EXECUTIVE BOARD MEETING

SM/20/56
Correction 1

March 13, 2020

To:	Members of the Executive Board
From:	The Secretary
Subject:	**Italy—Financial System Stability Assessment**

Board Action:	The attached corrections to SM/20/56 (2/28/20) have been provided by the staff:
Evident Ambiguity	**Pages 7 (third para., lines 1 and 6), 15, 19**
Factual Errors Not Affecting the Presentation of Staff's Analysis or Views	**Pages 7 (second para., line 10), 8, 10, 12 (Figure 3), 16, 20, 37, 62**
Typographical Errors	**Page 12 (second para.)**
Questions:	Ms. Khamis, MCM (ext. 36702) Mr. Ferreira, MCM (ext. 38860)

EXECUTIVE SUMMARY

Recent prudential measures have played a key role in bolstering the financial system. Regulation has been substantially enhanced by the implementation of European Union (EU) regulations and supervision by the creation of the Single Supervisory Mechanism (SSM). The Italian supervisory agencies have experienced staff, supported by advanced information systems and broadly sound supervisory processes. The Italian authorities have implemented measures that improved governance, facilitated capitalization, raised prudential requirements, and improved asset quality. Along with the economic recovery in 2014–2018, these measures have helped banks make substantial progress in tackling legacy NPLs and improving solvency ratios.

Nonetheless, the banking sector is still vulnerable. Italian banks are the largest users of the ECB's TLTRO, which provides substantial support to banks' liquidity and profitability. Many banks still suffer from low capital levels, low profitability, and weak asset quality. The average capital ratio of Italian banks remains below the euro area and NPL ratios are still among the highest in the EU. The FSAP estimates additional loan loss provisions needs of about €5 billion based on recovery rates of internal workouts, mostly related to loans identified as unlikely to pay, and an additional €7.2 billion for banks to meet the NPL reduction targets agreed with supervisors (through market sales). In addition, some banks' high structural operating costs and corporate governance weaknesses continue to weigh on profitability, which will be further impacted by additional regulatory requirements, including ~~the full implementation of International Financial Reporting Standard 9 (IFRS 9) and~~ the Minimum Requirement for Own Funds and Eligible Liabilities (MREL) required for the larger banks. Italian banks' exposure to the sovereign increases the potential impact of downside shocks, including through the risk of a substantial economic contraction and rising credit spreads, which would have strong negative repercussions for banks.

Solvency stress tests indicate that banks still face important challenges. Based on end-2018 data, ~~F~~for nine larger banks (significant institutions or SIs), the average common equity tier 1 (CET1) ratio declines by 370 bps to 8.2 percent in the adverse scenario. While the resulting capital shortfall against the capital thresholds is small (0.2 percent of GDP), capital needs to bring back the CET1 ratio of the nine SIs back to the starting level of 12 percent is about 2.2 percent of the GDP. For the smaller banks (less significant institutions or LSIs), using Q3 2018 data, sensitivity analysis using single-factor shocks indicates important vulnerabilities. An increase in yields similar to the one observed in 2011 would cause the capital of almost a quarter of the sample of LSIs by assets to fall below the 7 percent CET1 ratio threshold. Under an NPL shock, 35 percent of the LSI sample's assets would see their CET1 ratio fall below 7 percent. Liquidity stress tests suggest relatively comfortable positions, albeit boosted by the significant use of TLTRO and with a high concentration of liquid assets in Italian government securities, increasing vulnerability to sovereign risk.

Against this background, the authorities should adopt measures to further improve banks' capital levels and operational efficiency. The authorities should be guided by the results of the stress tests and a thorough review of banks' business models and governance for additional supervisory action. In tackling weak banks, the efforts of the Italian authorities have focused on market solutions. Escalation of corrective measure has generally taken time as consideration has been given to systemic implications and contagion risk. Going forward, with the bolstering of the banking system in recent years, consideration should be given to more timely escalation of corrective measures for weak banks to effect improvement (e.g., in capital levels, operational efficiency, governance) or achieve consolidation or orderly winddowns when needed so that weaknesses do not persist or even become exacerbated if not dealt with in a timely manner.

Banks have made remarkable progress in reducing NPL ratios, but more effort is needed. The BdI could consider extending the SSM's approach that sets expectations for the gradual path to full provisioning of the existing NPL stock to LSIs with high NPLs. The authorities should continue to scrutinize banks' credit risk and loan loss provisioning practices and challenge the progress and extent of banks' NPL reduction plans. Special attention should be given to "unlikely to pay" (UTP) credits given the potential for under-estimation of risks. The recent reforms to the insolvency regime to strengthen NPL resolution requires further adjustments and a considerable implementation effort. Greater legal certainty and increased flexibility of the out-of-court foreclosure mechanism and enhancing the recently created online platform for the advertisement of judicial auctions would be useful to this end. Enhancing the effectiveness of the judicial system is necessary, including by ensuring that courts have enough resources and expertise.

The authorities should consider using prudential policies to moderate the sovereign-bank nexus, with gradual phasing-in to minimize potential disruptions to markets. Also, the authorities should establish a national macroprudential policy authority and enhance the macroprudential tool kit. Some aspects of the supervisory agencies' regulatory powers should be upgraded. Also, more effort is needed to address banks' governance weaknesses by quickly adopting the amendments to the fit and proper rules for banks' management.

Reinforcing the bank crisis management framework is a priority. The authorities have enhanced the early intervention framework; aligned legislation underpinning the two deposit guarantee schemes (DGSs) with EU standards; introduced a new resolution regime; and intervened various weak banks—albeit with part of the costs absorbed by taxpayers and the banking sector at large. Further enhancements remain important: (i) a formal crisis management committee, including all safety net participants, is warranted to periodically review preparedness efforts and coordinate policy responses at times of stress; (ii) additional loss absorbing capacity—notably for LSIs for which a resolution strategy is foreseen; (iii) the use of public funds in resolution should be strictly limited to exceptional events that could undermine system-wide financial stability; (iv) DGSs' funding targets should be assessed to ensure their adequacy, stronger backstops should be established, and active bankers should be removed from their boards; (v) when dealing with distressed banks, preventive measures outside of resolution or liquidation (i.e., "open bank assistance") should only be used in exceptional cases with strong prospects for successful rehabilitation and restoring long-term viability; and (vi) a review of certain aspects of the policy framework for emergency liquidity assistance (ELA), in conjunction with the Eurosystem, is advisable. Enhancements of the EU's crisis management framework, including the potential introduction of an orderly liquidation regime for non-systemic banks and pared-back procedures for state aid oversight under certain conditions, would further facilitate resolution and liquidation.

BACKGROUND

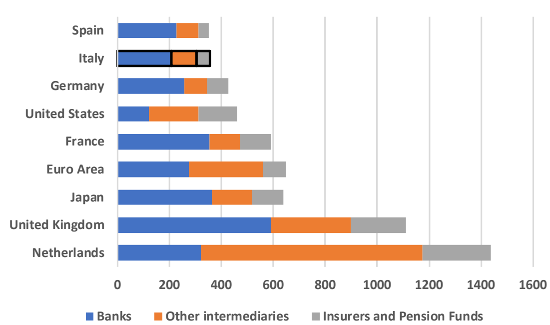
A. Financial System Structure

1. Banks continue to dominate the Italian financial system despite the significant growth of insurance firms and investment funds in recent years. While the banking sector has consolidated in recent years, the number of small mutual, cooperative, and regional banks remains relatively high. In January 2019, about 2~~40~~27 of the 2~~80~~66 mutual banks were merged into two new banking groups, which have been classified as SIs; the remaining mutual banks will enter into an institutional protection scheme (IPS). These consolidations reduced the number of banks in the financial system to about ~~170~~ 156 (as of June 2019). The insurance sector is the fourth largest in Europe and the eighth largest in the world by premium income. The industry has consolidated significantly in the past decade through mergers and takeovers, reducing the number of insurers from 162 in 2007 to 100 as of June 2018. While relatively small, the share of assets of investment funds and other financial intermediaries in the financial system has grown since 2011 from 15 percent to 18 percent (Figures 1–3).

Figure 1. Italy: Financial System Structure

The Italian financial system is large by global standards, but smaller than the euro area average.

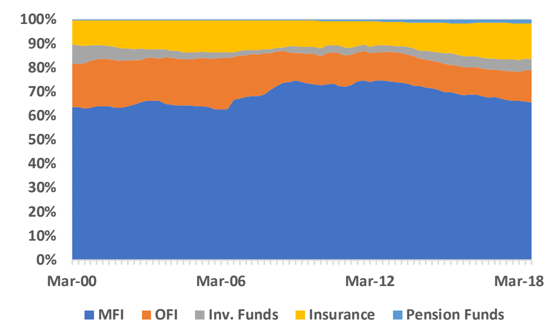
Total assets of financial institutions
(in percentage of GDP, Dec. 2017)



Source: Financial Stability Board and IMF staff calculation.

Banks continue to dominate the system despite the recent growth of other financial institutions.

Total financial assets of intermediaries
(in percentage of total financial assets of the system)

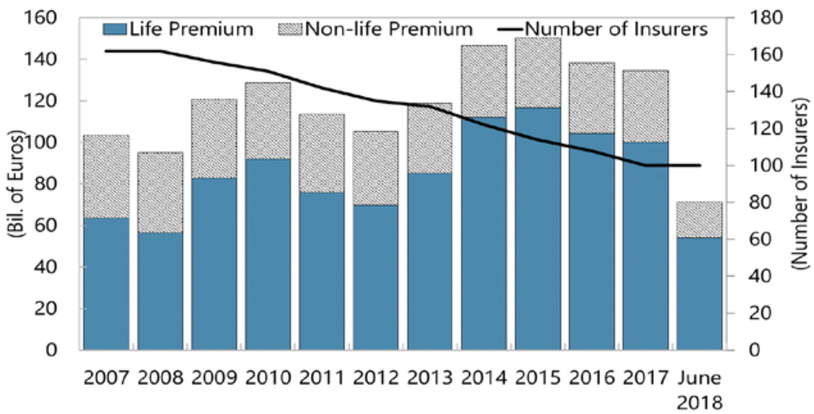


Source: BdI and IMF staff calculation.

Figure 3. Italy: Insurance Sector Developments

The insurance industry has consolidated significantly in the past decade, while total industry premium income has been stagnant after a surge in life insurance premiums in 2014 and 2015.

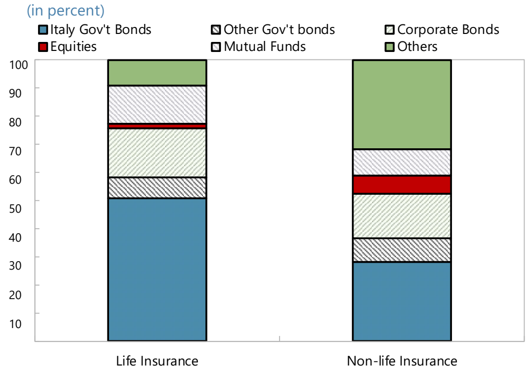
Italy Insurance Sector Overview



Source: IVASS.

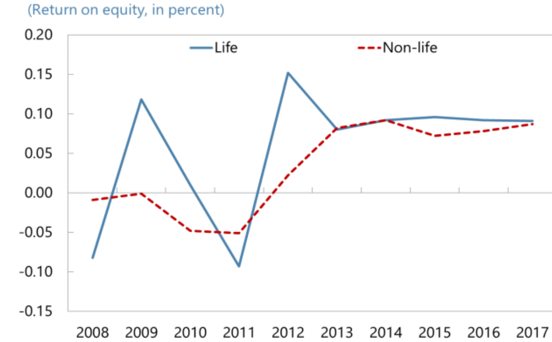
Life insurance assets are heavily concentrated in Italian sovereign bonds.

Insurance Industry Asset Composition
(in percent)



The insurance sector has returned to profitability in 2012 after a tremulous period during the fiscal crisis.

Insurance Sector Profitability
(Return on equity, in percent)



Source: IVASS.

2. **Regulatory and supervisory measures taken since the 2013 FSAP have played a key role in supporting the recovery of the banking system (Appendix V).** Financial system oversight has been substantially enhanced by the implementation of European Union regulations and the creation of the SSM and the SRB in the euro area. Several initiatives were also launched to improve asset quality, such as the publication of supervisory guidance on non-performing exposures and the EU Council's 2017 Action plan to tackle NPLs. The Italian authorities have also adopted important measures to strengthen banks' capital buffers, improve banking sector governance and consolidate the financial sector through the reforms of the cooperative banks (pop~~u~~olari and mutual institutions), and enhance asset quality and facilitate NPL disposal, particularly through the introduction of Garanzia Cartolarizzazione Sofferenze (non-performing loans' securitization guarantee or GACS). As a result, NPL reductions in recent years were significant, capital levels have improved, and various weak banks were intervened, albeit with more limited burden-sharing than envisaged in the euro area's unitary regime for bank

7. Further disposals of NPLs will require additional costs and could impact banks' capital level. Staff estimates that banks (SIs and LSIs) included in the FSAP stress tests need to book an additional €4.9 billion (0.3 percent of GDP) of loan loss provisions to facilitate NPL resolution through internal workout (Table 2).[1] However, banks' plans to reduce NPLs are heavily reliant on market disposals and write-offs due to limited internal workout capacity. As observed loss rates from market-based NPL disposals are, on average, 13 percentage points higher than loss rates from internal workouts, staff estimate that these banks could require €7.2 billion (0.4 percent of GDP) of additional provisions to meet the NPL reduction targets agreed with supervisors.

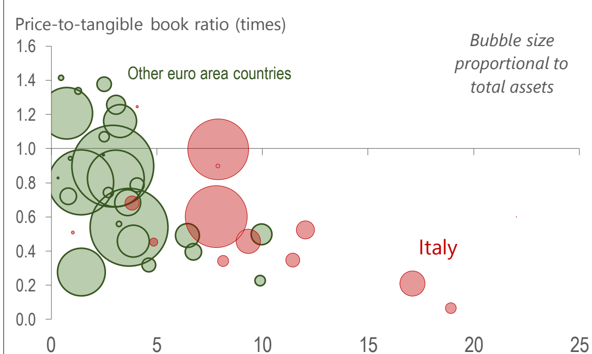
Table 2. Italy: Estimates of Additional Loan Loss Provisions Needs

	LSI (€bn)	SIs (€bn)	Total (€bn)
CET1	21	124	145
Gross Customer NPEs (€bn)	18	128	146
Provisions on NPEs (€bn)	9	68	77
NPE Additional Provisioning Needs - Internal Workout	0.6	4.3	4.9
of which, Bad Loans	0.0	0.5	0.5
of which, UTP and Past Due	0.6	3.8	4.4
NPE Aditional Provisioning Needs - Disposal	2.7	17.3	20.0
of which, Bad Loans	0.8	6.4	7.2
of which, UTP and Past Due	1.9	10.9	12.7

Source: IMF Staff estimation.

8. Market-based measures of bank capitalization show a sizeable discount relative to book value. In the euro area, and in Italy in particular, bank aggregate price-to-book ratios are mostly below one. In Italy, this seems to reflect to some extent the uncertainty related to asset quality and broad profitability concerns.

Net NPL Ratio Vs. Market Cap/ Tangible Book Value



Source: SNL, Reuters

Bank Profitability

9. Bank profitability has been challenging. Following large fluctuations during the past years, the banking sector's profitability rebounded in 2017–18, which was mostly driven by the largest banks, whose profitability surpassed the EU median, which has also been lackluster, in 2017 (Figures 10 and 11). Profitability for medium banks has been consistently low in recent years, although it has significantly improved since the euro area debt crisis. The profitability of

[1] See paragraph 15. The sample included in the stress testing exercise comprises 78 percent of banking sector assets (69 percent SIs and 9 percent LSIs). The SIs' sample excludes two banks that were under restructuring as of March 2019.

small banks entered positive territory in 2018 after having been negative for the past few years. Challenges from fintech and additional provisioning needs for further NPLs disposals will continue to negatively impact profitability.

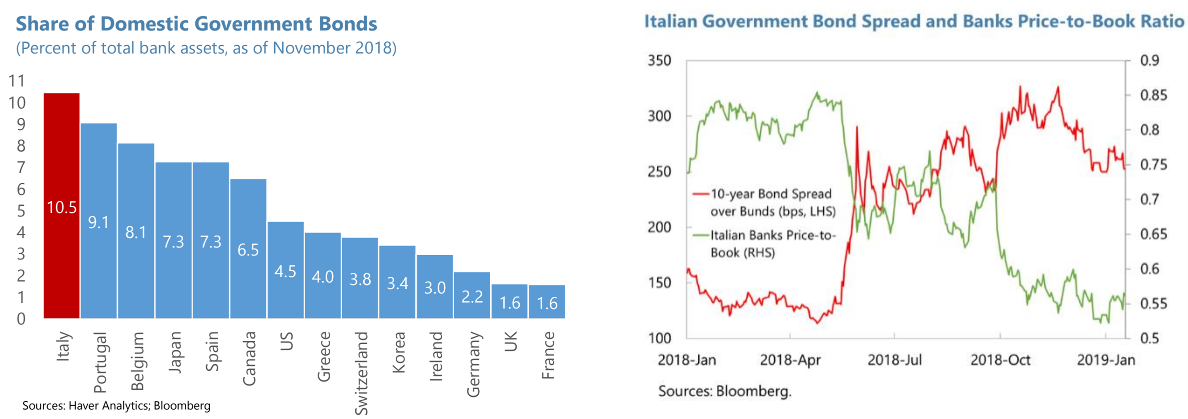
Sovereign-Bank Nexus

10. The large holdings of Italian sovereign debt by banks increase their vulnerability to a sovereign shock. At over ~~11~~ 10.5 percent of total assets, banks' exposures to domestic sovereign bonds is high and introduces linkages via the capital and liquidity channels. While the relationship between sovereign spreads and bank regulatory capital has been tempered by banks' accounting strategies—in the second half of 2018, banks moved a large share of sovereign bond holdings from the fair-value to amortized-cost accounting category—the link is still high. Notwithstanding the accounting treatment, the high concentration of sovereign debt renders banks' capital and liquidity vulnerable to adverse market valuations of these securities and impacts banks' equity prices and funding costs (Figure 5).

Figure 5. Italy: Sovereign-Bank Nexus

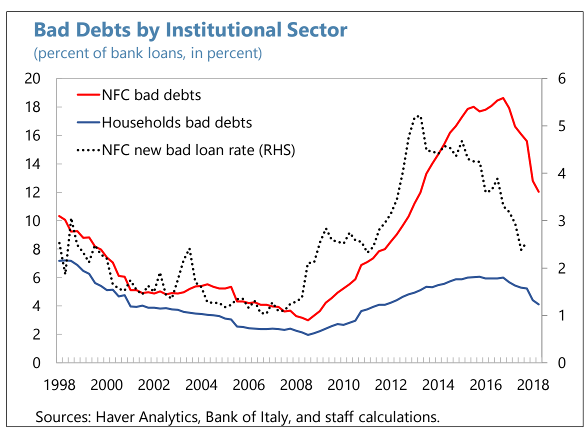
Exposures of banks to the sovereign is high.

Contributing to the reemergence of the sovereign bank nexus



Corporate Debt Overhang

11. The corporate sector remains vulnerable to adverse shocks. The corporate sector has been the primary source of banks' NPLs and faces highly differentiated lending rates. The corporate sector is still relatively vulnerable despite improvements in recent years in the rate of new bad loan formation. With net financial assets at -112 percent of GDP, the corporate sector is slightly more indebted than the euro area average. Corporate indebtedness continues to impose a significant drag



- **Stress test results are slightly more adverse if alternative assumptions and thresholds are used.** To assess the impact of potentially higher loan loss rates under the stress scenario, the FSAP calculated banks' CET1 ratios if loss rates were further increased by 20 percent.[5] Furthermore, CET1 ratios were evaluated against a higher threshold of 7 percent, which incorporates the capital conservation buffer. Combining the two new assumptions (CET1 threshold of 7 percent and a 20 percent increase in LGD), an additional bank will fall slightly below the 7 percent CET1 threshold.

- **The sensitivity analysis using single-factor shocks indicates important vulnerabilities among the LSIs.** Results using Q3 2018 data show that LSIs are vulnerable to NPL shocks and mark-to-market losses arising from an increase in the yield of Italian government bonds. An increase in yields similar to the one observed in 2011 would cause the capital of almost a quarter of the sample of LSIs by assets (10 banks) to fall below the 7 percent CET1 ratio threshold. Under an NPL shock,[6] 35 percent of the sample's assets (14 LSIs) would see their CET1 ratio fall below 7 percent (Figures 7 and 8).

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[5] The "no NPL disposal" adverse scenario was used for this exercise.

[6] The LSIs were subjected to a flow of new NPLs in line with the historically worst observed NPL flows, at the end of the twin peak crisis in 2013. See Technical Note on Systemic Risk Analysis and Stress Testing for details.

Box 1. Banks Under Restructuring—Background and Recent Developments

Monti Dei Paschi di Siena (MPS)

MPS is the fifth-largest Italian bank with €134 billion assets, a loan market share of circa 5 percent and a fully loaded CET1 ratio of 12.6 percent as of September 2019. The bank benefited from State recapitalizations in 2009 (€1.9 billion "Tremonti bonds") and 2013 (€2.2 billion "Monti bonds"), which were both repaid. Consistent with the framework provided in the BRRD, the Italian authorities effected a €8.1 billion precautionary recapitalization of MPS in July 2017 (involving the conversion of junior bondholders for €4.3 billion and a capital injection of €3.8 billion). An amount of €1.5 billion was provided by the State to compensate retail investors who were victims of mis-selling. Following the operation, which was found compatible with state aid provisions by the European Commission (EC), MPS' gross NPL ratio improved from 35 percent at end-2016 to 14.6percent at end-September 2019, mainly due to disposals. MPS' restructuring plan agreement with the EU aims to substantially reduce cost/income ratio from 61.2 percent in 2016 to 50.6 percent in 2021, including through reducing its branch network from 1,529 in June 2019 to 1,432 by end-2021. The bank is currently in discussions with the MEF and the EU to further dispose around €10 billion NPLs to AMCO, the state-owned bad loan manager. The MEF is due to submit a disposal plan to the EC that sets out how the state ownership in the bank will be divested by end-2021.

Banca Carige

Carige is a medium-sized regional Italian bank with assets of circa €23 billion. It is supervised by the ECB, who requested the bank to submit a plan ~~increase capital by end-2018 in order~~ to restore compliance with its applicable capital requirements by end-2018. In order to immediately secure the bank's solvency position, in November 2018 a €320 million Tier 2 subordinated bonds was subscribed by the voluntary intervention scheme (VIS) of the Italian Interbank Deposit Guarantee Fund (FITD). This was intended to be a temporary solution, ahead of a subsequent recapitalization. However, the bank's major shareholder withdrew support for a €400 million capital increase in December 2018, seeking more clarity on the bank's strategy. The majority of the Board of Directors subsequently resigned, and the ECB appointed three administrators in January 2019. Following the announcement (and EC approval for state aid purposes) of a state guarantee for new bond issuances in January 2019 to support the bank's liquidity position, its shareholders approved a €700 million share capital increase in September 2019. The recapitalization was completed in December 2019 with existing shareholders subscribing €23 million; VIS converting €313 million of subordinated debt into shares; FITD subscribing an additional €301 million; and Credito Cooperativo Italiano subscribing €63 million. The administrators' term ended in January 2020 as a new Board was appointed. The bank's Strategic Plan foresees reducing NPLs to below 5 percent by 2023, achieving the breakeven point by 2021 and returning to profit by 2022.

Banca Popolare di Bari (BPB)

BPB is the largest bank headquartered in Southern Italy with assets of circa €13 billion. It is one of two popolari banks that did not convert to a joint stock company as part of recent reforms of the sector and has a history of governance issues. It is supervised by the BdI, who ~~initiated~~ conducted a ~~special~~ full-scope on-site inspection between ~~in~~ June and December 2019. Based on preliminary findings of the on-site inspection, stemming from the credit file review, capital ratios fell below CRR minimum capital requirements. In mid-December 2019, BdI, in its supervisory capacity, decided to remove the management of BPB and appointed two special administrators. Later that month BPB, FITD and Mediocredito Centrale (a State-owned bank) agreed a recapitalization scheme that seeks to rehabilitate the bank; in this context, and to ensure compliance with minimum capital requirements, a capital injection of €310 million was effected by the FITD at the end of 2019. ~~The banks' special administrators are expected to finalize its~~ According to the agreement, it is expected that the new business plan ~~by the end of March 2020, with the~~ and the vote of the bank's circa 70 thousand shareholders ~~to vote~~ on its recapitalization and transformation into joint stock company ~~by~~ would be finalized end-June 2020. Discussions with the European Commission about the consistency of the bank's rescue plan with the state aid framework are ongoing.

aggressive reductions. Supervisors should continue with robust challenge of banks' strategies and the ambition of their NPL reduction targets.

44. **Banks' plans to reduce NPLs are heavily reliant on disposals and write-offs.** On aggregate, banks' projected volumes of NPL cures and internal workouts is almost matched by the new inflow of NPLs. This is reflective of the long delays with insolvency and enforcement procedures and of banks' internal capacity constraints. It means that banks expect to reduce NPL levels mainly through sales and write-offs. Banks' NPL disposal targets have been achieved or exceeded to date and disposals currently planned appear achievable in the current liquid market environment.

45. **Some complex features of the legacy NPL portfolio merits further supervisory investigation.** Over 40 percent of banks' current NPL gross stock is categorized as 'unlikely to pay' (UTP), reflecting banks' continuing efforts to rehabilitate a large volume of distressed enterprises~~ through restructuring~~. Successful rehabilitation is challenging due to multi-creditor issues and can involve a mix of financial and operational restructuring, a change of business model and supply of fresh credit. Considering the complex nature of these assets, bank supervisors are recommended to conduct targeted diagnostics using a representative sample of enterprises to ensure unviable firms are not being granted unsustainable forbearance. Given that assessing firm's viability involves industry and sector-specific expertise together with detailed data, it is recommended that banking supervisors consider partnering with one or more specialist firms for a one-off, limited-term project aimed at identifying existing balance sheet vulnerabilities and building the methodological approach for future on-site challenge. Furthermore, eventual findings of the SSM's asset quality review of the two new banking groups (formed by cooperative banks) should inform the supervision of the rest of the LSIs, particularly regarding the classification and provisioning of NPLs.

46. **Measures aimed at recognizing losses on deeply delinquent loans using a calendar-based approach are welcome.** The ECB and EU initiatives to introduce calendar-based provisioning will ensure banks are incentivized to quickly restructure cases that can realistically be rehabilitated and recognize the costs associated with the recovery process for those borrowers that cannot. Calendar provisions will also help incentivize banks that have so far been slow in reducing their NPLs to do so more quickly. The BdI should consider extending the SSM's approach that sets expectations for the gradual path to full provisioning on existing NPL stocks to LSIs with high NPLs.

47. **The BdI should consider more prescriptive guidance to LSIs on NPL management.** The NPL guidance issued to LSIs in 2018 sets out expectations that banks should adopt formal policies for asset classification, forbearance, and valuation of assets. The guidance could usefully include additional elements such as practical examples of when forbearance is appropriate; expectations on forbearance decisions and controls when applying multiple forbearance measures; application of time constraints on any forbearance granted; examples of when loans should be valued using a going versus gone-concern valuation approach and constraints on the

Recommendation	Implementation status	Comment
Amend law to enable supervisors to remove individual board members, officers, and auditors of financial institutions [*MEF/Parliament*]	Partially Implemented	The Legislative Decree No. 72 of 2015, transposing the CRD IV, amended the TUB that now provides that the supervisor has the power to remove board members and officers of credit institutions. BdI has no powers vis-vis banks' external auditors who are subject to the oversight of CONSOB.
Introduce risk sensitivity in the current solvency framework for insurers in anticipation of the EU implementation of Solvency II [*IVASS*]	Implemented	With the EU-wide implementation of Solvency II, the solvency framework for Italian insurance sector has been improved to introduce elements of risk sensitivity.
Financial Safety Nets		
Provide a statutory basis and detailed guidelines for RRPs to be prepared by all systemically important banks [*MEF, BI*]	Implemented	Recovery and resolution planning requirements have been introduced via the adoption of the two regulatory decrees (Legislative Decrees 180 and 181) that transposed the EU Bank Recovery and Resolution Directive into Italian legislation (effective as of ~~January 2016~~ November 16 2015, with the exception of the bail-in tool, which was implemented as of January 1, 2016).
Adopt depositor preference, expand the resolution tools to include bail-in, bridge bank powers and to recapitalize and transfer ownership, selectively transfer assets and liabilities, and be able to trigger these at an early juncture when the firm is no longer viable [*MEF, BI*]	Implemented	Addressed via the transposition of the EU Bank Recovery and Resolution Directive (as per Legislative Decrees 180 and 181). Note that as of January 1, 2019, all deposits (including those not covered by depositor preference in the BRRD) rank senior to other unsecured debt.
Amend the deposit guarantee framework to provide for ex ante funding, with a back-up credit line from the MEF, and remove active bankers from the board and executive committees of deposit guarantee schemes [*MEF, BI*]	Partially Implemented	Ex ante funding requirements were introduced in 2016 via the transposition of the EU DGS Directive (through Legislative Decree 30)~~; premium collection commenced in 2017~~. The two schemes (continue to) operate as private sector consortia with boards that are comprised of senior executives of the affiliated banks.