Ministero
dell'Economia
e delle Finanze

ITALIAN BANKING SECTOR: RECENT DEVELOPMENTS AND REFORMS

Contents

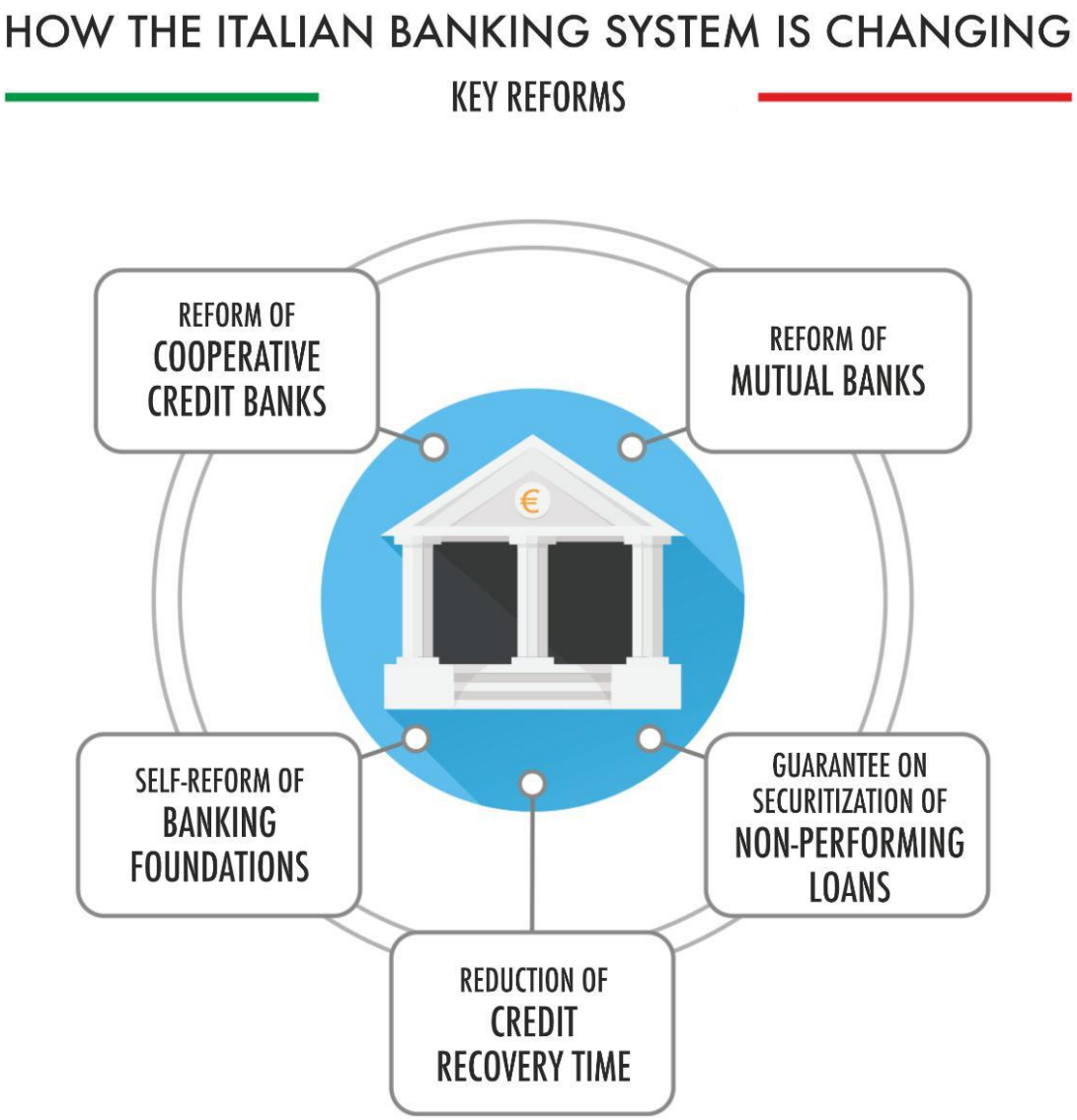
Italian banking system

Notwithstanding the lengthy recession, **the Italian banking system is solid and has demonstrated a good capacity of resilience**; it has managed to resist difficulties and to adapt to changes. In any event, the continuation of the severe economic and financial crisis through 2014 (which prompted an almost 10-percent decline of GDP and a 25-percent decrease in industrial production) had the effect of increasing the balance of the non-performing loans on bank balance sheets to a level above the average reported in other developed economies. The aggregate balance of non-performing loans should nonetheless be viewed in light of the rates of debtor-collateral coverage, which are much higher in Italy than in other countries.

An international comparison provides a proper representation of the state of health of Italian banks. From this perspective, Italy's banks are in an advantageous position vis-à-vis the banks of **other Euro Area countries,** which, for example, **are highly exposed to the emerging markets** that are currently facing economic difficulties. The comparison between Italian banks and the banks of other European countries also shows the latter's significantly higher exposure to the financial derivatives that were responsible for the outbreak of the financial crisis between 2007 and 2008. In comparison with their European peers, **Italian banks are less exposed to the real estate sector,** which also triggered a crisis, including in certain European economies. The Italian credit system is therefore solid as a whole, even though it is challenged by a high level of non-performing loans **concentrated within certain banks**.

Despite the solidity of the banking sector as a whole, the Italian government has demonstrated an awareness, since its investiture, of several historical limits of the

credit system: the excessive fragmentation of supply, the very limited availability of other types of financing as an alternative to bank credit, and the disproportionately long times for recovering doubtful credits. Radical changes to the banking sector were inaugurated in 2015: the reform of the mutual banks; the self-reform of the banking foundations supported by the government; the reform of the cooperative credit banks (CCB); the introduction of the Guarantee on Securitisation of Non-Performing Loans (GACS); and the acceleration of the timing for credit recovery.



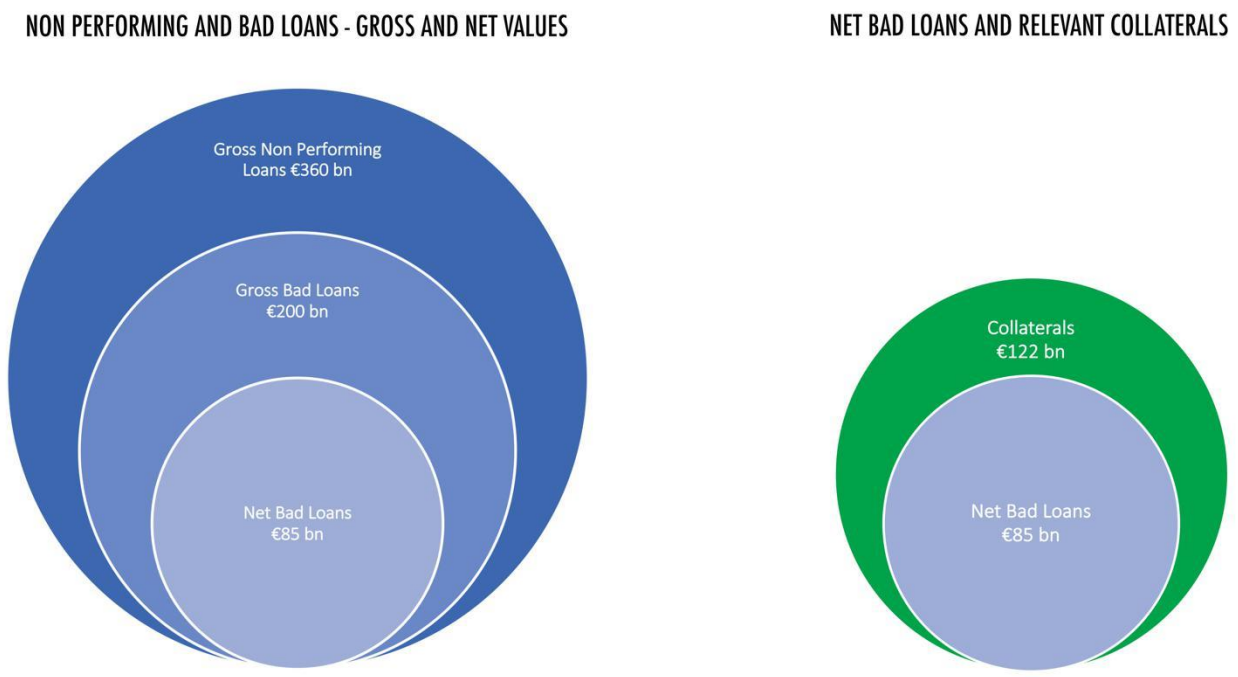
These measures have transformed and significantly reinforced the sector. The government has intervened with a strategy based on three fundamental aspects:

- **Consolidation of the banking sector**, through the **reform of the largest mutual banks**, the reform of the **banking foundations**, and the reform of the **cooperative credit banks**. The largest, strongest and most transparent banks will sustain the recovery, supply the best services to households and businesses, and manage the doubtful credits with greater efficiency.
- **Reduction of the timing for credit recovery**, which has historically been longer in Italy than elsewhere. The implementation of the **online civil court proceedings** and the "business courts" is producing important results; in 2015, an initial revision of insolvency proceedings was introduced, and other measures in this direction have been launched, pending more broad-based reform of bankruptcy law. These measures reduce credit-recovery costs and improve the potential price of the doubtful credits in the event of a sale.
- **"Finance for Growth" package,** a series of measures that the government has implemented in order to "open up" financing channels as alternatives to banks. Securitisation companies, credit funds, and insurance companies may now all grant credit to businesses. The Italian insurance regulatory authority ("IVASS") and the Bank of Italy have issued the guidelines for implementing the regulations that are allowing new players to enter the credit market. EU-based investors no longer pay withholding tax on medium-/long-term financing.

Actual weight of non-performing loans

The overall outlook for the non-performing loans (NPLs) of banks is improving. Bank of Italy data as of 31 May 2016 show that:

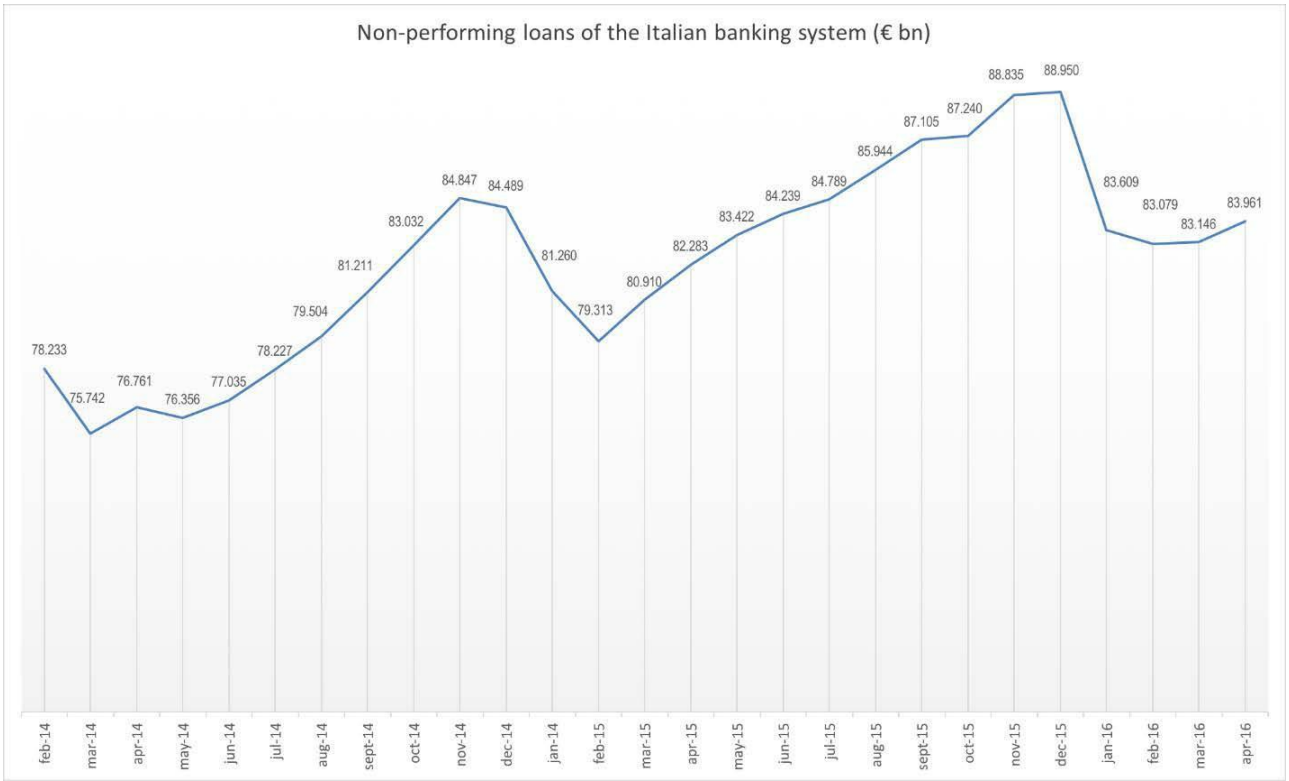
- The total NPLs before provisions (gross NPLs) amount to €**360 billion**: in the fourth quarter of 2015, gross NPLs decreased in absolute value for **the first time since 2008** and the ratio of gross doubtful loans to total loans stabilised.
- The total gross NPLs can be subdivided into i) **probable default** or past-due or overdue exposure (categories for which the return to "performing" status is possible), which amount to €160 billion, and ii) non-performing or **"bad" loans** (those with insolvent counterparties), which amount to €**200 billion;** both totals are gross values, and thus **they do not reflect the actual weight of these positions on bank balance sheets**.
- The weight of non-performing loans on bank balance sheets does not correspond to the nominal value of the loans because the banks have already written down the amounts of the loans or taken provisions against losses in their financial statements; the **net bad loans** thus amount to €**85 billion**, or a decrease of €2 billion compared with 31 December 2015.
- The €85 billion of net bad loans are backed by **guarantees and collateral amounting to €122 billion**.



(Source: Bank of Italy, Supplement to the Money and Banks Bulletin- July 2016, data as of 31/05/2016)

The rates of recovery of non-performing loans actually observed, including during recent years, are in line with the valuations used in bank financial statements.

The economic recovery registered as from 2015 is surely one of the factors that has favoured the decrease of the non-performing loans. According to the Italian Banking Association-Cerved outlook of May 2016, the total of the non-performing loans in 2017 should get close to the pre-crisis levels, hitting nonetheless the lowest point since 2009.



(Source: Italian Banking Association Monthly Report – April 2016)

Non-performing loans (€ bn)

	Gross exposure	Net exposure
Total NPLs including bad loans	360	197
Bad loans	200	85

(Source: Bank of Italy, Supplement to the Money and Banks Bulletin-July 2016, data as of 31/05/2016)

Net bad loans and collateral (€ bn)

	Net exposure	Collateral
Bad loans	85	122

(Source: Bank of Italy, Supplement to the Money and Banks Bulletin-July 2016, data as of 31/05/2016)

Reform of the mutual banks and the CCB

In tackling the problems linked to the governance and structure of the banking system, the government has legislated a series of measures inclusive of the reform of the mutual banks and the reform of the CCB. The **reform of the mutual banks** is paving the way to a more modern financial system in Italy, and is doing so through various modifications of the Consolidated Act of Banking and Credit Laws (Legislative Decree No. 385 of 1 September 1993). The reform, which has been welcomed by the ECB, involves the legal form and the governance of the institutions, and introduces **size limits** for the adoption of the form of mutual bank, with those mutual banks holding assets of more than €8 billion required to be transformed into joint-stock companies. The reform also provides for: i) the **regulation of the extraordinary corporate actions (transformations and mergers)** with the aim of introducing uniform rules for mutual banks, eliminating the majorities provided for such events that were provided by company statutes; ii) the introduction of the possibility of issuing financial instruments with specific capital and voting rights; iii) the easing of the restrictions on the appointment of corporate governance bodies, with the vesting of **greater powers with the shareholders meeting**; and iv) the introduction of per capita voting limits, making it possible for the articles of incorporation to attribute more than one vote to shareholders who are legal persons. The same decree-law also outlines **important changes for the smaller mutual banks**, so as to provide incentives for shareholder participation and to make these banks more attractive to institutional investors.

The **reform of the cooperative credit banks** is part of the package of measures introduced by Decree-law No. 18 of 14 February 2016, "Urgent measures concerning the reform of the cooperative credit banks, the guarantee on securitisation of the non-

performing loans, taxation treatment in relation to insolvency proceedings, and collective funds management".

The reform of the cooperative credit banks (CCB) allows for reducing the fragmentation of the sector, and for moving beyond the structural weaknesses resulting from the business model (heavily exposed to the trend of the economy in the core market of reference), organisational structures, and the small size of the individual banks.

The **guidelines for the reform of cooperative credit** may be summarised as follows:

a) confirmation of the role of the CCB as cooperative banks serving local communities;
b) better quality of governance and simplification of the internal organisation;
c) more efficient allocation of resources within the system;
d) the timely procurement of investor funds in the event of pressures on capital, including through the access of capital outside of the cooperative bank sphere;
e) the unity of the system for enhancing competitiveness and stability over the medium/long term.

Self-reform of the banking foundations

The protocol of intent signed on 22 April 2015 by the Minister of the Economy and Finance, **Pier Carlo Padoan**, and by the Chairman of the Association of Foundations and Savings Banks ("ACRI"), **Giuseppe Guzzetti**, is the start of the self-reform of the banking foundations. The protocol provides for diversification of investment among its key principles: **a foundation may not concentrate more than 33 percent of its capital in a single entity**. The protocol also restricts the foundations' reliance on borrowing, except in the event of temporary, limited needs for liquidity; the use of derivatives is not allowed unless for hedging purposes or in transactions in which there is no risk of capital loss. With the protocol, the foundations are committed to ensuring **transparency in their activity,** with the publication on their respective web sites of financial statements, information on contracts, formal procedures for making grants, procedures through which financial support can be requested, and criteria for selection of their initiatives.

This self-reform definitively severs ties between local political forces and management of institutions, which, in some cases, prevented the proper management of the institutions in the past.

More rapid credit recovery

The timing for recovery of credits in dispute is longer in Italy than in other countries. The gap between Italy's performance and the best practices has nonetheless been closing in recent years as a consequence of two changes:

- the online civil court proceedings, which have decreased the average time for a lower civil court decision to 367 days;
- the business court, namely, the creation of special tribunals for business disputes, with 80 percent of the case load being managed within one year.

In the past two years, the aforementioned changes have been rounded out by other measures.

The Decree-Law No. 59/2016 (*Urgent provisions on the subject of executive proceedings and insolvency proceedings, as well as in favour of investors in banks in liquidation*) converted by Parliament into Law No. 119 of 30 June 2016, contains important **measures for simplifying compliance formalities and streamlining credit-recovery procedures**. The legislation introduces a series of measures to support businesses and to accelerate credit recovery; the measures will make the proceedings certain and rapid, including through the use of information and communications technologies.

The application of IT tools will make a key contribution through:

- the creation of a digital register of the property repossession proceedings, insolvency proceedings and crisis management instruments; the register is considered essential to the development of a market for doubtful credits;

- the access, on the part of bodies handling insolvency proceedings, to information contained in the database;
- the acceleration of insolvency proceedings, with more digital processes used: i) at the outset of the formation of creditor committees; ii) during the hearings for ascertaining the liabilities of the bankrupt party; and iii) during the hearing of the creditors in the event of an agreement prior to bankruptcy.

The so-called **"Marciano Pact"** instead provides for the out-of-court assignment of real property used to collateralise financing to a business owner: when the financing is made available, the parties may sign a contract for the sale of an asset as a guarantee of the repayment of the financing. The asset used as the collateral cannot be the business owner's residence, nor the residence of the business owner's spouse. In the event of debtor default, the bank becomes the owner of the asset through very streamlined proceedings, without the need for going through the courts system. The question, however, is when the debtor goes into default. This default condition is met when the non-payment extends beyond nine months from the due date of at least three monthly instalments, even if not consecutive, or of a single instalment in the event in which the instalments are made with a longer-than-monthly frequency. Should the debtor, as of the due date of the first of the unpaid instalments, already have repaid at least 85 percent of the principal amount of the financing, the default period that triggers the transfer of the real property to the creditor is extended to 12 months. The value of the real property collateral is to be estimated by an appraiser, and, in the event in which such value exceeds the residual amount of the debt, the difference must be paid to the property owner. This provision thus allows for executing financing contracts with the option of the creditor to take possession of the collateral in approximately 12 months versus the estimated 40-month period required for appropriating real-property collateral through judicial proceedings.

The introduction of the Marciano Pact into the Italian legal system has radically changed the prospects for future credit recovery, with timing that is reduced to around one year. In addition, it will result in banks being able to work off past disputed credits, with the aggregate value of new disputed credits falling significantly and thus having a smaller impact on banks' current operations.

The measures outlined above are rounded out by those included in last summer's Decree-Law No. 83/2015 **which contains provisions aimed at tackling the issue of credit tightening**. The main changes introduced by this decree address: credit access for troubled companies; the opening to competition in pre-bankruptcy agreements with creditors; debt restructuring; the position of the bankruptcy trustee; acceleration of sale transactions; and amendment of the regulations governing the deductibility of credit losses.

Another measure aimed at facilitating the recovery of non-performing loans addresses **concessions made with reference to the sales of real property at auction**. The registration tax to be paid on such sales has been significantly reduced to a fixed amount of €200. The reduced taxation is available on the condition that the real property is resold within a subsequent two-year period, except in cases **in which the real property becomes the primary dwelling of the buyer.**

All of these measures are part of **a carefully planned reform that will have positive repercussions on the real economy** since the banks, which will be able to get their credit paid out with less difficulty, will have more balance-sheet leeway for providing new loans to businesses. At the same time, it becomes easier for businesses to obtain financing from credit institutions, which can count on simplified and streamlined proceedings to recover the sums disbursed in the event of default in the payment of instalments.

Guarantee on Securitisation of Non-Performing Loans (GACS)

A key aspect of this overall framework is the **Guarantee on Securitisation of Non-Performing Loans (GACS)**, an instrument that the Treasury has made available to banks and financial companies so as to facilitate the dismantling of non-performing bank loans. This is a guarantee that the Treasury provides to requesting intermediaries.

The State guarantees only the senior tranches of securitisations, namely, the more secure tranches that support the least likely losses from less-than-expected credit recovery. The higher risk tranches will not be repaid until the senior tranches guaranteed by the State have been repaid in full. The guarantee is priced at market, as also recognised by the European Commission, which has agreed on the fact that the **programme does not contemplate State aid** that would distort competition.

Atlante Fund

The changes taking place within the Italian banking system also embrace an **alternative investment fund** known as **Atlante Fund**. This is a private-sector initiative set up by an independent funds management company that sources capital from financial institutions (banks, insurance companies and foundations that invest on a voluntary basis).

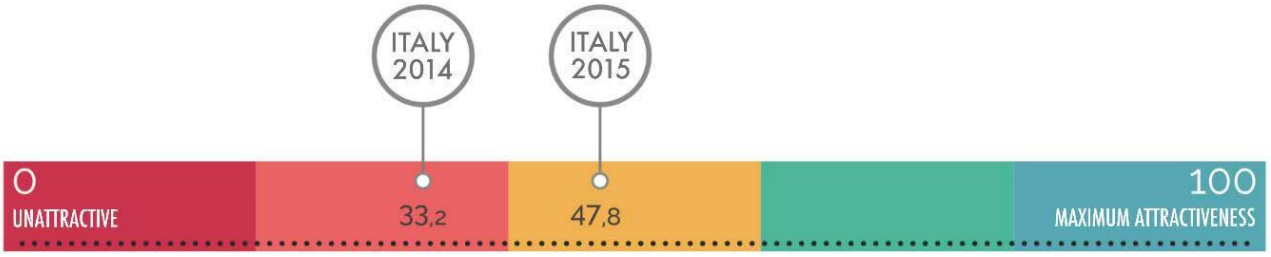
The fund's purposes are:

1. to ensure the success of the capital increases required by the regulatory authority of banks that are currently facing objective market difficulties, acting as a back-stop facility;
2. to contribute to the start-up of a market for non-performing bank loans: the amount of non-performing loans that could be taken off bank balance sheets is by far greater than those acquired by the fund, since Atlante is concentrating its investment on the junior tranches of securitisation vehicles, leveraging the more senior credit for which there is already investor interest;
3. to offer investors attractive returns over the medium/long term and benefits to the banking system that will be reflected on the nation's economy in terms of stability and growth prospects.

Changes in the banking system make Italy more attractive

The reforms affecting the Italian banking sector will also help to make Italy more attractive. In this regard, the Italian Association of Foreign Banks ("AIBE") has published a study that reports the **2016 Index, a summary index of Italy's attractiveness, had risen to 47.8 in 2015 from 33.2 in 2014** (0 = minimum attractiveness and 100 = maximum attractiveness). The change thus reflects an improvement of more than 14 points.

The index is computed based on data gathered in late 2015 and early 2016 by CENSIS (in collaboration with AIBE) from a sizeable and authoritative group consisting of multinational corporate managers, institutional investors operating in Italy, law offices that support investment initiatives, and qualified members of the foreign press. **Some 72 percent of the respondents indicated that Italy had become more attractive** than it was six months prior to the survey, and only 3 percent perceived a deterioration. **The perception of the Italian banking system is also positive, with 78.9 percent of the respondents indicating the system appears solid.**



Comparison with the international banking system

ITALIAN BANKING SECTOR: THE LIGHT SIDE OF THE FORCE

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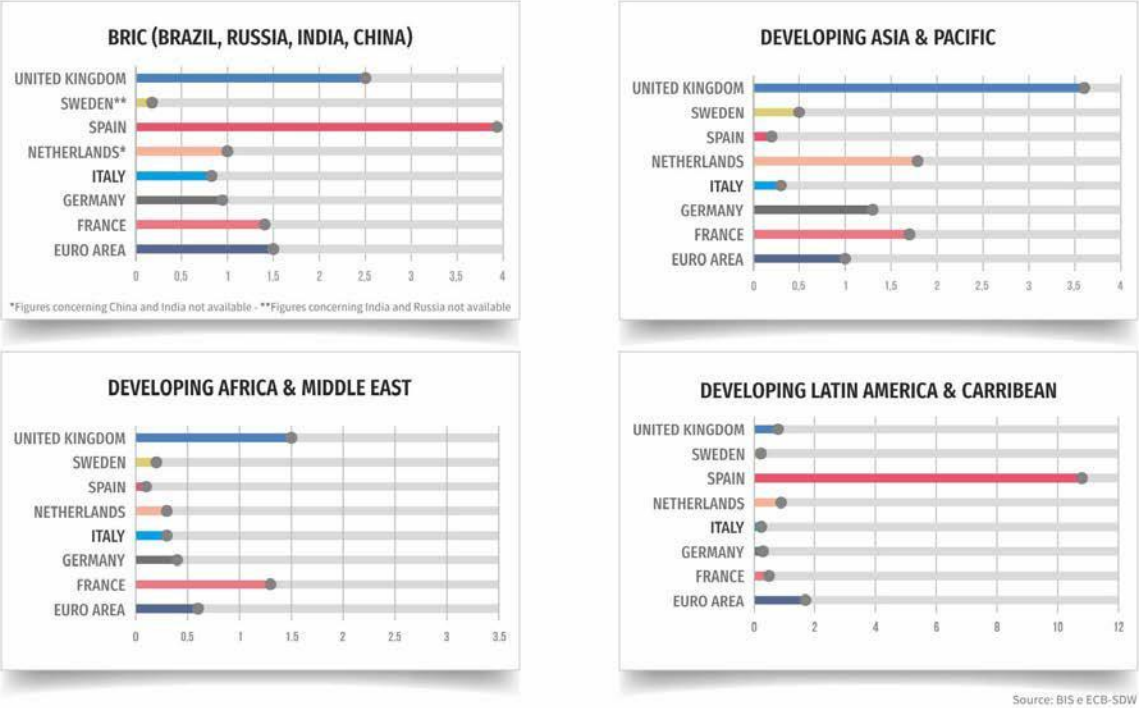
A COMPARED ANALISYS OF RISK EXPOSURE

EXPOSURES OF MAIN EUROPEAN BANKING SYSTEMS TO EMERGING ECONOMIES

As of June 2015 and as a percentage of banking systems assets



Source: BIS e ECB-SDW

The Italian banking system is significantly less exposed than other European countries to **emerging markets**, considering the incidence of the exposure either on GDP or on total assets of the banking system. Emerging economies are noticeably suffering in the current economic juncture: the fall in oil and other commodity prices is compounded by a steep deceleration of growth in some major economies, mainly China, weighed down by huge excess capacity. Against this backdrop, the limited exposure of the Italian banking system to emerging markets, even though it acted as a brake on Italy's recovery when emerging countries were sustaining global growth, might turn out to be a resilience factor.

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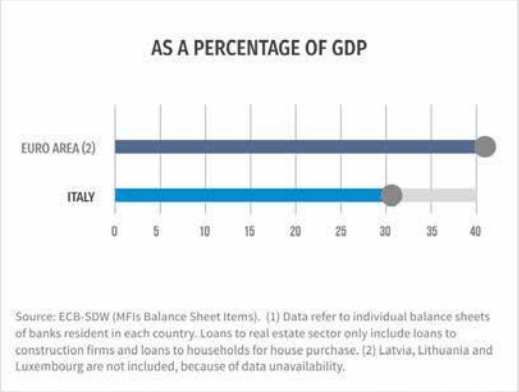
A COMPARED ANALISYS OF RISK EXPOSURE

BANK LOANS TO REAL ESTATE SECTOR AS OF JUNE 2015 (1)

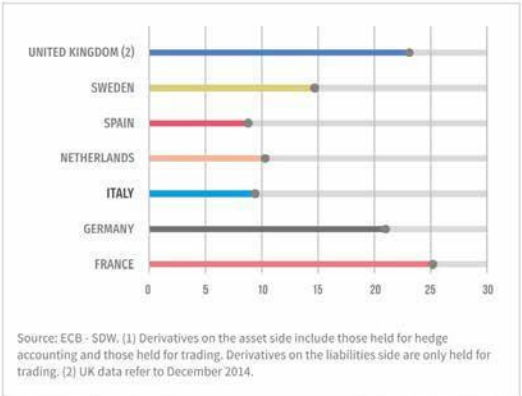


Source: ECB-SDW (MFIs Balance Sheet Items). (1) Data refer to individual balance sheets of banks resident in each country. Loans to real estate sector only include loans to construction firms and loans to households for house purchase. (2) Latvia, Lithuania and Luxembourg are not included, because of data unavailability.

The Italian banking system has limited exposure to the **real estate sector**, which may be characterised by high volatility and which in the past was associated with serious risks to financial stability: considering the loans granted to real estate developers and mortgage loans granted to families for home purchases, the size of the exposure of the Italian banks as a percentage of GDP is considerably lower than the average of the euro area countries.

EXPOSURE IN DERIVATIVES OF THE MAIN EUROPEAN BANKING SYSTEMS (1)

June 2015 as a percentage of total assets



Source: ECB - SDW. (1) Derivatives on the asset side include those held for hedge accounting and those held for trading. Derivatives on the liabilities side are only held for trading. (2) UK data refer to December 2014.

Italian banks' exposure in **financial derivatives** is relatively low compared to the other euro area countries; while this, to a certain extent, reflects a lower need to hedge against interest rates and exchange rates risks, the limited exposure to derivatives is definitely among the resilience factors of the domestic banking system, especially in the current scenario characterized by highly volatile financial markets and growing liquidity risks.

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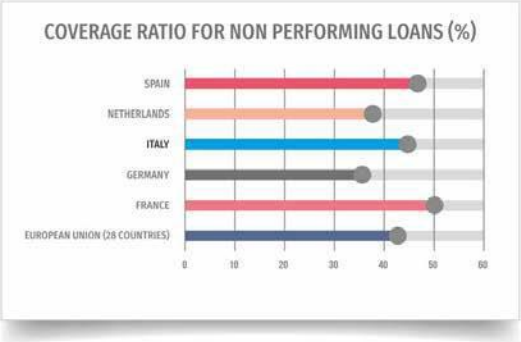
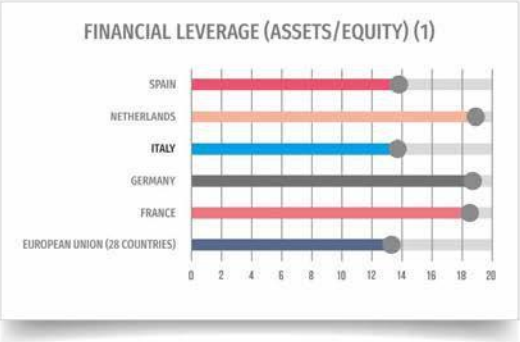
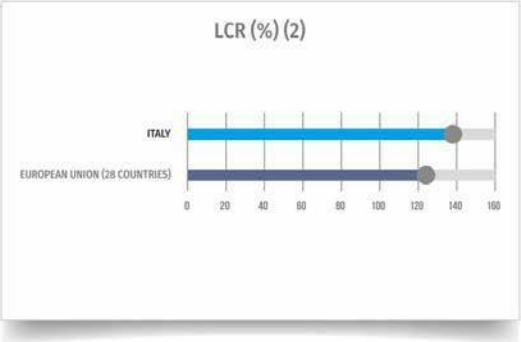
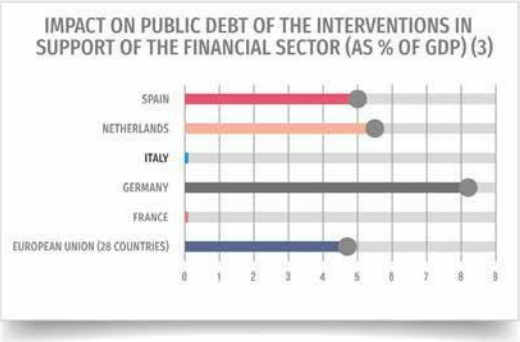
A COMPARED ANALISYS OF RISK EXPOSURE

BANKING SYSTEMS' SOUNDNESS, LIQUIDITY INDICATORS, AND PUBLIC SUPPORT TO THE FINANCIAL SECTOR AS OF JUNE 2015









Sources: Banca d'Italia, ECB - SDW, BIS. (1) Differently than leverage ratio, for this indicator a lower level indicates a higher level of capital. (2) Liquidity indicators are as of 31.12.2014. For Italy the indicators refer to 30 groups of the BIS Quantitative Impact Study sample, while the sample of comparison is made of 39 large European banks. (3) Data as of end 2014.

Italian banks have higher impaired loan **coverage ratios** than the European average. The impaired loan coverage ratio measures a bank's ability to absorb potential losses from its non-performing loans, via specific credit risk adjustments of total gross impaired loans. A higher coverage ratio is associated with a more cautious approach of the bank, which reduces its exposure to credit risk, recording credit losses in its balance sheet. Conversely, a low coverage ratio increases potential risks.

Italian banks show **limited financial leverage**, measured by the ratio of assets to equity. The smaller the degree of a bank's financial leverage, the greater its reliance on its own capital to finance its activities: other things being equal, this is usually associated with a lower risk profile.

To promote the short-term resilience of the liquidity risk profile of banks, while ensuring that banks have an adequate stock of liquid assets that can be easily and immediately converted into cash to deal with an adverse liquidity stress scenario, the Basel Committee's has developed the **Liquidity Coverage Ratio** (LCR). The LCR is defined as the ratio of the stock of high-quality liquid assets (HQLA) – i.e. cash or assets that can be easily and immediately converted into cash with little or no loss of value – to the total net cash outflows (expected cash outflows net of the expected cash outflows over the next 30 days) in an adverse liquidity stress scenario – deposit runoff, increased market volatility etc. Gradually , from the point of view of the supervisory authorities, the standard shall require that the value of the ratio shall be no lower than 100%.

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