Ignazio Visco: The stability of the Italian banking system

Speech by Mr Ignazio Visco, Governor of the Bank of Italy, at the 22nd ASSIOM FOREX Congress, Turin, 30 January 2016.

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1. Recent economic developments

At the start of the year, the international economic outlook became more uncertain. In the advanced countries the recovery is continuing, but it appears less robust than was hoped for just a few months ago. In China, as in other emerging economies, growth has slowed amid heightened fears of a further deceleration. Weakening demand is partly responsible for keeping the price of oil and other fuels at historically low levels and for reducing the prices of other commodities.

In the euro area growth continues at a moderate pace, but inflation is struggling to return to a path consistent with price stability; there are risks of second-round effects from consumer price developments to wages, and of a disanchoring of expectations. The Governing Council of the ECB has resolved to reconsider its monetary policy stance in March when new macroeconomic projections will be available; it reconfirmed that there are no limits on how far it is willing to deploy the instruments available within its mandate.

Monetary policy is supporting euro-area economic activity and, by countering the deflationary effects of international developments, has been unwavering in the pursuit of its objective. It cannot, however, act in isolation; the risks to growth and financial stability must be addressed with the help of budgetary policy and by pressing ahead with ongoing reforms.

In Italy the recovery is progressing at a comparable pace to that of the euro area. The boost from exports has weakened, as elsewhere in the euro area, but the contribution of domestic demand has strengthened, thanks to rising household consumption and the increase in inventories; the recovery in investment is still uneven, reflecting uncertainty over foreign demand. The rise in the number of those employed has continued, as has the shift towards more stable forms of employment, partly thanks to social contribution relief and new labour law provisions.

In the final months of last year bank lending to the private sector turned upward again; business lending has stabilized, with some fluctuations; lending to households, which had already picked up, accelerated further and residential mortgage loans have been expanding since the summer. The average cost of new business and home mortgage loans has dropped further, to 1.9 and 2.6 per cent respectively in November; the differential with respect to the euro-area average has been wiped out for business loans and is less than 0.3 percentage points for new home loans.

However, substantial differences remain between firms that are vulnerable and the – generally larger, mostly exporting – firms in sound financial shape. In November, bank credit expanded by 4.0 per cent on an annual basis in the manufacturing sector, was barely positive in the service sector – partly owing to the contraction in lending to firms that provide real estate services – and remained negative for the construction sector. While loans to businesses with 20 or more workers rose, those to smaller firms continued to decline. The difference in borrowing costs for loan amounts above and below €1 million is 1.5 percentage points, 0.4 points below the peak recorded during the crisis; at the start of 2008 it was 0.7 points.

As we reported in our *Economic Bulletin*, Italy's output could increase by around 1.5 per cent in 2016 and in 2017. This scenario assumes that domestic demand, and especially investment, will continue to strengthen. The uncertainty in the international arena and its impact, at times chaotic and violent, on the financial markets pose evident risks.

In recent weeks the stock markets have seen brusque movements, with bank stocks being especially volatile, particularly those of certain Italian banks. In addition to uncertainties regarding the international situation, the volatility in Italian bank stock prices reflects the doubts and concerns that have arisen concerning asset quality, in part related to the alarmist interpretation of a simple request for information by the ECB.

Tensions of this magnitude are not justified by the underlying conditions of Italian banks. As the President of the ECB also recently stressed, non-performing loans in banks' balance sheets were examined as part of the comprehensive assessment performed in 2014, the necessary provisions were made, and there will be no new requests to increase them or to strengthen banks' capital. The climate surrounding the resolution of four banks that had been placed under special administration has also contributed to the volatility.

2. The resolution plan for four banks

On 22 November of last year the Italian Government and the Bank of Italy applied the new rules approved by the Italian Parliament following its transposition of the Bank Recovery and Resolution Directive (BRRD) to resolve the crisis at Banca delle Marche, Banca Popolare dell'Etruria e del Lazio, Cassa di Risparmio di Ferrara and Cassa di Risparmio di Chieti. Together they held around 1 per cent of system-wide deposits. Contributing to the collapse of these banks, affected like all the others by the deterioration in loan quality due to the length and depth of the recession in Italy, were grave episodes of malfeasance.

Detailed information on the handling of these crises and on the supervisory actions that preceded them can be found in documents now available on the Bank of Italy's website, which follow on from the explanatory note published on 20 December regarding the bank rescue decree. Naturally we stand ready to provide any further information should this be required by Parliament.

In accordance with the law the decision to place a bank in special administration is taken only in the event of very substantial losses and serious irregularities that compromise the bank's ability to meet its capital requirements and threaten its very stability, or when it becomes clear that the management appointed by the shareholders are no longer capable of coming up with a credible plan for its restructuring. Before special administration is imposed, steps are taken that include, based on the circumstances, making changes to its governance structure, preparing new business plans, adopting capital strengthening measures and selling off assets or business units.

This sequencing was followed in all four cases, as in all the other bank crises that the Bank of Italy has handled (about 100 in the last 15 years), in a diligent and timely manner, and in accordance with the existing regulations.

The resolution was initiated, in the absence of alternative market solutions, in view of the irreversibility of the collapse and the emergence of unsustainable liquidity tensions. Despite the best efforts of the special administrators, and the launch of negotiations with several potential counterparties, no concrete offers were forthcoming from investors indicating their willingness to assume the risks associated with the impaired assets, against a backdrop of worsening macroeconomic conditions and the new regulatory environment.

Unlike what happened in the past it was not possible to seek financial support from the Interbank Deposit Protection Fund, which, although it draws on the resources of the member banks, in the European Commission's interpretation is tantamount to state aid and as such – according to the procedures announced and followed by the Commission since 2013, to which I will return shortly – can only be disbursed subject to burden sharing, i.e. by first imposing losses on shareholders and subordinated creditors. Discussions in this regard between the Commission and the Italian government have been lengthy and painstaking. The document published on the website of the Ministry of Economy and Finance on 23 December sets out the issues in detail.

A dispute at that point with the Commission, or indeed before the European Court of Justice, would not only have led to grave uncertainty for the stability of the system, with even more serious consequences for the banks involved and for investors but, under the current accounting rules, would also have required the banks concerned to set aside an amount to cover the cost of a potentially negative outcome with risks for business continuity. Intervention by the Fund would in any case have required authorization from the ECB, as the supervisory authority, which in turn would have had to request an opinion from the Commission's Directorate-General for Competition.

Having ascertained the absence of any concrete alternatives, other than the far more traumatic option of liquidating the four banks, the Bank of Italy, with the approval of the Ministry of Economy and Finance, implemented the new resolution procedure provided for by the BRRD immediately upon its transposition into Italian law on 16 November 2015. Recourse to this procedure made it possible to use the new tools introduced, in particular the creation of four bridge banks and a company for managing the bad debts of the banks under resolution. This intervention guaranteed the continuity of the essential services provided by banks.

The assessment of the losses and therefore of the resolution costs was made in accordance with strict European rules and was in no way discretionary. The particularly conservative estimate of bad debts is in keeping with the provisions of the BRRD and with the interpretation of the rules on state aid adopted by the Commission during its talks with the Italian government; it roughly corresponds to the theoretical average market value of their immediate divestment. The costs were borne predominantly by the banking system through the newly-established Resolution Fund, but also by holders of shares and subordinated bonds; there was no transfer of public resources. The heavy sacrifice made by shareholders and subordinated bondholders was inevitable given the new regulatory framework. Had this intervention not been made, a compulsory administrative liquidation would have eroded value and generated losses for holders of ordinary bonds and unsecured deposits; it would also have jeopardized regular banking activity, with widespread repercussions at local level.

Thanks to the new capital resources and the good quality of the assets, and under the guidance of the completely overhauled governing bodies, the bridge banks to which the businesses were transferred resumed lending to the local economies, as the banks in crisis had no longer been able to do so. The new banks had their bad debts written off and were recapitalized, thereby creating the conditions necessary to make them attractive to investors. In approving the rescue package, the European Commission requested a very brief time frame for the banks' divestment. This procedure has begun over the last few days.

Parliament has recently approved the establishment of a Solidarity Fund – to be funded entirely by the banking system – to compensate investors holding subordinated bonds issued by the four banks under resolution; in the arbitration procedure, compensation is contingent on verification of whether banks have violated their obligations of due diligence, fairness and transparency as provided for by the Consolidated Law on Finance. The procedures and conditions for eligibility shall be established by ministerial decrees. The Bank of Italy has assured the authorities involved of its complete cooperation.

Based on the legislation in force, and in line with European law, the Bank of Italy does not exercise control over the issuance of bonds or other bank funding instruments; these decisions are adopted independently by banks in compliance with the limits and conditions provided for by law and by the supervisory authorities.

Savings flow into the banking system in various ways. Bank deposits are the savings that are afforded the best protection on three levels: supervision of banks' stability, now entrusted to the EU's Single Supervisory Mechanism, of which the Bank of Italy is part; the rules on transparency and fairness to which banks are subject for the opening and management of deposit accounts, to be complied with under the supervision of the Bank of Italy; and the guarantee scheme, which protects deposits of up to €100,000 for each account holder.

Bank bonds and shares are investment instruments. As such, there is no guarantee that their value can be preserved, but in order to protect investors their placement must comply with the obligations, harmonized throughout Europe, of due diligence, fairness and transparency, and the risks and returns of each instrument must be correctly set out and fully understood.

The supervisory authorities are unceasing in their oversight of banks in financial difficulty, though oftentimes the general public is not aware of this. In most cases their actions help to prevent the emergence of crises and thus avoid the costs involved in managing and resolving them. No supervisory action in any country can entirely eliminate the risk of banking crises, especially in times of deep recession.

3. The new European legislation on banking crises

The legislation on banking crises has two potentially conflicting objectives: maintaining financial stability – which leads to interventions in support of troubled banks to avoid systemic repercussions – and preventing banks from behaving opportunistically in the expectation of public intervention.

Following the global financial crisis, the prevailing position at international level has leaned towards the latter objective, far more so than in the past. This change in direction has certainly been influenced by the massive public interventions for rescuing banks that have weighed heavily on the state finances of many countries, in some cases jeopardizing their stability.

To reduce the likelihood and size of bank bail-outs to be borne by the taxpayers, rules have been drawn up that would allow the costs of a crisis to fall mainly on a bank's creditors. At the end of 2015 the Financial Stability Board drafted strict requirements on total loss absorbing capacity (TLAC) for global systemically important banks, focusing on subordinated instruments and envisaging their gradual entry into force by 2022.

There have been rapid, sweeping changes in European legislation. In 2013 a Communication from the European Commission had provided for the immediate application of a new burden-sharing scheme which, in the event of a bank crisis, imposed losses on shares and subordinated bonds as a prerequisite for public intervention. In 2014 the BRRD, approved by the Council and the European Parliament, extended that scheme, starting this year, to include ordinary bonds and deposits of over €100,000 (bail-in); among the latter, those held by households and small businesses receive preferential treatment. As part of the burden-sharing scheme and according to the resolution procedures defined by the BRRD, resolution measures were implemented last November for the four banks mentioned earlier.

During this delicate changeover at European level, insufficient attention was given to the transition period. At the technical meetings that laid the ground for the BRRD, the Ministry of Economy and Finance and the Bank of Italy argued, without mustering the necessary support, that an immediate and, more importantly, retroactive enforcement of the burden-sharing mechanisms to 2015, and subsequently of the bail-in, could – in addition to a costlier and less plentiful supply of credit to the economy – have posed risks to financial stability also in relation to the treatment of creditors who had subscribed bank liabilities many years ago, at a time when the possibility of losing the original investment was very remote. Our views were expressed in the Bank of Italy's official publications. A gradual, less abrupt transition would have been preferable. This would have enabled investors to be fully acquainted with the new rules and to adapt their choices to the new regulatory environment. A targeted approach, with the application of the bail-in to only those financial instruments with a specific contractual clause to that effect, and a sufficient transition phase, would have allowed banks to issue new liabilities subject to express bail-in conditions. Such an approach, particularly the emphasis on subordinated instruments, would have been more in keeping with that adopted by the Financial Stability Board in setting the TLAC requirements.

A clause in the BRRD provides for its review, to be started no later than June 2018. The opportunity must now be seized, drawing on the experience gained to date, to align European legislation more closely with international standards.

In Italy the share of household savings invested in bank bonds is considerably higher than the euro-area average. This is largely due to how these bonds were taxed between 1996 and 2011, which made after-tax interest on bank bonds relative to medium-term deposits much more attractive. When the preferential tax treatment ended, the bonds were gradually replaced with deposits or asset management products as they came to maturity. Given the current term structure, if there were no new purchases, the stock of bonds held by households would be halved by the end of 2017 (from around €200 billion to €100 billion), and would fall below €20 billion in 2020.

Under the new BRRD rules and with the launch of the Single Resolution Mechanism (SRM), the resolution procedure is activated when there is a public interest at stake, particularly if it is necessary to preserve the stability of the financial system. In all other cases of evident crisis, the only option is to wind up the bank. Among the initiatives the Italian banking system must evaluate to limit the costs of a crisis for investors are voluntary intervention mechanisms – in addition to the mandatory deposit guarantee schemes – to which, in accordance with the European Commission's stance, the rules on state aid would not apply. The cost of participation would be compensated by the benefits that all intermediaries would reap, thanks to increased customer confidence and greater systemic stability. Banks should carefully weigh the advisability of such mechanisms.

4. The situation of Italian banks

Italian banks' regulatory capital is much higher today than it was in the past. Since the end of 2008 the highest-quality capital ratio has risen on average from 7.1 to 12.3 per cent. Contrary to what happened in other countries, capital strengthening was achieved without weighing on the public finances. The limited support afforded to banks by the Italian State ultimately generated a net profit in the form of interest and other remuneration. Other countries instead reported substantial losses. Italian banks increased their capital despite the fact that the crisis had severely hampered their income capacity.

With the cyclical turnaround, profitability has started to improve. In the first nine months of last year annualized ROE was about 5 per cent, against 3 per cent recorded in the same period of 2014. Loan loss provisions as a share of gross operating profit declined from 70 to 57 per cent.

Seven years of crisis have inevitably left a mark in terms of non-performing loans. Since 2008 more than 90,000 firms have been declared bankrupt and more than 4 per cent of households have suffered a reduction in earnings owing to a family member losing their job; industrial production is now over 20 per cent lower; almost one million fewer people are in employment. This has affected households' and firms' ability to repay bank debt. Non-performing loans now amount to around €360 billion or 18 per cent of the total. More than half are recorded as bad debts and are subject to lengthy and onerous procedures to seek their partial recovery. As the crisis unfolded, the Bank of Italy acted to ensure the steady increase of NPL coverage ratios which now stand at 45 per cent, in line with the European average; for bad debts the coverage is around 60 per cent. Collateral held by banks against non-performing exposures amounts to approximately €160 billion.

As the economic recovery proceeds, the flow of new bad debts is gradually decreasing. We expect the improvement to continue in the coming months. It will take time to clear the stock of bad debts, whose large volume depresses market assessments of banks, makes bank funding costlier, and generates high capital requirements.

We have long advocated the need for measures designed not to alleviate individual banks in difficulty, but to soften the impact of the deep and protracted recession and to foster the

development of a private market for non-performing debt where this struggles to emerge by itself. I referred to such measures two years ago before this same audience, noting the need to assess their compatibility with EU legislation. It was not, however, possible to proceed owing to the interpretation given to the rules on state aid. In my view this interpretation fails to take sufficient account of the gravity of the macroeconomic shock; at the same time it seeks to avoid, through state intervention, preferential treatment in one jurisdiction rather than another, an undoubtedly valid objective which might perhaps have been assessed over a longer-term horizon than that beginning with the sovereign debt crisis.

But progress on other fronts has and can still be made. Last summer new measures on bankruptcy and foreclosure proceedings were adopted to speed up credit recovery. Although we still need time to appraise the results in full, feedback from market operators indicates that the first effects are beginning to be seen. Further legislative provisions, in addition to those already passed, could further cut credit recovery times: a thorough review of bankruptcy legislation with a view to creating incentives for the rapid settlement of disputes and to removing the obstacles that hinder or delay out-of-court settlement; new measures on how the courts are organized. When I addressed the Italian Banking Association last July, I underlined how a reduction of two years in credit recovery times could substantially decrease, eventually even by half, bad debts as a share of the total.

The Ministry of Economy and Finance has reached an agreement with the European Commission on a government guarantee scheme for senior tranches of securitized bad loans. The agreement does not require banks to make further provisions and marks an important step toward the creation of a secondary market for non-performing loans, ending the uncertainty of the past few months. Easier access to resources to finance the purchase of these loans enables them to be sold more rapidly and may lead to a non-negligible increase in their market value. Along with possible new measures to expedite credit recovery the scheme could help to consolidate the balance sheets of Italian banks and improve their ability to finance the real economy. There has been mixed market reaction to the announcement of the agreement; a detailed analysis of its terms and effects will improve its reception.

Banks must step up their intervention in this area. The Bank of Italy will soon undertake a statistical survey of bad debts, designed to help banks to do more. It is time that the management of non-performing loans be given resources proportional to their weight on balance sheets, adopting a more business-oriented approach, bank size and operating model permitting. Failing this, their management should be outsourced to specialized operators, with gains in efficiency and effectiveness.

Moreover, the share of non-performing loans (almost one third of the total) to firms in temporary difficulty but with sound chances of making a turnaround, especially given the strengthening of the economic recovery, could be managed better. Proper coordination of the banks involved is essential, as is the intervention of corporate restructuring specialists.

Another fundamental question that banks cannot ignore concerns the need to keep costs down, stemming not only from the prolonged period of low inflation and low interest rates, which have compressed net interest income, but also from the evolution of the financial system that obliges banks to increase operational efficiency, especially those which, as is the case in Italy, are focused on traditional intermediation. Technological developments call for changes to banks' branch networks, which are still too numerous, and to the cost, size and composition of staffing. To facilitate the implementation of these measures, limiting the economic and social costs, traditional unemployment benefits could be complemented by the industry's solidarity funds.

The strength and nature of the measures aimed at recouping efficiency must be tailored to each intermediary's needs. Greater efficiency must partly be achieved through recent and upcoming reforms of corporate governance. The conversion of the cooperative or *popolari*

banks into joint stock companies, in addition to encouraging more effective governance structures, will enable consolidation dictated not by the reform law or by the supervisory authorities but rather by market forces. This process could involve the revamping of a small number of intermediaries, which we have been monitoring for some time, now also under European supervision.

Mutual banks, a highly fragmented sector, are facing strong competitive pressures and have been severely affected by Italy's prolonged economic downturn. The need for greater consolidation, something we have long called for, has become more pressing. The reform being finalized, while preserving the mutualistic nature of these banks, will strengthen systemic resilience and improve corporate governance.

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Italy is emerging from a recession of exceptional duration and intensity, eclipsing the depression of the 1930s. The crisis has put severe strain on firms and households, and has caused a spike in bankruptcies and unemployment. Its impact on the banking system, which is rooted in the real economy, has been violent. Though shaken, it has endured. Now that the indicators point to a more favourable economic outlook, banks must put themselves in a position to effectively counter future risks.

Europe now has a common regulatory framework for bank crisis management. This provides for a vast array of instruments, some borrowed from Italy, others new to us. The most radical innovation is the obligation for holders of capital and debt instruments issued by banks to bear a much higher proportion of the costs of a crisis than in the past. The European Commission's strict interpretation of this principle means it is no longer possible to manage a crisis by resorting to the Interbank Deposit Protection Fund and the Mutual Banks Deposit Guarantee Fund, without sacrificing investors, as had traditionally been the case in Italy.

On the one hand the new European rules on banking crises require that investor awareness be raised, as we have repeatedly said in recent years; on the other the transparent and accurate presentation by banks of investment opportunities must be guaranteed. The implementation of burden sharing at four Italian banks has been a lesson: warnings alone, however often they are repeated and included in specific brochures, cannot in themselves prevent risks to reputation and stability; nor is it enough to tell the banks that capital instruments must only be sold to those who can fully evaluate their sometimes complex risk and return profiles.

Additional legislative action should be considered, mainly to take into account circumstances where conflicts of interest may be more pronounced, such as the placement with retail customers of complex financial instruments by the issuing bank. Discussions on this topic are ongoing with the competent authorities. To considerations regarding bank stability, which fall within the purview of the Bank of Italy, must be added the no less important ones related to market integrity and the fair treatment of investors, for which Consob is responsible.

In order for the regulations protecting investors to be fully efficacious, the latter must be able to make proper use of the information they are given and to make wise investment choices.

Recent international surveys have demonstrated that public awareness of financial matters is particularly lacking in Italy. We must invest in educating people on the characteristics of the most common financial instruments, on fundamental concepts such as the notion that a higher return corresponds to a higher risk and that the failure to diversify investments is always a gamble. For years, the Bank of Italy has supported financial education programmes in schools, with the voluntary cooperation of many teachers, and it is currently seeking to coordinate with additional private and public initiatives. But financial education must involve everyone as a matter of priority.

The flow of bad debts, which swelled during the crisis, is gradually ebbing. We must now manage the legacy of the past. The guarantee scheme recently agreed with the European Commission will prove useful for facilitating the divestment of bad debts. The closing of this chapter and a decisive reduction in uncertainty will allow the reactivation of this market. However, it must be clear that no reasonably conceivable measure can cancel at a stroke the stock of bad debt. Rather, the banking system must tackle it with determination, in a medium-term horizon. No less important is the need to continue working on legislative and organizational procedures to improve and streamline the credit recovery, by assessing the effects of the public measures already undertaken and, where necessary, implementing new ones.

Italian banks are well capitalized, thanks also to the prudent and swift action taken by the Bank of Italy and, for over a year now, to European supervision, in which we are fully engaged. The stock of non-performing loans is amply covered by provisions and guarantees. The current economic situation is favouring a recovery in profitability, for banks and non-financial firms alike. Now is the time to address and decisively reduce structural costs, and to lay the foundation for robust growth, to the benefit of banks themselves and of the economic system as a whole.

Confidence is essential to the stability of the banking system. At a time in which the short-term economic outlook remains favourable, but uncertainty and market volatility appear to be on the rise, the best way to strengthen stability is to aim to be unequivocal in both intent and deed. It is an objective wholly within our reach, provided all actors play their part: banks, supervisory authorities, Government. The Bank of Italy's commitment can be counted on.