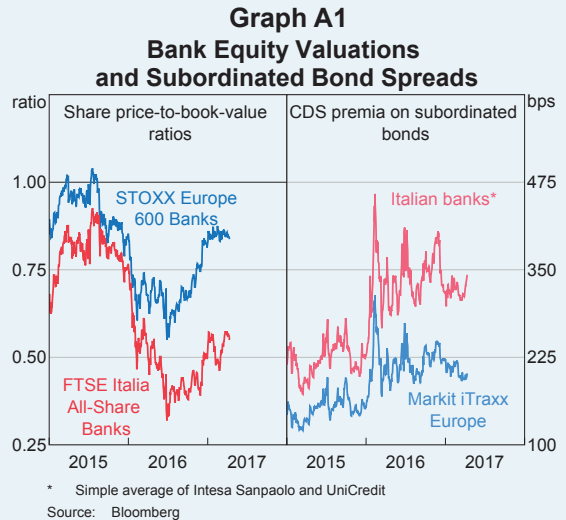


Box A

Bank Restructuring Challenges: A Case Study of Italy

As outlined in ‘The Global Financial Environment’ chapter, many European banks have faced significant challenges in the years since the financial crisis, including low revenue growth, loss-making legacy assets and a high cost base. The consequent prolonged period of low profitability, along with post-crisis regulatory reforms, has provided a strong impetus for banks to restructure their operations, including by shedding non-core assets, boosting equity funding and improving operating efficiencies. While these restructuring efforts are ongoing, their benefits are yet to fully accrue, in part reflecting the slow economic recovery in the euro area. As such, some European banks and banking systems remain vulnerable to adverse shocks and sudden shifts in market sentiment.

Italian banks are widely thought to be among the most vulnerable of the European banks. They account for about 30 per cent of all banks’ non-performing loans (NPLs) in the European Union, and their profitability remains especially low, even relative to other European banks. Italian banks’ equity prices have traded at low price-to-book valuations, with uncertainty about the resolution of NPLs contributing to ongoing price volatility and increases in measures of credit risk (Graph A1). This box outlines the challenges the Italian banking sector faces as well as the restructuring measures that have been taken by regulators and the banks to address them. These developments in Italy provide a useful case study, highlighting in particular the challenges that can arise when problem bank balance sheets are addressed only slowly, and



how corporate governance and inefficient insolvency arrangements can affect ongoing bank performance and resilience.

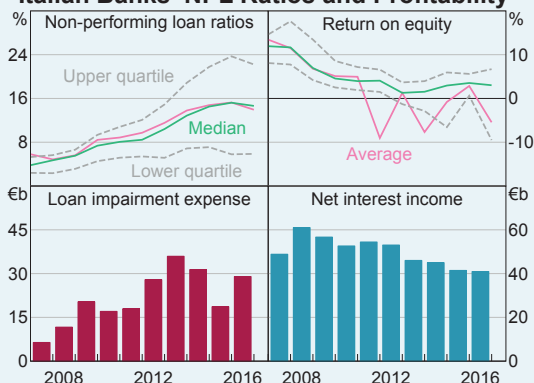
Challenges

Italian banks’ profitability has been weighed down by poor loan performance for some time. Gross NPLs have risen steadily over the past decade to very high levels, reaching around €360 billion in 2016 or around 15 per cent of Italian bank loans. The loan-loss expenses resulting from these NPLs, combined with declining net interest income, have weighed on profitability, with returns on equity commonly in the low single digits or even negative in recent years (Graph A2).

Italian banks’ poor loan performance has occurred amid a protracted economic downturn. Both consumption and investment have been depressed, which has particularly affected firms

Graph A2

Italian Banks' NPL Ratios and Profitability*



* Data are for a sample of 52 Italian banks; NPL ratios include both domestic and cross-border loans

Sources: RBA; S&P Global Market Intelligence

in the construction, manufacturing, real estate and wholesale & retail trade sectors, where NPLs have tended to be concentrated. Corporate governance arrangements have also played a role, partly reflecting the influence of banking foundations on bank boards and ownership restrictions at cooperative banks.¹ In addition, tax rules have discouraged prompt loss recognition. For example, until late 2015 loan-loss provisions were required to be deducted over five years, reducing the immediate tax benefit for Italian banks from making provisions.

Insolvency and enforcement procedures in Italy have also made the process of resolving NPLs difficult and lengthy, in turn reducing the net present value of the collateral to the banks (by increasing costs and the time to recover them from defaulting debtors). In addition, excess capacity and fragmentation in the banking

sector have placed upward pressure on banks' cost bases, as evidenced by a high number of bank branches per capita.²

The prolonged low profitability and uncertainty about the resolution of the large stocks of NPLs in Italian banks have reduced their ability to enhance resilience, with several implications for financial stability in Italy and Europe more broadly.

- Large stocks of NPLs increase uncertainty about banks' capital positions because they are hard to value and can take a long time to resolve. This uncertainty means that capital ratios might not be a good indicator of a bank's resilience and makes it harder for banks to raise new equity funding from private investors (which can hamper recapitalisation efforts). NPL portfolios are also difficult to sell in the private market without large discounts, as buyers want to be compensated for the uncertainty around the value of their investment.
- Low profitability reduces capital accumulation from retained earnings. In turn, this slows the growth of capital buffers that can help to absorb financial shocks, makes it harder to meet rising capital requirements and, therefore, can restrict banks' ability to finance the real economy. Low profitability also encourages loan forbearance, as banks find it more difficult to absorb additional loss provisions.
- Further, low profitability can make it more challenging to restructure business models, given that costs are generally incurred up-front while the benefits only materialise over time. This contributes to a degree of inertia at a time when the regulatory and market environment typically requires restructuring.

1 Banking foundations are non-profit organisations with independent boards that aim to use their financial resources for public benefit. They can be subject to political influence and can influence bank boards through disproportionate voting power for board members and committees. Cooperative bank ownership and control structures, such as one vote per member and membership limitations, have made it difficult to raise capital from outside sources and weakened market discipline. For details on corporate governance at Italian banks, see IMF (International Monetary Fund) (2014) 'Reforming the Corporate Governance of Italian Banks', Working Paper 181.

2 ECB (European Central Bank) (2016) 'Report on Financial Structures', Final Report, October.

Public and Private Sector Responses

The Italian authorities have implemented a number of reforms to address the difficulties in the banking sector. Their efforts to date have focused on strengthening bank governance, boosting tax incentives for loss recognition and making substantial changes to business insolvency laws to simplify and speed up corporate restructurings and loan foreclosures. These longer-run policy initiatives have been complemented by efforts to stimulate demand in the secondary NPL market, by making available government guarantees on senior tranches of NPL securitisations and by creating two industry-funded vehicles (Atlante and Atlante II) to purchase subordinated tranches of NPL securitisations.³

Against this background, some Italian banks have raised new equity from investors, at times at the direction of regulators. Some banks have also made substantial efforts to reform their balance sheets and business models, including through selling NPLs and non-core assets, closing branches and reducing headcounts. For example, UniCredit was recently able to raise €13 billion in new equity from investors (the largest non-acquisition-related rights offering in Europe to date) as part of a strategic overhaul and to help cover €11 billion of NPL-related losses recognised in late 2016.

However, other banks have lagged in their efforts to restructure their operations and recent attempts by banks with weak asset quality to raise new equity from private investors have been unsuccessful. In particular, Banca Popolare di Vicenza and Veneto Banca received equity injections in mid 2016 from Atlante after there was very little investor demand for their initial equity offerings. Atlante – which assumed close

to 100 per cent ownership in each of the banks following the initial capital injections – injected more capital into these banks in late 2016 as an advance payment for future capital increases. When additional losses were recognised in early 2017, these banks announced a plan to merge and (individually) applied for a precautionary recapitalisation. If approved, this will involve the conversion of subordinated bonds to common equity and a public injection of capital from the Italian Government's recently established €20 billion recapitalisation fund. Banca Monte dei Paschi di Siena (MPS), Italy's fourth-largest bank, similarly applied for a public recapitalisation in late 2016 after it was unable to raise new equity funding from private investors to close a regulatory capital shortfall.⁴ All three banks have issued government guaranteed bonds to support their funding liquidity. EU rules requiring creditors to take some losses as a precondition for public capital injections have added to the challenges in addressing these banks' issues, because Italian households own a substantial volume of bank bonds.⁵

Despite this progress, the policy measures announced to date have not yet led to significant improvements in the overall health of the Italian banking sector. This is partly because some are still to be completely implemented and the benefits from others are yet to be fully realised. Even so, further work – from both the public and private sectors – may still be required to escape the unfavourable dynamics associated with a large stock of NPLs, weak profitability and low price-to-book valuations. ❖

3 Atlante can also purchase common equity in banks with low capital ratios.

4 The recapitalisation will mark the fifth time that MPS has raised new ordinary equity since the start of 2008.

5 A provision in the legislation establishing the €20 billion recapitalisation fund seeks to reduce this risk by allowing compensation for retail investors who purchased securities prior to 1 January 2016, when the EU's 'bail-in tool' became active in Italy. The rationale for the compensation was that retail investors were provided with insufficient information about the risks of the bank bonds they purchased.

