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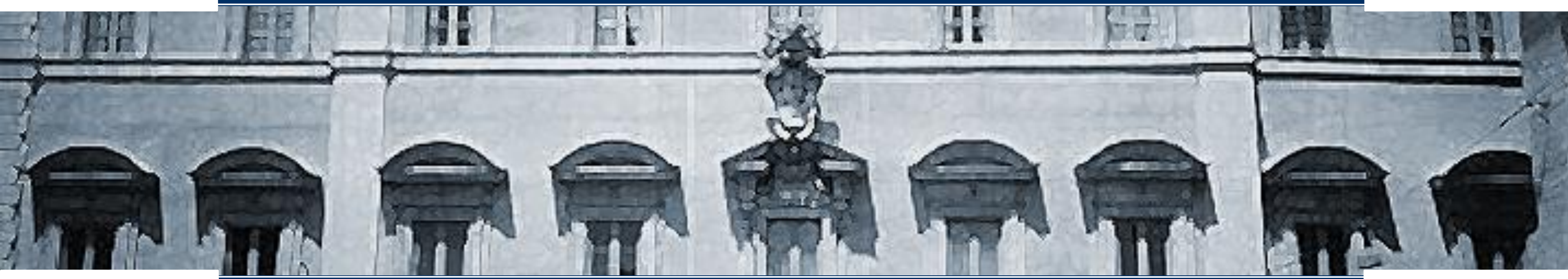

THE ITALIAN BANKING LANDSCAPE: (the country & the banks: latest trends and the residential mortgage market)

ANGELO PEPPETTI

October 5th 2018

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- Key features of Italian banks
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Recovery in Italy is underway and based on solid foundations

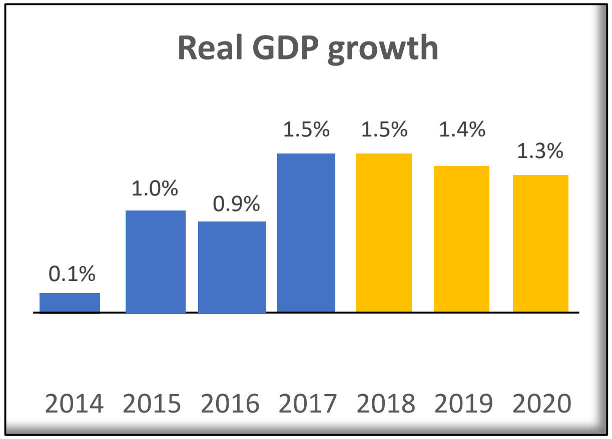
Fiscal efforts and measures implemented from the beginning of the crisis ensure economic recovery and consolidation of public finances in Italy

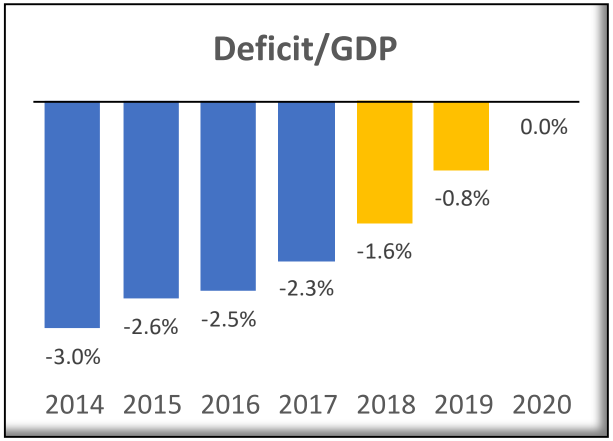
- **The outlook is positive:** the economy is on a solid footing, GDP growth increased in 2017, rising to 1.5% from 0.9% in 2016. It is expected to moderate in 2018 and 2019 but to remain positive and higher than 1%.
- **Public finances under control:**
  - ✓ low deficit: deficit consistently below 3% of GDP
  - ✓ high primary surplus
  - ✓ Debt, even if still higher than the EU average, has increased considerably less than other countries over the 2009-16 … and the Debt/GDP ration is going down (from 2017)
- **Macroeconomic environment and political uncertainty are putting under discussion the Italian debt sustainability, but there are relevant reasons not to be overly worried** (see following charts)

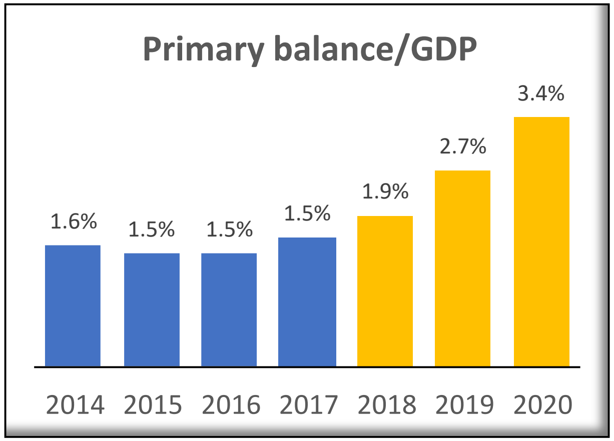
The Italian outlook is improving faster than expected. So far the outlook remains favourable

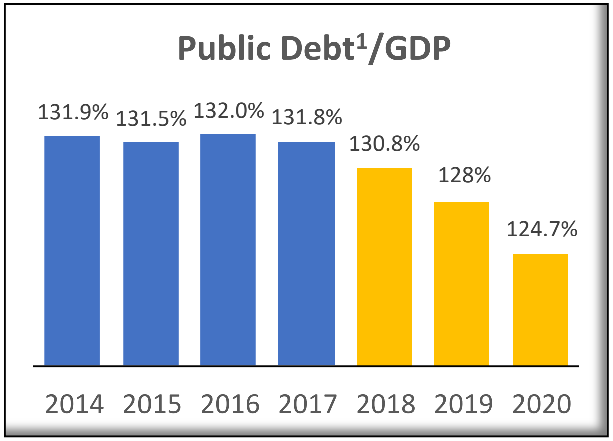
Italian public finance outlook based on unchanged legislation

(Italian Government projections as at April 2018)









(1) Including the Italian share of loans to Member States (bilateral or through EFSF) and the capitalization of the ESM. As at year-end 2017 the whole amount is equal to €58.2 billion (of which 43.9 bln for bilateral and EFSF loans) and 14.3 for he capitalization of the ESM. (2) Economic and Financial Document (DEF)" update

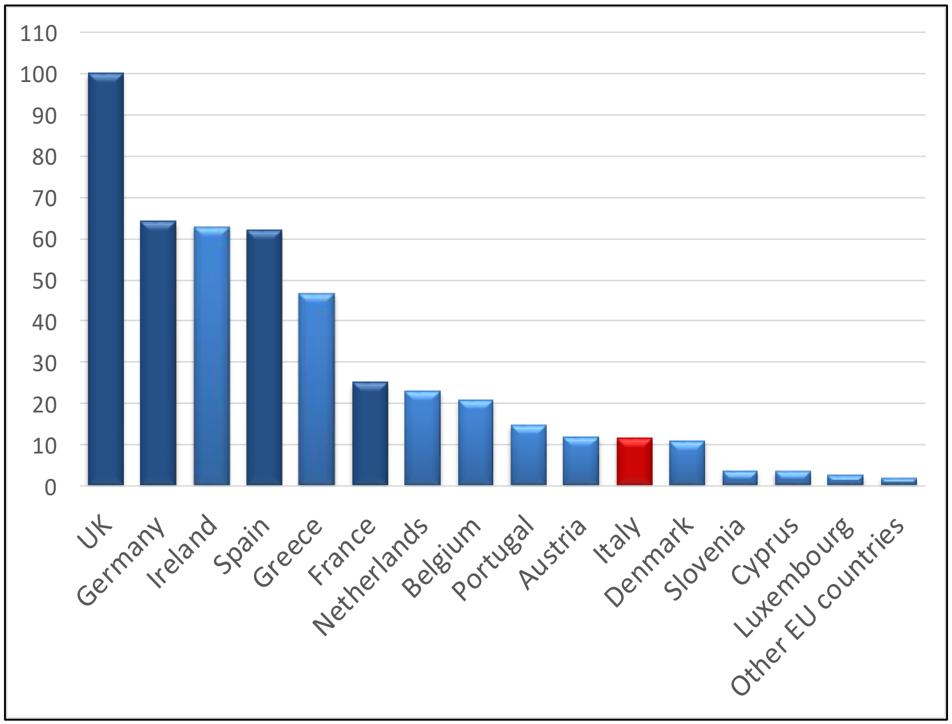
Source: ABI on Italian Government's «Economic & Financial Document (DEF)» - April 2018, Istat
Source: ABI on Istat

Italian banks in a nutshell

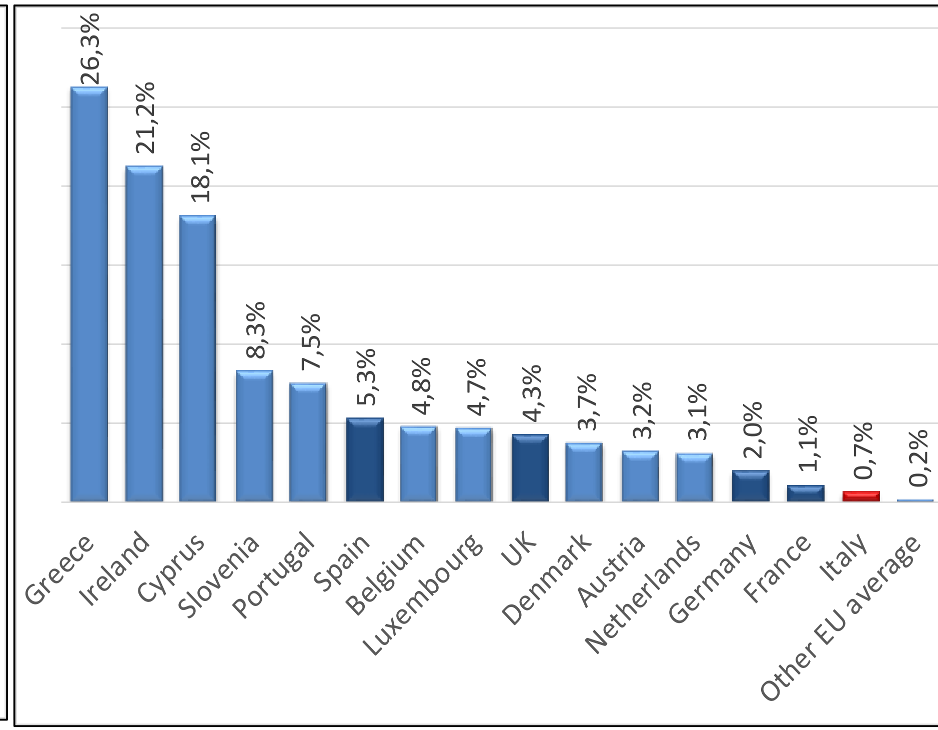
1. **ITALIAN BANKING SECTOR ON A RECOVERY PATH**. Following the precautionary recapitalisation of MPS and the orderly liquidation of Banca Popolare di Vicenza and Veneto Banca, headline risks have been removed. Favourable macro environment is supporting improvments in credit quality and banks soundness & profitability.
2. **LENDING TO PRIVATE SECTOR GROWING AS OF 2016.** In July 2018 loans to households and firms (net of repos and taking into account securitisation of NPLs) grew at around 2.6% YoY.
3. **CREDIT RISK BELOW THE PRE-CRISIS LEVEL**. The flow of new non-performing loans (NPLs) has been decreasing since 2014. It is now about 1.7% of total loans, below the pre-crisis average.
4. **NPL STOCK DIMINISHING AT A REMARKABLE PACE**. Banks are selling large amounts of NPLs in the market. Including the sales that will be completed in the next months, by mid-2018 the volume of NPLs net of provisions will amount to around €120 billion (6.8% of total loans). The gross NPL ratio stands at 13.4%, against over 18% in 2016.
5. **NPL RATIO EXPECTED TO DECLINE AT ACCELERATED PACE**: in our June 2016 forecasts (based on 2015 year-end data) we expected NPL ratio at 2020 lower than 10%. Latest actual figures (Dec. 2017) show the ratio is declining more quickly than we expected. In our updated forecasts (July 2018), gross NPL ratio is expected to fall below 10% by mid 2019 and at around 6% by year end 2021.
6. **COVERAGE RATIO INCREASING**: it now stands at about 53% for total NPLs and 65% for bad loans; the implict recovery rate on bad loans is 35%, well above the effective recovery rates (about 43% in average for all the NPL position closed between 2006 and 2015).
7. **PRUDENTIAL CAPITALIZATION LEVELS CONTINUE TO RISE:** common equity tier 1 ratio standed at around 13.8% at year end 2017, up from 10.4% in 2016.
8. **EXPOSURE TO THE DOMESTIC SOVEREIGN AROUND 9.5% OF TOTAL ASSETS**
9. **PROFITABILITY GROWING:** ROE increased to 4% in 2017 net of extraordinary costs and revenues (reported ROE was over 7%). Annualized 1Q 2018 ROE increased at around 9%.
10. **RESTRUCTURING & CONSOLIDATION GOING ON:** 300 cooperative banks will soon form 3 large banking groups. The largest «banche popolari» were transformed into joint stock companies. All in all, the sector is less fragmented than often claimed: around 115 groups and independent banks in total.

Despite the intensity of the crisis, public interventions in favor of the banking sector in Italy were much lower than in other large European countries

Recapitalisation measures* to support banks (2008-2016 cumulated data, bln €)



Recapitalisation measures* to support banks (2008-2016 cumulated data, as a % of 2017 GDP)



(*) 2008-2016 cumulated data referred to State recapitalizations used

Source: ABI on European Commission «State Aid scoreboard 2017 – Aid in the context of the financial and econoimic crisis»

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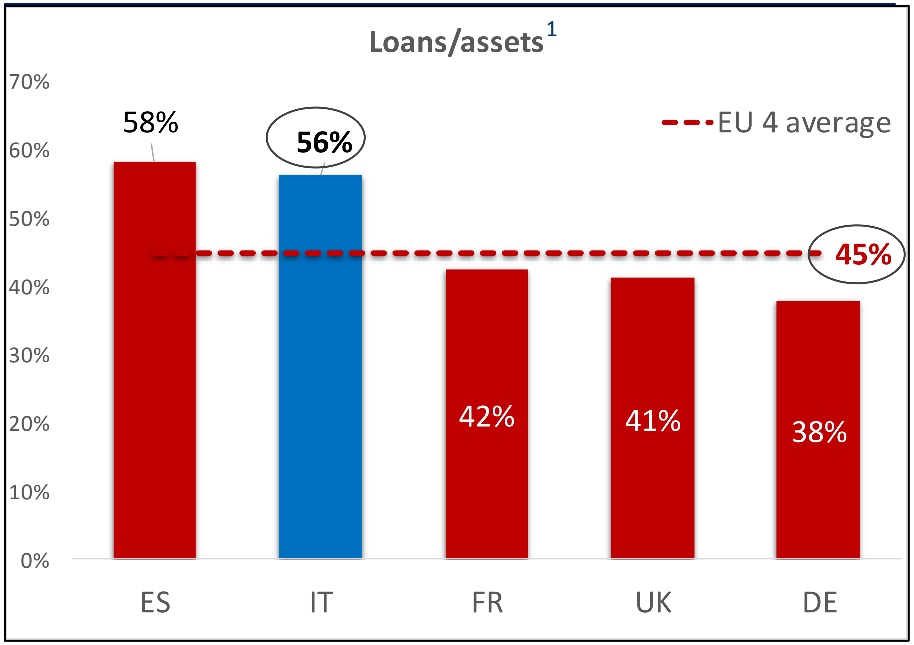
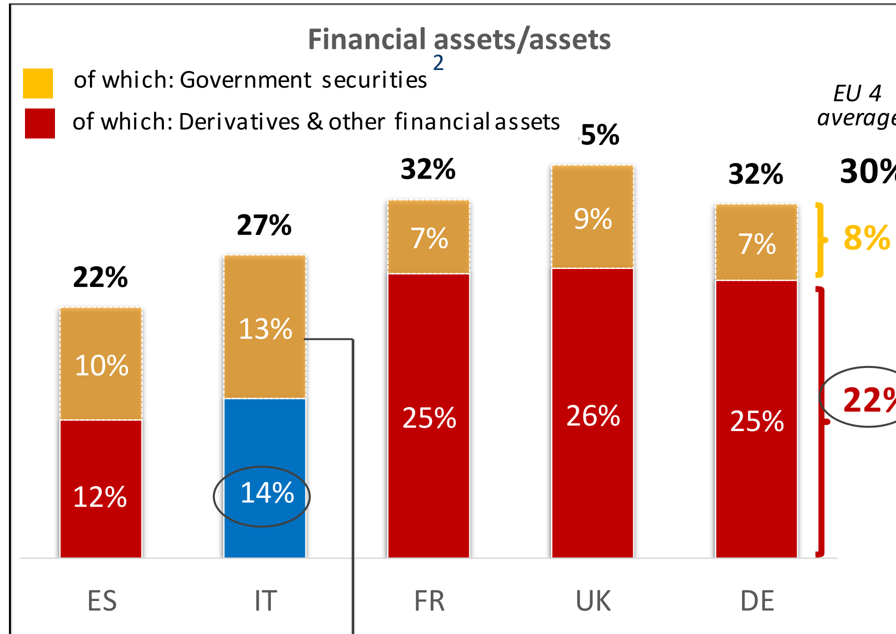
Business mix traditionally oriented to lending, unlike other European banks more exposed to finance

Figures referred to a sample of 80 large EU banking groups

(ABI on banks balance sheets and EBA trasparency exercize figures as at June 2017)





As at May 2018 Italian banks exposure towards domestic sovereign was 361 bln € (about 60 bln less than 2 year before), which is 9,6% of banks total assets[3]

(1) Loans do not include exsposure to banks.(2) Domestic exposure to sovereign plus foreign sovereign exposure (3) Note that banks and banking groups sovereign on assets ratios are not perfectly comparable for accounting reasons ((inter-bank assets between institutions belonging to the same group are eliminated at the consolidated financial statements level))

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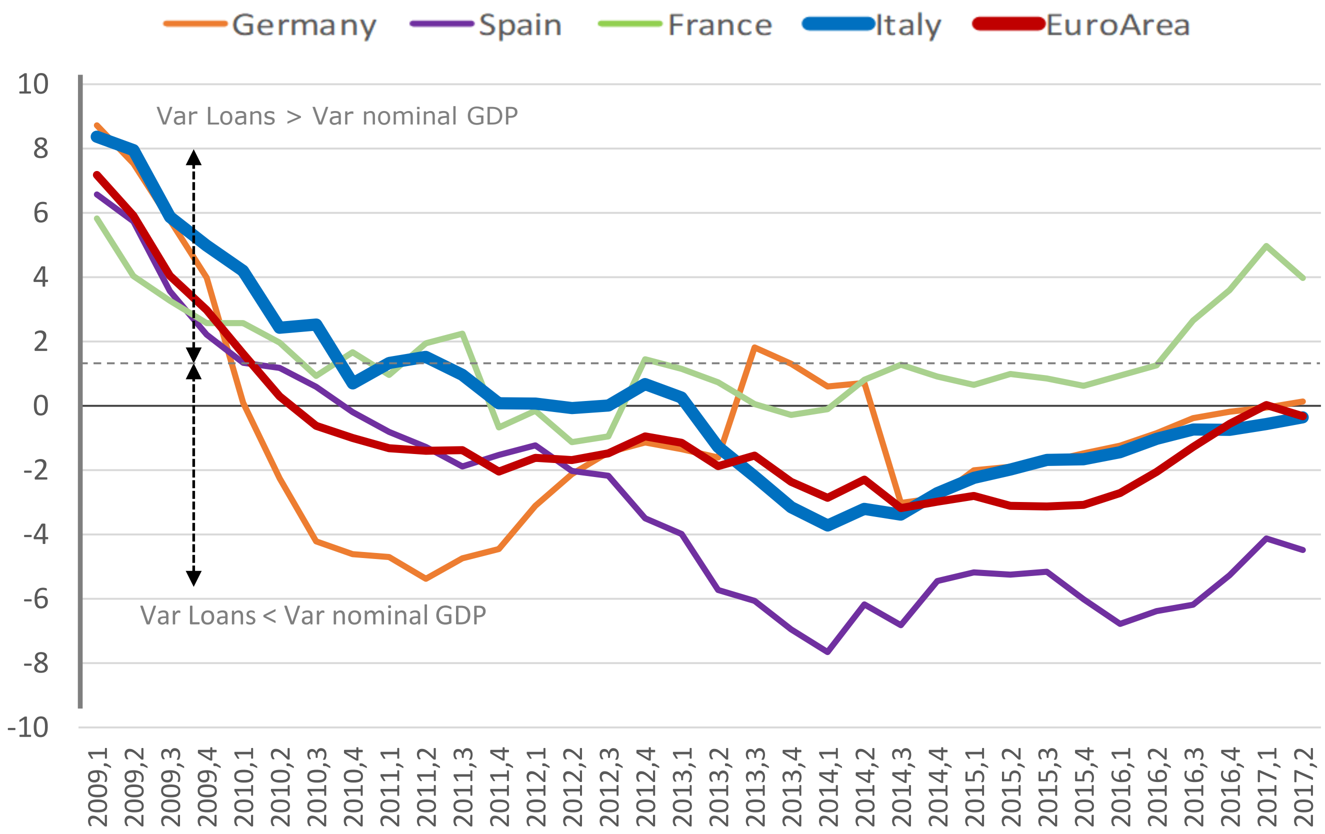
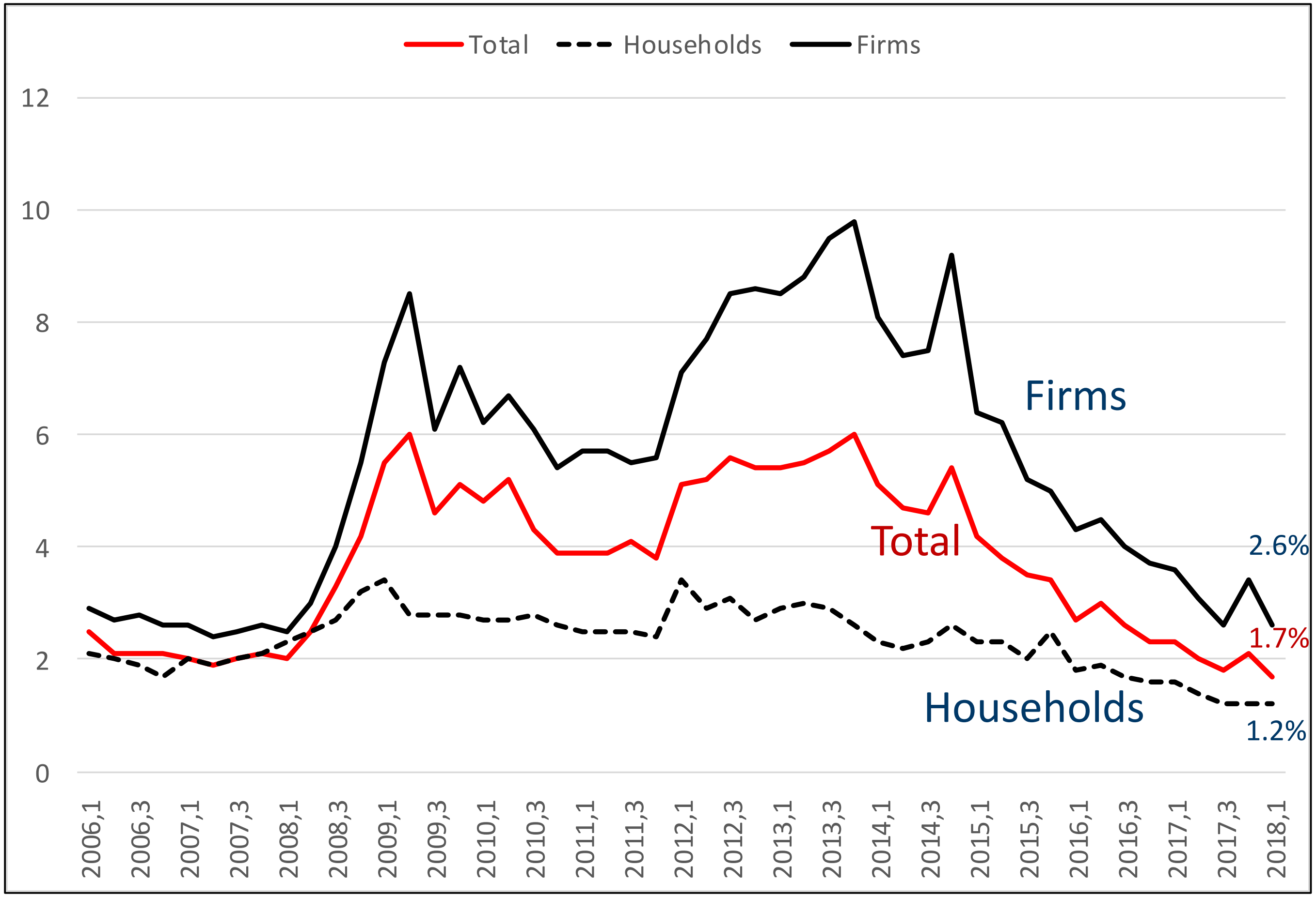
Lending evolution is in line with the GDP growth, as in the main EU countries (but much better than others such as Spain)

''Loans to Nominal GDP'' ratio evolution
(percentage variation; YoY, quarterly data)



Loans growth mainly due to the positive evolution of credit risk, which is driven by the recovery of the economy

Loans risk evolution in Italy*
(New NPL/loans; referred to total loans to households & firms)

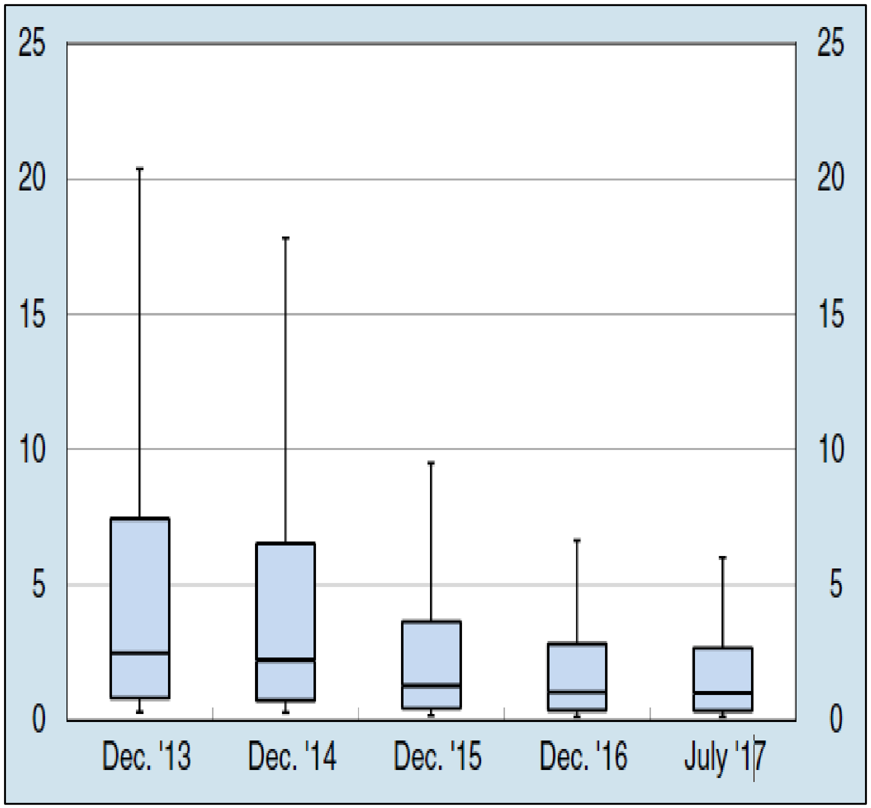


(*) Annualized quarterly flow of adjusted NPLs (past-due by more than 90 days, other NPLs and bad loans) in relation to the stock of loans net of adjusted NPLs at the end of the previous quarter. Data seasonally adjusted where necessary.

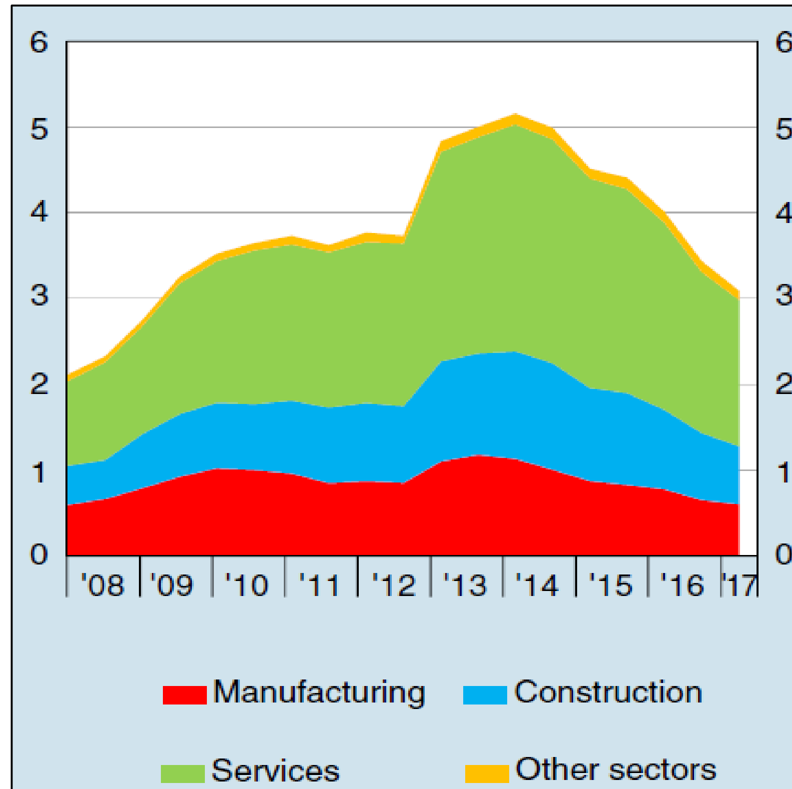
Source: Abi on Bank of Italy data

Italian firms' financial situation is improving as well as firms ability to repay loans : the probability of default and the number of bankruptcy proceedings have significantly declined

Distribution of the probability of default (1)
(12-month percentage changes)



New bankruptcy proceedings (2)
(half-yearly data; thousands)

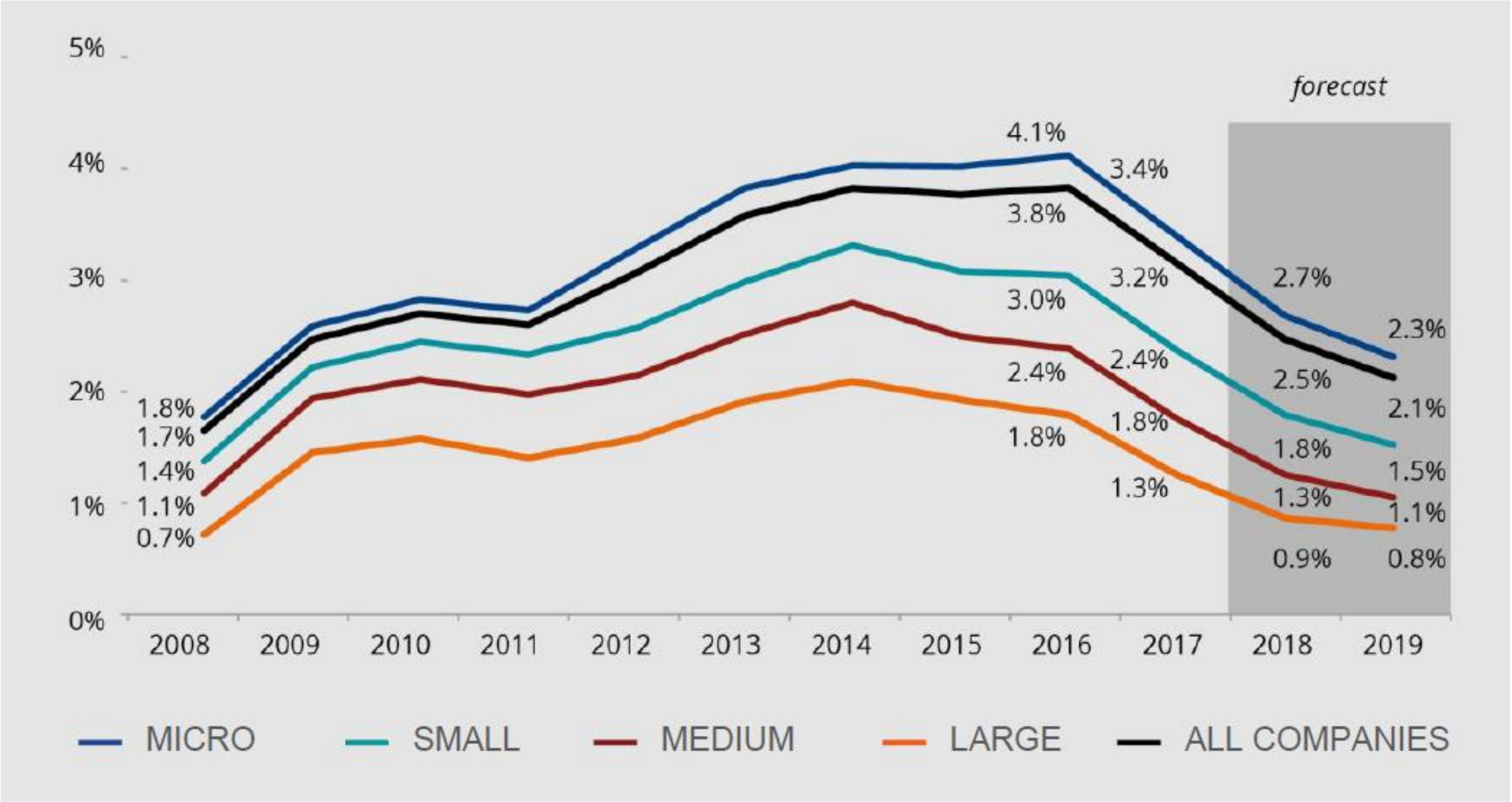


(1) The probability of default is estimated over a 12-month horizon on an open sample of non-financial companies resident in Italy that includes, for each reference date, all the firms for which balance sheet and Central Credit Register data are available and which have not yet defaulted. The graph shows the 90th, 75th, 50th, 25th and 10th percentiles of the distribution for each year.
(2) The data refer to active companies that submitted their annual financial statements at least once in the three years before the start of the bankruptcy proceedings.

Source: ABI on Bank of Italy data

Looking forward: credit risk is expected to further reduce (at all firms size)

New bad loans as a percentage of total loans to non-financial companies in Italy
(Annual influx of bad loans, adjusted and expressed as a percentage of total loans)



Source: Abi-Cerved estimates and forecasts

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The causes of the NPL issue: enforcement procedure length is a key factor

Causes of NPLs

- In Italy **80% of NPLs growth explained by macro/country factors** (Real GDP, enforcement procedure length; interest rates spread) compared to 50% on average in Europe

- **In particular, enforcement procedure length is key**: it explains 50% of NPLs growth in Italy

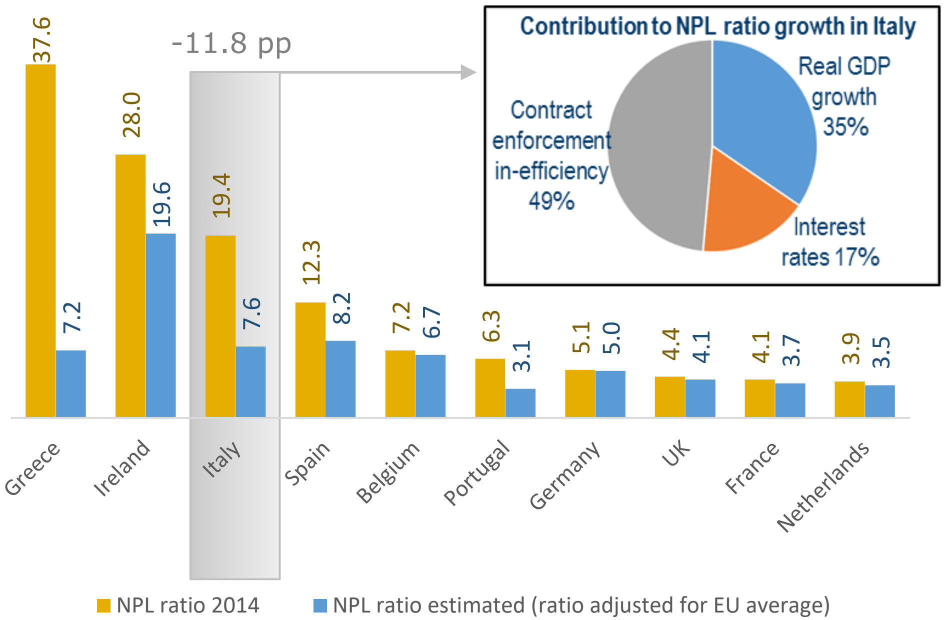
Improvement in the civil justice efficiency is a key priority, as its slowness was the main responsible of the NPLs increase in Italy

What if simulation

Country-specific determinants of NPLs in Italy (Average value)

Factors modified in the simulation	from	to	Explanation
Real GDP growth	-1.3%	0.40%	GDP growth in line with the Euro Area f/2008 t/2014
Interest rate on BTP	4.3%	2.2%	Spread vs. Bund limited to 30 p.b. from 2010 to 2014
Contract enforcement efficiency	1224 days	584 days	Contract enforcement efficiency equal to the European mean f/2008 t/2014

NPL ratio 2014 (our estimates[1] vs. actual figure)



NPLs evolution since 2008 mainly determined by lower GDP growth, higher Sovereign benchmark rate and lower contract enforcement efficiency. Using Abi econometric model, we find that for the Italian banks the cumulative impact of these three factors explains the 80% increase in NPLs (around 12 pp) - of which almost the half is due to the Contract enforcement in-efficiency - as compared to 50% in the other European countries

1) The estimated NPL ratio is equal or lower than the actual NPL in all the countries as we apply the European Average (for one or more of the 3 key variables) instead of the country actual figure only in case the change produces a positive effect. Indeed, in each year observed, we divide the countries into two groups: (i) those with GDP growth higher than the EA; (ii) those with GDP growth lower than the EA. Then, we assign the EA GDP growth solely to the second group. Moreover, we assign, solely to the stressed countries (i.e., GIPSI), the Germany benchmark rate plus 30 bp. Finally, we assign the mean value of EA contract enforcement efficiency to all countries that have a value of this index higher than the average (i.e., Greece, Ireland, Italy and Slovenia).

Source: ABI based on "Non-Performing Loans in the Wake of Crises: What Matters for Large European Country vs. Bank Determinants" ABI Research Paper, TEF Special Issue N. 4, March 2016

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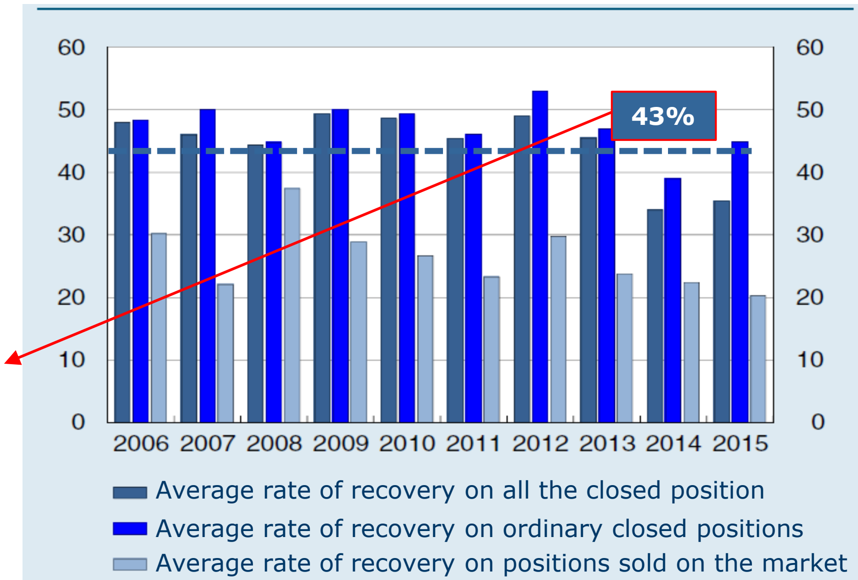
Current coverage ratios aligned with effective recovery rate of bad loans. Recovery rate on ordinary closed positions significantly higher than those on positions sold

Amounts of NPLs and coverage ratios in Italy
(by class of NPLs; %; December 2017)

	December 2017
	Coverage
Loans	*8.1%*
NPLs total:	*52.7%*
- Bad loans	*64.4%*
- Unlikely to pay	*33.9%*
- Past due loans	*21.4%*

Implicit recovery rate: 36%

Actual recovery rates of Bad loans in Italy
(total and by type of recovery procedure)

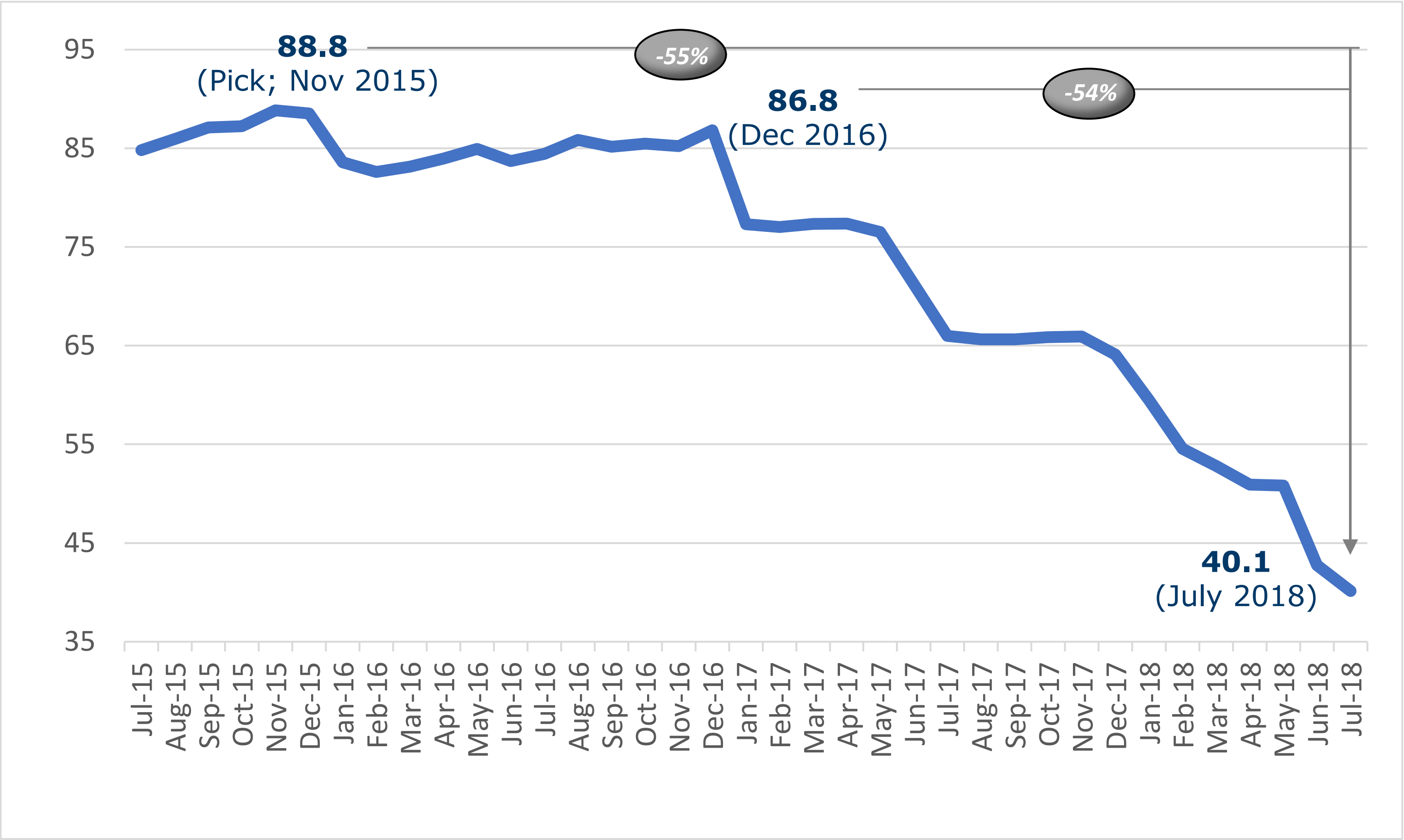


The average rate of recovery on bad loans between 2006 and 2015 was 43% (which corresponds to 57% of losses, a percentage in line with the current average coverage rate (64.4% at December 2017)

Recoveries on ordinary closed positions are significantly higher (around 45% in 2015) than those recorded on positions sold on the market (around 20%)

In particular, Bad loans ("sofferenze") down to 40.1 bln €, 55% less than the pick touched in November 2015 (88.8 bln €) and 54% less than the amount at year end 2016

Italian net bad loans (sofferenze)
(total Italian banks; July 2015 – July 2018; bln €)



Source: ABI on Bank of Italy data

The expectation on the NPL issue: NPLs ratio estimated to speedily return to manageable value

Expectations

- **NPLs ratio expected to speedily return to manageable value,** even in the context of a modest growth and in the absence of extraordinary acceleration in NPL disposals
- Improvement in **civil justice efficiency is a key priority:** positive impact of recent reforms begin to be visible (on procedures length and on the Bid/Ask price gap)
- **ECB guidelines welcome.** They also recognise that: i) NPL issue needs time to be managed; ii) **internal management is an options**
- impact on IBR banks' **LGD calculation of extraordinary NPL disposal (or M&As) to be sterilised**

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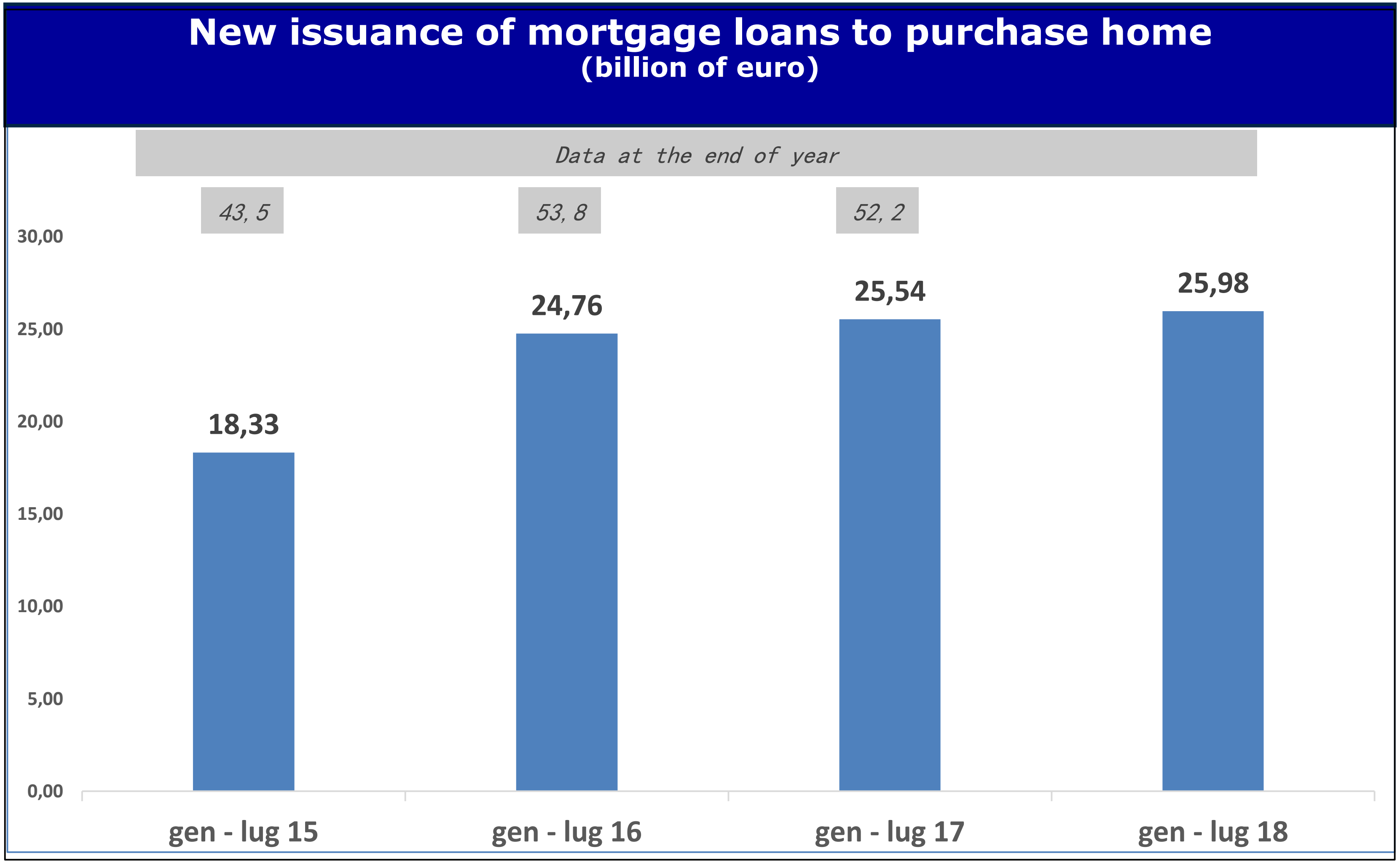
NEW ISSUANCE OF RESIDENTIAL MORTGAGE LOANS



Source: ABI

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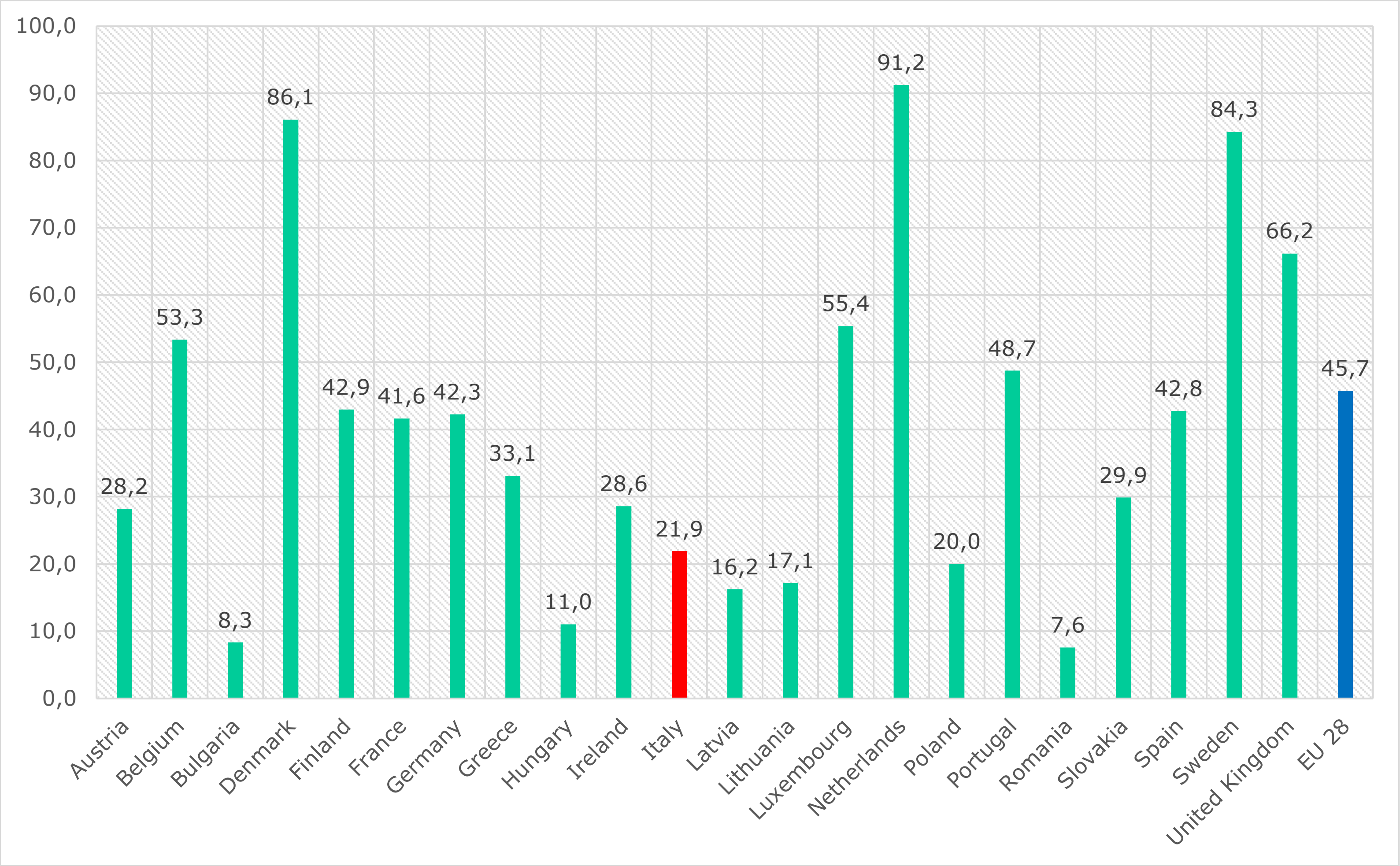
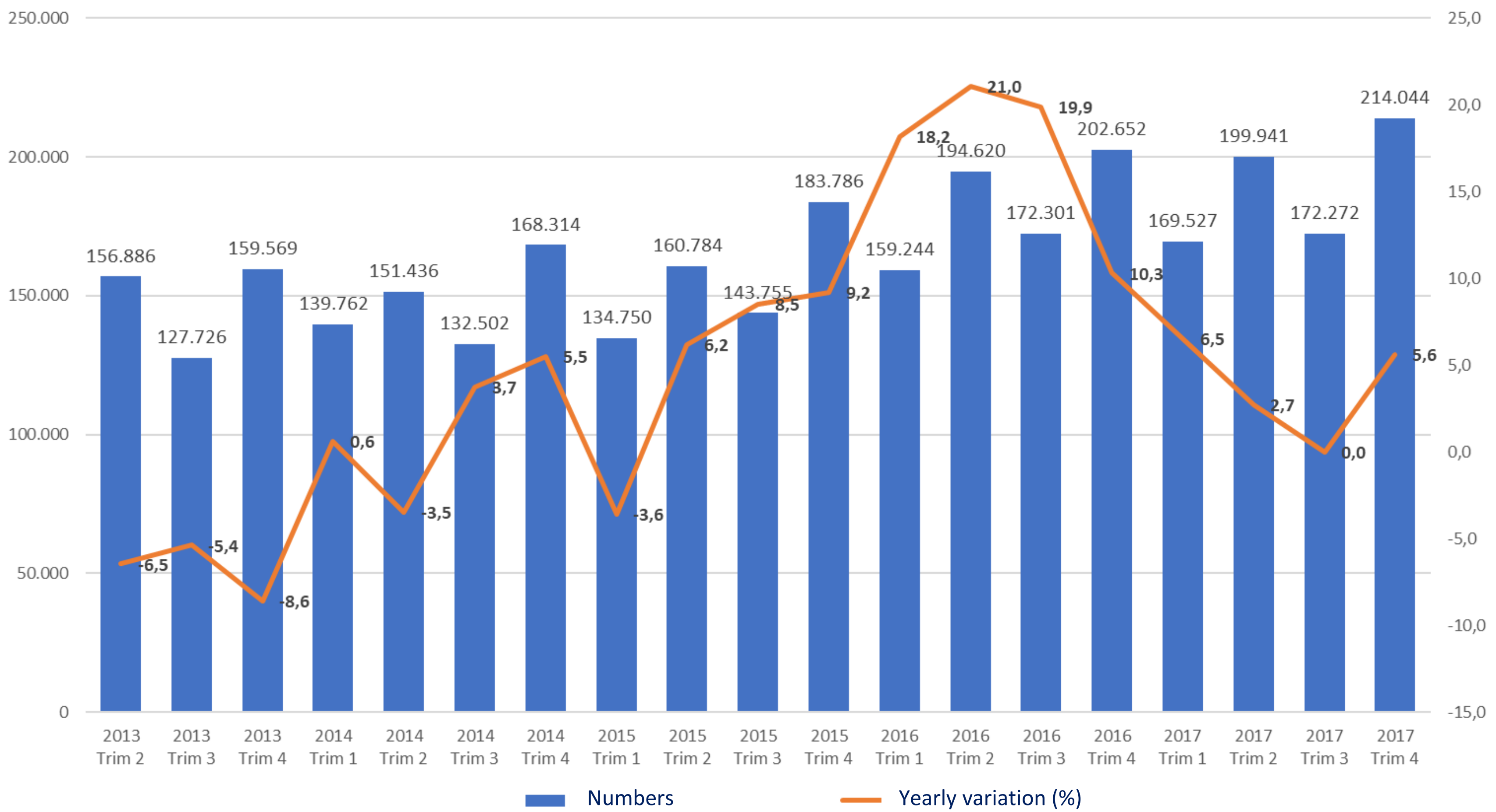
Stock of Residential Real Estate mortgage loans on GDP in EU



Source: EMF

INCREASE OF ITALIAN HOUSEHOLD TRANSACTIONS…

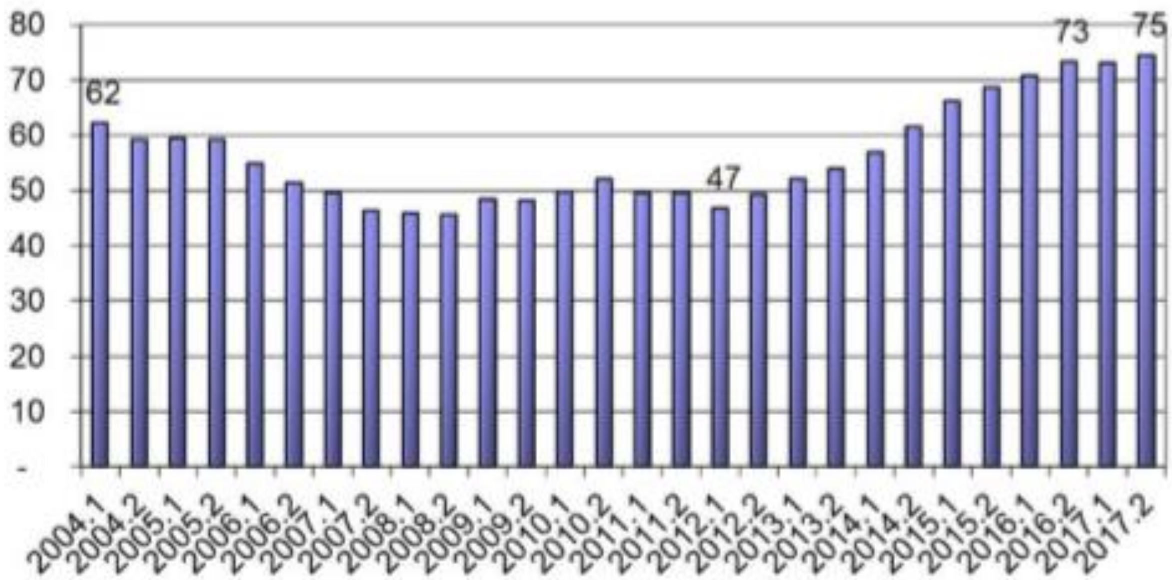
Number of real estate transactions in Italy



Source: ABI on Istat data

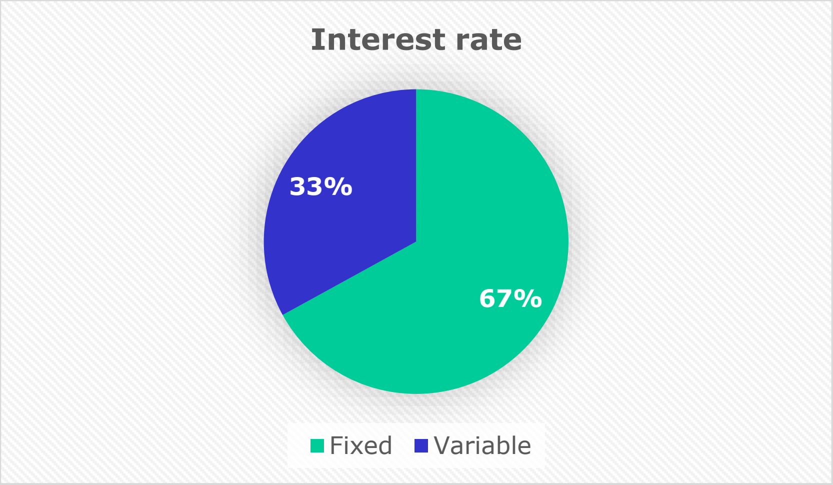
... IN LINE WITH THE INCREASE OF ITALIAN HOUSEHOLDERS AFFORDABILITY

% of Italian families who can afford to purchaase an house



Source: OMI, Istat and Bank of Italy

MAIN TOPICS OF ITALIAN RESIDENTIAL MORTGAGE MARKET



Size	**126.000**
Maturity	**> 20 y**
LTV	**71%**
Trasactions funded by loans	**50%**

Source: OMI, CRIF, Prometeia, Assofin

THANK YOU FOR YOUR ATTENTION

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