8 Italy

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The Italian banking landscape

Italy's banking system is less concentrated than those of most other euro-area countries, especially when the absence of large institutional protection schemes such as those in Germany or Austria is taken into account. Following a series of mergers in the 1990s and 2000s, two groups, UniCredit and Intesa Sanpaolo, are positioned ahead of their peers, with combined assets representing 47 percent of the Italian total. All other Italian SIs combined add up to only 25 percent of this same total, and about 500 LSIs account for the remaining 28 percent. In other words, the Italian banking system can be described as two large pan-Italian banks (even though, with less than €1 trillion each in assets, they are not among the very largest in the euro area), and a 'long tail' of small banks, most of which only have a regional or local footprint[92].

Italy had historically relied on strong local and regional public savings banks (Casse di Risparmio or Monti di Pietà), and a number of national state-owned banks from nationalisations during the first half of the twentieth century. In the 1990s and early 2000s, the savings banks were transformed into commercial entities and the state-owned banks were privatised, triggering a wave of mergers that led to

92 The figures in this paragraph are based on data from different sources. The consistency of these sources has been checked with the Bank of Italy.

the formation of Intesa BCI, UniCredit, SanPaolo IMI and Capitalia. As a result of the savings banks reform and bank mergers, the local public interests in the biggest banks were managed through foundations, which retained controlling stakes in the consolidated groups. In 2007 Intesa and SanPaolo merged, and Capitalia was absorbed by UniCredit. Meanwhile foundations typically became minority shareholders, and Italy's central government almost entirely exited the banking sector[93].

Among the medium or small-sized banks a number are cooperatives (Banche Popolari and Banche Cooperative) with governance historically based on a one-shareholder-one-vote principle, as opposed to the usual one-share-one-vote – ie all shareholders, large or small, have identical voting power, even for those Banche Popolari (SI or LSI) that are publicly listed. The Banche Cooperative are local banks, often very small.

The national central bank, Bank of Italy (Banca d'Italia, often referred to as Bankitalia), is the Italian national supervisory authority and also the national resolution authority.

The 2014 comprehensive assessment and its interpretation

From mid-2012 to the end of 2013, Italian banks started a process of recapitalisation and continued the deleveraging process started in the second half of 2011, when Italian sovereign spreads rose significantly. However, this was insufficient to align Italian banking indicators with European ones in terms of risk-weighted capitalisation and profitability. Crucially, the Italian banks were unable to reduce their stockpile of non-performing loans (NPLs), which instead kept growing. These are the main reasons for the Italian banking sector's poor performance in the 2014 comprehensive assessment, which involved an asset quality review (AQR) and stress tests.

93 Cassa Depositi e Prestiti (CDP), a large government-controlled entity, is not a bank but a special financial institution supervised by the Bank of Italy.

The final report published on 26 October 2014, identified 25 banks as failing the assessment as of the end of 2013, with an aggregate capital shortfall of €24.6 billion and an additional asset value adjustment (from the AQR) of €37 billion, adding up to a total impact of €61.6 billion. Of these 25 banks, nine were Italian, or three-fifths of the 15 Italian banks reviewed[94]. Italy thus contributed 36 percent of all banks failing the assessment, with a total capital shortfall of €9.7 billion (around 39 percent of the total), far higher than any other euro-area country.

By the beginning of 2014, the majority of these banks realised they would not meet the capital adequacy conditions. They therefore intensified their recapitalisation efforts during the first three quarters of that year. By the end of September 2014, 12 of the 25, including five of the nine Italian banks, were able to overcome their capital shortfall by implementing recapitalisations during 2014 for an aggregate amount of €15 billion (€8.2 billion for the five Italian banks). Conversely, the other 13 banks, including four Italian banks, still had inadequate capital by the time of publication of the comprehensive assessment's results. The four Italian banks accounted for an aggregate capital shortfall of €3.3 billion or a third of the €10 billion total for the 13 remaining 'outliers'. The four Italian banks were: Banca Popolare di Milano (BPM), Banca Popolare di Vicenza (BP Vicenza), Cassa di Risparmio di Genova (Carige) and Monte dei Paschi di Siena (MPS).

These four, together with the other nine negative outliers from other countries, were given two weeks to establish capital plans that would rectify their capital gaps within nine months. BPM and BP Vicenza had approved but not yet implemented capital adjustments

94 See ECB (2014a) and Bank of Italy (2014a). The list of 130 banks participating in the comprehensive assessment in 2014 does not completely match the list of SIs euro-area-wide. This also applies to Italy. Banca di Credito Valtellinese and Credito Emiliano were assessed in 2014 but are now designated as LSIs. The 15 Italian banks assessed accounted for 11.5 percent of the total number in the comprehensive assessment, making up 10.4 percent of total assets.

sufficient to meet these conditions as of September 2014. Thus, by the end of October 2014, only MPS and Carige failed to meet the new requirements, with a shortfall of €2.92 billion still representing slightly more than 30 percent of the total residual capital shortfall in the euro area.

The ECB and Bank of Italy presented different public interpretations of the results. The ECB (2014a, 2014c) focused on the final results based on bank balances at the end of December 2013. Conversely, the Bank of Italy (2014b, 2014a) focused on the updated AQR results, taking into account the recapitalisation efforts during 2014. It also emphasised that the capital shortfall of Italian banks according to the AQR at the end of 2013 was only €3.25 billion out of their total shortfall of €9.68 billion, or in other words, the major part of the shortfall arose from the stress test results, the adverse scenario in particular. Moreover, the updated bank balances at the end of September 2014 showed that none of the 15 Italian banks (even MPS and Carige) had any capital shortfalls resulting from the AQR and that all the late-2014 shortfalls came from the stress tests, especially the adverse scenario[95].

This different emphasis framed a three-pronged narrative promoted by the Bank of Italy. First, the AQR was also a measure of the effectiveness of previous supervision; hence, the overall compliance of Italian banks with respect to AQR requirements meant an absence of past supervisory failures in Italy. Second, Italian banks did not represent a problem for the European banking sector – their limited capital shortfall involved only two banking groups and was mainly a consequence of the severity of the Italian adverse scenario. Third, as opposed to most other European countries, these results were attained with minimum public financial support since the start of the crisis.

95 Of course, stress tests are not a forecast of a country's economic evolution. Moreover, according to the Bank of Italy, the Italian adverse scenario was particularly severe because it under-assessed the effects of the double recession characterising the Italian economy (pro-cyclicality bias: see also the Bank of England's position).

Thus the ECB and Bank of Italy had starkly different interpretations of the same events.

The Bank of Italy's view is supported by the fact that the Italian economy was one of the euro area's worst performers in terms of growth and sovereign spreads. Italian banks consequently faced deep increases in borrower insolvency and bankruptcy, and an increase in the cost of their liabilities, which were often independent of their specific riskiness. In light of this negative legacy, the average performance of the Italian banking sector was not that poor. Apart from cases such as that of MPS, the Bank of Italy had been able to guarantee stability during a tumultuous period characterised by more than six years of national recession. That said, if one ignores the legacy problems and takes a snapshot of the Italian banking sector at the end of December 2013 or even at the end of September 2014, the comprehensive assessment's results unambiguously demonstrated that Italian banks represented one of the biggest problems for the European banking sector as a whole.

Four additional points deserve mentioning with respect to the comprehensive assessment:

- First, as the ECB (2014c, 2014b) partially acknowledged, the capital definitions were generally sounder in Italy than in other member states. The comprehensive assessment, being based on the national transposition of the European CRR/CRDIV, suffered distortions because of different national definitions and measures of capital often deriving from heterogeneous accounting rules of banking sectors. All Italian banks applied IFRS, unlike a number of German banks. On the other hand, since 2015, Italian banks have been allowed to count deferred tax credits (DTCs) as capital. Full implementation of the single rulebook could complete transitional arrangements and overcome these problems and other harmonisation deficiencies.

- Second, traditional credit risk was treated more harshly than risk from capital market activities. The Italian banking sector is characterised by a dominant weight of loans as a share of total assets. It can be argued that European regulation is biased against bank loan risks in favour of financial asset risks. As a consequence, Italian banks could have been penalised by the emphasis on credit risks relative to market and operational risks. However, even though the ECB did increase capital requirements in one go by 100 basis points during the comprehensive assessment, it only applied CRR/CRDIV regulation in assessing different types of risk. The ECB cannot be blamed of any bias inherent in the EU legislation.

- Third, and in relation to the previous point, Italy was penalised by the European emphasis on risk-weighted assets. Italian banks had an average CET1 ratio below the European mean, but also had among the soundest leverage ratios on average. A number of scholars (Haldane, 2012; Acharya and Steffen, 2014a; Dermine, 2015) have highlighted weaknesses in the risk-weighted regulatory approach underpinning CET1 ratio calculations, eg pro-cyclicality and excessive complexity. Moreover, econometric exercises such as Barucci *et al* (2015) suggest that the leverage ratio tends to be more effective than risk-weighted measures in controlling for the riskiness of banks in the stress tests. From this point of view, the methodology used for the comprehensive assessment may have been too focused on risk-weighted measures. It would be a stretch, however, to argue that the leverage ratio could entirely replace the risk-weighted capital framework.

- Fourth, Italian banks suffered from their lack of use of internal ratings-based (IRB) risk models. IRB models are costly to build, complex to manage, and thus only affordable for large and sophisticated banking groups. On the other hand, IRB models often allowed the introduction of devices to disguise the riskiness of assets (Behn

et al, 2014; Barucci *et al*, 2015). Thus, their comparative under-utilisation may have penalised Italian banks in the comprehensive assessment. However, it should be noted that, starting in 2010, international banking regulation has tended to strengthen risk management and internal controls instead of cutting down IRB.

In sum, one can identify many shortcomings in the comprehensive assessment, but these do not conclusively add up to the identification of a negative bias against the Italian banking sector, only that a level playing field has yet to be built for banks across the euro area. With a lack of trust between member states, and weak cooperation between European institutions and national governments, this can explain why the first moves of the new European supervision were characterised by a certain rigidity. In this sense, the ECB and SSM behaved more as rule-setters than supervisors (see also European Parliament, 2016, point 16).

The evolution of supervision

Once in place, European banking supervision shifted its attention to the SREP process, using a methodology based on a common set of rules (ECB 2015b, 2015e). In principle, the SREP methodology follows EBA guidelines, with an overall risk control framework that frames the SSM's constrained judgement of each examined bank. Every judgement implies the inclusion of the bank under assessment in one of the four score categories. However, the evaluation is too complex to be reduced to a simple score, so European banking supervision retains discretion for modulating the requirements for each bank's risk-weighted capital. This discretionary margin also applies to governance requirements.

The first full-fledged SREP exercise under the new European supervisory framework started in February 2015 and ended in November of the same year. It is difficult to summarise its overall result, since each bank case was different. European banking supervision urged various

banks to strengthen their organisation and improve their governance. Above all, it imposed increases in capital requirements that ranged from 60 to 120 basis points for all banks that met the comprehensive assessment's minimum requirements; these increases were mainly due to a further tightening of Pillar-2 requirements[96]. The Bank of Italy was reported to disagree with the ECB on this approach, by means of a letter sent to the ECB's Supervisory Board[97]. The Bank of Italy's argument was that the new increases in capital requirements arbitrarily overlapped with those of the comprehensive assessment, and thus risked harming the banks' operations and stability.

A recent unofficial note of the European Commission (2016; see also Draghi 2016) aimed to limit the SSM's discretionary power to tighten Pillar-2 capital requirements[98]. An analogous approach is suggested by the European Parliament (2016, points 21-25). Hence, the next SREP exercise, which started at the end of February 2016 and will be concluded later in 2016, might have to introduce substantial changes in methodology.

Despite the rigidity of the adopted criteria, the major Italian banks performed better in the late-2015 SREP than in the 2014

96 In contrast to Pillar-1 requirements which are standardised (under CRR in the EU), Pillar-2 capital requirements address risks that are specific to each bank and involve supervisory discretion. The supervisor may also impose Pillar-2 capital guidance, if the capital requirements can be unmet under specific circumstances (European Commission, 2016).

97 Patrick Henry, (2015) 'Bank of Italy slams 'arbitrary' ECB over capital demands,' *Bloomberg*, 21 September.

98 At the end of the 10 March 2016 press conference, Draghi said: "*...I want to point your attention to a communication by the Commission [...] that does clarify the nature of Pillar-2 requirements*". This Communication acknowledges that "*competent authorities may impose additional Pillar-2 capital requirements to address the more specific risk profile of each institution*". However, it adds that these same authorities have to "*provide clear and detailed justification to the institution of why Pillar-2 capital guidance is transformed in a Pillar-2 capital requirement*" and "*the institution concerned should have the right to appeal the decision*" (see European Commission, 2016).

comprehensive assessment. The latter's unflattering picture of the Italian banking sector triggered various initiatives by the Italian banking sector or imposed by the government, which included more recapitalisations, attempts to restructure or liquidate part of the NPL stockpile, and changes in corporate governance. On this last point, in March 2015, the Italian Ministry of Economy and Finance signed an agreement with the Italian banking foundations to reduce the foundations' stakes in each bank, and separately conducted a normative reform of the largest Banche Popolari (over €8 billion in total assets), requiring them to move towards a one-share-one-vote framework by July 2016. More recently (April 2016) the ministry implemented a normative reform of the Banche Cooperative to consolidate them into a few banking groups or to transform them into joint-stock companies. Meanwhile, despite their persistent weaknesses in terms of organisation and governance, MPS, Carige, BP Vicenza and Veneto Banca were able either to meet the specific capital requirements set by European banking supervision, or to commit to a sufficient recapitalisation within an agreed timeframe (see below).

As mentioned above, LSIs are important in Italy. They currently represent more than a quarter of total assets, with no large institutional protection schemes. Some of these smaller banks either came under special administration (an Italian form of corrective action) or were otherwise in need of significant restructuring. The SREP process shed light on their most pressing problems. However, EU competition policy rules that entered into force in August 2013 (European Commission, 2013) limited the Bank of Italy's ability to address LSIs' weaknesses in its role of direct supervisor. These rules mandate losses on shareholders and junior bondholders as a precondition for state aid, and thus severely restricted state guarantees on the securitisation of NPLs, as detailed below. On this basis, the European Commission Competition Directorate-General placed constraints on the utilisation of an Italian inter-bank fund to resolve bank crises. Moreover the BRRD, approved in 2014, extended the principle of bail-in to all types of bank bonds and

deposits above €100,000 from the beginning of 2016 but, at the same time, set the normative framework for banks' crisis management[99]. The Italian Parliament was late in transposing BRRD into national legislation, which was only done in mid-November 2015[100].

Recent developments and prospects

In November 2015, these constraints crystallised in the Italian approach to addressing the weaknesses of four small banks (three regional savings banks and one cooperative bank) which, combined, held around 1 percent of total Italian banking deposits. The impossibility of finding solutions through the national inter-bank fund brought the structural fragilities of the Italian banking sector to the fore. The Italian government spun off the NPLs of these failing banks into a single 'bad bank' at around 18 percent of their nominal value, as required by the European Commission, and formed four new viable banks. In the process, the value of shares and subordinated bonds previously issued by the failing banks was wiped out. Since the Italian banking sector had sold an abnormal amount of different types of bank bonds to retail investors between 2001 and 2012, the obliteration of the value of subordinated bank bonds created alarm. It also affected the market values of all listed Italian banking groups[101].

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99 See Visco (2015, 2016). In these works, the Governor of the Bank of Italy compares the application of these new European rules with the introduction of total loss absorbing capacity (TLAC) requirements for the systemically important banks. TLAC was decided by the Financial Stability Board in 2015 and must be implemented before 2022; conversely, the new European rules have very short transition periods and retroactive effects on outstanding debt. Visco argues that this hasty European implementation has a distortionary impact.

100 This late transposition implied that the Italian authorities were left with little time to implement the new rules on crisis management before the full implementation of the bail-in.

101 The negative market reactions at the beginning of 2016 were worsened by the spreading of false news. For instance, an ECB Supervisory Board inquiry at a number of European banks on their NPL stock was interpreted as a sign of a further and generalised strengthening of capital requirements for the Italian banks.

At the beginning of 2016, the Italian government reached a controversial agreement with the European Commission to offer a partial and costly guarantee to Italian banks securitising their NPLs (Italian Ministry of Economy and Finance, 2016). It soon became apparent that this guarantee, limited to the senior tranche, would be ineffective to reduce significantly the gap between the average value of NPLs accounted for by the Italian banks (around 41 percent) and the benchmark value set in the case of the four failing banks (around 18 percent). The size of this gap meant that Italian banks would have been unable to liquidate a significant portion of their NPLs without resorting to further recapitalisation. In the European context of a still unfinished banking union, these events highlighted the fragility of the Italian banking sector. They further jeopardised the scheduled recapitalisations of BP Vicenza and Veneto Banca which had still to meet their SREP capital requirements and were charged with administrative misbehaviour in previous liquidity raisings; and put the other banking groups with the highest weight of NPLs – MPS and Carige – under strain. Separately, at the beginning of April 2016, the ECB approved the first significant bank merger under its supervision, between Banco Popolare and BPM[102]. This piece of good news, however, failed to counterbalance the bad news on other fronts.

In April 2016, the Atlas fund (Atlante in Italian) was launched as Italy's response to this situation. The fund, endowed with an initial capital of €4.25 billion by a large majority of the Italian financial institutions, has two aims: to underwrite new recapitalisations by Italian banks (up to 70 percent of its capital), playing the role of 'shareholder of last resort', and to act as a purchaser for the junior tranches of

102 ECB banking supervision approved this merger after a lengthy negotiation on NPL liquidation, the re-capitalisation of Banco Popolare and changes to the governance of BPM. Italian newspapers complained about the Supervisory Board's rigidity because both banks had already met the 2015 SREP requirements. However, the new banking group will be stronger thanks to these additional requests being met.

securitised Italian NPLs (up to 30 percent of its capital).

The governance and operation of this fund have at least three weaknesses. First, Atlas's endowment is insufficient to pursue its double aim, even under optimistic assumptions of its possible leverage ratio; the two recapitalisations of BP Vicenza and Veneto Banca could consume 85 percent of the capital devoted to this task, almost extinguishing Atlas's capacity. Second, Atlas's design implies that the stronger financial institutions subsidise those in trouble: it is debatable whether this solution should be chosen over a new round of consolidation. Third, Atlas's ownership structure is such that its main shareholders, the Italian banking groups, are also its contracting parties, meaning that the same set of agents will act on the two opposite sides of the market, which can hinder competition and generate conflicts of interest. Despite these weaknesses, Atlas might effectively temper financial instability in the short run. At the beginning of May 2016, it acquired full ownership of BP Vicenza, whose capital call had attracted demand from market investors for less than 10 percent of the amount requested. Without this intervention, either Unicredit as a formal guarantor of the capital increase would have had to buy the new shares, with a negative impact on its CET1, or BP Vicenza would have had to enter into a resolution procedure. At the time of writing, the same could happen in the case of Veneto Banca and its guarantor, Intesa-San Paolo. Moreover, Atlas still wants to increase the market prices of Italian NPLs, and thus to allow banks such as Carige and MPS to reduce the expected losses from the gradual liquidation of their NPLs.

The threat of financial instability does not imply that the Italian banking sector is on the brink of bankruptcy. Moreover, given the ECB's policy of quantitative easing and other non-conventional initiatives, the Italian banking system has never faced serious risks of illiquidity. Even so, Italian banks will be unable to play a significant and efficient role in intermediating financial wealth and lending to the Italian economy without restructuring and consolidation. The implementation of these processes is not made easier by the lack of

trust among euro-area countries, and between them and the European institutions. This mistrust risks making European banking regulation and supervision excessively rigid; an excess of rigidity could hinder the actual construction of a single financial market.