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Italian bank DTAs: non-performing loans, regulation and tax rules

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- **Deferred tax assets or DTAs have built up in the banking systems of Southern European countries, including Italy. The process started in 2007 and has accelerated in 2010. The main reasons behind such increase are higher levels of non-performing loans as economic conditions have deteriorated, and tax rules.**
- **Previously, loan losses and write-downs were only partly deductible from the taxable income of Italian banks in the year they were recognised. The surplus of corporate income tax paid by banks gave rise to DTAs, part of which was not deducted from regulatory capital and so inflated bank solvency ratios.**
- **As a result, Italian banks were not incentivised to accelerate the cleaning up of their balance sheets. To encourage them to do so, the Italian government has changed the tax rules. Banks can now immediately deduct all losses and write-downs from their taxable income. This is reducing the build-up of DTAs and is having a less positive effect on bank solvency ratios than the previous tax rules.**

The Italian banking sector, like those of other Southern European countries, has seen an increase in deferred tax assets or DTAs (Chart 1) because of higher levels of non-performing loans as the economic situation has deteriorated.

In the past, Italian banks could not immediately deduct from their taxable income all the losses and write-downs that they recognised in a given financial year. The non-deducted losses meant that banks paid more tax than was due with respect to the period or previous periods. The excess of tax paid gave rise to deferred tax assets *(attività fiscale differita),* which were then deducted from future income on a straight-line basis over a period of up to 18 years. As a result, DTAs are, to some extent, non-interest-generating economic assets that banks are forced to acquire from the Treasury, and whose sole purpose is to cover future liabilities to the latter.

DTAs as a proportion of total bank assets in a selection of European countries

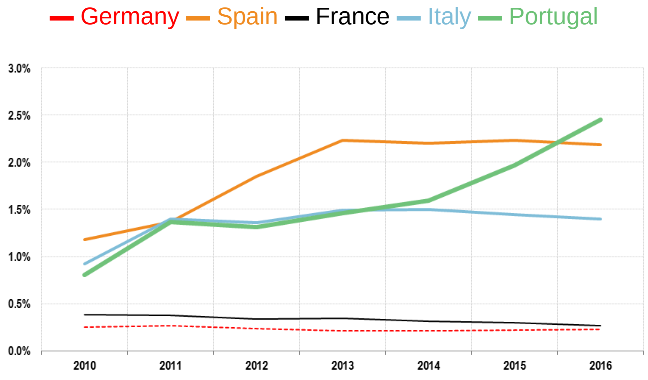

Chart 1 Sources: SNL, BNP Paribas Economic Research

Accordingly, Italian banks had no incentive to speed up the recognition of their losses, and this delayed the process of cleaning up their balance sheets (De Vicenzo & Ricotti, 2014[1], Jassau & Kang, 2015[2], Garrido et Al., 2016[3]). To encourage

[1] De Vicenzo, A. & Ricotti, G., 2014, *The use of tax law from a macroprudential perspective: the impact of some recent tax measures on procyclicality and banks' stability*, Notes on Financial Stability and Supervision, Banca d'Italia

[2] Jassau, N. & Kang, K., 2015, *A Strategy for Developing a Market for Nonperforming Loans in Italy*, IMF Working Paper, 24

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them to do so, the Italian government enacted two tax reforms in 2013 and 2015, so that banks can now immediately deduct all losses and write-downs from their taxable income. These reforms also reduce the opportunity cost that DTAs represent for banks and make their situation and the amount of income tax they pay more cyclical.

However, deferred tax assets that are available for unrestricted and immediate use to cover risks or losses are not deducted from regulatory capital[4]. DTAs, recorded when non-performing loans have increased, have therefore inflated Italian bank solvency ratios. Conversely, deducting new losses immediately from taxable income prevents any build-up of DTAs, which automatically has a less positive impact on bank solvency ratios. Excessively hastening the sale of non-performing loans, without an adequate transition period and without a sufficiently deep secondary market, would risk further increasing the losses recognised by Italian banks. This could delay, instead of accelerate, the clean-up of their balance sheets. As a result, deferred tax assets are at the crossroads of non-performing loans' management, income tax paid by banks, and prudential regulation.

An accounting definition of deferred tax assets

IAS 12 "Income Taxes"[5] defines deferred tax assets as *"the amounts of income taxes recoverable in future periods".* As a result, DTAs correspond to an amount of tax paid that exceeds the tax due with respect to the current period and previous periods. That surplus tax paid by banks to the Treasury is, for example, recoverable with respect to temporary differences[6], which are deductible from future taxable income. Hence, the proportion of DTAs that exceed a bank's tax expense cannot be reclaimed from the tax authorities, unlike tax credits.

Since DTAs are only recoverable if taxable income exists, their carrying amount must be reviewed at each accounts closing date and reduced if forecasts of future taxable income fall[7]. In algebraic terms, deferred tax assets can be expressed as follows:

$$\begin{aligned}&\mathit{Deferred\ tax\ assets}\\ &\qquad = (\mathit{Carrying\ amount\ of\ the\ asset}\\ &\qquad - \mathit{Tax\ base\ of\ the\ asset})\\ &\qquad \times \mathit{Applicable\ tax\ rate}\end{aligned}$$

The amount of DTAs therefore depends on the carrying amount of the assets on bank balance sheets, the value attributed to those assets by the tax authorities[8] (tax base of the assets) and the corporate income tax rates applicable to banks.

Accelerated recognition of losses and clean-up of bank balance sheets

In its 2014 budget[9], followed by urgent bankruptcy-related measures in 2015[10], the Italian government reduced the amount of time needed to fully deduct new losses resulting from the management of non-performing loans from banks' taxable income.

Loan losses, write-offs and write-downs are now immediately deductible from banks' taxable income (see table 1). These successive reforms encourage banks to clean up their balance sheets more quickly, and concern both types of tax to which they are subject, i.e. corporate income tax (IRES – *Imposta sul reddito delle società*), which is levied nationally, and value-added tax (IRAP – *Imposta regionale sulle attività produttive*), which is levied regionally.

The 2013 act was an initial tax-related gesture to encourage the clean-up of bank balance sheets. It brought the tax treatment of losses for IRAP purposes into line with that for IRES, and generally reduced the DTA recovery period to five years. Before that first reform, for IRES purposes, the only losses that could be deducted immediately were those recognised when loans were sold for less than their carrying amount, along with write-offs. In addition, write-offs could only be deducted against tax if, for example, the borrower were legally recognised as insolvent, which could take several years. For IRAP purposes, only losses on loans before 2013 could be deducted.

Those relatively strict conditions did not encourage banks to remove non-performing loans quickly from their balance sheets, and contributed to the build-up of DTAs. It was to address that situation that the 2015 reform authorised the immediate deduction of all losses from taxable income, regardless of the nature of the losses or the tax in question. The reform also limited the production of deferred tax assets.

Write-downs – the main method for recognising losses in Italy – have seen the greatest impact from these tax changes. Until 2012, they were only tax-deductible for corporate income tax purposes subject to a limit of 0.3%[11] of bank total loans outstanding. The tax paid by banks over that limit was treated as DTAs that could be recovered from the Treasury on a straight-line basis over the next 18 years. Hence, as the economic environment deteriorated, an increasing proportion of write-downs exceeded the 0.3% limit and was no longer immediately deductible. De Vicenzo & Ricotti (2014) calculate that until 2007, 90% of write-downs were immediately tax deductible, as opposed to barely 20% in 2012. Banks therefore had little incentive to set aside more provisions for their non-performing loans, even if they were allowed to do so by accounting rules. That situation has also contributed to the build-up of deferred tax assets on bank balance sheets.

[3] Garrido, J., Kopp, E. & Weber, A., 2016, *Cleaning-up Bank Balance Sheets: Economic, Legal, and Supervisory Measures for Italy*, IMF Working Paper, 135

[4] *Capital Requirement Regulation* - CRR, article 26(1), Regulation (EU) no. 575/2013 of the European Parliament and of the Council of 26 June 2013

[5] Commission Regulation (EC) no. 1126/2008 of 3 November 2008.

[6] "Differences between the carrying amount of an asset or liability in the balance sheet and its tax base", Commission Regulation (EC) no. 1126/2008 of 3 November 2008

[7] Deferred tax assets are recognised at their notional amount, without discounting. According to IAS 12, measuring DTAs at their amortised cost or fair value would involve carrying out a set of projections regarding their flows and those of taxable income ; which would create a great deal of complexity and lead to a relatively uncertain measurement.

[8] Commission Regulation (EC) no. 1126/2008 of 3 November 2008

[9] Act no. 147 of 27 December 2013, provisions for the preparation of the state's annual and long-term budget (Stability Law for 2014)

[10] Decree-law no. 83 of 27 June 2015, urgent measures concerning bankruptcy, the civil code, the civil procedure code and the organisation and functioning of judicial administration

[11] Versus 0.6% between 2000 and 2004 and 0.4% between 2005 and 2007

Tax deductibility of DTAs in Italy

	IRES (*Imposta sul reddito delle società*)			IRAP (*Imposta regionale sulle attività produttive*)		
	Up to 2012	From 2013 (Legge 27 dicembre 2013, n.147)	From 2016 (Decreto-legge 27 giugno 2015, n.83)	Up to 2012	From 2013 (Legge 27 dicembre 2013, n.147)	From 2016 (Decreto-legge 27 giugno 2015, n.83)
Loan losses	Immediatly deductible	Immediatly deductible	Immediatly deductible	Immediatly deductible	Immediatly deductible	Immediatly deductible
Write-offs	Immediatly deductible	Deductible in equal installments over 5 years	Immediatly deductible	Not deductible	Deductible in equal installments over 5 years	Immediatly deductible
Write-downs	Immediatly deductible up to 0,3% of the total loan outstanding amount, the remaining part is deductible in equal installments over 18 years. If the loan is sold or written off afterward, the amount of DTA remains the same	Deductible in equal installments over 5 years	Immediatly deductible	Not deductible	Deductible in equal installments over 5 years	Immediatly deductible

Table 1

Sources: Banca d'Italia, BNP Paribas Economic Research

The write-downs as an example

To illustrate how DTAs work, the following calculation looks particularly at write-downs before and after the IRES reforms of 2013 and 2015.

Table 2 presents the example of a fictional Italian bank that, in each period, has a total loan outstanding amount of EUR 100,000 million (mn) and gross operating income of EUR 2,000 mn. In 2010, the bank records a write-down of EUR 500 mn, of which EUR 300 mn (= 100,000 * 0.3%) is immediately deductible from taxable income. EUR 55 mn (=(500-300)*27.5%) is recognised as deferred tax assets on the income statement and balance sheet. The bank's net income in 2010 is EUR 1,087.5 mn which, due to the accrual principle, takes into account all gains and losses for the period (=(2,000-500)*(1-27.5%)). As a result, distributable income factors in the deferred tax assets.

In 2012, the bank does not record any write-downs and therefore does not produce any additional DTAs. Those produced in 2010, however, are deducted from 2012 taxable income and net income still reflects gains and losses during the period.

In 2016, the bank records a further EUR 500 mn write-down, but can now deduct it immediately from its taxable income. 1/18 of the DTAs produced in 2010 are again charged against income tax, and only EUR 36.7 mn of DTAs remain on the bank's balance sheet. The bank's net income is not affected by the old DTAs produced in 2010 nor by the new tax rules. The speed with which losses are deducted against taxable income does not affect banks' net income because of the accrual principle. However, the bank may be encouraged to carry out more write-downs than in 2010 in order to clean up its balance sheet more quickly, if that is necessary and/or possible in accounting terms. This would enable it to produce interest on the amounts not converted into DTAs but directly deducted from taxable income (EUR 55 mn in this case), in

Tax-deductibility of losses in Italy before and after the reforms (in EUR millions)

	2010		2012		2016	
Total loan - outstanding amount	100000,0	a	100000,0	a	100000,0	a
Gross operating income	2000,0	b	2000,0	b	2000,0	b
Loan write-downs	500,0	c	0,0	c	500,0	c
of which write-downs immediately deductibles	*300,0*	*d=a*0,3%*	*0,0*	*d=a*0,3%*	*500,0*	*d'=c*100%*
Pre-tax income	1500,0	e=b-c	2000,0	e=b-c	1500,0	e=b-c
Taxable income	1700,0	f=b-d	2000,0	f=b-d	1500,0	f'=b-d'
Corporate tax income (IRES)	467,5	g=f*27,5%	546,9	g'=f*27,5%+h'	409,4	g'=f'*27,5%+h'
Deferred Tax Asset (Profit & loss account)	55,0	h=(c-d)*27,5%	-3,1	h'=h/18	-3,1	h'=h/18
Deferred Tax Asset (Balance sheet)	55,0	h=(c-d)*27,5%	48,9	h''=h*(16/18)	36,7	h'''=h*(12/18)
Corporate tax income net of DTA	412,5	i=g-h	550,0	i'=g'-h'	412,5	i'=g'-h'
Net income	1087,5	=b-c-i=(b-c)*(1-27,5%)	1450,0	=b-c-i'=(b-c)*(1-27,5%)	1087,5	=b-c-i'=(b-c)*(1-27,5%)

Table 2

Source: BNP Paribas Economic Research

addition to the other benefits that a bank gains from a stronger balance sheet in terms of solvency and liquidity.

Regulatory treatment of deferred tax assets

The accelerated deduction of losses from taxable income limits the build-up of DTAs and has a less favourable impact on Italian bank solvency ratios compared with the previous tax rules. For Italian banks, these considerations are especially important because their combined DTAs represented almost 30% of their CET1 (Common Equity Tier 1) at 31 December 2016 (see Chart 2). The effect of those reforms might be particularly large for the banks with the lowest solvency ratios.

However, tax changes are not the only DTA-related factors that influence the regulatory ratios of Italian banks. Articles 36(1)(c), 38(1) and 48 of the Capital Requirement Regulation[12] require them to deduct from CET1, above a certain threshold and after a transitional phase, deferred tax assets dependent on future income. Only DTAs that result from temporary differences and that do not depend on future income are not deducted (article 39(2))[13].

This change in prudential regulations would have depressed Italian bank solvency ratios if the government had not made it possible to convert deferred tax assets dependent on future income into tax credits[14]. This conversion option is subject to very specific circumstances such as the bank's liquidation or resolution. As a result, these restrictions severely hamper the impact of the changes made by the Italian government. In addition, under an amendment made in 2016[15], Italian banks must pay a fee equal to 1.5% of the amount of DTAs on which banks have not made an advance tax payment, in order to retain the possibility of converting them into tax credits. The European Commission took the view that granting this conversion option to all DTAs dependent on future income, including those on which banks have not made an advance tax payment, was incompatible with EU rules on state aid.

Due to the effect of deferred tax assets for domestic bank solvency ratios, the Italian government sought the best way to balance the need to clean up bank balance sheets and the need to support their regulatory solvency ratios. Hence, when the IRES rate fell from 27.5% to 24% on 1 January 2017 as a result of the 2016 budget[16], the government applied a 3.5% surtax on banks, which maintained their overall tax rate and its impact on their solvency ratios.

Tax rules designed as an incentive

The management of non-performing loans in Italy, but also in other Southern European countries, may be affected by a raft of reforms including tax reforms. As a result, tax changes in Italy are designed, among other things, to encourage banks to clean up their balance sheets more quickly, even though the reduction in DTAs is also likely to push down their solvency ratios.

DTAs as a proportion of total bank equity in a selection of European countries

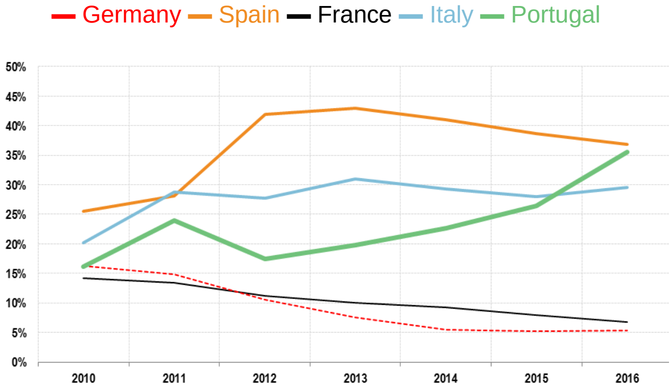

Chart 2 Sources: SNL, BNP Paribas Economic Research

These various factors emphasise how complex a task it is to manage non-performing loans given, on the one hand, the willingness to improve the quality of bank assets, and on the other, the need to ensure stability in bank solvency ratios. Selling large amounts of non-performing loans at the same time in a narrow market would reduce their valuation. Wealth would be transferred away from banks to the investors buying the non-performing loans. That would also drag down bank solvency ratios and would go against the reforms' objective of making them more robust. As part of the measures taken to encourage banks and make it easier for them to clean up their balance sheets more quickly, regulators should not be too hasty, since there is the risk of unintended consequences, particularly for the real economy, that run counter to the original intention.

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[12] Regulation (EU) no. 575/2013 of the European Parliament and of the Council of 26 June 2013
[13] This distinction is due to the fact that the amount of equity is uncertain if the future value of DTAs can only be fully realised in the event that taxable income is generated, which goes against the prudential principle of banking regulations.
[14] Act no. 214 of 22 December 2011, transposing into law, with modifications, decree-law no. 201 of 6 December 2011, consisting of urgent provisions for growth, equity and consolidation of public finances
[15] Decree-law no. 59 of 3 May 2016, urgent provisions relating to enforcement and insolvency proceedings, as well as in favour of investors of banks subject to winding up
[16] Act no. 208 of 28 December 2015, provisions for the preparation of the state's annual and long-term budget (2016 Stability Act)

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