Mario Draghi: 2010 World Savings Day

Address by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the 86th World Savings Day, Rome, 28 October 2010.

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The international economy three years after the start of the crisis

The recovery and international cooperation

Economic recovery is strong in the emerging countries, weak in the United States and uneven in the euro area. Economic policy responses have differed.

Monetary policies have remained expansive everywhere, but while in the euro area there is now talk of tightening, in the United States a further expansion of liquidity through Federal Reserve purchases of treasury paper has been announced.

In Europe budgetary policies are now clearly directed at containing deficits and reducing debt; this is not the case elsewhere.

Some countries are making foreign exchange interventions to support their exports. International payments imbalances are beginning to widen again; currencies with market-determined exchange rates are being affected by the policy differences and the resulting speculative pressures; global recovery is at risk.

The only answer is for the main countries to coordinate their economic policies more closely. Some commitments were made at the last meeting of the G20: to pursue structural policies to support global demand; to keep current account imbalances within sustainable limits; to forgo all forms of protectionism; to move towards flexible exchange rates more consistent with the fundamentals, while working to reduce the volatility of capital flows to the emerging countries; and, in the advanced countries, to draw up budget consolidation programmes for the medium term that are credible and promote growth. These are not rhetorical conclusions, but follow from a hard-won recognition of the inevitability of collective action.

Financial regulation

Where this action is already taking the greatest steps is in the construction of a global system of financial regulation. The driving force is to be found within the G20; the reform of the Basel rules is a milestone.

The new rules introduce a definition of bank capital that is common to all countries; they provide for a significant increase in both the level and the quality of this aggregate; they limit financial leverage, counter liquidity risks, and mitigate the procyclical trends inherent in financial intermediation.

In comparison with the rules in force, those that have now been defined are innovative on several fronts and incisive. At the same time, they will be applied gradually to ensure that banks can continue to operate smoothly and that firms and households do not suffer from credit restrictions.

To make the transition to the new rules easier for banks, the Bank of Italy will set up a help desk to explain how the rules are to be interpreted and to ensure that intermediaries implement management policies consistent with achievement of the new requirements.

Basel III will make the banks stronger, but it does not address the question of the risks posed by Systemically Important Financial Institutions (SIFIs), whose size or presence in the most important financial nerve centres means they would be rescued at any cost if they were about to fail.

At the next G20 summit, the Financial Stability Board will submit a set of proposals for the creation of an institutional and regulatory environment within which SIFIs will be better able to absorb very large losses without going into a full-blown crisis and governments can allow them to fail when necessary.

These proposals, endorsed by G20 Finance Ministers and Central Bank Governors at the recent meeting in Seoul, are based on four pillars:

i) Institutional arrangements should be adopted in all countries that will allow SIFIs to be resolved without the global financial system running severe risks and without having recourse to taxpayer money, as happened for the desperate rescues of the last few years. The national laws that hinder international cooperation today must be amended; agreements between home and host authorities must be drawn up, with roles and responsibilities clearly defined. Under Italian law the Bank of Italy already has sufficient instruments at its disposal; only a few adjustments will be required to transpose the international recommendations. In particular, the supervisory authority must be empowered to set up bridge banks to which the assets and liabilities of a troubled institution can be temporarily transferred, to ensure continuity of operations pending its disposal on the market.

ii) SIFIs, especially those operating at global level, will need to have capital or other instruments equally capable of absorbing losses available in amounts greater than those laid down by the Basel III standards. Shareholders – and in some cases bondholders as well – must be asked to shoulder some of the losses in difficult times; among other things this would strengthen both market discipline and investor scrutiny of management decisions. It is therefore possible to envisage the introduction of more severe capital requirements than those imposed on non-systemic intermediaries, debt instruments that would automatically convert to capital when banks' ratios fall below a certain safety threshold (contingent capital), reductions (haircuts) for some creditors in the face value of debt during a crisis (bail-in).

iii) Supervision of SIFIs needs a broader mandate ensuring greater independence of supervisors, enhanced resources and powers consonant with the degree of complexity of the supervised institutions.

iv) The trading of the derivative products that can be standardized must take place on regulated markets or platforms with central counterparties, supervised by the authorities and having adequate capital and organizational resources. Trade reporting for all products must be channelled to trade repositories that the authorities can access, including for economic policy purposes.

The FSB will also submit proposals on another issue raised by the recent financial crisis: the role and function of credit rating agencies. The importance of external ratings for regulatory purposes must be gradually reduced. It is not a question of denying their general validity, but rather of addressing the most obvious drawbacks associated with their mechanical application, in terms of systemic procyclicality and potential destabilization of markets.

Italian banks and the supervisory authority

Banks' situation and performance

The results of the stress tests for the European banks published on 23 July 2010 confirmed the high degree of resilience of the major Italian banks to scenarios prefiguring not only macroeconomic decline but also a significant increase in sovereign risk.

From the beginning of April to yesterday, CDS premiums for the three largest Italian banks rose by 63 basis points, reflecting the increase in those on sovereign debt. The Italian banks, together with their Spanish counterparts, are the only ones in the euro area to have maintained premium levels lower than those on sovereign debt. However, the increase weighs on the cost of long-term fund raising, at a time when large volumes of bonds are nearing maturity.

It is important that the maturity structure of banks liabilities not be unduly tilted towards the short term, increasing the vulnerability of their liquidity position, which up to now has remained balanced in even the most severe phases of the crisis.

As of June, the resources of the five leading Italian banking groups best able to absorb losses (core tier 1 capital) had reached on average 7.7 per cent of their risk-weighted assets, 1.2 points more than in June 2009 and 2 points more than at the end of 2007.

Compliance with the new rules imposing a higher standard of quality, a minimum requirement of 4.5 per cent for core tier 1 capital, and an additional buffer of 2.5 per cent will also make it necessary for Italian banks, above all the large ones, to strengthen their capital base significantly, although the time allowed to make the adjustment will mitigate the severity of the reform. Italian banks are not at a disadvantage internationally: the requirements have been tightened even further for trading in securities and derivatives, which generate less business in Italy.

As regards lending to small and medium enterprises, the preferential treatment already applying to the calculation of capital adequacy will remain in place. The capital of the smaller banks, which are the main ones serving SMEs, is already well above the new regulatory requirements.

International studies indicate that the macroeconomic cost of adapting to the new rules will be more than offset by the benefit of a lesser likelihood of new systemic crises.

Our fiscal treatment of write-downs and losses on loans has encouraged the setting up of balance-sheet provisions that do not entirely qualify as capital under the new Basel III rules. We must work towards finding a solution to this problem in the coming months, one that combines the need to prevent an evident competitive disadvantage for our intermediaries with the need to safeguard the public finances in the medium term.

Like other banking systems founded on the traditional business of intermediation, our banks are also experiencing a decline in profitability. In the first half of this year the average ROE of the five leading Italian banks fell to 4 per cent, one percentage point lower than in the same period of 2009.

Trading and investment banking contribute less to profits than in some of the other European groups. Profit and loss accounts, already affected by low interest rates and small volumes of business, now also have to cope with a significant deterioration in loan quality.

We will be careful to ensure that banks' provisioning policies take account of the delicate nature of this phase, to ensure that internal models for assessing asset quality pick up tensions and internal stress tests are promptly updated.

It is imperative, in order to support profitability, to take action on costs, which are higher in relation to income than the European average. The temptation to resort to strategies entailing excessive risks or to demand exorbitant commissions from clients who are less well-informed or in difficulty must be avoided.

In the months to come, if the pick-up in lending we now see proves lasting, it will support interest income. Not long ago, Italian banks demonstrated that they were able to boost revenue by increasing the range and quality of the services they offered, improving their risk-assessment procedures and raising the level of their operating efficiency. This course must be resumed. Only by taking action on several fronts will it be possible to achieve levels of profitability that allow the system's capitalization to be increased while ensuring the ability to finance the economy.

Banks' governance and the role of the foundations

More than two years have passed since the Bank of Italy, anticipating international developments, laid down rules on banks' governance. Adequate debate and collegiality in taking strategic decisions, unity of managerial approach in running the business and an effective and aggressive structure of controls at every level are the essential elements of sound and prudent management. I take this occasion to underscore some guidelines for action in this field.

The Bank of Italy does not interfere improperly with entrepreneurial autonomy. It does not pretend to dictate specific internal structures, especially for the largest and most complex banks. However, it does consider it necessary, whatever the structure chosen, that the chains of reporting and command be established unambiguously, that effective flows of information to and from the top be ensured, and that the responsibilities of the governing bodies and the individual managerial levels be set down in a transparent manner.

One of the clearest lessons of the crisis is that the risk management function in banks must cover all strategies and transactions, dialogue authoritatively with the lines of business at every level, report directly, promptly and thoroughly to top management and the corporate management bodies.

The corporate officers of banks with control tasks, who have particularly sensitive functions, must have professional expertise adequate to the complexity of assets and risks. The obligation to inform the Bank of Italy of every fact that might affect sound and prudent management must be complied with, on pain of sanctions.

The delicate, specific responsibilities of directors and members of the control bodies of banks require adequate time and commitment. With this in mind, it is advisable to consider the possibility of rules limiting multiple office-holding.

The Italian experience of banking foundations is positive, not only for the important contribution they make to socially commendable activities, but also for the role they have played as stable, solid shareholders in banks; a role filled in other countries by institutional investors, which are rare in Italy. During the crisis, the foundations' long-term view of banks' prospects and their roots in the territory – factors driving development at local, regional and national level – were crucial. When other shareholders, such as investment funds, until the eve of the crisis so vociferous in demanding efficiency gains and changes of management, vanished, often for good, it was the foundations that subscribed for the repeated capital increases that made it possible to weather the storm unscathed.

Just as the future promises to be challenging for banks, it will be challenging for their largest shareholders as well.

The foundations will have to act on three key fronts: their own governance, the recapitalization of banks and self-discipline in their relationship with banks' managements.

For the action of banks' control bodies to be adequate, it is necessary that the boards of their main shareholders, which help to elect them, be equally adequate.

For the reasons described earlier, they will be asked to make a significant effort to strengthen banks' capital, an effort to be faced without flinching. The foundations must continue to take a long view; they must understand that they cannot sacrifice the prospects of their banks and the economies they serve to the desire for immediate monetary returns, which, besides, are now harder to obtain.

The Italian experience of public banks is vivid in our memory. Certain relationships between local economic groups, public banks and politics ultimately proved disastrous for the banks and deleterious for civic mores; in more than one case, local development was hindered rather than helped. With great, conscious effort we worked our way free of this logic twenty years ago; other countries now look to the Italian experience. No one wants to turn back.

Growth and employment

While the Italian banking system may have withstood the global financial crisis of 2007–08 better than others, the recession that it provoked was especially severe in our country, driving annual output in 2009 down to the level of nine years earlier. And as we have seen, the difficulties of households and firms are now having repercussions on banks. But the recession does not appear to have halted the modernization of the productive system that we began to see towards the middle of the decade.

The forecasts for GDP growth this year and next are scarcely 1 per cent. In the first half of this year economic activity benefited from the expansion of exports, which are now slowing.

Economic growth needs the contribution of domestic demand: the virtuous circle in which advanced models of consumption and farsighted investment lead to high and widely distributed incomes, hence further consumption and well-being.

Consumer spending is stagnating today because the real incomes of households are not rising and there is widespread uncertainty about the future. The central issue is the state of the labour market, which needs to be analyzed considering all the available indicators and reliable sources of information.

The number of people in work in Italy fell by 560,000 between the second quarter of 2008 and the fourth quarter of 2009, largely among fixed-term and part-time employees and persons who are formally self-employed but in almost every way have the characteristics of wage-earners. The first half of 2010 saw a sluggish recovery, with a gain of 40,000 jobs.

As in other European countries, the impact of the recession was attenuated by large-scale resort to short-time programmes. Between September 2008 and August 2010 a total of 1.8 million hours of Wage Supplementation were authorized, equivalent to about half a million full-time workers each year. From the onset of the crisis, the Government extended eligibility for these benefits to additional workers.

The unemployment rate has reached 8.5 per cent of the labour force, including off-the-books workers. For a fuller assessment of the state of the labour market, many national and international statistical agencies also use other measures of underutilization of labour. In addition to the officially unemployed, such measures also count workers on short-time programmes like Wage Supplementation, discouraged workers (those who want jobs and are available to work but have given up active search for a job because they have lost hope of finding one), and those who have part-time but want full-time jobs. In Italy, counting only the first two of these categories, the labour underutilization rate is above 11 per cent of the potentially employable, about the same as in France and higher than in the United Kingdom and Germany.

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Italy faced the crisis with a budget deficit still close to 3 per cent of GDP and a public debt that, though gradually diminishing, was still high by international standards. The response to the crisis was prudent, and the repercussions on the public finances were smaller than in other countries, thanks in part to the absence of bank bailouts. If fully implemented, the measures of the three-year public finance package approved in July, curbing current expenditure and reducing tax evasion, could bring the debt ratio back onto a downward path.

The euro-area countries have responded to the recession of recent months both individually, with fiscal policy measures designed to contain sovereign risk and prevent contagion, and collectively, with new institutions and rules. This demonstration of cooperation, solidarity and firm resolve has consolidated the euro. Though the process has not yet been completed, it has shown that the countries with the weakest public institutions are not in a position to overcome their economic policy difficulties on their own. With European rules that are quasiautomatic, fast-acting and sensitive to market signals, they draw on the stronger countries for the determination they themselves lack.

Much has been done in controlling deficits on the front of the public finances, but the fundamental pillar of financial stability is economic growth, without which debts will not be repaid. This is the front on which the Union's cohesion will be tested: the ability to foster harmonious, rapid, sustained growth embracing all the member states, with common rules that, like those governing the public finances, help the countries lagging behind in undertaking the structural reforms needed if they are to return to faster growth.