Mario Draghi: Monetary policy and the banking system

Address by Mr Mario Draghi, Governor of the Bank of Italy, at the Annual Meeting of the Italian Banking Association, Rome, 11 July 2007.

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I wish to thank the Italian Banking Association for extending its traditional invitation to the Governor of the Bank of Italy to take the floor on the occasion of your Annual Meeting. And I should like to convey my special greetings to President Corrado Faissola, who is presiding over the gathering for the first time.

Economic and monetary developments

The euro-area economy will continue to expand in line with its potential growth rate. The rapid increase in exports should be accompanied by lively internal demand. Industrial production is now at a five-year peak, as is the indicator of business confidence, and consumer confidence continues to improve. In the second quarter of 2007 GDP growth was about 2 per cent on an annual basis. The EuroCOIN coincident indicator calculated by the Bank of Italy has declined slightly since the start of the year but remains at a high level.

The Governing Council of the European Central Bank, clearly perceiving the signs of expanding economic activity, has been making its monetary policy progressively less accommodating since the end of 2005. This prompt intervention, in advance of actual pressure on prices, has kept inflation expectations anchored to a stable scenario.

Lending conditions for households and firms remain favourable.

The money supply and credit in the euro area are still expanding rapidly. M3 growth remains near the highest rates recorded since the start of monetary union. The most liquid components, cash and current accounts, have decelerated. Bank credit to firms is growing at a strong pace, while lending to households has slowed slightly. The deceleration in mortgage lending for house purchase reflects the slackening of property prices and rising interest rates.

Since January the rate of inflation has been just under 2 per cent. It may exceed that value temporarily in the months to come as a result of the recent rise in energy prices.

The euro has contributed substantially to Italian and European economic growth. Since its introduction, thanks to the Eurosystem's monetary policy, inflation expectations have remained low and stable, even in the face of sharply rising energy prices. The credibility of the monetary policy stance has kept interest rates significantly lower than in previous decades in every phase of the economic cycle, not just in Italy but in the other euro-area countries. The predictability of monetary policy has helped reduce the volatility of the financial markets.

At the launch of the monetary union there were fears that certain structural features would make the Italian economy more vulnerable than others to variations in the official rates. Monetary policy produces its effects on the economy above all by influencing the cost differential between firms' external and internal finance. Its impact is therefore amplified by information asymmetry concerning the state of the borrower, or by the impossibility for firms of replacing bank loans with market instruments such as bond issues. A situation that is especially common in Italy, where small firms depending on bank credit are prevalent and where private capital markets are still less highly developed than in other large industrial countries. The effect is heightened if the loan market consists mainly of short-term, variable-rate loans.

Studies conducted by the Eurosystem using a broad range of econometric techniques have nevertheless found that, albeit with modest differences, the economies of all the euro-area countries have so far responded in similar fashion to changes in interest rates. In recent years the exceptionally low level of risk premiums and of interest rates, the abundance of finance in the form of both loans and other financial instruments, and the large volume of firms' internally generated funds may have softened the effects of structural disparities, which could re-emerge in the presence of less favourable economic and financial conditions.

At the same time, however, the structure of the Italian economy is becoming more robust. The consolidation of the credit system has given birth to large banks capable of operating on a range of markets. The improved efficiency of intermediaries and the considerable lengthening of corporate debt maturities have removed earlier weaknesses. The extraordinary development of the euro bond market and the recent opening of the Italian stock exchange to international alliances will also help a system that had lost the market for corporate bonds and where firms' recourse to the equity market is still limited. Further progress on these fronts is essential if we are to fully exploit the advantages of participating in the Monetary Union.

Financial innovation and monetary policy

The diffusion of financial innovations, the creation of new products and new intermediaries, and the changing structure of the financial markets alter the importance of the various channels of monetary policy transmission and affect the analysis of money and credit aggregates and their role in monetary management.

The role of the banking system in transmitting monetary policy impulses has been diminishing in importance. If the recent changes in the structure of the financial markets prove to be permanent, banks will increasingly be agents that originate loan assets which they then combine and transfer in part to the market. Loan securitizations are booming. In 2006 they were equal to more than one fifth of the increase in lending in the euro area and in Italy. Credit derivatives, though still small in volume, are growing explosively. The transfer of assets to non-bank investors such as pension funds and hedge funds gives banks an alternative channel for procuring liquidity. The transfer of risk by means of derivative instruments can reduce the supervisory capital requirement for a given volume of lending. A study by the Bank of Italy and the ECB on eight years of data from 3,000 intermediaries in the euro area has shown that the banks that make the greatest use of securitization decrease their lending less than others in response to rises in the official interest rates.

Other transmission channels are gaining in importance. Innovation has made financial markets more liquid, efficient and complete. The speed with which official rate changes are reflected on a broad range of financial instruments, and hence on saving and investment decisions, has increased. The markets respond to expected moves by the central bank even before its actual moves.

The promptness with which markets react to new information increases the risks of instability inherent in unclear communication by central banks. Monetary policy decisions that diverge from the expectations of the market already embodied in financial asset prices can have devastating effects on liquidity and prices in extreme cases. In recent years central banks have augmented the predictability of monetary policy, making objectives and strategies clear and explicit.

Central banks take expectations into account, but they do not lose sight of the fundamentals. To avoid surprising the markets is preferable but not always possible. It remains essential for price stability that the authorities' actions orient the market, not the other way around.

The changes in financial structure also affect the information content of the monetary aggregates. Until not many years ago virtually all euro-area M3 consisted of transaction instruments of households and firms, whose behaviour as holders of money was stable enough. In recent years there has been considerable growth both of the portion held by non-bank intermediaries, including investment funds and loan securitization vehicles, and of the portion consisting of negotiable instruments, holdings of which are largely determined by portfolio choices rather than consumer spending.

Nevertheless, the money supply is still an essential element in central banks' assessment of price stability. To extract the full information content, a broad set of aggregates and indicators should be analyzed. The analytical tools need to be adapted, an objective shared by all the central banks of the Eurosystem. The Bank of Italy is developing techniques for the analysis of a set of monetary indicators that includes all the components of money and credit.

The transformation of the banking system

In the year since your Association's last annual meeting, three major bank mergers, two of them involving cooperative banks, have been concluded with approval by shareholder meetings. A fourth, passed by the boards of the banks involved, awaits shareholder approval.

The Italian banking system has become more robust in terms of the size of institutions. Today the two largest groups both have a significant presence abroad; the conditions exist for competing on a European scale. The other mergers have created banks that are among the largest in Italy.

The consolidation of banks is just the starting point. Reorganization can only be said to have been successfully carried through when the gains in efficiency envisaged by the business plans are achieved. The market expects savings from the unification of technological platforms, the integration of distribution channels, the increase in labour productivity. Having a greater number of national-scale banks will increase competition. In order for increased size to engender greater competitiveness, integration synergies must be exploited in full. Past experience shows how complicated it is to integrate different organizations, technologies, networks and corporate cultures. There is a serious risk of heel-dragging and slowness to adapt. A high degree of unity on the part of management and the greatest possible reserve in external communication are of the essence. There is no time to lose.

The quality of corporate governance is crucial to the success of integration. Choices must be guided by clear objectives and a rational division of responsibilities. The Bank of Italy is active, attentive. We shall continue to examine the solutions adopted and the way corporate bodies operate, ensuring their proper functioning for purposes of sound and prudent management and intervening whenever necessary. Specific rules on the governance of banks will be issued.

It is essential that the new groups organize their system of internal controls as a matter of urgency. The complexity of integration and the rapid expansion of innovative products heighten operational, legal and reputational risks. Clear accountability and the ability of top management to keep control of the key processes are prerequisites for stability even more than efficiency.

All the banks involved in the mergers had developed advanced methods of risk measurement to be submitted for supervisory approval as an instrument for calculating capital requirements. In some cases the project will have to be revised to take account of the new situation. In no case is a deterioration of risk control, even a transitory one, permissible.

The consolidation of the banking industry will facilitate the reorganization of the asset management industry and the realization of the scale economies that could result if integration synergies are exploited in this field too. Consideration should be given to measures to guarantee the complete independence of the directors of asset management companies. It is commendable that the majorities of the boards of the two largest bank-owned asset management companies consist of independent directors.

Italian banks have large market shares in the countries of eastern Europe, where lending is expanding rapidly. The loans go above all to households for the purchase of houses, whose prices have risen rapidly. In Slovakia, Poland, Bulgaria and Hungary, where Italian banks' market share is around one fifth, lending is increasing by more than 20 per cent per year on average. These countries' external current account deficits are large and persistent. Last year Bulgaria ran a deficit of 16 per cent of GDP. Bank loans, which are mostly indexed to the euro or other foreign currencies, carry lower interest rates than those in domestic currencies. In the short run they are attractive to borrowers but expose them to a severe exchange rate risk, with potential financial and reputational repercussions on the banks.

I have repeatedly called attention to the need to complete the reform of the governance of Italy's cooperative banks. The aim, which I believe is generally shared, is to release the extraordinary potential of these institutions, make sure their corporate bodies are satisfactorily representative, not to question their cooperative mission. To those who want to maintain the present equilibria, I shall not cease to recall the benefits – especially for the largest cooperative banks listed on the stock exchange – of a reform that removes the anomalies of a legal framework tailored to small, local banks. We must ask whether decision-making mechanisms in which small minorities have a decisive voice in strategic choices are consistent with the rules of the market.

Banking supervision in Europe

The concentration of banking systems, the removal of barriers between markets and the transnational nature of the largest groups have given banking supervision a European dimension. These developments have demanded a rethinking of the instruments of supervision that has already had important consequences but is still under way.

Harmonization of the rules on banking supervision has reached an advanced stage. There is agreement on the fundamental choices and extensive cooperation among the supervisory authorities, in the first place within the Committee of European Banking Supervisors. For transnational groups supervisory panels are at work, formed by the authorities of all the countries in which a group is present and coordinated by the authority responsible for consolidated supervision. The Bank of Italy chairs the panels for UniCredit and Intesa Sanpaolo and participates in many others. The exchange of information and experience is continual, the climate of cooperation excellent.

It is necessary to extend harmonization gradually from supervisory rules to supervisory practices: more effective action, equal conditions of competition, a lighter burden on banks, especially those present in different countries, are the objectives. Further harmonization of the rules on own funds and risk concentration appears urgent. It will also be necessary to design common criteria for stress tests and work for the adoption of a homogeneous prudential statistical reporting format.

In the coordination fora the authorities have conducted simulations to prepare for the crisis of a large bank. One learns a great deal from these exercises, and it would be a good thing if they were held more often. Principles and procedures for the allocation of tasks and responsibilities are being defined; the process must be completed rapidly. A strengthening of the role of the CEBS will speed up convergence of supervisory practices and simplify cooperation between authorities. Thought also needs to be given to the possibility of emphasizing the position of the coordinating authority in supervisory panels by giving it the role of lead supervisor, with greater powers on the group's subsidiaries for purposes of preventing and managing crises.

However, the remaining differences between countries in deposit insurance, insolvency procedures and the rules on the transfer of assets between units of the same group could seriously complicate the management of a crisis. Eliminating or attenuating these differences must be placed on the legislative agenda at national and European level.

Banks, firms and innovative products

Bank's dealings with firms now embrace not only the provision of loans and payment services, but also the supply of innovative financial services, including risk management products. These can increase the efficiency of the system and be a growth opportunity for banks, provided the customer is given complete information, the seller fully understands the product and the bank's top management, whose duty it is to appreciate these products in all their complexity, is clearly aware.

Banks provide an important service to firms if they assist them in selecting instruments suited to their characteristics. The purpose must be the hedging of risk, not anything else. To encourage customers to assume financial risks rather than hedge them increases counterparty risk, with large possible losses; it creates legal and reputational risks that can undermine the bank's prospects for growth and even call its stability into question.

This is before our eyes in a case now being clarified. An inspection that the Bank of Italy began at a bank in January of this year found that it had sold business customers complex derivative products, highly exposed to an increase in interest rates. Owing to market developments, these derivatives have caused a sudden surge in the indebtedness of the customers who had bought them. The result was an increase in the bank's exposure to counterparty risk as well as to legal and reputational risks. The Bank of Italy intervened; it is following the case with the utmost attention.

Proper conduct, transparency and adequate organization are essential to every bank that alongside its traditional credit operations sells complex products. There must be a clear line of decision-making connecting top management to operating decisions and to customers' demands.

Transparency, proper conduct and the protection of bank customers

The Bank of Italy's supervisory provisions on compliance have been approved and will shortly be published. They lay down general principles, granting banks discretion in selecting the most effective organizational arrangements. Banks' governing bodies decide the overall design of the compliance function and monitor its actual operation.

In all customer relations, transparent and correct information increases the public's range of choices, fosters competition and prevents legal disputes. Lawmakers and regulators have become more responsive than in the past to the need to ensure correct relations; banks themselves are rapidly becoming aware that the point is not only to defend and enhance the reputation of the industry, but also to gain an important tool of competition.

As I have said on other occasions, it is appropriate for regulators to intervene where economic agents and the market are unable by themselves to ensure adequate standards. Self-regulation, if based on agents' clear determination to pursue its underlying objectives, can be more effective than mandatory rules in many cases. The most powerful tool for pursuing the interest of consumers remains competition, which can function well, however, only if transparent terms and conditions are ensured and the obstacles to customer mobility eliminated. This requires rules at various levels; statutory provisions, administrative regulations, self-regulation and competition are complementary instruments.

I therefore take note with favour of the action plan ABI has just adopted to improve relations with customers. The intent to capitalize on cooperation with consumer associations and the authorities is commendable, the declared objectives endorsable: to enhance the transparency and simplicity of relations with customers, to assist customers before and after the sale of financial products, to strengthen their confidence, to eliminate residual barriers to mobility. It is in the system's interest that customers see concrete progress soon.

Self-regulation must benefit competition. The cooperative relationship between the banking system and the Antitrust Authority is positive.

In recent times Parliament has intervened on various aspects of the bank-customer relationship, in particular by ordering the abolition of costs for closing current accounts and introducing the customer's right to extinguish a mortgage loan without a penalty. The Bank of Italy looks with favour on the purposes of these measures, even if it has raised doubts on certain technical aspects and suggested leaving room for secondary legislation and self-regulation. For current accounts, the new rules have given rise to problems of interpretation, and progress has been insufficient: complete portability of accounts is not yet guaranteed. For fixed-rate mortgages, the ban on penalties for early repayment may lead to banks setting higher rates: early repayment is an implicit option in favour of the debtor and thus has a financial cost.

Parliament is examining a bill that will prohibit the maximum overdraft fee, a practice not easily defensible and in fact one that some banks have already dropped in a logic of competition. An amendment approved during the bill's passage through Parliament will, in line with views expressed by the Bank of Italy, allow banks to apply fees for open credit lines, a common practice in other banking systems.

The MiFID Directive on Markets in Financial Instruments, which will enter into force in November, will also affect relations between customers and intermediaries. Its more precise description of information requirements, differentiated according to the nature of the customer and the service, will enhance the transparency of the instruments offered. Customers will be in a position to benefit from a larger dataset and make more informed decisions. Fulfilment of the obligation to offer best execution, extended to include factors other than the price, will be entrusted to suitable organizational solutions identified by intermediaries. The Bank of Italy, with the other authorities, is engaged in defining a flexible regulatory arrangement consistent with the need to limit the costs for intermediaries and with the objective of enhancing the attractiveness of the Italian financial marketplace. We have organized training courses for the staff of some of our branches to assist banks in adapting to the new rules.

Protection of the parties to bank contracts requires swift-acting, effective and economical dispute resolution instruments. The law now asks intermediaries to subscribe to non-judicial mechanisms. The Bank of Italy, which will have to submit a proposal to the Credit Committee for the regulation of the matter, is about to begin a consultation with intermediaries and customers. The proposal will be based on the experience gained in Italy and elsewhere and on a specific European recommendation; it will ensure that the adjudicating bodies are not only independent but also clearly perceived to be so. The Bank is ready to contribute by taking part in the appointment of disputes resolution panels and providing technical secretariat services. The success of the initiative requires both involvement of the associations of consumers of financial services and convinced participation by the associations of intermediaries, which will also make it possible to draw on the experience of the Banking Ombudsman.

No rule on transparency and protection is truly effective if customers lack the means for making informed decisions. With the growing complexity of supply, ensuring the financial education of consumers of banking services has become a matter of crucial importance. The Bank of Italy cooperates with other institutions in projects of financial education, has begun to develop a dedicated section of its own website and, with the Ministry of Education, has launched initiatives targeted at schools. But much remains to be done.

The Bank of Italy is committed to preventing and combating money laundering. The planned incorporation of the Italian Foreign Exchange Office into the Bank and the transposition of the new European Anti-Money-Laundering Directive will create the conditions for further progress. The independence of the Financial Intelligence Unit will be confirmed. The rules will be made more incisive, controls increased and new forms of intervention introduced.

Loans to households

Household debt has risen from 31 to 48 per cent of disposable income since the end of the 1990s. Compared with the situation in the other main industrial countries, both the amount of household debt and the burden of instalments and interest payments are still limited. The debt is largely concentrated with high-income households, which normally are better able to absorb additional costs due to rising interest rates, but its rapid expansion is involving ever-broader strata of the population.

Financial innovation, more flexible rules and increasing competitive pressures have multiplied the forms of financing available, especially for house purchases. Until not long ago mortgages rarely exceeded 15 years in duration or 50 per cent of the purchase price. Today more than one third of mortgages last more than 25 years and the cover ratio is considerably higher. Access to consumer credit has also become easier. The market in lending to households has expanded and matured.

Further progress must be made, however. Both for home mortgages and for consumer credit, the interest rates charged by banks in Italy are higher than the euro-area averages for similar transactions. The recent change in monetary conditions has led to a shift in the demand for mortgages from variable to fixed rate loans; for the latter, the increase in interest rates has exceeded the European average. The new rules on covered bonds will enable banks to expand the range of funding instruments to finance long-term loans and reduce their costs; this will have to be reflected in more favourable conditions for customers.

Data harmonized at European level show that Italian banks' annual percentage rate of charge on consumer credit is still about one percentage point higher than the euro-area average, even though the gap has narrowed in the last few months. Not all of the difference is due to risk factors or to the still limited development of the consumer credit market in Italy. Not even the entry of foreign intermediaries, which now account for more than one third of such lending, has proved a sufficient stimulus to competition. This must be strengthened, especially in distribution channels.

According to data gathered pursuant to the law on usury, the interest rates charged by financial companies are higher still. Furthermore, especially where small amounts are involved, rates vary widely even for transactions of the same type, such as personal loans, loans secured by wages and instalment purchases of consumer goods. This probably indicates insufficiently transparent contractual conditions and a pronounced segmentation of the market.

The attention banks pay to customers and to their own reputation must be greatest when their contact with the customer is made through outside collaborators. It is necessary to check that each link in the chain leading to bank products charges commensurate fees, to assist in the fight against usury, and to act promptly in cases of suspected unauthorized banking or financial activity.

The instruments are not lacking. Brokers' terms and conditions are subject to transparency requirements. A bank employee who steers someone to an unauthorized person for banking or financial transactions commits a specific crime. Certain characteristics of current account transactions that suggest usury have been made known by the Italian Foreign Exchange Office.

The Council of the European Union has reached agreement on a new directive on consumer credit, which will be examined by the European Parliament in the autumn. If approved, the directive will enhance consumer protection by providing for forms of transparency and assistance and new rights. It is in the nature of "maximum harmonization" and will therefore facilitate intermediaries that want to operate in more than one country, thereby stimulating competition. The Government has the commendable intention of anticipating the main points of the directive with ad hoc legislation and introducing, for loan and financial brokers, more detailed regulation and more effective controls, to be entrusted in part to organizations created by trade associations.

Payments: lowering costs, improving quality

Competition between banks will also be based increasingly on their ability to offer efficient payment services. There is room for improvement in payment completion time, costs and security. Completing a payment by cheque still takes an average of seven days; a legislative amendment facilitating digital transmission of the images would make a significant reduction possible. The creation of the Single Euro Payments Area will provide the occasion for modernizing instruments and infrastructure at national level as well and will be conducive to the specialization of intermediaries and to innovation.

The Payment Services Directive has harmonized the European legal framework, strengthened the protection of users and opened the market to new agents competing with banks. But Italy is still considerably behind in the use of electronic payments. Although the diffusion of POS terminals and payment cards is not less than in the rest of Europe, the number of transactions per capita with these instruments is far below the average. The excessive use of cash lowers the efficiency and security of transactions, increases the cost per transaction and hinders the reduction of the prices of payment services. ABI's commitment in favour of a rapid development of electronic payments is commendable.

The results of the survey on the costs of bank current accounts that the Bank of Italy has already begun will be available in the autumn.

The stock exchange

I cannot conclude these remarks without mentioning the developments involving the stock exchange.

A year ago on this occasion, I recalled at some length the essential role that the stock market plays in fostering the growth of the economy. I noted the strong boost to efficiency deriving from the integration of European and world exchanges and the drive to consolidate stock exchanges, including on a federal basis. Just a month has passed since my Concluding Remarks to the annual meeting of the Bank of Italy where I again underscored the growth opportunities that are emerging for exchanges that open to international cooperation and the risks for those that stay on the sidelines.

Borsa Italiana has taken steps to capitalize on its strengths – operational efficiency, local roots and its strong presence in some markets – and to reap the benefits of integration in a market of global dimensions. This opening is definitely a positive development. As in other fields, the Bank of Italy points to what it considers the right route. It does not seek to determine any institution's traveling companions. It notes that the road ahead is still very long and urges that it be traveled resolutely.