FINANCIAL SYSTEMS

Italian banks: still challenges ahead

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Solvency needs to be further strengthened

In the ECB comprehensive assessment the Italian banking sector stood out as one of the weakest, with nine out of 15 banks displaying capital shortfalls in the adverse scenario (€9.4bn) and eight banks in the AQR and the baseline scenario. These shortfalls were relatively manageable for most banks and for five of them were covered throughout 2014. Nevertheless, capital cushions are quite limited for a few banks. Two of the failing banks (Banca Monte dei Paschi, BMPS, and Banca Carige) are currently undertaking rights issues which will be concluded before the end of June.

At the end of 2014, the CET1 capital ratio at system level stood at 11.8% (vs a median of 12.8% for Euro area significant banking groups) falling to 11.3% (11.5%) on a fully-loaded basis. In the European context, Italian banks display above average leverage ratios, as result of the relatively high proportion of RWA to total assets. At the end of 2013, the average for the 15 banks participating in the stress test stood at 5% (versus 4.2% for the European average) and it has further improved throughout 2014.

High non-performing loans despite no asset price bubble

Despite an improved economic outlook, Italian banks continue to display deteriorating asset quality indicators. Since 2007, the ratio of impaired loans to total loans more than tripled and as of December 2014 stood at 17.7%. This high ratio is explained by (i) the large exposure to the corporate segment, particularly SMEs, (ii) the lengthy workout times due to a slow judicial system and a conservative write-off policy and (iii) a conservative definition of NPLs which includes also substandard and restructured loans. In the first quarter of 2015 the volume of problematic assets continued to increase. Regarding provision coverage it fell from around 50% in 2007 to 40% in 2012 and improving to a still modest 43% at end-2014, due to the stress test.

Given the high absolute level of NPLs (around €350bn, 22% of GDP) the Italian authorities are studying targeted measures to reduce the banks' stock of NPLs, in particular, the setup of a bad bank. In principle, it would only acquire bad debts for up to €100bn and most likely only including corporate and SMEs loans.

Structural modest efficiency and profitability

In 2014 banks' profitability remained negative for the fourth year although losses receded considerably. The ROE of Italian banks net of goodwill impairments was close to zero, which compares to -11% in 2013, -1% in 2012 and -13% in 2011. For the three largest banks, 2015 first quarter results show profitability improvements underpinned by higher revenues, flat operating expenses, still elevated loan loss provisions but significantly below the peak experienced in the fourth quarter of 2013 and 2014. Foreign operations, chiefly focused on CEE countries, not only failed to protect Italian banks' income statement, but also added losses to those generated in Italy. With a still fragmented banking sector, Italian banks have room for efficiency improvements.

The Bank of Italy analysed the effect of the ECB asset purchase programme on banks' profitability and it concluded that the impact on net interest income is negative in 2015 and positive in 2016 (due to an increase in volumes) and in terms of pre-tax profits it is positive in both years.

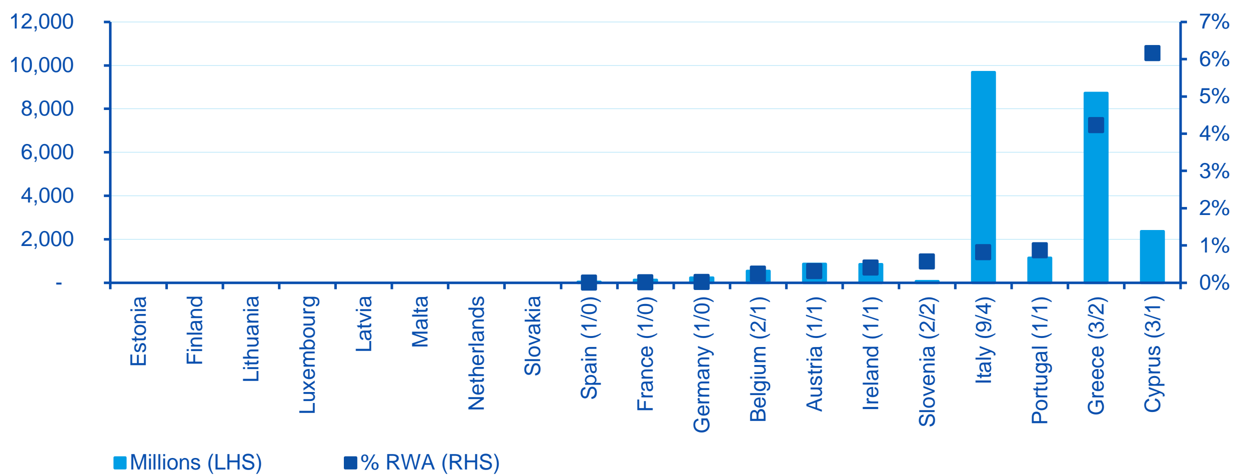
Comfortable liquidity position

Italian banks have solid deposit bases and relatively reduced funding gaps which place them in a better position to deal with potential liquidity squeezes. The remuneration of deposits has come down but remains almost 90bps higher than that offered, for example, by Spanish banks. This probably helps to explain the continued increase in volumes. Italian banks participated actively in the TLTROs demanding €93bn in the first three auctions (1/3 of total funds) and reached total ECB funding of €155bn (4% of total assets) at the end of April 2015. At system level liquidity and funding is not a concern but some small players mostly retail funded banks may face challenges to comply with new regulatory requirements such as the MREL.

1. Solvency needs to be further strengthened

In the ECB comprehensive assessment the Italian banking sector stood out as one of the weakest with nine banks out of 15 displaying a capital shortfall (€9.4bn) at end-2013 in the adverse scenario. Eight banks had also a capital shortfall both in the AQR (€3.3bn) and in the baseline (€5.3bn) scenario. The latter indicates that absent of any stress test eight banks had a CET1 ratio below 8%. With capital raising initiatives taken throughout 2014 (and accepted by the ECB, i.e. rights issues), the number of failing entities fell to four in the adverse scenario (€capital shortfall of €3.3bn). With all capital strengthening initiatives taken in 2014 (including divestments or de-risking which were not contemplated in the exercise reporting templates) the number of failing entities falls to two with a €2.9bn capital shortfall.

Figure 1
Capital shortfall in the stress test scenario (€ million and as % of RWA)



In parenthesis displays the number of failing entities in the adverse scenario as reported at end-2013 / with capital raising initiatives conducted in Jan-Sept 2014).

Source: BBVA Research based on ECB

Within failing banks, Banca Monte dei Paschi (BMPS) showed up with an initial capital shortfall of €4.3bn (falling to €2.1bn with capital increases in 2014) and Banca Carige with €1.8bn (€0.8bn). Both banks are currently performing capital increases.

Table 1
Capital shortfall in the ECB comprehensive assessment as of December 2013

	Capital shortfall					
	AQR		Baseline		Adverse	
	bps	€ million	bps	€ million	bps	€million
Banco Popolare - Società Cooperativa	6	34	130	693	77	427
Banca Popolare Dell'Emilia Romagna	0	0	0	0	28	128
Banca Popolare Di Milano	111	482	146	647	153	684
Banca Popolare di Sondrio	63	148	76	183	130	318
Banca Popolare di Vicenza	41	119	54	158	233	682
Banca Carige	412	952	566	1.321	786	1.835
Banca Piccolo Credito Valtellinese	48	88	105	197	199	377
Banca Monte dei Paschi di Siena	123	845	199	1.516	559	4.250
Veneto Banca	230	583	222	574	277	714
Total		3.252		5.290		9.413

Source: BBVA Research based on ECB

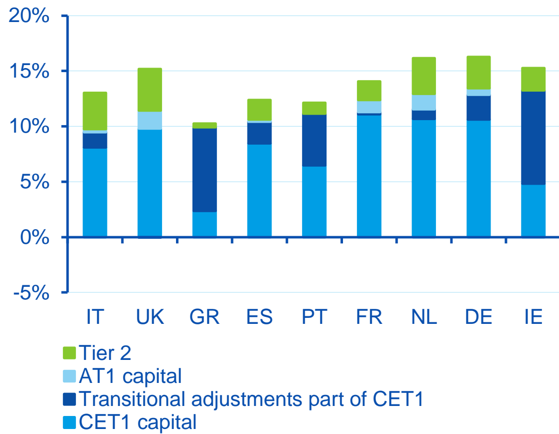
BMPS is conducting a €3bn rights issue which is fully underwritten by a pool of investment banks and is expected to be completed by the end of Q22015. At the end of the first quarter, the CET1 ratio stood at 8.1% and is expected to increase to 10.9% after the capital increase, above the 10.2% prudential requirement imposed by the ECB.

Banca Carige has also approved a €850 million rights issue, fully underwritten by a pool of investment banks, which will raise the CET1 ratio to 12.3%, 70bps above the 11.5% prudential requirement imposed by the ECB, which needs to be accomplished by July 2015.

As can be seen in chart 4, Italian banks participating in the ECB comprehensive assessment displayed the lowest CET1 ratio (8.1%) from the sampled banking sectors. According to the Bank of Italy, the CET1 capital ratio at the end of 2014 improved considerably standing at 11.8% for the entire banking system. For the five largest banks this ratio stood at 11.4%, with the two largest banks at 11.7%. Similarly to other European banking sectors, capital ratios, and in particular the CET1 capital includes transitional adjustments which will be phased out during a period of 5 to 10 years. With the full implementation of Basel III, the CET 1 ratio would amount to 11.3% at end-2014[1].

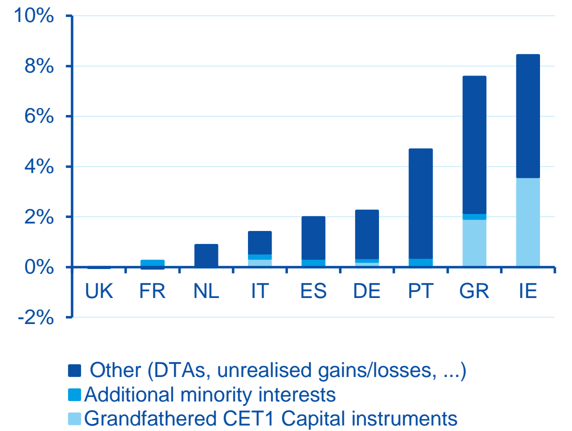
1: Information included in the Bank of Italy's Financial Stability Report, April 2015.

Figure 2
Breakdown of regulatory capital ratios, Dec 2013



Source: BBVA Research based on ECB

Figure 3
Breakdown of transitional adjustments (% risk weighted assets)

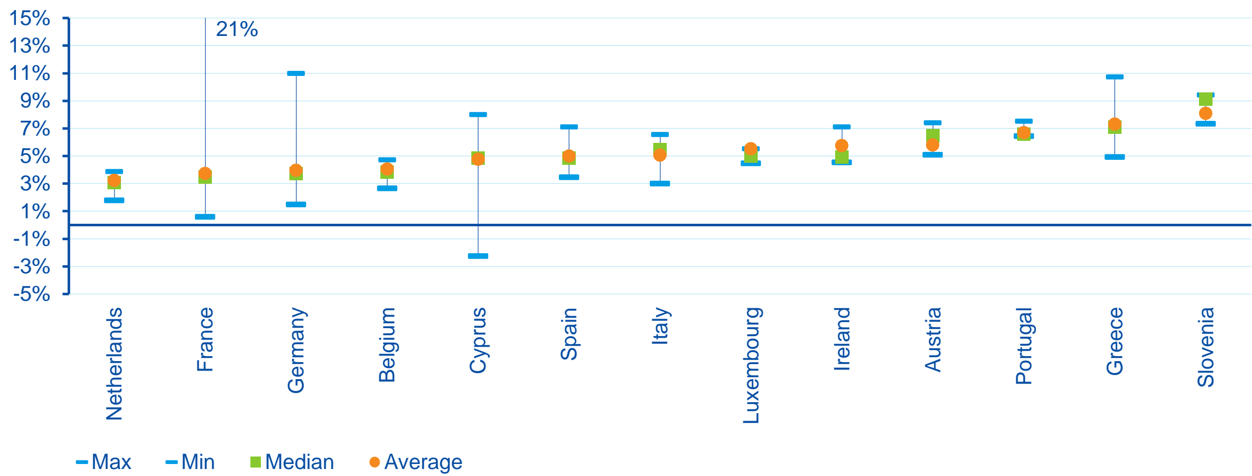


Source: BBVA Research based on ECB

These transitional adjustments amounted to 1.4% of RWA at year-end 2013 for the 15 banks participating in the European stress test (chart 5), which means that transitional adjustments decreased throughout 2014, as they would only represent 0.5% of RWA at end-2014 for the entire system (this also means that smaller players are likely to have lower transitional adjustments than larger players). At system level transitional adjustments stood at €55bn at end-2014, most of which (€43bn) were DTAs that arise from temporary differences and do not rely on future profitability and therefore are risk-weighted at 100% for regulatory capital calculation purposes. The European Commission recently asked Italy and other member states for information on the characteristics of the tax rules that allow the transformation of DTAs in tax credit, in order to make sure that they do not constitute state aid to the financial sector. In Italy they do not discriminate between sectors of economic activity and they only reduce the tax disadvantage to which banks are subject to as loan loss provisions are not tax deductible immediately but over a period of 18 years (up to the 2012 tax year and five years since 2013), so in principle they should not be considered state aid.

In the European context, Italian banks display above average regulatory leverage ratios, as result of the relatively high proportion of RWA to total assets (as they are mainly retail banks). At the end of 2013 the median and average for the 15 participating in the ECB comprehensive assessment stood at around 5% (versus 4.2% for the European average) but it has further improved with the capital strengthening initiatives taken throughout 2014.

Figure 4
Leverage ratio for European banks as of December 2013



Source: BBVA Research based on EBA

Although solvency is satisfactory at system level, it does not inform about heterogeneity across entities and the need that some still have to reinforce their capitalisation, as is the case of BMPS and B. Carige (6% of total assets). In addition, there were several Italian banks whose excess of capital over the 5.5% threshold in the adverse scenario was very limited, even after the capital raising initiatives conducted in 2014, such as Veneto Banca, Banca Popolare de Sondrio or Banca Popolare de Vicenza or Banca Popolare de Milano. Finally, among the largest banks, Unicredit displays lower than average capital ratios with CET1 ratio standing at 10.4% at the end of 2014, above the 9.5% required by the single Supervisor Mechanism (SSM).

Public capital injections to Italian banks have been very small by international standards and represent only around 0.5% of GDP. Given the Banking Recovery and Resolution Directive (BRRD) implementation it is very unlikely that public support will increase in the foreseeable future as private solutions will take the lead. It is nevertheless noticeable that Italy has not transposed the BRRD into Italian law (the limit for transposing the Directive expired at end-2014) and the bail-in provisions must be incorporated into Italian law by 1 January 2016. Bank of Italy has recently urged to meet these deadlines not only to avoid sanctions by the European institutions but also to enable the authorities to use the tools assigned to them by the European legislation (bail-in, bridge bank, etc).

Finally, we should not forget that the Italian banking sector remains very fragmented and that there are several small Italian banks which did not participate in the ECB comprehensive assessment as they will not be directly supervised by the SSM and for which there is limited available financial information. It is likely that the Italian central bank has also required vulnerable banks to strengthen their capital base. However, given the potential limited ability of some of the small players[2] to raise capital, it is likely that they are absorbed by larger players with stronger capital bases.

2: Banks with assets between €3.6-€21bn (considered by Bank of Italy as small banks) and minor banks (assets below €3.6bn) account for 15% of total lending but represent about 90% of banks incorporated in Italy.

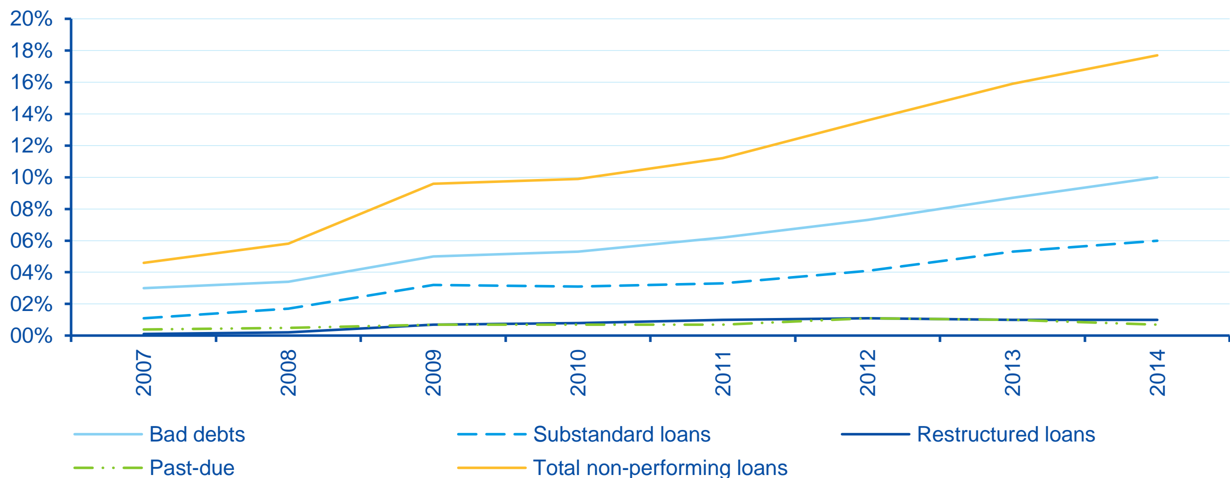
2. High non-performing loans despite no asset price bubble

Despite improved economic prospects, Italian banks continue to display deteriorating asset quality indicators. Since 2007, the ratio of impaired loans (which includes not only non-performing loans but also substandard and restructured loans) to total loans more than tripled and as of December 2014 stood at 17.7%.

Italian banks have always displayed poorer asset quality indicators when compared to their European peers. This is due to the lengthy workout times for problem loans which on average last seven years on a bank's balance sheet (vs 2 years in Spain) as result of a conservative write-off policy (banks can only write-off when a borrower is in bankruptcy) and a slow judicial system. Another important reason is that Italian banks include restructured and substandard (borrowers in temporary difficulties) in their NPL ratio, which does not occur in most European countries. Since January 2014, the Bank of Italy has aligned the definition of NPLs to the nonperforming exposures and forbearance notion provided by the EU regulation on supervisory reporting.

Despite this relatively conservative accounting criteria, in the AQR Italian banks saw their non-performing exposures in the corporate segment reviewed slightly upwards and the impact of the AQR in the capital ratios was the fourth largest (gross impact of 150bps in the 2013 CET1 ratio), just below Greece, Estonia and Slovenia. The impact was underpinned by the need of reinforcing provisions in the corporate loan book, which accounts for 58% of the loan book versus 45% in the Eurozone and 43% in Spain. The above-average concentration in the corporate segment (mainly composed of SMEs) is another reason for the high NPL ratio. In fact, more than 80% of NPLs are concentrated in this segment. The NPL ratio in the corporate segment reached 30% and is significantly higher in the South of Italy. In the first quarter of 2015 the volume of problematic assets continued to increase.

Figure 5
Evolution of the NPL ratio for the Italian banking sector



Source: BBVA Research based Bank of Italy

The deterioration is across all sectors although the sharpest rise is in construction, which accounts for 11% of total credit to the private sector (5% in Spain). The Italian corporate sector is highly leveraged, with a substantial amount of firms dedicating at least half of their operating profits to service their debt (according to the IMF the health of the corporate sector is only worse in Portugal and Spain, in which businesses spend an even higher proportion of their revenues to pay the interest on their debt).

Problem loans to households have increased more modestly (household leverage is not an issue in Italy with one of the lowest household debt to disposable income ratio, standing at 55% versus 63% for the Eurozone.) than in the corporate sector although they represent a smaller share of the private loan book (42% at the end of March 2015). Within the household loan book, mortgages, which entail a more limited risk for banks, represent 60% of lending to families.

With regards to provisioning coverage (total provisions as percentage of NPLs) it did not keep pace with the increase in NPLs, declining from around 50% in 2007 to 40% in 2012. This ratio improved ahead of the European comprehensive assessment results' publication to a still modest 43% at the end of December 2014 (compares to 58% in Spain). Large banks display larger coverage ratios than smaller entities, despite improvements across the entire system as result of inspection programmes conducted by the Bank of Italy and the AQR.

Given the high absolute level of NPLs (around €350bn, 22% of GDP, of which €190bn are bad debts) the Italian authorities are studying targeted measures to reduce the banks' stock of NPLs, in particular the setup of a bad bank, which would acquire Italian banks' bad debts. The IMF has claimed about the need of a strategy to deal with NPLs in Italy. Italian authorities claim that the long workout times are the result of (i) long credit recoveries and insolvency procedures; (ii) NPLs consist mainly of exposures to SMEs operating in different sectors with borrowers providing collateral whose value is more difficult to assess than if the collateral provided was just for example real estate; (iii) the fragmentation of the Italian banking market with many small banks lacking the expertise and the technologies to manage and or /sell NPLs; (iv) lack of incentives to sell these assets as the sale would probably entail the recognition of losses as buyers want to make profits from the transactions.

In principle the bad bank would only acquire bad debts (excluding the other impaired loans, i.e., substandard and restructured loans) for up to €100bn (gross of loan loss provisions) and most likely only including corporate and SMEs loans. Similarly to the Sareb in Spain it would exclude positions below a given threshold. The ownership structure of the bank is not decided yet but the Bank of Italy and Italian authorities want to avoid the introduction of state aid rules which would force participating banks to perform restructuring and bail-in of subordinated creditors. In order to avoid that transfers are considered State aid these need to be done at market price, which given the Spanish experience is very difficult to implement (transfers to the Sareb were considered State aid in all cases) and in any case are likely to trigger the recognition of losses for selling banks.

Regarding the evolution of the loan portfolio, lending to households has been very stable in the last couple of years (-1% contraction) and stabilising in the last months, while in the corporate segment the contraction was around -5% in 2013, -2% in 2014 and is around -3% in the first quarter of 2015.

Finally and regarding the exposure to Italian public debt, Italian banks have maintained a stable portfolio since mid-2013, which accounts for around 10% (€427bn) of total assets[3], after a period. According to the Bank of Italy, portfolio revaluations explain the recent slight increase in absolute value and are not the result of acquisitions. Actually, Italian banks made some disposals to book capital gains. The exposure of Italian banks to domestic government bonds is similar to that of Spanish banks, which accounts for 9% of total assets and stood at €275bn at the end of March 2015. Considering that the European Systemic Risk Board has issued a report in which it put forward several alternatives on the regulatory treatment of sovereign exposures, Italian banks would be, together with the Spanish, the most impacted by the hypothetical removal of the zero risk-weight.

3: During 2012 and the first of half of 2013 the bond portfolio had increased by around €180bn, but has mentioned above has remained relatively stable since then.

3. Profitability and efficiency

In 2014 the profitability of Italian banks remained negative for the fourth consecutive year although the amount of losses receded considerably from previous years. The return on equity of Italian banks net of goodwill impairments was close to zero, which compares to a ROE of -11% in 2013, -1% in 2012 and -13% in 2011. The Bank of Italy analysed the effect of the asset purchase programme on banks' profitability (using Bank of Italy's econometric model) and concluded that banks' pre-tax profits would increase €300 million in 2015 and €1.4bn in 2016. It also concluded that the impact on net interest income would be negative in 2015 as the decline in interest revenues would not be compensated by the decline in interest expenses, but that in 2016 the impact on NII would be positive due to the positive effect on volumes.

For the three largest banks, the first quarter of 2015 shows profitability improvements underpinned by strong trading income, fee and commission income and, in the case of BMPS, better NII as result of the reimbursement of government-backed financial instruments. Administrative expenses are flat, while loan loss provisions remain high with the cost of risk[4] above 100bps for BMPS and around 80bps for Unicredit and Intesa, but significantly below the peak in the fourth quarter of 2013 and 2014.

With regards to foreign operations, chiefly focused on CEE countries, and concentrated on two players, they were not able to smooth the losses booked domestically. In fact they not only failed to protect Italian banks' income statement, but also added losses to those generated in Italy. This is in clear contrast with profits booked by Spanish banks abroad.

Italian banks do not stand out for their efficiency levels. According to the information from the ECB consolidated banking statistics, the cost-to-income ratio for the system stood at 59.5% as of June 2014 down from above 60% in the previous years. There is heterogeneity across banks with some of the largest players with good ratios (Intesa with 44% in Q12015, positively impacted by trading gains) while smaller players are likely to have less efficient cost bases. Unicredit and BMPS are in line with the average.

The outlook in terms of profitability is gloomy not only due to the low interest rate environment and the subdued business volumes but above all because Italian banks retain a considerable amount of unproductive assets on their balance sheets which have not started to fall yet. It is unclear if the balance sheet clean-up has ended particularly for smaller players which were not directly scrutinised by the SSM. The setup of a bad bank might also force the recognition of additional losses. Nevertheless, in a scenario of economic growth it is likely that asset quality indicators start to improve and loan loss provisions fall leading to improved bottom line results. Despite cost-cutting efforts in the last years, there seems to be room for further efficiency improvements, particularly considering the relatively fragmented Italian banking sector and the potential for cost synergies arising from consolidation in the banking sector.

4. Comfortable liquidity position

Italian banks have solid deposit bases and relatively reduced funding gaps which place them on a better position to deal with potential liquidity squeezes. Deposits from households, which account for most of customer deposits, grew by 3% in 2014 while corporate deposits grew by 8%. In the first months of 2015 deposits continue to increase at a similar pace. The remuneration of deposits in Italy has come down but at a slower pace than that in Spain, for example. In March 2015, Italian banks still paid on average for new time deposits 1.24% (which compares to 0,44% in Spain) and therefore there is room for lowering deposits remuneration with a potential negative impact in terms of volumes (substituting deposits by off balance sheet products).

4: Loan loss provisions as percentage of the gross loan book.

The growth in retail and wholesale funding together with the deleveraging process (in 2014 loans to households and corporates fell 1% and 2.5%, respectively) allowed Italian banks to reduce their dependence on ECB funding which stood at €155bn or 4% of total assets (compares to 4.5% in Spain) at the end of April 2015 (the peak was in the fall of 2012 at €280bn). Italian banks participated actively in the TLTROs demanding €93bn in the first three TLTROs (€29bn in each of the first two and €36bn in the third one), which corresponds to 1/3 of the liquidity requested in these auctions by all Eurozone banks. It is likely that Italian banks will continue to borrow from the ECB in the next TLTROs because they have a substantial amount (€53bn) of 3 months refinancing operations and main refinancing operations account for an additional €10bn. According to the Bank of Italy, Italian banks have a substantial amount (€250bn) of freely available eligible assets (mainly composed of central government securities) that could be pledged with the ECB. Since September 2014, the Bank of Italy has expanded the collateral accepted for Eurosystem monetary operations and therefore loans currently account for 20% of the pool of assets committed to the Eurosystem (freeing up other types of collateral).

According to an analysis performed by the Bank of Italy, the ECB ABS and covered bonds purchase programmes have had an impact on the ABS and covered bond market in Italy. RMBS and covered bonds spreads at issuance decreased 41bps and 55 bps, respectively, of which Bank of Italy estimates that 30bps (RMBS) and 25bps (covered bonds) were attributable to the programmes announcement although the purchases per se had a limited impact. Additionally, the programmes allowed issuers to mobilise securities on banks' books as 70% of Italian ABS purchases performed by the ECB in the secondary market were from "retained" securitisations.

Liquidity is not a concern for the Italian banking sector as a whole given the (i) better market sentiment towards most peripheral countries, (ii) the ability of Italian banks to tap wholesale markets, (iii) the on-going increase in retail deposits, (iv) the small funding gaps, (v) the more modest reliance on ECB funding than in the past and the existence of unencumbered collateral to increase funding at the ECB if needed. However, at micro level there could be some banks with a more challenging funding position: those with higher than average dependence on ECB funding and lower ability to tap wholesale funding markets, particularly for those banks which are mainly retail funded and may face difficulties in complying with new regulatory ratios, such as the MREL.

5. Conclusions

The Italian banking sector was not at the epicentre of the financial crisis and has muddled through in a relatively favourable position requiring very little public support. However, its performance in the ECB comprehensive assessment was amongst the worst, which indicates that the review and stress test of Italian banks was a necessary condition for additional clean-up and recapitalisations. Italian banks are in the process of reinforcing their capital base while asset quality indicators remain challenging with still rising NPLs. National and international authorities are focused on reducing the level of problem loans with the setup of a national bad bank and other initiatives that could speed up the workout of problematic assets (simplification of judicial procedures, improvements in the insolvency law). This is a structural problem for Italian banks and therefore addressing it in a comprehensive way will be positive for the economic recovery. Other issues that also deserve attention are the on-going improvements in the corporate governance of Italian banks cooperatives and foundations which should also ease consolidation processes going forward. In broader terms, and similarly to other European peers, Italian banks also face a challenging profitability environment, which nevertheless could be improved with a more efficient cost base, particularly considering the relatively fragmented Italian banking sector and the potential for cost synergies arising from consolidation in the banking sector.

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