Italian Banking Association
Annual Meeting

Address by the Governor of the Bank of Italy
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Rome, 12 July 2017

The current economic scenario and the outlook

The Italian economy has gained strength. The latest economic indicators confirm that production is picking up. All in all, the most recent surveys of households and firms signal persistently high levels of confidence and a resumption of investment; the outlook for exports and employment remains favourable. The upturn in growth has had a positive impact on lending, even though firms' demand for financing is still weak, reflecting the ready availability of own funds and the problems facing certain sectors.

If the economy is to continue to strengthen, the global cycle must keep improving, there must be no increase in the volatility of international financial markets, and monetary and credit conditions in the euro area must remain highly expansionary. In early June the Governing Council of the ECB confirmed its commitment to maintaining a very substantial degree of monetary accommodation. To ensure a sustained convergence of inflation towards the price stability objective, it expects that official interest rates will remain at present levels for an extended period of time, and well past the horizon of the net asset purchases, which will run until at least the end of this year.

But to erase the legacy of the most severe economic crisis in our nation's history, the consequences of which can be seen in the record levels of unemployment, the public debt-to-GDP ratio and the ratio of non-performing loans to total outstanding loans, we need more than just a cyclical recovery. In Italy economic development is still hampered by the rigidities and inefficiencies of the environment in which firms operate and by weak productivity growth. The process of reform must continue, requiring a collective commitment, far-sightedness and measures to mitigate the costs of the transition.

Banks, too, must change, seeking to become more resilient and to regain an adequate level of profitability. The success of this transformation depends on the entire economy returning to a path of sustained and enduring growth to which banks must contribute; at the same time banks must be prepared for the possibility that it may take a long time to achieve a more satisfactory rate of expansion in production. In 2016 and in the first few months of this year both new NPL flows and their ratio to total loans fell. This is a trend that should be encouraged through active management of these exposures. To recover profitability, additional decisive steps must be taken to cut costs, reorganize business models, adopt effective corporate governance arrangements, and engage in mergers. More investment is required to enable banks to meet, including by updating their business models, the challenges posed by the sweeping changes taking place in technology, regulation, market structures, and client demands.

The resolution of episodes of bank crisis

A number of banks experienced particularly severe difficulties, which could not be blamed on the decline in productive activity alone. When the crisis began, these banks were already in a weak position owing to deficiencies in their governance structures and imprudent lending practices, compounded, in some instances, by malfeasance.

Over the last few weeks important steps have been taken to resolve some of the most serious cases. The precautionary recapitalization of Banca Monte dei Paschi di Siena was approved, an orderly liquidation of Veneto Banca and Banca Popolare di Vicenza was undertaken involving the use of State funds, and the sale of Nuova Carife, the last of the four banks put in resolution at the end of 2015 to be placed on the market, has been concluded. As for other troubled, but small banks, the public authorities, the banks' own directors and fellow institutions are committed to finding solutions.

The measures chosen eliminate the tail risk that in recent months has weighed on conditions at individual banks and on the sector as a whole, especially as perceived by financial operators. This is borne out by the positive response of the markets to the announcement of the most recent decisions.

The decisions complied fully with European legislation and procedures. To the extent that these permitted, efforts were made to find the solution that best protected the interests involved. The use of state funds, which have a good chance of being recovered, should be viewed in this instance as a necessary response to specific market failures, but as exceptional, also in view of the underlying principles of the new European rules.

The measures adopted arose from a process that was made particularly complex – and exceedingly long – by changes in the institutional and legislative framework. The management of banking crises today is entrusted to a multiplicity of independent authorities and institutions. There is a lack of effective coordination for setting priorities and establishing guidelines on the margins of discretion afforded by law. This is also demonstrated by the problems that have arisen in finding a solution to the crises at the Veneto banks. There must also be specific procedures in place to account for the decisions taken.

To build on the progress made to date, the plans that have been drawn up must be implemented with dedication and determination. Banca Monte dei Paschi di Siena must begin the corporate reorganization and turnaround contemplated in its multi-year business plan, which has been scrutinized by the European institutions and which is capable of returning it to an adequate, and enduring, level of profitability. The precautionary recapitalization approved by the European Commission on 4 July avoided the very serious consequences of a resolution procedure; it permits an €8.1 billion recapitalization, of which €3.9 billion injected by the State and €4.2 billion resulting from the conversion into shares of capital instruments subject to burden sharing. To prevent or end disputes over the placement of these instruments with non-qualified customers, the State can acquire up to €1.5 billion worth of the shares resulting from the conversion in exchange for senior bonds issued by MPS.

Overall, in exchange for public funding of no more than €5.4 billion, the State will acquire a share in the bank's capital equal to about 70 per cent. The recapitalization will be completed by early August with the issue of the ministerial implementing decrees. The operation will enable the bank to raise its capital ratios to levels comparable to those of its main competitors; to free itself of its entire portfolio of bad loans and increase the coverage ratios on the remaining non-performing loans, also thanks to the Atlante fund; to significantly raise efficiency, productivity and profitability by offering early-retirement incentives to a large portion of its staff; to again contribute fully to financing the economy. Once adequate profitability levels have been restored, the State will sell its holding on the market, maximizing its investment.

For Veneto Banca and Banca Popolare di Vicenza, precautionary recapitalization was not an option due to the lack of sufficient private resources to cover the losses they were likely to incur in the near future. The losses estimated by the European authorities involved in the procedure increased progressively during their assessment of the restructuring plan; that same assessment included a negative opinion on the banks' ability to return to an adequate level of profitability. It therefore became necessary to examine the alternatives to precautionary recapitalization.

On 23 June 2017, the ECB declared that the two banks were 'failing or likely to fail'. The Single Resolution Board (SRB), the European authority responsible for the management of bank crises, agreed with the ECB's assessment and concluded that there were no alternative market or supervisory measures that could prevent the failure of the banks. The SRB further concluded that resolution action – as a substitute for liquidation – was not warranted in the public interest.

The Italian Government and the Bank of Italy, in close cooperation and in constant communication with the European authorities, therefore resolved the crises of the two banks by means of compulsory administrative liquidation in accordance with the European rules and the principles of the Consolidated Law on Banking. The Decree Law issued by the Government on 25

June 2017 offered a suitable framework for dealing with the two banks, including by making provision for the public sector support necessary to guarantee their orderly exit from the market. The liquidation was carried out in such a way as to ensure the continuity of existing business relationships and to limit the effects of the crisis on the productive economy. Shareholders and junior bondholders participated in the losses, but no bail-in was used, which would have included senior bondholders as well as customers with deposits above €100,000; provision has also been made for compensating some retail junior bondholders.

The European Commission found these measures to be fully compatible with the rules on State aid as defined in the Treaty on the Functioning of the European Union; it also found that the public intervention satisfied the conditions set out in the 2013 Communication on State aid to support banks in the context of the financial crisis. This Communication established that shareholders and junior creditors participate in the costs and, if the liquidation calls for the en bloc sale of the struggling bank's assets and liabilities, that the acquirer be chosen through an open, competitive and non-discriminatory process so as to select the most advantageous offer and minimize the effects on the public finances. That is what occurred, in full compliance with the agreed rules and conditions.

The selection process involved six potential acquirers: four were Italian (the two leading banking groups, a mid-size bank and a major insurance group) and two were large European banks. At the close of the process, two binding offers had been submitted; Intesa Sanpaolo's was the only one that could ensure the continuity of the two banks' critical functions. The acquirer must now proceed to integrate and restructure the assets and liabilities sold as part of the operation.

The banks in liquidation continue to hold, on the asset side, shares and other stakes totalling €1.7 billion and all their non-performing loans (€9.9 billion net of write-downs); on the liability side, they hold capital, junior bonds and risk provisions totalling €6.2 billion. The €5.4 billion difference constitutes a debt to Intesa Sanpaolo, which simultaneously acquires all the other assets and liabilities of the banks in liquidation. This debt (which may be revised upwards to €6.4 billion following the due diligence on the performing loans) is guaranteed by the State, which has also granted the acquirer other guarantees, with an estimated fair value of €400 million, to cover various risks. The immediate burden on the State consists of a cash injection of €4.8 billion, of which €3.5 billion to Intesa Sanpaolo to cover its capital needs following the acquisition, and €1.3 billion to cover the cost of the restructuring measures that Intesa Sanpaolo must implement.

As a counterpart of these undertakings, the State is a creditor vis-à-vis the banks in liquidation and will be reimbursed through the sale of their assets. The non-performing loans will be assigned to Società di Gestione delle Attività (SGA), which will have to work towards eventually obtaining recovery rates consistent with those implied by the loans' book values, which are net of write-downs. The costs of a standard liquidation procedure ('atomistic liquidation'), the only available alternative once precautionary recapitalization has been excluded, would have been much higher for customers, the banking system, and even the State.

The situation of Italy's banks and the problems currently being addressed

Credit quality continues to improve, sustained by the economic recovery. The ratio of new non-performing loans to total outstanding loans has fallen to the levels prevailing before the crisis, dropping to 2.4 per cent in the first quarter of this year. The stock of NPLs has also fallen: at the end of March, the ratio of NPLs to total outstanding loans fell for the significant banking groups as a whole to 9.2 per cent, net of write-downs, from a peak of 11.4 per cent recorded in the second half of 2015. The coverage ratio had reached 53 per cent, compared with an average of 45 per cent for the leading European banks. Sales and securitizations currently under way will lead to a further significant drop in the volume of net non-performing exposures: in the next twelve months their share of the total could fall below 8 per cent.

This process must continue. The reforms of the credit recovery procedures launched in Italy in recent years are a step in the right direction; they must be strengthened to ensure a sharp reduction in recovery times. As I recalled in May, it would be especially useful to increase the level of specialization in the handling of insolvency cases, providing for the centralization of the more complex proceedings, including by reviewing the territorial jurisdiction of Italy's courts. For their part, banks must make the best possible use of the instruments already available in the form of out-of-court agreements with firms on debt restructuring and the transfer of real estate pledged as collateral.

All financial intermediaries must increase the availability of sufficient and timely information on non-performing exposures, essential for making the management of these assets more efficient and less costly, thereby facilitating their sale. The new reporting on bad loans that the Bank of Italy introduced last year, motivated by the scant availability of computerized data at banks, is providing a significant contribution to improving the management criteria for non-performing loans. The Commission has asked the European Banking Authority to consider launching a similar initiative for banks in all member states.

The first results of the new NPL reporting confirm that the survey has prompted the banks to speed up actions to improve data organization and digitalization. The quality of the responses was initially poor but has become better, partly thanks to monitoring by the Bank. There is still room for improvement: in many cases the data on the status of recovery procedures and on the type of assets pledged as collateral are incomplete, particularly as regards valuations. Approaches to the recovery procedures differ considerably: some banks are not taking sufficiently prompt action. Efforts should be stepped up to eliminate the backlog and take full advantage of the possibilities offered by the new database.

By exploiting the information to the full it will also be possible to conduct a more active management of non-performing exposures other than bad loans, raising the rate of reclassification to performing and adjusting coverage levels where necessary. Unlikely-to-pay exposures account for half of total NPLs; swift action is required to maximize their value, especially by means of restructuring agreements to set firms back on the path to sustainability. The 2015 reform introduced tools that give financial creditors far greater room for manoeuvre under these agreements; they should be exploited fully.

The debate at European level is focusing again on the practicality of setting up a specialized company for managing the non-performing assets with public support to reduce the weight of these exposures in banks' balance sheets and to develop the NPL market. As I have already pointed out, we believe that introducing this type of measure could be useful, provided it is finalized as soon as possible. To be truly successful, the disposal price of the assets should not diverge too much from their real economic value. Banks' participation in the scheme should be voluntary and the various elements of their restructuring plans should be decided beforehand.

Europe is also considering the introduction of mechanisms that set compulsory minimum write-downs, increasing over time, on new loans to be classified among non-performing exposures (known as calendar provisioning) – so as to reach high levels of coverage fast. Should such mechanisms be introduced, even with the necessary graduality, the significant differences in civil justice processes and loan recovery times across Europe would acquire even greater weight.

The creation of cooperative banking groups is proceeding along the lines set out in the reform law. At the end of this process, two of the three new groups (Iccrea and Cassa Centrale Banca) will be 'significant' for supervisory purposes and will therefore be subject to direct supervision by the ECB. Before this happens, the two groups must undergo a comprehensive assessment, based, as in 2014, on an asset quality review and a stress test. This is currently scheduled for the first half of next year and will be tailored to take account of the fact that the institutions will not only be new to Italy's banking sector but will also still be taking shape.

Certain key elements are essential for the reform to be successful. The parent banks must complete a difficult transformation over the next few months to enable them to head very large and complex groups. Extensive discussions are already under way with the supervisory authorities, which will need to approve the main contractual clauses: by-laws, cohesion contracts and cross-guarantee schemes. The process must now continue apace: organizational and decision-making mechanisms must be strengthened, senior management must possess high levels of competency and professionalism, and the steps needed to integrate IT systems must be rigorously planned. The comprehensive assessment should be prepared well in advance; in terms of capital adequacy, the parent companies will have to draw up plans enabling them – with equanimity and right from the word go – to establish the new groups.

The participating banks must begin to operate in harmony, under the guidance of the parent company, well before the groups have been formally established. The asset quality review will need to be thoroughly updated to take account of the necessary value adjustments and write-downs already entered in this year's balance sheets.

The Bank of Italy is committed to strengthening the other banks under its direct supervision in order to increase their efficiency and productivity, promote the supply of innovative services for households and firms, and diversify their sources of income. For their part, banks are being called on to undertake wide-ranging action, including mergers to facilitate investment, economies of scale and, where necessary, access to capital markets. A first step towards greater integration could be recourse to consortiums to provide services and the pooling of data for internal models to compute capital requirements. In line with other countries, a more decisive step would be to introduce Institutional Protection Schemes (IPS), which do not remove the autonomy of individual banks but give rise to mutual support agreements that can be activated in the event of capital or liquidity needs.

Expenses, income and structural changes in the banking industry

The significant progress made in overcoming the grave difficulties of some banks and the gradual improvement in balance sheet conditions throughout the banking industry are undoubtedly positive developments. Several factors, however, are altering the context in which banks operate: changes in demand for financial services, technological progress and the digital revolution, and the regulatory reforms introduced in the wake of the financial crisis.

The profitability of European banks has diminished considerably over the last ten years. The global financial crisis first hit the large merchant banks, who earn much of their income on the capital market. The recession and sovereign debt crises then took their toll on the balance sheets of banks whose core business is lending. Italy's banking sector suffered a particularly sharp fall in profits; the return on capital, which was about 10 per cent in the middle of the previous decade, has been virtually nil for the last five years, exceptional factors aside.

At the same time, the profits of Italian banks have been eroded by heavier losses on loans and a drop in income. Because of corporate crises in particular, from 2008 to 2016 write-downs on loans absorbed 80 per cent of operating profit. Interest income is now one third lower in relation to total assets than in the middle of the last decade; other income has also diminished.

As the economic recovery gains strength, the outlook for the banking industry is improving, though only gradually. A return of new NPL flows to normal values will reduce the cost of credit risk. More intensive economic activity will spur households' and firms' demand for loans and financial services; eventually, profits could be boosted by higher interest rates. However, it is still unclear how much of the drop in banks' net income is due to the economic cycle and how much to long-term factors.

The growth in lending to firms may continue to be hampered by the ample supply of internal funds. The non-financial corporations sector has been a net creditor of the other sectors of the economy since 2012; this is an anomaly with respect to the past, but one that is also present worldwide.

The modest expansion in lending to firms can also be put down to a gradual strengthening of their financial structure. Since 2011, leverage (i.e. the ratio of financial debt to its sum with net equity) has diminished by 7 percentage points. The share of bonds in total financial debt has risen by 5 percentage points, to 11 per cent; the proportion of bank loans has similarly diminished. Initially, the switch between the two types of financing concerned only a small number of firms, typically the big industrial groups already active on the bond market; it has now spread to small firms as well.

The greater financial soundness of firms and their more diversified sources of finance are a positive, long-sought-after, development. If the trend takes root, it will make Italy's financial system more resilient by splitting macroeconomic risk among a much larger number of investors. For many banks, however, it will potentially reduce credit and income growth. The challenge is to exploit the large pool of information on firms and on the economic system to offer new services. This process requires qualified human resources and an ability to interact with investors and markets without entering into any conflict of interest.

The sweeping reform of the rules on bank capital launched in the aftermath of the crisis significantly increased the quantity and quality of own funds and inevitably put pressure on profitability. Going forward, the completion of Basel III, the introduction in Europe of requirements regarding loss-absorbing liabilities in situations of crisis, and the adoption of new accounting rules for write-downs on loans will bring further pressure to bear, notably on the cost of wholesale funding. For the banks that are unable to withstand this pressure it is important to prepare in advance measures that will make it as easy as possible for them to leave the market by means of mergers or sales, and at no cost to ordinary customers.

To help the banking industry adapt more rapidly to the new environment, all the problems not yet solved by the regulations must be addressed without delay. An interval in the process of changing the rules would be welcome, not only to allow the banks to fully adapt to the new system, but also to prevent the incessant production of rules from itself becoming a source of uncertainty, and thus a hindrance to banking activity.

Over a broader time frame, the growth of digital technologies is bound to increase the pressure of competition and squeeze banks' profit margins. The availability of information on households' and firms' economic behaviour has increased enormously in the last ten years, as has the ability to process it. A new group of companies, called Fintech, are using this data to create innovative products, processes and business models. Already today they are in a position to offer financing and investment services, financial consultancy, and retail and wholesale payment services in competition with traditional banks.

In the light of these developments and of the uncertainty surrounding the potential growth in business volumes and income, the banks are being called on to make an exceptional effort to reduce operating expenses, improve efficiency, and redirect spending towards investment in innovation. Greater use of digital technologies in the production and distribution of services will have a significant impact on the organization of labour, on its quantity and quality, and on how it is used. The number of payroll employees in the banking industry has fallen by 12 per cent since 2008, a trend that is bound to continue, including through the adoption of well-designed early retirement incentive schemes. During this period of transition, cost-cutting measures should apply to overall compensation as well, at all levels, and should reduce the many organizational duplications.

A by no means small number of banks are still struggling to keep pace with the rapid reorganization of distribution channels. To date, the increase in the role of digital channels and the reduction in traditional ones have mainly concerned the largest banks. Since 2008, the number of branches has decreased by 5,000, or 15 per cent, a trend that will inevitably continue, both here and in the other main European countries. At the end of 2016, just over half of bank customers had access to online banking facilities.

Investment aimed at exploiting the opportunities offered by the new frontiers of the digital economy is growing, but it is still restricted to a small number of large banking groups. Barely a third of banks have started projects to exploit internal big data and organize information on customers' habits and potential requirements. The main obstacle is the lack of technology and of human and financial resources; it must be overcome if Italy's financial industry is to remain competitive and continue to create value for the economy.

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The crisis that hit our economy has disrupted banks' activity. The equilibrium that ensured almost a decade of growth and stability for Italian banks between the last millennium and this has been broken. However, as the problems of failing banks are solved and the economy recovers, the risk that the system may not hold up is receding. The market's assessment of the outlook for Italy's banks has improved in recent months, leading to a robust recovery of their share prices. Much remains to be done before the sector reaches a state in which the banks are able to generate sufficient profits to support the levels of capital adequacy imposed by the rules safeguarding the stability of individual banks and of the system as a whole.

The supervisory authorities cannot stand in for the banks' senior management in corporate decision-making. Their task is to prompt those responsible for strategic decisions to evaluate the opportunities and risks of the new environment and make a realistic assessment of their bank's strengths and weaknesses. Reinforcing corporate structures, improving efficiency and productivity, seeking alliances or mergers to overcome the limitations imposed by size, and investing in new technologies, are key elements in the effort to reinvigorate the Italian banking system.

Designed and Printed
by the Printing and Publishing Division of the Bank of Italy