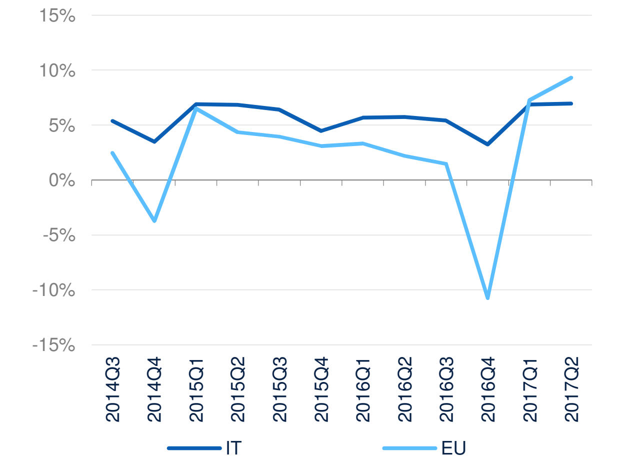
2. The Italian banking sector: Improving but from very low levels

The Italian banking sector was one of the most severely hit by the international economic crisis. Only recently is the system showing the first signs of recovery, but the starting point is so low that Italian banks remain well below the European average in some indicators.

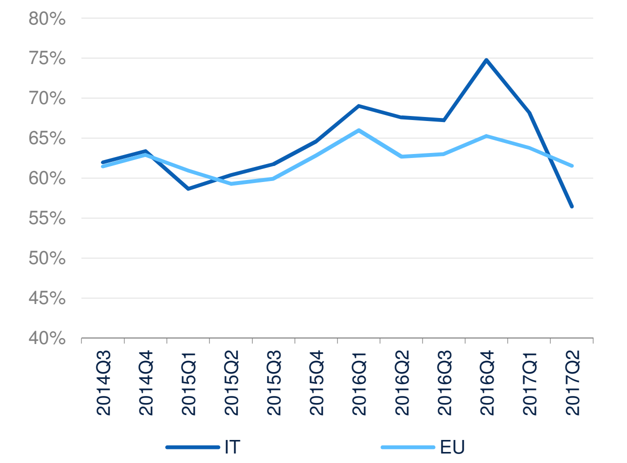
Regarding profitability, the levels registered in the first and second quarter of 2017 are back to positive territory after the negative results of December 2016. Last year a significant decline in income and an increase in operating costs related to the restructuring process led the Return on Equity to levels around -11%. The improvement in profitability is also reflected in the Italian cost-to-income ratio, which in the first quarter of 2017 narrowed the gap with the EU average reaching a 68% and in the second quarter reached an efficiency ratio of 56%, which is below the EU average.

Figure 1 Italian Banks ROE evolution, %



Note: The data of the Dashboard risk from the EBA is a selection of main banks.
Source: BBVA Research and EBA risk dashboard

Figure 2 Evolution of cost to income ratio, %



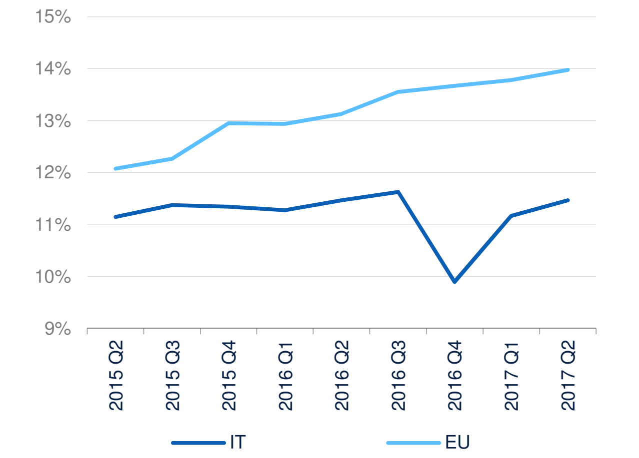
Note: The data of the Dashboard risk from the EBA is a selection of main banks data.
Source: BBVA Research and EBA risk dashboard

Solvency and prudential indicators recovered after the significant decline suffered at the end of 2016, in part due to the precautionary recapitalization of Monte dei Paschi, the Unicredit capital increase and the liquidation of two Veneto banks. Thus, CET1 *fully loaded* evolved positively, from 9.89% as of December 2016 to 11.47% as of June 2017, with a higher impact of the increase of CET1 than that of the reduction of the RWAs (the denominator). The improvement in solvency in the first quarter of 2017 is confirmed by the improval of the leverage ratio, which reached a 5.18% on June 2017, above EU-average (5.12%).

The system holds a liquidity surplus being the LCR ratio 195% as of June 2017, well-above the minimum requirements (80% for 2017) and the EU average (146%). The resort to the ECB liquidity is behind this number, and therefore asset encumbrance (assets used as collateral) has increased significantly since 2015, reaching 29.6% as of June 2017. The Italian system is, after Greece, the country with the greatest share of central bank funding in credit institutions' liabilities.

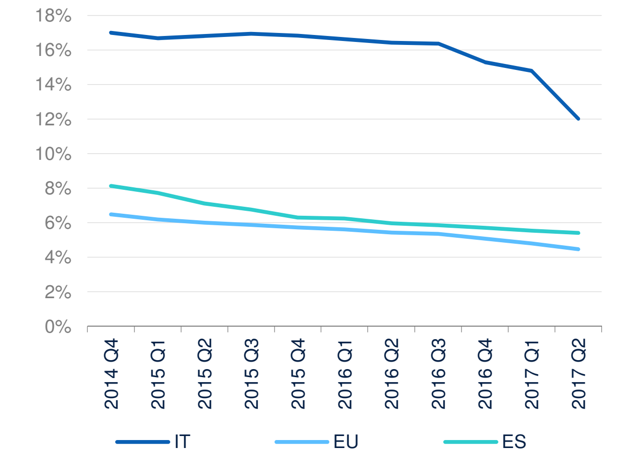
Asset quality issues are the main problem for the system, and have also evolved positively in the first half of 2017. Although the NPL ratio is still very high (12% as of June 2017, down from 16.4% as of June 2016), the coverage ratio is well above the EU average.

Figure 3 CET1 *fully loaded*, evolution, %



Source: EBA and BBVA Research

Figure 4 NPL Ratio, EU aggregated data, %



Source: EBA and BBVA Research

The improvement in asset quality has been partially caused by the insolvency reforms carried out both in 2015 and in 2016[2], which reduced the length of the proceedings and improved recovery rates. The The Law 132/2015 was introduced to enforce the protection to creditors in case of difficulties of the borrowers (foreclosure procedures are expected to become speedier and less costly) with forced sales improved by extra-judicial and more market-oriented mechanisms. Moreover, the law introduced an improvement in some of the available tools to provide solutions to a firm's crisis and to avoid irreversible insolvency[3]. On the other hand, Law 132/2016 and Law 119/2016 improved the process for recovering non-performing loans, reducing the length of proceedings, improving recovery rates and introducing new mechanisms to ensure a more effective protection to lenders.

2: See Plata, C; Rocamora, M; Rubio, A; (2017) *"Italian Banking Sector Improving, but from very low levels"* BBVA Research. Madrid
3: See Marcucci, M; Pischedda, A; Profeta, V;(2015) The changes of the Italian insolvency and foreclosure regulation adopted in 2015 in *Notes of Financial Stability and Supervision Nº 2* Banca d´Italia.

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