January 27, 2017

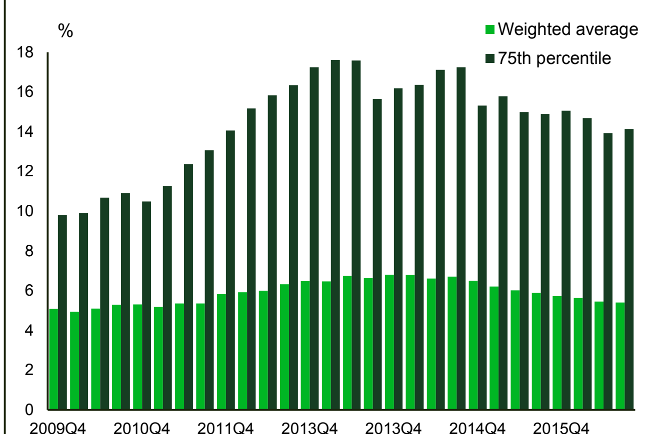
MORE NEEDS TO BE DONE TO RESTORE VIABILITY TO ITALY'S BANKING SECTOR

Highlights

- The large stock of legacy non-performing loans (NPLs) has weighed on the profitability of the Italian banking sector over the past several years.
- The government's "precautionary recapitalization" plan, backed by €20 billion in public funds, will provide much needed capital to help instill confidence in troubled banks but will not resolve the more underlying sources of the problem.
- More fundamental changes are needed to break the vicious circle between the dismal economic growth environment, low profitability of the banking sector and binding credit constraints.
- The risk of political instability ahead adds to the urgency of implementing much-needed structural reforms to accelerate resolution of NPLs, improve the growth outlook and enhance the efficiency of the banking sector.

Banking sectors across EU countries became encumbered by non-performing loans (NPLs) in the wake of the global financial crisis and ensuing European sovereign debt crisis. The total value of NLPs outstanding in the 129 banks examined by the European Banking Association (EBA) has declined from a high of 6.8% of total loans and advances (NPL ratio) in December 2013 to 5.4% in September 2016, which is just above the ratio in late 2009 (5.0%). There is, however, wide disparity across banks. As of September 2016, NPL ratios exceed 14% in one-quarter of the 129 banks, compared to 10% in late 2009 (implied by the 75th percentiles shown in Chart 1). There is also wide disparity across countries. NPL ratios are at extremely high levels in Cyprus (46.7%) and Greece (47.1%), and remain elevated in Portugal (19.8%), Italy (16.4%), Slovenia (16.3%) and Ireland (14.4%), all well above the EU weighted average of 5.4% (Chart 2). Italy ranks 4th on this list but its much greater economic size raises far-reaching issues of a systemic nature. Italy's GDP is about four times that of Cyprus, Greece, Portugal, and Slovenia combined and is the 4th highest in the EU (behind Germany, the UK and France).

CHART 1: NPL RATIOS IN 129 EU BANKS



Source: EBA Risk Indicators.

Recent reforms have yet to have a discernable impact on NPL resolution process

Reducing the large stock of NPLs has been a core element of the policy agenda for some time[1]. Italy has undergone a series of major reforms to modernize insolvency laws dating back to 2005[2]. In April 2016, the Italian parliament approved a series of legal and financial sector reforms introduced to facilitate the process. This includes measures to expedite the foreclosure process by making it

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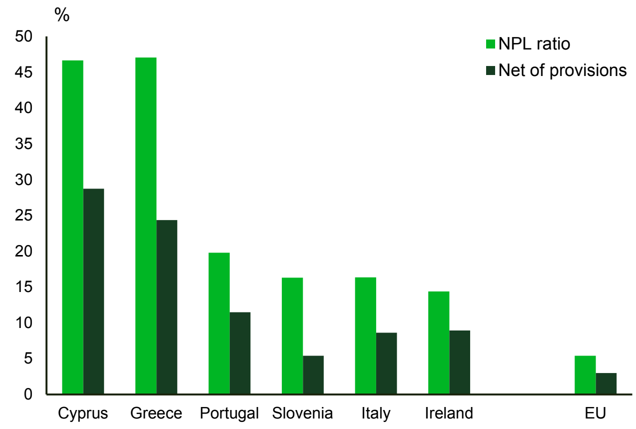
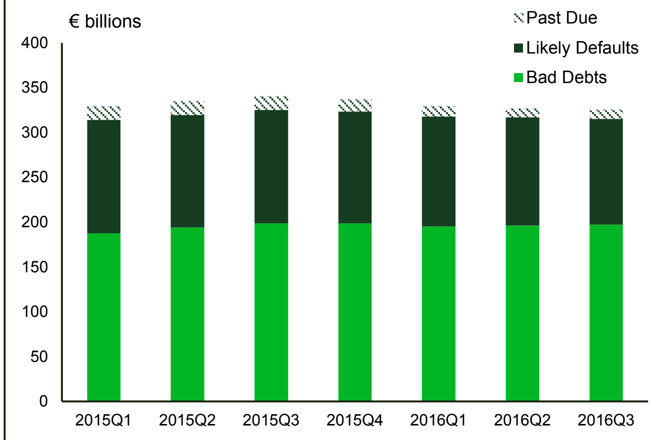
CHART 2: EU COUNTRIES WITH HIGHEST NPL RATIOS



Source: EBA Risk Indicators Q3 2016.

CHART 3: NPLS IN THE ITALIAN BANKING SECTOR



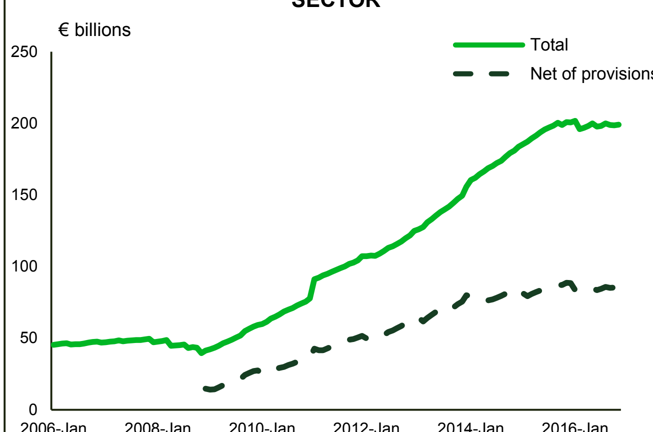
Source: Bank of Italy.

easier to collect collateral (bypassing the courts) and attach assets in a more timely, and less costly, manner. Measures were also undertaken to develop the market for distressed debt. There was an active market for securized NPLs in Italy, but demand collapsed in the wake of the global financial crisis and has not resurfaced. In January 2016, the Italian government, with the agreement of the European Council (EC), introduced the Garanzia Cartolarizzazione Sofferenze (GACS) mechanism designed to redevelop the market for NPL securitizations. The mechanism enables investors to buy public guarantees for investment grade tranches of NPL-backed securities. An industry-sponsored initiative (Atlante Fund) was established as a buyer of last resort for non-investment grade tranches.

Those reforms have yet to have a discernable impact. The amount of NPLs in the Italian banking sector has been virtually unchanged since early 2015 (Chart 3)[3]. In 2015, the EBA began classifying NPLs into three categories: 1) bad debts: exposures to insolvent companies; 2) loans likely to default: unlikely to pay in full and in a timely manner; and 3) payments past-due. Bad debts account for 60.5% of the total (as of September 2016), up from 56.9% in early 2015. This implies that credit quality has worsened, requiring higher provisioning (the provisioning rate for bad debts is 60%, compared to 28% for loans likely to default). Bad debts outstanding increased from around €50 billion prior to the global financial crisis in 2008-09 to close to €200 billion in mid-2015.The amount provisioned for losses increased by close to €85 billion over this period, equal to €14 billion a year on average, causing a major drag on profitability. Only about €6 billion in bad debts were sold or written off over the first nine months of 2016[4]. Yet, bad debts declined by only €1.7 billion over this period, indicating that banks incurred an additional €4.3 billion in bad debts. There has been virtually no change in the value of bad debts over the past eight months since the reforms were introduced (Chart 4).

The ability of Italian banks to sell or write off NPLs has been hampered by several factors. NPL sales have never played an important role in the Italian financial sector. For example, sales accounted for only 1% of bad debts in 2013[5]. Many corporate sector defaults involve family-owned businesses, which are especially problematic because collateral is hard to value and assets are difficult to attach. Non-financial corporations account for just over 70% of bad debts, up from 60% during the period prior to the global

CHART 4: BAD DEBTS IN THE ITALIAN BANKING SECTOR



Source: Bank of Italy.

financial crisis. Banks under financial pressures from low profitability and capital shortfalls are reluctant to discount NPLs to levels that investors demand to compensate for the high uncertainty surrounding recovery rates. Banks will ultimately have to accept deeper discounts in order to sell NPLs at market prices. Fragile banks are reluctant to acknowledge discrepancies between market and book value of NPLs because it would require higher provisioning and could lead to significant capital shortfalls. Raising new capital would clearly be difficult in the current environment clouded by political uncertainty, especially for banks saddled with high NPLs and an unfavorable profitability outlook.

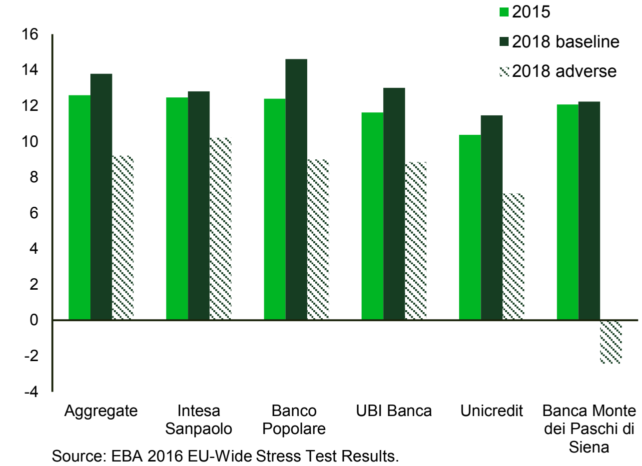
The Atlante fund is a positive development but its limited capacity constrains the overall impact for the banking sector as whole. The fund has raised €4.25 billion in equity, which can be leveraged at a maximum of around €9 billion, only €2.7 billion of which can be used to purchase non-investment grade securitized assets. This will also constrain the application of the public guarantee mechanism because at least 50% of the non-investment grade tranches have to be sold before public guarantees can be provided on the investment grade tranches.

EBA stress tests provide good insight into five of the largest Italian banks

It's hardly surprising that two of the five Italian banks that took part in the EBA 2016 stress tests came up short relative to other large EU banks. The stress tests are designed to gauge the resilience of individual banks to adverse economic developments captured by a hypothetical adverse scenario. The Common Equity Tier 1 (CET1) ratio aggregated across the 51 banks that participated in the exercise decreases from 12.6% in 2015 to 9.2% under the adverse scenario, compared to 13.8% in the baseline (Chart 5). In the case of Unicredit, the CET1 ratio declines to 7.1% in the adverse scenario, the fifth lowest ratio among the 51 banks that participated. The results for Banca Monte dei Paschi di Siena's (MPS) were more worrisome – its CET1 ratio declines to -2.4%, by far the worst performer.

UniCredit, the second largest bank in Italy (by assets), and Banca Monte dei Paschi di Siena (MPS), the fourth largest bank in Italy and oldest bank in the world, were required to restore their capital to levels deemed adequate by the ECB. In mid-December UniCredit announced a comprehensive plan that included a new equity issue, a major sell-off-of NPLs, and significant cost cutting measures. Shareholders approved a rights issue to raise €13 billion on

CHART 5: RESULTS FROM EBA 2016 EU-WIDE STRESS TESTS



Source: EBA 2016 EU-Wide Stress Test Results.

January 12th (following two previous rights issues of €4 billion in 2010 and €7.5 billion in 2012). UniCredit plans to sell €17.7 billion in NPLs (taking a one-off provision of €8.1 billion) and reduce operating costs by €1.7 billion a year by 2019. This entails cutting 6,500 jobs (on top of 7,500 previously announced), reducing its workforce by 14% in total and closing around 1000 branches.

MPS faces a much more difficult challenge. MPS had until the end of December 2016 to raise €5 billion in additional capital. A J.P. Morgan-led plan comprised of new equity, debt-for-equity swap and the sale of €27.6 billion in bad debts (taking a one-off provision of €18.5 billion) failed to attract sufficient investor interest, bringing an end to a private sector solution. The ECB subsequently revised its estimates of the capital shortfall to €8.8 billion, partly due to liquidity concerns stemming from substantial deposit draw-downs. MPS is expected to present a business plan in February that will include significant cost cutting measures (including the closure of 500 branches and cutting 2450 jobs over the next three years).

In an effort to restore confidence in the banking sector, the Italian government approved €20 billion in public funds to help stabilize banks under pressure. Of that, €6.5 billion has been allocated to MPS under a "precautionary recapitalization" scheme, which includes compensating 40,000 retail investors holding around €2.0 billion of the €4.5 billion in MPS's unsecured debt. Bailing-out subordinated debtholders conflicts with the broad objective of the Single Resolution Mechanism (SRM), one of the three main pillars of the EU banking union initiative. The SRM has at its core a uniform set of rules designed to ensure that bank's shareholders and creditors are able to finance capital shortfalls without the need for public funds. This is intended to short circuit the bank-sovereign risk negative feedback loop that plagued most countries at the center of the European Sovereign debt crisis. The EC may grant an exemption on grounds that the "precautionary recapitalization" plan for MPS remedies a serious disturbance to the Italian economy and preserves financial stability.

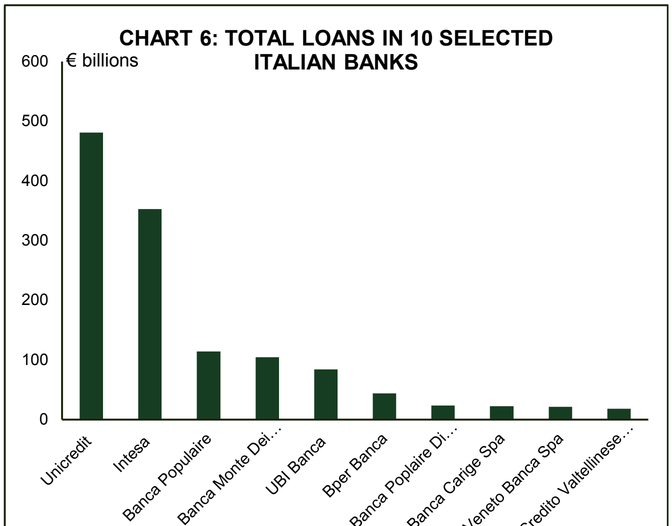
The SRM came into force in January 2016 and has yet to be tested. The EC may be reluctant to set a precedent by granting an exemption to Italy. Rejecting the plan, however, could weaken popular support for the ruling Democratic Party. Policy makers from across the political spectrum will recall the events in late 2015 when the restructuring of four Italian banks involved bailing-in €400 million in subordinated debt held by retail investors. The ensuing public unrest ultimately forced the government to backtrack and compensate retail investors for losses. If the plan is not approved by the EC, the Italian government could opt to compensate retail subordinated debt holders on grounds that they were misinformed by investment advisors.

Some small- and medium-sized banks are also heavily exposed

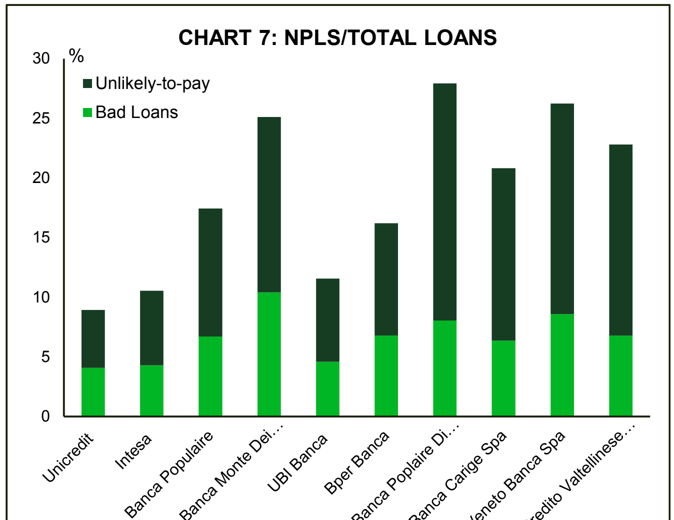
The five Italian banks that took part in the 2016 EBA stress tests account for about 63% of total NPLs and hence, provides a good indication of the extent which legacy NPLs weigh on the largest banks. Bad debts account for 10.7% of total loans (4.4% net of provisions) for banks deemed by the Bank of Italy as "significant", compared to 11.8% (5.1% net of provisions) for those deemed to be "less significant" (as of June 2016)[6]. This indicates that NPL exposures are somewhat higher for small- and medium-sized lenders, on average. This is supported by our analysis of ten Italian banks which indicates that there is no apparent relationship between the size of banks (measured using total loans) and NPL ratios (charts 6 and 7). Nor is there an apparent relationship between NPL exposures (chart 7) and the results from the 2016 EBA EU-Wide Stress Tests (chart 5). Specifically, stress test results were worse for Unicredit than for Intesa, Bansca Populaire and UBI Banca despite have lower NPL exposures.

Will €20 billion in public funds be enough to resolve Italy's legacy NPL problems?

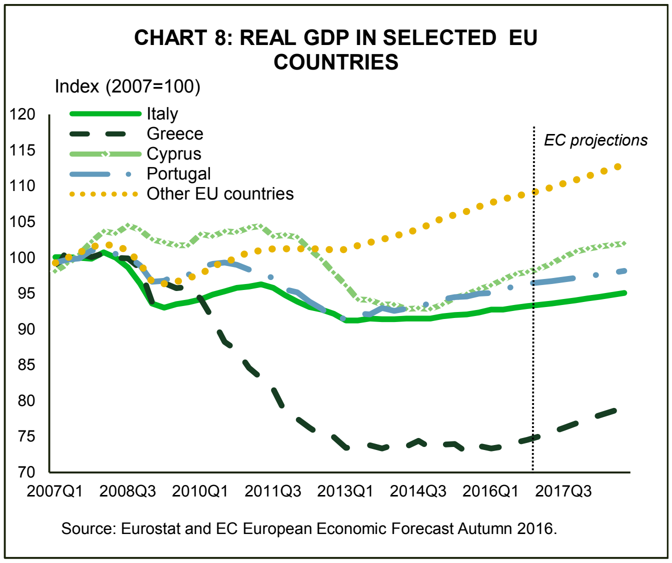
The government's "precautionary recapitalization" plan will help provide liquidity and restore capital buffers in banks that come under pressure. However, more fundamental changes are needed to address the deep-seeded problems underlying the dismal profitability outlook for the banking sector. The return on equity for the Italian banking system as a whole was only 1.5% for the four quarters ending 2016Q3, ranking above just Portugal (-2.4%) and Greece (-10.1%) among the 28 EU countries[7]. Provisioning to cover legacy NPLs have been but one factor weighing on profitability. Operating costs have increased over the past few years. Administrative and depreciation expenses have risen from 60.8% of net operating income in mid-2013 to 67.2% in September 2016, while the median ratio across EU countries has remained constant. The Italian banking system has the 4th highest operating costs among the 28 EU countries[8]. Major consolidation is needed to enhance the efficiency of the banking sector. This will entail closing branches (a core



Source: TD Economics calculations based on quarterly financial statements.



Source: TD Economics calculations based on quarterly financial statements.



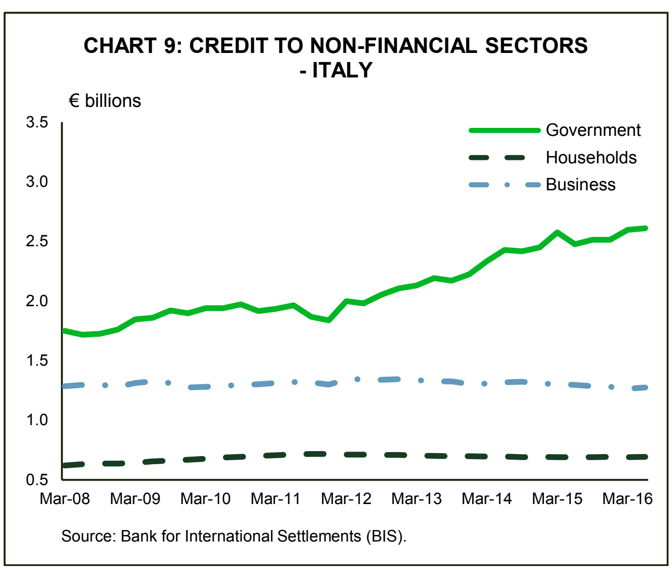
element of restructuring plans for Unicredit and MPS) and merging institutions.

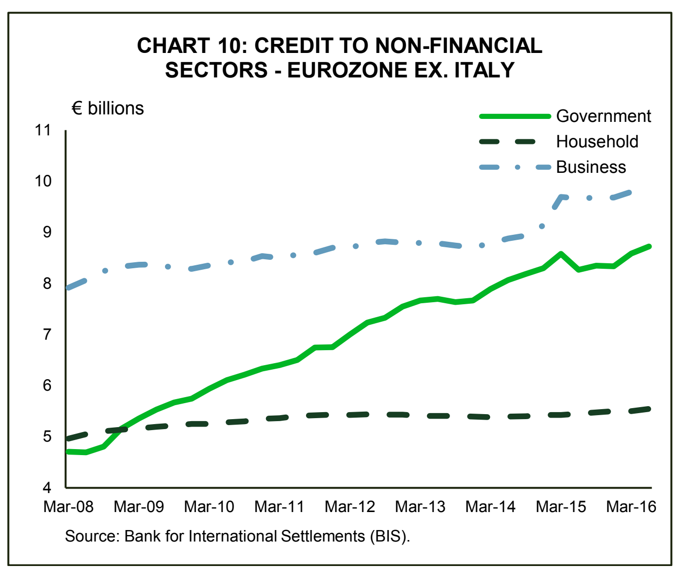
The dismal economic growth environment has also played a critical role. The Italian economy has yet to recover from the global financial crisis and ensuing European sovereign debt crisis. Real GDP remains well below its 2007 level (7% as of 2016Q3). On this basis, Italy ranks only above Greece among EU countries (Chart 8), and is outperformed by three countries—Ireland, Cyrus and Portugal—that were supported by troika (EC / ECB / IMF) programs during the period. The medium-term growth outlook for Italy is not encouraging. In January the IMF revised projections for real GDP growth in Italy from 0.9% to 0.7% for this year and 1.1% to 0.8% for next year, well below of growth projections for the Eurozone as a whole (1.6% in 2017, 1.7% in 2018)[8]. At this pace, Italy's real GDP will remain 5% below its 2007 level at the end of 2018.

The dismal growth environment and troubled banking sector have taken their toll on business credit. Credit provided to the non-financial sector in Italy has been stagnant since the onset of the global financial crisis, while credit provided to the public sector has doubled (chart 9). More recent data reported by the Bank of Italy indicates that credit provided to the non-financial sector registered zero growth over the 12 months ending in November. By contrast, credit provided to businesses across the Eurozone picked up noticeably in late 2014 and early 2015 (chart 10). The pickup coincides with policy measures introduced by the ECB to stimulate private sector credit growth - enhanced targeted longer-term refinancing operations (TLTROs) in September 2014 and the expanded asset purchase programme (APP) in March 2015. Those measures appear to have been successful for the Eurozone as a whole, but have had little discernible impact in Italy. Italian banks have little scope to expand lending activity in the stagnant growth environment. In cases where banks are unable to expand credit due to weak capital positions, credit constraints in turn further worsen the growth outlook, creating a vicious circle.

What can be done to break the vicious cycle?

On the macroeconomic policy front there is little scope for monetary and fiscal policy levers to improve Italy's growth outlook. The ECB is expected to begin the policy normalization process once there is firmer evidence that a robust recovery is underway in the Eurozone as a whole, or if mounting inflationary pressures raise concerns that





inflation will exceed its target. Higher interest rates, especially at the long-end of the yield curve, will improve profitability of the banking sector through higher net interest margins. The monetary policy normalization process is not expected to take hold until early 2018 and likely to be gradual, having little impact on the growth outlook for some time. Meanwhile, fiscal policy options for Italy are severely constrained by its high public debt burden. With gross general government debt at 132% of GDP (as of end-2015), the second highest among EU countries next to Greece (177%), reducing the public debt burden to manageable levels over time remains the priority.

This leaves structural reforms as the main policy area for fostering an economic environment more conducive to sustainable growth. Items high on the agenda include ambitious product and service market reforms to enhance competition, a wage bargaining framework to align wages with productivity and full implementation of public sector reforms. Progress has been made on implementing legal and financial sector reforms designed to facilitate the NPL resolution process, but more needs to be done. A recent IMF working paper provides a comprehensive set of recommendations along these lines[10]. This includes developing the market for distressed debt and requiring banks to have NPL-reduction strategies with clear targets and timelines. Operating costs also need to be reduced significantly for the banking sector as a whole, through downsizing and mergers.

The risk of political instability ahead adds to the urgency of implementing the structural reform agenda. The resounding rejection of the referendum held on December 5th adds political uncertainty to the mix of complicating factors. The caretaker government, formed following the resignation of Prime Minister Renzi, faces the difficult challenge of pushing forward on key reforms without losing popular support leading to general elections which must take place before March 2018. All three opposition parties favor leaving the Eurozone, two of which - Five Star Movement and Northern League-have anti-establishment platforms. The possibility of anti-establishment / Eurosceptic opposition parties forming a coalition government raises doubt that progress on the reform agenda would be sustained over the medium term.

Heightened political uncertainty alongside stalled progress on implementing structural reforms could worsen Italy's growth prospects, reinforcing the adverse feedback loop to undermine profitability of the banking sector. High dependence on wholesale funding makes the banking sector susceptible to a sudden swing in investor sentiment. A marked deterioration in funding conditions would have a major impact on liquidity. This would bring into question whether the "precautionary recapitalization" plan would be enough to address mounting solvency concerns, leading to a "banking resolution" stage of policy discussions.

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End Notes:

1. This was a central element of a TD Economics report that was prepared in July and has been highlighted in recent IMF surveillance activities, documented in the IMF Staff Reports for the Article IV consultations that took place in May (IMF Country Report No. 16/222, July 2016) and "Italy – Selected Issues" (IMF Country Report No. 16/223, July 2016).
2. Documented in "Insolvency and Enforcement Reforms in Italy" by José Garrido, IMF working paper WP/16/134 (July 2016, Box 1).
3. This estimate excludes NPLs to monetary and financial institutions, which totaled €29 billion in June 2016, 8% of the total.
4. Bank of Italy Financial Stability Report (November 2016, p. 32)
5. Nadège Jassaud and Kenneth Kang, "A Strategy for Developing a Market for Nonperforming Loans in Italy", IMF working paper WP/15/24 (February 2015, p. 17)
6. Bank of Italy Financial Stability Report (November 2016, Table 4.1).
7. Based on the EBA return-on-equity measure: profit or loss over past four quarters / total equity reported in EBA Risk Dashboard (data for Q3 2016).
8. Based on the EBA operating cost / income measure: administrative and depreciation expenses / total net operating income reported in EBA Risk Dashboard (data for Q3 2016).
9. January 2016 IMF World Economic Outlook Update.
10. " Cleaning-up Bank Balance Sheets: Economic, Legal, and Supervisory Measures for Italy" by José Garrido, Emanuel Kopp, and Anke Weber IMF working paper WP/16/135 (July 2016, pp. 20-23)