Ignazio Visco: Brief overview of the Italian economy and its banks

Address by Mr Ignazio Visco, Governor of the Bank of Italy, at the Annual Meeting of the Italian Banking Association, Rome, 11 July 2012.

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The sovereign debt crisis and the Italian economy

The Italian economy is still in recession. The consensus forecasts indicate that Italy's GDP will decline by nearly two percentage points in 2012 as a whole. The increase in the cost and the deterioration in the availability of credit following the sovereign debt crisis have contributed to the worsening of the situation.

The difference between the yields on Italian and German government securities is far greater than could be justified by our economy's fundamentals. It reflects general fears of the monetary union breaking up – a remote possibility but one that is nevertheless influencing the choices made by international investors.

The decisions taken at the euro-area summit of Heads of State and Government and the European Council of 28–29 June, and clarified in last Monday's Eurogroup meeting, underlined the will to preserve the single currency and to break the vicious circle between the sovereign debt crisis and the situation of the banks.

To properly orient the markets' judgment concerning the progress made by the member countries in fiscal adjustment and structural reform, the resources of the European stabilization funds, the EFSF and the ESM, must be put to the best possible use, including the containment of funding costs within limits that are consistent with the fundamentals of the different economies.

We must continue to strengthen the European construction, advance towards a true federation, and lay the foundations of a fiscal union in which national sovereignties will end at the point where the sharing of resources and responsibilities begins. The common currency can only be a lasting source of stability and progress if it rests on these foundations.

A single system of banking supervision is necessary in an integrated financial market such as the euro area; the presence of large banks operating in several different countries requires uniform rules and controls, so as to eliminate duplications and local differences and pursue the stability of the European banking system as a whole. European supervision should be defined as a single, mutually supportive and independent system, in which decisions are taken collectively and implemented at the appropriate level, based on the experience and expertise of the national supervisory authorities. A fully-rounded plan requires that a single banking supervision system be flanked by the introduction of European funds and mechanisms to protect depositors and resolve crises, with the necessary prerequisites for tax sharing; otherwise, the credibility and sustainability of the system would be called into question.

The reduction of the official interest rates to an all-time low, decided on 5 July, reaffirmed the determination of the ECB Governing Council to ensure that monetary conditions are appropriate to the economic and financial situation of the area. This is an important decision; it follows on from other measures adopted last month to continue to guarantee the necessary liquidity for the banking system and to counter the effects of the segmentation of the money and financial markets within the area, which is an obstacle to the uniform transmission of the single monetary policy. The ECB cannot but continue to act for these objectives.

Italy must continue the work it has already begun on two fronts: the public finances and structural reform; it must be prepared to seize the opportunities offered by the stabilization of financial market conditions. The crisis has impelled us to address the problems that have bridled our economy for so long. This task was put off for far too long, following the advent of monetary union, at the cost of a progressive loss of competitiveness and a gradual deterioration of the public finances. We must make our economic environment propitious for enterprise, eliminate waste and make the public administration more efficient.

Italian banks must accompany this effort. Low financial leverage, the emphasis on the traditional banking business of deposit-taking and lending, and the absence of any housing bubble have shielded them from the impact of the global financial crisis that began five years ago. They have been able to maintain financial assistance to solvent, creditworthy customers. To continue along this road, now that strong sovereign debt tensions making themselves felt, banks must increase their capital endowments and strengthen their management of credit and liquidity risk, proceeding along the path already taken.

The activity of Italian banks

Since the middle of last year, with the cyclical downturn, the quality of business loans has worsened. The flow of new bad debts on loans to non-financial firms, which between 2005 and 2007 had been steadily below 1.3 per cent of total outstanding lending, rose to 2.9 per cent in the first quarter of this year, 0.2 percentage points higher than at the end of 2011. For households, by contrast, during the same period this indicator fell by 0.2 points to 1.2 per cent. Loans classed as substandard, restructured or overdue increased.

At the end of 2011 the stock of bad debts amounted to 6.2 per cent of total loans to non-bank customers, nearly a full percentage point more than a year earlier. For the top five banking groups the bad debt ratio was 6.9 per cent, for the other banks 5.0 per cent.

The stock of impaired positions (bad debts and substandard, overdue and restructured loans) was equal to 11.2 per cent of total loans to non-bank customers at the end of 2011, this too representing an increase of about one percentage point in the year. International comparison of the balance-sheet incidence of impaired loans is distorted by cross-country differences in practices. The Italian definition of the aggregate is broad, including assets that are still generating income. Moreover, the slowness of legal proceedings for credit recovery in Italy means bad debts remain on the balance sheet longer, thereby raising the level recorded in the accounts.

In any case, having a large share of impaired claims in balance sheets puts pressure on banks' capital and liquidity. The first safeguard against the risk of deteriorating credit quality is effective borrower screening based on objective criteria, robust valuation models and optimal utilization of the information available to assess customers' prospects.

During the first half of 2012 the Bank of Italy conducted targeted inspections of credit risk at 14 intermediaries that account for 59 per cent of lending by Italian banking groups. The inspections examined the banks' procedures and controls during the granting of loans, the adequacy of their internal risk measurement models, the quantification of risk assets, and the adequacy of their provisioning policies.

The new rules on related-party transactions, which will be fully in effect by the end of this year, will help to strengthen credit quality and foster greater impartiality in the allocation of credit.

The bad debt cover ratio – the ratio of value adjustments to exposures – declined last year from 57.2 to 55.7 per cent. This is higher than in the early 1990s but lower than the ratio registered before the outbreak of the financial crisis. In times of recession, when bad debts increase more rapidly, such a decline is normal, at least in part, but banks' value adjustments for deteriorating credit quality (which were equal to €18.4 billion in 2010 and €19.3 billion in 2011) must continue to grow.

Even during the present phase the increase in provisioning can be funded out of banks' ordinary earnings. Effective policy for provisioning not only strengthens balance sheets but can also favour the liquidation of impaired assets. Suitable ways of reducing their weight on balance sheets must be devised.

The increase in sovereign risk has hampered our banks' wholesale funding. Total fund-raising, net of Eurosystem refinancing, shrank by 4.6 per cent in the twelve months through May, reflecting a contraction in funding on international markets. The Eurosystem's two longer-term refinancing operations compensated for this shortfall and averted liquidity strains.

By contrast, retail funding provided by savers resident in Italy has not been affected by the crisis. In May bank deposits were 1.2 per cent greater than twelve months earlier.

The current slow growth in lending depends in the first place on the slackening of demand due to the recession. A brusque tightening of credit supply owing to the wholesale funding strains and the deterioration in loan quality was observed at the end of last year. Supply conditions improved in the early months of 2012 thanks to Eurosystem refinancing. New strains have emerged in recent months in connection with the instability of the markets. The three-month rate of change in bank lending to firms was slightly negative in May, while credit to households remained stable.

The more stable forms of fund-raising – deposits and bonds subscribed by households – are sufficient to finance over 80 per cent of Italian banks' lending, more than at the end of 2011. Banks need to continue their pursuit of a structural rebalancing of sources of funding.

The technical forms of credit must be evaluated with care. The share of total lending consisting of current account overdrafts is 28 per cent in Italy against an average of 12 per cent in the rest of the euro area. This method of supplying credit to customers exposes banks to liquidity risk, makes cash outflows less predictable, and hampers the formation of eligible collateral for Eurosystem refinancing. More attentive management of liquidity by firms could foster a reduction in recourse to overdrafts.

The strict liquidity requirements for banks introduced by Basel III represent a necessary prudential safeguard of stability. The rules need to be fine-tuned to avoid potential pro-cyclical effects. In particular, the liquidity buffers built up during periods of expansion must be effectively usable in times of difficulty. The disincentives to the circulation of funds through the interbank market must be eliminated. The risks of wholesale banking business have to be more clearly distinguished from those of retail intermediation.

Capital endowment and cost containment

Italian banks have been making progress in strengthening their capital for some time now, partly at our request and despite the difficult market conditions. Between the period before the crisis and March of this year the banks' core tier 1 capital increased from 7.1 to 9.9 per cent of risk-weighted assets. Since the beginning of 2011 the five largest banking groups have increased their capital through recourse to the market for a total of over €17 billion and by restructuring convertible bonds as core tier 1 capital worth a further €3 billion; their core tier 1 ratio now stands at 10.0 per cent. The average capital ratio of the remaining 66 groups has risen to 8.7 per cent. The capital of the other 472 institutions not belonging to a group, for the most part mutual banks, amounts to 13.7 per cent of risk-weighted assets.

The five largest Italian banking groups now comply with the capital target set by the European Banking Authority (EBA), which asked banks to increase their core tier 1 capital taking into account sovereign risk exposure. The EBA's exercise set their total capital needs at €15.4 billion, more than 70 per cent of which has been covered by means of privately subscribed capital increases and self-financing. The reduction of risk-weighted assets as a result of more widespread use of internal models, carefully evaluated by the supervisory authorities, has also contributed. We examined the measures proposed by the banks with the specific aim of preventing any significant contraction in lending to the economy.

Public intervention was needed in the case of Banca Monte dei Paschi di Siena owing to the pronounced tensions affecting the financial markets, which made the cost of new issuance prohibitive, and the difficulty of making asset disposals in very strained market conditions. Achieving the same target by alternative means would have entailed a reduction in lending to the economy.

Even with this operation, the total amount of government intervention in support of the Italian banks is still low by international standards. This also reflects the low level of trading in opaque and risky financial instruments.

From 2008 to 2010 government aid disbursed to European banks for recapitalization and coverage of losses amounted to €409 billion, or 3.3 per cent of GDP; the guarantees utilized for new issues of debt totalled €1,111 billion (9.1 per cent of GDP). In Italy, equity transactions amounted to €4.1 billion or 0.3 per cent of GDP, and the banks required no guarantees.

Including approved state financial assistance, for which figures are available up to the autumn of 2011, the value of government measures in Europe has now risen to 37 per cent of GDP; however, this does not take account of the latest recapitalization measures in favour of some European banking systems or of the guarantees given in respect of bank liabilities. In Italy, such measures are of limited magnitude: specifically, the additional capital increase for Banca Monte dei Paschi di Siena will amount to around 0.1 per cent of GDP, while the guarantees attached to bonds used as collateral for Eurosystem refinancing currently total 5.5 per cent of GDP.

The progress achieved in capital strengthening must now be consolidated. On the basis of analyses calibrated according to the intermediary's exposure to the different types of risk, we have asked banks to further raise their higher quality capital above the regulatory minima.

The new rules on capital are one of the pillars of the Basel III reform. In Europe, their adoption will mark a turning point. The Bank of Italy continues to uphold the importance of properly implementing the regulatory provisions already agreed by the G20. It would be a grave error to undermine the reform approved at international level. The markets would punish such a decision.

As a result of the capital operations conducted in the early months of this year, including those in connection with the EBA's recommendation, the capital needed by Italian banks in order to comply with the new common equity requirements that will apply when Basel III comes into full operation has been significantly reduced. About 60 per cent of the capital increase still needed can be put down to the fall in the prices of sovereign securities from the second half of 2011 on. Under the new prudential requirements all capital losses directly affect regulatory capital. Italian government securities represent about one tenth of the assets of the country's banks. A decline in their yields from present levels will make it easier for the banks to comply with the new prudential requirements.

Compared with the phasing-in envisaged for Basel III, the European rules (not all the main aspects of which have been finalized yet) allow the accelerated application of all or part of the new capital regulations. The markets apparently already assume that the core tier 1 capital ratios will be on the order of 7 per cent (the minimum of 4.5 per cent plus the 2.5 per cent capital conservation buffer). The change-over to the new system must nonetheless be promptly and clearly prepared by banks and authorities working together.

Ensuring the soundness of banks necessitates that national supervisory authorities apply rigorous criteria in assessing risk-weighted assets (the denominator of capital ratios). Italian banks' ratio of risk-weighted assets to total exposures is high by international standards.

For global systemically important banks, the higher capital levels approved by the G20 and crisis management measures will strengthen their ability to absorb losses and will limit how far banks are interconnected and the risk of contagion among intermediaries and between finance and the real economy.

On 29 June the Basel Committee began a public consultation on its proposed principles to ensure that domestic systemically important banks too are endowed with a high capacity to absorb losses. Compared with the rules for the global systemically important banks, the national authorities are given more leeway to determine which intermediaries are subject to additional loss absorbency requirements and to calibrate capital requirements. Implementation of the principles will be subject to peer review. For cross-border groups, it is envisaged that host supervisors may establish additional requirements if the subsidiary is systemically important; reflecting a position we argued for vigorously in the international discussion, the principles recognize the need for robust mechanisms of coordination between home and host authorities in order to avoid measures that could harm the integration of financial markets.

In a phase of weak growth in the volume of business, heightened tensions on the financial markets and mounting credit risk, a recovery of profitability must be sustained by gains in efficiency. As I have remarked on other occasions, strategies to improve production and distribution processes, to exploit the contribution of new technologies in full, must be rapidly put into practice.

In the first quarter of this year the operating costs of the five largest banking groups declined in relation to gross income. Operating profitability consequently benefited. The action undertaken to curb costs must continue. Banks must rapidly rationalize supply structures.

Compensation policies too must be aimed at the objective of reducing costs. The main Italian banks have made progress since March 2008, when the Bank of Italy issued its first supervisory instructions on compensation: the total pay of top management has declined in the last two years; bonuses have diminished.

Cost containment is still not widespread enough among medium-sized listed banking groups, nor has it involved all the top positions. At a number of institutions the compensation of top management is fixed, not tied to the bank’s performance over a number of years. Non-executive directors, who often hold multiple positions within the group, have received increasing compensation in line, on average, with that of general managers. The Bank of Italy also expects the banks to reduce the size of severance packages: overly generous benefits impinge on prudent management and the proper functioning of governance mechanisms.

The communication addressed to the banks on 2 March reiterated the need, in the current cyclical conditions, to align the pay incentives of directors and managers with the risks taken, to make them consistent with a policy of strengthening capital and curbing costs.

The protection of consumers of banking and financial services

The Minister for the Economy and Finance, in his capacity as Chairman of the Interministerial Committee for Credit and Savings and acting on a proposal from the Bank of Italy, recently issued the decree implementing the new provisions of the Consolidated Law on Banking concerning fees for overdrafts and overrunning.

The decree gives effect to the principles of transparency, simplification and reasonable costs for customers provided for in the law; it also clears up some interpretative doubts to which market participants had drawn attention during the public consultation.

The choices made go in the direction that I have indicated to be desirable, including in my Concluding Remarks in May: towards legislation based mainly on the promotion of competition, transparency and consumers’ awareness of their financial options. They meet the objective of allowing customers to understand the costs of the services provided, thus also helping to make competing offers comparable. Within the limits established by the law, their quantification will continue to be left to intermediaries. It is essential that charges be proportional to the costs banks bear in performing their activities and the risks they assume; in particular, the charges for making funds available must remunerate the services and risks connected with the liquidity guaranteed to the customer.

The protection of consumers of banking and financial services is one of the Bank of Italy's objectives; we pay it a high level of attention; we pursue it with a variety of instruments, including inspections at individual bank branches.

Action to promote and develop citizens' financial literacy increases their awareness when they face investment choices; we are taking a series of steps on this front too, aimed especially at the younger generations. Financial education is important, but it is even more important to seek the necessary complementarities with good regulation and supervision.

Reduction of the risks for customers also depends on the reform of the rules governing non-bank intermediaries that grant credit, financial agents and loan brokers. In recent years the Bank has paid a high and increasing level of attention to such reform. The objective is to have rules that encourage a smaller number of sound and professional operators, together with reliable and diversified channels of distribution that can also stimulate competition in the sector.

We have worked to permit the prompt application of the new rules. The usual cooperation was provided to the Ministry for the Economy and Finance for the drafting of the implementing measures within its sphere of competence; the framework for the supervisory rules to be applied to financial intermediaries is being prepared after a first round of public consultation; the necessary support has been provided for the start of operations of the Financial Agents and Loan Brokers Oversight Body, which a few days ago began to accept new registrations.

In June the Council of Ministers approved the first reading of a measure that introduces further amendments to the text of the reform and is now being examined by Parliament. As regards the rules for financial agents and credit brokers, care must be taken to avoid uncertainty about the duties and powers of supervision and interpretative and applicative difficulties for the market.

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The Italian economy needs intermediaries and financial markets that allocate the savings entrusted to them in the best possible way and at the lowest possible cost. In this period banks are being called on to make difficult decisions: to ensure viable businesses continue to be financed and to avoid prolonging support for those destined to fail. This is the essence of sound and prudent management. The timing and strength of the economic recovery also depend on the outcome of these choices.

In Italy the ratio of corporate debt to GDP is similar to the level in the other leading euro-area economies. Here bank loans to the productive sector are a larger share of the total, a difference that is only partly explained by the greater presence of small and medium-sized firms. For many businesses bank loans are the sole source of external funding, even though their size and characteristics are comparable to those of firms that in other countries raise funds directly on the capital markets. A very large portion of the risk stemming from business activities falls on banks' balance sheets, and in times of recession translates into impaired loans, bad debts and losses, with serious repercussions on the flow of new lending. The costs are high for banks and for the economy.

In the medium term there is a need to achieve greater access to the capital markets for Italian firms, through the adoption of consistent incentive policies. Starting now, banks must review the validity of their business models in relation to firms, especially large ones. Lending policies must be based on the solidity of business plans, not on relationships and connections that are irrelevant to them: forged in times of economic growth and easy funding conditions, they are no longer sustainable today.

Banks that are attentive to firms' growth prospects, and firms that in turn are more highly capitalized and more willing to access capital markets directly, are preconditions for ensuring that the Italian economy emerges from this crisis on a path to lasting recovery.