BANCA D'ITALIA
EUROSISTEMA

Risks and innovation: the supervisory approach of the Bank of Italy

Italian Banking Association
Event on 'Supervision, Risks & Profitability'

Speech by Giuseppe Siani
Head of the Bank of Italy's Directorate General for Financial Supervision and Regulation

Milan, 21 June 2022

Introduction

At this historical juncture, the role of the Italian banking and financial system is a critical one. It is called upon to contribute, together with the resources made available under the National Recovery and Resilience Plan, to the funding of our country's economy and of the green and digital transition. In this new scenario, supervisory action is geared towards monitoring the sound and prudent management of financial intermediaries, identifying potential new risks and, where necessary, stepping in to improve their ability to respond to the changes underway on a global scale, in line with developments at the European and international level.

The Bank of Italy's supervisory arm sets its priorities based on an analysis of current and future risks. It also pursues maximum integration between the different supervisory tasks and full consistency with the rules established under the Single Supervisory Mechanism (SSM), while taking into account the broader portfolios of functions and responsibilities attributed to the Bank of Italy at national level. The following elements will play a key role over the next three years: the changes in the credit risk referring to the entire financial system; the monitoring of technological innovation, together with the assessment of third party providers of critical or important functions; the sustainability of business models, including the market entry phase; and governance arrangements and their implications in terms of facilitating the climate transition.

From an operational standpoint, supervisory activity consists of a circular process, in which the various elements (rules, methodologies, analysis and control activities, and risk identification and monitoring) feed into and complement one another. On the one hand, the rules lay out standards for intermediaries and the methodologies guide the analysis and control activities of the Bank of Italy, as well as those of the SSM. On the other hand, the experience acquired in the analysis of intermediaries' and financial market risks, as well as in carrying out concrete supervisory actions, facilitates the updating over time of methodologies, prudential standards and rules, in cooperation with the other oversight authorities.

Against this background, the size and complexity of intermediaries have always been the focus of the Bank of Italy, not only in terms of implementing prudential regulations and simplifying the framework, but also for the application of methodologies and the resulting supervisory action. The principle of proportionality, however, comes up against a prudential limit deriving from risk analysis outcomes, both at the individual financial intermediary level and in terms of overall systemic stability, in light of the profound changes underway in the financial system.

Risk profiles and supervisory activity in the traditional financial system

The Bank of Italy exercises direct supervision – be it prudential supervision, the prevention of the unwitting involvement of entities in money laundering, or consumer protection – over a large number of intermediaries. These intermediaries display very diverse legal statuses, risk exposure and stances on innovation, requiring dedicated methodologies and approaches, as well as horizontal analyses to detect all possible risk interlinkages.

At the end of 2021, the Italian banking system comprised more than 200 financial intermediaries, a number that has decreased considerably in recent years following M&A operations, in particular because of the reform of the cooperative banking sector. This reform reflects the special characteristics of the cooperative banking sector and has allowed individual cooperative banks (BCCs) to strengthen their internal governance and risk monitoring mechanisms and to increase their capital to the level and at the rate required by the regulations and by market conditions, while retaining their typically cooperative nature.

At the same time, the role and importance of non-bank entities have grown. They numbered more than 600 at the end of 2021. Most of the growth is to be ascribed to the asset management sector, creating an ever more pressing need for a more effective regulatory and oversight framework, at both national and international level.

Alternative investment funds (AIFs) have continued to grow at a fast pace, though the sector is still small, with equity rising from €9 billion to €30 billion from 2015 to 2021 and the number of AIFs more than doubling. The increase was recorded above all in the private equity and private debt segments (i.e. funds that invest in loans and unlisted debt securities). The risks stemming from the activity of Italian AIFs remain limited, thanks to the low leverage used and the measures introduced to address liquidity risk. While still much smaller, the private equity segment is also registering a trend that must be monitored carefully, including through targeted supervisory measures.

The development of the non-bank component of the system is a positive aspect, in line with the legislative measures designed to facilitate the growth of alternative funding channels to the economy that are complementary to the banking channel. Digitalization has certainly played a key role in this, helping to expand the range of products, improving their features by tailoring them to customer needs, and fostering the inclusion of customers that are underserved or excluded by the traditional financial system.

At the same time, the proliferation of small non-bank financial intermediaries has made the financial system more fragmented, with potentially higher idiosyncratic (cyber, governance) and systemic risks. This reinforces the need to monitor the interlinkages between the banking system and financial intermediaries, in the various forms in which they may occur (direct funding, investments, shareholdings and so on). Past experience confirms that possible crisis situations in the non-bank sector can influence the risk profiles of banks and the smooth functioning of the system as a whole.

The Bank of Italy carries out very intense supervisory activity on this broad set of entities, either independently or in cooperation with the international competent authorities, including the SSM. In 2021, about 16,000 supervisory measures were taken, comprising intervention letters, meetings and analyses, and more than 120 on-site inspections were conducted.

Risk monitoring is a continuous process: banks' credit profiles do not currently have negative indicators, especially when compared with the past. In March 2022, the stock of non-performing loans (NPLs) was equal to €82.9 billion in gross terms and €39.8 billion net of loan loss provisions.[1] The share of non-performing loans in total lending (equal to 1.6 per cent, net of loan loss provisions in March 2022) fell below the level observed before the onset of the global financial crisis and is overall in line with the average for the major euro-area countries. The net NPL ratio for significant banks is equal to 1.4 per cent, while it is 3.9 per cent for less significant institutions, pointing to greater difficulties for smaller intermediaries in pursuing effective NPL reduction strategies.

The new non-performing loan rate, which remained low during the pandemic, was only slightly affected by the gradual expiry of debt moratoria: about two thirds of the firms benefiting from them have already resumed full compliance with their commitments. Around 6 per cent of the exposures, for which debt moratoria were granted, have been classified as NPLs. In the remaining cases, there have been delays in payments, which are currently being analysed.

In general, the conditions facing financial intermediaries in this challenging period are more favourable than in the past. Decisive supervisory action vis-à-vis less significant banks has led to an overall improvement for the sector, though critical areas remain. However, the conflict between Russia and Ukraine and the inflationary pressures are a reminder of the need to further reinforce protection against credit, IT and cyber risks, as well as against the consequences of changes in market rates.

Taking into account the current elements of uncertainty, banks must continue to pursue prudent classification and provisioning policies, harnessing the potential of IFRS9, and to carefully consider any dividend distribution policies that might not be fully in line with the objective of sustaining capital levels over time. Greater market volatility and rises in interest rates, which might have a positive impact on profitability, do however increase the exposure to market risks, with potential capital losses in the securities portfolio. Moreover, while the frequency of cyber-attacks has not increased for the time being, also

1 The data include subsidiaries of foreign banks operating in Italy.

thanks to significant investments in IT security, it is necessary to reinforce risk control and mitigation measures, especially regarding plans for business continuity and for restoring critical services.

Over the years, the reduction in NPLs has exceeded the estimates laid out in the reduction strategies presented by the banks themselves – both significant and less significant – and transmitted to the supervisory authorities on a yearly basis.

From 2017 to 2021, gross sales on the part of Italian banks totalled around €200 billion, mainly concentrated in exposures to bad loans. Sales also continued during the pandemic (more than €30 billion in 2020 and €21 billion in 2021). With specific reference to bad loans, most of these took place via securitizations for an overall sum of more than €100 billion in the last five years, increasingly accompanied by the issuance of state-backed guarantees on senior tranches (GACS).

The NPL secondary market has grown significantly, in part thanks to the gradual refining of portfolio assessment techniques and to the introduction of reporting on bad loans promoted by the Bank of Italy, which have helped to reduce the information asymmetries between banks and investors. This has also reflected favourably on sale prices, which have not been affected by the increase in the volume of sales and have risen on average, making it possible to reduce the gap between the more favourable internal recovery rates and those of exposures sold on the secondary market.

The non-banking sector has played a very important role in supporting the reduction of non-performing loans in the banking sector. Nevertheless, NPLs sold by banks are clearly still present in the financial system and thus remain under supervisory scrutiny, thanks also to the gathering of systematic information from servicers and to specific supervisory interventions, with reference to both the recovery phases and the creation of new entities in the asset management sector.

In this field, the objective of supervision is to assess the effectiveness and adequacy of organizational arrangements, also using benchmarking analyses, and to identify possible room for improvement in the current regulatory framework. This is in order to increase the efficiency of the secondary market and help it to function smoothly, so as to promote the overall stability of the system and, at the same time, to safeguard customer protection.

National legislation currently decrees that servicing be limited to banks and financial intermediaries to ensure effective controls on these operations through the direct involvement of supervised specialized entities. Nevertheless, the Bank of Italy's supervisory activity has brought to light practices that are not always in line with the regulations. Specifically, servicing activities are sometimes entrusted to two distinct types of entity: the 'master servicer', a supervised entity only responsible for the guarantee tasks provided for by Law 130/99, which cannot be delegated, and the 'special servicer', an operator tasked with recovery activities that holds a licence according to the public safety laws but is not supervised by the Bank of Italy.

These practices relegate the role of the supervised servicers to a purely formal level, resulting in uncertainty in identifying the scope of responsibilities. With the communication published by the Bank of Italy last November, supervised servicers are therefore invited to place the utmost focus on assessing the consequences that such operational schemes have on their responsibility and risk profiles and, more generally, on the transparency and reliability of the securitization market.

As regards the performance of outstanding securitizations, the analysis underway based on the new reporting evidence appears to show limited problem areas so far; the lags compared with initial business plans are more frequent for less recent operations, which seem to be the result of the initial difficulties encountered by operators in preparing estimates and of the slowdowns in the recoveries observed during the pandemic.

The recent review of the European legislation on the sale and management of loans could contribute further to the harmonization and growth of the secondary NPL market within a defined legislative and supervisory framework; however, there are aspects that require choices at national level that can influence to what extent some assets and some categories of loans sold are regulated.

Technological innovation and finance

Technological innovation has created businesses and services that supplement traditional financial operations and, by blurring the traditional separation of risks, make it more difficult to identify entities effectively exposed to risks and elements of the value chain that need monitoring. In addition, the legislative framework and the relative institutional responsibilities are undergoing profound change and the timeframes for implementation may be long and complex: delicate and detailed negotiations are required to strike a suitable balance between the need, on the one hand, not to hinder ongoing innovations and, on the other, to guarantee adequate safeguards for the stability of the system.

There is broad agreement on the proposals for promoting the harmonization of the regulations, and the Bank of Italy takes an active part by helping to draw up the international legislative framework, drawing on its experience and know-how. The approach usually adopted by regulators and international authorities is one of organizational and technological neutrality, but the strength of this principle will have to be carefully assessed when the rules are being drawn up, given the specificities that often characterize the many technological solutions.

However, supervision cannot always expect to have a complete legislative toolkit available. Market phenomena move swiftly and risks often emerge unexpectedly and abruptly, requiring immediate, anticipatory and sometimes supplementary responses compared with what is being defined in the regulatory debate. The challenge for supervision is more complex than ever nowadays and, for this reason, the relative operational approaches need to be updated.

Particular reference is made to three areas of ongoing supervisory activity: intermediaries, outsourcers and crypto-asset businesses.

As regards the first one, the Bank of Italy's 'FinTech Survey'[2] confirmed that investment in innovation is steadily increasing; traditional entities are implementing new ways of working and partnerships with FinTech companies, also in order to build customer loyalty. At the same time, they are enhancing internal skills, acquiring high value-added expertise. This is why the traditional model seems destined to be flanked by the development of alternatives designed to satisfy customer demand more effectively. The rise of 'challenger' banks and of non-bank intermediaries, which offer a limited range of services but have advanced digital platforms,[3] are a further spur to traditional banks to simplify and 'digitalize' their relations with customers.

The risks depend on how each intermediary intends to place itself in the value chain and on the specific business model it adopts. To this end, we are stepping up the exchange of information with supervised entities in order to have as complete and up-to-date a picture as possible, in order to be able to act promptly. At the same time, we are refining our analysis methodologies and creating new supervisory practices to monitor the risks connected with technology, including a system for reporting serious operational or security incidents.

The Bank of Italy carried out an important in-depth analysis of outsourcing activities in 2021 with the goal of obtaining more granular data to understand the phenomenon, in some ways anticipating the current trends at international level. More than 10,000 contracts and around 3,000 third party providers were surveyed, of which 1,800 relating to critical or important functions.[4]

The Bank of Italy is paying growing attention to IT outsourcing. Between 2020 and 2021, thematic inspections were carried out on some of the main IT third party providers of less significant institutions. These highlighted some areas for improvement including, among other things, the practices and methodologies for monitoring technological risks and IT safeguards, for which outsourcers have planned specific initiatives; the results have been shared with third party providers and banks, which have been called upon to reinforce their monitoring activities.

Further initiatives are underway on this front, also in collaboration with the SSM, in the belief that the focus of supervision needs to shift to where risks are generated rather than to where they appear, an idea in part inspired by the ongoing discussions at the Financial Stability Board.[5]

The Bank of Italy has also conducted an in-depth analysis to identify the distinctive characteristics and risks stemming from the spread of open banking in the Italian market.

---

2 https://www.bancaditalia.it/pubblicazioni/indagine-fintech/2021/2021-FINTECH-INDAGINE.pdf

3 This refers to the example of the 'buy now pay later' scheme, provided on the main e-commerce platforms.

4 The most frequently outsourced functions include administrative and supervisory services (more than 18 per cent of the total), IT systems (around 17 per cent), loan-related activities (around 13 per cent) and customer relations (more than 9 per cent).

5 https://www.fsb.org/wp-content/uploads/P140621.pdf

The results, published in November 2021,[6] show that there is still only limited recourse to this kind of service in terms of customers involved and transactions made (just over than 350,000 payment transactions in six months), although there are quite a few active providers (in the second half of 2020, around 100 operators made at least one call on an open banking interface).

The risks linked to these services are specifically: i) technological, also because of the greater exposure to possible cyber-attacks; ii) linked to customer protection, since the use of exclusively digital channels could limit the effectiveness of the transparency information, especially regarding third party interventions; and iii) potential violations of anti-money laundering rules, which should not be underestimated when adopting these new paradigms. The functioning of the open banking ecosystem is made even more complex by the presence of local providers in other European Union jurisdictions and of big-tech companies. This means it is now possible for customers' data to be memorized outside of Italy and even outside of the European Union.

As far as crypto-assets are concerned, on 15 June, the Bank of Italy published a communication on distributed ledger technologies in finance and crypto-assets, addressed to supervised intermediaries and entities, technology providers, users and all those working in various capacities in decentralized ecosystems.[7] Although the document is not prescriptive, it is designed, in the absence of any mandatory regulatory references, to be a concrete and pragmatic point of reference to guide the conduct of all the players in these digital ecosystems from now on, leveraging on the practical experience gained so far in an area that is still evolving. It is therefore a first important step towards improving supervision in this delicate business sector: the communication aims to draw on rules and practices that are already applicable and can serve as a useful reference, both currently, pending the entry into force of the European legislation under completion (MiCAR), and thereafter, given that the new regulations will not entirely govern all the components involved.

Pending the preparation of the international regulations, the current prudential frameworks already contain principles to which banks and other supervised intermediaries can immediately refer in order to assess and monitor the risks connected to the possible launch of crypto operations. These are the principles that have guided us in the supervision we have carried out over the last few months. Specifically, we have reminded intermediaries of the need to introduce controls and limits in collaborations with third parties, to put in place specific safeguards against the risk of money laundering (which has increased due to the Russia-Ukraine conflict), to carefully assess the reliability of any partners chosen and to improve the management of cyber-security systems.

Furthermore, although there are no specific transparency rules, intermediaries have been urged to focus on the need to properly communicate to customers that crypto-

---

6 https://www.bancaditalia.it/compiti/vigilanza/analisi-sistema/approfondimenti-banche-int/2021-PSD2-Open-Banking.pdf

7 https://www.bancaditalia.it/media/notizia/bank-of-italy-communication-on-distributed-ledger-technologies-in-finance-and-cryptoassets/

assets are not regulated. Lastly, it has again been stressed that it is important to ensure that the internal supervisory functions and decision-making bodies are fully involved before undertaking new activities. This is without prejudice to the fact that there are certain categories of crypto-assets — speculative and highly risky — whose diffusion continues to be strongly discouraged.

Corporate governance arrangements

Governance is always given priority treatment among the Bank of Italy's supervisory activities. The survey conducted in 2020 on corporate governance frameworks involved a select sample of less significant institutions (LSIs), chosen on the basis of a variety of criteria (business model, geographical area, legal form and so on) in order to ensure that they accurately represent the system. The study was then extended to the LSIs of the other Member States, as part of an initiative undertaken with the SSM. The survey focused in particular on the fitness and properness of their boards of directors, the functioning of their corporate bodies and committees, and their risk awareness level. The findings are being used to improve the SREP currently under way and will help calibrate subsequent supervisory actions.

The analyses showed that, on average, there was very little diversification in terms of gender, age and competencies within these boards. Women made up less than 20 per cent on average of the corporate bodies of the banks chosen, and there were very few members under 40 years of age. As for the issue of gender representation, the Bank of Italy recently intervened, modifying the national regulations in November to require that at least 33 per cent of the members of the bodies exercising strategic supervision and control functions be of the less represented gender. We will focus our attention on this question during our upcoming supervisory assessments.

As for the directors' individual competencies, the survey indicates that there is a severe under-representation of risk management and IT experts, considering the digital transformation projects in progress. In some cases, the survey uncovered poor communication within the boards of the directors, and positions of authority of some of the members not duly counterbalanced by the other members, in particular the non-executive directors. Greater attention is also paid to business-related issues, rather than those regarding risk. Inefficiencies in the reporting process of the internal control functions also threaten to undermine the timeliness of board action.

There is also a great deal of attention to this area in the non-bank sector, where governance carries greater weight than the traditional capital adequacy profiles do. We are also updating the supervisory methodologies with additional analyses linked, for example, to remuneration systems, to the outsourcing of internal control systems and to relationships with depository banks.

The Bank of Italy, along with the supervisory authorities at global level, is encouraging intermediaries to hasten the adoption of management and organizational tools suitable to protect against ESG risks. Indeed, it is crucial that bank and non-bank intermediaries incorporate ESG risks into their business strategy, governance, approach to risk and disclosures to the market. The Bank of Italy recently published its supervisory expectations for climate-related and environmental risks, targeted at bank and financial intermediaries; soon an initial dialogue will be opened with the intermediaries on their level of compliance with supervisory expectations and on the plans for conforming to them.

It is important that intermediaries, thanks to suitable internal safeguards, be able to help firms engaged in the transition process by providing new financing and appropriate advisory services. Equally important is the ability to adequately communicate how climate-related and environmental risks have been incorporated into their strategic and operational business models, avoiding unfair practices (e.g. greenwashing) that, on the contrary, could discourage the development of sustainable finance and undermine their own reputation.

Conclusions

The financial system is undergoing significant changes stemming from technological development, shifting customer preferences, and heightened uncertainty regarding the economy and the markets at global level. Intermediaries are reviewing their business strategies with the involvement of external partners as well, adapting their internal processes, and streamlining their distribution networks in order to withstand the competitive pressure exerted by non-financial operators that offer high-tech and value-added services.

This evolution renders traditional prudential supervisory activity more complex due to the number and the nature of the entities operating in the financial system and owing to the high degree of interdependence and interconnection between sectors, including unregulated ones. It has never been so essential as in these stages of profound change to ensure that there is an effective dialogue with the market to understand and, if possible, anticipate developments in FinTech.

Similarly, the regulatory framework has undergone modifications that have sparked debate about firmly established paradigms intended to favour a system of rules based on the legal nature of the intermediaries. The changes being made will help provide a clearer and more stable framework.

However, supervision must be able to react quickly to changes that are already occurring and that have an impact on intermediaries' risk profiles. It is therefore necessary to adapt the supervisory tools that, by integrating the specialized skills and resources in different sectors, improve the monitoring of risks and make it possible to choose the most appropriate regulatory and supervisory responses.

At the same time, there has been an increasing need to strengthen horizontal analysis, which weakens the rationale of entity-based supervision, in favour of a function-based approach. In this regard, collaboration and dialogue with the authorities of other countries have intensified in an attempt to detect signs of significant risk, to influence the international debate and to find agreement on measures and approaches regarding cross-sector phenomena.

In this highly complex environment, suitable governance arrangements are crucial for supporting intermediaries in effectively addressing the multiple challenges they face. In carrying out its supervisory duties, the Bank of Italy is contributing to the transformation process taking place in order to ensure intermediaries' sound and prudent management and to safeguard financial stability overall.

Designed by the Printing and Publishing Division of the Bank of Italy