BANCA CENTRALE
DELLA REPUBBLICA DI SAN MARINO

DATA AND TRENDS OF THE SAN MARINO BANKING SYSTEM

April 2019



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Data and trends of the San Marino Banking System

"Papers" Series – No. 5



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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 past decade, the Sammarinese banking system has faced significant challenges arising from both external and internal issues affecting individual institutions as well as the banking sector as a whole.

Overall, this trend has led to an important level of disintermediation of the banking system, considerably impacting also 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 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 embarked on a process to strengthen its institutional communication as a part of a broader strategy to bring its accountability and transparency practices into line with the highest international standards. As part of this initiative, the "Papers" series was relaunched and enhanced as a tool for stakeholders to access more information on the state of the Financial System, increase awareness and support informed decision-making.

In addition, CBSM intends to develop a dedicated periodic analysis of the stability of the System (Financial Stability Report). This Paper represents a preliminary step towards that objective, providing an overview of the current state of the financial system and its main trends ahead of the introduction of the periodic Financial Stability Report.

CBSM's institutional communication framework will be further expanded in the near future with the renewal of the quarterly statistics and the introduction of a specific quarterly Supervisory Bulletin.

CBSM considers this "Policy Paper" as a contribution to understanding the factors that have caused the current situation in the Financial System. The paper also introduces the Financial System Strategy (FSS), 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 policy implementation , that lie under the responsibility of political authorities and stakeholders at large.

Given the banking sector's pivotal role within the financial system, the paper focuses primarily on this sector and is structured into three closely interconnected parts.

The first part examines the causes, mainly external, which over time have led to the current situation of the banking system and the related consequences on the economy of San Marino.

The second part analyzes the technical profiles of the banking sector (asset quality, capital adequacy, profitability and liquidity), from a macro prudential supervisory perspective. This part is mainly focused on identifying areas requiring improvement where the Financial System Strategy (FSS) can be implemented.

The final part of the paper presents key recommendations for policymakers identifying potential policy interventions consistent with the FSS that could enhance its effectiveness in stabilising the financial system.

* * *

This paper provides a synthesis that complements, without replacing, the analysis developed in the annual Summary Reports, published on the CBSM website in the "Publications and Statistics" section ([1]), which may be consulted 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]), particularly taking into account 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 emerged in 2008, driven by an intensified process of bank disintermediation and a gradual deterioration in asset quality, 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 backed by State subsidies in the form of tax credits (2011-2017).
- Italian Voluntary Disclosure (2015).

The causes described above emerged following a period of substantial growth in traded volumes and were grafted into a changing regulatory framework, as the Republic of San Marino pursued the adoption of higher standards of transparency and compliance (see infra). This transition contributed, among other things, to a decline in the financial system's attractiveness to investors seeking tax advantages and operating within opaque structures characterised by limited international cooperation.

In particular, the disintermediation phase progressively brought to light structural weaknesses within the banking system. These were generated over time also due to the inadequacy of the risk management functions, against a backdrop of incomplete regulations and supervision.

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

Against this background of limited resources, the Central Bank of the Republic of San Marino faced a series of crises involving individual financial intermediaries, which formed part of an overall process of disintermediation that gradually reduced the financial funds managed. Among other things, this process exacerbated existing critical factors within the system (e.g. reduction in quality assets and related increase in NPLs and non-interest-bearing assets relevance).

(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 CBSM Supervision's degree of compliance with the Fundamental Principles for an effective Banking Supervision of the Basel Committee (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 laws and regulations.

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

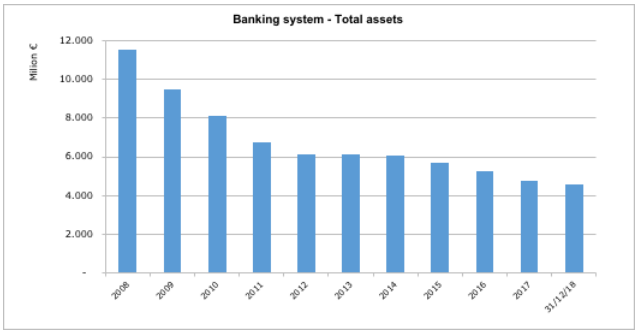
In some cases, such as for tax credits granted for the resolution of banking crises, the identified instruments allowed to overcome contingent problems of individual institutions at the time, preserving the trust in the system and, especially, in the other banks. However, the monitoring of such credits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

These difficulties have coincided, for CBSM, with crises that in subsequent moments impacted the Governance. This has led to direct consequences on the (reduced) effectiveness of the action as Supervisory Authority, as a result of periodic reductions of the quantitative and qualitative level of resources available.

3.1.2. The banking system data of the last 10 years

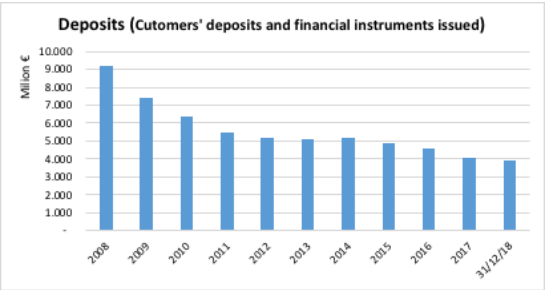
The banking system total assets decreased from 11.5 bn (2008) to 4.6 bn (December 2008), with a reduction by 60%, while the number of banks halved from 12 to 6 ([5]).

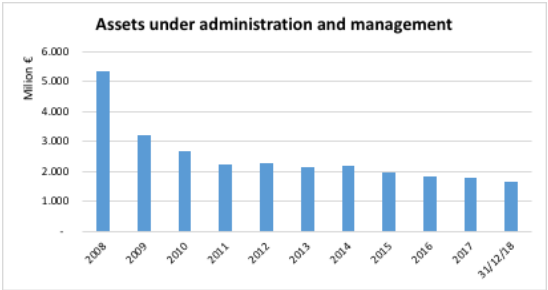
Chart 1 – Banking system trend in total assets



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 recapitalizations carried out in the meantime, primarily for Cassa di Risparmio, the main bank of the system.

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

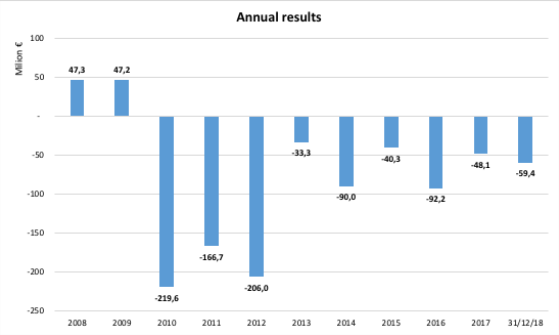




Between 2008 and December 2018, the banking system recorded net losses totaling 861 million. The losses were recorded from 2010, for a total of 956 million, dropping from the 95 million profit result of the 2008-2009 period. The dynamics described of the income results have consequently affected the 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



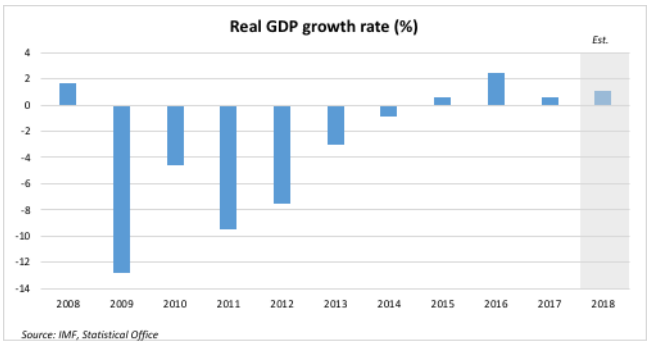
3.2. The Real Economy and the State Budget

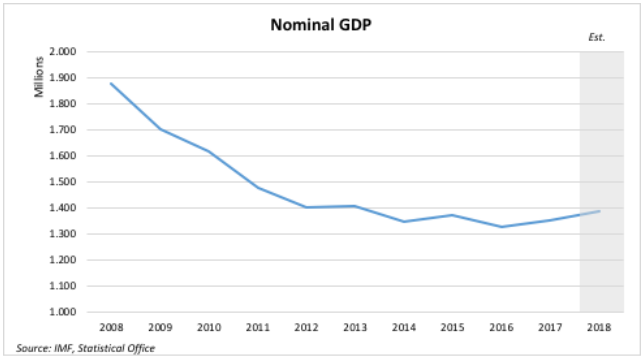
The disintermediation process described above, the inclusion of the Republic of San Marino in the Italian tax black list (until 2014), and, most importantly, the path taken by the country towards goals of full transparency and compliance with international regulations, have brought an end to the model based on banking secrecy, corporate anonymity and privileged taxation. This had significant implications for the national economy, given the financial sector's relevance in it.

The country's GDP, in real terms, decreased by about 1/3 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, by the worsening of public accounts' situation and, in general, by the deterioration of economic operators' trust in the system. Estimates of GDP growth and unemployment rate in 2017 stand at 1.5% and 8%, respectively.

Chart 5 e 6 – GDP trends

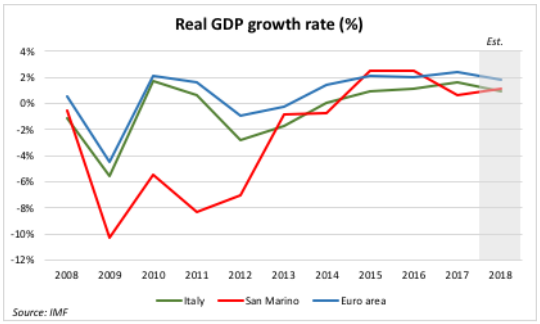


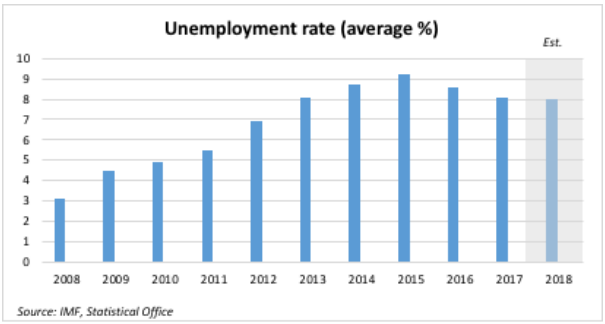


The long period of economic recession and the banking sector crisis have led to huge costs, especially coming from state support for the system's the largest bank. These costs have occurred in a framework of compressed tax revenues, and a progressive increase in the (public) debt-to-GDP ratio, which from the 13.5% level of 2008, is estimated to reach 27.5% in 2018 (data source: IMF and Statistics Office).

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

Chart 7 e 8 – GDP trend and unemployment rate





As a result of what described above, San Marino had a correlated credit risk downgrade: 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 98 million nominal (face) value (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 face value and May 31, 2016 – May 31, 2016 of 10 million face value (both with a fixed rate of 2% for the first two years and Euribor 6m + 150bp with a cap of 4% for the following years).

4. TECHNICAL PROFILES OF THE BANKING SYSTEM

4.1. Introduction

For the purposes of this macroprudential analysis, the following evaluations focus on the banking system as a whole, with the aim of identifying areas for improvement and appropriate courses of action for the sector. The data provided ([7]) do not therefore reflect the situation of each individual player, but rather aggregate figures, with inevitable off-setting effects.

The micro supervisory activities on individual intermediaries continue to be carried out by the Central Bank, as part of its broader task to assess and safeguard the system as a whole.

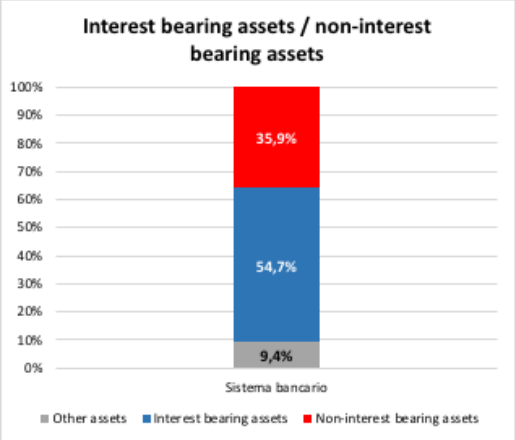
4.2. Asset Quality and Equity

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

The amount of non-interest-bearing assets (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 system's main bank, tax credits granted to institutions that acquired assets and liabilities of distressed banks (resolution costs), deferred tax assets, credit funds, net doubtful loans ([8]) and cash - reaches the amount of about 1.5 billion.

If we add to this value the one of the real estate properties acquired from bad creditors, the total amout 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).

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

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 to the one of other countries, and determines consequences for the capital adequacy profiles and the profitability of the banks, such as the amount of non-interest bearing asset set out above.

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 later in this paper.

4.3. Profitability

The high amount of non-interest-bearing assets highlighted above reduces 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 system's main bank (Cassa di Risparmio of the Republic of San Marino - CRSM). The latter, over the years, made huge adjustments to loans, which have reduced the previous high level of capital.

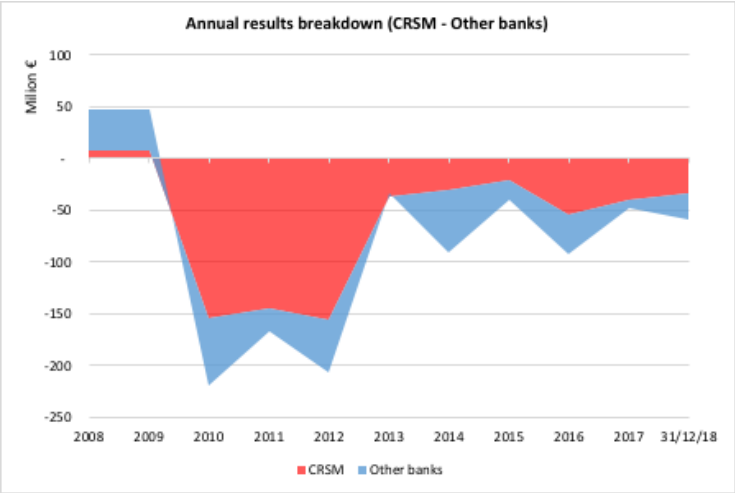
Table 3 – Profitability 2017 - 2018 ([9])

	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



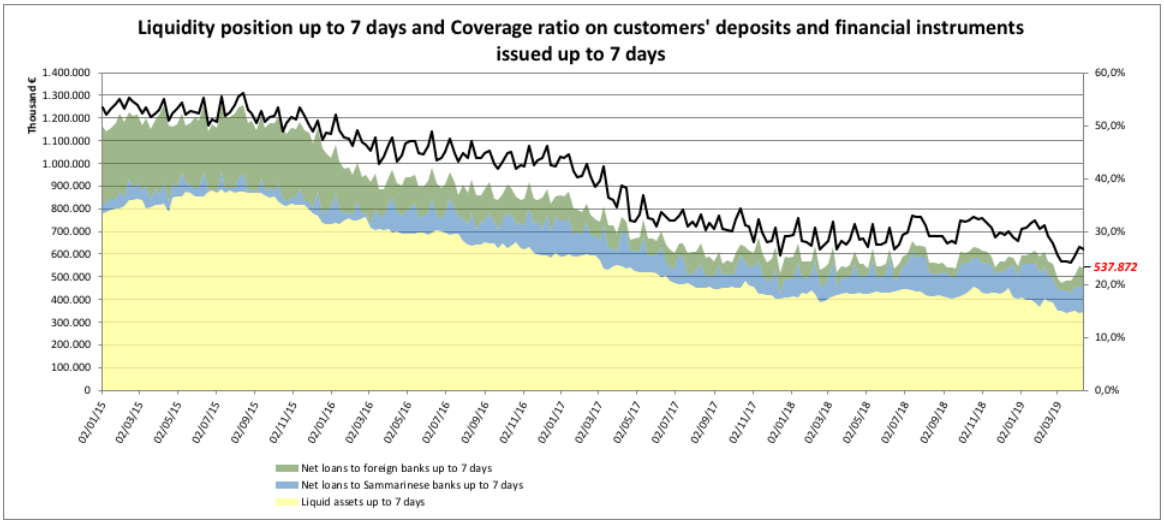
The profit and loss account of the banking system is also affected by poor revenue diversification and generally low interest rates, therefore with effects on the spread between active and passive rates. In addition, banks face a competitive disadvantage relative to Italian banks, which can access ECB funding at near-zero interest rates. Other factors weighing on profitability include high administrative expenses, high deposit funding costs, a declining trend in loans, reflecting both the unfavorable economic environment and generally constrained liquidity conditions.

4.4. Liquidity

In mid-April 2019, the banking system showed a 7-day liquidity position ([10]) of 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.

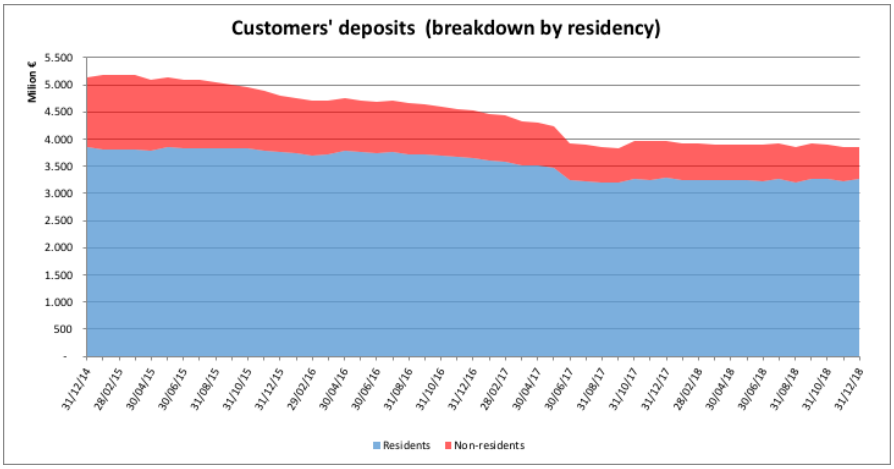
Chart 11 – liquidity trend



(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 ([11]) decreased by a quarter (about 1.3 billion) 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 and 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, as the one within 7 days currently stands at 53% of total funding.

A significant part of the banking system's liquidity comes from pension funds: at the end of 2018, funding from this source amounted 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.'s 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 embarked on a process of alignment with international standards, European directives and regulations in 2008, thereby strengthening its legal and regulatory framework. This process 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, and focusing here on the most recent developments, the Republic of San Marino has participated in the Organization's automatic information exchange program for the Economic Cooperation and Development (OECD)'s automatic exchange of information programme since its inception as an "early adopter" jurisdiction. In 2018, a dedicated peer review report upgraded the country's rating to "Compliant", from the previous rating of "Largely Compliant".

Furthermore, at the end of 2018 the Council of the European Union 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 the banking and financial sectors initiated following the signing of the Monetary Convention with the European Union in 2012, 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 in 2018, provisions from several European Union legal acts were transposed into San Marino's 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) was transposed into primary legislation, as well as the provisions of Directive 2014/57 / EU together with EU Regulation 600/2014 concerning market abuse (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

In drafting the aforementioned legislative instruments transposing EU law, CBSM provided technical assistance to the competent Ministry.

Improvements in overall regulatory compliance, particularly in the financial sector, together with the strengthening of CBSM's relations with peer supervisory authorities, provide a renewed and positive framework within which to develop the Financial System Strategy (FSS), as outlined in the final section of this 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) was developed with the support of the Central Bank of the Republic of San Marino, drawing on the periodic missions of the International Monetary Fund. Its purpose is to identify specific areas for improvement within the financial system and define appropriate remedial measures that the Supervisory Authority and other stakeholders can implement within their respective areas of responsibility.

The FSS was formulated using a "global approach" to identify international best practices, combined with "local implementation" tailored to the specific characteristics of the San Marino banking system. This approach was intended to establish clear objectives and intermediate milestones that could realistically be achieved.

The FSS is not intended to redesign the banking sector's business model, as such matters fall primarily within the remit of individual banks and their banking association, where direct involvement by the Supervisory Authority would be inappropriate. Rather, the FSS adopts a comprehensive approach to addressing the structural issues affecting the banking system, combining international best practices with locally tailored solutions to create the conditions for sustainable development and enable the sector to overcome existing constraints.

Nor is the FSS an initiative to be implemented independently by CBSM. Its success requires the active involvement of the State, political authorities and social partners within a broader framework aimed at stabilizing and developing the banking system. Even measures falling directly within the Central Bank's remit require the cooperation and active participation of other stakeholders, reflecting the need for a coordinated, system-wide approach.

The following sections first outline CBSM's role in implementing the FSS and then present, in a separate section, the policy recommendations that the Central Bank intends to put forward to relevant stakeholders, with a view to establishing a coordinated, system-wide approach to resolving the challenges currently facing the banking system, in line with the objectives of 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 a building block approach aimed at removing or reducing existing critical issues while strengthening the structural soundness of banking intermediaries and, consequently, the stability of the financial system as a whole.

The Asset Quality Review (AQR) serves as the starting point for the FSS, helping to identify the key areas of the banking system requiring improvement, both on a qualitative and on a quantitative level, and providing the basis for subsequent interventions, which will focus primarily on 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 and other stakeholders to the implementation of the strategy is of paramount importance, both in addressing issues affecting the system's main bank, which is publicly owned, and in defining and implementing structural reforms (see below) capable of generating positive spillover effects across the banking sector and thereby enhancing the impact of CBSM's actions.

5.3.2. The Asset Quality Review (AQR)

The San Marino banking system started the process of testing 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 30 June 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 30 June 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 designed to identify the key weaknesses of each institution across the following areas: governance and organization, asset quality, capital adequacy, profitability, liquidity, and 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 identified the additional provisions required to address implicit credit risks in banks' loan portfolios that had not yet been formally recognized, over and above the provisions already recorded for identified risks (explicit risks). These additional provisions should not to be confused with any capital shortfalls that may arise from them. CBSM calibrated these provisions in accordance with San Marino's own criteria, adopting a two-step approach to ensure a gradual implementation of the AQR process: first, compliance with domestic requirements, followed by a gradual transition towards EU standards.

In this regard, it should also be noted that in December 2018, CBSM made available to banks, for the first time, the full dataset from 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.

The disclosure of the AQR results marked the launch of the FSS, which, as of the date of this policy paper, was being implemented in the manner described in the following sections, with the aim of achieving a structural improvement in the technical profiles of intermediaries.

5.3.3. Capital Adequacy

As described above, the AQR determines a value of additional provisions required to address implicit risks in banks' loan portfolios. Although the recognition of these provisions may be deferred, depending on the intermediary's decisions or applicable legal requirements, the existing implicit risks represented by the mentioned additional provisions cannot be mitigated in the absence of adequate capital, which 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 international best practices, CBSM therefore initiated an assessment of individual intermediaries aimed at determining the adequacy of the existing capital in relation to the AQR results, calculated on accounting data as of December 2018. The assessment aimed to identify any real capital shortfalls and ensure that they were addressed promptly.

Where supervisory action identifies an inadequate level of capital, the intermediary is required to prepare and submit to CBSM a recapitalization plan. This should primarily focus on securing additional sources of capital, but may also include measures to reduce the institution's asset base, particularly 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).

Profitability is another important factor in this regard, as the positive earnings generated by banking management can also contribute to rebuilding capital. The elements described above, as well as any additional ones that the intermediaries may propose, must be included in the recapitalization plans required by CBSM's Supervision in a comprehensive and coordinated manner. The Supervision Department is responsible for assessing the content of such plans and, above all, their degree of reliability over time, which are just as important as the promptness of their implementation.

5.3.4. Profitability

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

The comprehensive assessment, as an instrument of Off-Site Supervision, also aims at analyzing the factors limiting an intermediary's ability to generate an adequate income flow, both to provide a return on invested capital and to strengthen its capital base. Where imbalances in profitability are identified, remedial measures should focus primarily on the following areas: cost reduction, organizational restructuring, and enhanced 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 constrain the liquidity of banks' asset portfolios by tying up funds in assets that are difficult to realize and generate low returns. As a result, these assets may not generate sufficient income or liquidity to adequately support the funding structure, thereby contributing to imbalances in both profitability and liquidity.

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, whether the initiatives are implemented at the individual institution level or on a system-wide basis is immaterial. The key consideration is their effectiveness, namely, their ability to achieve a tangible and sustained reduction in the stock of NPLs, even if gradually over time.

The Supervisory Authority is committed to accompanying intermediaries in the process of reducing the stock of NPLs, first by monitoring compliance with the plans prepared by individual intermediaries and, second, by introducing general regulatory measures, applicable to all intermediaries, or 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 measures described above concerning asset quality, 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 promote lasting structural improvements and reduce the risk of a recurrence of the problems experienced in the past.

Particularly, governance-related measures are complemented by more stringent requirements for members of management and supervisory bodies through the Fit and Proper framework, which San Marino intends to transpose as part of the implementation of the Basel III regulatory framework. In this regard, all intermediaries completed a self-assessment exercise in early 2019, the results of which are currently being reviewed by the Supervisory Authority.

5.3.7. Banking system initiatives and the merging process

System-wide initiatives aimed at addressing the aforementioned issues as well as any consolidation processes that may arise, are initiated by the 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 were 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

In recent years, the banking system of the Republic of San Marino has faced significant threats that challenged its very survival and its role in supporting and driving the broader economy. These threats have been overcome with a "system-wide approach", whereby all stakeholders contributed to identifying and implementing the most appropriate responses to the successive phases of the crisis.

Nevertheless, longstanding structural weaknesses persist and continue to constrain the system’s capacity for development, potentially jeopardizing its stability and, in turn, that of the wider economy.

As the sole Supervisory Authority of the Republic of San Marino, the Central Bank is at the forefront of the system's stabilization and development strategy. At the same time, it is committed to promoting a comprehensive approach, consistent with international best practices and building on the measures undertaken in previous years. The Central Bank recognizes that only through a shared and coordinated effort involving all stakeholders can the system’s current challenges be overcome and the foundations laid for a new phase of sustainable and stable development.