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The Italian Banking System in the Perspective of the Banking Union

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Outline of the Presentation

1. **The Banking Union (BU) project**
   - the Single Supervisory Mechanism (SSM)
   - the Balance Sheet Assessment (BSA)

2. **The Italian banking system in the perspective of the SSM**
   - a bird's eye view on the current state of affairs
     - *credit quality, capital and profitability*
   - the Bank of Italy's supervisory action

3. **Summary assessment & outlook**

The Banking Union in the Euro Area

- **What is the BU?**
  - A Single Supervisory Mechanism (SSM) by the ECB & NSAs
  - A Single Resolution Mechanism (SRM)
  - A harmonized deposit guarantee system
  - Financial backstops and bank recapitalization at the EU level
- **Why a BU in the Euro Area?**
  - Break the perverse banks/sovereigns feedback loop
  - Preserve the Single Market, avoid fragmentation
  - Empower a supranational supervisor for large, cross-border banks

The SSM: Coverage, Timeframe

- **Mandatory for EA countries, open to other EU countries**
- **ECB will directly supervise 130 large banks (TA>€30bn or TA>20% of domestic GDP)**
  - NSAs will supervise the remaining 6,000 banks following common guidelines
- **SSM will be operational in Q4-14**
- **From Q4-13 to Q3-14 ECB & NSAs will conduct a comprehensive assessment – including a balance sheet assessment (BSA) and a stress test (ST)**

The BSA: a Key Step of the BU Process

- **Exercise must be credible and rigorous, in order to:**
  - restore full confidence on banks' soundness
  - enhance transparency of their balance sheets

- **This requires putting banks on a level playing field (eg using severe/homogeneous definitions of NPLs) and reaching opaque corners of balance sheets (L3 assets, derivatives, etc.)**

- **Possible follow-up includes recapitalisation**
  - Viable banks should be recapitalised first of all by private investors (no bail-outs)...
  - ... but public backstop will be available upfront (otherwise the credibility of the exercise might be put at risk)

Italian Banks and the BU

- **The BU will bring straight benefits to Italian banks by:**
  - reducing market fragmentation, thus improving funding conditions
  - increasing transparency, hence comparability of balance sheets
  - breaking the link between sovereign risk and bank risk
- **Italian banks are ready for the BU and the BSA**

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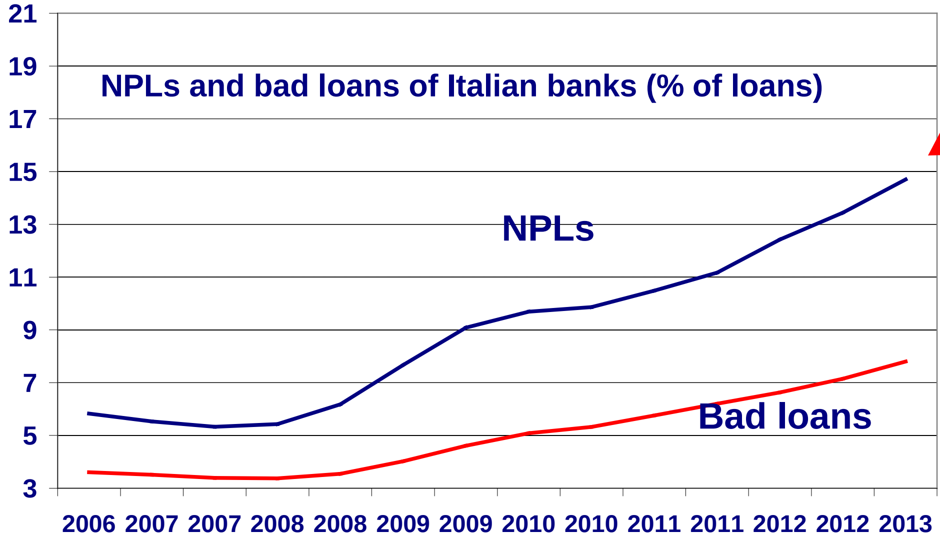
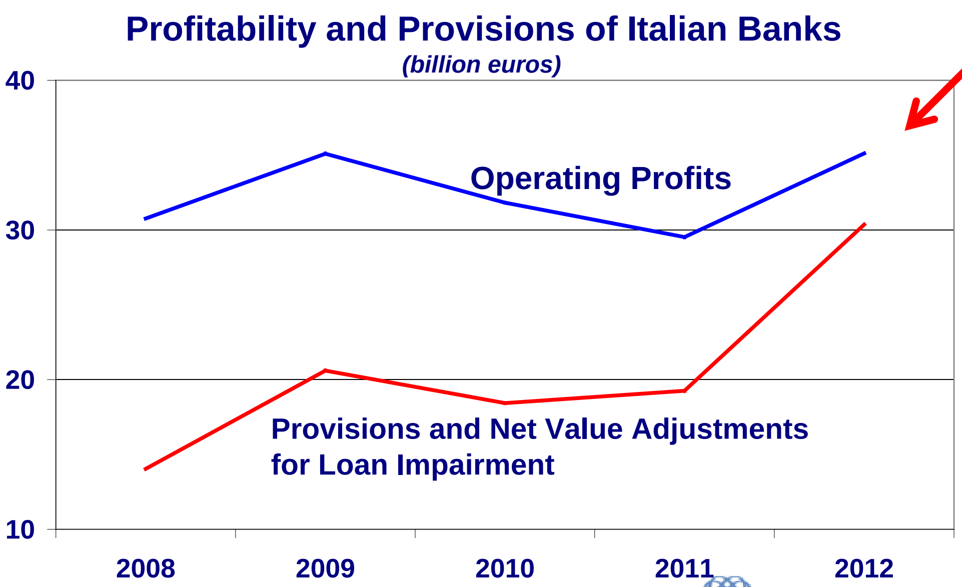
  - breaking the link between sovereign risk and bank risk
- **Italian banks are ready for the BU and the BSA**
- **The above arguments, however, are <u>NOT</u> meant to downplay the risks that the Italian banking system faces**

Banks' Key Problem: Rising Credit Risk



- Credit quality is deteriorating, driven by loans to non-financial corporations (NFCs). HHs more resilient



- Gross (operating) profits have resumed growth in 2012 (but 2013 results like-ly affected by low rates).
- The increase in provisio-ning is eating up a large part of <u>gross</u> profits. <u>Net</u> profitability is low

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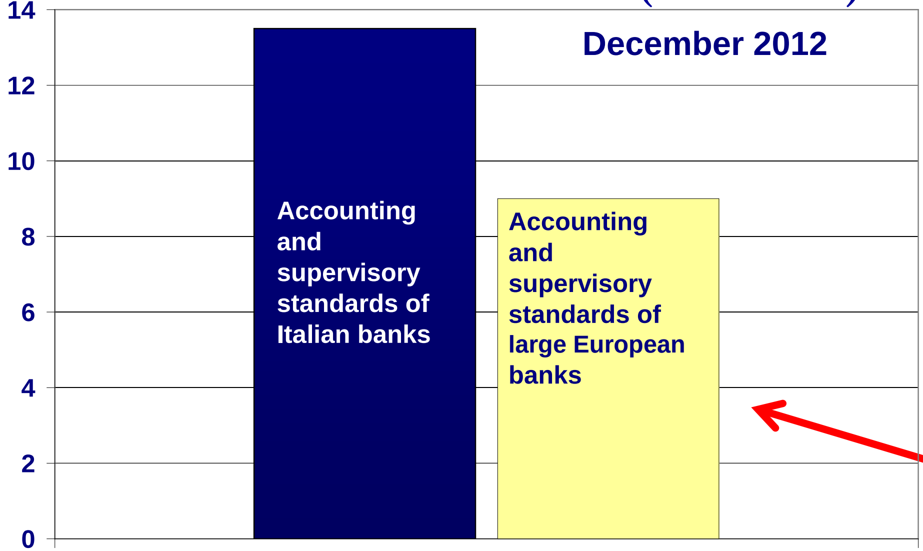
Banks' Key Problem: Rising Credit Risk (2)

Flows of new NPLs: Firms

- Gross operating profits sufficient to cover loan loss provisions in 2013 <u>and</u> 2014
- The flow of new NPL and of bad loans to NFCs are sho-wing signs of a turnaround.

Italy's Classification Standards Are Rigorous: Credit Risk May Look Larger Than it is

NPL ratio of Italian banks (% of loans)



Coverage ratio of Italian banks (% of NPLs)

- Italian banks follow prudent supervisory standards
- If Italian banks followed the standards used in other jurisdictions (e.g. excluding fully-collateralized NPLs) then:
  - the NPL ratio would be 1/3 lower
  - coverage ratios would be higher by 20 pct. points
- NPL definition proposed by EBA is in line with (or less comprehensive than) Italy's definition.

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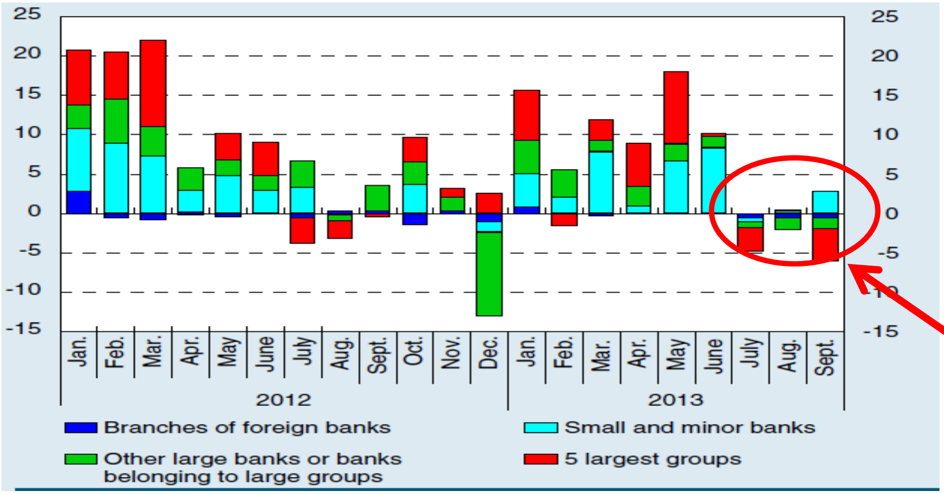
Stock of NPLs Will Have to Be Reduced

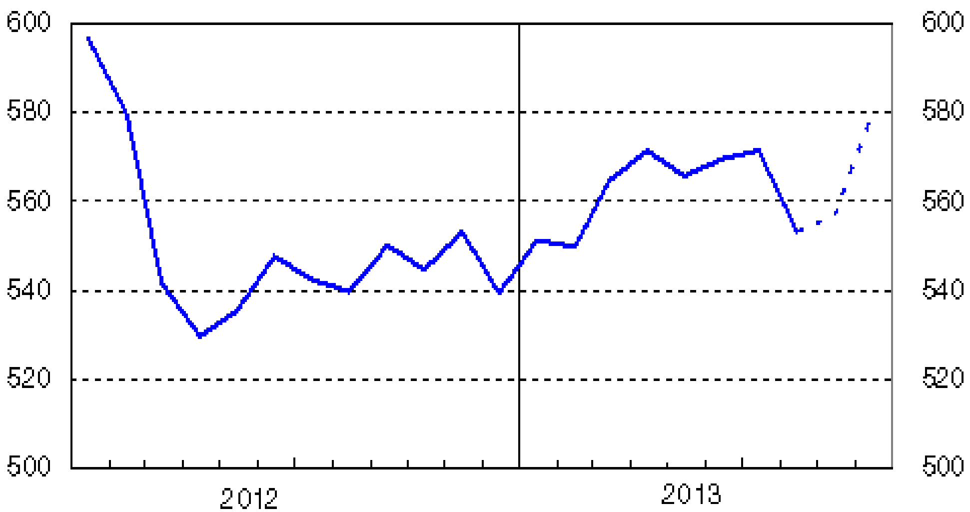
- Market for assets securitization very thin. Price differential between supply and demand of NPL large but likely to narrow:
  - The Bank of Italy's recent action on value adjustments
  - Reduced financial market fragmentation (economic recovery, SSM comprehensive assessment)
  - The Stability Bill for 2014 provisions on tax treatment of loan losses and value adjustments

Banks' Holding of Sovereign Bonds

Purchases of sovereign bonds by Italian banks



Italian sovereign bonds of non-residents



- Large purchases of domestic sovereigns over 2 years.
  - a. ample differential sov's vs loans
  - b. precautionary demand
  - c. fragmentation
- In last 3 months sov. portfolio shrank (€10bn), due to improvement in (a), (b), (c).
- The conditions of sovereign markets are improving. Not just rates and spreads: foreign holdings are increasing.

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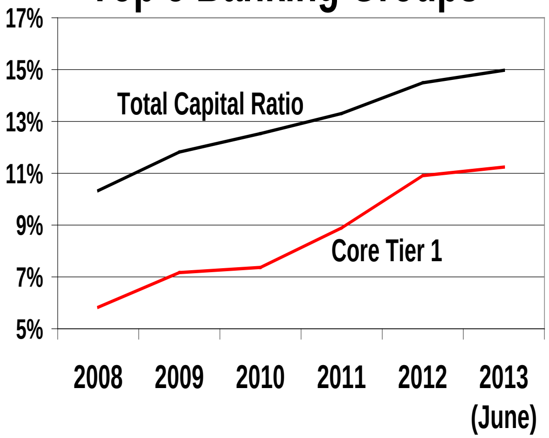
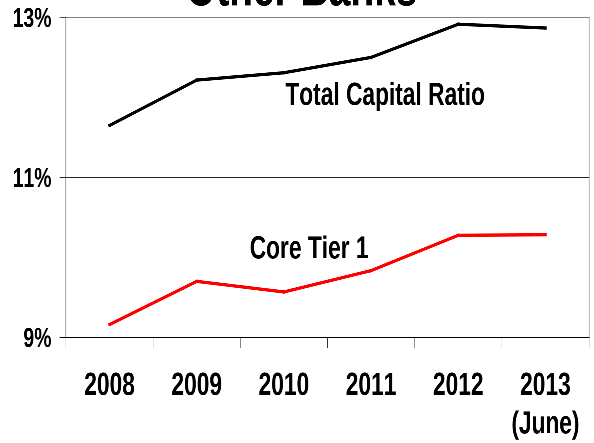
BUT the system has several points of strength
Capital Positions Continue to Improve

Top 5 Banking Groups

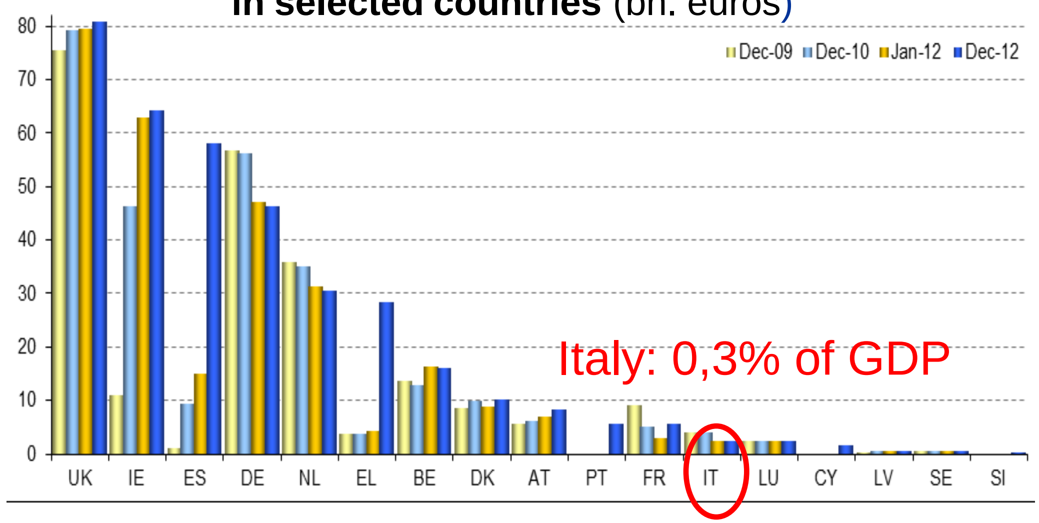


Other Banks



- Capital ratios have increased continuously since 2008, as a result of both capital issues and lower RWAs.

Bank capital injections by the public sector in selected countries (bn. euros)



- The amount of public funds injected into the banking system by the Italian State is very low.

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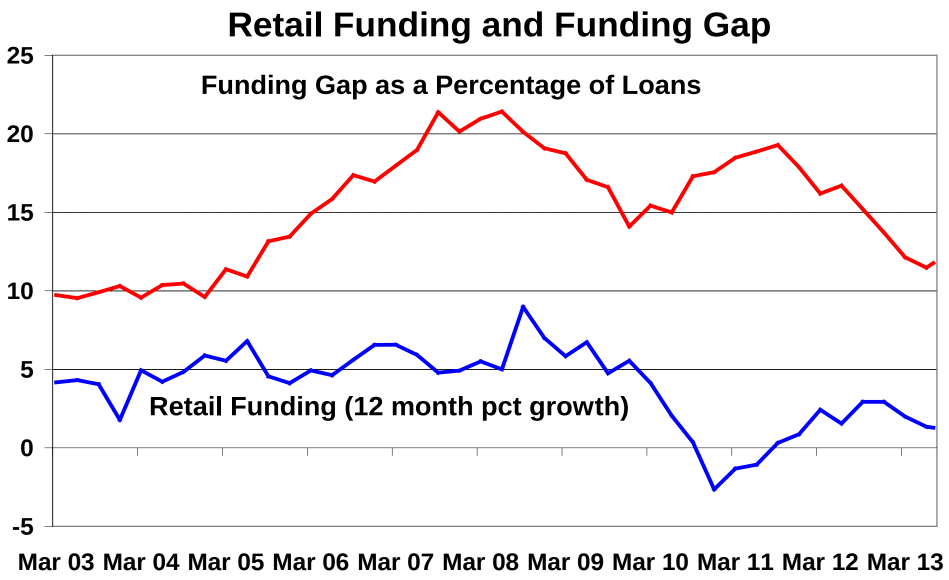
Retail Funding Continues to Grow



- The system is retail-based
  - deposits continued their steady growth throughout the crisis
  - the funding gap is low and declining

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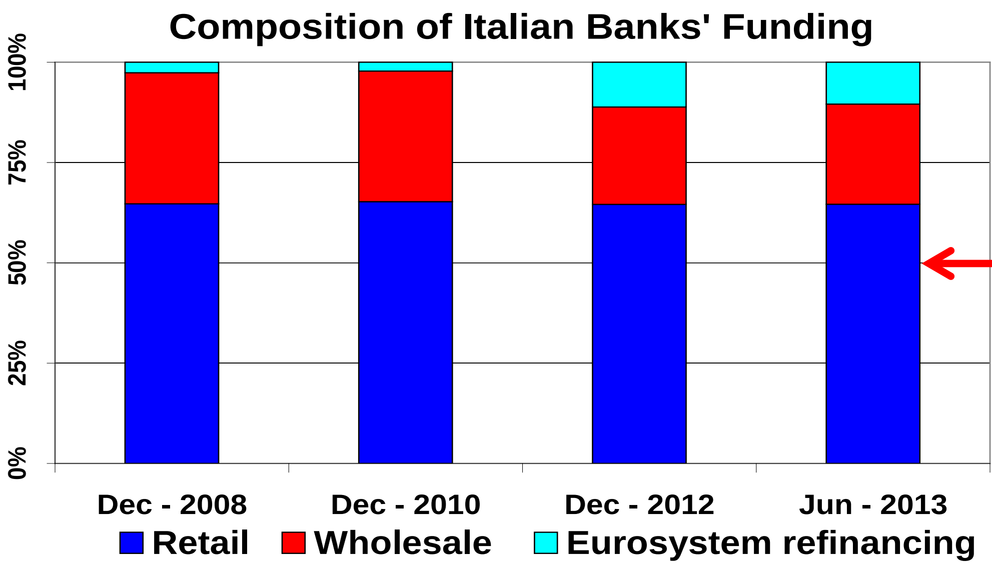
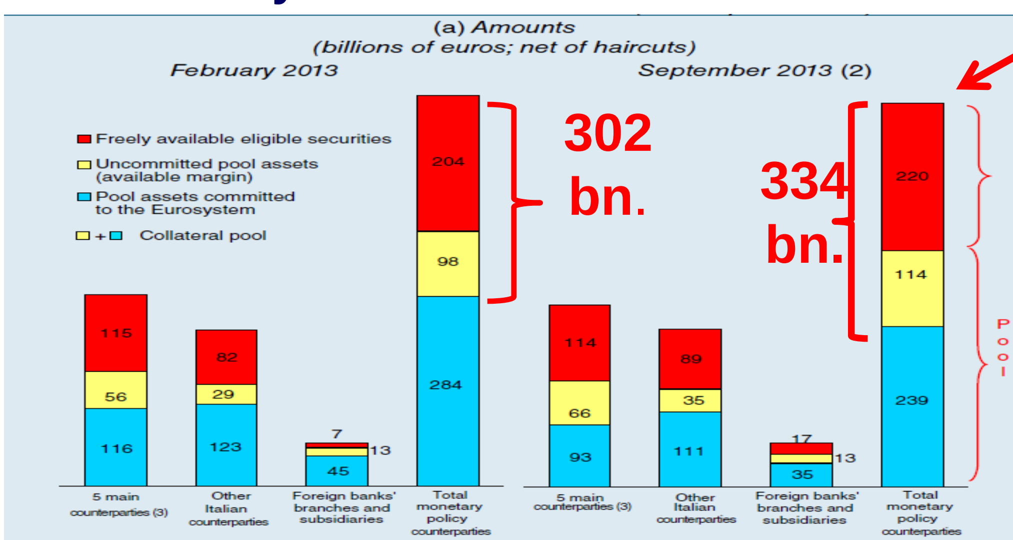
Liquidity Conditions and Eurosystem Borrowing



Availability of Collateral for Italian banks



- Overall liquidity position is satisfactory
- Dependence on ECB funding significant but falling
  - banks (especially large ones) have regained access to wholesale markets
- Available eligible assets continue to increase
- Ongoing work to make revolving loans (an Italian feature) and pools of loans pledgeable

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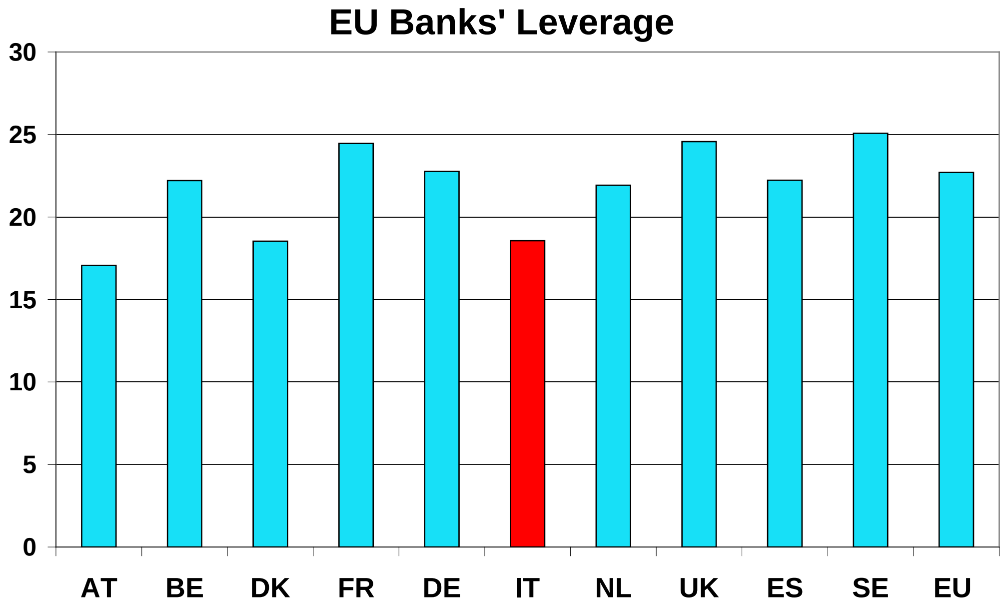
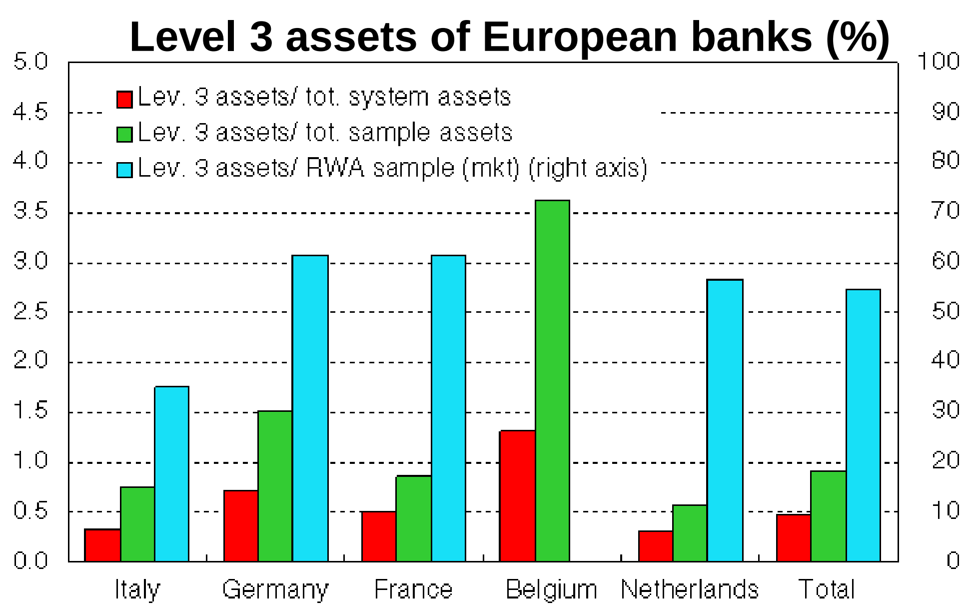
Leverage is Low and Declining





- Banks are deleveraging. Credit growth is negative, mainly in response to weak loan demand by NFCs
- Leverage (total assets / tier1 capital) is low by international standards
- Level 3 assets are negligi-ble

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Supervisory Action by Banca d'Italia

- Capital strengthening has been driven by supervisory pressure
- Ad hoc action on provisioning initiated in 2012, also by running targeted on-site inspections
- Intensified off-site monitoring
- Pressure on cost cutting and restructuring (i.e. disposing of non-core assets)

Capital Needs: the FSAP of the IMF

IMF FSAP estimates of cumulated capital shortfall
(billion euros)

Scenarios	*CET 1*			*T 1*		
	# of failing banks	capital shortfall		# of failing banks	capital shortfall	
		€bn	% of GDP		€bn	% of GDP
Baseline (at end-2017)	5	1.0	0.1	10	3.4	0.2
Low growth (at end-2017)	11	4.9	0.3	15	10.2	0.7
Adverse (at end-2015)	13	6.0	0.4	20	13.8	0.9

Capital benchmark: Basel 3 phasing in for both CET1 and T1.

- IMF (FSAP, Sept. 2013): 32 banks, individual data:
  - capital need in stressed conditions €bn. 6.0-13.8 (0.4-0.9% GDP)
  - shortfalls mainly in small-medium local banks
- Estimates of private analysts: based on heterogeneous (sometimes simplistic!) hypotheses and methodologies, but results are of similar magnitude

Summary Assessment & Outlook

- The Italian banking system has shown strong resilience in the face of an exceptional economic crisis
- A successful, gradual exit from currently stressed condition is possible
- SSM and BSA are not a further problem. <u>They are part of the solution</u>

Summary Assessment & Outlook

- Economic recovery after a double dip recession is the critical success factor for Italian banks. It is a precondition to start reduction of the stock of nonperforming loans and to restore profitability.

- Expectations for key ECB interest rates to remain low for as long as necessary provide support to recovery

- Continuing national efforts at reform of the economy and consolidation of public finances are key

Thank you!

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