold 73 per cent of the euro-area total and five banks (none of them Italian) 58 per cent. The available data do not tell us whether the risks

[1] Italian banks show misalignments in the credit conversion factor and in the prudential treatment of exposures in default. As regards this last point, the estimation of the loss given default parameter must take into account the recovery processes still under way.

[2] See B.W. Goh, D. Li, J. Ng, K. Ow Yong, 'Market Pricing of Banks' Fair Value Assets Reported under SFAS 157 since the 2008 Economic Crisis', *Journal of Accounting and Public Policy*, 2015, 34:2, 129–145.

embedded in assets in these classes are covered by liabilities in the same class. Only with a "perfect hedge" would the underlying risks be offset. The uncertainty about the valuation could therefore manifest itself through both an overestimation of assets and an underestimation of liabilities, thereby compounding the risks rather than cancelling them out.

Since its establishment the SSM has tackled resolutely the issue of loan valuation, especially for non-performing loans, or NPLs. Opaque, illiquid and difficult to evaluate, L2 and L3 instruments are in many ways similar to NPLs, although they require much lower capital charges. Especially in a stress scenario, a decrease in the prices of these instruments could have systemic repercussions. It is therefore crucial to enhance supervision of the accounting and prudential treatment of L2 and L3 instruments and of the appropriateness of the values recorded in banks' balance sheets. Within the SSM the Bank of Italy will submit a specific proposal to this effect to the Supervisory Board.

While most of the issues mentioned so far mainly concern large banks, many others affect smaller ones. An example is the new IFRS 9 accounting standard, which will change loan valuation starting from 2018; banks will have to recognize provisions for expected losses and no longer only in relation to defaults. This will lead to an increase in loan loss provisions as soon as credit quality worsens.

The new standard will force banks to improve the allocation and assessment of loans and to adopt new criteria to measure credit risk and calculate loan loss provisions. To make the impact on banks' supervisory capital more gradual, the European Commission has proposed a five-year transition period. The methods and procedures, however, will have to be in effect at the beginning of next year. Supervisory authorities, both in Europe and in Italy, are closely monitoring the adjustment process, for example through ad hoc surveys. For Italian banks the progress is mixed; in many cases there are delays in project governance, information quality and model development. They must be tackled and eliminated rapidly.

Starting next year the prudential filter on available for sale (AFS) exposures towards central Government will be removed for Italian less significant banks as well, following the SSM's decision to lift them for significant banks starting from October 2016. Smaller banks must assess carefully the impact of this measure on their capital ratios and should start planning as of now any necessary countermeasures.

The move to IFRS 9 and the removal of the AFS filter will increase the volatility of regulatory capital. The effect on banks could be more pronounced in Italy owing to the high level of sovereign exposures and to the fact that securities with a lower ratings display greater volatility.

Scenario analysis based on changes in the interest rate and risk premium curves is a very useful tool for capital planning. In adopting IFRS 9, banks will be allowed to decide whether to allocate government securities to portfolios other than the AFS one.

The consequences of the introduction of the MREL requirements will also be far from negligible, as banks will need to issue liabilities capable of absorbing losses if a resolution procedure is initiated. When fully phased in, the rules will make crisis management easier, but in the short term they will increase costs by a factor that will depend on the choices − still being debated − regarding the calibration of the requirement and the nature of eligible liabilities. The funding instruments that qualify for compliance with the MREL requirements are costlier than those currently in the balance sheets, especially in countries like Italy characterized by a large share of bank liabilities placed with retail customers − who could become unwilling to hold instruments potentially subject to bail-in − and by the limited development of institutional investors, i.e. those more interested in liabilities of this kind.

The difficulties and costs of compliance with the MREL requirements will be greater for smaller banks owing to their limited access to wholesale markets and less liquid issues. This will have to be kept in mind when setting the requirements for this type of bank.

More generally, an excessive burden should not be placed on small banks, in adherence to the principle of proportionality. For example, for such banks there is a tendency to rule out the existence of a general public interest, which is necessary to initiate resolution procedures. In spite of this, the current regulatory framework calls on these banks to pay into a crisis management system from which they cannot benefit. As part of the review of EU regulations, some thought should be given to measures that respond to the needs of smaller banks, which play a key role in lending to small firms, the backbone of the Italian economy.

Crisis management

In the crisis years the Bank of Italy dealt with numerous cases of banks in difficulty. Since 2011 there have been 36 special administration procedures. In 17 cases where it was not possible to find a market-based solution, the process led to the start of compulsory administrative liquidation. These cases involved small banks and accounted for a combined 0.2 per cent of Italian banks' total assets.

In market conditions where it has become difficult to transfer bank assets, the new European regulatory framework makes managing the crises of large banks problematic. Action is entrusted to

a plethora of authorities and institutions − national and European − which are independent of each other, have non-aligned objectives and have no effective coordination in place between them. This extends the time necessary for a solution and makes the decision-making process inefficient and not very transparent, with the very real risk of confusing the responsibilities of the actors involved. Recent experience shows that these problems can be mitigated as long as there are concrete market solutions.

The new rules have so far been interpreted in a such way as to deny recourse to some of the tools used in the past to manage problematic company cases without causing disruption. In practice, this makes crisis management more complicated. In particular, preventive intervention through deposit guarantee funds is not allowed today, as it is considered equivalent to state aid; in this regard the Italian government lodged an appeal with the European Court of Justice. Furthermore, excessively stringent limits have been established for the use of public funds, even if advantageous financially and following the full involvement of shareholders and subordinated bond holders; this is the case even in the presence of serious risks for systemic stability or contagion of financial intermediaries.

Effective crisis management requires a rapid and reliable time frame, a clear definition of priorities and responsibilities, and full cooperation between the entities involved. In respect of the European regulations, the action of all the authorities must aim to preserve the value of the banking business to the benefit of savers, employees and the companies to which they lend. In the absence of these conditions, the vulnerability of the banks in crisis will increase, as we have seen in practice.

The difficulties that preceded the agreement on the precautionary recapitalization of Banca Monte dei Paschi di Siena and the long and troubled discussions involving Banca Popolare di Vicenza and Veneto Banca are not due to financial constraints, since the resources earmarked by the Italian government are much greater than those needed to restructure these banks. The difficulties stem from regulatory obstacles, which can and must be removed.

A solution for these two Veneto banks must be outlined very shortly, protecting savers and guaranteeing the continuity of the business relationships maintained by the many small and medium-sized enterprises based in an economically important area of the country. The Italian authorities are totally committed to resolving this problem.

Non-performing loans

The problem of non-performing loans is easing as the economy recovers. The flow of new NPLs in relation to total loans now stands at 2.7 per cent, which is lower than before the crisis. The stock, net of loan loss provisions, is also diminishing, from 10.9 to 9.4 per cent of total loans in 2016. The disposals already scheduled by the main Italian banking groups will speed up the rate of decrease.

The Bank of Italy has voiced its opinion on the matter of NPLs on several occasions. I will therefore simply mention again the key issues and refer you to other documents for a more detailed analysis.[3] One of the first issues relates to the strategies adopted by banks to manage NPLs. Far-reaching changes are necessary here. The guidelines published by the SSM are an important point of reference; the Bank of Italy is extending them, with the necessary adjustments, to the banks under its direct supervision. There are a large number of options from which the banks can choose and they should take advantage of them. The Italian banking system is now more aware of the various incentives, as is clear from the initiatives already under way, but a stronger and broader commitment is needed.

Banks need to get the most out of the instruments available for out-of-court settlement with firms regarding debt restructuring and the transfer of real estate collateral. The measures will only be effective to the extent that the banks make use of them.

Complete and reliable information on NPLs also needs to be made more widely available. The new system for reporting bad loans introduced by the Bank of Italy is a step in the right direction.

There is ample scope for improvement in the quality of the data reported. In many cases the information on the status of recovery procedures and the nature of the collateral is incomplete. Approaches differ as regards ongoing procedures; not all banks act promptly. More effort is needed to reduce the backlog and exploit the new database to the full. The information must become part of the dossier provided to senior management so that strategies can be developed to maximize recovery rates.

Another important issue concerns the length of judicial proceedings. The global reform of arrangements with creditors that the Government has set in motion, incorporating the Rordorf Committee's proposal in a draft bill, will effectively lead to more efficient procedures and better

[3] See I. Visco, *The Governor's Concluding Remarks*, 31 May 2017; F. Panetta, *Seminario istituzionale sulle tematiche legate ai* non-performing loans, 15 May 2017; C. Barbagallo, *I crediti deteriorati delle banche italiane: problematiche e tendenze recenti*, 6 June 2017.

outcomes. Rationalizing and simplifying procedures – the aim of the delegated legislation – is an important step forward.

Organizational changes to encourage judicial specialization within the court system (particularly as regards arrangements with creditors) could be introduced within a short space of time. A law effectively creating specialized sections of the courts across the country – possibly by reviewing the competencies of the different courts and pooling at least the more complex proceedings – would bring further improvements.

Part of the problem of the excessive length of judicial proceedings is not due to the legislative framework. The Italian courts vary widely as to the duration of proceedings for bankruptcy and arrangements with creditors. According to data by the Ministry of Justice, comparing the situation in the north and the south of the country, at the end of 2015 the average duration of mortgage foreclosure proceedings was 2 years in the Trieste court district and 8.2 years in that of Messina. In the case of bankruptcy proceedings the duration ranges from 4.8 years in Trento to 15.4 years in Messina. Improving the efficiency of the courts where proceedings take longer than average would be of considerable help in reducing the stock of NPLs.

Large fire sales of NPLs can only be a solution when the bank's stability is at risk. The generalized adoption of policies aimed at selling off NPLs, which would effectively lead to an unwelcome transfer of resources to the detriment of Italian banks but to the advantage of a few specialized investors, mostly foreign, operating in an oligopolistic market for NPLs must be avoided. This type of policy would erode banks' own funds at a time when raising capital is still beset with difficulty.

A solution to the problem of NPLs is on the horizon, but as in the past it will take time.[4] The banks still need to tackle it resolutely, following prudent provisioning policies and improving the way they manage internally not only NPLs but also exposures with a smaller degree of impairment. They should assess whether or not to keep impaired loans on their balance sheet according to the real likelihood of recovery.

Business models

As they overcome the legacy of the double dip recession, Italian banks must equip themselves with the means to cope with the new competitive environment, one in which technology plays a central role. The rise of Fintech companies, which provide financial services at various points of

[4] After the lira crisis of 1992, the bad debt ratio jumped from 5 per cent that year to 10 per cent in 1996. The bad debts generated by the crisis were absorbed by banks' balance sheets over the following four years, with the bad debt ratio dropping back to 5 per cent in 2001 (see Pierluigi Ciocca, 'Sulla questione del problema bancario', mimeo, 2017).

production, and the entry of major web companies in the payment services market bring strong competitive pressure to bear but also support innovation. These may represent valuable opportunities for the banks.

There is no single, winning business model. Our analyses indicate that profitable banks are active in many different sectors but have in common a high efficiency and productivity. Of the 125 banking groups supervised by the SSM, about 20 have had an average ROE of at least 6 per cent in the last three years. This subset has a low cost-income ratio, mainly thanks to much higher than average unit revenues. Such results are achieved by combining technology with human capital and efficient organization.

Last year, the operating costs of Italian significant banking groups were higher than the average costs of their 'virtuous' competitors by about 0.5 percentage points of total assets. This is a considerable gap, even adjusted to take account of non-recurring expenses; it is largely due to staff costs. Measures already taken to rationalize branch networks and reduce personnel will go some way towards reducing the discrepancy, but they must be accompanied by more efficient labour organization with the assistance of technology. In order to ensure that cost cutting does not diminish the quality of the products offered or the effectiveness of internal controls, it will be necessary to adopt strategies to increase human capital.

The need to re-assess costs and revenues is particularly pressing for small and medium-sized banks, whose reduced scale of operation limits their capacity to invest and achieve economies of scale and scope. Consolidation can be an opportunity, particularly for banks not belonging to mutual banking groups. Progress in this direction could be achieved through measures designed to forge closer bonds between banks, along the lines of the institutional protection schemes introduced by European legislation and already adopted in other countries; this would make it easier for them to obtain liquidity or capital in case of need.

Improving the structure of the financial system, with the markets playing a greater role in financing business, is part and parcel of the current transition. The Government has introduced several measures in this direction and a capital market union is one of the objectives pursued at European level. As I have pointed out in the past, it is in the banks' interest to support these changes, which will bring benefits to our corporate sector.

Conclusion

Now that the economic recovery is gaining strength, progress in the Italian banking system can be pursued with determination. Gradually eliminating the risk factors that have been clouding analysts' perception of Italian banks will facilitate this process; banks can now focus on their main objective: to restore profitability.

The conditions are now right for Italian banks to approach the challenges of the new market context with confidence, once again providing full support to the economic recovery. Those challenges can only be overcome with commitment and determination.