July 26, 2016

UNRESOLVED NON-PERFORMING LOANS IN ITALIAN BANKS RISKS DERAILING THE EURO AREA ECONOMIC RECOVERY

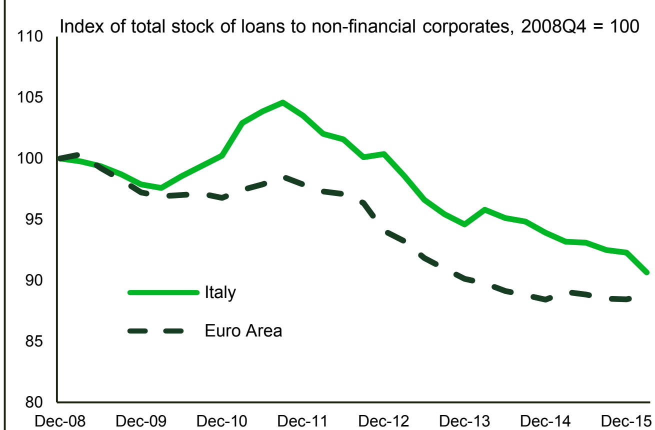
Highlights

- Markets have recently shifted attention away from the UK and toward the health of European banks in the lead-up to stress test results scheduled to be announced at the end of this week. Italian banks are not expected to perform well due to the large amount of non-performing loans (NPLs) on their balance sheets.
- Over the past two years, Italian authorities have been working toward a solution to recapitalize the bank sector by laying the foundation for much needed legal and banking sector reforms, including engaging the private sector for a market-driven solution. Despite their efforts, Italy is still far from a solution fully compatible with the EU's bank resolution framework that came into effect this past January.
- We anticipate that an eventual resolution to the NPL problem plaguing Italian banks will require a compromise between Italian authorities seeking support for retail bondholders and the resolution directives set forth by the EU. Legal reforms, bank consolidation, private sector investment with state backing, as well as some support for retail bondholders are all likely to feature in the agreement.
- Given the fragile economic recovery in Italy, a recapitalization of its banking sector in an environment of low inflation and highly accommodative monetary policy is a necessary condition to ensuring the transition to sustainable economic growth. The risks of delaying action cannot be overstated. As the Euro Area's third largest economies, a banking crisis in Italy would spillover to its major trading partners, jeopardizing the viability of the currency union.

In recent weeks, attention has quickly shifted from the UK referendum to the large amount of outstanding non-performing loans (NPLs) in the Italian banking sector. The mood swing was largely precipitated by European Union (EU) regulators giving Monte dei Paschi di Siena, Italy's third largest lender and Europe's oldest bank, notice that it should work toward reducing its bad debts from last year's €46.9 billion to €32.6 billion by 2018. In addition, following on the heels of the U.S. Federal Reserve's stress test results, those of the ECB's are scheduled to be announced on July 29th, and Italian banks are not expected to fare well.

Unlike other Euro Area countries that were forced to recapitalize their banks in the aftermath of the financial crisis, Italy decided to delay action, hoping instead that bank balance sheets would improve with the economic recovery. However, since 2012, Italy suffered through three successive years of economic contraction, while net interest margins became ever more compressed due to

CHART 1: BANK LENDING IN ITALY AND EURO AREA HAS DECLINED SINCE END OF 2008



Source: Banca d'Italia and ECB via Haver Analytics, TD Economics.

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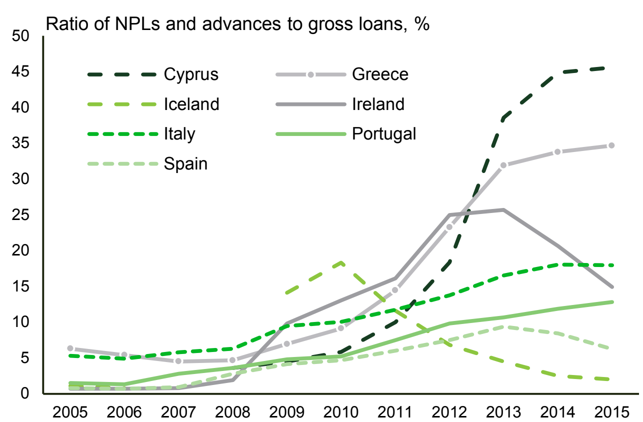
ECB easing actions. This virtually eliminated the possibility that Italian banks would be able to utilize retained earnings to restructure in a timely manner.

Addressing the issue this year rather than delaying further intervention is probably best for a number of reasons. The Italian economy has recently escaped from recession and an economic recovery is taking place in its major trading partners. In addition, by resolving the NPL issue, it is hoped that Italian banks will be able to lend more, encouraging new firm creation, new hiring, greater business investment, and thereby reinforce the Italian economic recovery (Chart 1). A restructuring of Italian banks would be complementary with the ECB's bond buying strategy that is acting to keep borrowing costs low, encouraging investment by households and firms through the currency union. In fact, credit easing by the ECB would help improve overall domestic bank profitability, although up to a third of Italy's 15 largest banks could still face profitability challenges.[1]

Failure to resolve NPLs in a timely fashion raises long-term financial stability risks not just for Italy but for the Euro Area and European Union (EU). Italy is the third largest economy in the Euro Area, and its banking sector comprises about 9% of the total EU banking system.[2] Furthermore, Italian banks have increased their holdings of domestic sovereign bonds since 2012, leaving them more exposed to interest rate risk than prior to the euro crisis. Consequently, a banking crisis in Italy will not be confined within Italian borders, and the potential contagion effects to peripheral Europe could once again jeopardize the long-term viability of the euro.

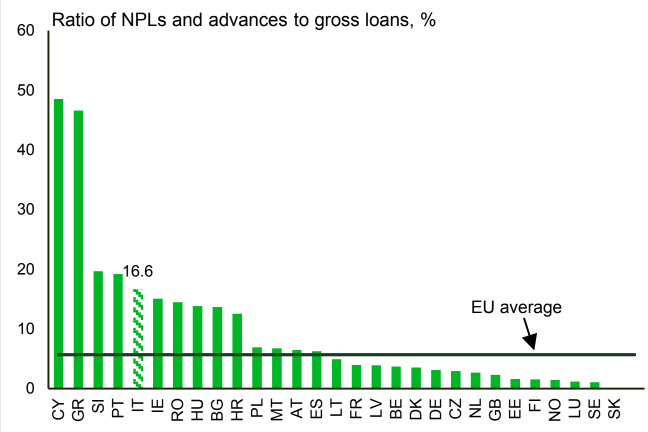
Given the likelihood of losses on the household sector from EU's Bank Recovery and Resolution Directive (BRRD) and immature private sector solutions, we expect that the resolution of NPLs in the Italian banking sector will require a BRRD program that combines legal reforms, industry consolidation, and government support to mitigate the impact on households. While a bail-out utilizing private funds but backed by the state is not out of the question given existing exemption clauses in the BRRD, it's unlikely that European authorities will support any agreement that strays significantly from the BRRD.

CHART 2: ITALIAN NPL RATIO ELEVATED HISTORICALLY RELATIVE TO EUROPEAN PEERS



Source: IMF Global Financial Stability Reports (April 2011 to April 2016), TD Economics. Last observation 2015.

CHART 3: ITALY HAS THE FIFTH HIGHEST NPL RATIO OF ALL EU NATIONS



Source: European Banking Authority, as at March 2016/end of 16Q1, TD Economics.

The composition of Italy's non-performing loans

Italian banks have had a history of carrying large NPL's on their balance sheet (Chart 2), accentuated by structural issues that have hindered their ability to address them in a timely manner. At 18% of gross loans, NPLs remain well below that of Cyprus (45.6%) and Greece (34.7%) (Chart 3).

According to IMF estimates, non-financial corporates account for almost two-thirds of bank NPLs, a large fraction of which are subject to enforcement.[3] Furthermore, about three-quarters of the bad loans are in the corporate sector, which in Italy is mostly comprised of micro and small enterprises (often with less than 10 employees). Out of all the bad debt, about 75% are in amounts in excess of €250,000. However, in terms of number of borrowers, about 75% of the bad debts are for loans less than €75,000.

Within the non-financial corporate sector, the service sector and other less capital and technology-intensive sectors have generally had the most difficulty in making loan repayments. Moreover, on a regional basis, firms located in central and southern Italy have experienced a rapid rise in bad debts since 2009.

In Italy, bank credit is heavily collateralized. Collateral and personal guarantees in 2015 amounted to €87 billion and €37 billion respectively. This is in addition to average loan loss provisions that stood at 45.8% for total NPLs and 58.7% for bad loans. (Chart 4). While NPLs are generally concentrated in large banks, NPL ratios are high for all Italian financial institutions that lend commercially.

Solutions will require compromise

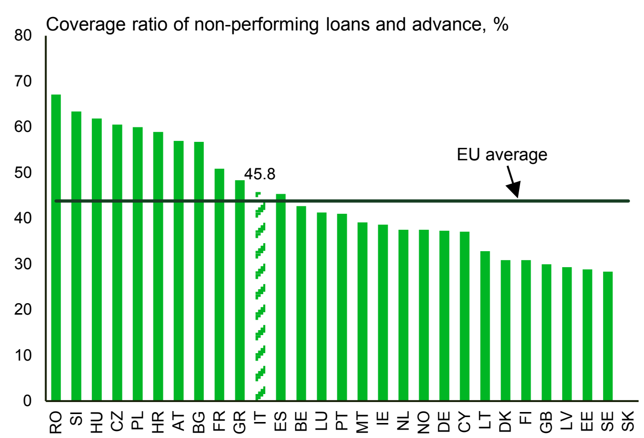
Since early 2015, Italian authorities have been working on implementing a variety of measures to resolve the NPL problem (see Appendix 1 for a list of government initiatives). Box 1 discusses the longer-term reforms necessary to ensure that problem loans don't become a recurring theme in the Italian banking sector.

At the heart of the current debate on how to resolve Italy's NPLs is whether the BRRD provides a sufficient constraint to a solution that minimizes the impact on households. Some of the proposed solutions seem to contradict recent measures by the European Banking Authority (EBA) to limit the use of public funds. Below we discuss the options on the table, and potential conflicts.

i) EU's Bank Recovery and Resolution Directive (BRRD).

A new process came into force at the start of this year that is intended to be the template for recapitalizing banks in the EU. Known collectively as the BRRD, the directive provides guidance on the resolution of capitalization problems with EU domiciled banks, with limits imposed on the use of public funds. Specifically, the BRRD was the EU's attempt to end the moral hazard associated with public bailouts of "too-big-to-fail" banks. As such, a bail-in utilizing private sector funds is the objective of the directive. Bank liabilities that are subject to bail-in by creditors include capital instruments, followed by subordinated debt, and subsequently uncovered bank bonds and other senior liabilities. Deposits can be bailed-in only for the part exceeding €100,000, but it should be noted that Italian law goes beyond BRRD by establishing full depositor preference over unsecured senior debt from January 1, 2019. Between January 1, 2016 and December 31, 2018, uninsured deposits rank the same as senior debt, unless the resolution authorities decide otherwise.

CHART 4: ITALIAN BANKS HAVE MADE SIGNIFICANT LOAN LOSS PROVISIONS



Source: European Banking Authority, as at March 2016/end of 16Q1, TD Economics.

One controversial aspect of the BRRD is that it requires creditor bail-in of at least 8% of total liabilities as a precondition for availing resolution funds. Near the end of last year, four small banks representing less than 1% of EU wide deposits were resolved in this manner, ultimately resulting in Italian authorities imposing a limited bail-in of equity of subordinated debt, sparing senior bondholders. However, since about half of the €800 million of subordinated debt that was bailed in was held by retail investors (including households), a public fund was setup to help compensate retail investors amidst allegations of mis-selling by Italian banks. The last aspect is important, because Italian households hold just under 40% of total domestic bank debt securities, compared with a little over 10% in Germany, and under 5% in France, Portugal, Spain and the Netherlands.[4] While these household holdings have been declining over time as a result of changes in their tax treatment and the low yield environment, they are still high. Households hold about one-third of senior bank debt and almost half of total subordinated bank debt.

Given the large exposure that households face in the event of a bank restructuring, it shouldn't come as much of a surprise that Italian authorities have tried to delay acting. Any poorly planned resolution could have significant social and political costs.

The IMF has run an exercise that illustrates what a resolution under the BRRD would imply for the Italian banking sector.[5] Current rules would likely entail a bail-in of junior and senior creditors. For the majority of the 15 largest Italian banks, the 8% minimum requirement would currently imply bail-in of retail investors of subordinated debt. Additionally, for about two-thirds of the banks, losses would also be imposed on some senior debt holders. However, the IMF cautions that these calculations are an example of the current liability structure of the largest banks and are not an assessment of viability. Realistically, the banks' own capital would have shrunk further, which would mean that a bail in of 8% of liabilities would require greater losses on senior debt holders. This example helps highlight the importance of taking proactive measures to reduce the systemic build-up of NPLs in banks.

ii) Bail-out using public and/or private funds

As it currently stands, Italian authorities are pushing for a possible solution led by Matteo Renzi to bail-in banks via private sector sourced funding in excess of €40 billion, but effectively backstopped with public funds. However, any intervention in its banking sector that utilizes public funds will likely violate the EU BRRD mentioned above, although there are some possible exceptions.

In early 2016, Italian authorities launched or supported initiatives to backstop capital issuances of banks and facilitate NPL securitization. As part of these efforts, the Bank of Italy is helping to create an NPL information center to encourage private non-bank participation in the market for NPLs.

More specifically, all these efforts included coordination between Italian authorities and the private sector in order to come up with a market solution for bank re-capitalization. In January of this year, Italian authorities agreed with the EC on a mechanism called GACS to securitize and guarantee NPLs. Later on in April, Italian authorities set up a fund named Atlante that would involve private sector investment to not only help backstop future capital increases of banks, but to also facilitate the trade of NPLs. The details of these two recent private sector bail-out mechanisms are below.

- **GACS**: Purpose is to provide a state guaranteed scheme for securitized bad debts and NPLs more generally. Under GACS, banks can move their bad loans at market value into special purpose vehicles for their eventual sale to markets. Public guarantees for the senior investment grade tranches of securities issued against these bad loans can be purchased. Most importantly, no public funds are expected to be utilized in the implicit backstop, since the fees paid by the banks for the public guarantees should cover expected costs. Authorities anticipate that

Box 1: Establishment of legal and procedural framework for resolving NPLs in Italy

Structural reforms are being undertaken by Italian authorities but their successful implementation necessitates a reinforced legal framework, as well as improvements to asset owner and creditor registration systems. The scope includes strengthening of legal remedies as well as improving the efficiency of the judiciary that should act to shorten the duration of insolvency procedures for both financial and non-financial enterprises. In turn, these measures should then act to increase both the survival rates of distressed enterprises and creditors' recovery values.

The current insolvency procedures for Italy are notoriously long and somewhat antiquated. On average, liquidations have lasted more than 8 years compared with an average of 2 years in the EU. Preferential creditors recover roughly 29% of claims, while unsecured creditors recover only about 6% of claims. Much of the low rate of recovery has been blamed on the slow initiation of claims, which then reduces the probability of recovering the full claim amount. Claims are often slow to be initiated because of the high collateralization rate; lenders worry less when they can seize the collateral if the loan cannot be repaid. However, as time passes, the risk rises that the value of the collateral could become impaired, making it even more important for a quick initiation of claims and efficient process of adjudication.

Other measures that the Italian government has either implemented or is working toward implementing include improvements to debt enforcement, an out-of-court mechanism for the enforcement of secured credit over immovable assets in commercial loans, and flexible forms of security interests over enterprise assets. Examples of these measures include an emphasis by Italian authorities to allow for renegotiation or sale of NPLs or enforcement of existing contract clauses, such as expediting the foreclosure on collateral on a case-by-case basis or through collective insolvency.

The IMF has also advocated the necessity for consolidation and governance reform of the Italian banking sector. Italy's banking system is comprised of about 640 banks, and to help spur consolidation authorities passed legislation over the last two years that would transform the governance structure of both large and small cooperative banks. The largest banks are expected to evolve into joint stock companies by the end of 2016, while smaller banks must consolidate under joint-stock (holding) companies with at least €1 billion in equity in about 18 months' time.

While recent reforms have generally acted to improve the legal framework, there are important remaining challenges to the institutional framework that have to be tackled, such as the overburdened judicial system and the general lack of expertise in dealing with insolvencies and NPLs. These reforms will take considerable time to implement, but will go a long way to ensuring that NPLs in Italy's bank sector are no longer a concern.

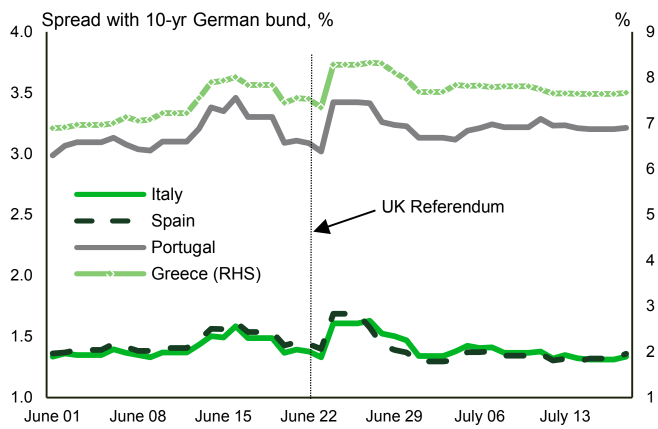
this scheme will at best have a marginal impact on the large gap between the price of NPLs on banks' books and their market price.

- **Atlante**: Setup earlier this year to prevent the failure of smaller banks to raise new capital in order to meet regulatory requirements and to spur purchases of NPLs by reducing the pricing gap between what banks are willing to sell at and what investors seek. Atlante is a bank rescue fund comprising of banks, insurance companies, pension funds and institutional investors. The fund is intended to essentially act as a buyer of last resort for non-performing loans, and its legal status as a private fund avoids any potential violations of BRRD rules on state aid. While the market had initially responded positively to the news of the fund's establishment, optimism has since waned as the fund's low level of capital – currently estimated at just under €5 billion – was not viewed to be adequate to fully remove the non-performing loans of Italian bank balance sheets and therefore unclog the bank lending channel in Italy. However, the Italian government has recently been pushing to expand private investment in the Atlante fund to over €40 billion, an amount that is believed sufficient to resolve the majority of the NPL concerns within the Italian banking sector.

Getting to the endgame

It is widely expected that the resolution of NPLs in the Italian banking sector will entail a combination of the solutions proposed above. Without consolidation of the fragmented Italian banking industry and reforms that enable an efficient judicial system, neither a strict BRRD resolution agreement, nor private investor involvement would be sufficient to address the NPL problem in the long-run. Furthermore, the high degree of retail ownership of the Italian banking sector debt would result in fairly substantial losses imposed on households at a time in which the Italian economic recovery is still in its early stages. As a result, some form of aid will likely have to be provided by the Italian government to mitigate the hit to household wealth and income from a BRRD bail-in, at least to compensate those who were unaware of the risk of their investment. Lastly, while it's encouraging that Italian authorities have put together the pieces that will support a private sector solution to the problem, the market is still immature. It could take quite some time until a mature market for securitized NPLs develops in Italy, time that Italian authorities don't necessarily have. The referendum this October on Italian constitutional reform for which a "no" result could trigger an election would likely act to delay implementation of any NPL resolution.

CHART 5: BOND YIELDS IN THE EURO AREA PERIPHERY REMAIN HIGHLY CORRELATED



Source: S&P Capital IQ, TD Economics. Last observation July 19, 2016.

Although the EU's BRRD was intended to be applied to member nations in a non-discriminatory manner, there is some precedent for flexibility. For example, Italian authorities have already been able to provide liquidity support to banks, and there are inherent exemption clauses which allow for a precautionary recapitalization of solvent institutions, encompassing temporary state injections of capital to shore-up and shortfalls. This would require a bail-in of only junior creditors – no senior creditors or depositors would suffer any losses.[6] Moreover, this would limit any potential contagion to other EU member nations, since this is something that has been a part of the state-aid control framework applied in the EU over the past three years.

Convincing EU authorities that the NPL situation in the Italian banking sector qualifies for an exemption should not be difficult in a post-UK referendum world. Prime Minister Matteo Renzi needs a win in the October referendum, and avoiding a deal that hits retail investors hard would be in the best interest of EU authorities who would prefer a pro-EU government remain in power in Italy.

The risk of doing nothing at this time cannot be understated. Yields on peripheral Euro Area sovereigns remain highly correlated, as observed in the uptick in the aftermath of the UK referendum (Chart 5). As such, an Italian banking crisis would likely spillover to peripheral Europe sovereigns and negatively impact core EU economies via trade and financial channels, raising questions on the future of the euro.

Given the downside risks, it's likely that Italian authorities will successfully negotiate an agreement with the European Commission (EC) that will require some flexibility on the imposition of the BRRD.

A compromised resolution will have to be implemented delicately

Whatever the details of the compromise agreement on the NPL resolution, the implementation process will be a delicate one. A number of challenges have to be addressed in order to achieve successful implementation:

- Adequate capital buffers and asset quality across all Italian banks would have to be enforced through strengthened supervision of the Italian banking sector.
- Historically, uncertainties in recovery values created disincentives for Italian banks to write-off NPLs. Therefore it's important for Italian authorities to move to remedy the problem of an overburdened and inexperienced judicial process regarding loan resolutions. Strong legal reforms to allow for swift enforcement and recovery of claims by lenders would go a long way to helping mitigate this challenge
- Relationship lending has been hindering swifter progress on NPLs. Lenders fear damaging their long-term relationship with borrowers, preferring to wait until borrowers can repay rather than proceed with calling in the loan. Perhaps with a more efficient judiciary and certainty of loan recovery this would be less of a concern.
- The establishment of strong incentives for banks to deal with NPLs in a timely manner. For example, the removal of tax disincentives that penalized Italian banks from pursuing an aggressive plan to reduce NPLs. The government has already moved on this front; since 2013, provisions and write-offs were deducted in equal installments over five years and with a higher tax rate, while since August 2015 write-offs are immediately tax deductible.
- Consolidation in the banking industry should help bring economies of scale to the Italian financial sector while helping expedite some of the market based solutions that Italian authorities have been working on implementing.
- The concentration of NPLs in commercial enterprises, particularly micro and small enterprises, makes it difficult to target particular industries for collective enforcement. Furthermore, the establishment of restructuring vehicles within a corporate sector to deal with restructuring of loans to micro and small business would also help.

Bottom line

The Italian economy is in the process of recovering from three consecutive years of recession. In order to ensure a long, sustainable economic recovery, a negotiated agreement between Italian authorities and the EC that expedites the resolution of the high amount of NPLs in its domestic banking sector is necessary in the near term. However, the agreement will be in the best interest of all parties if it includes a combination of structural reforms to the Italian banking framework with some form of state support – particularly to mitigate the losses on households from creditor bail-in. A negotiated deal is likely to occur in the near-term, possibly this week, but will likely take years to fully implement.

The risks of delaying a resolution cannot be understated. First, as the Euro Area's third largest economy, and given the high degree of trade and financial integration of the currency union between members and with the EU, a banking crisis in Italy could have significant negative repercussions for Euro Area and EU member states. A resolution in the current low inflation, low interest rate environment would work to proactively mitigate the crystallization of downside risks from an Italian banking crisis. Secondly, a solution that implicitly provides support to the pro-EU government of Matteo Renzi in this fall's referendum will mitigate concerns about the future of the euro. Lastly, the outcome of the negotiations will serve as a template in how flexible the BRRD will be expected to be applied to other Euro Area member states in need of bank restructuring.

ENDNOTES

1. IMF. "Staff Report for the 2016 Article IV Consultation". IMF Country Report No. 16/222, July 2016.
2. As a share of total EU bank assets in 2013 based on statistics from the European Banking Authority.
3. Garrido, Jose et al. "Cleaning-up Bank Balance Sheets: Economic, Legal, and Supervisory Measures for Italy". IMF Working Paper WP/16/135, July 2016.
4. IMF. "Staff Report for the 2016 Article IV Consultation". Box 5, IMF Country Report No. 16/222, July 2016.
5. IMF. "Staff Report for the 2016 Article IV Consultation". Box 5, IMF Country Report No. 16/222, July 2016.
6. Merler, Silvia. "Italy's bail-in headache". Bruegel.org, July 19, 2016. http://bruegel.org/2016/07/italys-bail-in-headache/.

Appendix 1: Timeline of actions taken by Italian authorities thus far

- In March 2015, both houses of parliament approved a decree to reform the governance of cooperative banks that had scored weakly in the FSAP. The reform removes key structural inefficiencies such as one vote per head and limitations on the size of individual shareholdings. The reforms are aimed at promoting consolidation and balance sheet cleanup, and improving profitability.
- In April 2015, a protocol of intent was signed by the Ministry of Economy and Finance and ACRI (the association of foundations) to foster the self-reform of the banking foundations. Foundations have committed among other things to adopt appropriate portfolio diversification to limit risk concentration and their participation in the capital of banks.
- In August 2015, the Italian government enacted a decree law containing measures that help banks offload NPLs. The decree includes a number of measures, including (1) improving the insolvency law to shorten the duration of procedures and increase both the survival of distressed enterprises and the creditors' recovery; (2) accelerating the fiscal deductibility of provisions by allowing banks to deduct loan losses from their tax bill within a year instead of five; (3) changes in civil procedures to strengthen debt enforcement; and (4) reforms to civil justice, including streamlined enforcement procedures, increased use of electronic processes and an increase in staff (through hiring from other administration areas).
- In November 2015, the authorities resolved four small banks.
- In late January 2016, the Italian authorities agreed with the European Commission (EC) on a mechanism called GACS to securitize and guarantee NPLs. The agreement appears to have put to rest for now the long-running discussion with the EC on setting up an asset management company (AMC), owing to EU state aid concerns.
- In February 2016, the Italian government approved a reform of small mutual banks, pushing them to consolidate under joint-stock (holding) companies with at least €1 billion in equity, in a bid to strengthen the fragmented local banking sector. The hope is this will create a single group in the next 18 months, the deadline for mutual banks to implement the reform.
- In April 2016, Italy's largest banks together with nonbank financial institutions and banking foundations, created a fund called Atlante that, so far, has raised €4.25 billion. The aim was to backstop capital increases of banks and purchase non-investment grade tranches of NPL securitizations (so as to reduce the gap between the prices that banks want to sell at and those sought by investors).
- In May 2016, a decree-law introduced out-of-court enforcement mechanisms for commercial lending relationships secured by immovable collateral; a new framework for non-possessory security interests over movable assets; a registry of enforcement and insolvency procedures; and other improvements to enforcement and insolvency procedures.

Source: Garrido, Jose et al. "Cleaning-up Bank Balance Sheets: Economic, Legal, and Supervisory Measures for Italy". IMF Working Paper WP/16/135, July 2016.