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Delusive security in the Italian banking sector

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- The latest Financial Stability Report by the Bank of Italy concludes that “risks are diminishing in the banking sector”.
- This could give a false sense of security. The decline of non-performing loans reflects one-off write-downs rather than an improvement in credit quality.
- Moreover, due to cyclicality in credit risk modelling, provisions for bad credits started to diminish of late as economic conditions have improved. This is likely to create problems in the future.

The Bank of Italy (BoI) set an upbeat tone in its latest Financial Stability Report from November 24, 2017. To support the claim that risks are diminishing in the banking sector, the report highlighted:

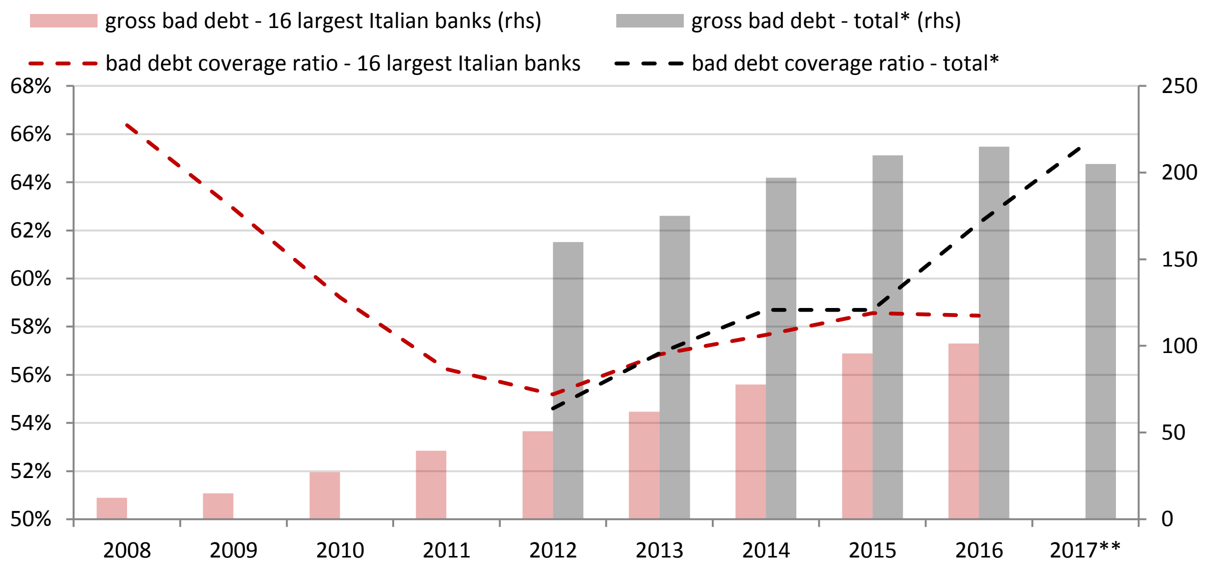
“The resolution of crises at some banks during the summer has boosted share prices and reduced the cost of funding. New non-performing loans are decreasing as the economic recovery continues; the stock of outstanding NPLs is also falling sharply. A number of bad loan sales have been completed while others, involving large amounts, are being finalized. Italian banks' capitalization has begun to increase again.”[1]

Indeed, the stock of NPLs and of their most problematic category, bad debts, declined in the first half of 2017. Also the coverage ratios – defined as the loan loss reserves on bad or non-performing loans relative to their respective gross amounts – continued to increase, as shown in Figure 1. But Figure 1 also shows that the strong accumulation of bad debts since the Great Financial Crisis took place despite high levels of coverage ratios, which points to deeper economic problems behind this accumulation, as we discussed in two previous notes.[2] Moreover, it has to be noted that the recent reduction

[1] Financial Stability Report No. 2 – 2017, available at: https://www.bancaditalia.it/pubblicazioni/rapporto-stabilita/2017-2/index.html.

[2] Agnieszka Gehringer (2017), “Monte dei Paschi is only the tip of the iceberg”, Flossbach von Storch Research Institute Economic Policy Note 12/6/2017; and Agnieszka Gehringer (2016), „Non performing loans in the euro periphery were not built in a day“, Flossbach von Storch Research Institute Economic Policy Note 28/10/2016.

Figure 1. Gross amounts of bad debts (in billions of euros) and their coverage ratios in the Italian banking system



* Data is taken from Financial Stability Reports of the BoI. According to the BoI definition, "total" comprises all Italian banks, also subsidiaries of foreign banks that are not classified as either significant or less significant Italian banks. Coverage ratios are loan loss reserves in percentage of bad loans.

** As of June 2017.

Source: Bank of Italy, Annual Reports of banks between 2008 and 2016 (see Appendix for their full list), Flossbach von Storch Research Institute

in the stock (net exposures) of non-performing loans from €191 billion in June 2016 to €151 billion in June 2017 is mainly due to €26 billion of loans written off from balance sheets of four large banks.[3] These are one-off effects, which improve aggregate credit quality indicators. The credit quality of other banks has changed only little.

However, the BoI's assessment could create a false sense of security for still another reason. In the course of the economic recovery, the quality of credit tends to improve for cyclical reasons. But banks' credit risk models capture this as a structural improvement, allowing banks to reduce their credit loss provisions. When the cycle turns, banks have insufficient reserves to cover credit losses in the downturn.

The perils of cyclical accounting rules

In a recent book entitled "Der Draghi-Crash", Markus Krall – a German economist and experienced consultant to the banking sector – offered an in depth description of accounting mechanisms leading to a cyclical measurement of risks on the balance sheets of banks.[4] Two main factors are likely responsible for this[5]:

[3] UniCredit alone sold EUR 17.7 billion worth of bad loans during 2017. The other three banks are Monte dei Paschi di Siena, which in mid-2017 was put under precautionary recapitalization procedure, and the two Veneto banks (Banca Popolare di Vicenza and Veneto Banca), which were liquidated in June 2017.

[4] Although there are some specificities of accounting practices in each of the European countries, the core set of rules are harmonized under international accounting rules, established under the International Accounting Standards Board (IASB) and specified by the IRFS Interpretation

- *Inaccuracy in the credit risk assessment over the entire credit portfolio*: under conditions of economic expansion and low interest rates the perception of economic risk diminishes and with it both the average risk of default and, as a result, the average credit loss provisions.

- *Inaccuracy in the credit risk assessment with respect to each individual borrower*: the level of interest rates influences characteristics of each single borrower, namely profitability and interest payment ability, which are used in the internal individual ratings; consequently, low interest rates improve individual borrowers' financial standing and hence their ratings.

The combination of these two factors leads to a pro-cyclical provisioning for credit losses. Provisions diminish in the upswing of the business cycle, irrespective of the possibility that 1) the stock of problematic loans might be still high; 2) the structural financial conditions of individual borrowers remain unaffected; 3) the supply of new credit increases.

The above described cyclical behavior in the provisioning for credit losses can be observed in data for a sample of the 16 largest Italian banks. Figure 2 shows the so called cost of credit, calculated as the amount of credit loss provisions (net of recoveries) relative to the value of total loans to customers.[6] The higher the ratio, the more banks set aside in relative terms to cover future credit losses. Under favorable economic conditions banks tend to be more optimistic on the performance of their loans and set lower credit loss provisions. This has apparently been the case since 2014 – a period with a higher (although still weak) average GDP growth of 0.89%. In this period, the cost of credit fell from 2.9% in 2014 to 1.9% in 2016. Also, between 2010 and 2011 the cost of credit remained low as the economy rebounded from the recession of 2008-09. Against this, Italy's GDP growth was negative between 2012 and 2013 and this lifted credit loss provisions by banks.

Outlook

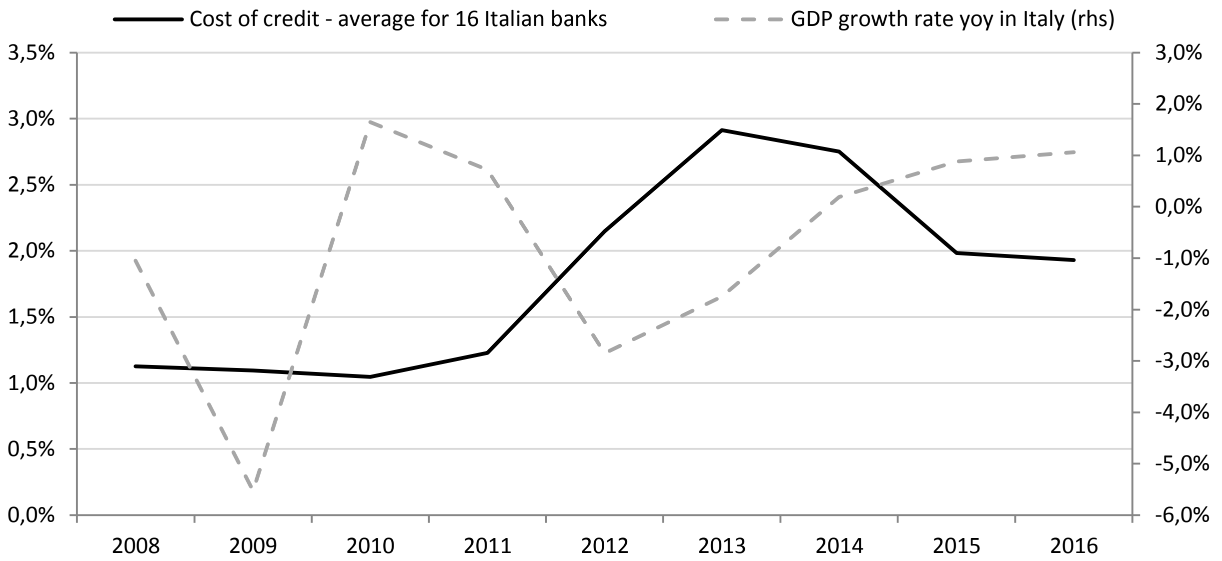
On 1 January 2018 new accounting standards established by the IASB under the IRFS 9 enter into force. Accordingly, the current incurred credit loss approach (ICL) to loan loss provisions will be replaced by an expected credit loss approach (ECL). Specifically, under the incurred loss model, impairment losses can only be recognized with evidence that such losses actually exist. Loss identification is dependent on the occurrence of "triggering" events, delivering material evidence of losses. Consequently, it is not allowed to consider the impact of expected losses. The operating of such rules has arguably contributed to the severity of the Global Financial Crisis as provisioning for credit losses has been "too little, too late". As a result, the IASB suggested adopting the ECL approach, under which a more forward-looking assessment would be adopted. Accordingly, it is no longer necessary that a trigger event has occurred before the credit losses are accounted for. It is sufficient that there is reasonable and supportable information on the probability of future credit losses.

Committee. Thus mechanisms described by Markus Krall should apply not only to German but also to Italian banks.

[5] Another factor mentioned by Markus Krall leads to a structural underestimation of credit risk. Due to the left-skewed credit loss distribution over the credit cycle, median credit loss is normally lower than the average, so that banks tend to systematically underestimate losses.

[6] Credit loss provisions are the amounts set aside for credit losses each year net of recoveries and are classified under item 130 (a) in the banks' income accounts.

Figure 2. Cyclicality of the cost of credit* in the Italian banking sector



*Cost of credit is defined as credit loss provisions relative to the value of total loans to customers

Source: Annual Reports of Italian banks included in the sample (see Appendix for the full list of the banks) between 2008 and 2016, Flossbach von Storch Research Institute

The first impact analysis conducted on a sample of 50 European banks by the European Banking Authority shows that the change in the accounting standards would lead to an average growth of provisions by around 18% from the levels of December 2015. At the same time, however, the move from incurred to expected losses could make provisioning even more cyclical as expectations often overshoot actual developments.[7]

All this suggests that changes to accounting standards should aim at explicitly reducing cyclical provisions. But such changes alone would most probably not be capable to solve the underlying problems in the Italian banking sector and also elsewhere. As discussed in a previous note, structural economic weakness may lead to a persistent erosion of credit quality. The only salvation is permanently higher economic growth.[8]

[7] For a recent review of the arguments, see Abad, Jorge and Suarez, Javier (2017), "Assessing the procyclicality of expected credit loss provisions", CEMFI mimeo.

[8] Agnieszka Gehringer (2016), „Non performing loans in the euro periphery were not built in a day“, Flossbach von Storch Research Institute Economic Policy Note 28/10/2016. See also Mohaddes, K., Raissi, M. and Weber, A. (2017), "Can Italy grow out of its NPL overhang? A panel threshold analysis", IMF Working Paper WP/17/66. According to their estimations, a real GDP growth of 1.2% sustained for a number of years would lead to a significant decline in the NPLs ratio. Italy enjoys such growth first since the first quarter of 2017. A contributing factor here is accelerating growth of fixed investment, which is most likely linked with the nation-wide restructuring plan dubbed *Industria 4.0*. This is by no means a positive signal. However, it remains to be seen to which extent this faster investment growth will translate in permanently higher economic growth.

Acknowledgements

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Appendix – Methodological and data issues

Based on the size of individual bank's total assets above €10 billion as of December, 31 2016, we analysed balance sheets of 16 Italian banks: **1)** *Unicredit*, **2)** *Intesa Sanpaolo*, **3)** *Banco Popolare di Milano*, **4)** *Banco Popolare* (which merged with Banco Popolare di Milano on January, 1 2017), **5)** *UBI Banca*, **6)** *Banca Nazionale del Lavoro*, **7)** *BPER Banca*, **8)** *Crédit Agricole Italia*, **9)** *Credito Emiliano*, **10)** *Banca Popolare di Sondrio*, **11)** *Banca Carige*, **12)** *Credito Valtellinense*, **13)** *Deutsche Bank Italia*, **14)** *Banca Popolare di Bari*, **15)** *Banca Sella*, **16)** *Unipol Banca*. These are the largest Italian banks (parent companies or large subsidiaries of foreign banks, as is the case for Credit Agricole, Deutsche Bank and Banca Nazionale del Lavoro) with the main business consisting in the loans provision. Consequently, we had to exclude some large banks (ICCREA and Cassa Depositi e Prestiti) having another business focus. Finally, we excluded Banca Mediolanum due to a substantial change in accounting standards, which occurred starting in 2014. The list of banks was constructed based on the report "Le principali banche italiane" by Mediobanca and on Bloomberg data.

We did not consider the two Veneto banks (Banca Popolare di Vicenza and Veneto Banca), since they become insolvent in summer 2017 and are no longer existent. We also excluded another problematic bank, Banca Monte dei Paschi di Siena, which has been struggling for some time to avoid insolvency and was finally overtaken by Banco Popolare di Milano at the end of 2016.

When calculating the cost of credit, we used the definition applied by the majority of banks, i.e. net impairment losses on loans (reported under item 130 (a)) relative to net total loans to customers. However, some banks preferred a slightly different concept, namely, the cost of risk. The difference with respect to the cost of credit is that net loan loss provisions are adjusted for some other items (in the case of Unicredit it is item 100 (a) – profits (losses) on disposal or repurchase of loans and item 130 (d) – net losses/recoveries on impairment of other financial activities). However, the adjustment is marginal so that the two concepts – cost of credit and cost of risk – correlate strongly. To remain consistent, we adopted the cost of credit across our sample. Finally, in the case of Unicredit, we considered the net loan loss provisions for 2016 net of the extraordinary provisions made under the two projects launched in 2016, PORTO and FINO.

Contrary to the approach of the Bank of Italy, we concentrated on the individual accounts of the banks, rather than on consolidated accounts of the group. In this way, we obtain a non-diluted picture of the actual situation of each single bank.

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