Ministero dell'Economia e delle Finanze

The outlook for the Italian banking system

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BBA International Banking Conference

London, 20 October 2016

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After eight years into the global financial crisis, the international banking system is better capitalized, less leveraged and more resilient. The outlook for financial stability has improved, although as the IMF recently argued in its Global Financial Stability Report, "financial institutions in advanced economies face a number of cyclical and structural challenges and need to adapt to low growth and low interest rates, as well as to an evolving market and regulatory environment."

The resilience of the banking system has benefited from reforms agreed in recent years both at the international and European level. The revision of the Basel regulatory framework has significantly increased the shock-absorbing capacity of financial institutions, raising quantity and quality of capital and introducing sounder rules for risk management. The introduction of the new framework is nearing completion, with the planned phasing in of the TLAC, the NSFR and the leverage ratio, as well as the refinements being developed by the Basel Committee. With respect to the latter, let me emphasize that the approach of supervisors can be broadly shared, provided that it is in line with the G20 indication of avoiding significant increases in capital requirements.

In my view, once these regulatory changes are completed, a period of regulatory stability will be necessary in order for policymakers and regulators to assess the effects of new regulations on credit extension and financial stability. In fact, the FSB has already started such exercise, which of course yielded only preliminary results and will have to be developed further as the regulatory environment stabilizes. Discussions about further reforms or refinements can be fruitful, but we should not rush into new regulatory straitjackets until we have a better understanding of how banking systems, the global economy and markets are adapting to Basel III and, in Europe, to the 'single rulebook' (CRR, CRD IV and BRRD).

At the European level, the Banking Union has further strengthened and harmonized the European banking system through the establishment of the Single Supervisory Mechanism and the Single Resolution Mechanism. However, in order to reap the benefits of the Banking Union we must complete this important project, which means putting in place a common backstop and a European deposit insurance scheme. Only with a complete Banking Union will European financial stability genuinely improve.

Regulatory stability at international level and completion of Europe's Banking Union are crucial if the global banking system is to support the economic recovery – especially in Europe, where – despite the progress being pursued and made with the Capital Markets Union – credit extension depends in large measure on banks. Credit institutions need a stable framework to respond to the structural issues recently highlighted by ECB President Mario Draghi, namely poor asset quality, shrinking margins, overcapacity and technological innovation. Let me also stress that these challenges can be thoroughly addressed only if we succeed in enhancing global and EU economic recovery in a sustainable way.

In the remainder of my speech, leaving aside technological innovation, I would like to illustrate how these issues have been tackled in Italy in the last two years, a period characterized by an unprecedented reform effort aimed at making the banking system more efficient and resilient.

Unlike most other Euro area countries, in the past eight years the Italian banking system has weathered a sovereign crisis as well as a long and severe recession without significant government aid. Systemically-relevant financial institutions, now supervised by the ECB, recently showed their resilience vis-à-vis the adverse scenario of the EBA stress test. Monte dei Paschi di Siena is the only exception, even if I would emphasize that this Bank is still under a restructuring plan (linked to the State aid received in 2012 and completely reimbursed in 2015), which imposes stringent constraints on the management. A market-based recapitalization plan for MPS is in the making and will be implemented in the coming months.

Despite the progress made, the Italian system is still characterized by fragmentation, high operating costs and an oversized branch network. The share of NPLs is among the highest in Europe. This is thoroughly understandable considering the prolonged weakness of the Italian economy, which has picked up pace only in the recent period.

Against this background, the government has implemented a series of reforms and promoted market solutions to recapitalize the weaker banks and help them offload NPLs. We feel this will put the system on a much safer course and provide the necessary support to the economic recovery.

In the last two years, the government introduced radical changes in the governance of Italian banks in order to increase their market accountability and make them more resilient and efficient. These reforms concern in particular banking foundations, mutual banks ('Popolari') and cooperative banks ('Banche di credito cooperativo').

Moreover, in order to facilitate the securitization of NPLs, the government introduced a Guarantee on Securitization of Non-Performing Loans (GACS) and pushed through parliament enhanced procedures for credit recovery. These measures have transformed and significantly strengthened the sector in three key aspects:

- consolidation of the banking sector;

- reduction in credit recovery times;
- development of an NPL secondary market.

In addition the government's "Finance for Growth" initiative has introduced a series of measures to "open up" alternative non-bank financing channels, in particular for Italian small and medium firms.

The reform of '*Popolari*' introduces size limits for the status of mutual bank. Credit institutions with balance sheet size in excess of €8 billion must be transformed into joint-stock companies by December 2016. This means simpler and more transparent governance and provides a stimulus to consolidation of this segment of the banking industry. In response to the new rules, two large mutual banks, *Banco Popolare* and *Banca Popolare di Milano*, have just approved their merger, that will take place by year-end and will create the third largest Italian banking group.

At the beginning of this year the government tabled new legislation reforming cooperative banks. These banks are now required to either:

- set up a cooperative banking group, under the umbrella of a holding company which is a joint stock company; given the high minimum capital requirements laid down by the law for the holding company, the creation of one or two groups at most is expected;,
- or, if they are large enough, convert into a limited liability company.

The new framework will reduce fragmentation, exploit economies of scale and enhance capital market access. Moreover, once mutual banks are brought under one umbrella, they will become more resilient and less exposed to idiosyncratic factors (regional, local and sectoral).

The MoU signed with the Association of Foundations and Saving banks (ACRI) sets diversification of investment among its key principles. A foundation may no longer be able to concentrate more than 33% of its capital in a single entity.

As I mentioned before, in the last year the Government acted on another key aspect, which concerns the timing for the recovery of credits. These reforms, together with the ones relating to NPL, have been positively appraised by the ECB and the IMF.

Insolvency procedures and credit recovery have traditionally been very lengthy processes in Italy. In 2015-2016 the Italian government implemented several enhancements that bring our system closer to European standards:

- streamlined insolvency and recovery procedures , with the goal of halving average credit-recovery time;
- new possibilities for out-of-court enforcement of collateral;
- online data registers and civil court proceedings.

The Parliament passed a government-sponsored bill that introduces the ‘Marciano Pact’ which provides for out-of-court settlements for business loans, where the arbitrator can assign assets that were posted as collateral. The creditor will take possession of the collateral in approximately 12 months versus the estimated 40-month period required for seizing collateral through judicial proceedings.

The average NPL ratio for Italian banks remains high. As of August, bad loans (‘sofferenze’) were equivalent to 18.1 percent of total loans. However, net of provisions and adjustments, the stock of bad loans falls from €200.1 billion to €84.5 billion[1], covered by guarantees for a larger amount of €120 billion. Moreover, thanks to the recovery in the economy, the rate of entry into non-performance has fallen and the NPL ratio has stabilized. Considering the main sectors of the economy, the NPL ratio is falling in manufacturing and trade, whereas it is still rising in construction.

Incentives for developing a secondary market for NPLs come from the State Guarantee Scheme for non-performing loans (GACS). A further contribution has come from market-driven initiatives, such as the Atlante fund.

The Guarantee on Securitization of non-performing Loans (GACS) is the instrument that the Treasury has made available to banks and financial companies so as to facilitate the reduction of non-performing bank loans stock. The State guarantees the senior tranches of securitizations. The guarantee is granted at market prices and therefore is not considered state aid by the European Commission.

Atlante is a private-sector initiative set up by an independent funds management company which raised capital from banks, insurance companies and foundations that invest on a voluntary basis.

The fund's purposes are:

- to take part in **capital increases** of banks, acting as a back-stop facility;
- to contribute to the start-up of a **market for non-performing bank loans,** investing in junior tranches of NPL securitizations;
- **to offer investors attractive returns** over the medium/long term.

The Atlante Fund has already invested in Banca Popolare di Vicenza and in Veneto Banca, two distressed banks in need of recapitalization. The Atlante-2 Fund was recently set up with the goal of investing in NPL securitizations.

This year the Italian banks, together with their European peers, have come under heavy scrutiny in the financial markets. Overall, I believe that thanks to the reforms that I have just described and to an ongoing recapitalization effort, our banking system is sound and on the way to a sustained recovery.

That said, there is still plenty of work to do.

First, we need to fully implement the reforms and regulatory changes that have been adopted. I am confident that this will happen swiftly. I believe it is highly simplistic to link, as many observers and investors are doing in these days, the completion of reform initiatives to the outcome of the Constitutional referendum that is scheduled for December 4. Important as the latter may be, economic and banking-sector reforms will continue regardless of short-term political developments.

Secondly, Italian banks that need to increase their capital buffers and to offload non-performing loans should and will do so -- under the supervision of the ECB and of the Bank of Italy as their respective regulators. Again, this will happen regardless of the referendum outcome. The regulatory framework to implement GACS has been finalized and sizable transactions are now in the pipeline.

The first transaction based on GACS was carried out by *Popolare di Bari* bank in August with a guaranteed senior tranche of €126.5million of NPLs. *Carige* bank is currently structuring a new operation under GACS.

Third, like their European peers, Italian banks must improve their profitability, which requires not only adapting business models to new economic realities and evolving technology, but also greater flexibility in human resources management. The 2017 Draft Budgetary Plan includes measures to facilitate banks in the reduction of labor costs and the rationalization of their branch networks.

Last but not least, we also need a stronger and broader economic recovery. In turn, this calls for new policy initiatives both at the national and European level. At the Italian level, the past two years have witnessed a broad and intense economic reform effort and significant reductions in tax rates, even as we gradually reduced the budget deficit. The 2017 Budget, builds on, and expands, this approach. We need to provide an additional stimulus to aggregate demand, and in particular to capital accumulation.

The Budget envisages additional private-sector investment incentives and a boost to public investment, which so far has recovered only modestly following cumulative cuts of more than one percent of GDP in the 2010-2014 period. Increased investment in infrastructure, anti-seismic and energy-efficient public and residential buildings will not only improve the quality of life, but also promote a recovery of the construction industry, the hardest-hit sector of our economy during the recession. Banks will benefit too, given that construction is the sector with the highest share of NPLs over total loans.

At the Euro area level, the ultra-accommodative policy of the ECB is highly supportive. But we need to combine it with renewed fiscal stimulus and determination in continuing the reform efforts. The overall fiscal stance of the area is too tight given still-high unemployment rates and the slow pace of the recovery in output. Italy is not advocating a reversal of fiscal discipline. But we believe that these difficult times require new approaches in order to achieve a more growth-friendly fiscal stance, invest in modern infrastructure and sustainable development, leveraging ultra-low bond yields and, finally, deploy fiscal stimulus in countries where it is most needed. All this, I think, will also strengthen our banking system and pave the way for consolidating financial stability on a durable basis.