

Ignazio Visco: Overview of Italy's economy and banking system

Address by Mr Ignazio Visco, Governor of the Bank of Italy, at the Annual Meeting of the Italian Banking Association, Rome, 10 July 2013.

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The economic climate and outlook

In the first half of 2013 Italy's GDP again diminished, largely owing to the fall in domestic demand; exports also declined. Our forecasts, which will be published in the *Economic Bulletin* in a week's time, put the contraction of GDP this year at close to two per cent. Economic activity is expected to begin to expand at a moderate pace from the end of the year, with overall growth of more than half a percentage point in 2014. In the short term, domestic demand will have to be buoyed by the timely payment of general government commercial debts.

The level of uncertainty is high. The timing and strength of the recovery are subject to the risk of a slowdown in the global economy, in particular in the emerging economies, together with the risks inherent in financial market developments. Italy's large public debt and weak growth prospects, as well as the uncertainties over European governance, make risk premiums on government securities highly sensitive to swings in market confidence, as has been shown recently by the wide fluctuations in interest rate spreads relative to German Bunds. A deterioration would further narrow the scope for fiscal policy measures and would have repercussions on banks' funding and hence on the availability and cost of credit to firms and households.

We cannot risk losing investors' confidence, which is fragile and exposed to the changeable evaluations of analysts. Budgetary policies must continue to be responsible; the reforms already decided and those still to be implemented should be set within a comprehensive design and the aims clearly defined.

Monetary policy will sustain the recovery. On 4 July the ECB Governing Council announced that monetary conditions would continue to be accommodative for as long as necessary. It adopted innovative communication procedures, specifying that it expects official rates to be kept at or below their current levels for an extended period of time given the subdued outlook for inflation, the weakness of economic activity and modest monetary growth in the euro area.

The Italian banking system has been under severe strain from the financial crisis, the double-dip recession and sovereign debt tensions. The banks' income-producing capacity has been reduced; in the absence of an adequate response it would be further undermined by the persistence of the crisis or the occurrence of new adverse shocks.

Credit

The contraction of lending to firms intensified in the first half of this year, to an annual pace of over 5 per cent in the three months ending in May. The decline in lending to households was less severe, amounting to 1.6 per cent. The average interest rate on new business and house purchase loans remained the same as at the start of the year, at just over 3.5 per cent. The spread over the euro-area average did not change significantly, hovering around three quarters of a percentage point.

The cyclical downswing is squeezing credit demand. It is aggravating debtors' repayment difficulties: in the first quarter the new bad debt ratio for business loans was around 4.5 per cent, which was high in historical terms; other impaired loans are also increasing sharply.

Heightened risk is weighing on banks' credit supply policies, discouraging lending and driving up interest rates. This can be seen in the surveys conducted with banks and firms alike. The

strains will continue over the next few months; past experience indicates that the deterioration in loan quality tends to continue beyond the start of a cyclical upturn.

Above all, the difficulties affect small firms, which have less opportunity to access the capital markets. The Government's recent changes to the workings of the Guarantee Fund for small and medium-sized enterprises are a step in the right direction. The implementing provisions should allow firms with good growth prospects to apply to the Fund, even in the face of a temporary recession-induced deterioration in their accounts. The guarantees should be made conditional on the effective granting of loans, with more favourable terms provided for banks showing better overall credit growth. The availability of guarantees must translate into an actual improvement in credit terms, enabling firms themselves to apply directly to the Fund.

On 1 July the Italian Banking Association and the country's trade associations signed a new agreement allowing firms in difficulty to obtain a temporary suspension of repayments of medium- and long-term loans and an extension of loan maturities, and to be granted new loans if they increase their capital. The Bank of Italy will make sure that the moratorium provides support for deserving firms without concealing the actual riskiness of the loans. Past experience in this regard has been positive.

Italian banks must guard themselves against the risk of a worsening of their funding conditions. The supply of assets eligible for use in Eurosystem refinancing operations is now very substantial thanks in part to a large volume of public guarantees on bank bonds, which will mature in the next few years, however. Going forward, the supply must be maintained by increasing the share of eligible assets, among other things by adding new types. Great care must be taken to ensure that loan granting procedures meet the requirements for Eurosystem refinancing. In the coming weeks we will call on the banks for an examination of the steps to be taken.

In several cases Italian banks not only provide finance, they also participate directly in the capital of firms. This can lead to a more accurate assessment of a firm's growth prospects and a better evaluation of its financial needs. However, a participating interest can sometimes distort lending decisions; as the size of shareholdings and loans increases, there is the risk of collusion or of actions designed to delay the surfacing of difficulties.

The banks' governing bodies must properly safeguard against these risks: to maintain loan quality and keep banking profitable, in the banks' own interest; to protect the value of the savings entrusted to them, in the interest of their customers; and above all to ensure the efficient allocation of savings and boost the competitiveness of the productive economy.

In January the legislation on related-party transactions came into force. It aims to protect banks from potential conflicts of interest with closely connected parties; it provides a necessary counterweight to the European rules easing the restrictions on the links between banks and industry. The limits on exposure to each related party are calculated in relation both to the amount of credit granted and to the size of the bank's shareholding in the company. The decision-making process on these matters must be transparent and correct and the outcome suitably motivated.

The banks must be scrupulous in applying the new rules. The Bank of Italy will evaluate the effectiveness of the measures they adopt; when necessary, it will intervene, possibly by setting stricter limits and conditions for related-party transactions.

The difficulties besetting the credit system highlight once again firms' overdependence on bank lending. By international standards Italian firms are undercapitalized, make very limited use of the capital market, and tend to limit scrutiny by investors.

The credit market tensions will persist in the months to come. Bank loans cannot be the sole source of external finance, as they are at present for most firms. The financing of investment must also tap new resources as well. It is in the banks' interest to encourage this process by

seeking to maintain a balance between loans and deposits, sharing the risks of financing customers with the markets, and carefully avoiding potential conflicts of interest.

Above all, it is necessary for firms to increase their equity. The tax deductibility of new equity capital invested in a company, which was introduced in 2011 under the rules on the Allowance for Corporate Equity (ACE), could be increased, in order to eliminate the remaining tax advantage of debt. The financial soundness of firms and their ability to finance medium- and long-term investments would benefit significantly.

Asset quality and capital

International analysts' fears about the soundness of Italian banks' balance sheets should not be underestimated, even though they are not always well justified. The policies undertaken to curb costs, improve risk management and strengthen banks' capital base must continue. Our ongoing intervention concerning the adequacy of provisioning for non-performing loans aims to ensure a satisfactory level of risk coverage; it will enable the banks to preserve investor confidence and attract low-cost external financing. It is essential in order to guarantee a satisfactory flow of credit to households and firms.

The stock of impaired assets, which reached 14 per cent of total loans in March, remains high in part owing to the slowness of credit recovery procedures. Another factor is the exceptionally long time it takes for loan write-downs to become tax deductible. By international standards, the representation of loan quality on balance sheets reflects a prudent definition of impaired assets.

In the mid-1990s, when the ratio of bad debts to loans was higher than it is now, the reduction in the stock of impaired loans was favoured by the development of a market in these assets, with the participation of foreign investors. Initiatives of this sort could be successful today, provided that transparency is guaranteed and that the mechanisms of risk transfer from banks to investors are fully consistent with prudential rules and accounting standards, permitting the definitive cancellation from banks' balance sheets of the impaired assets transferred.

Over the last few difficult years the Italian banking system has strengthened its capital base considerably. Banks' ability to withstand adverse shocks has improved. The increase in high-quality capital needed to satisfy the capital adequacy requirements envisaged by the Basel III rules that will be phased in by 2019, which was €35 billion at the end of 2010, dropped below €9 billion last December; already today most of the largest intermediaries would meet the new prudential requirements.

Still, capital strengthening must continue. While this may automatically reduce the return on capital, at the same time it favours its stability. By increasing banks' ability to withstand adverse shocks it boosts investor confidence and lowers the cost of external funding.

Exposure to the public sector has increased significantly since the beginning of 2012. Contributory factors included the high risk of loans, the objective of expanding the supply of collateral eligible for refinancing operations with the central bank, and the high yields on government securities. Widespread among banks, these purchases were concentrated in securities with an original maturity of three years or less and were mostly recorded in the banking book. Economic recovery and a return to normal conditions in the credit market will enable fund allocation policies to return to what they were before the crisis and permit an expansion of lending to households and firms.

Banks' stability is also founded on appropriate risk management and control systems: organizational shortcomings prevent the correct allocation of capital, encourage the unwitting assumption of risks, render the institution vulnerable to violations of internal norms and procedures, and expose intermediaries to potentially severe reputational damage.

In recent days the Bank of Italy has issued new supervisory provisions on banks' internal control systems. The new rules require that governing bodies be fully involved in the design of risk management and control systems, the determination of "tolerated risk" and the approval of key decisions, such as offering new products, undertaking new business or entering new markets. They also underscore the need to ensure the independence and authority of the control functions. The banks will be granted sufficient time to adapt and must inform the supervisory authorities of the measures they intend to adopt.

Profitability and governance

The events of recent years have depressed banks' profitability and their ability to generate the resources needed to increase capital and thereby support the financing of the economy.

In the banking industry, which is labour-intensive, wage levels and dynamics must be made fully consistent with the objective of preserving banks' stability. Careful consideration must be given to measures, possibly temporary, aimed at significantly reducing staff costs in relation to revenues. There must be full awareness of the constraints stemming from the difficulties that the banking system currently faces, a change of pace to deal with contingent difficulties for intermediaries, including with a view to safeguarding employment. The effort to adapt productive factors and distribution channels to the opportunities offered by new technology must be stepped up.

In recent years banks have become aware of the importance of corporate governance. Ahead of global regulatory developments, the Bank of Italy has issued rules on governance and stiffened them over time. It has urged the adoption of best practices and intervened repeatedly with corrective actions.

Progress in this direction must continue. A number of unresolved problems remain to be tackled. I addressed two – the role of the banking foundations and the governance of cooperative banks – in my concluding remarks last May. Here I would like to offer some further considerations.

In most cases the presence of the foundations among banks' shareholders has fostered stability. During the crisis, in the absence of other large investors, some of them underwrote very substantial capital increases.

At this point foundations should be encouraged to diversify their investment portfolios, so as to loosen their sometimes excessive dependence on the performance of their reference bank and prevent interference in banks' governance and business choices. This would be conducive to the inclusion of new investors in the banks' shareholder base.

Analyses of banks' bylaws, shareholder pacts and shareholders' behaviour at general meetings have shown that some foundations tend to interpret shareholders' prerogatives very extensively indeed. This has produced excesses, at times impeding the necessary turnover within the governing bodies and causing directors to be chosen according to criteria other than professional qualifications.

Episodes of this sort have an adverse effect on banks' performance, limiting their ability to finance the economy. Measures to prevent their recurrence must be taken as soon as possible.

The Charter adopted by the association of savings banks and foundations in 2012 calls for transparency in the criteria and procedures for appointing the members of foundations' decision-making bodies. It establishes waiting periods and incompatibility conditions with respect to previously held political positions. It sets experience and independence requirements for the top officers of foundations and also of the banks in which they hold stakes. These indications must be made fully effective. They must also be strengthened by prohibiting passage from top positions in foundations to those in banks.

The ban on controlling stakes to which the largest foundations are subject must be fully observed, if necessary by redefining control in such a way as to cover its exercise on a de facto basis or jointly with other shareholders. Adequate measures for enforcement of the ban must be instituted. Incompatibility with other positions and stricter requirements for bank directors also need to be provided for.

The imminent application of the fourth revision of the capital adequacy directive offers the occasion for reinforcing the standards of experience, independence and reputation for banks' corporate officers and enabling the supervisory authorities to intervene, when the situation so requires, including by removal from office. The application of the rules on transactions with related parties, which I mentioned earlier, will also help to guarantee the independence of the banks against undue interference and influence.

The cooperative banks, in recent years, have experienced a healthy process of membership renewal. The increase in widespread share ownership and the greater presence of institutional investors have strengthened their capital. These changes now require a review of the cooperatives' governance arrangements, which were originally conceived for small, local banks and are not suited to today's large institutions with a substantial national presence and a broad membership base or stock exchange listing.

For the largest of these banks the rigid application of some of the rules typical of cooperatives – one person one vote, share ownership ceilings, approval clauses for new members – may have negative effects on the quality of governance and the capacity for capital strengthening. In the absence of adequate counterweights, a fragmented and dispersed shareholder base is likely to result in low attendance at meetings and a lack of incentive to monitor the performance of the directors.

Within our powers, we have intervened in respect of cooperative banks' bylaws to encourage an increase in the number of proxies that may be conferred on a member, to limit the fragmentation of holdings and to remove the obstacles to institutional investors' presentation of candidates when governing bodies are renewed. Important as they may be, however, these actions cannot resolve the structural governance problems of the cooperative banks, especially the largest ones.

It is necessary to embark on a course of gradual but incisive reform. Considering, among other things, the prospect of banking union and the changeover to a single supervisory mechanism, the more noticeable and unjustified are the differences vis-à-vis the other large banks, the more sudden could be the call for change.

The revision of governance structures can be pursued in two directions. First, shareholders' control of management's activity must be enhanced and the injection of capital by new members encouraged. The transparency and effectiveness of management must be ensured by increasing shareholders' awareness of risk-taking, by combating potential conflicts of interest. Expectations of sure profits and, for unlisted cooperative banks, of easy disposal of shares must not be engendered. Institutional investors, whose presence confers stability thanks to their long investment horizon, must be given adequate representation in the bodies charged with supervisory functions. Sound and prudent management demands that the presence of current and former employees in the shareholding structure should not influence management policies and decisions.

Second, there should be no hesitation to change the bank's legal form. International authorities and investors concur that the limited share company is the model most consistent with the characteristics of large banks, encouraging contributions of capital and fostering transparency of ownership structures and governance. The larger cooperative banks must open up to this transformation, easing the way by setting realistically achievable quorums for their general meetings.

The revision of governance is essential to ensuring informed risk management, a correct allocation of credit to the economy and an efficacious management of conflicts of interest. By

removing the obstacles to capital strengthening, it will reassure investors as to the banks' ability to cope with the difficult macroeconomic context and growing competition.

The banking union

The work to create a single supervisor in the euro-area, consisting of the ECB and the national authorities is proceeding expeditiously. Starting out from the national authorities' store of technical knowledge, the new institution will have to ensure a supranational vision based on best practices in supervisory methodologies, modelling and assessment of banking risks. The transition to the single supervisory mechanism will give stability to the euro area, helping to counter the trend towards the segmentation of the financial markets along national lines, which we have seen during the crisis. It will facilitate comparisons between the banks and systems of the different countries.

On 20 June the Eurogroup reached an agreement on the possibility of using the resources of the European Stability Mechanism (ESM) to recapitalize banks directly under certain stringent conditions for a maximum of up to €60 billion. This will be conditional on the launch of the single supervisory mechanism, which in turn will have to be preceded by a balance sheet assessment of the banks subject to centralized supervision at European level and, in particular, by an asset quality review.

In the following days the Ecofin Council reached a general agreement on the rules for the recovery and resolution of banks in crisis. The procedures whereby creditors are to share the costs of a banking crisis were decided, with entry into force scheduled for 2018. These so-called bail-in mechanisms are consistent with the recommendations of the Financial Stability Board aimed at curbing opportunistic behaviour and limiting the costs of bank crises for taxpayers.

The agreement specified the bank liabilities covered by a creditor bail-in and the order in which they will be called on to participate. At national level, a minimum share of liabilities able to ensure sufficient loss-absorbing capacity will be established for each bank. In addition, it was decided to set up national resolution funds financed by the banks themselves; within ten years these funds must have an endowment equal to 0.8 per cent of the deposits covered by the respective deposit guarantee schemes. Only if a number of conditions are met and if there are severe risks for the system's financial stability may public funds also be used.

Recourse to the resolution fund – allowed when the bail-in process makes available resources equal to at least 8 per cent of the bank's liabilities – enables account to be taken of national specificities, such as the widespread use of retail bond funding in Italy. The work to establish the fund must proceed rapidly, with appropriate negotiations with national and Community authorities. The transition phase must be completed well before the time limit of ten years indicated in the agreement, while assessing the scope for synergies with the entities already in place. When the fund is fully operational, the availability of adequate resources will allow the cost of crises to be divided between the bank's creditors and the banking system as a whole, with advantages for the cost of banks' funding.

The agreements reached are an important step towards banking union but they do not break the vicious circle between the conditions of sovereigns and banks or eliminate the fragmentation of financial markets along national lines.

A European resolution mechanism must be created as soon as possible, based on a single resolution authority and pooled resources, able to cope with systemic crises and prevent contagion. The possibility of using ESM funds to recapitalize banks directly has in practice been postponed for many months, since it depends on the entry into operation of the single European supervisor. There remains the possibility of using such funds indirectly, by means of ESM loans to member states, but recapitalizing banks in this way bears on the public debt of the countries concerned.

The asset quality review of euro-area banks that will be carried out in the coming months will make heavy demands on the participating countries' supervisory authorities. It will have to be based on common rules and methodologies and valuation methods that are uniform across countries. We are confident of the outcome of this exercise, aimed at eliminating doubts about banks' solidity. In Italy analyses of this kind are routinely part of both on- and off-site supervision. The inspections carried out recently at twenty intermediaries made it possible to assess the adequacy of their loan loss provisions and to request corrective action where necessary. The same action is now being taken at other intermediaries. The methods used provide an example of how such analyses can be conducted.

Any capital shortfall that emerges for some European intermediaries will be met in the first place with private-sector resources. Prompted by supervisory authorities, banks will have to take appropriate action to meet their needs, such as restricting the distribution of dividends or disposing of non-strategic assets. The definition of an adequate financial back-stop, to be established ex ante, will be necessary to prevent deleveraging.

The asset quality review will be followed, in 2014, by stress tests conducted by the European Banking Authority and the ECB to assess banks' ability to withstand low-probability extreme shocks. The similar exercises performed by the IMF under its Financial Sector Assessment Program (FSAP) show that, all told, the capital of the Italian banking system is well above the regulatory minimum and meets the capital requirements established for the Basel III phase-in period. However, given the low level of profits, in extreme circumstances capital buffers could be rapidly depleted. These results confirm the need to carry on the process of capital strengthening.

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The Italian economy remains in a difficult transition phase. To pass through it successfully requires a universal effort. The banking system must play its part. There cannot be a lasting recovery in the absence of sufficient financial support for firms.

To counter the effects of the recession on their accounts, banks must press ahead with measures to improve their profitability and strengthen their capital. To ensure an adequate flow of funds to the real economy, they must take account of their clients' growth prospects. Intermediaries must be fully aware of the positive effects of this on the Italian economy and of the advantages for themselves.