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Statement at the End of the IMF Financial Sector Assessment Program (FSAP) Mission to Italy

An International Monetary Fund (IMF) mission, headed by Dimitri Demekas, visited Italy during January 14-31 and March 12-26, 2013, to conduct an assessment under the IMF's Financial Sector Assessment Program (FSAP). The mission held meetings with Bank of Italy (BI) Governor Ignazio Visco, the Director General of the Department of the Treasury at the Ministry of Economy and Finance Vincenzo La Via, the Chairman of the securities supervision authority (Consob) Giuseppe Vegas, BI Director General and President of the Insurance Supervisory Authority (IVASS) Fabrizio Saccomanni, other officials from BI, Consob, IVASS, and the Ministry of Economy and Finance, and private sector representatives.

The Italian financial system has shown remarkable resilience in the face of a severe and prolonged recession at home and a major crisis in Europe. The system has so far managed to overcome these shocks and indeed increase domestic deposits and raise additional capital. In contrast to other countries, capital adequacy was accomplished with modest state support. Impact estimates suggest that the phasing-in of Basel III requirements will leave the banking system as a whole with a comfortable capital cushion. The expansion of European Central Bank's liquidity facilities have also blunted the impact of the sovereign debt crisis on banks and temporarily shielded Italian banks from market funding volatility. Progress toward a banking union will reinforce this trend.

But while stabilized, the Italian financial system is not immune from risks: continuing weakness in the real economy and the link between the financial sector and the sovereign remain key risks. The recession is reflected in low bank profitability and deteriorating loan quality. The coverage of non-performing loans by provisions and collateral has declined, although international comparisons can be misleading as loan classification rules are more conservative in Italy than elsewhere. The near-term economic outlook will continue to weigh on profitability, but a program of targeted on-site inspections by the Bank of Italy aims at reversing the downward trend of provision coverage. Banks with large holdings of sovereign securities remain exposed to losses and higher funding costs if sovereign yields rise substantially. Insurance companies also have large sovereign bond holdings, but are benefiting from higher profitability on these assets, given the level of their guaranteed returns. While Italian sovereign yields have declined from their peaks, the crisis in Europe has not ended.

Preliminary stress test results suggest that the Italian banking system as a whole should be able to withstand both a scenario of concentrated shocks and one of protracted slow growth, thanks to the banks' strong capital position and ECB liquidity support. At present, the Italian banking system as a whole appears well capitalized. The substantial capital buffers over regulatory minima built in recent years would offset most of the losses generated by an adverse macroeconomic scenario, even taking into account the phase-in of Basel III requirements. Under such scenarios, however, the system would find its buffers depleted. In addition, market liquidity shocks can be absorbed by the substantial amounts of available collateral.

Targeted financial sector actions would further shore up the defenses of Italian banks. Restoring economic growth through the pursuit of macroeconomic stability, prudent public finances, and growth-enhancing structural reforms remains the most important precondition for financial stability. But important contributions can be made by targeted financial sector action aimed at increasing provisions, improving bank efficiency and profitability, developing a market to dispose of impaired assets, and strengthening capital and funding plans, where needed. Some of these steps have already been initiated by BI.

Foundations have played an important role as stable long-term bank shareholders, but their systemic presence and peculiar governance structure warrant closer oversight. This can be partly achieved by tightening banking regulations in a few areas. But the current legal framework should also be revised to require greater transparency, better corporate governance, and sound financial management, and encourage further diversification.

The strong financial sector oversight in Italy is a critical pillar of financial stability. Compliance with international standards for banking and securities supervision is high—indeed approaching global "best practice" in several areas. Existing regulations on fit-and-proper rules for directors and shareholders should be strengthened, and the regulator should have the authority to impose fines not only on individuals but also on legal entities and dismiss individual bank board members and managers. Ongoing changes in the supervisory architecture will allow to increase the effectiveness of insurance supervision.

Italy has an effective framework for crisis management and bank resolution. Certain aspects, however, should be enhanced to allow greater flexibility, including by aligning promptly the Italian resolution toolkit with the forthcoming reforms at the European level.