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SCOPE Scope Ratings

Tackling the Structural Causes of the Italian NPL Problem

The latest data from Bank of Italy shows a 16% increase in non-performing loans (NPL) in Italy which stood at EUR187bn at the end of February. Together with the depressed level of profitability, the large stock of NPLs is in Scope's view a key factor negatively affecting the credit quality of Italian banks.

At the end of 2014, Intesa (BBB+, Positive Outlook) and Unicredit (BBB, Positive Outlook) reported total impaired loans in the high teens, albeit with encouraging signs of stabilisation. Within impaired loans, "sofferenze" typically account for more than half the total on a gross basis.

Given the rosier outlook for economic growth in Italy in 2015, as well as the decline in net migration of performing to non-performing loans in 2014, we expect a turnaround in trends, with a stabilisation in NPL ratios and lower impairments in the P&L. However, we expect NPL ratios to decline very slowly due to structural factors negatively impacting the speed of NPL resolution.

In the short run, setting up a bad bank would certainly help, but it would move the NPL problem from private banks onto the public balance sheet – assuming both funding and solvency risks are transferred. However, it would likely be unpopular and costly for the public purse, and could face EU challenges.

In the longer run, we deem it more important to tackle the underlying causes of the high level of NPLs. Among them, we highlight:

- The fiscal disincentives to provision against NPLs and write off bad debts. In Italy, loan loss provisions can only be deducted from taxable income over a period of five years.
- The lengthy and expensive process to resolve insolvency and enforce on collateral.

This report looks in particular at the inefficiency in the judiciary and legal system as a cause for the structurally high levels of NPLs. This is partly due to a dysfunctional system of contract enforcement and a lengthy and expensive process for corporate insolvency. According to our calculations, based on World Bank survey data, the cost to resolve insolvency in Italy is double that of Spain, and three times that of Germany.

The reform impulse is ongoing, and we view initiatives aimed at reforming the Popolari banks' governance favourably. As we have highlighted in a previous report, this could lead, in time, to a more consolidated and profitable banking sector.

At the same time, the recently proposed limits to asset concentration and leverage in the banking "fondazioni" would reduce the room for political influence on the banks.

Further reforms towards a faster workout of NPLs would help Italian banks rid themselves of the heavy asset quality burden, freeing up necessary capital and funding for new lending growth.

Addressing the anomalies in fiscal legislation with respect to loan loss provisions would in our view incentivise the banks to provision more aggressively against NPLs, and possibly facilitate NPL sale transactions.

Improving the efficiency of the judiciary would improve the ultimate realisation value of NPLs, by reducing related insolvency fees and the cost of carrying the assets for several years before being allowed to seize the collateral. Some good places to start would be to encourage out-of-court settlements for minor claims and increase the use of advanced IT systems.

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Italian NPLs are still high and rising, albeit at a slower pace

Together with the depressed level of profitability, the large stock of non-performing loans is in Scope's view a key factor negatively impacting the credit quality of Italian banks. Even when only looking at "sofferenze", the most serious category of non-performing assets, the amounts are large by both historical and international standards.

At the end of 2014, Intesa (BBB+, Positive Outlook) and Unicredit (BBB, Positive Outlook) reported total impaired loans in the high teens, albeit showing encouraging signs of stabilisation. Within the impaired loans, sofferenze typically account for more than half of the total on a gross basis.

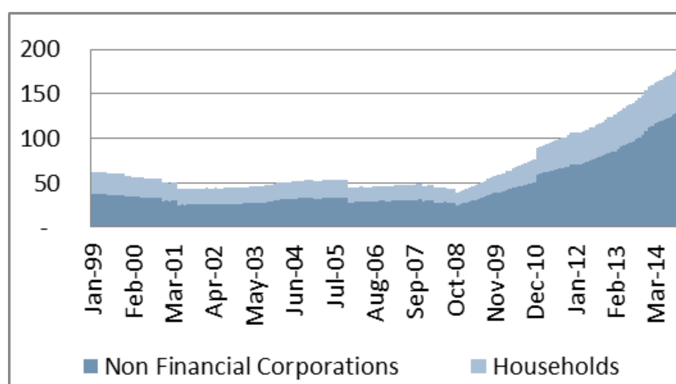
Table 1: Selected asset quality measures for Unicredit and Intesa

	2010	2011	2012	2013	2014
Unicredit					
Gross Impaired Loans	68,215	72,531	79,787	83,590	84,360
of which sofferenze	*38,538*	*42,245*	*44,377*	*49,059*	*52,143*
Impaired as % of total gross loans	11.6%	12.2%	13.7%	15.8%	16.3%
of which sofferenze (%)	*6.5%*	*7.1%*	*7.6%*	*9.2%*	*10.1%*
Intesa					
Gross Impaired Loans	37,102	41,798	49,673	57,575	62,867
of which sofferenze	*20,521*	*24,961*	*28,362*	*34,595*	*38,043*
Impaired as % of total gross loans	9.4%	10.5%	12.4%	15.4%	16.9%
of which sofferenze (%)	*5.2%*	*6.2%*	*7.1%*	*9.3%*	*10.3%*

Source: Scope Ratings; company data

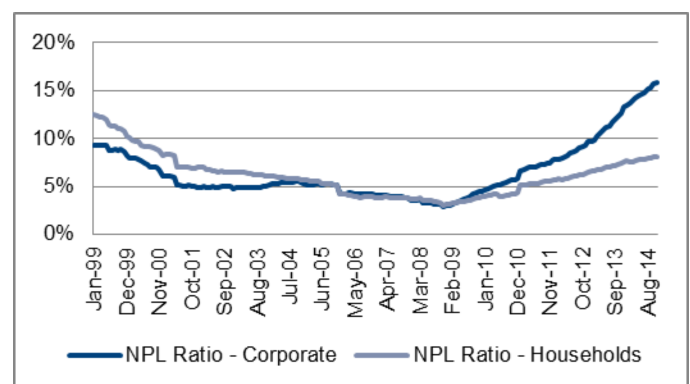
Overwhelmingly, the source of the asset quality problem of the two banks is the decline in loan quality in Italy, a result of the long recession from which the country is emerging. Sector data shows that non-performing loans continue to increase, especially in the corporate sector. Scope believes a change in asset quality trends is key to an improvement in the rated banks' credit ratings.

Chart 1: System NPLs are still increasing



Source: Bank of Italy, Scope Ratings

Chart 2: NPL ratios, non-financial corporations and households



Source: Bank of Italy, Scope Ratings

Our base case is that as the macroeconomic backdrop improves, NPL ratios should at first stabilise and then decline organically. Although NPL sales may help the process, they are not necessarily maximising value at this stage of the cycle. We accept that banks have different strategies with respect to sales depending on their confidence in the collateral values, in the borrower quality and on their own liquidity and capital resources. Our expectation of a more favourable environment for asset quality supports the Positive Outlook for Intesa's and Unicredit's ratings, as well as possible future upgrades.

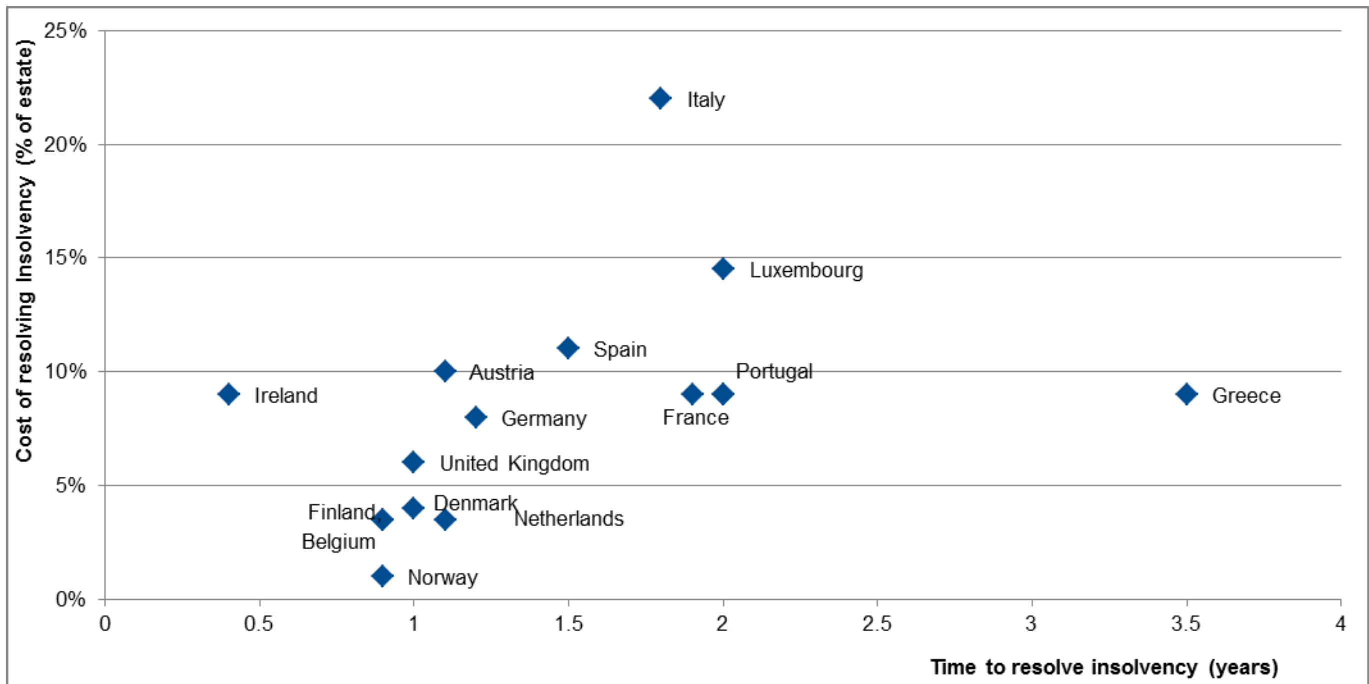
High NPL levels are the result of structural, as well as macroeconomic factors

While the unfavourable macro environment explains much of the increase of NPLs in recent years, we note that Italian banks' NPL ratios have been historically higher than European peers. In our view, this partly results from structural features of the Italian system. On the one hand, the unfavourable tax treatment of loan-loss provisions and write-offs, whose deductibility is limited, providing a disincentive for banks to provision and clean up their balance sheets. At the other end, the lengthy and expensive insolvency process that delays the recovery of collateral and hinders the deepening of a market for non-performing bank loans.

Legal obstacles add to costs and cause delays

Data from the World Bank's "Doing Business Survey" shows that resolving an insolvency process in Italy takes on average 1.8 years, roughly in line with Portugal and France, but higher than most other European countries, with only Greece taking significantly longer. Even more eye-popping is the comparison of the estimated cost of resolving the process. Here, Italy is a true outlier among European countries. The cost of insolvency amounts on average to 22% of the insolvency estate, is double the percentage it is in Spain, and three times that of Germany (see Chart 3).

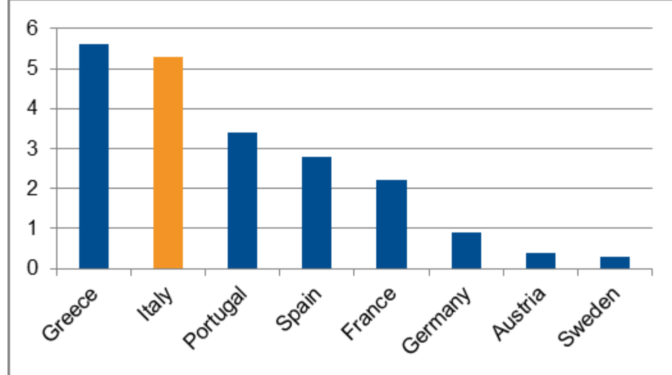
Chart 3: Length and cost of insolvency in Europe



Source: World Bank doing business survey; Scope Ratings

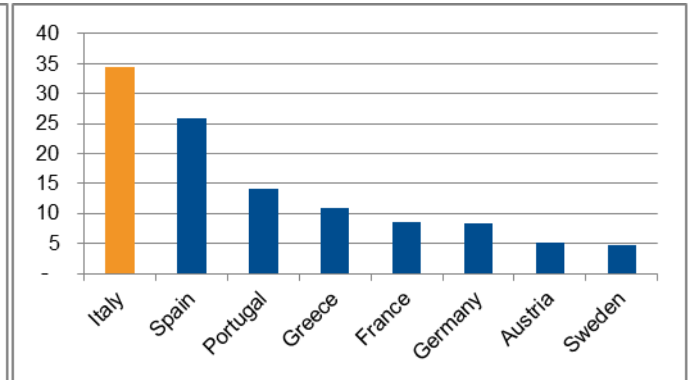
This estimated cost, based on survey responses, includes fees for the courts, administrators, lawyers, the assessors and all parties involved in the process. In Scope's view, the large difference in cost between Italy and the rest of Europe is hard to justify and reflects a civil justice system that is burdened with a large backlog and clearly not equipped to deal with the workload. Data from the European Commission's 2015 "Justice Scoreboard" supports this view. Italy has over five litigation cases pending per 100 inhabitants, well above the European average (see Chart 4). We also find there are fewer judges per head in Italy, which adds to the backlog of pending cases. On the other hand, Italy has one of the highest density of lawyers per head, evidence of a byzantine legal system that is hard to navigate. Only Greece and Luxembourg have a higher density of lawyers in the respective countries. We calculate that in Italy there are 34 lawyers for every judge, compared to 26 in Spain, 14 in Portugal and 11 in Greece.

Chart 4: Number of pending litigious civil and commercial cases per 100 inhabitants, 2013



Source: EU Commission; Scope Ratings
Note: Data for Spain refers to 2012

Chart 5: Ratio of lawyers to judges



Source: EU Commission; Scope Ratings
Note: Data for Spain refers to 2012

We are aware that the Italian government has been discussing the possibility of creating a bad bank to relieve private sector banks from their NPL burdens. Such a move would indeed be credit positive for the banks, assuming that both the liquidity and the credit risk are effectively transferred and without further losses to the banks. However, such a structure would worsen government finances – only shifting a problem from the private to the public sector. In our view it could also face EU competition challenges, and be unpopular as it might be seen as a bail-out of the banks at taxpayers' expense.

It would not tackle the underlying reasons for the high level of NPLs. Scope believes it would in fact be preferable to encourage banks to provision and write off or sell bad loans, for example, by removing the fiscal disadvantage of loan-loss provisions. This in turn would facilitate the deepening of a private market for NPLs, whereby professional asset management companies could become "private bad banks", which are better placed to work out NPLs than a large governmental institution.

Improving the efficiency of the judiciary would improve the ultimate realisation value of NPLs, by reducing related insolvency fees and the cost of carrying the assets for several years before being allowed to seize the collateral. Some good places to start would be to encourage out-of-court settlements for minor claims and increase the investments in process digitalisation.

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