Ignazio Visco: Effective reforms needed for balanced and rapid growth of the Italian economy

Speech by Mr Ignazio Visco, Governor of the Bank of Italy, at the ASSIOM FOREX (the Financial Markets Association of Italy), Bergamo, 9 February 2013.

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Italy has not yet left behind the effects of the financial crisis and the double-dip recession that accompanied it. The renewed decline in economic activity that began in mid-2011 has wiped out the partial recovery that took place after 2009: GDP has fallen to about 7 percentage points below its pre-crisis level; in five years industrial output and gross fixed investment have fallen by almost a quarter and the number of people in work by more than half a million.

The decline in activity could come to a halt in the second half of 2013, with a return to modest growth rates and with a high margin of uncertainty. I am not going to talk about the forces which could spark the recovery, nor about the risks overshadowing this scenario. These topics are discussed in the Bank's *Economic Bulletin*, published in January.

It is crucial that the progress made in the sovereign debt market continue and increase. It followed on the ECB's announcement of the new procedures for Outright Monetary Transactions (OMTs) in the secondary markets for government securities, accompanied and made possible by an overhaul of European economic governance, the agreements on assistance to Greece, and the preparation and implementation of public finance consolidation programmes and reforms in the countries affected by financial strains.

While due attention should be paid to the need to mitigate their social and income-distribution effects, these programmes must continue. In Italy, this means an effort should be made to significantly improve firms' competitiveness by containing costs but above all by increasing productivity, including a far-reaching modernization of industry and private services and larger and better productive investments and technological innovations, in a setting of simpler rules and more efficient public services. The issue of the high level of taxation for Italy's citizens, firms and banks is also crucial. It must be tackled in a medium-term perspective, with a balanced and farsighted approach that takes account of budget constraints.

The case of Monte dei Paschi di Siena and the control of financial risks

In the past we have argued that our banking system has withstood the global financial crisis thanks to its fundamentally sound business model and limited exposure to structured financial products, within a regulatory and supervisory framework oriented to prudence. The exceptionally long and deep recession, however, has inevitably affected the quality of bank loans, while the deterioration in the creditworthiness of the sovereign issuer has increased the cost of funding and made it especially difficult for Italian banks to procure resources in the international market.

The grave developments of recent weeks at Monte dei Paschi di Siena (MPS) do not alter our assessment of the overall state of the Italian banking system. The MPS group's problems originated in an ambitious acquisition carried out on the eve of the crisis, by procedures which are now being subjected to intense and obligatory scrutiny, as well as in poor management of financial risks, whose repercussions were aggravated by the sovereign debt crisis.

Even counting the additional interventions already decided for MPS, the public support provided to banks in Italy remains very limited by comparison with other countries. Public recapitalizations in Italy have amounted to 0.3 per cent of GDP. According to the latest study of the European Commission, as of June 2012 such aid came to 1.8 per cent of GDP in

Germany, 2.0 per cent in Spain, 4.3 per cent in Belgium, 5.2 per cent in the Netherlands, and over 40 per cent in Ireland. For the Spanish banks, a programme of recapitalization using European funds of up to €100 billion was authorized in July, of which €41 billion (3.9 per cent of GDP) has already been disbursed.

Unlike many of the foreign interventions, the support extended to MPS, like that given to other, smaller Italian banks in recent years, is not the bail-out of a troubled bank. It is in the form of a loan that is eligible as regulatory capital, granted by the government at an interest rate that is particularly high and rising over time. The intervention was decided last summer in order to enable MPS to comply with the European Banking Authority's recommendation to constitute an exceptional and temporary capital buffer, well beyond the minimum capital requirement, against its large holdings of government securities. This support, provided by the government in complete compliance with the European rules on state aid, was authorized by the European Commission. The Bank of Italy's assessment of the current and prospective capital adequacy of MPS, in the opinion submitted under the law to the Ministry for the Economy and Finance, is positive.

In the course of the last two decades the balance sheets of the major banks around the world have grown more complex. Alongside the inherent difficulty of evaluating the quality of loans, there is the problem of fully understanding the effective role of the structured financial products that the banks hold for investment or hedging purposes. The importance of these products for Italian banks is limited, definitely less than for other important banking systems.

Derivatives and structured finance products can facilitate risk management for well-informed operators. The granting of fixed-rate mortgages to households is favoured by the possibility of managing the related interest-rate risk; the internationalization of firms depends crucially on the possibility of hedging foreign exchange risk; and the provision of retirement saving products at low cost over very long time horizons benefits from the ability to mitigate the impact of fluctuations in securities prices.

However, the high leverage and complexity typical of these instruments means that they can also be used to take high-risk, speculative positions; in addition, they can be used to mask the economic impact of previous transactions, exploiting the ample scope for interpretation allowed by accounting standards. Internationally, some banks have misused these instruments in recent years, in part in response to the drying-up of the sources of income from traditional credit business. These are the circumstances most likely to trigger fraudulent conduct designed to conceal from the market and from supervisors the real object of the derivative transactions.

On the occasion of the recent parliamentary testimony of the Minister for the Economy and Finance, we furnished him with a detailed account of the case of MPS and our own supervisory actions. The document is available on our website. The rules, the procedures, the methods and the timing of our supervisory interventions are strictly and formally predetermined at every stage, in order to guarantee uniform application. They depend on the constraints of the law governing administrative procedures. The Bank of Italy is strongly committed to making its actions ever more effective and timely; we carefully consider all suggestions; we are open to a constructive dialogue.

MPS resorted to complex financial transactions in part as a consequence of losses on previous financial investments. The transactions were presented, even to the Bank of Italy, as funding instruments and hedges against positions in government securities held as long-term investment. The correction of their accounting representation will produce a substantial negative effect on net worth as of the end of 2012. But the impact is not such as to compromise the bank's overall capital adequacy. We took account of this in the opinion submitted to the Ministry for the Economy and Finance.

These transactions gave rise to serious liquidity risks for MPS. We identified these risks in the course of 2010 and imposed a significant capital increase and a strengthening of the internal control and risk management system. We subsequently intensified our control activity, up to the decisive inspection begun in September 2011 and the consequent request in November of that year for a sharp change in the bank's management. Our intervention has made it possible, in an environment of increasingly severe financial tensions, to preserve the bank's stability by strengthening its capital base and beginning to bring the precarious liquidity situation back to normal. The transactions deemed to be illegitimate have been brought to the attention of the competent judicial authorities, with which the Bank of Italy's Supervision Area and the Financial Intelligence Unit, for the matters within their respective powers, are cooperating fully.

With the crisis, the need for strict regulation of the derivatives market has come to the fore. The initiatives promoted by the Financial Stability Board at the behest of the G-20 go in the right direction, increasing the market's transparency through contract standardization, the requirement to trade on regulated markets, settlement through central counterparties, and the reporting of the terms and conditions of transactions to trade repositories. The aim is ambitious. Progress has been made, but it is necessary to pick up the pace, overcoming the difficulties of implementation, particularly for cross-border transactions, and the industry's resistance.

A timely reflection is under way at international level on the organizational structure of banks, on the need to separate traditional credit business from activity in the financial field. The reports of the Vickers Commission in the United Kingdom and the Liikanen Group for the European Commission trace out possible lines of intervention. With stringent rules for supervised institutions, it will be necessary to keep risks from migrating to the shadow banking system – the ensemble of intermediaries, products and markets that slip through the regulatory net. Let us not forget that the financial crisis originated in the US securitization market, largely populated by unregulated or scantily regulated operators.

But the correct conduct of credit and financial business requires competence and good faith on the part of intermediaries, both factors being decisive to ensure sound and prudent management and preserve the confidence of savers. This necessity is heightened by the complexity of the external environment, by the presence of large intermediaries, and by the economic and reputational damage that can result from illicit behaviour. No market can function without rules, nor is prudent management possible without correct conduct, embodied not only in scrupulous compliance with the law and the supervisory rules but also in complete adherence to business ethics.

In its supervisory action, the Bank of Italy has for some time intensified its discussions with banks' directors and senior managers, reminding them of their responsibilities. We have imposed rules to ensure that boards are functional and suitably composed and that appointment procedures are transparent. However, the integrity and experience requirements are laid down by rigid legislative provisions: disqualification can be imposed only for failure to satisfy expressly listed criteria; when a bank is not in a crisis situation, the Bank of Italy may ask the shareholders to renew the governing bodies, but it cannot dictate their decisions, nor can it directly remove a member of the board.

The legislative framework needs to be strengthened. The supervisory authority must be able to make a thorough assessment of the fitness of directors and senior managers, in accordance with standards of transparent and impartial administrative action. It must be able to intervene effectively in cases where, on the basis of solid evidence, it considers that it must object to the appointment of directors and senior managers or remove them from office.

Good finance contributes to the working of the economy, to efficient allocation of risk, to removing liquidity constraints that can impede innovation and growth. Opportunistic behaviour must not be allowed to make finance an object of distrust. The role played by a robust and rigorous system of internal controls in banks is essential to avoid excessive risk-taking, especially when a bank operates in highly complex and innovative business segments.

In the case of improper conduct, the truth must be sought unstintingly. Reports and suppositions must be checked scrupulously; if they are not properly verified, hypotheses and opinions which may be unfounded and rash can cause severe harm to savers, institutions and society as a whole. Saving is protected by the Constitution, Italian law and European legislation. We are well aware of this and act with all our powers in support of that protection.

Italian banks

There are other, more general problems of concern to public opinion or recurrent in discussions with economic operators and international organizations.

A first important question is why credit to the economy has continued to contract, in Italy as in other euro-area countries, notwithstanding the exceptional measures adopted by the Governing Council of the ECB to support bank liquidity. Other questions centre on the quality of loans, the reliability of international comparisons and the credit assessments we require banks to make, at times considered overly stringent and such as to curb the financing of the economy. Another important issue is the profitability of banks, in light of the current economic and financial situation.

Liquidity and credit to the economy

The measures adopted by the ECB from late 2011 onwards – the two three-year refinancing operations (LTROs), the expansion of the range of assets eligible as collateral for refinancing with the central bank and, most recently, the announcement of Outright Monetary Transactions (OMTs) – kept the banks' fund-raising difficulties in the markets from triggering a disorderly contraction of balance sheets and jeopardizing the functioning of the monetary policy transmission mechanism in the euro area. For Italian banks, whose ratio of lending to the more stable forms of funding approaches 120 per cent, these measures provided the means to cope with the decline in international interbank funding that began in mid-2011 and to redeem their maturing bonds.

In 2012 residents' deposits and bank bonds held by households expanded by €58 billion. Wholesale funding, instead, recorded a further contraction, equal to €76 billion, offset in part by net recourse to Eurosystem refinancing of €66 billion. In recent months the improvement in market conditions following the announcement of OMTs enabled the major Italian banks to resume bond issues, including of unsecured bonds.

The amount of wholesale bonds maturing by the end of 2014, when the three-year LTROs expire, exceeds €110 billion. In part to address the need to constitute a liquidity reserve, in the course of 2012 banks increased their holdings of government securities by around €100 billion (of which one third with residual maturity of less than one year).

Bank lending to the non-financial private sector diminished by €38 billion overall in 2012. The contraction was chiefly in loans to firms. Lending activity has been conditioned by the recession. If, on one level, the decline in output and investment was reflected in a fall in demand, on another the high volume of non-performing loans increased the risks for intermediaries.

Without the longer-term refinancing measures decided by the ECB, the contraction in credit would have been devastating. The results of the quarterly Bank Lending Survey, also confirmed by surveys of firms, indicate that with respect to the extraordinary tightening recorded at the end of 2011 the terms of lending have improved significantly, but have still not normalized. Supply continues to be braked by high credit risk, above all in relation to the weakening of firms' balance sheets. Partly for this reason, although the cost of credit for firms and households has declined from the levels reached at the end of 2011, it remains higher than the euro-area average; another factor is the persistent gap in the cost of funding.

From the onset of the crisis a series of important measures were taken to support credit to firms, especially smaller ones. The Central Guarantee Fund for SMEs, which was increased during the crisis, was guaranteeing almost €14 billion in loans at the end of 2012. The two moratoria agreed by the Government, the Italian Banking Association, and employers' associations involved the suspension of repayments amounting to almost €17 billion. Cassa Depositi e Prestiti made €18 billion available to banks for lending to SMEs. The resources involved are considerable. These measures have enabled a large number of firms to access credit. Any future reinforcement must aim to support the most dynamic and innovative firms, those best placed to contribute to the economic recovery.

Credit quality, supervision and capital

A growing number of firms are having difficulty repaying their loans: in the third quarter of 2012 the ratio of new bad debts to the stock of outstanding loans was 2.2 per cent for bank customers as a whole, while for firms it was 3.3 per cent. In November the share of loans to firms in temporary difficulty (substandard and restructured loans) again increased. By contrast, the deterioration in loans to households has been small, thanks to the limited amount of household debt and the low level of short-term interest rates.

Statistics examined at international level suggesting that the ratio of impaired loans to total assets is higher for Italian banks than for those of the other leading countries have raised questions about the adequacy of the amounts in banks' balance sheets to cover these risks. International comparisons of credit quality and the adequacy of write-downs nevertheless suffer from the lack of a uniform definition of impaired loans.

For Italian banks the definition of impaired loans – in conformity with rigorous prudential rules – is broad. It includes assets, such as restructured loans, that continue to generate cash flows. Moreover, the incorporation of the reclassifications requested during the inspections that the Bank of Italy carries out periodically results in the prompt emergence of impaired loans, and the stock of them is kept large by the slowness of recovery procedures. It should also be noted that in the last few years the proportion of impaired loans backed by guarantees has risen for Italian banks.

In the meetings with the International Monetary Fund, which is currently performing its periodic assessment of the stability of the Italian financial system, we stressed the need to bear these aspects in mind when attempting to draw policy implications from international comparisons.

Another question that is sometimes raised is whether the loan assessments that we require banks to make are not excessively cautious and therefore likely to slow the financing of the economy. Here again it is necessary to be clear. The prudence we require in the assessment of loans helps to safeguard the integrity of banks' capital and contributes to increasing the market's confidence in them. Analysts and investors want the amounts stated in balance sheets to reflect the actual quality of banks' assets and provide reliable indications of the risks involved. Prudent provisioning policies encourage the disposal of impaired items. It also needs to be recognized that such policies are likely to be hindered by a harsh tax treatment, which should be gradually removed.

In periods of market tension, the intensity of supervision cannot be relaxed until the economic recovery produces its effects on banks' accounts. Tolerance towards situations of persistent support to borrowers with a precarious financial condition and no prospect of growth would not only risk undermining the soundness of the banks but also hinder the efficient allocation of resources to the economy.

The inspections we perform make it possible to assess the situation of each intermediary on a case-by-case basis. We pay due attention to the risk of generating procyclical effects. To this end, above all we ask banks that need to strengthen their capital bases to free resources by reducing their costs, selling non-strategic assets and retaining earnings in the business. Beyond the short term the prudent assessment of assets is beneficial to the financing of customers, especially if coupled with action by the banks to increase their ability to resist and react to external shocks. Efficient production processes and attention to strategic sectors contribute to the growth of credit business and in this way to the support of the economy.

In recent years Italian banks have increased their capital resources considerably, especially core tier 1 capital. Since 2007 the core tier 1 ratio of the banking system has risen from 7.1 to 10.4 per cent. For the five largest banking groups, which have raised €17 billion on the equity market since 2011, the average core tier 1 capital ratio has risen from 5.7 to 10.8 per cent; the ratio stands at 8.8 per cent for the other banking groups and at 13.8 per cent for the smaller banks, mostly mutual banks. The capital of the smaller banks is generally adequate. Some large and medium-sized groups must make further progress in strengthening their own funds.

Capital strengthening will permit compliance with the Basel 3 rules and achievement of the objectives that will be set for the assessment of banks' overall risk profiles. It makes it possible to limit the degree of leverage without reducing credit support to the real economy. Capital strengthening is in the interest of shareholders: the resulting decrease in risk lays the foundation for reducing the cost of capital and, looking ahead, raises the return on the resources invested. A low exposure to financial risks also helps to curb the cost of funding.

In 2012 the capital gains on government securities purchased at prices far below those consistent with the fundamentals of the Italian economy cushioned the impact of the macroeconomic deterioration on banks' income statements. Any dividends paid must not draw on banks' capital reserves; they must be compatible with capital targets communicated to banks at the end of the annual supervisory and review process.

Banks' profitability

Given the persistently unfavourable economic and financial situation, it has been contended that banks' profits are high, especially compared with those of firms. So the banks, the argument runs, should be called on to expand the supply and lower the cost of credit, to reduce their fees, and to offer an array of services free of charge.

Actually, two recessions in the span of three years, undermining the quality of banks' assets, have generated loan losses that seriously erode profitability. The sovereign debt crisis has made funding in the wholesale markets harder and more costly, further reducing the profitability of traditional credit activity. The profitability of the major banking groups is low. In the first nine months of 2012 their return on equity, annualized and net of extraordinary goodwill impairments, was just above 3 per cent.

The modest growth in the volume of business and the incidence of loan losses will continue to compress banks' earnings until the economic recovery takes hold. The uncertainty over economic and financial market developments will continue to weigh on the speed and the extent of the rebuilding of profit margins, which are in any event bound to remain below their unsustainable pre-crisis levels.

The entrepreneurial nature of banks has been axiomatic for many years now, and capital cannot be raised in the absence of expectations of sustainable rates of return; the drive for profit is legitimate, it serves growth. However, earnings must derive not only from operating efficiency but also from offering products that correspond to customers' real needs, not costly, needlessly complicated and risky services.

In the first nine months of 2012 banks' staff costs diminished by about 2.5 per cent compared with the year-earlier period. The containment of operating expenses must proceed resolutely. The banks must enhance the quality of human capital, which is essential to the assessment of creditworthiness and risk management.

The variable portion of the compensation of risk takers must be reduced in line with banks' earnings. Specifically, loss-making banks must not pay bonuses. Bonuses must reward the achievement of stable earnings, not simply the fruit of extraordinary operations. Only the structural components of income can serve as the standard for the determination of bonuses and, in the arrangements that so provide, for their restitution.

Executives' severance packages too must be clearly and effectively bound to the results attained. They must reflect proper evaluation of the manager's performance. And compensation must be deferred long enough to validate the true quality of management. If banks do not conform spontaneously to these principles, rules and controls will have to be made more stringent.

The spread of information and communication technology has affected the behaviour of customers, heightened competition and opened up new opportunities to streamline and digitize business processes. These trends require a revision of distribution channels that will be all the more important going forward. Maintaining a local presence is essential, but it has to be combined with the rationalization and upgrading of the branch network. The simplification of company and group structures remains a priority.

In the problematic context in which these actions must be undertaken, the materialization of the savings expected requires significant improvement in the ability to actually carry them out. Concretely feasible solutions have to be designed long enough in advance, just as the investments necessary for their implementation need to be programmed.

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These are still difficult times for the Italian economy. The long financial crisis has taken a heavy toll on the markets and the institutions. It has put monetary union itself to a severe test.

The banks are suffering the heavy consequences of the double-dip recession and the sovereign debt crisis. They have met with serious funding difficulties, coped with the need for capital strengthening, and suffered a sharp drop in profitability. Their initial, underlying soundness, also a reflection of supervisory action, has enabled them to withstand the shock.

However, overcoming the crisis once and for all will necessitate a further, protracted effort. I have described the steps that are ineluctable, on which intermediaries must take action without delay. In addition, with the farsightedness demanded of all parties, the problem of the quality of ownership structure and governance must be addressed, bearing in mind the interest of the real economy and the stability of the banks themselves.

The decisions of the ECB Governing Council, aimed at safeguarding the effective transmission of monetary policy within the euro area, have preserved the liquidity of the banking system, contained the financial market distortions caused by the sovereign debt crisis, and countered fears for the solidity of monetary union. We evaluate the correspondence between monetary conditions and economic outlook with the greatest care.

Monetary policy can do much, but by itself it cannot get us out of the crisis. Investors' fears have abated since the tension was at its height, but they have certainly not vanished. The quality of national economic policies and the completion of the reform of European economic governance – moving towards full monetary, banking and fiscal union and, further down the road, political union as well – will be decisive.

Italy must not lower its guard. The international investors continue, rightly, to concentrate their attention on our ability to keep the public finances in balance and energetically pursue the goal of increasing potential growth. The recurrent tensions are a reminder of how fragile the situation remains. The yield spread between Italian and German government securities is still wider than is consistent with the fundamentals and potential of our economy. Its further reduction could facilitate banks' funding and the revival of lending to the economy on more advantageous terms.

The return to balanced and rapid growth of our economy must be pursued even more resolutely. Keeping the public finances in balance is a prerequisite to this, not an impediment. Only the full implementation of comprehensive and systematic reform, certainly a challenging task, can ensure the necessary gains in competitiveness and thereby favour the expansion of employment. The cornerstones of the reform have been identified: we must invest in knowledge, provide higher-quality public and private services, fight illegality and promote competition. We have barely embarked on this course; we must continue with conviction, aware of the responsibilities of each but confident in the possibilities of all.