ABI Associazione Bancaria Italiana

“The Italian banking sector and the impact of the new Basel framework”

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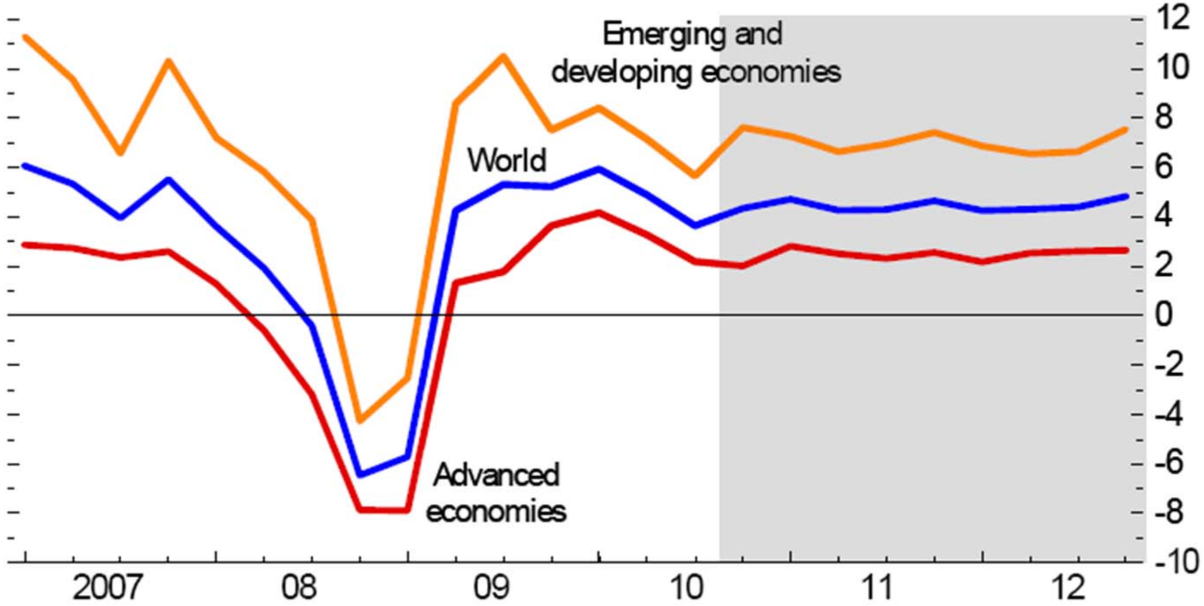
Global recovery advances but remains uneven: the two-speed recovery continues

Overview of the World Economic Outlook Projections

(% change)

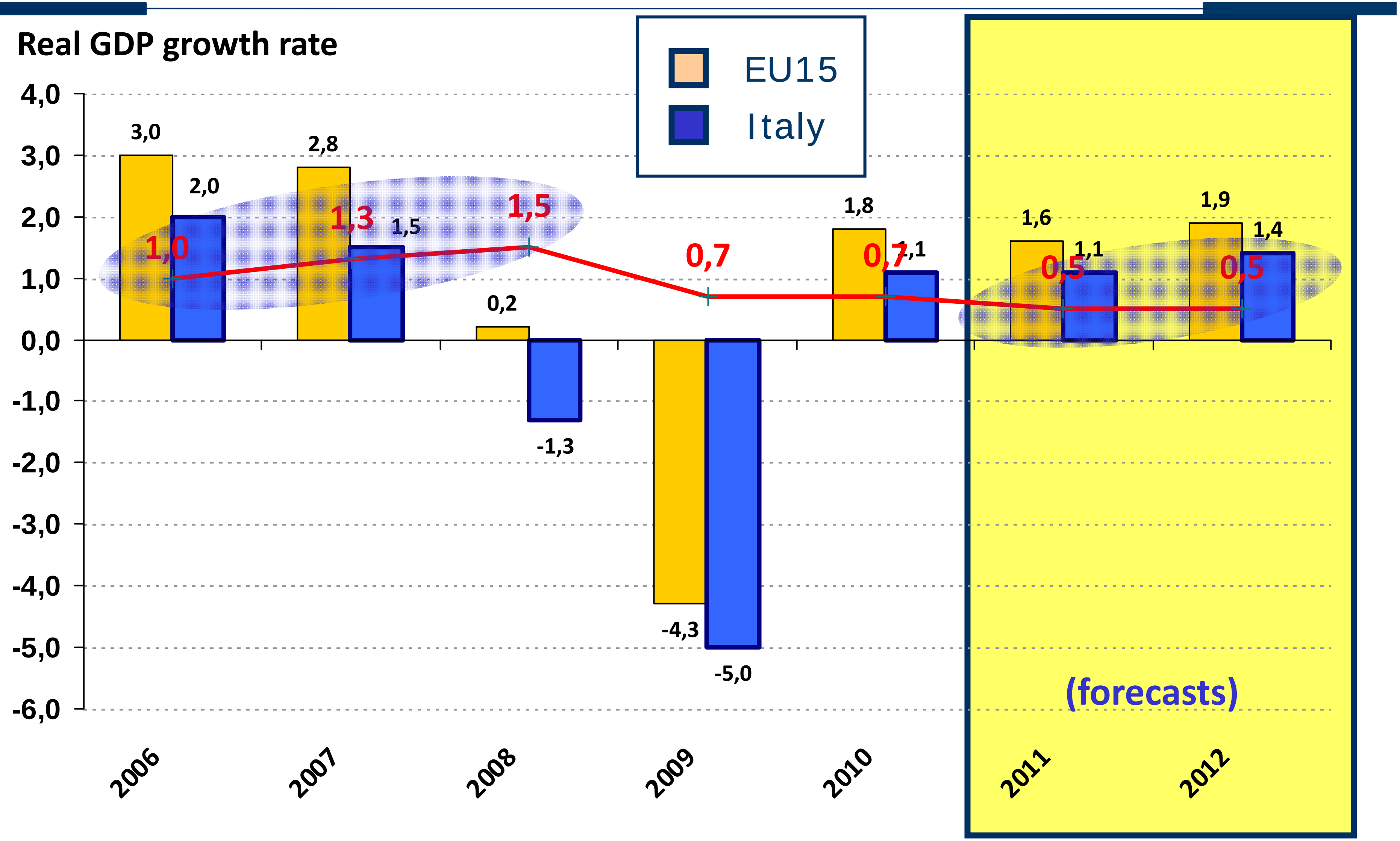
Global GDP growth

(%; quarter over quarte; annualized)



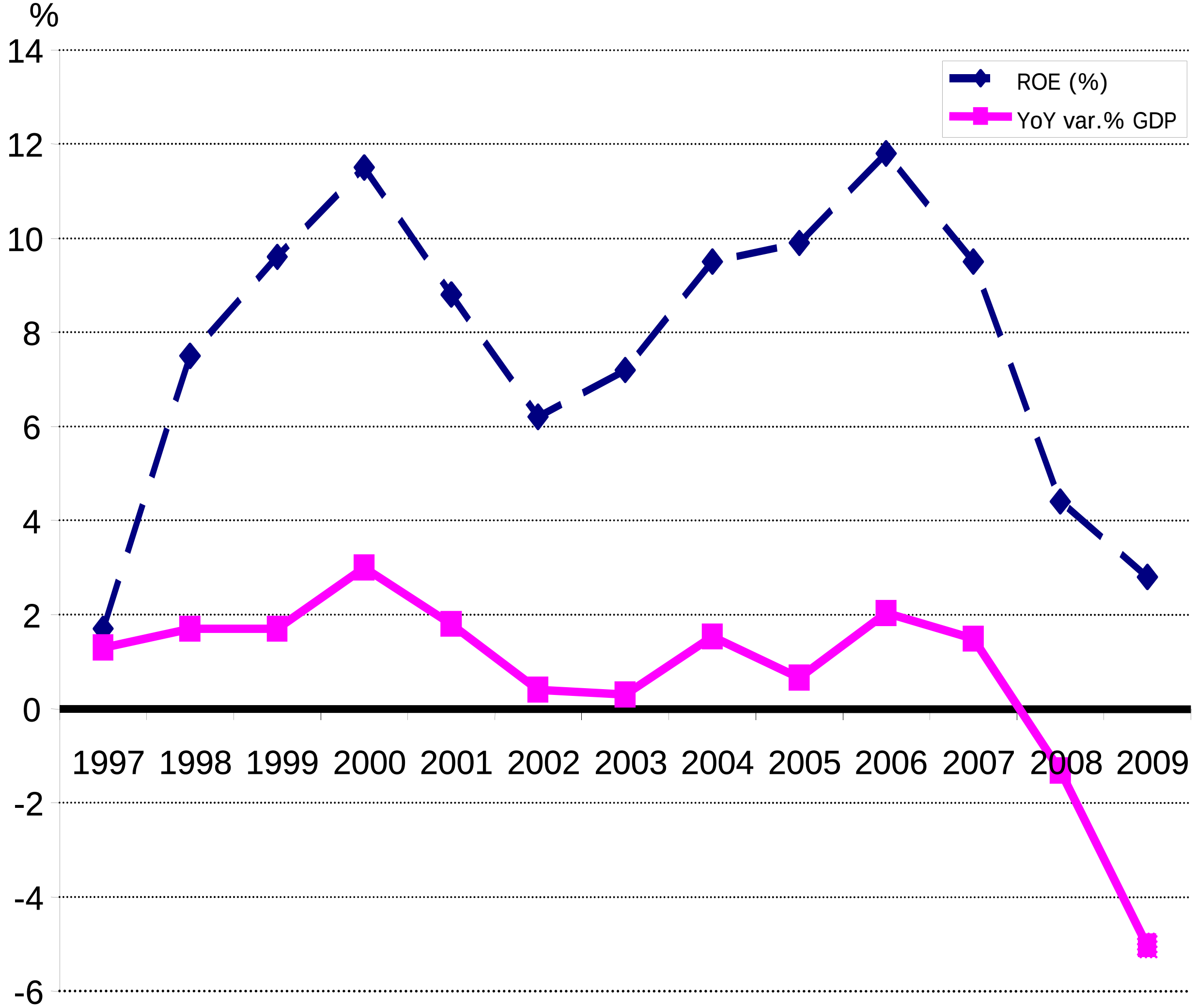
Source: IMF staff estimates.

Italy is closing the Gap versus the EU15 countries average



Economic recovery remain key for Italian banks' profitability…

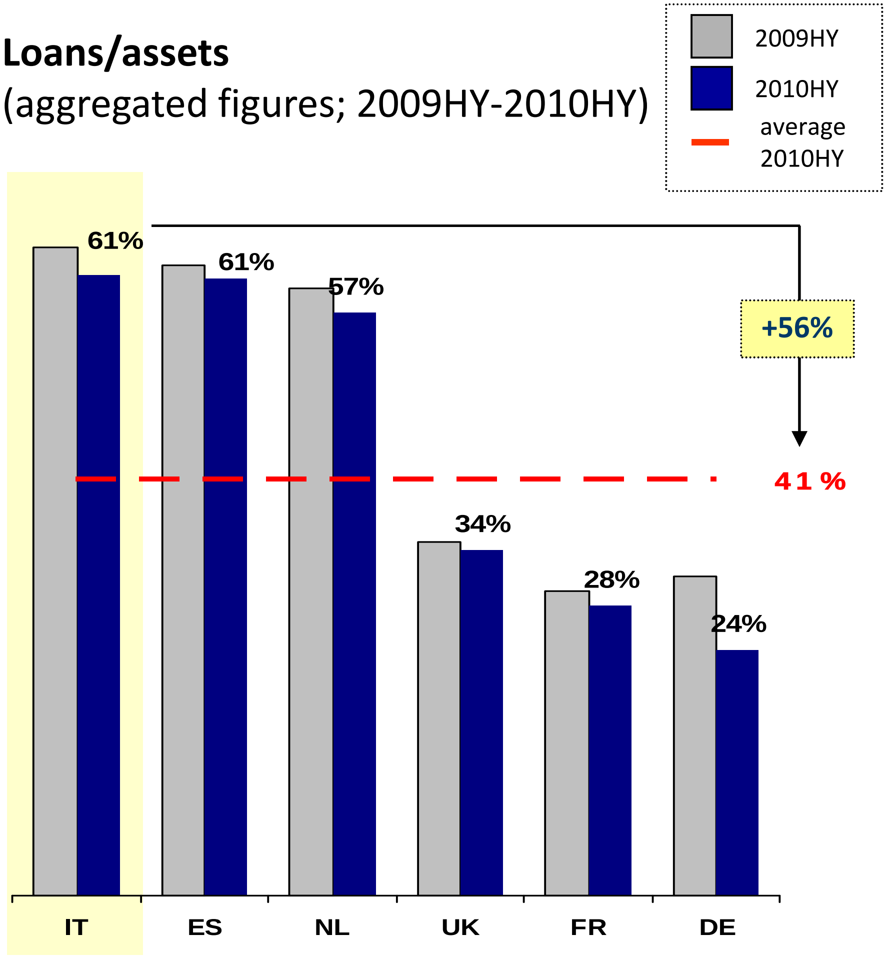
Italian banks' Return On Equity vs Italian GDP growth rate



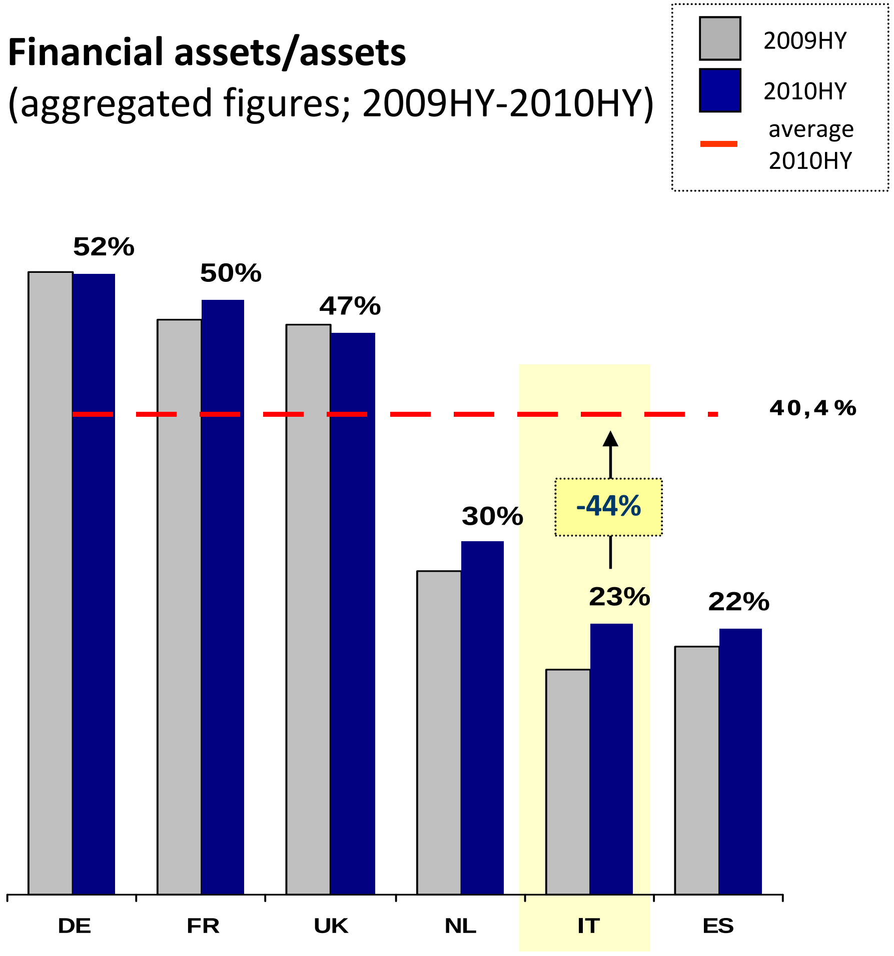
Source: ABI on Istat and Bank of Italy

… as a consequence of Italian banks traditional (low risky) business model…

Loans/assets
(aggregated figures; 2009HY-2010HY)



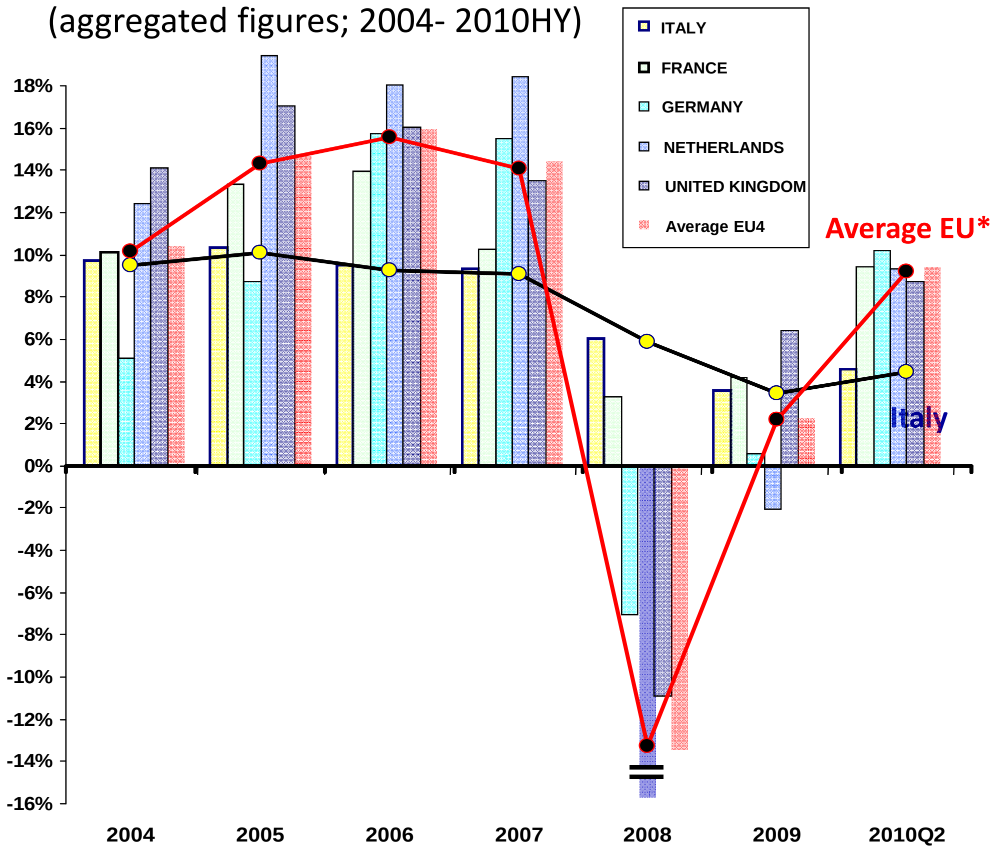
Financial assets/assets
(aggregated figures; 2009HY-2010HY)



Source: EBR (ABI) on banks' annual report

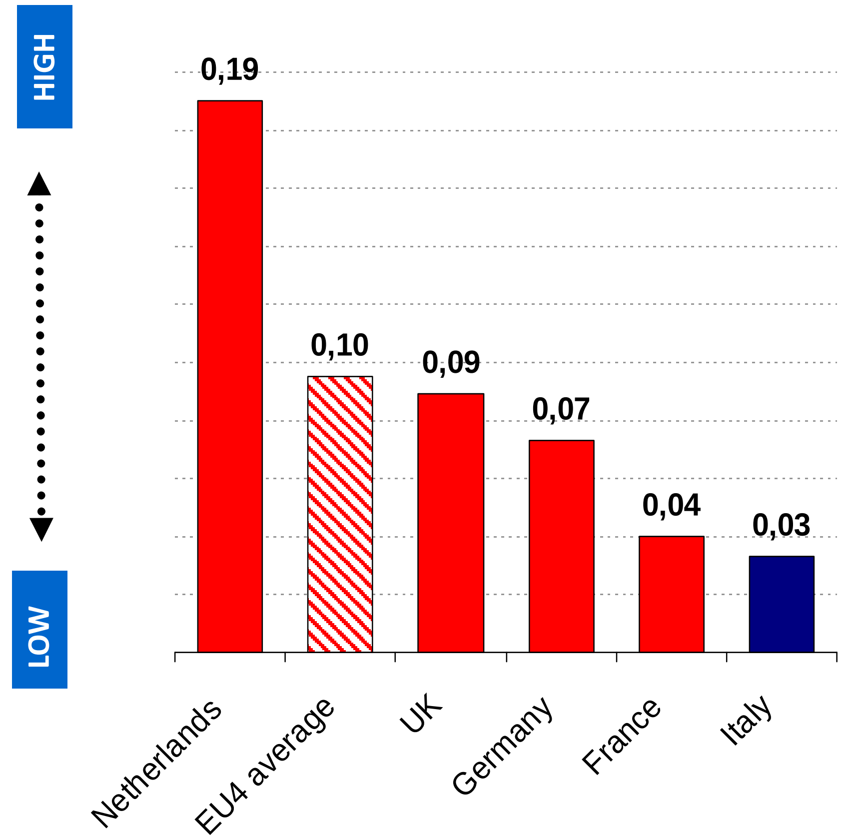
… which means a lower risk profile respect to many peers

RETURN ON EQUITY FOR A SAMPLE OF EUROPEAN BANKING GROUP
(aggregated figures; 2004- 2010HY)



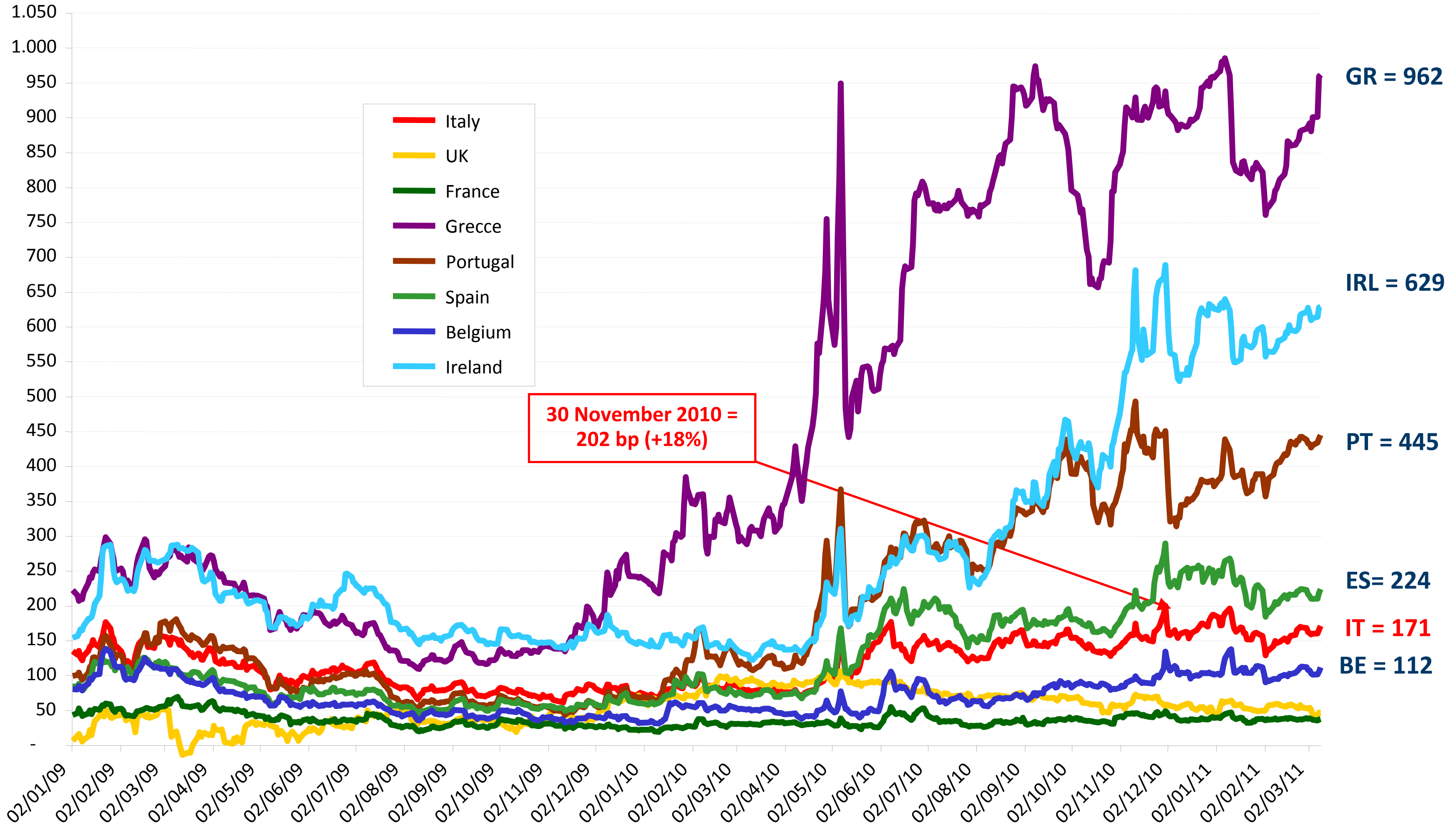
(*) Average France, Germany, UK, Netherlands

PERFORMANCE VOLATILITY
(standard dev. ROE; 2004 – 2010 HY)



Italian Government spreads extremely lower than the ones of GIPS countries

European Government bonds yield spread vs Deutsche bond (basis points; January 2009 - 9 March 2011)

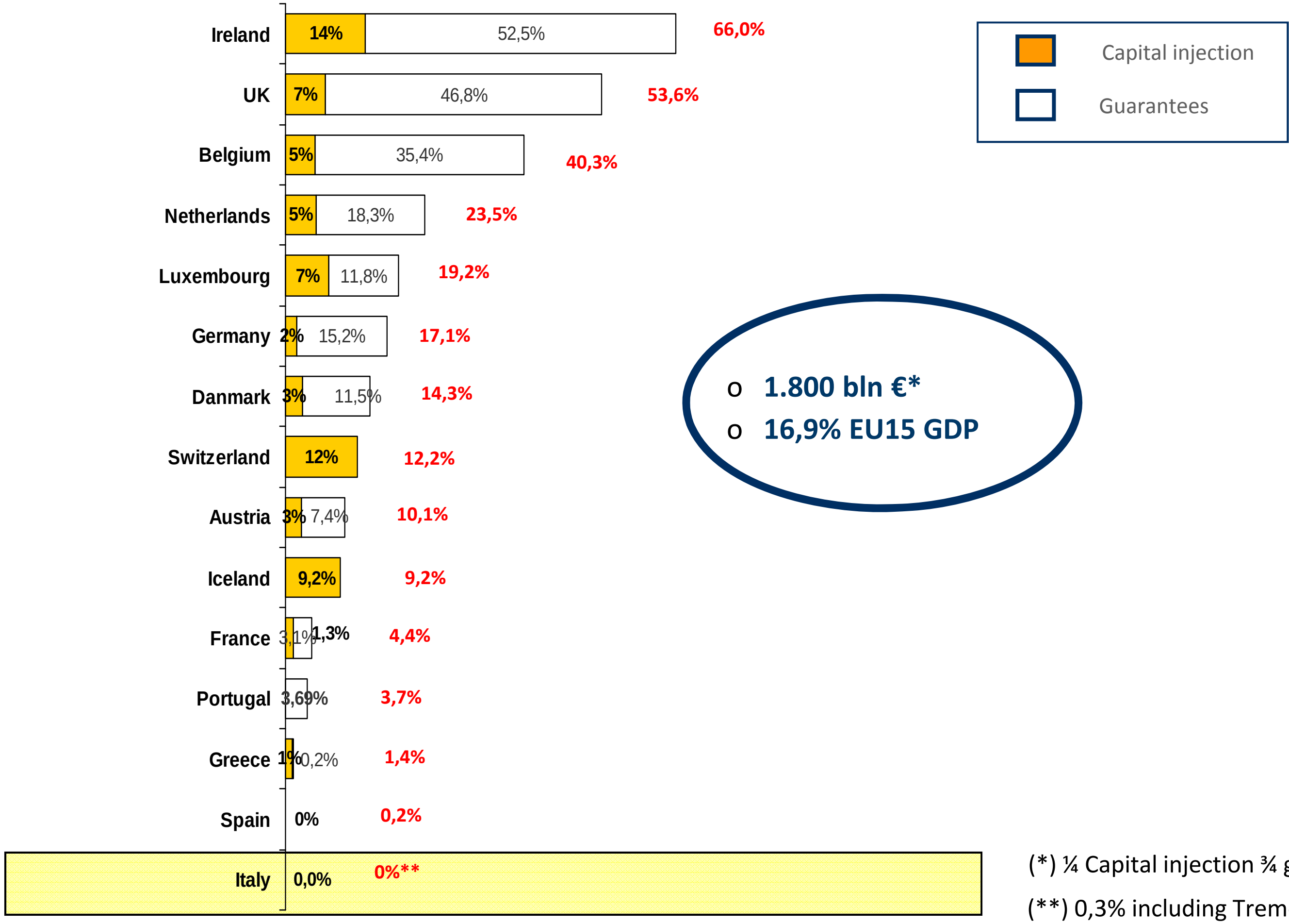


Strong macro fundamentals…

- **low public deficit**: government deficits have increased in many countries and so has public debt. Italian Government has managed public debt in a responsible way during the crisis respect to many other EU countries. Mr Tremonti's deficit-cutting austerity package has helped protect Italy from the worst of the eurozone storm
- **primary balance**: Italy was the only large European economy to have achieved a positive result in term of cyclically adjusted primary balance in 2010, that is the public deficit net of interest expenditure and of the decrease in revenues (and increase in spending) due to the adverse economic cycle.
- **high level of financial asset** as a % of disposable income of Italian households
- **high percentage of internally funded public debt**: almost 55% of Italian public debt is held domestically versus 47% average in Europe. This makes it easier to refinance the public debt, since Italian households employ a significant proportion of their savings for the purchase of sovereign bond
- **low Italian private debt**: the lowest in Europe (108% of GDP at the end of 2009)…
- …which means **a good position in terms of national aggregated debt**

… and specific favorable bank characteristics such as…
the absence of any State support

State support to financial institutions/GDP
(June 2007-December 2009; %)



- 1.800 bln €*
- 16,9% EU15 GDP

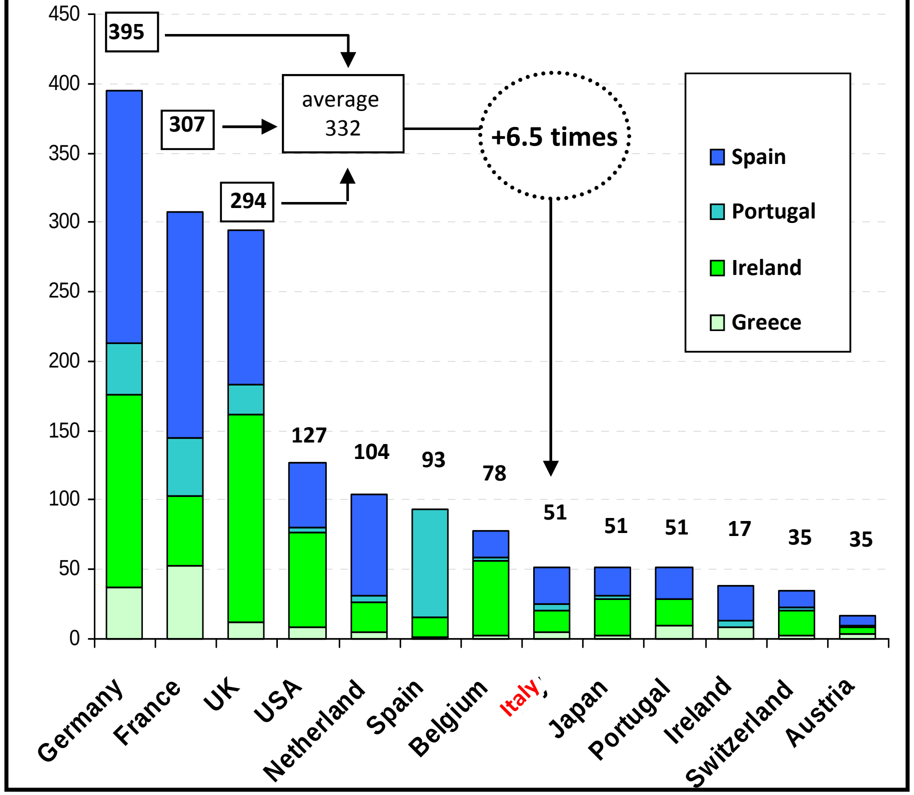
(*) ¼ Capital injection ¾ guarantees

(**) 0,3% including Tremonti Bonds

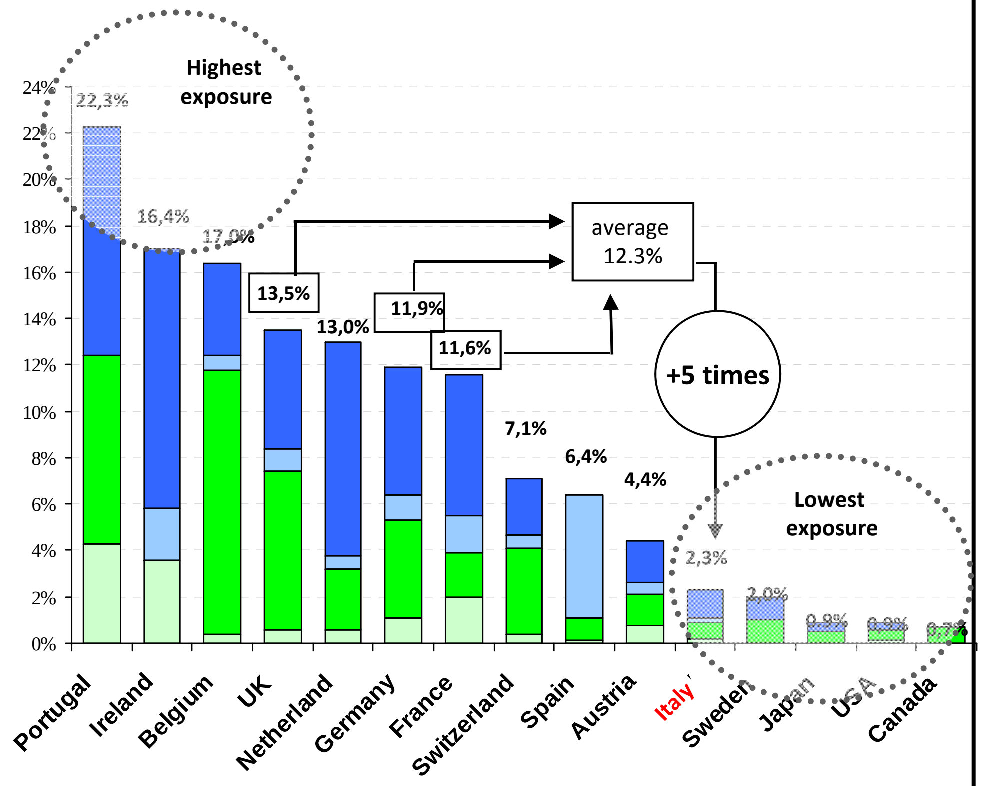
the low exposure both to GIPS countries…

Banks' foreign exposures in GIPS countries*

End-Q2 2010; bln dollars



End-Q2 2010; as a % of GDP



(*) Consolidated foreign claims of reporting banks - immediate borrower basis.

… and North African & Middle East countries

Consolidated foreign claims of reporting banks
September 2010 (mln €)

	European banks	France	Germany	Italy	Spain
domestic reporting banks foreign exposure (mln €)					
Africa & Middle East	358.687	94.397	37.999	9.445	4.107
-Algeria	4.242	3.763	99	114	8
-Egypt	28.624	13.069	843	4.749	143
-Libya	427	138	86	11	-
-Morocco	19.258	17.415	163	70	837
-Tunisia	5.067	4.113	268	118	4
-Altri	301.069	55.899	36.542	4.383	3.115
as a % of all banks foreign exposure by each Country					
Africa & Middle East	**2,52%**	**3,50%**	**1,59%**	$\boxed{\textbf{1,33\%}}$	**0,39%**
-Algeria	0,03%	0,14%	0,00%	0,02%	0,00%
-Egypt	0,20%	0,48%	0,04%	0,67%	0,01%
-Libya	0,00%	0,01%	0,00%	0,00%	0,00%
-Morocco	0,14%	0,65%	0,01%	0,01%	0,08%
-Tunisia	0,04%	0,15%	0,01%	0,02%	0,00%
-Altri	2,11%	2,07%	1,53%	0,62%	0,30%

To sum up: the Italian Banking Sector in a nutshell

Strengths

- The industry is very sound. No State aids during the financial crisis
- Low exposure to GIPS countries
- A traditional business model, with a high share of loans to the household and business sectors rather than to the financial sector
- Funding largely from retail markets
- Low leverage ratios
- Positive trend in capital ratios growth. New Basel III requirements affordable

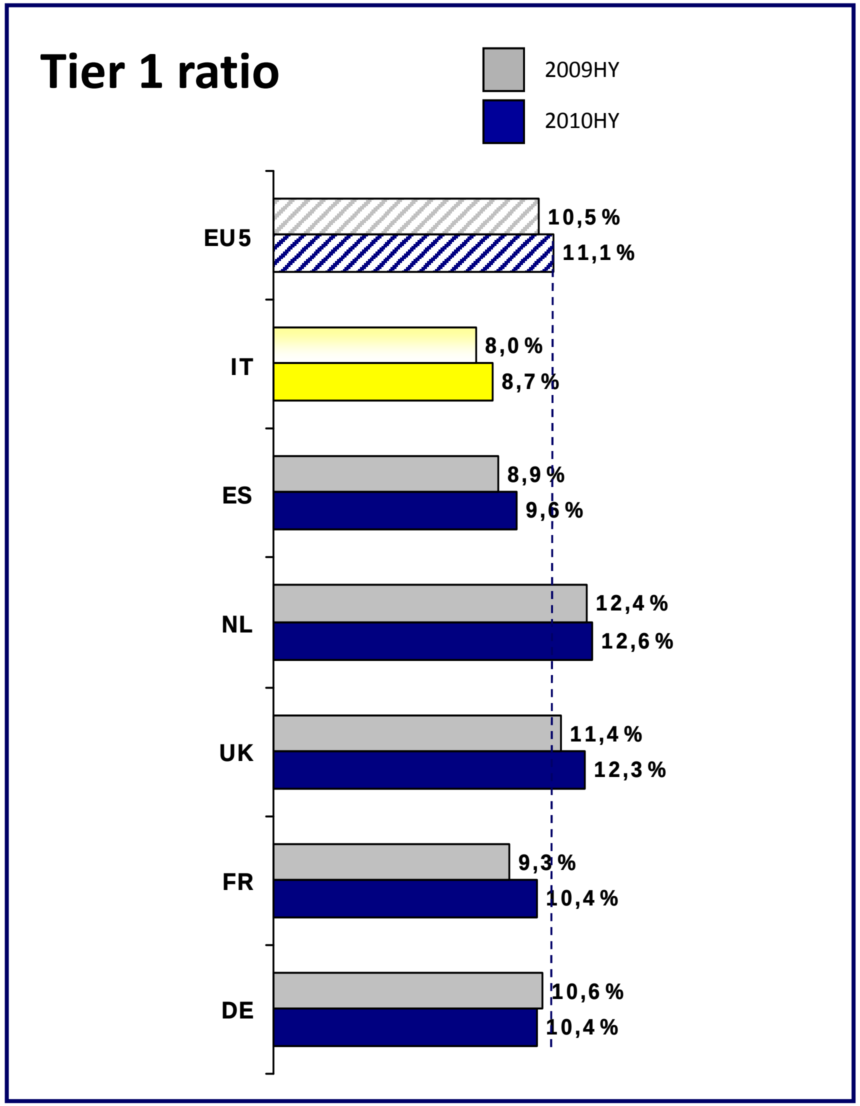
Weaknesses

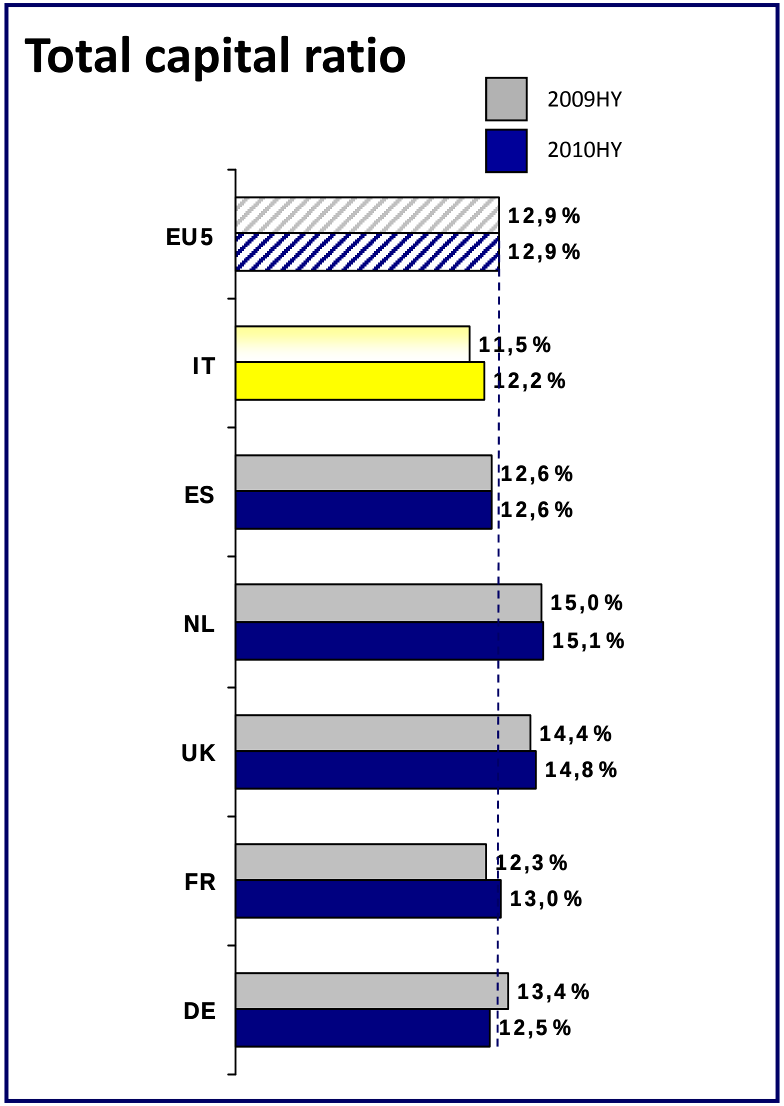
- The recession has penalized our traditional business model
- Profitability levels in danger
- Increasing profits implies acting both on revenues and costs

Basel 3 rules: some concerns

- "One size fits all" principle looks unfair
- global impact study crucial to evaluate the effects of the reform
- the impact on the economy (credit costs & availability)
- a level playing field must be guaranteed between banks and non-banking intermediaries to respect the principle that equivalent assets must be subject to the same rules, including those of prudential supervision
- trade-off between global harmonization and domestic specific peculiarities
- the role of saving and preference shares;
- the deductibility of Deferred Tax Assets (DTAs)

Basel 3 reform proposals: Italian banks are solid and have sufficient capital to meet the new Basel 3 requirements



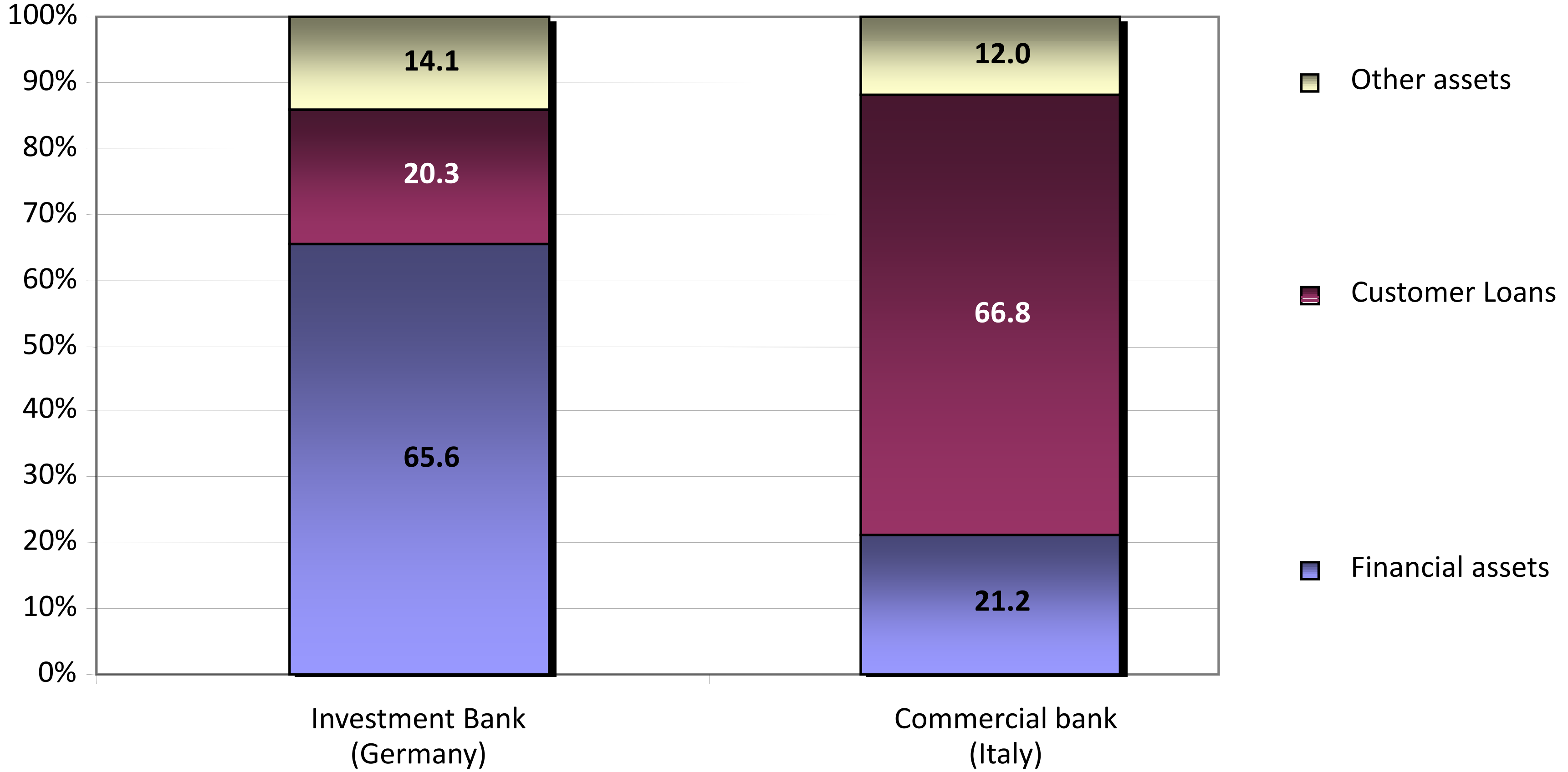


Source: (EBR) ABI on banks' annual report (sample of 25 banking groups)

The impact of Basel 3 will be relevant

To assess the impact of Basel 3 by business model, we consider the higher capital requirement of two European banks with different assets composition

Business mix composition (as a % of total assets)



Source: ABI

The analysis shows the impact of the new requested capital ratios on the RWAs value and, therefore, on the level of Common equity needed to be regulatory compliant

INVESTMENT BANK (DE)	UNDER BASEL II FRAMEWORK			UNDER BASEL III FRAMEWORK		
Common equity/RWAs	2%			7%		
	Amount (a)	Risk Weights (b)	RWAs (c= a*b)	Amount (d)	Risk Weights (e)	RWAs (f = d*e)
Total assets	100		36.7	100		58.6
Financial assets	65.6		10.9	65.6		32.8
ow vs financial institutions	*36.4*	10%	3.6	*36.4*	30%	10.9
ow vs non-financial inst.	*29.2*	25%	7.3	*29.2*	75%	21.9
Customer loans	20.3	75%	15.2	20.3	75%	15.2
Other assets	14.1	75%	10.6	14.1	75%	10.6
Common equity/assets	**0.73**			**4.10**		

COMMERCIAL BANKS (IT)	UNDER BASEL II FRAMEWORK				UNDER BASEL III FRAMEWORK		
Common equity/RWAs	2%				7%		
	Amount (f)	Risk Weights (g)	RWAs (h=f*g)		Amount (i)	Risk Weights (l)	RWAs (m = i*l)
Total assets	100		62.6	1	100		69.7
Financial assets	21.2		3.5		21.2		10.6
ow vs financial institutions	*11.8*	10%	1.2		*11.8*	30%	3.5
ow vs non-financial inst.	*9.4*	25%	2.4		*9.4*	75%	7.1
Customer loans	66.8	75%	50.1		66.8	75%	50.1
Other assets	12.0	75%	9.0		12.0	75%	9.0
Common equity/assets	**1.25**				**4.88**		

The amendment to the market risk framework mainly affects the investment banks but the total impact of the reforms will strongly hit the commercial banks as well

Capital requirements under Basel II and Basel III (as a % of total assets)

Impact on RWAs

Total impact on Capital

Type of bank	RWA		Var. (%)	Common Equity		Var. (basis points)
	Basel II	*Basel III*		*Basel II*	*Basel III*	
Investment bank (Germany)	**36.7%**	**58.6%**	+60%	**0.73%**	**4.10%**	+337
Commercial bank (Italy)	**62.6%**	**69.7%**	+11%	**1.25%**	**4.88%**	+363

+26bp

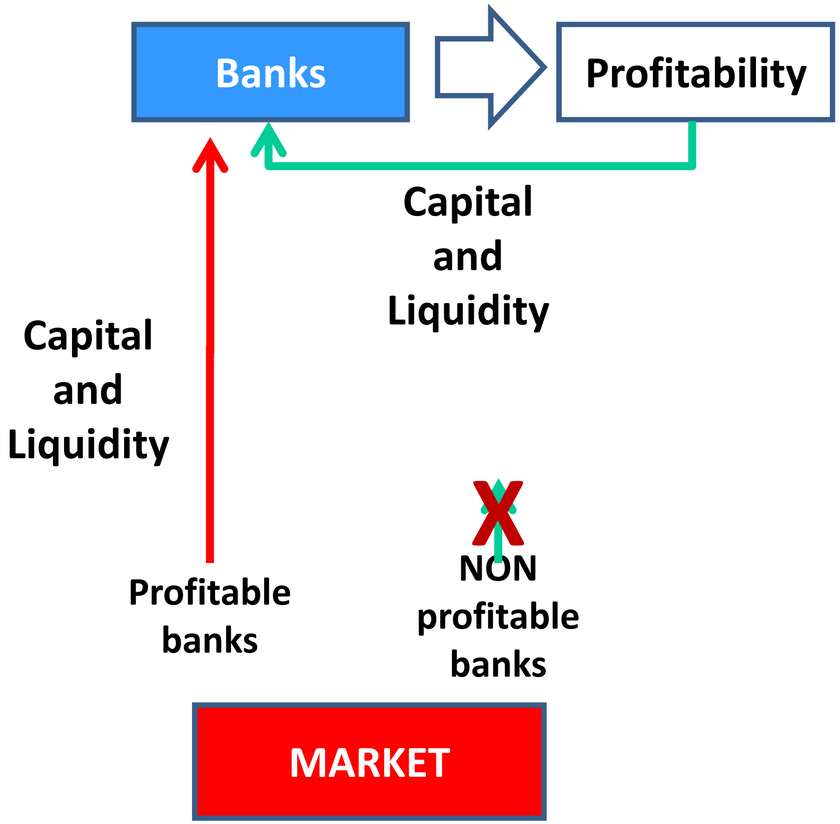
Largest banking groups by Country (aggregated figures)

Germany	44.1%	61.8%	+40%	**0.88%**	**4.32%**	+344
Italy	61.6%	69.3%	+12%	**1.23%**	**4.85%**	+362

+18bp

Source: ABI

But profitability of banks is not a compressible variable at will, otherwise the uselessness of measures to reinforce banks' strength



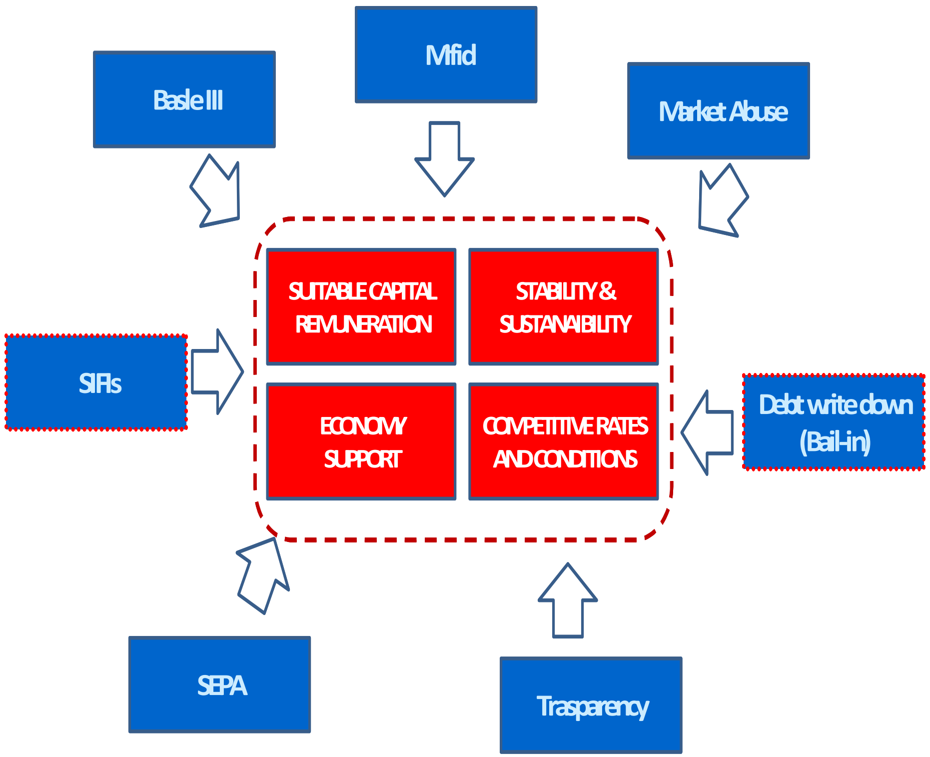
Suitable profitability is an internal source of capital and liquidity a necessary condition to attract equity and fixed income investors

Banks' profitability is under pressure by a number of regulatory constraints that could generate some distortions and regulatory arbitrage between both countries and banking models

The EU Commission has targeted banking with exponential growth in regulatory activity

National regulators are also very active, often going further than the EU

European rules



Italian rules

- **Interest rate cap per product:** Maximum interest rate limited to 1.5 times the average rate by product
- **Mortgage price and transfer policies**:
  - Early repayment fees eliminated or reduced
  - Possible to move the mortgage to another bank with no fees
- **Overdraft fees**: Overdraft fee eliminated on overdraft balances lasting less than 30 days

Implemented – 2007-2009

Capitalisation, profitability, and the growth of banking activities: remarks on some tradeoffs

In the on-going debate over the capital requirements reform

- very much has been said on the efforts banks are asked to make in order to meet the higher capitalisation levels
- but little attention has been paid on the consequences that higher capital ratios will have on the "steady-state" profitability levels

QUESTION:

- In the "new-normal" environment (the B3 world), once the new and higher standards will have been met, will banks be able to yield a profitability level sufficient to keep stable over time the new ratios?
- And what about the main tradeoffs banks will face (activity growth vs dividend distribution policy vs degree of riskiness, etc)?

A simple numerical example

Euro Area (billions euros - 2009)	T1	T2
RISK WEIGHTED ASSETS	18000	18900
- rate of growth		5,00%
CAPITAL RATIO	8,00%	8,00%
CAPITAL	1440	1512
(CAPITAL RATIO) STABILISING CAPITAL INCREASE		72
CAPITAL RATIO	10,00%	10,00%
CAPITAL	1800	1890
(CAPITAL RATIO) STABILISING CAPITAL INCREASE		90

……. moving from 8% to 10% → :

1) 360 billions of additional capital to reach the new required level (10%)

2) 18 billions of increase in the additional capital (90 bln instead of 72 bln) to keep stable a Tier1 ratio of 10%

The (Capital Ratios) Stabilising ROA: the formula

Capital ratio

Asset growth

Risk weighting coefficient

$$Roa_{stab} = \frac{\%Tier1_t \times \left(\Delta\%Rwa \big/ \left(1 + \Delta\%Rwa\right) \right) \times \%Rwa}{\left(1 - d\right)}$$

Share of distributed dividends

The stabilising ROA, is a function of:

- capital ratio (+);

- **(risk weighted) asset growth (+);**

- **risk weighting coefficients (+)**

- **share of profits distributed (+)**

Stabilising ROA, Tier1 levels, and asset growth

- So, what is the Stabilising ROA for different combinations of capital ratios and asset growth, taking distributed profits and risk ratio as given ?

Table 1.

Roa level necessary to stabilise the Tier 1 ratio

(share of profits distributed=50%, risk ratio=63.4%)

		Assets growth rate					
		5%	6%	7%	8%	9%	10%
Tier1 level	5%	0,30%	0,36%	0,41%	0,47%	0,52%	0,58%
	6%	0,36%	0,43%	0,50%	0,56%	0,63%	0,69%
	7%	0,42%	0,50%	0,58%	0,66%	0,73%	0,81%
	8%	0,48%	0,57%	0,66%	0,75%	0,84%	0,92%
	9%	0,54%	0,65%	0,75%	0,85%	0,94%	1,04%
	10%	0,60%	0,72%	0,83%	0,94%	1,05%	1,15%

Source: ABI

- The table shows the tradeoffs: with the share of retained profits and asset riskness taken as given, higher levels of capitalisation require higher profits (higher Roa). And for a given level of capitalisation, profitability must increase if banks want to increase their assets (e.g. bank loans to the economy)

Stabilising ROA, Tier1, and Profit Distribution Policy

Setting aside:

i) a reduction in the rate of growth of assets

ii) a change in the degree of asset riskness

iii) an issuance of new capital shares

we can ask what are the effects of a **reduction in the share of profits distributed**

- PROFIT DISTRIBUTION POLICY. Table 2 shows the Stabilising ROA for different combinations of Tier1 ratios and pay out ratios with asset growth and risk ratio taken as given.

Table 2.

Roa level necessary to stabilise the Tier 1 ratio

(asset growth=7%, risk ratio=63.4%)

		Pay out ratio					
		35%	40%	45%	50%	55%	60%
Tier1 level	5%	0,32%	0,35%	0,38%	0,41%	0,46%	0,52%
	6%	0,38%	0,41%	0,45%	0,50%	0,55%	0,62%
	7%	0,45%	0,48%	0,53%	0,58%	0,65%	0,73%
	8%	0,51%	0,55%	0,60%	0,66%	0,74%	0,83%
	9%	0,57%	0,62%	0,68%	0,75%	0,83%	0,93%
	10%	0,64%	0,69%	0,75%	0,83%	0,92%	1,04%

Source: ABI

- Cutting the share of profit distribution by 5 p.p. (from 50% to 45%) makes it possible to reduce, in the case of a Tier1 at 10% (almost Basel 3 like), the stabilising RoA level by 8 b.p., from 0.83% to 0.75%.

Stabilising ROA, Profit Distribution Policy, and ROE

QUESTION:

What does all this mean in terms of returns for shareholders?

Table 3.

Stabilising Roa and corresponding Roe for the shareholder

(asset growth=7%, risk ratio=63.4%, Tier 1 ratio=10%)

	Pay out ratio					
	35%	40%	45%	50%	55%	60%
Stabilising ROA	0,64%	0,69%	0,75%	0,83%	0,92%	1,04%
Shareholders ROE	3,52%	4,36%	5,35%	6,54%	8,00%	9,81%

Source: ABI

- A reduction in the share of profits distributed from 50% to 45% succeeds in filling the resource gap for the banking system, but at the cost of a 119 b.p. reduction in the shareholder return: if, based on a profit distribution of 50%, the dividend flow stands at 6.54% of capital, a distribution limited to 45% reduces said return to 5.35%.

Closing remarks (1)

- Despite having one of the highest public debt/GDP ratios in Europe, Italy has a relatively **low deficit in 2010**
- Italy is the only country, among the largest in Europe, to exhibit a **cyclically adjusted primary surplus**
- The **household base** is quite **underleveraged**
- Banks run a **traditional deposit business**
- The Italian **business model is solid**
- Nevertheless, new domestic and international rules put pressure on net margins reducing the tools available to support **bank's profitability** that is currently a **major priority** for banks **to ensure that the impact of Basel 3 will be managed** while ensuring that the provision of credit and financial services to the economy will be not impaired

Closing remarks (2)

- To sustain a higher level of capitalisation will require banks generating higher profitability. **Profitability becomes a key challenge**.
- In principle, the search for higher profits could entail an increase in the degree of risk of bank activities which, to some extent, could offset the effect of the reduction in system risk implicit in the higher capital endowment.