Mario Draghi: An overview of banking in Italy

Address by Mr Mario Draghi, Governor of the Bank of Italy, at the Italian Banking Association Annual Meeting, Rome, 8 July 2009.

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Credit and the banks

Lending to the private sector has slowed further. In April the change over three months turned negative: in May it was equal to an annualized contraction of 0.9 per cent. In the last decade, the average annual rate of growth of lending to the private sector was 9.6 per cent. The contraction involves credit to firms, while that to households continues to expand, although at a significantly slower pace than in recent years. The slowdown in lending by the leading banking groups has been particularly marked.

The Governing Council of the ECB has increased its support of banks' liquidity in exceptional measure. It has also launched a plan to purchase covered bonds issued by intermediaries in the euro area for a total of €60 billion, with the main objective of easing the financing conditions for credit institutions and firms and of encouraging the banks to maintain and increase lending to their customers. The Bank of Italy is participating in these purchases in proportion to its share of the ECB's capital.

Following the reduction in the Eurosystem's official rates, the interest rates on bank loans to Italian households and firms have fallen to the average level for the area, except for consumer credit rates, which remain higher. The increase in credit risk has translated into a widening of the gap in the cost of credit between small and large firms, with an adverse impact on those that currently have the greatest need for bank financing.

The recession is also affecting credit quality. In the first quarter of this year, the ratio of new bad debts to total bank loans outstanding reached 1.6 per cent, the highest level this decade; it had risen to more than 3 per cent following the recession of the early 1990s. The increase in non-performing loans and overdue instalments prefigures a further deterioration.

In the South of Italy, borrower risk is on average greater than in the Centre and North, but in March the rate of growth of bank loans in the South exceeded that in the other parts of the country, even though the cost of a loan was 1.7 percentage points higher on average.

The deterioration in loan quality is increasingly affecting bank profits. In the first quarter of this year, the loan loss provisions of the main banking groups more than doubled, absorbing half their operating profits. Profits fell overall by 40 per cent; the ROE on ordinary operations halved to 4.5 per cent.

The factors that are constraining bank profitability today will become more intense, responding to the recession with the usual lags. The commitment to curbing costs must be intensified and the economies foreseen in business plans must be achieved more quickly.

The banks will be decisive in determining whether the crisis we are facing is more or less long-lasting, more or less deep. It is necessary to reconcile prudent management and capital soundness with the need not to deny financial support to firms with good potential for growth and a real ability to weather the crisis.

It would be dereliction of duty if the banks and the Bank of Italy were to stray from the path of rigorous evaluation of creditworthiness. A healthy banking system is essential to growth; it safeguards the savings entrusted to banks.

However, it is equally important that in deciding on loans banks use all the information available, that they supplement statistical scoring methods which lose some of their predictive power at times of crisis with direct knowledge of customers and their real potential for growth and profitability in the long term. A banking system with local roots is of great value; it needs to be exploited and where it has been lost it must be rebuilt. Banks must take advantage of their grass-roots knowledge of customers and avoid over-reliance on automatic processes. There is ample scope for improvement. Some banks, some of them large ones, are beginning to move in this direction, reviewing their organizational models and their decision-making procedures.

What prudential supervision requires of banks

Capital

Italian banks' own funds are well above the regulatory minima and have remained so even through the worst of the financial crisis. The capital ratios of the leading banking groups increased in the first three months of this year.

I have said, and I say again, that a strengthening is nonetheless necessary. It is not just a question of maintaining strong safeguards for stability; we must compete on an equal footing with the foreign banks which have had to resort to massive injections of public money in recent months; we must be prepared, as of now, to operate with a capital endowment that future regulations will require to be larger than at present. Above all, capital strengthening is indispensable in order to face the deterioration in the macroeconomic situation without neglecting to give firms, households and the economy the support they need.

During this phase the Bank of Italy does not allow banks to make early redemptions of capital instruments without a plan for their replacement with resources of equivalent quality and quantity.

The quality of the Italian banks' capital is high by international standards. We are also aware that the rigour with which we evaluate the inclusion of financial instruments in regulatory capital has appeared, in the past, to put Italian banks at a disadvantage with respect to the situation in other countries. We deliberately maintained this policy, even when the market seemed to tolerate particularly high levels of risk.

These practices, these evaluation criteria, which have been put to the test in the last two years, have so far brought benefits to banks, the economy, and the public finances.

Liquidity

The system's liquidity is still guaranteed by the massive injections of funds from the central banks. The oversight policy we introduced in 2007 has helped Italy's banking system to weather the severe strains of the last part of 2008 without major shocks. We continue to ask the banks to ensure that foreseeable outflows are covered over a broad range of maturities.

The tools of analysis and intervention are being continually improved. The ten leading Italian banking groups were asked to conduct a liquidity stress test, the results of which have shown that the largest groups have a high resistance to stress.

In international cooperation fora, work is under way to draw up common safeguards against liquidity risks. The Bank of Italy favours a system based on two instruments: on the one side, the requirement permanently to keep sufficient liquid reserves to ensure that, even in the presence of stress, outflows are covered for an adequate period of time; on the other side, the maintenance of a minimum structural equilibrium between the duration of liabilities and that of assets. Opinion is broadly converging on these positions.

The one-year financing operation recently conducted by the Eurosystem has achieved records both in the number of counterparties (1,121) and in the amount allotted (more than €442 billion). The participation of Italian banks amounted to less than 3 per cent of the total.

Stress testing bank assets

For the quality of loans, and more generally of bank assets, thorough stress testing, performed in a coordinated manner under the guidance of the supervisory authorities, is likewise essential in order to verify the soundness of the single banks and of the system as a whole, to improve the transparency of their balance sheets, and to restore the credit circuit to normal operation.

In the United States, in the weeks immediately following the publication of the stress test results the 19 banks concerned were able, in part by selling non-strategic assets, to raise almost $65 billion of new equity capital and issue over $20 billion of bonds without government guarantee. The effect spread to all the US banking sector, which jointly placed almost $90 billion of new shares in the quarter just ended.

Ahead of a similar coordinated exercise planned at the European level, in recent weeks we completed a stress test of the Italian banking system by estimating the loan losses that would occur in the period 2009-10 in even more unfavourable macroeconomic conditions than the present ones: the portion of losses not covered by operating profit would equal about one fifth of the system’s end-2008 excess capital; overall, the outcome confirmed banks’ capital adequacy.

For the time being, the diversity of intermediaries, methodologies that are still too varied, and difficulties in comparing results make it impracticable to publish the individual results of the stress tests under way at European level. I believe, however, that this objective cannot be deferred for long without delaying the necessary return of banks to the private capital market.

Good rules, the right incentives

Banks’ governance

Rigorous risk management, the safeguarding of banks’ reputations, the verification of correct conduct and compliance with the rules require reliable and effective systems of corporate governance and internal controls: these, even before the Bank of Italy’s supervision, are the first line of defence for the stability of banks and the system as a whole. Last year we issued rules with which banks had to comply by 30 June, where appropriate by amending their bylaws.

Bylaws require our approval; the interaction with banks has been intense. While respecting every bank’s autonomy in choosing its own model of governance, we stressed the need for consistent and uniform approaches, clear rules, and a proper balance of power. We called on banks to simplify their governance structures by limiting the number of directors, avoiding overlapping tasks and administrative bodies. We asked that the Chairman act as coordinator and guarantor in a dialectical relationship with top management and laid down the conditions for his correct activity within the executive committee, whenever this was established. For the first time, we requested the inclusion of independent members on the boards of directors of unlisted banks.

Owing to the distinctive traits of the shareholder base and governance structures of cooperative banks, we paid special attention to the mechanisms for appointing their governing boards, aiming to maintain their strengths (social responsibility, close ties with households and the productive fabric) and curb the risk of management being excessively self-referential. In keeping with the spirit of mutualism and the egalitarian principle underlying these banks’ structures, we promoted voting mechanisms capable of giving voice to significant minorities among shareholders; favoured an enlargement of proxy voting; and suggested other instruments to enable more effective participation by shareholders. Significant, if uneven, progress has been made; but more remains to be done.

Remuneration and incentives

One of the lessons to emerge from the crisis is that bad systems for compensating management and those responsible for key functions in banks can favour the excessive accumulation of risks. People paid on the basis of short-term results pursue immediate gain without taking account of the associated risks. The result is a false accounting of profit that generates a deadly risk spiral.

Starting last year the Bank of Italy, first among the authorities of the leading countries, introduced specific rules on compensation schemes as part of the rules for banks' governance. In April this year the Financial Stability Board issued the principles underlying sound compensation practices.

First and foremost, provision must be made for an adequate balance between the fixed and variable components of compensation; moreover, pay should be related to actual profits over the longer term, taking the related risks into proper account. Special precautions must be taken to protect the integrity and status of banks' control function; the governing bodies, and shareholders especially, must be involved in setting compensation policies and in verifying their implementation.

The Bank of Italy has formed a task force to assess current compensation schemes and call for correctives when required. The supervisory area is attentive to any international practices that might emerge in applying the principles and recommendations recently issued.

The prevention of money laundering

Last year the Bank of Italy took over direct responsibility for the anti-money-laundering controls that had previously been carried out by the Ufficio Italiano dei Cambi.

Cooperation with the magistracy and the Finance Police is essential to the success of the Financial Intelligence Unit (FIU), to which the Bank of Italy allocates adequate resources for its increasingly demanding tasks.

Anti-money-laundering controls have become a regular part of the Bank of Italy's onsite inspections of financial institutions. In 2008 the Supervision Area and the FIU carried out 191 inspections at banks, investment firms, asset management companies and other intermediaries. A number of recurrent failures to comply fully with the rules were found: insufficient checking of customers, incomplete record-keeping, inadequate assessment of anomalous transactions, poor staff training, and methods of control lacking in incisiveness.

Sanctions, reprimands and numerous reports to the law enforcement authorities show that the banks underestimate the need for full compliance with the rules, for strict performance of their obligations. A change of attitude is necessary. Corporate bodies and officers must take responsibility for the proper functioning of the anti-money-laundering systems. The control bodies have specific duties for which they can be called to account, including in the course of inspections.

This anti-money-laundering strategy is beginning to produce effects. The number of reports of suspicious transactions that intermediaries transmitted to the FIU increased by 16 per cent to around 14,600 in 2008, and in the first four months of 2009 there was a further sharp rise of about 50 per cent compared with the same period of the previous year.

Customer protection

The crisis has accentuated the need for continuing action to raise the standards of correctness and transparency in relations with the public, to resolve disputes between banks and customers quickly and to promote the informed use of financial instruments by savers and investors. The stability of the financial system hinges on customer confidence.

The Bank of Italy's new rules on the transparency of banking and financial services represent a thorough overhaul with respect to the past. Customers must be provided with information that is easy to understand and effectively useful for determining whether the transactions proposed are in their interest and for assessing the correctness of the person making the proposal. The rules require intermediaries to institute internal procedures that guarantee correct conduct.

The comments received in the course of the public consultation that was completed in May confirmed the validity of the reform, which will be issued this month.

As a complement to the civil justice system, a Banking and Financial Arbitrator has been created to give customers an economical and rapid means of obtaining impartial rulings in disputes over banking and financial services. Three boards will be instituted, one for the North of Italy, one for the Centre and one for the South. Bank customers will also be able to appeal to the boards through the branches of the Bank of Italy, which will provide the facilities and technical support for the Arbitrator.

I raised the question of the fee charged on a customer's maximum overdraft at the beginning of 2007, calling on the banks to abandon a practice that is almost indefensible in terms of transparency and efficiency. The law gave the Bank of Italy only the power to make sure that these clauses were applied transparently – not the power to replace them with different contractual provisions. Repeated acts of moral suasion were only effective with the major banking groups. Legislative intervention was necessary, although the reordering of the various provisions governing relations between banks and customers remains desirable and is provided for in the Community law recently passed by Parliament.

The banks must now solve the problem at the root. Let them, of their own accord and once and for all, supplant these complex, opaque fees with reasonable commitment fees based on the amount of funds made available. For the rest, everything must be brought back to the transparent application of interest rates.

From the beginning of 2010 the threshold rates for anti-usury purposes will include all accessory charges: the maximum overdraft fee, if it is still being charged, commitment fees, mediation fees, and any other costs in connection with the loan.

Non-bank intermediation

Among more than 1,000 non-bank financial intermediaries registered under Article 106 of the Consolidated Law on Banking and 160,000 financial agents and loan brokers, more than a few are marginal, fragile, of doubtful professionalism and sometimes dubious legality. In the public interest and in the interest of the more responsible, qualified operators, it is urgent to set the situation to rights.

We have begun a rigorous selection, intensifying the checks at the time of entry in the registers and those on continuing satisfaction of the minimum standards set by law and compliance with the rules. The Report that we recently submitted to Parliament and the Government gives an account of this.

We have struck more than 11,000 financial agents from the register. In cooperation with the Finance Police, we have begun extensive checks in the sectors at greatest risk. Acting on our proposal, the Ministry for the Economy and Finance has deregistered more than 30 financial companies for which significant anomalies were found; many of them had been engaged in providing guarantees and sureties. Controls are being carried out on the intermediaries specialized in granting loans secured by a pledge of one fifth of the borrower's salary and have already given rise to sanctions.

Recent measures of the Ministry for the Economy and Finance and the Bank of Italy have begun to make the criteria for entry in the registers more stringent. But more far-reaching interventions are essential to update obsolete provisions and fill regulatory gaps. We are ready to offer the Government our technical support.

Asset management

The crisis has exacerbated the longstanding problems of the Italian asset management industry.

For years, the Bank of Italy's watchwords for the industry have been consolidation and independence.

A competitive repositioning of the largest asset managers is under way at international level. Some steps towards rationalization are also beginning to be taken in Italy. Recent months have seen spin-offs by banking groups aimed at creating independent operators. Consolidation can yield efficiency gains, which need to be transferred to investors in order to reduce the costs borne by them and fuel the resumption of investment.

Management companies' full autonomy remains essential. We have just begun a consultation on new regulations concerning the management and coordination exerted by bank parent companies on their asset management subsidiaries. Besides clearly defining the strategies they pursue in the sector, banking groups will have to ensure the genuine independence of asset management companies as regards their investment choices and marketing policies.

I have repeatedly underscored the disadvantage that derives from the difference between the tax regime for the sector in Italy and abroad. This needs to be revised.

The reform of European supervision

Supervisory colleges that oversee the consolidated position of international groups, uniform supervisory rules and practices, and a close relationship between the European Central Bank and national supervisory authorities are the three pillars of future European supervision.

The proposals put forward by the de Larosière group largely meet these needs but envisage a complex architecture.

A European Systemic Risk Board, in which central banks and supervisory authorities will participate, will be responsible for macroprudential analysis and supervision. It is important that it be headed by the president of the ECB, that its activity go beyond merely warning about risks, that it be able to verify implementation of its recommendations and promote the introduction of countercyclical measures.

Supervision of all banks, including European groups, will remain a national responsibility. The overall context must change, however. The objective is: common rules, common practices, a common culture, with a single rulebook applicable throughout Europe, and a strong coordinating role for the supervisory colleges.

Equally important is the harmonization of depositor-guarantee schemes, of the instruments for intervention in crises, and of the rules for the transfer of liquidity between the units of a banking group.

The Bank of Italy is already at the forefront in promoting concrete progress for the groups for which it is home supervisor. Joint and coordinated inspections in the various subsidiaries of a group, conducted together with the host-country authorities, are becoming standard practice. Just a few years ago, such progress was inconceivable.

Best practices must be disseminated as supervisory authorities continue to converge. The particularly incisive approach to inspections and supervision that typifies the Italian tradition is a valid reference point.