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La banca nel nuovo ordinamento europeo: luci e ombre

Ideas for the future of Italy’s financial system

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Italy's banks in the new European system

Italy's economy was already weak when the 2007-08 global financial crisis struck. Its productive system was structurally incapable of delivering innovation, efficiency and genuine development; its financial system was overly reliant on banks. The old dinosaur that was its banking system had already begun to stir back to life, but many banks lagged behind as a result of ingrained bad habits in governance and management. These weaknesses fed on each other and were decried at conferences and publicly condemned. Given that they were also deeply rooted in the country and its history, at least its recent history, a solution appeared remote.

If you get a raging temperature when already under the weather, you run a serious risk, as Italy did in these years. The country is only now coming round and while not yet decisive, the signs are encouraging.

What happened outside our borders in recent years – worldwide efforts to draw up new regulations for finance, banking union in Europe and its first faltering steps – will be analysed by future historians.[1] Europe's banking union is here and we must ensure it functions smoothly, starting with the Single Supervisory System (SSM) and the Single Resolution Mechanism (SRM) established in Frankfurt and Brussels. I will return to this point shortly.

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[1]For an overview of these events from Italy's perspective, see I. Visco, speech at the 23rd ASSIOM FOREX Congress, Modena, 28 January 2017; S. Rossi, 'The Banking Union in the European integration process', delivered at the conference on European Banking Union and bank/firm relationships, CUOA Business School, Altavilla Vicentina, 7 April 2016.

From a legal perspective, banking union formally rests on numerous and complex legislative acts, which I will refer to using their English acronyms. For the euro area only, there are the two SSMR and SRMR Regulations establishing the new bodies tasked with supervision and banking resolution, dating from 2013 and 2014 respectively; for the European Union as a whole, we have CRD IV (the Capital Requirements Directive), followed by the CRR (Capital Requirements Regulation), both from 2013; finally, there is the BRRD (Banking Recovery and Resolution Directive), from 2014, and the DGSD (Deposit Guarantee Schemes Directive), also dated 2014. Several of these acts are still being revised and refined.

On the question of banking resolution, a vital component in the overall project for banking union, the European Commission's July 2013 Communication updated its own earlier interpretation of the rules on State aid in the banking sector. Taken together, the BRRD, DGSD and this Communication have played an important role in the case of the failing Italian banks that were wound up, placed under resolution or sold to other banks.

Banking union makes sense if markets and investors believe that Europe's banks are European first and foremost, and only then Italian, German or French. It follows that if a bank is in difficulty, it must be a matter for Europe, not just for the country in which that bank is headquartered. This implies the sharing of risks, both at private and public level, a concept that many countries have yet to accept. For several good reasons, I might add. However, one point must be clear: banks run many risks that have to do with how they are managed, but they also share with the State in which they are established – and whose government bonds they hold in their portfolios – what is commonly termed sovereign risk. In the euro area today this is a reflection not only of idiosyncratic factors in that State, but also of the possibility – which the markets continue to entertain, though much less than in 2011 – of a euro break-up and the redenomination of credits into renascent national currencies. This element of risk must be eliminated by driving the message home at every opportunity: whatever happens, the euro will endure.

Proceeding with banking union necessarily implies sharing banking risks: all countries must work to make this a reality.

The problems besetting the 'business of banking' today

What problems do Italian banks face today, now that the fall-out from the crisis, specifically the ratio of non-performing loans, is slowly diminishing? Essentially, our banks generate too little profit, even excluding the cost of bad loans. To understand why, it helps to look at what has happened internationally.

Over the last five years the return on capital and reserves, namely the return on equity (or ROE), of our banks has been virtually nil, while in the euro area ROE has been just under 2 per cent and in the United Kingdom it has hit 3; in the United States it has reached as much as 9 per cent.

Italian banks have not only had to make enormous write-downs of non-performing loans on their balance sheets, they have also had to bear higher costs than in other countries. Up to now, traditional lending, especially when concentrated around smaller customers, has obliged banks to allocate a large amount of human resources per unit of revenue; moreover, for our major banks labour productivity, expressed as the value added per employee, is modest, averaging

€124,000 over the last five years, compared with €170,000 for a sample of large European groups with similar business models.

The low interest rate environment, created the world over by monetary policies, has squeezed interest margins and reduced profits. Although this is a global phenomenon, Italian banks have suffered more than those of other countries owing to their traditional business model: for several years their ROE has been much lower than the cost of capital, which does not make it easy for them to find new funding on capital markets.

As we see, Italy's entire financial structure is in difficulty. Despite the progress made in recent years, we still have companies that are poorly capitalized (as well as too small on average) and a bloated banking sector within the financial system.

And yet the overall size of Italy's financial sector is no greater than that of other advanced countries. On the contrary! At the end of last year, the financial debt of the private sector (excluding banks and other financial entities) was below 120 per cent of GDP, compared with around 160 per cent in the euro area, the United Kingdom and the United States.

But, for our companies, equity finance accounts for only 46 per cent of their total liabilities, compared with an average of 53 per cent in the euro area. Moreover, they turn mainly to banks rather than to financial markets or non-banking intermediaries: bank loans represent more than 60 per cent of firms' financial debts, while the euro-area average is not even 40 per cent and in the United States and the United Kingdom it is one third.

As a result, Italian banks, even the largest ones, have specialized in retail lending to firms. They are therefore more exposed to adverse cyclical conditions.

The transition of the Italian financial system

The rules are changing

The response of governments and supervisory authorities to the global financial crisis has focused on two key concepts: ‘more capital in banks’ and ‘no more taxpayer-funded bail-outs’. This is not all: action has been taken on liquidity, securitizations and off-balance-sheet transactions. Limits on leverage have also been recognized as necessary supplements to risk-based capital requirements. Even stricter rules have been envisaged for systemically important financial institutions. Instead, less attention has been paid, at least so far, to two extremely important non-banking topics: the shadow banking system and over-the-counter derivatives transactions.

Has the pendulum swung too far towards rules for banks? Many institutions have naturally begun to think so. The Basel Committee on Banking Supervision is where the world’s supervisory authorities are now debating this question, during the negotiations on the proposed Basel III reform package, which should reinforce and refine banking supervision rules. I have three observations to make, in line with the stance adopted by the Bank of Italy.

<u>First observation</u>. A period of adjustment for the reforms will be needed to produce a stable legal framework, otherwise uncertainty will increase, as will risks and the costs of banking. We must allow the rules to settle into place and then look at their effects on business conduct

and models. The burdens, especially for smaller banks, need to be reduced where possible, though how this is to be done is a subject for discussion.

Second observation. The desire for a period of stability is not to be confused with an easing of the rules, and the USA is currently wrestling with this problem. The Fed has defended the reforms it made in response to the global financial crisis by showing how they have strengthened the banking system without limiting economic growth. However, the new administration has yet to define its negotiation strategy. This uncertainty, which can occasionally be seen in the position taken by American representatives in some international forums, deprives the entire international community of important leadership.

Third observation. Work is ongoing in the euro area on regulatory and institutional reforms. This is a good thing as banking union is still incomplete. Yet in Europe, we also need to consolidate what has already been achieved, starting with the SSM and the SRM, the two organizations responsible for the supervision and resolution of euro-area banks. Practices need to be harmonized by taking the best from each national system without prejudice. Progress is under way, including a contribution from Italy, and must be continued.

Rules can contribute to forging the business model for all banks. If the rules change, banks must take this into account when deciding on their identity and strategy. We hope that the uncertainties in the global and European regulatory framework will be dispelled as soon as possible, because banks, especially in Italy, must reinvent and redefine themselves; and do so also in the light of new technologies.

Technology and its uses are changing

FinTech is the new buzzword at the centre of any debate on the future of banking. FinTech companies make use of existing technology, and of new technology as it becomes available, to offer financial products to their customers that up to a few years ago could only be purchased through a bank. This business is expanding rapidly in the markets for loans, payment services, and financial advice and has managed to attract substantial funding from venture capital and private equity firms: last year such firms invested more than $13 billion in FinTech. This is still a trifling amount compared with the trillions of dollars involved in global finance, but its growth is exponential.

Until very recently, the banks benefited from being the main gateway to the financial world for most of the population. By providing a simple but fundamental product like the current account, they were able to reach a vast client base and make profits. Today, FinTech companies are trying to unpack the bundle of financial services offered by the banks, leaving the latter with only the least profitable ones.

FinTech uses innovative data analysis techniques (artificial intelligence and machine learning) to process efficiently the information that individuals and companies put online, sometimes unknowingly (big data). Using this data, algorithms calculate the creditworthiness of those applying for a loan and the result is available, on digital platforms not requiring a bank to act as intermediary, to the savers who directly disburse the financing. The method seems particularly profitable when an individual or a small company is asking for a loan: in this case, according to the advocates of FinTech, an algorithm based on big data is far more efficient than an office peopled by bank clerks.

FinTech companies are radically changing the relationship between clients and financial service providers, even in terms of usability. They mainly meet the needs of younger people, enabling them to conduct financial transactions at any hour of the day or night using their mobile devices.

This poses a serious threat to traditional banks. The only factor that keeps borrowers and lenders tied to a traditional bank is trust, based on familiarity with other human beings behind a counter or even based purely on a brand. This is an imponderable factor, one that is difficult to predict. Certainly, the banks will have to give much more importance to the digital distribution channels and radically alter the way that client data are analysed and stored. Substantial investment in technology and human capital will be necessary.

Another option for traditional banks is to acquire one or more FinTech companies, as seems to be happening with payment services. Smaller banks could team up with FinTech companies and outsource some of their own business, as has happened in many English-speaking countries.

FinTech also raises questions and problems for those with a public responsibility as financial regulators and supervisors. There is a risk, for instance, of enlarging the boundaries of shadow banking, that is financial entities that elude any kind of supervision. Progress cannot be stopped, but it should be pointed in the right direction in the public interest. We are already considering the best approach to take.

The system's transition

The financial crisis, the global reaction that widened and hardened the perimeter of banking regulation, the tumultuous developments in technology and in the market and, in the case of Italy, the long-standing problems in the structure of the economy require that our financial system be transformed. The changes are already under way, and the system is in a state of transition.

Throughout the euro area, the banking system has progressively consolidated since the crisis. At the end of last year, the number of banks was just over 5,000, a drop of 25 per cent compared with eight years ago, while the number of residents per bank branch has grown by more than 30 per cent. In Italy, the first figure is in line with the euro-area average, while the second is lower (19 per cent), but nonetheless considerable.

Similarly, the productive capacity of Italy's banking industry is no more excessive than that of the euro area. At the end of last year, the number of residents per bank in Italy was about 100,000, much higher than the average of 67,000 in the euro area and 48,000 in Germany, even if the number of residents per bank branch was lower: about 2,000 compared with 2,300 in the euro area and 2,600 in Germany.

However, the future does not so much hinge on the number of banks and bank branches, as on the composition of the financial system and the types of activities that banks undertake.

I mentioned earlier that our financial system perceives firms as being overly indebted, especially towards banks but without them having benefited in terms of profitability. In order to increase the profitability of the Italian banking system and make it sounder, counterintuitive events are necessary: firms must increase their capital and diversify their sources of financing in order to reduce the role played by banks in the financial system.

Signs of this are already apparent. The moderate expansion in bank lending to firms in recent years, despite its recent recovery, is also a result of this process. From 2012, firms' leverage (the ratio of debt to debt plus equity) has fallen, the share of bonds in total financial debt has increased and the share of bank lending has diminished in equal measure. Changes in the composition of financing sources, initially limited to large industrial groups already active in the bond market, are now being seen among smaller firms as well.

Over the past few months individual savings plans (PIR funds) have been introduced, i.e. instruments offering tax breaks and designed to channel investment directly towards Italian firms. The experiment has thus far been a success, attracting a net amount of approximately €5 billion. Special Purpose Acquisition Companies (SPAC) are another relatively new addition to the market, with growing success: in essence they are small private equity funds that gather resources from a limited number of investors solely on the basis of the personal reputation of the promoters. The resources are used to purchase equity in a target company, to be acquired within a set time limit after the vehicle has been established. SPACs are listed companies and serve to accelerate the listing of the target company.

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It is not enough for Italy to change the composition of its financial structure. Banks must advance their business model by accepting and facilitating a narrowing of their traditional role.

In the long run, regulatory and technological changes make the Italian model of banking that prevailed in the ten years prior to the global financial crisis no longer sustainable. However, the transition to a new model is far from being free of obstacles and risks. For example, the immediate repercussions on employment of a rebalancing of the financial structure that lowers the share of the banking sector must be considered carefully, and tools to upgrade the skills of redundant staff must be set up – as we have already begun doing.

There is no one solution. Each bank is a unique case and generalization must be avoided. Some banks might increase the supply of bond or share placement services to small and medium-sized enterprises, leveraging the wealth of information gathered over time: in short, this would translate into less direct credit but greater support and the provision of collateral for firms seeking access to financial markets. Other banks might remain totally retail-oriented but enhance their use of digital tools, boosting their online channels and expanding the transactions and services available through them.

Such decisions are up to the banks. Analysts and supervisors can only try to glimpse the trends and prospects that, interspersed with risks, lie in the mist that always clouds the future. Of one thing we can be certain: the financial and banking systems cannot remain as they are if we want our country to return to a path of growth as it has done in the past.