

DATA AND TRENDS OF THE SAN MARINO BANKING SYSTEM

April 2019



Series "Papers", Number 5, April 2019

© 2019 CBSM all rights reserved

The contents of this document may be reproduced solely when the original source is quoted and not for profit purposes

Mailing address
Via del Voltone 120, 47890 SAN MARINO (RSM)

<http://www.bcsn.sm> - e.mail: info@bcsn.sm

Data and trends of the San Marino Banking System

Series “Papers” – No. 5



© CENTRAL BANK OF SAN MARINO, 2015
Private Legal Entity with public and private shareholders
Cod. Op. Ec. SM04262 – Endowment Fund: euro 12.911.425,00 i.v.
Legal address – Via del Voltone, 120 – 47890 San Marino –
Repubblica di San Marino
tel. 0549 882325 fax 0549 882328
Country Code (+) 378 Swift Code: icsmsmsm
www.bcsm.sm

All rights reserved

The contents of this document may be reproduced solely when the original source is quoted and not for profit purposes



Summary

1. ABSTRACT.....	5
2. INTRODUCTION.....	6
3. CAUSES AND TRENDS OF THE CURRENT SITUATION	7
3.1. Banking system trends.....	7
3.1.1. <i>Causes of banking system disintermediation</i>	7
3.1.2. <i>The banking system data of the last 10 years</i>	8
3.2. The Economy and the State budget	10
4. TECHNICAL PROFILES OF THE BANKING SYSTEM	12
4.1. Introduction	12
4.2. Asset Quality and capital	12
4.3. Profitability.....	13
4.4. Liquidity.....	15
5. THE RESTRUCTURING PROCESS OF THE BANKING SYSTEM	17
5.1. Introduction and the fully compliance path.....	17
5.2. The Financial Sector Strategy (FSS).....	19
5.2.1. Strategy development: guidelines and subjects	19
5.3. The role of CBSM in the Financial Sector Strategy (FSS)	20
5.3.1. Main components of the FSS.....	20
5.3.2. The Asset Quality Review (AQR)	20
5.3.3. Capital Adequacy	21
5.3.4. Profitability	22
5.3.5. NPLs reduction.....	22
5.3.6. Strengthening of Governance.....	22
5.3.7. Banking system initiatives and the merging process.....	22
5.3.8. Strengthening of Supervision and of CBSM's international cooperation.....	23
5.3.9. The improvement of the legal and regulatory framework	24
5.4. The structural reforms (<i>policy recommendations</i>)	25
5.4.1. Introduction	25
5.4.2. Structural interventions and reforms.....	25
6. CONCLUSIONS.....	26



Acronyms

AML/CTF	Anti-Money Laundering and Combating the Financing of Terrorism
AQR	Asset Quality Review
CBSM	Central Bank of the Republic of San Marino
BIS	Bank for International Settlements
IMF	International Monetary Fund
MoU	Memorandum of Understanding
NPLs	Non Performing Loans
GDP	Gross Domestic Product
FSS	Financial Sector Strategy



1. ABSTRACT

Over the last 10 years, the Banking System of San Marino has been facing issues, due to external and internal factors pertaining to individual banks and the system.

Overall, this trend has led to an important level of disintermediation of the banking system, also impacting considerably other sectors of the financial system (i.e. Financial Companies), which in turn has led to general criticalities, such as pressure on the liquidity of the system and the increase of the NPLs phenomenon.

The challenges that the system is currently facing have deep roots and require a "systemic approach" in which all the entities must operate in a coordinated manner to solve the problems.

The Central Bank of the Republic of San Marino (hereinafter CBSM) is the only Supervisory Authority for the San Marino Financial System and since its creation has been promoting the stability of the system and the protection of savings, as required by its Statutes, defined by Law 96/2005. In full compliance with its statutory purposes, CBSM has helped to develop a comprehensive Financial Sector Strategy (FSS), that requires the contribution of all the stakeholders in order to stabilize the system and eliminate the current issues, thus facilitating a structural improvement of the banks.

The implementation of the comprehensive strategy will allow the system to overcome the current critical issues and will set the conditions to start a new path of development, fully compliant with the International Regulations and Standards, as well as with the best practices in Financial System Oversight and Management.



2. INTRODUCTION

At the end of 2018, CBSM launched a process to strengthen its institutional communication as a part of its strategy to align accountability and transparency with the best international standards. In this process, the "Papers" series was restarted and strengthened as a tool for stakeholders to access more information about the state of the Financial System in order to increase awareness and enable informed decision making.

In addition, the Central Bank of the Republic of San Marino intends to develop also a specific periodic analysis of the stability of the System (Financial Stability Report). The present document represents a preliminary step aimed at defining the current situation of the Financial System and its trends, prior to developing the periodic Financial Stability Report.

The institutional communication of CBSM will be further expanded in the near future with the renewal of the quarterly statistics and with the development of a specific quarterly Supervisory Bulletin.

CBSM considers the present "Policy Paper" as a contribution to understand the factors that have caused the current situation in the Financial System. The paper also introduces the Financial System Strategy (FSS), that can be defined as a "comprehensive complex of structural reforms and supervisory measures to stabilize the system and start a new phase of development". It also provides suggestions for implementing policies under the responsibility of political authorities and stakeholders at large.

The paper is mainly focused on the Banking Sector due to its importance in the Financial System. It is divided into three closely interconnected parts.

In the first part, the paper highlights the causes, mainly external, which over time have led to the current situation of the Banking System and to the consequences on the economy of San Marino.

In the second part, the paper describes the technical profiles of the banking sector (asset quality, capital adequacy, profitability and liquidity), using a macro prudential supervisory approach. The second part is mainly focused on highlighting the areas of improvement where the Financial System Strategy (FSS) can be applied.

The final part of the paper presents key recommendations for policymakers regarding interventions that could fully fall within the FSS, increasing its effectiveness in the stabilization of the Financial System.

* * *

The paper represents a synthesis that integrates without replacing, the analysis developed in the annual Summary Reports, published on the CBSM site in the "Publications and Statistics" section ⁽¹⁾, that can be used for further analysis of the topics presented in this paper.

The data presented refer, unless otherwise expressly mentioned, to the information available as of December 31, 2018 ⁽²⁾, taking into account in particular the IMF Staff Report of April 2019.

⁽¹⁾ <https://www.bcsm.sm/site/en/home/publications-and-statistics/summary-reports.html>

⁽²⁾ Data as of December 31, 2018 are taken from the monthly supervisory report "Situation of accounts" and therefore may not fully take into account the typical valuations carried out in the financial statements, as well as the AQR results (see infra).



3. CAUSES AND TRENDS OF THE CURRENT SITUATION

3.1. Banking system trends

3.1.1. Causes of banking system disintermediation

The banking system of the Republic of San Marino is currently facing a complex situation, that began in 2008, as a result of an accentuated process of bank disintermediation combined with a progressive reduction in the quality of assets, the causes of which are mainly due to:

- Global financial market crisis (2008);
- legal proceedings involving the main bank of the system (Cassa di Risparmio di San Marino) with the subsequent start of the liquidation of the subsidiary Gruppo Delta (2009);
- Italian tax amnesty "Scudo Fiscale" (2009-2010);
- domestic banking crises of four San Marino banks and acquisition of assets and liabilities of these banks by other institutions against State subsidies in the form of tax credits (2011-2017);
- Italian Voluntary Disclosure (2015).

The causes described above occurred following a period of high growth in traded volumes and were grafted into a changing regulatory framework, in relation to the path taken by the Republic of San Marino towards the best standards of transparency and compliance (see *infra*), which has determined, among other things, the loss of attractiveness of the financial system by investors looking for tax havens and schemes characterized by opacity and limited international collaboration.

In particular, the disintermediation phase outlined, with ever increasing evidence, the issues present in the banking system, generated over time also due to the inadequacy of the risk management functions, in a general framework characterized by still incomplete regulation and supervision.

The Central Bank of the Republic of San Marino, the single Supervisory Authority of the entire financial system, was in fact established only in 2005. The related supervisory functions ⁽³⁾ and regulation of banking activities were consolidated and began to operate effectively only after a few years, when a part of the causes described above had already begun to produce their effects ⁽⁴⁾.

In the situation described, the Central Bank of the Republic of San Marino faced, in a framework of limited resources, a series of crises by individual intermediaries in the context of an overall process of disintermediation which gradually reduced the financial funds managed, exacerbating, among other things, the relevance of the critical factors present in the system (eg. reduction in quality assets and related increase in the relevance of the NPLs and non-interest-bearing assets).

⁽³⁾ In 2010 the Republic of San Marino joined the Financial Self Assessment Program - FSAP of the International Monetary Fund and the World Bank (<https://www.imf.org/en/Publications/CR/Issues/2016/12/31/%20San-Marino-Financial-Sector-Assessment-Program-Detailed-Assessment-of-Basel-Core-Principles-24290>), for a comprehensive assessment of the compliance degree of the CBSM Supervision with the Fundamental Principles for an effective Banking Supervision Committee Basel (https://www.bis.org/publ/bcbs230_it.pdf). The results of this verification led to a further improvement in the Supervision framework, thanks to interventions on law and regulation.

⁽⁴⁾ The Capital Adequacy Supervisory Regulation, drafted transposing the principles of the Basel agreements, entered into force in 2008, with a full entry for individual institutions which took several years to complete, in order to transition from the previous regulatory framework to the new one.



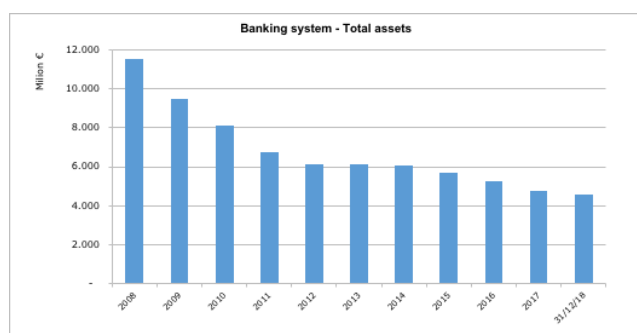
In some cases, such as for tax credits granted for the resolution of banking crises, the identified instruments allowed to overcome contingent problems of individual institutions at the time, preserving the trust in the system and, especially, in the other banks, but the monitoring of such credits by the appointed entities was not effective, thus determining a burden in terms of State Budget and, sometimes, a loss of effectiveness by banks in the recovery of the credit positions linked to the tax credits.

These difficulties concurred, for CBSM, with the crises that in subsequent moments invested the Governance, with direct repercussions on the (reduced) effectiveness of the action as Supervisory Authority, as a consequence of periodic reductions of the quantitative and qualitative level of resources available.

3.1.2. The banking system data of the last 10 years

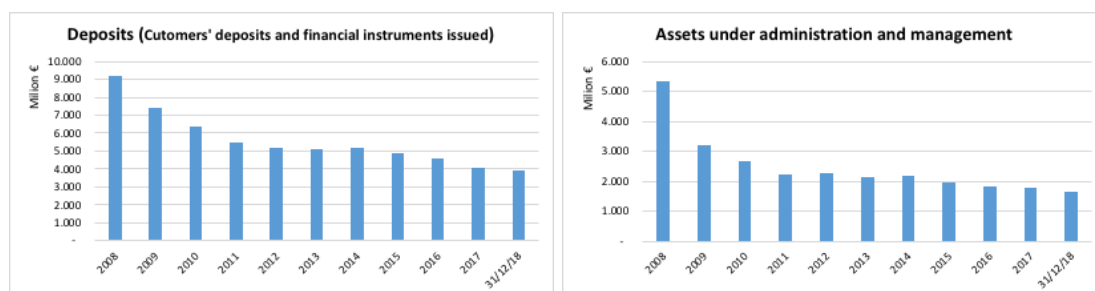
The banking system total assets decreased from 11.5 bn (2008) to 4.6 bn (December 2008), with a reduction by 60%, while the number of banks halved from 12 to 6 ⁽⁵⁾.

Chart 1 – Banking system trend in total assets



Over the same period, deposits decreased from 9.1 bn to 3.9 bn (-56%), the asset under administration and management from 5.1 bn to 1.6 bn (-68%), while total capital of the system decreased by more than 70%, from 1,232 to 328 million, despite the recapitalisations carried out in the meantime, mainly for Cassa di Risparmio, the main bank of the system.

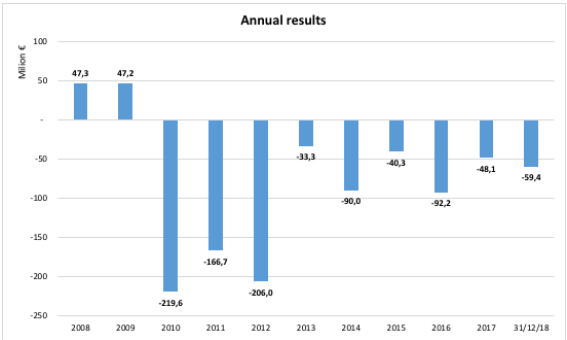
Charts 2 and 3 – Trends in Deposits and Assets Under Administration



Between 2008 and December 2018, the banking system recorded net losses totaling € 861 million. In fact, compared to the profits recorded in the two-year period 2008-2009 for a total of 95 million euros, starting from 2010 the banking system has recorded negative results for a total of 956 million. The dynamics described of the income results have consequently affected the level of capitalization of the system (see infra).

⁽⁵⁾ The data exclude "Banca Partner" which, although it is recorded in the Register of Authorized Parties, is not operating and include the "Banca Impresa di San Marino" which has negligible operating volumes.

Chart 4 – Profit and loss trend



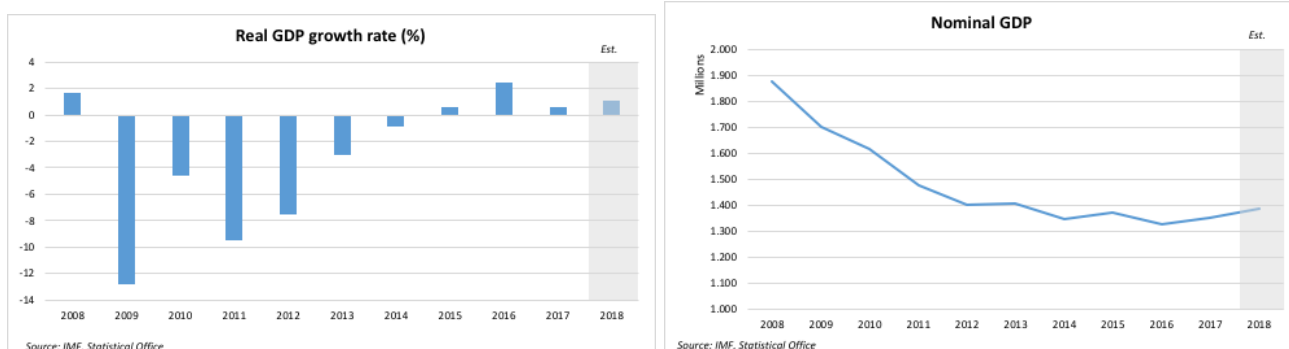
3.2. The Economy and the State budget

The disintermediation process described (see above), together with the inclusion of the Republic of San Marino in the c.d. Italian tax black list (until 2014), but above all the path taken by the country towards goals of full transparency and compliance with international regulations, have determined the end of the model based on banking secrecy, corporate anonymity and privileged taxation, with reflections also for the national economy, given the importance in this of the financial sector.

The country's GDP, in real terms, decreased by about a third between 2008 and 2015 and, over the same period, the unemployment rate rose from 3.1% to 9.2%.

The economy showed a rebound in 2016 (+ 2.2%), however the recovery lost strength in the following period, conditioned by the persistence of serious uncertainties in the financial system, the deterioration of public accounts and, in general, the deterioration of the confidence of economic operators. Estimates of GDP growth and the unemployment rate in 2017 stand at 1.5% and 8% respectively.

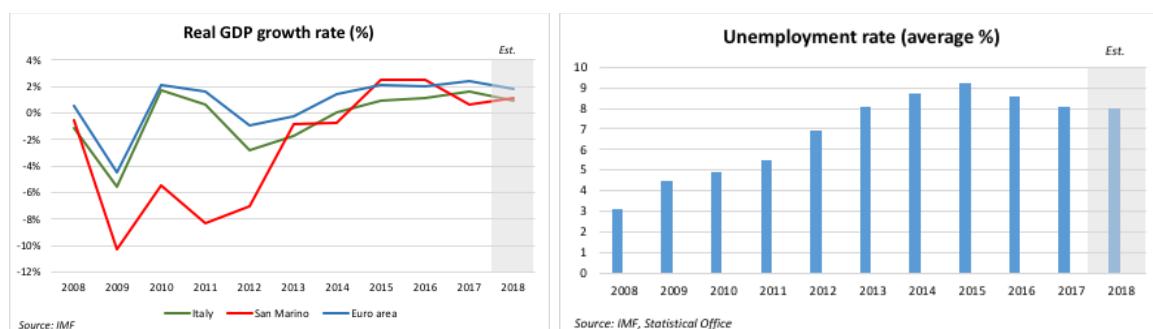
Chart 5 e 6 – GDP trends



The long period of economic recession and the crisis in the banking sector has entailed huge costs resulting especially on state support for the largest bank in the system, which have occurred in a framework of compression of tax revenues, with a progressive increase in the ratio between public debt and GDP, which from 13.5% in 2008, is estimated to grow to 27.5% in 2018 (data source: IMF and Statistics Office).

The phenomena described have led to a significant divergence in the trend of real GDP, which only since 2012 has resumed showing growth rates similar to those of the Euro Area and neighboring Italy, as well as on the dynamics of unemployment in the country.

Chart 7 e 8 – GDP trend and unemployment rate



As a result of the trends described above of the national economy, San Marino had a correlated change over time in the credit risk: the sovereign rating assigned by Fitch, equal to AA- in 2009, decreased by 6 steps (notch), to BBB- in the 2016; since then the rating has remained stable ⁽⁶⁾.

Table 1 – Rating of the Republic of San Marino

Rating History	
Data	Long-Term Foreign Currency
2017	BBB-
2016	BBB-
2012	BBB+
ott-09	A
mag-09	AA-
2001	A

Fonte: Fitch Ratings

⁽⁶⁾ The Republic of San Marino has issued bonds for a total nominal value of 148 million. In particular, the RSM Zero Coupon issue of Dec. 30, 2013– Dec. 30 2023 of a nominal value of 98 million (with a gross yield of 1.43%) was fully subscribed by the Cassa di Risparmio as part of the capital strengthening initiatives by of the State. There are other two issues placed with banks and private customers: Mar. 23, 2016 – Mar. 23 2026 of 40 million and May 31, 2016 – May 31, 2016 of 10 million (both with a fixed rate of 2% for the first two years and then Euribor 6m + 150bp with a cap of 4%).



4. TECHNICAL PROFILES OF THE BANKING SYSTEM

4.1. Introduction

In order to fulfill the purposes of macro-prudential supervision of this analysis, the following evaluations refer to the banking system as a whole, to identify areas for improvement and lines of action to be applied to the sector. The data provided ⁽⁷⁾ do not therefore represent the situation of all the single, but only the aggregation of the same, with inevitable phenomena of compensation between the values.

The micro supervisory activities on the individual intermediaries continue to be carried out by the Central Bank, even within the framework of an evaluation and stabilization of the system as a whole.

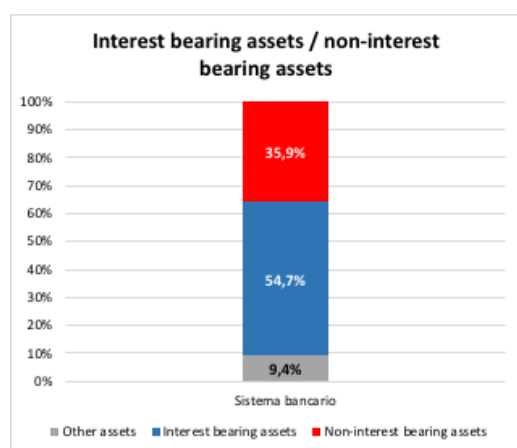
4.2. Asset Quality and capital

The trends described in the previous chapter led to a situation of asset quality in the San Marino banking system characterized by certain structural criticalities which are consequently reflected also in the balance sheet, income capacity and liquidity of the system.

The amount of the non-interest-bearing asset (or not fully interest-bearing), calculated by summing the "deferred losses" defined by law (Law Decree n. 93/2017 of 7 August 2017, art. 5 ter, as amended by the Decrees 101/2017 and 122/2017) for the main system bank, tax credits granted to institutions that acquired assets and liabilities of banks in crisis (resolution costs), deferred tax assets, credit funds, net doubtful loans ⁽⁸⁾ and the cash, reaches the amount of about 1.5 billion euros.

If we add to the above amount the value of the real estate properties acquired from bad creditors, the total amount equal to approximately 36% of the total assets.

Grafico 9 – Asset quality of the banking system



⁽⁷⁾ Unless otherwise described, the data reported in this chapter refer to December 31, 2018 (source: Supervisory Reports submitted by banks to CBSM).

⁽⁸⁾ Non Performing Loans represent only partly (Bad Loans) fully non bearing assets, while the remaining components are characterized by an income capacity that depends directly on the quality of the exposure. However, for the purposes of this analysis, NPLs represent a component of assets characterized by the risk of the assets being fixed and limited profitability, for which they were included as a whole in interest-bearing assets, also in relation to the exercise of Asset Quality Review in progress that has determined implicit risks in this component (see infra).

I crediti dubbi lordi verso clientela, ricompresi nel valore di attivo infruttifero sopra esposto, ammontano a 1.500 milioni di euro. I crediti dubbi al netto delle rettifiche di valore ammontano a euro 627 milioni. Nell'ambito dei crediti dubbi, le sofferenze lorde si attestano a 576 milioni, quelle nette a 239 milioni.

The NPLs (gross amount), included in the non-interest-bearing assets shown above, amount to 1,500 million euro. The net value of the NPLs is euro 627 million. Within the amount of NPLs, Bad Loans amounted to 576 million (gross amount) and 239 million (net amount).

The NPL ratio, represented by the ratio between gross NPLs and total gross loans to customers, equal to 53%, highlights the limited quality of the credit, especially if compared with that of other countries and determines, like the amount of non-interest bearing asset set out above, consequences for the capital adequacy profiles and the profitability of the banks.

Table 2 – Loans classification

Banking system loans to customers as at 31/12/2018	Value at gross of provisions	% (total)	Value at net of provisions	% (total)
Non performing loans (NPLs)	1.500	53%	627	32%
Bad loans	576	20%	239	12%
Other NPLs	923	33%	387	20%
Performing loans	1.329	47%	1.309	68%
Total	2.829	100%	1.936	100%

Data in milion euros

The net equity of the system stands at 328 million, but only partially takes into account the outcome of the statistical exercise with the prudential purposes of Asset Quality Review (AQR), which will be described in the past part of this paper.

4.3. Profitability

The high amount of non-interest bearing assets highlighted above riduce the Gross Income (interest margin plus commissions), which, at the system level, from 2015 fails to cover operating costs, consisting of administrative expenses and adjustments on fixed assets. The gross operating result, at the end of 2017, was a negative 8 million. The system operating result shows a negative sign starting from 2010, affected by the losses recorded by the main system bank (Cassa di Risparmio of the Republic of San Marino - CRSM), which, over the years, made huge adjustments to loans, which have had reduced on the previous high level of capital.

Table 3 – Profitability 2017 - 2018 ⁽⁹⁾

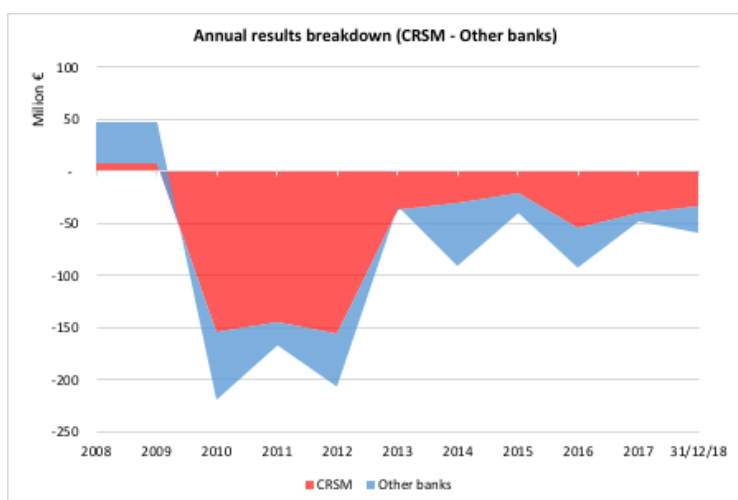
	Banking system	
	2017	Dec.31, 2018
Interest margin	41	34
Service revenues	51	42
Gross income	96	68
Operating costs	104	82
Gross operating income	- 8	- 14
Ordinary income	- 46	- 22
Extraordinary income	- 0	- 5
Total income before taxes	- 46	- 27
Net profit / loss of the year	- 48	- 27

Data in milion of euros

⁽⁹⁾ The data referring to 31 December 2018, were taken from monthly supervisory reports and are not fully comparable to the 2017 financial statements.



Chart 10 – profitability trend with data on CRSM



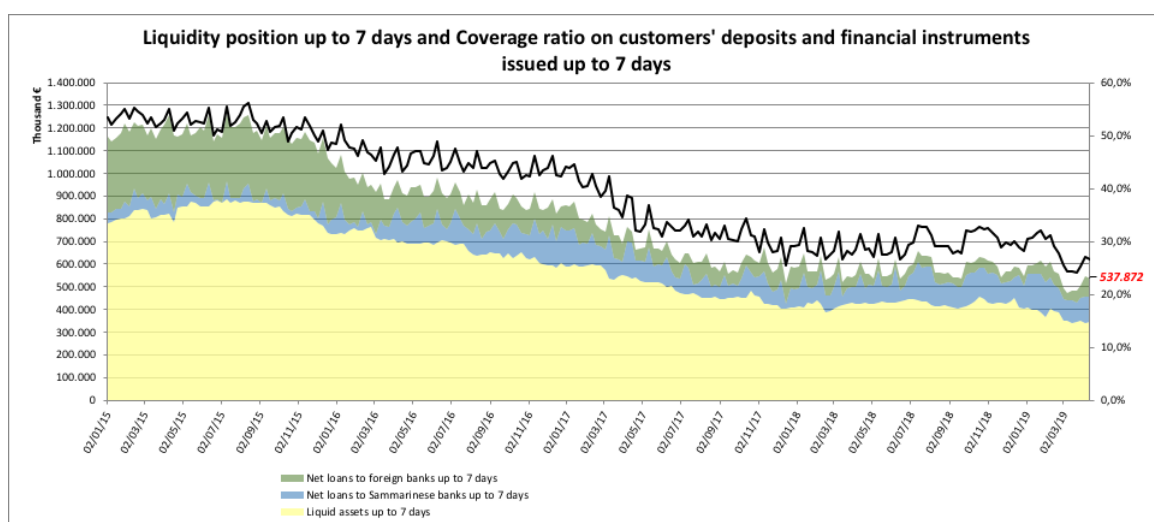
The profit and loss account of the banking system is also affected by the poor diversification of revenues, low interest rates in general, with effects therefore also on the spread between active and passive rates and, with regard to loans, of the most favorable situation of Italian banks who can benefit from ECB loans at substantially zero rates. Further negative elements to the income profile are represented by the high administrative costs, by the high cost of deposits and by the negative trend of loans, influenced by the unfavorable economic situation and by a generally reduced liquidity situation.

4.4. Liquidity

In mid-April 2019, the banking system showed a 7-day liquidity position ⁽¹⁰⁾ of euro 538 million. The coverage ratio of the 7-day liquidity position on the collection of 7-day savings is 26.7%. It should be noted that the aforementioned data refer to the banking system as a whole and that the liquidity situation presents substantial differences between the various banks.

The system's 7-day liquidity position stands at levels similar to those of the second half of 2017, despite being substantially stabilized, after having reached a peak at 1.2 billion in August 2015, with a coverage ratio higher than the 50%. The large outflows recorded starting from 2015 are mainly related to the introduction of the Italian legislative measure on the return of capital from abroad (Voluntary Disclosure) and from a new context, also characterized by the agreements on the automatic exchange of information at the fiscal level between countries .

Chart 11 – liquidity trend

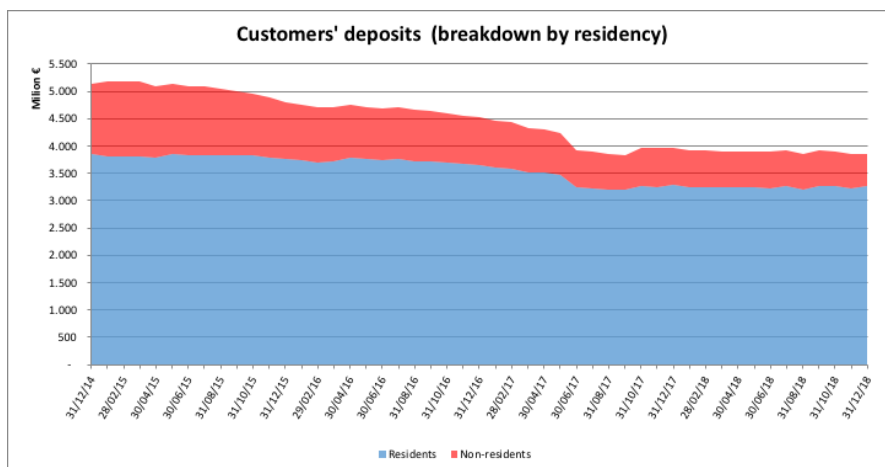


⁽¹⁰⁾ The liquidity position of the system is calculated by adding to the 7-day liquid assets (cash and securities) to the 7-day loans to banks, net of 7-day debts to banks.



From 2015 to 2018 deposits () decreased by a quarter (about 1.3 billion euros) from 5.1 to 3.9 billion, with a dynamic between residents and non-residents expressed in the following chart.

Chart 12 – Deposit of resident nd non resident customers ⁽¹¹⁾



With regard to the breakdown of deposits by residual life range, starting from the beginning of 2015, there has been a marked decline in the longer-term component (over three months) and a greater stability of the shorter-term components, with that within 7 days which currently represents 53% of total funding.

A significant part of the banking system's liquidity comes from pension funds: at the end of 2018, funding attributable to them came to 433 million: 356 million ISS (first pillar) and 77 million FondISS (second pillar), representing about 11% of total system funding.

⁽¹¹⁾ The reduction in deposits in the June-October 2017 period is also due to the Asset Banca S.p.A. compulsory liquidation and to the consequent termination of supervisory reports. With the sale of Assets and Liabilities to Cassa di Risparmio of the Republic of San Marino SpA, the data resumed to be submitted to CBSM through the supervisory reports of this second intermediary and therefore have been included again, with their updated value, in the data of the system.

5. THE RESTRUCTURING PROCESS OF THE BANKING SYSTEM

5.1. Introduction and the fully compliance path

The analysis of the San Marino banking system's trends cannot be separated from the path taken by the Republic of San Marino towards full compliance with international regulations and best practices.

In this regard it must be emphasized that for example in the area of the AML / CTF the Republic of San Marino has initiated since 2008 a path of compliance with international standards and directives and regulations European institutions, thus strengthening its regulatory and regulatory framework. The activities carried out for the aforementioned course also led - at the end of 2017 - to the implementation of the (EU) 2015/849 Directive (so-called 4th Anti-Money Laundering Directive).

With regard to international taxation, recalling only the most recent events here, it can be seen how the Republic of San Marino has adhered, since the start-up phase as an "early adopter country", to the Organization's automatic information exchange program for the Economic Cooperation and Development (OECD) also receiving in 2018, as part of a special peer review report, a "Compliant" judgment (compared to the previous "Largely compliant").

Furthermore, at the end of 2018 the Council of the European Union has certified the compliance of the Republic of San Marino with all the commitments relating to transparency, fairness and anti-BEPS measures.

The Republic of San Marino is also continuing the process of adopting the "acquis communautaire" in banking and finance initiated following the signing in 2012 of the Monetary Convention with the European Union, which replaced the analogous treaty signed in 2000 between the Republic Italian, on behalf of the European Community, and the Republic of San Marino

In particular, in 2018 the provisions of various legal acts of the European Union were included in the San Marino legislation at the level of primary legislation, including Directive 2013/36 / EC (the so-called CRD IV), Directive 2002 / 87 / EC (so-called FICOD), as well as EU Directive 2015/2366 (so-called PSD II).

In the first quarter of 2019 Directive 2014/65 / EU (so-called MiFID II) has been adopted at the level of primary legislation, as well as the provisions of Directive 2014/57 / EU together with EU Regulation 600/2014 relating to market abuses (so-called MAD II-MAR).

Table 4 – Main EU Regulation included in Monetary Agreement signed by SM

Sigla	Descrizione
CRD IV-CRR	Capital Requirements Directive IV and Regulation
BRRD	Bank Recovery and Resolution Directive
PSD II	Payment Services Directive II
MIFID II + MIFIR	Markets in Financial Instruments Directive II and Regulation
MAD-MAR	Market Abuse Directive and Regulation
EMIR	European Market Infrastructure Regulation
CSDR	Central Securities Depositories Regulation



With regard to the drafting of the aforementioned legislative transposition texts, CBSM has provided its technical advice to the competent State Secretariat.

The improvement of the overall regulatory compliance, and in particular in the financial sector, together with a framework of renewed and positive relations of CBSM with similar supervisory authorities, may constitute the new framework in which to insert the Financial System Strategy (FSS) described in the last part of the paper.

Table 5 – EU Regulation adoption plan

Monetary Agreement EU Legal Acts	Acronym	Transposition Year	Transposition Legal Instruments	Updating on transposition	San Marino Legal Instrument adoption date	San Marino Legal Instrument for the adoption of EU Legal Acts
Council Directive 89/117/EEC on the obligations of branches established in a Member State of credit institutions and financial institutions having their head offices outside that Member State regarding the publication of annual accounting documents		2018	CBSM Regulation	CBSM Regulation adopted	28/08/2018	CBSM Regulation no. 2018-02
Directive 2002/47/EC on financial collateral arrangements as amended	FCD		Primary Legislation	Primary Legislation adopted	31/08/2018	Art. 57 of Law no. 147/2017 + Delegated Decree no. 113/2018 ratified by Delegated Decree no. 150/2018
Directive 97/9/EC on investment compensation schemes	ICD		Primary Legislation + CBSM Regulation	Primary Legislation adopted	31/08/2018	Art. 10 of Law no. 104/2018 + Delegated Decree no. 110/2018 ratified by Delegated Decree no. 148/2018
Amendments to the Directive 98/26/EC on settlement finality in payment and securities settlement systems (transposition of only the amendments to the Directive 98/26/EC, considering that the Directive has already been adopted in SM in the initial version - SM Law no. 45/2007)	SFD		Amendments to Primary Legislation	Primary Legislation adopted	31/08/2018	Art. 10 of Law no. 104/2018 + Delegated Decree no. 111/2018 ratified without amendments
Directive 2001/24/EC on the reorganisation and winding up of credit institutions as amended			Primary Legislation	Primary Legislation adopted	31/08/2018	Art. 10 of Law no. 104/2018 + Delegated Decree no. 112/2018 ratified by Delegated Decree no. 149/2018
Directive (EU) 2015/2366 on payment services in the internal market	PSD 2		Primary Legislation + CBSM Regulation	Primary Legislation adopted	28/12/2018	Delegated Decree no. 177/2018 ratified without amendments
Directive 2013/36/EU on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms + Regulation (EU) No 575/2013 on prudential requirements for credit institutions and investment firms	CRD IV - CRR (BASEL 3)		Primary Legislation + CBSM Regulation	Primary Legislation adopted	28/12/2018	Delegated Decree no. 176/2018 ratified by Delegated Decree no. 50/2019
Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate as amended	FICOD		Primary Legislation + CBSM Regulation	Primary Legislation adopted	28/12/2018	Delegated Decree no. 176/2018 ratified by Delegated Decree no. 50/2019
Directive 2014/65/EU on markets in financial instruments as amended + Regulation (EU) No 600/2014 on markets in financial instruments as amended	MiFID II + MiFIR	2019-Q1	Primary Legislation + CBSM Regulation	Primary Legislation adopted	29/03/2019	Delegated Decree no. 61/2019
Directive 2014/57/EU on criminal sanctions for market abuse + Regulation (EU) No 596/2014 on market abuse as amended	MAD + MAR		Primary Legislation + CBSM Regulation	Primary Legislation adopted	29/03/2019	Delegated Decree no. 61/2019



5.2. The Financial Sector Strategy (FSS)

5.2.1. Strategy development: guidelines and subjects

The Financial System Strategy (FSS) has been developed with the support of the Central Bank, during the periodic missions of the International Monetary Fund, to highlight the individual areas for improvement of the system and identify the appropriate remedial actions that the Supervisory Authority and other stakeholders can implement in their respective areas of competence.

To draft the FSS a "global approach" was carried out, to identify the best practices existing at international level, but with a "local implementation", aimed at an application capable of taking into account the specificities of the San Marino banking system, thus determining objectives and intermediate steps capable of being carried out.

The FSS does not represent a rewriting of the business model of the banking sector, activities strictly related to banks and the related banking association, in which an active presence of the Supervisory Authority would be inappropriate. The FSS represents instead a comprehensive approach to the solution of the issues in the banking system, with the above described global-local approach, in order to constitute the best conditions in which to develop the banking system, free therefore from the limitations determined by the existing issues.

The FSS does not even represent an independent activity of CBSM: the Strategy requires the active contribution by the State, political authorities and social partners, in an overall framework aimed at stabilizing and developing the banking system. Also the activities of strict competence of the Central Bank require the active contribution of the remaining subjects, with a comprehensive approach.

In the next paragraphs will be firstly described the CBSM role in the FSS and then highlight, in a separate paragraph, the policy recommendations that the Central Bank intends to propose to stakeholders, in order to build a "system" approach to solution of current problems as envisaged by the FSS.



5.3. The role of CBSM in the Financial Sector Strategy (FSS)

5.3.1. Main components of the FSS

The FSS is based on an building block approach: removal / reduction of the current critical issues and structural improvement of banking intermediaries and therefore of the system as a whole.

The Asset Quality Review (AQR) represents the FSS trigger, helping to identify the improvement of the banking system in its main areas, both on a qualitative and on a quantitative level, in which to apply the subsequent interventions, mainly focused in the following areas:

- ✓ technical parameters' improvement, especially capital adequacy;
- ✓ path towards an effective reduction of the NPLS stock, through regulatory and supervisory initiatives, to encourage also the banks' cooperation (systemic vehicle);
- ✓ banks' governance and supervision strengthening in order to act effectively on the causes of the current criticalities;
- ✓ strengthening of international cooperation of the the Supervisory Authority.

In this context, the contribution of the State to the strategy, as well as of the stakeholders, is extremely relevant, for the interventions on the main bank of the system, publicly owned, but also in order to define and implement structural reforms (see *infra*) able to generate positive effects for the banking system, thus amplifying the benefits of the CBSM action.

5.3.2. The Asset Quality Review (AQR)

The San Marino banking system started the process of verifying the quality of its assets (Asset Quality Review - AQR) in the last quarter of 2016, with an approach that involved all the banks and the main financial companies active in granting loans.

The AQR, carried out with the support of leading consulting firms, made it possible to define a first qualitative-quantitative result in mid-2017, with data referring to June 30th, 2016. For reasons that fall outside the scope of the present policy paper, the AQR results were not disclosed to banks, so at the beginning of 2018 an update of the AQR was carried out, with data referring to June 30th, 2017. However, in October 2018 the results of the updated AQR had not yet been disclosed to the banks, thus limiting the possibility to act upon the credit risks made evident by the AQR exercise.

In November 2018, the new CBSM Governance launched a complete revision of the CBSM approach with regard to AQR, in order to pursue transparency, accountability and inclusion of the AQR exercise in the context of supervisory activities. This approach was presented to the IMF during the "preparation visit" of 13-16 November 2018.

As a result of the CBSM new approach, in December 2018 all banks received the results of the AQR exercise as part of a comprehensive assessment, to highlight the critical issues existing in the intermediaries in relation to the individual technical profiles (Governance and Organization; Asset Quality; Capital adequacy; Profitability; Liquidity; Risk Sensitivity).

In line with international best practices, the AQR carried out in the Republic of San Marino represents a statistical exercise of a prudential, not accounting, nature and therefore is not automatically reflected in the financial statements of banks. However, the AQR makes it possible to quantify the component of "implicit risks" in the intermediaries' loan portfolio, allowing the supervisory authorities to activate prudential interventions aimed at mitigating, by the supervised parties, the aforementioned implicit risks.

In a manner consistent with this approach, the AQR results were included in the framework of an overall assessment of the intermediary, aimed at allowing the administrative bodies and the shareholders to acquire full visibility on the critical issues and areas of improvement, in order to promptly activate the appropriate remedial actions.

The AQR results define additional provisions necessary for the intermediaries to mitigate the implicit credit risks in the loan portfolio, but not yet formally highlighted, in addition therefore to the provisions already recorded (explicit risks). These additional provisions, not to be confused with any capital shortfalls that may arise from them, were calibrated by CBSM according to San Marino criteria, in order to make the AQR process gradual, according to a two-step approach: compliance with the San Marino criteria and subsequent gradual evolution towards EU criteria.

In this regard, it should also be noted that in December 2018, CBSM made available to banks, for the first time, the full data of the credit file review used to calculate additional provisions, in line with the purposes of transparency and accountability that the Supervisory Authority intends to pursue in its supervisory action. This information enabled the intermediaries to identify the positions highlighted by the AQR as most critical.

With the disclosure of the AQR results, the FSS was activated, being implemented at the date of the present policy paper in the manner outlined in the next paragraphs, in order to pursue a structural improvement of the technical profiles of the intermediaries.

5.3.3. Capital Adequacy

As described above, the AQR determines a value of additional provisions that must be considered to mitigate the implicit portfolio risks. The timing of the registration of these provisions can potentially be postponed, in relation to the intermediary's autonomous choices or to legal provisions, but the existing implicit risks represented by the mentioned additional provisions cannot be mitigated in the absence of adequate capital, that enables intermediaries to cope with latent negative components of income in their assets. This approach is consistent with the purposes of prudential supervision of CBSM as Supervisory Authority.

In line with best international practices, CBSM has therefore initiated a check with the individual intermediaries aimed at determining the adequacy of the existing capital in relation to the AQR results, calculated on the accounting data of December 2018, in order to identify the effective, shortage of capital, if any, with the aim of filling it promptly.

If the supervisory action shows an inadequate level of capital, the intermediary is required to draw up and send to CBSM a recapitalization plan that can be based primarily on finding new sources of capital, but which may also be integrated by a reduction in assets, in particular in non-interest-bearing assets and high-capital absorption assets (eg. non-performing loans) or other kind of interventions (eg. reduction in high capital absorption assets).

A further element in this sense is constituted by profitability, given that the positive flow generated by banking management can also contribute to restoring capital. The elements above described, as well as further ones that the intermediaries may outline, must be included in a comprehensive and coordinated manner in the recapitalization plans required by CBSM Supervision, which is responsible for assessing the content of such plans and, above all, their degree of reliability over time, that is as relevant as their timeliness.



5.3.4. Profitability

As noted above, the capacity to generate income represents a primary value for the bank, as it enables (and it should enable) the bank to cover the costs of the sources of financing, as well as at the same time restore the capital in case of need.

The comprehensive assessment, as an instrument of Off-Site Supervision, also aims at analysing the determinants that limit the ability of the intermediary to produce an adequate income flow, in particular to remunerate the capital invested and also to strengthen capital. In the event of an imbalance in the income profile, the main areas in which measures are required are: reduction of costs, reorganization of the structure, increase in revenue sources.

5.3.5. NPLs reduction

Non Performing Loans – NPLs are a burden for intermediaries, but also for the system as a whole and, consequently, for the country's economy. The NPLs result in a tightening of the asset structure with scarcely liquidable assets, characterized by low profitability, which therefore does not allow a portion of the assets to correctly finance the liabilities, contributing to imbalances in the profitability and liquidity profiles.

For these reasons, in particular, the bank is requested by the Supervisory Authority to carry out structural reduction measures (with the complete exit of the credit risk - derecognition) on the NPLs stock. In this regard, it is of no relevance whether such initiatives are of a single or systemic type, but what is important is their effectiveness, i.e. the ability to determine an effective, albeit gradual, reduction over time of the stock of NPLs.

The Supervisory Authority is committed to accompanying intermediaries in the process of reducing the stock of NPLs, firstly by monitoring the degree of compliance with the plans prepared by individual intermediaries and, secondarily, with regulatory general interventions (valid for all intermediaries) or with specific supervisory measures (for specific intermediaries). The size of the stock of NPLs in the system has a significant reporting relevance, for this reason, as well as for the solidity of the individual intermediaries, an effective reduction plan is urgent and cannot be postponed.

5.3.6. Strengthening of Governance

In addition to the above in relation to the technical profiles related to the quality of assets, capital and liquidity, supervisory off-site measures are taken to verify and improve the governance arrangements and internal organization of the individual intermediaries, in order to facilitate a process of structural improvement of the same, able to preserve the system from a recurrence of the problems of the past.

The measures on governance, in particular, are accompanied by a general increase in the requirements of the members of the administrative bodies, through the Fit & Proper regulation, which San Marino will transpose in the framework of the regulation so called Basel III, and in relation to which a self-assessment exercise was already completed at the beginning of 2019 by all intermediaries, the results of which are currently being analyzed by the Supervisory Authority.

5.3.7. Banking system initiatives and the merging process

The system initiatives aimed at solving the described problems and the consolidation processes that may develop are initiated by individual intermediaries, under the coordination of the banking association, and do not fall within the scope of the responsibilities and goals of the

Supervisory Authority. This view is confirmed in order to avoid any misunderstanding about the competences, roles and aims of the subjects belonging to the banking system and its stakeholders.

The Supervisory Authority, however, without entering into their promotion and management, welcomes systemic initiatives that can raise the level of effectiveness of individual intermediaries' actions, for example in the field of NPLs. Such initiatives must be characterized by technical elements consistent with the secondary regulations and with the aims of sound and prudent management that must inform the action of the banks, such as an effective transfer of risk (derecognition) in the case of NPLs.

Likewise, in the case of consolidation processes, the Supervisory Authority only evaluates any operation for the necessary authorizations, with a view to assessing the effects for intermediaries and for the system, in accordance with the statutory purpose of promoting the stability of the system⁽¹²⁾.

5.3.8. Strengthening of Supervision and of CBSM's international cooperation

As for the strengthening of the governance of the intermediaries described above, the strengthening of supervision (oversight) is also an essential prerequisite for guaranteeing structural stability and development prospects for the system.

Since the end of 2018, CBSM launched an overall supervisory strengthening plan aimed at restoring its effectiveness and operating capacity. The plan focuses on two milestones: internal strengthening and international cooperation.

The internal reinforcement started with the identification and removal of the impediments to the complete unfolding of supervisory capacities. The action, still ongoing, focuses on internal processes, information sharing, organization of structures, but above all on human resources, the main element for an effective functioning of any structure. The personnel was strengthened with specific temporary support in order to acquire and consolidate the knowledge necessary for the various activities and delegations and powers were revised, in order to improve the supervision of the banking system, as well as of the financial system as a whole, in full consistency with the statutory purposes of the Central Bank of the Republic of San Marino.

In this context, a fundamental change regarded the almost complete termination of the past roles of external consultants, sometimes leading to a substantial isolation of the structure in the decision-making process.

International cooperation is aimed at re-establishing and consolidating collaborative relationships with similar foreign supervisory authorities, in order to take advantage from operational support in the ongoing transition process (for example for the completion of the regulations related to transposed European standards).

Further areas of collaboration concern the exchange of information, under the primary provisions that allow it, as well as a general improvement in the Central Bank's ability to pursue its statutory purposes, not only in the context of supervision. In this regard, signing Memoranda of Understanding (MoU) represents the culmination and consolidation of cooperation and certifies its quality, opening also operational possibilities of cross-border supervision of intermediaries and, within the framework of European standards, broadening operations possibilities for the San Marino banking system.

⁽¹²⁾ Law 96/2005, art. 3, par. 1 a).



5.3.9. The improvement of the legal and regulatory framework

At the end of this paragraph, as an ideal link with the next one related to structural reforms, the needs in terms of structural reforms must be highlighted, as necessary elements to guarantee the complete unfolding of the FSS, expanding and consolidating its effects. As for structural reforms, some have a greater technical value and for this reason are mentioned in this part of the document.

The reform of the Central Bank was also called for by the IMF, in order to provide the Supervisory Authority with greater independence and autonomy, in the presence of a closely related accountability, as a necessary counterweight. In particular, the reform should be based on international best practices, following the indications of the Basel Committee at the Bank for International Settlements (BIS).

Further regulatory measures closely related to the financial system are those concerning NPLs (for example tax incentives on provisioning), consolidation of banking groups (to reduce their complexity, thus reducing structural costs and freeing capital from the absorption in prudential supervision) and an anticipation of European rules on bank resolution, in order to provide CBSM with new and more incisive tools for the management and resolution of banks' crises.

Moreover, the described measures are grafted within the framework of a progressive integration of the Republic of San Marino in the European context, through the transposition of the legal acts provided for by the Monetary Agreement (see above).

5.4. The structural reforms (*policy recommendations*)

5.4.1. Introduction

In full compliance with the CBSM aims, established by law 96/2005, to promote the stability of the financial system and to protect savings and with the purposes of this policy paper, some policy recommendations are provided below in order to finalize a comprehensive approach to solve the issues presented in the previous chapters.

The following indications are the expression of a technical assessment by the Supervisory Authority, which does not intend to interfere in the free determination of the policies of competence of the Political Authorities and Social Partners, but only to provide a contribution from a technical point of view.

5.4.2. Structural interventions and reforms

The San Marino banking system requires first and foremost external resources that can contribute to its recovery, within the framework of an overall restructuring and reorganization process (Financial Sector Strategy - FSS), which also includes the contribution of new financial resources.

With the same timeliness, the technical issues concerning the quality of assets of the main bank of the system should be resolved (so-called 5 Ter, Law Decree n. 93/2017 of 7 August 2017, art. 5 ter, as amended by Decrees 101/2017 and 122/2017), identifying solutions to equip the intermediary with profitable items in place of the current non-interest bearing asset which has a decisive influence on the bank's profitability.

A similar intervention should be envisaged in relation to the "Tax Credits" connected to the solution of banking crises, to favor their mobilization, so as to reduce, at least partially, the amount of the non-interest-bearing and illiquid components of the assets of the banking system. Moreover, as already highlighted, transitional periods of tax relief should be identified to allow banks, for example, to activate internal simplification processes, which could also bring benefits in terms of profitability as well as capital absorption.

The major AQR adjustments should be entirely covered by the banking sector, through injections of private capital or internal restructuring interventions, but without moving forward the implicit risks (Article 40 of the 2018 Budget Law), a possibility that should therefore be eliminated from the current framework regulatory.

Asset management industry can be further developed, including entry into the territory of San Marino of qualified foreign operators, would be the preferable sector from which to start for the rehabilitation and growth of the country's financial system.

The management of NPLs within the banking system, with the related recovery efforts, should be accompanied by legal, fiscal and regulatory reforms aimed at improving the effectiveness of insolvency proceedings and reducing the time taken to acquire assets under guarantee by the creditors. Furthermore, legislative measures to open the real estate market to non-residents would contribute to sustaining the values of the real estate assets used to guarantee credit.

Finally, the adoption of a more incisive regulatory framework for the loan classification and the application of adjustments should therefore be considered in order to allow banks to guarantee effective capital adequacy, in line with international standards to deal with impaired loans.



6. CONCLUSIONS

The banking system of the Republic of San Marino has faced important challenges in these years, able to compromise its very existence and the role of support and driving force for the economy. These threats have been overcome with a "system approach", in which all the components have contributed, in a coordinated manner, to the determination of the best answers, time to time, necessary to face the imminent crisis.

At present there are still critical issues that have distant roots, but which can again compromise the system's development capacity, to the point of undermining its own stability and with it the stability of the economic framework.

The Central Bank, as the sole Supervisory Authority of the Republic of San Marino, is at the forefront of the system's stabilization and development strategy, working at the same time to contribute to the realization, in line with what has been done in the past, of a global approach, it also complies with international best practices, fully aware that only through a shared and concerted effort of all the components, the current critical situations can be overcome, laying the foundations for a new path of stable development.

