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Fact-finding inquiry on the Italian banking and financial system and the protection of savings, also regarding supervision, crisis resolution and European deposit insurance

Testimony of the Governor of the Bank of Italy

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The macroeconomic context and its impact on banks

From 2008 to the present day Italy has been buffeted by the worst economic crisis of the post-war period.

The trouble started with the explosion of defaults in the US subprime mortgage sector and soon spread to the markets for several complex and difficult-to-value assets, dubbed 'toxic'. When it became apparent that several European banks – but not Italian ones – also had considerable exposure to these instruments, the euro-area interbank market all but collapsed.

Then came Europe's sovereign debt crisis, which originated in Greece and rekindled the financial crisis. Beginning in the summer of 2011 the tensions spread to Italy; the further contraction in international interbank lending was countered by the ECB's extraordinary refinancing operations. Interest rates on Italian government bonds soared far above those of the corresponding securities in other euro-area countries, especially Germany. Only with the announcement, in the summer of 2012, of exceptional monetary policy measures designed to combat unjustified and excessive market rate rises in the euro area did the tensions begin to subside. Inevitably, however, they had already been transmitted to the banking market and, coupled with the drying up of the wholesale funding market, led to a sharp increase in the cost of credit and a consequent thinning of supply. This, in turn, exerted a brake on manufacturing activity which lasted over three years and was compounded by unresolved structural problems in Italy's economy.

Europe is now slowly exiting the crisis. The recession's legacy is especially heavy in Italy: the loss in real GDP compared with the pre-crisis peak amounts to around 9 percentage points, while industrial production has shrunk by about a quarter; in the euro area as a whole, output has generally held steady and industrial production has contracted by around 10 per cent, much less than in Italy.

Developments in national banking systems have closely mirrored those in the respective economies. In the first phase the crisis hit the systems that were exposed to toxic assets: the United States, the United Kingdom, and a number of euro-area countries. The result was widespread bank failures, countered by large-scale state support.

Italy’s banking system, which was not exposed to toxic assets, emerged almost unscathed from the early stages of the crisis. It was, however, profoundly shaken by the deep and prolonged recession. In those years Italian banks, whose main business consists in lending to firms, recorded heavy loan losses: in the period from 2008 to 2015 these totalled about €200 billion, eroding 73 per cent on average of operating income.

The banks responded with large capital increases. At the end of last year, the ratio of their core equity capital to risk-weighted assets reached 12.3 per cent, compared with 7.1 per cent in 2007. The average capitalization gap with respect to European banks as a whole, whose core equity ratio was 13.6 per cent at the end of last year, also reflects the massive recapitalizations with public money that occurred in several other euro-area countries.

All in all, Italy’s banking system proved resilient. This was confirmed by the IMF in September 2013, in the foreword to its Financial Sector Assessment Program (FSAP), in which it gave a favourable judgment on Italy’s supervisory system.[1]

The Bank of Italy’s supervisory action

Banks specializing in traditional retail services – as is the case in Italy – are more vulnerable than others to periods of recession, especially if deep and prolonged. The exceptional contraction of the Italian economy has dented banks’ earnings capacity and saddled them with a large volume of non-performing loans, reflecting widespread business failures and the decline in employment. When, as occurred on a number of occasions, the repercussions of the crisis were aggravated by imprudent policies or episodes of mismanagement, the deterioration of banks’ assets became critical.

In this difficult context, the Bank of Italy’s supervisory action prevented the onset of a profound and system-wide banking crisis. Where necessary, it adopted corrective measures within the scope of the powers conferred on it by law. Only with the transposition of CRD IV in 2015 did these powers become more incisive, making it possible to remove individual bank executives or to impose changes in management and control bodies, powers which the Bank of Italy had long advocated and whose absence had been heavily criticized by the IMF. For

[1] ‘The Italian financial system is coping with a severe and prolonged recession at home and the crisis in Europe. The system has so far managed to overcome these shocks and indeed expand domestic deposits and build additional capital buffers. In contrast to other countries, the latter was accomplished without significant state support’.

the long period in which these powers were lacking, moral suasion took their place, albeit with the objective limits this entailed.

Well before the launch of the single supervisory mechanism in November 2014, the Bank of Italy called on credit institutions to strengthen their capital bases and make their balance sheets more transparent. Inspections of write-downs of non-performing loans at the main banks in 2012-13 partly determined the adoption of stricter provisioning policies and the consequent raising of these loans' coverage ratios. This restored the credibility of the largest intermediaries when they turned to the market to raise capital. The capital resources raised, in excess of €40 billion from 2008 onwards, allowed banks to comply with increasingly strict rules even in adverse economic conditions. Calls for capital strengthening were flanked by robust corrective action on corporate governance, risk measurement and control methodologies, and internal controls.

Taken together, these measures enabled Italy's banking system – with just a few exceptions – to pass the European-wide comprehensive assessment. But even constant, incisive supervision cannot prevent the outbreak of financial ills, especially in a fragile economic environment.

Italian and European law and the prudential supervisory model successfully ushered in by the Basel Committee promote the business independence of banks. Bank executives take most of their decisions without prior supervisory control; they are responsible for their actions first and foremost to the shareholders. The supervisory authority cannot systematically encroach on their decisions, even when they adopt imprudent or short-sighted policies. Banks are businesses, after all. They are subject to market forces; their directors must be in a position to take fully independent decisions.

The success of supervision in preserving sound and prudent management depends on many factors, not least the full transparency of directors, management and shareholders in their dealings with supervisors. However widely it has exercised its powers of sanction and notwithstanding numerous reports to the judiciary, banks have not always reacted promptly, nor have the corrective measures adopted always been sufficient. Rash and occasionally fraudulent behaviour by top management are also partly to blame for the deterioration in banks' situation.

Supervision aims to reduce the likelihood of a crisis occurring and to mitigate its consequences. As a rule anomalies and irregularities emerge or are confirmed following in-depth inspections. Whenever they have been identified, the Bank of Italy has acted with the maximum determination. Any suspected criminal acts have been reported immediately to the public prosecutor's office. The situation has not changed with the entry into effect of the single supervisory mechanism; the inspections of the banks classified as significant, including those that brought to light the irregularities at the two former *popolari* banks, Banca Popolare di Vicenza and Veneto Banca, were conducted by the Bank of Italy's inspectors, and the schedules for the investigations and any subsequent interventions were drawn up in full agreement with the Bank of Italy.

Identifying irregularities or illegal acts is neither easy nor automatic. There is a widely held belief among the public that the Bank of Italy's supervisory and investigative powers are limitless. On the contrary, pinpointing anomalies that are sometimes carefully concealed requires painstaking in-depth analysis and finely-tuned investigative techniques, such as confiscations and searches, which are exclusively judicial powers.

Despite this, the Bank of Italy's supervision has dealt decisively with problem banks, enabling them to repair imbalances in their economic and financial situation. Most of these cases are not known to the public at large: with few exceptions, the Banking Law stipulates that any news, information or data that is acquired by the Bank of Italy in the course of its supervisory activities is covered by professional secrecy.

In some instances (Banca Monte dei Paschi di Siena, Banca Carige and, more recently, Banca Popolare di Vicenza and Veneto Banca), given the banks' poor economic and financial conditions, weak liquidity positions, and grave irregularities, restoring the necessary conditions for staying in business required a radical shake-up of directors and management and substantial capital increases, some of which are now being finalized.

For an analysis of specific aspects relating to these banks' conditions and a detailed description of the supervisory action undertaken by the Bank of Italy, please consult our website.[2] For now, I will limit my observations to the following main points.

Over the years the Bank of Italy's inspections of Monte dei Paschi di Siena examined all the main areas of operation: capital adequacy, liquidity position, financial risks, performance of the Italian government bond portfolio, credit quality, and the adequacy of management and internal control bodies.

[2] https://www.bancaditalia.it/media/approfondimenti/index.html.

Little by little, as the off- and on-site inspections began to pinpoint problems and shortfalls, the Bank of Italy intervened with increasing forcefulness. In November 2011 this culminated in the summoning of the top executives of Monte dei Paschi and its Foundation (the principal shareholder at the time), who were asked to implement rapid and sweeping change, something that came about in the months that followed with the appointment of a new Managing Director and the replacement of the majority of the members of the Board of Directors and Board of Auditors, as well as a major management shake-up.

As is well known, the bank's previous management had failed to transmit to supervisors the information that was vital for a full recognition of the scale and nature of several operations that had been carried out in violation of the law. The Bank of Italy imposed heavy sanctions on those responsible and brought the case to the attention of the judiciary, to which it offered its full cooperation.

All in all, the actions taken enabled anomalous high-risk practices to be identified and brought to an end, impelling Monte dei Paschi di Siena to reinforce its organizational safeguards and controls. The bank continues to be closely monitored nonetheless. The supervisory review and evaluation process (SREP) for 2015 highlighted the persistence of several weaknesses, most importantly the share of non-performing loans. This was partly due to the highly expansionary lending strategy pursued before the crisis, which the bank is now actively addressing. Structural solutions have also been called for, such as mergers with other credit institutions.

In the case of Carige, in recent years the Bank of Italy's supervisory activity focused on the group's weak capital position, which failed to meet the highest standards of Basel III that were about to be introduced, the progressive deterioration in the quality of its loan portfolio, and malfunctions in corporate governance arrangements and controls.

The inspections conducted in 2013 confirmed these weaknesses and brought to light further, more clearly detailed issues, such as the existence of conflicts of interest on the part of the group's top management. They also stressed the need for decisive and timely intervention to make a clean break with the past, enabling a proper rebalancing of corporate governance powers and the adoption of strategic repositioning and capital strengthening plans. Following the inspections, sanctions were applied and the public prosecutor's office informed.

The new top executives appointed at the end of 2013 launched a restructuring plan in line with the requests advanced by the supervisory authorities. Despite the results obtained, the volume of non-performing loans remains substantial and, as for other banks, the unfavourable macroeconomic context continues to pose major challenges to earnings.

Events at the two former *popolari* banks came to the public's attention when there were new reports of inquiries launched by the judiciary, with which the Bank of Italy had been cooperating for some time. In the debate that ensued the Bank of Italy's actions were repeatedly called into question, often based on mistaken premises or fundamental misunderstandings.

In the case of Banca Popolare di Vicenza, most of the criticism was directed at the price of the shares and their funding by the bank.

On the first aspect, it is important to specify that Italy's Civil Code assigns responsibility for setting the price of shares to the general shareholders' meeting, which votes on a proposal by the Board of Directors. The Bank of Italy has no direct power in the determination of share prices, although it is entitled to question the reasonableness of the procedures followed and the objectivity of the criteria adopted to set the price, which it did. Given the exclusive power of the management bodies in this instance, the Bank of Italy could only advance methodological criticisms but not value judgments. The Banca Popolare di Vicenza did too little for too long and its underlying inertia over the corrective action was therefore sanctioned. Only in 2011 did it issue guidelines for fixing the share price, using an external consultancy service to do so. As a result, the price stayed unchanged for several years before being drastically reduced (as had already occurred for the shares of other listed banks) following findings originating from the anomalies that had emerged in trading in own shares.

Regarding this second aspect, in 2013 supervisors intervened on several occasions to remind Banca Popolare di Vicenza of its duty to comply in full with the prudential limits envisaged by law before 2014 and to call to its attention the need to not generate among shareholders expectations of certain and immediate liquidity of their holdings and guaranteed minimum returns.

In the course of 2014 it emerged that the bank was buying its own shares without having first sought the necessary authorization. In accordance with the new European supervisory set-up, the Bank of Italy planned a targeted inspection for early 2015 to verify these operations. The inspection was again conducted, within the single supervisory framework, by Bank of Italy staff. In addition to revealing unauthorized share buy-backs by Popolare di Vicenza, it highlighted a further problem with the funding of the shares issued in recapitalizations: the bank had not deducted from the supervisory capital the funds raised against the substantial loans it had disbursed to subscribers of its shares, as instead required by prudential regulations.

Already after the initial findings of the inspection the bank had been called on to take corrective measures, including a virtually complete change of management. Once the inspection had been completed the bank was ordered to restore capital adequacy buffers to regulatory levels, draw up a new business plan, and strengthen its organization and internal control functions. In accordance with the new business plan, the bank then passed a resolution approving a comprehensive plan to strengthen its capital and radically overhaul its governance, including its transformation into a joint stock company, now completed, a €1.5 billion capital increase, and stock market listing.

In the case of Veneto Banca, an inspection carried out in 2013 found major anomalies of a technical and administrative nature, highlighting the practice of disbursing loans to customers against purchases of the bank’s own shares, which were then not deducted from supervisory capital. We did everything in our power: prohibited the bank from disbursing new loans to corporate executives; called a meeting of the Board of Directors to examine the bank’s overall situation and pass the appropriate resolutions; read out to the meeting of shareholders the official request for action to ensure that it was aware of the bank’s situation and of the measures taken by the Bank of Italy; and imposed fines on the persons responsible.

At the same time, where it was not in our power to intervene directly, we used strong moral suasion, calling on the bank to replace all of its management boards and to plan a merger at the earliest opportunity.

The bank’s response at the time was unsatisfactory. It did not make all the required changes to its governance and continued to engage in conduct contrary to the principles of sound and prudent management, such as granting loans to subscribers of the capital increase made in 2014, which emerged in the course of the follow-up inspection in 2015. Because of the consequent reduction of supervisory capital and further rapid deterioration in the quality of assets, the situation could only be remedied through a €1 billion capital increase, now under way. The Bank of Italy’s supervisory action, ensuring continuity with the past but now endowed with more incisive powers under CRD IV, brought about the replacement of the bank’s president and most of its senior executives and is currently monitoring the implementation of a more radical reform of corporate governance that began with the bank's transformation into a joint stock company and will be completed with its stock market listing.

As regards other banks, delays and resistance on the part of the governing boards have gone hand in hand with a marked worsening of their corporate profiles, particularly their credit risk, and an unwillingness on the part of the market to provide capital support, inevitably resulting in the appointment of a special administrator. This is the case of the four banks placed under resolution in the month of November. Before discussing these banks in greater detail I would like describe briefly the changes that have affected the management of banking crises and determined how these situations are handled.

Changes to the framework for banking crisis management

Before 2015 the Bank of Italy's objectives in handling banking crises were to minimize the impact on customers, the payment system, and the banking system as a whole. In many instances, extremely fragile banks were taken over by healthier ones. When a bank was likely to fail, special administration was set in motion and in the worst cases the bank was wound up.

Special administration can only take place if the legal conditions for it are met; these include serious violations of regulations, serious irregularities of management, and serious capital losses. The definition of serious applies to irregularities and violations of the law which have a wide-ranging impact on the bank's situation (for example, repeated violations of anti-money-laundering legislation, serious and frequent conflicts of interest, and opaque ownership structures), which must cease as soon as possible, and which the bank is unlikely to be able to rectify on its own. Capital losses are considered serious when the regulatory minimum capital adequacy ratios are not observed.

Special administration does not come out of the blue. As a rule, it is preceded by intensive discussions with the Bank of Italy's supervisors, repeated attempts to remedy the situation, and a number of inspections, the last of which usually ascertains that it is no longer possible to restore normal business conditions or comply with capital adequacy ratios. This is what happened in the case of the four banks for which a resolution procedure was activated and for the others that were placed in special administration.

The latter entails the dissolution of the bank's administrative and control bodies and their replacement by one or more administrators and a supervisory board. The administrators act independently of the Bank of Italy, which only authorizes certain decisions of particular importance. The functions of the shareholders' meeting are suspended until the procedure comes to a close.

The administrators are charged with ascertaining the true situation of the bank, eliminating irregularities and establishing the conditions to prevent their recurrence, as well as favouring a solution to the crisis that is in the interest of depositors. The task of ascertaining and eliminating the irregularities may take several months. The longest and most complex phase is generally the search for solutions.

Since 2008 there have been 65 cases of special administration, most of them ending with the bank's return to ordinary operation. In about 20 cases, the outcome was the compulsory administrative liquidation of the bank, which occurred more frequently during the crisis. There were no major implications for customers, however, as the failing banks' exit from the market was managed either by finding other credit institutions interested in an acquisition or by covering the losses with interventions by the Interbank Deposit Protection Fund or the Mutual Bank Deposit Guarantee Fund. This last solution stemmed from the participating banks' desire to avoid further outlays in the event of liquidation (the principle of least cost).

More recently, the economic crisis and the raising of prudential requirements have made it rather impracticable to resort to mergers such as those that had helped in the past to overcome bank difficulties without causing disruption. Moreover, the new European regulatory framework has brought about some radical changes. In particular, the Interbank Deposit Protection Fund's scope for action has been restricted by the European Commission's Directorate-General for Competition, which now considers any intervention by deposit guarantee schemes other than the reimbursement of deposits to be tantamount to state aid, even though it is privately financed and decided independently by the fund's management bodies.[3]

Following a Communication issued in August 2013, the D-G for Competition has made intervention of this type conditional on burden sharing, whereby in the event of a bank's failure the face value of its shares and subordinated bonds must be reduced or the latter converted into equity before any recourse is made to public funds. Burden sharing is not the same as the 'bail-in' principle, which was introduced on 1 January this year with the adoption, in November 2015, of the Bank Recovery and Resolution Directive (BRRD). The bail-in rules provide that,

[3] In March 2015 the D-G for Competition initiated a procedure against Italy under Article 108(2) of the Treaty on the Functioning of the European Union for presumed violation of the regulation on state aid in connection with support measures taken by the Interbank Deposit Protection Fund in favour of Banca Tercas, which allowed the crisis to be overcome without involving savers. After lengthy discussions between the Ministry of Economy and the Commission, during which the Bank of Italy submitted several memos, in December 2015 the Commission decided to bring the procedure to a close with a negative decision, which has been appealed before the European Court of Justice.

before the National Resolution Fund (or, more generally, public funds) can be utilized, the face value not only of shares and subordinated bonds but also of senior claims such as ordinary bonds and deposits of over €100,000 must be reduced. A bail-in respects insolvency rankings: therefore, it is applied first to shares, then to other equity and subordinated instruments, and then to unsecured debts, including ordinary bonds issued by the bank in difficulty. Until the end of 2018, corporate unsecured deposits contribute to the same extent.

The crises at the four banks subject to the resolution procedure

It is in this new context that the crisis of the four banks resolved in November last year was managed. Details of how the four situations unfolded can be found on the Bank of Italy's website, to which I refer you.[4] On this occasion, I will confine my remarks to some of the most widely debated aspects that require clarification.

The Banca delle Marche group had a number of weaknesses, mainly stemming from its governance and control structures and poor credit quality. These problems emerged more clearly from the three inspections conducted in rapid succession in 2010 and 2011. Based on the findings of the inspection at the bank, major corrective measures were called for. When an inspection at another bank brought to light anomalous transactions involving the Managing Director, Banca delle Marche was asked in June 2012 to find a replacement as soon as possible. At that time it was not in the Bank of Italy's power to remove bank executives. A new Managing Director was appointed in September of the same year. Also in view of Banca delle Marche's delay in implementing the corrective measures requested, at the end of 2012 a new inspection was ordered to assess whether Banca delle Marche had allocated sufficient provisions for credit risk. The bank's efforts to remedy the shortfall were found to be highly unsatisfactory and in March 2013 the inspection was extended to other risk profiles; it was brought to a close in September 2013. The findings were of such gravity that the bank was placed first under provisional management and then on 15 October 2013 into special administration.

Inspections at the Carife group focused primarily on the level of risk of its credit portfolio and on its capital adequacy. On more than one occasion the Bank of Italy's supervisory arm reiterated the need for a reorganization of the group and a strengthening of its

[4] http://www.bancaditalia.it/media/approfondimenti/2015/info-soluzione-crisi/index.html.

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control functions. Carife's liquidity profile was also closely monitored and the strains were only overcome through the issue of government-guaranteed bonds. Owing to the delays in making the corrections requested, at the end of 2012 a full-scope inspection of the group was set in motion. Owing to the extremely serious nature of the situation that emerged – there was no possibility of the group restoring the necessary economic and financial equilibrium on its own in the short run – a special administrator was appointed in May 2013.

In 2010 and 2012 two inspections of the Cassa di Rispamio di Chieti group found problems of disorderly growth, irregularities, and poor management. The Bank of Italy ordered the subsidiary's merger into the parent group and the removal of the Chief Executive Office, who also held the position of Managing Director of the Cassa di Risparmio di Chieti. The supervisory action was then stepped up and the bank was invited on several occasions to take strong measures to put the problems to rights. The feedback from the executives of Carichieti indicated that they were largely unaware of the problems. It was therefore decided in 2014 to conduct another inspection. This not only found a significant deterioration in the bank's profitability and capital base but also revealed extremely serious irregularities and regulatory violations, such as the persistent obscuring of information from supervisors, serious administrative anomalies, lack of independence from the controlling bank Foundation as regards decision-making processes, and negligent management of relations with associated parties. Accordingly, on 5 September 2014 Carichieti was put into special administration.

Following a series of delays in responding to the Bank of Italy's requests, an inspection of Banca Etruria was launched towards the end of 2012. Initially, its purpose was to verify the adequacy of the bank's credit risk provisions but in March 2013 it was extended into a full-scope inspection. It ended in September 2013 having ascertained that the management boards were unable to restore the bank to health and that there had been a considerable deterioration in claims. The capital adequacy ratio was above the regulatory minimum thanks to the €100 million increase made in August 2013. Hence, Banca Etruria was asked to take resolute steps to remedy the problems, including the appointment of temporary management and above all a merger with another bank of suitable standing. The Board of Directors, of which half of the members, the Chairman and Deputy Chairman had been replaced, failed to appoint temporary management and, citing the need to safeguard its local roots and ensure the bank's independence, refused to entertain the only official offer of a merger made of its own volition by Banca Popolare di Vicenza. The Bank of Italy increased meetings with senior management, calling attention to the fact that the group would have difficulty in the future ensuring compliance with capital adequacy requirements. As no solution was found, a new inspection was conducted in November 2014, which identified serious capital losses and serious irregularities. On 10 February 2015 the bank was put into special administration.

As a result of the various inspections carried out at the four banks, fines were levied on the executives totalling more than €11 million. All the inspection reports were forwarded without delay to the judicial authorities.

The administrators appointed for the four banks spent considerable time seeking market solutions, contacting a number of banking groups and other intermediaries. However, owing to the lack of interest in banks burdened with a large volume of non-performing loans and a very low capital base, it proved impossible to find a solution involving mergers or acquisitions. At this point the Interbank Deposit Protection Fund signalled its willingness to take part in recapitalizations conducted by other banks.

However, the European Commission's position – which, as I mentioned earlier, likens the intervention of the Fund to state aid – made it impossible to take up the offer. In fact, because of the Commission's own rules, this interpretation would require burden sharing to be activated first, that is the conversion of subordinated bonds or annulment of their value, something not envisaged in Italian legislation until the implementation of the BRRD in mid-November 2015.

It should be noted that had this step been taken without the approval of the European Commission, trusting in a favourable decision by the Court of Justice, under accounting rules it would have entailed allocations to provisions for the same amount as the intervention in order to cover the consequent risk of legal action, completely cancelling its effect. The banks willing to underwrite capital increases would never have participated owing to the uncertainty and legal risks involved. Nor would the ECB, as competent authority, have authorized the operations without the agreement of the European Commission.

The Commission, which has direct contact with the Italian Government and not with the supervisory authority, set out its position on several occasions in the course of the technical discussions but only formally notified the Italian Government on 19 November 2015. According to this position, intervention by the Interbank Deposit Protection Fund to prevent a 'resolution' procedure under the BRRD was effectively limited to voluntary intervention by the banks belonging to the Fund using resources other than the mandatory funds deposited with it. However, the banking system was unable to organize such intervention in the short time available, owing to the precarious liquidity situation of the failing banks. Moreover, the imminent entry into force, in January 2016, of the bail-in scheme would have extended the annulment of the value of customers' holdings to ordinary bonds and unprotected deposits before the National Resolution Fund could intervene.

The deterioration in the technical situation of the four banks had reached the point of no return. It was no longer possible to delay taking measures to overcome the crisis. Accordingly, the resolution programme had to begin immediately once the new rules introduced by national legislation transposing the BRRD had been put in place.

Under this programme, four new entities were created and the business activities were transferred to them to ensure the continuity of essential services, thus allowing them to continue banking activities in their geographical areas and to preserve the goodwill value of the old banks. A vehicle company was then created and the bad debts were transferred to it with the aim of maximizing their recovery value in the medium term.

The resolution costs were mostly borne by the Italian banking system through the Resolution Fund and by shareholders and subordinated bond holders. Their sacrifice was proportionate to the valuation of their assets. The start of the resolution procedure requires, in fact, an independent assessor to furnish the Resolution Authority with the elements to ascertain if action is necessary and decide on the most appropriate measures to adopt. For reasons of urgency, a provisional evaluation can be made, which must be followed as soon as possible by an independent final evaluation.

With reference to the four banks under resolution, once the reasons of urgency had been confirmed, in its provisional assessment the Bank of Italy had to take into account the communications to Government offices from the European Commission which, interpreting EU law on state aid, indicated that the 'real economic value' of the divestment of the bad debts was 25 per cent of the nominal value for the portion backed by mortgages and 8.4 per cent for the unsecured part (with a weighted average of 17.6 per cent). These divestment values were checked in the final valuations made by the independent experts last Friday. The value of the transfer of the four banks' bad debt was determined to be 31 per cent on average for the portion backed by mortgages and 7.3 per cent for the unsecured portion (with a weighted average of 22.3 per cent).[5]

[5] Other 'risky positions' were discovered in the loan portfolios requiring further asset write-downs; the resulting greater capital requirement cancelled the savings made from the lower percentages of the write-downs of the bad debts in relation to the provisional evaluation.

In relation to the disposal of the four bridge banks, in order to maximize the sales price, last January the Bank of Italy, in its capacity as national resolution authority, launched a transparent and competitive selection process to identify potential buyers capable of ensuring the operational and financial continuity of the four banks and the rapid conclusion of the purchase.

Several expressions of interest were received from banks and investment funds, located both in Italy and abroad. The next stage of the tender will begin soon and potential buyers will be invited to present their binding offers for the purchase of one or more bridge banks or of all four banks en bloc.

The operation will be evaluated by the ECB as regards the eligibility of potential buyers to acquire large shares in banks.

Considerations on the BRRD

I have recently emphasized the importance of reconsidering the adequacy of the new legislative framework for managing banking crises. Just as the crisis has impaired the quality of bank credit, the legislative response on crisis management has engendered uncertainty about investing in bank liabilities. An instrument devised to reduce the impact of a crisis must not create the premises to make one more likely: if this is the case, it must be rethought. We must strike the right balance: indeed, investors who have been hit will find no comfort in the fact that they have been protected as taxpayers.

Our negotiating approach, repeatedly taken on official occasions, was different: the bail-in tool should have had a contractual nature, with no retroactive effects on previously issued debt securities, and it should have been phased in gradually. In March 2013, during the BRRD negotiations at the EU Council of Ministers, the Bank of Italy and the Ministry of Economy and Finance presented a technical ‘non-paper’ to all the delegations in order to illustrate the reasons for our preference for contractual (or targeted) bail-ins, applied only to newly-issued securities containing a specific clause in the contract recognizing the power of the authorities to write down or convert the securities if the conditions for starting a resolution procedure were met. We were – and remain – convinced that this approach would have given the authorities a credible tool to be used to resolve a bank crisis effectively, with no undesired effects on financial stability and at no extra cost to the taxpayer.

According, instead, to the approach that prevailed, a wide range of liabilities are subject to bail-ins, with very few exceptions. This approach can be a source of risk for financial stability. We should not rule out the possibility of temporary public support in the event of systemic bank crises, when the use of a bail-in is not sufficient to achieve the resolution objectives but instead risks compromising financial stability.

The specific nature of the banking sector and the requirements of financial stability should also be treated in a more structured way in the European Commission's approach to competition and state aid. Adopted in 2013 – and based on the unfortunately premature conviction that the difficulties of euro-area banks had by then been dealt with – this approach greatly limits government intervention to support banks that are fundamentally viable in order to remedy market failures that are not originated by prudential shortcomings. In fact, according to the BRRD, any public intervention that counts as state aid (and is not among the few exceptions allowed by the directive) automatically triggers the resolution procedure. This, in turn, determines an overlap and, as a result, the prevalence of competition and state aid policy objectives over the objective of safeguarding financial stability. It does not take sufficient account of the fact that financial stability, in particular that of the banking system, is of vital importance to the real economy.

The need to assess the degree of flexibility of the BRRD during the review of the directive scheduled to take place by June 2018 was recalled by the IMF in its Global Financial Stability Report published a few days ago. It highlighted the necessity of applying the new rules (including those on state aid) with flexibility and caution during the changeover to the new regime, when public intervention is no longer admissible but the banks have not yet put in place sufficient buffers to absorb losses without undesired effects on systemic stability.

Even in the case of public intervention in the management of bank crises, a company's value must be preserved as far as possible, enabling the transfer of assets to other intermediaries. Destruction of value clashes with the principles of the BRRD, increases the losses for bank's creditors, and expands recourse to public resources. To ensure clarity and legal certainty for investors and to encourage the development of the market for bank funding instruments, the order in which creditors get paid in bankruptcy proceedings should be standardized at the European level.

Lastly, the third pillar of the banking union must be completed: a fully mutualized deposit insurance scheme at the European level supported by a public backstop, again Europe-wide, to prevent any negative effects on financial stability when the resources of the Single Resolution Fund and the Single Deposit Insurance Fund are not sufficient.

The outlook

Only a stable banking system can meet the objective, in a lasting and effective manner, of funding households and businesses at a reasonable cost. Today the rules that safeguard stability require more capital, more liquidity, and less leverage; all of this implies fewer revenue opportunities, a pressing need to keep costs down, and the necessity of adopting new technologies more widely.

In the aftermath of the crisis, Italy's banking system faces three main areas of weakness: a high share of non-performing loans, low profitability, and the need to adjust its business model to the new technological and market environment. The three areas are closely interlinked. The reform of Italy's banking system, already approved last year, aims to raise the quality of corporate governance, strengthen banks' capacity to raise capital on the market, and to facilitate the disposal of non-performing loans. The reforms also provide an opportunity to encourage bank mergers, allowing risks to be diversified, costs and revenues to be shared, and conflicts of interest to be addressed, including by improving governance arrangements – all in line with the recommendations of the IMF.

As regards non-performing loans, we may have reached a turning point. The cyclical recovery is in fact gradually easing the pressure on banks' balance sheets. Loan loss provisions in 2015 fell to 65 per cent of banks' operating income, from about 100 per cent in 2014. In the fourth quarter of 2015 the loan default rate (3.3 per cent) fell to its lowest level since the end of 2008. In the same quarter the ratio of gross non-performing loans to total loans stabilized at around 18 per cent. The coverage ratio for non-performing loans (provisions to total non-performing exposures), which has steadily improved in the last three years, now stands at 45.4 per cent, in line with the average for the main European banks. It is also noteworthy that at the end of last year, against €210 billion of gross bad debts (which net of write-downs amounted to €87 billion), the banks held real estate collateral worth about €85 billion and further personal guarantees for almost €40 billion. The consolidation of the recovery is the sine qua non for the continued reduction in the stock of non-performing exposures.

The reduction of non-performing loans must be managed without undermining the results achieved as regards capital adequacy. The bad bank solution adopted in numerous European countries prior to the adoption of the new framework on state aid did not prove practicable in Italy. Reducing the stock of NPLs would therefore only be possible by selling bad debts on the market. The Italian State Guarantee Scheme (GACS) defined by the Government following extensive talks with the European Commission would work in this way.

The supervisory authority encourages banks to reduce their stock of non-performing loans by every means, including divestments on the market. This objective ought to be pursued gradually, as the President of the ECB and the Chair of the Supervisory Board have reiterated on more than one occasion.

In the last few days the private sector has started work on an important initiative, known as the 'Atlante Fund', to provide insurance against systemic risks and facilitate the reduction of the large stock of bad debts. This would mainly be done by ensuring that unfavourable market conditions do not preclude access to the capital market on the part of banks that have already decided on such interventions. Moreover, the fund could purchase securities issued as part of bad debts securitizations, thus reducing their volume without weighing too heavily on banks' balance sheets.

It is expected that the fund will raise resources equal to at least €4 billion from banks, insurance companies, foundations and other institutional investors. It will be managed by a company that is independent from the investors in the fund itself. The operation is currently being evaluated by the ECB. Given that it is an independent initiative of a private nature, it is in line with the European rules on state aid. The Ministry of Economy and Finance has informal contacts with the European Commission to which it has described the project's key characteristics.

For these important projects to be successful additional complementary measures will be required.

In the first place, banks must improve their internal procedures for managing non-performing loans. In many cases, the resources allocated to this have remained virtually unchanged since before the crisis, despite the fact that the share of non-performing loans has tripled. Banks must therefore devote new human and financial resources to optimizing the management of these assets. In the context of European financial supervision, the Bank of

Italy has been working for some time to persuade banks to make significant progress on this front. We have recently started a statistical survey on bad debts, designed to encourage banks to digitalize their records so as to optimize the management of non-performing loans, whether they intend to sell or recover them.

In the second place, progress is still needed to make both judicial and out-of-court recovery proceedings faster and more effective, an area in which Italy is at a particular disadvantage by international standards. I have recently emphasized that if we can cut credit recovery times by two years, we can considerably reduce, even halve, bad debts as a proportion of total loans.

Last August the Government approved a reform package that is providing an important boost to the efficiency of the credit recovery mechanism. But more can be done. There is no real conflict between creditors' and debtors' rights: recovery times in line with international best practices ultimately lead to better conditions for bank customers and an increase in the availability of credit. The Government's announcement of further measures to make the procedure for recovering non-performing loans faster and more effective is a step in this direction.

In 2015 banks' profitability showed signs of improvement: ROE returned to positive territory (about 3 per cent for the system as a whole). Nevertheless, it is still low, including by international standards. The flow of loan losses, while smaller than in the past, continues to erode operating income. Banks' efforts to grow and diversify their sources of revenue and to keep structural costs down must continue and intensify.

An essential contribution must come from the review of banks' traditional business model: that fundamentally based on the presence of large, nationwide branch networks no longer appears sustainable. For traditional services that can be standardized, we must move decisively towards intensive exploitation of technology (for example e-banking and digitalization) and modern-day local branches should focus instead on the provision of corporate finance services for businesses and household savings management.

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Italy's banking system, which is primarily oriented towards traditional intermediation activities, and within which the share of loans to total assets remains particularly high, has been dealt a severe blow by what economists call 'an exogenous shock': the long and profound recession which hit the country's economy after the global financial crisis and, in Europe, the sovereign debt crisis. A crisis that the Italian banks in no way caused but whose impact they inevitably felt.

Despite this and without weighing on the public finances, the system as a whole has withstood both the blow of the crisis and the consequent tightening of international regulation and supervision (capital, liquidity, leverage and crisis management): a tightening initially intended to be gradual and limited, which then became marked and rapid, also due to market pressures.

The high level of non-performing loans continues to represent the main factor of vulnerability for Italian banks. But the many measures to address them – already taken by the Government, Parliament, other authorities, and the banks themselves – have begun to bear fruit. We need to press ahead so that the banking system can return as soon as possible to fully supporting the economic recovery that Italy needs.

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