Ignazio Visco: Italian banks and single European supervision

Speech by Mr Ignazio Visco, Governor of the Bank of Italy, at the presentation of the Rosselli Foundation's 18th Report on the Italian Financial System, Rome, 7 October 2013.

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Six years of financial crisis, first global and then of sovereign debts in the euro area, and two recessions have dealt a severe blow to the euro area and Italian economies. In 2012, GDP in the euro area was still 1.3 per cent less than in 2007. In Italy, where the recession has been more protracted and deeper than in the bulk of the other member countries, it was almost 7 per cent lower. In the first half of 2013 Italy's output continued to decline, albeit at a slower pace, thanks above all to the stimulus provided by exports. The latest indicators point to a gradual recovery, but much uncertainty remains. Any residual doubts must be dispelled as regards our ability to continue down the arduous path of reform begun in the last two years, to return to stable growth, and to guarantee balanced public accounts.

The widening of yield spreads between government bonds in the euro area, the most obvious sign of the sovereign debt crisis, reflects two factors: one national and one European. These are, respectively, the weaknesses of countries' economies and public finances (sustainability risk) and the incompleteness of the European construction and the attendant fears of a break-up of the monetary union (redenomination risk).

The tensions have been tackled on these two fronts. On the one hand, countries in difficulty have pledged to adopt prudent budgetary policies and structural reforms to support competitiveness. On the other, a far-reaching reform of EU economic governance has been undertaken which, while taking shape in emergency conditions along lines that were not always clear and consistent, has nevertheless made significant progress. The strengthening of the budgetary rules, above all as regards prevention, and the extension of multilateral supervision to macroeconomic imbalances have accompanied the establishment of mechanisms for managing sovereign debt crises and paved the way for launching the banking union, resuming discussions on the budgetary union and, in the future, planning a political one.

The exceptional measures adopted by the Governing Council of the ECB prevented this strategy, whose implementation will necessarily take a long time, from being compromised by the malfunctions and distortions which in the meantime have continued to affect financial and credit markets, hindering the correct transmission of monetary policy. The three-year refinancing operations approved at the end of 2011 were especially decisive, as was the announcement in the summer of 2012 of new methods of intervention on the secondary market for government securities, Outright Monetary Transactions (OMTs).

Thanks to the measures taken both at national and European level, financial conditions in the euro area today are much less strained than they were at the end of 2011, when the yield spread between ten-year BTPs and the equivalent German Bunds had reached 550 basis points, or even with respect to the summer of 2012, when that same differential, after previously narrowing, had regained similarly high levels. However, a full return to normality is still a long way off. Although the segmentation of financial markets along national borders has eased, it remains marked. To restore lasting financial stability and more favourable funding conditions in the countries most exposed to the tensions, it is vital to break the vicious circle between the conditions of sovereign issuers and those of banks. Resolute progress must be made on the completion of the European Union as set out in the reports presented last year by the European Commission and the President of the European Council (jointly with the Presidents of the European Commission, the Eurogroup and the ECB).

The Banking Union

Banking Union is a crucial milestone. It has three components: a single supervisory mechanism, a single crisis resolution mechanism and, with a view to budgetary union, a single deposit insurance scheme. Priority has been given to the construction of the first component, the Single Supervisory Mechanism, comprising the ECB and the national supervisory authorities. Its launch is scheduled for autumn 2014, one year after the entry into force of the regulation already approved by the European Parliament on 12 September and now before the EU Council.

This is a far-reaching institutional innovation which will require an organizational adaptation at least as complex as the one needed to introduce the single currency; work is continuing apace. The ECB will supervise the largest banks, assisted by the national supervisory authorities, which in turn will remain responsible for supervising the other banks in accordance with guidelines set by the ECB. Building on the technical experience of the national authorities, the single supervisory mechanism will be charged with upholding a supranational vision drawing on the best practices in supervision, analysis and assessment of banking risks, enabling easier comparison between the intermediaries and systems of the various countries, and facilitating the control and attenuation of systemic risks. The transition to a single supervisor will accordingly provide stability to the euro area, helping to improve the monetary policy transmission mechanism and curtail the trend towards financial market segmentation.

The preparations for the launch of the single resolution mechanism and single deposit insurance must now be stepped up. Both are indispensable for aligning the supervisory responsibilities with those for the management and resolution of crises, and for breaking the perverse feedback loop between banks and sovereigns. In July the European Commission proposed a regulation to introduce a single banking resolution authority, drawing on common financial resources. A directive on the constitution of a European network of national deposit guarantee schemes has also been under discussion for some time.

The ECB will soon undertake a comprehensive assessment of banks' conditions prior to the launch of the single supervisory mechanism. This will be followed by an assessment of the risk profile of all the intermediaries which will be subject to centralized supervision. There will be balance-sheet assessments of all the banks, including an asset quality review and stress test. Other relevant aspects of banks' business will also be examined, including leverage, governance and, more generally, organization. This is an especially delicate stage in the management of the crisis in the euro area and in the process of building a more complete Union.

The exercise is designed to ensure that banks are managed in a sound and prudent manner and to dispel any market concerns over their financial soundness. It must be rigorously designed in order to boost the credibility of the single supervisory mechanism and foster mutual trust among the participating countries. To this end it must ensure equal treatment of all the banks, which are currently subject to supervisory systems based on very different national accounting and supervisory practices; examples include differences in the definition and measurement of impaired loans, risk-weighted assets, off-balance-sheet items and "level 3" assets (very illiquid assets whose fair value is estimated through internal bank models). In all of these areas at least de facto harmonization towards the best and most rigorous practices must be attained before the assessment can begin; the credibility of the entire exercise depends on it. The European Banking Authority is working on the harmonization of the definition of impaired loans and has recently published a consultation document. It is a step in the right direction.

The methodologies employed must be fully transparent. The findings should be published together with all the information that the market needs for a comprehensive assessment. The contribution of external experts, provided that care is taken to avoid conflicts of interest, will improve the credibility of the exercise.

The assessment must embrace all types of risk, bearing in mind the existing prudential rules. The markets should be given reassurance that a proper evaluation will also be made of those risks which, by virtue of the underlying instruments and the method of computing the related capital requirements, are noted for their extreme opacity. In the case of sovereign risk, there is no denying that its perception by the markets continues to be influenced today by fears – unfounded, in our opinion – concerning the euro's resilience. It would be a mistake to base any assessment of the riskiness of sovereign exposures on this perception, thereby implicitly sharing it. Banking union is part of a broader strategy aimed at reassuring the markets about the irreversibility of the euro, and the assessment exercise is key to achieving this objective; we cannot risk fuelling the very fears we wish to dispel. At the same time there must be full transparency regarding the composition of banks' assets.

Any capital shortfalls will have to be met by first drawing on banks' own funds, not distributing dividends, disposing of non-strategic assets, and cutting back on all cost items, including executive pay. When necessary, additional funds should be raised on the market. National plans should, in any event, be drawn up to cope with the eventuality of residual recapitalization requirements, given the decision that the European Stability Mechanism (ESM) will only be able to intervene directly when the Single Supervisory Mechanism becomes fully operational. In the meantime, the ESM's resources can be used indirectly, in the form of loans to member states; these would nonetheless weigh on their public debt, threatening to rekindle the vicious circle between sovereign risk and bank credit conditions.

The Italian banking system

Factors such as the weakness of the economy, uncertainty regarding the depth and strength of the recovery, and the still fragile state of the financial markets are forcing Italian banks to continue down the road of monitoring liquidity and credit risks, strengthening capital and reigning in costs.

The increased availability of assets eligible as collateral in Eurosystem refinancing operations has improved the banks' liquidity position, allowing them to cope with the large volume of bonds due to mature in the coming months. However, these assets include government-backed own use securities maturing over the next few years. For the future, the availability of collateral must be ensured by extending the range of eligible credits, including to new categories; special care must be taken to ensure that the methods of granting the loans comply with the requirements for Eurosystem refinancing. The amount of collateral must also be sufficient to withstand a possible depreciation of the eligible assets caused by a sovereign downgrade. In any event, recourse to central bank financing cannot be the only answer; efforts to regain access to the markets must continue.

The banks' exposure to Italian government securities has increased considerably since the beginning of last year. Contributory factors have been the sharp drop in the returns on (risk-adjusted) investment and the relatively high yields on government securities, set against the need to temporarily invest the liquid assets obtained from the two three-year Eurosystem refinancing operations. The recovery of the economy and a return to normal conditions on the credit market will allow banks to adopt asset allocation policies that enable them to provide greater lending support to households and businesses. Renewed confidence on the part of domestic and foreign investors, along with balanced public accounts and pro-growth reforms, will pave the way, without tensions developing on the market for government securities.

Lending continues to perform poorly as a result of the unfavourable economic situation, which is dampening demand and conditioning supply because of the adverse selection risks stemming from the deterioration in borrowers' creditworthiness. In the second quarter of this year, the ratio of the flow of new bad debts to outstanding loans, on an annual basis, reached 2.9 per cent; the increase affected only businesses. In June this year, impaired loans (which include not only bad debts, but also non-performing, restructured and past-due loans) amounted to €300 billion gross. Net of the value adjustments already made, this figure drops to around €190 billion, of which just over €70 billion are in bad debts, now amply covered at system-wide level by collateral and personal guarantees.

Gross impaired loans represent 14.7 per cent of total lending, falling to 9.6 per cent after value adjustments. In the first half of the year, losses on loans absorbed three quarters of operating income.

The banking system's difficulties are unlikely to be overcome soon. There is still pressure to reduce the size of banks' balance sheets. However, these developments may provide the right incentives to Italian firms to overcome their heavy reliance on bank credit. The business sector needs to find other means of financing investment. On the other hand, it is in the banks' interest to keep a balance between loans and deposits, and to share with the markets the risks of lending to customers. Helping businesses access the capital markets is not an easy task for the banks, requiring the ability to assess firms' economic and financial prospects; care must be taken to avoid potential conflicts of interest.

Our supervision, conducted both off-site and on-site, reflects our concern for the trends in lending and credit quality. Its purpose is to make sure, in particular, that impaired loan coverage ratios are adequate, and are increased whenever necessary. Far from damaging the banks, it helps to strengthen them, reassuring the markets as to the quality of their assets.

The findings of the inspections carried out between the end of 2012 and the early months of this year are set out in a report published on our website. We are verifying that the corrective measures, including organizational ones, which the banks were asked to take have been promptly put in place. Meanwhile, work to verify the adequacy of coverage ratios continues, in some cases also taking in the whole credit portfolio.

The opinion, voiced repeatedly during the crisis, that Italy's banking system stands in dire need of recapitalization is unfounded. Only a few days ago the International Monetary Fund published the results of its periodic Financial Sector Assessment Program for Italy. It acknowledges that the Italian banking system has managed, overall, to weather the double-dip recession and the sovereign debt tensions, extending its solid deposit base and strengthening its capital. Unlike other countries, it has succeeded, notwithstanding the difficult conditions, in raising additional funds almost entirely on the capital market, without burdening public finances and heightening sovereign risk.

The banking system's resilience was aided by a model of supervision, regarded by the IMF as a pillar of financial stability, which adheres closely to established international standards and is based on intense and strict oversight. The IMF also recommended that steps be taken to improve the effectiveness of supervision in some specific areas: transactions with related parties, the requirement for shareholders and corporate officers to act honourably and professionally, and the power to impose corrective measures such as the removal of company directors and executives.

The crisis management and resolution system has been effective, making it possible to address the effects of the crisis without affecting the stability of the system. The IMF's recommendations, aimed at further strengthening the system, are in line with the proposed European Bank Recovery and Resolution Directive, to be approved in the coming months. We will make sure that the IMF's recommendations are put into practice.

To evaluate the banking system's capacity to withstand adverse macroeconomic scenarios, the IMF conducted the usual series of stress tests. These were based on the situation of banks' balance sheets at end-2012, which had already incorporated the results of our own supervisory action on the adequacy of impaired loan coverage. The IMF evaluated the impact of macroeconomic scenarios over three or five-year time horizons.

The results, in line with those of similar tests conducted by the Bank of Italy, show, first of all, that the system can cope with a weak macroeconomic situation over the coming years as hypothesized in the baseline scenario and, at the same time, will be able to accommodate the gradual entry into force of the Basel III capital requirements.

Thanks in part to the capital strengthening achieved over the last few years, the overall system should now be able to weather a more adverse scenario, one in which GDP growth in the three years 2013–15 is cumulatively more than 4 percentage points lower than in the baseline scenario. In this case, the amount of additional capital which some banks would need to raise in order to meet the minimum regulatory requirement would not be large. Depending on the definition of capital used, the IMF estimates that total capital requirements would be between €6 billion and €14 billion and, in any event, less than 1 per cent of GDP.

It is worth recalling that these are hypothetical capital requirements, which would result from a very unlikely scenario, although not an extreme one. In addition, they are based on the hypothesis that over the time horizon covered by the tests, the banks do not independently strengthen their capital position, which some of them will need to do anyway with a view to their balance-sheet assessment.

The difficulties mainly concern medium-sized and small banks, which are particularly affected by macroeconomic developments, including those at a local level, or whose governance structures make it hard for them to implement capital-strengthening measures. These are mostly cooperative banks or banks in which a foundation holds at least 20 per cent of the capital. Last June the core tier 1 ratio of these two categories of banks was 9.5 and 9.2 per cent respectively, against 11.4 per cent for the other intermediaries set up in the form of limited liability companies.

On several occasions I have underlined the importance of corporate governance profiles in ensuring an informed assumption of risks, correctly allocating credit to the economy, managing conflicts of interest, and facilitating capital strengthening. In the light of the forthcoming Banking Union as well, the necessary interventions can no longer be put off. The review of cooperative banks' governance should encourage new shareholders to inject capital and to increase the control over management through less subdivision of shareholdings. For large cooperative banks with many and wide-reaching business activities, the most suitable legal structure is that of a limited liability company. Banking foundations must diversify their portfolios to limit their reliance on the performance of investee banks. Above all, they must not interfere in the banks' governance or management decisions. The composition of their management bodies, often too numerous, must be streamlined to make individual directors responsible, ensure that the collegial bodies function well and eliminate unnecessary costs.

The strengthening of Italy's banking system must include a return to profitability. Compared with the pre-crisis period, when it stood at around 60 per cent, the cost-income ratio has not decreased. Last June it averaged 62 per cent for the top five banking groups. This can be attributed to a fall in earnings, in turn affected by the lack of diversified sources of income.

In the present situation it is hard to imagine a significant increase in bank income, in view of the performance of lending, reduced margin rates and low demand for asset management products. In the short term the recovery of profitability will require incisive action on the cost front, including labour costs. This will entail a thorough review of the combination of factors of production and of the structure of distribution channels. Remote channels will handle the distribution of highly standardized products and products with low added value; the size of the traditional distribution network will be reduced, freeing up resources to develop the remaining branches, which should concentrate on the more complex products.

Italian banks, besides issuing loans, often own shares in companies. In some cases these links have distorted lending decisions, giving rise to collusion or attempts to delay the emergence of difficulties. On previous occasions I have stressed that these risks, like all those deriving from relationships with entities closely connected to the banks, must be properly monitored by the management bodies. The Bank of Italy will continue its supervision and will require any shortcomings to be rectified.

Concluding remarks

Economic activity in the euro area is on the path to recovery, but the pace is slow and differs from country to country. In Italy, as in other euro-area economies, conditions remain difficult, despite some signs of stabilization. The timing and strength of the recovery will depend not only on continuous and effective reform but also on the availability of sufficient financial support for businesses.

Decisive progress towards the completion of the European Union could halt the downward spiral caused by the strains on sovereign borrowers and on financial intermediaries, encouraging a return to more favourable credit conditions. The Banking Union is the first important step towards a budgetary, and ultimately a political, union through a process that should not be taken as purely sequential: on the one hand, the pooling of national resources is necessary to complete the Banking Union but, on the other, strong signals of political union would counter the perception of reversibility risk for the single currency. It is a delicate passage, to be undertaken with rigour and responsibility, avoiding errors which could rekindle tensions on the financial markets. The Italian banking system is moving along this path, beset by structural problems and weakened by the long recession. But the system can count, partly thanks to the work of the Bank of Italy, on strengthened capital and prudent evaluations of the quality of its assets.

There is no immediate, simple solution that will allow the banks to fully resume their role of supporting economic activity. They must continue to work towards restoring profitability and strengthening capital, as well as adapting their corporate strategies to the changed technological and market conditions. Today, the banks are also being called upon to rapidly change pace.