Mario Draghi: An overview of banking in Italy

Address by Mr Mario Draghi, Governor of the Bank of Italy, at the Italian Banking Association Annual Meeting, Rome, 9 July 2008.

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Rising inflation and the outlook for the world economy

Expansionary monetary policies together with severe tensions in the market for oil are at the origin of the present international economic and financial difficulties. The protracted monetary expansion in the United States and other countries spread to the main emerging countries because their currencies are pegged to the dollar. The fragilità of the markets originated in the gaps in the regulatory framework and was worsened by perverse incentives that fueled the tumultuous growth of the financial industry. But, as with the weakness of the dollar, the roots can also be found in overly accommodating monetary policies. The massive flight of capital from no longer profitable financial investments and the depreciation of the dollar have contributed to the rise in the price of oil, which is based on the structural tensions underlying this market.

The price of crude oil has been rising since the beginning of the decade; in real terms it has already gone beyond its previous all-time peak in 1979-80; it is still rising. The fundamental cause has been the sharp increase in the emerging countries' demand for energy, with supply struggling to keep up. Demand is inelastic in the short term owing to technical constraints. Supply is even more inelastic because of the increasing cost of discovering and developing new fields, rigidity in refining and transport, and unresolved geopolitical difficulties. But this is not enough to explain the latest price surges. That abundant liquidity worldwide has played a part is confirmed by our estimates, which indicate that the fall in real interest rates since last summer may explain about a quarter of the subsequent rise in world crude oil prices.

This not only puts pressure on current and expected inflation, it also poses a threat to world growth itself. The transfer of resources to the oil-producing countries, only offset in part by an increase in their imports, is holding down growth in the industrialized countries. Higher inflation, due also to food prices, is depressing the real value of wages and therefore consumption.

International financial markets, influenced by the more uncertain economic outlook and the increases in the price of crude oil, remain fragile. After a return to lower levels in March, risk premiums for corporate bonds and banks' credit default swaps have begun to rise again. The market for structured credit products has not recovered; money market spreads are still wide. The major international banks have begun to put their balance sheets in order, by reducing their exposure to the riskiest instruments and to a large extent covering their losses by injections of capital. But this capital strengthening is not yet sufficient, it threatens to be hindered by further falls in house and stock market prices. In the United States, rising insolvency rates and the possibility that poor economic conditions could undermine the quality of corporate loans are causes for concern.

It is important not to repeat the economic policy errors made in response to the oil shocks of the 1970s. In some countries, an initially expansive monetary policy destabilized inflation expectations; a sharp restriction had to follow. The consequences, partly because of widespread indexation, were persistently high inflation, enormous fluctuations in real interest rates and severe repercussions on economic activity.

Compared with thirty years ago, an oil shock has less of an effect on the economies of the consumer countries today, not only thanks to greater energy efficiency and more flexible markets but also because of the credibility that monetary policies have acquired. We estimate that with monetary union the impact of an increase in the price of oil on consumer price inflation in Italy has been reduced fivefold by comparison with the 1980s and 1990s. The credibility of monetary policy has contributed to this achievement. It needs to be preserved in the advanced countries and pursued in the emerging countries, by heightening awareness of the seriousness of the risk of inflation and the growing inadequacy of pegging exchange rates to the dollar.

Inflation and monetary policy in Europe

The rate of inflation has increased in all the major countries. Although "core" inflation – excluding energy and food products – is lower, the warning signals are growing.

Consumer price inflation in the euro area had already reached the highest level since the start of the 1990s in May (3.7 per cent); on the basis of provisional data, it rose to 4 per cent in June. There has been a sharp acceleration in Italy, too. According to Eurosystem forecasts, the rise in inflation in the area will be temporary but more persistent than was predicted several months ago. Inflation is now expected to subside only gradually in the course of 2009, remaining higher than 2 per cent for quite some time.

The idea that the rise in inflation is permanent must not take hold. On the eve of the meeting of the Governing Council of the European Central Bank on 3 July, the risks of an increase in inflation appeared to have grown. Albeit in a context of wage moderation, the first signs of an acceleration in costs were visible. Other warning signals were coming from market expectations: inflation expectations measured on the basis of long-term index-linked government bonds were tending to rise; the prices of inflation swaps signaled growing fears of inflation for long-term maturities as well. Against this background, the Governing Council of the ECB decided to raise reference rates by 0.25 percentage points. In the days following the rate hike, inflation expectations derived from the financial markets ceased their upward trend; it appears that they are now beginning to fall back.

By taking timely action we intend to help to avert the risk that the rise in the international prices of energy and food products might set off a spiral between expectations and the setting of wages and prices, and to bring inflation gradually back down to levels consistent with price stability in the medium term.

Households' disposable income is defended by combating the rise in inflation, which erodes purchasing power, lowers the real value of financial wealth and is a drag on consumption and growth. We estimate that in Italy the acceleration in prices recorded since last summer has reduced the growth in disposable income by more than one percentage point, by three points if the losses of the real value of financial wealth are also taken into account; it can reduce consumption by more than two points by the end of next year.

Average per capita earnings of employees, after tax and social security contributions, are not much higher today in real terms than they were fifteen years ago. Meanwhile, unit labour costs have increased by more than 30 per cent, compared with about 20 per cent in France and practically nil in Germany. This gap between the spending capacity of workers and the competitive capacity of firms reflects the meagre growth in productivity, the persistently high level of taxation and social security contributions, and the effect of inflation; it is at the root of the stagnation of our economy.

Price stability is a prerequisite for the resumption of growth. A price-wage spiral would be an illusory remedy and one that monetary policy must oppose. If monetary policy is credible, even if it cannot insulate the economy from the fluctuations of commodity prices, it can cushion their effects on expectations and domestic prices. A prompt monetary adjustment reduces the risk of tardy but violent corrections.

Italian banks' income and capital

Excluding capital gains and extraordinary income, the profits of the five largest Italian banking groups fell in the first three months of this year by about a third compared with the same period of 2007; the rate of return on equity fell on an annual basis by nearly five percentage points, to about 9 per cent. The deterioration began in the third quarter of last year. Contributory factors included the decline in fee income, caused mainly by the contraction in asset management activity, the losses on securities trading and portfolio writedowns.

In 2007 the tier 1 capital ratio of the largest groups fell slightly, from 6.8 to 6.5 per cent on average, although it remained above the regulatory minimum.

Loan quality has remained stable up to now. The ratio of non-performing loans to balance sheet assets for the groups as a whole remains close to 5 per cent; for bad debts alone, the ratio is close to 3 per cent. More than 60 per cent of the nominal value of bad debts is covered by write-downs. The ratio of new bad debts to outstanding loans holds at about 1 per cent for firms and 0.8 per cent for consumer households, levels that can be considered normal.

The impact of the international financial turbulence on the accounts of Italian banks has been relatively limited so far. However, income and profitability will continue to be affected if the tensions do not ease. The cost of funding on international markets remains high. The slowdown in economic activity could have an impact on loan growth and quality, weighing on profitability on a risk-adjusted basis. The exposure of Italian firms and households to interest rate risk is particularly large, given the high proportion of loans at short term or indexed to short-term rates: some 90 per cent of the total for firms and more than 70 per cent of mortgage loans to households. The uncertainty of the macroeconomic and financial picture demands that banks adopt a prudent policy of provisioning against future losses.

The measure regarding the partial non-deductibility of banks' interest expense is equivalent to an increase in funding costs of nearly 10 basis points. It is difficult to predict how this cost will be divided: depending on the evolution of market conditions, it could fall on the terms and conditions offered to depositors and borrowers, profits distributed or resources allocated to reserves.

Banking supervision

The Basel II capital adequacy rules went into force in Italy in January 2007; since the start of this year they have applied to the entire banking system.

From 2001 onwards the Bank of Italy had asked the major Italian banking groups to overfulfill the minimum capital requirement, in order to provide for the risks not covered by the Basel I accounting standards. This ensured that the massive process of concentration within the Italian banking industry could take place without jeopardizing balance-sheet soundness. With the new rules of Basel II, however, and in today's market environment, capital soundness takes on an even more important role, and the banks have been invited to proceed to the necessary strengthening. This autumn intermediaries will also be required to specify the additional capital safeguards to be constituted, where necessary, as part of the obligations laid down under the second pillar of Basel II.

It is essential that banks be in a position at all times to evaluate the impact of improbable but devastating events on income and on capital as well as to gauge the possible interactions among different types of risk: credit risk, market risk, liquidity risk and interest rate risk. The Bank of Italy has asked the leading banks to make stress testing a regular practice. The first results, although they are reassuring on the whole, revealed that in some cases the liquidity safeguards against extreme events were not adequate. These banks were asked to restore an adequate level of liquidity without delay.

New rules on bank governance came into effect recently; one of their provisions requires that the criteria for the remuneration of bank managers be designed so as to avoid perverse incentives in the matter of risk taking and risk management. With the cooperation of the banks' compliance units, we shall assess the consistency of incentive schemes with the principles laid down by the new rules.

Transparency and information comparability are essential to reducing the uncertainty that weighs on market trends. In accord with the other G7 national supervisory authorities, and in implementation of the recommendations of the Financial Stability Forum, on 16 June we asked Italian banks to include in their mid-year financial statements a detailed treatment of their risks in connection with subprime mortgage loans and structured finance, thus retaining and extending a procedure that had already been instituted in Italy for the annual financial reports for 2007.

In line with the indications of the Basel Committee we have asked the leading groups to adopt integrated systems of liquidity risk analysis and control providing for effective liaison between risk management and treasury management.

Preparation for critical contingencies continues. In coordination with the other supervisory authorities, we are conducting crisis simulation exercises and specifying the data flows to activate in the event of an emergency.

Coordination between the different countries' authorities and convergence of supervisory practice reduce the cost of supervision over international banks, helping to foster the integration of the European market in banking services. This is another reason for speeding up coordination. At the same time Community directives are progressively harmonizing the regulation of financial markets and products and consumer protection. But there remain significant differences in corporate, commercial and bankruptcy law. Action by European and national legislators is indispensable to strengthen the single market and simplify crisis response.

The restructuring of the banking system

Our system took full advantage of the opportunity presented by the favourable financial situation of the past years to conceive and carry out major banking mergers, which would be much harder to effect in today's market conditions. The end-product must be a system that is sounder, more efficient, with a wider range of higher-quality services, and in which banking intermediation is less costly for the economy.

Swift execution of planned mergers and continuous verification of the results are essential, especially in the current market situation. Above all, the rapid integration of information systems is a prerequisite not only for efficiency gains but also for risk control, which is increasingly necessary with the growing complexity of business operations and expansion into new markets.

It is still early for a full assessment of the impact of mergers on banks and customers. The data available show that at 31 March this year the economic results of the four main groups involved in mergers were substantially in line with their business plans. These indicate, however, that the greater part of the benefits of the mergers carried out in 2007 – estimated at €3.9 billion a year when fully achieved – will not be realized until subsequent years. The extraordinary costs of the mergers, consisting largely of severance benefits for redundant personnel, came to €3.3 billion and were mostly charged to the accounts for 2006 and 2007.

In order for customers to benefit from mergers and acquisitions, it is important that the increase in concentration not weaken competitive pressures. In the 1990s, a period marked by intense and growing competition but also by many mergers, the resulting efficiency gains were passed on to customers, albeit with a lag. In the end the banks involved in the concentrations offered their customers more favourable terms both on deposits and on loans.

The network economies stemming from mergers enable banks to extend their distribution channels, with a reduction in charges for some kinds of transaction, such as cash withdrawals, and to broaden and rationalize their product range. Concrete progress has already been made. Today, in order to intensify the competitive pressure and enhance customers' ability to choose, it is especially important to facilitate client mobility. Contributions to this end have come from the rules introduced in recent years on current account closing charges and the early repayment and portability of mortgage loans, from the Bank of Italy's action on behalf of transparency and fairness in banking products, and from the other authorities' action in defence of transparency and competition.

Local mutual banks continue to have significant weight within the Italian credit system. In recent years over 400 independent mutual banks have expanded the scope of their business within the credit market, especially with firms, exploiting their dense network and a banking model centred on continuity in customer relations.

Globalization heightens the need, for mutual banks, like others, to adapt their services to the needs of small and medium-sized enterprises, to increase their operating efficiency and to improve their risk control and management. In other countries mutual banking uses integrated systems to overcome the disadvantages of small size by centralizing production and ancillary services. Italian mutual banks must continue their efforts to work out new organizational solutions that can enhance the integration and efficiency of the network without prejudice to the independence of individual banks.

Customer relations

I have remarked on other occasions that correct relations with customers, in addition to being a legal obligation, are a strategic factor in the soundness of banks. The most pressing problems concern the portability of mortgages, the maximum-overdraft fee, the transparency of contractual conditions and the regulation of brokers and agents.

Regarding mortgages, the legislation introduced in the last few years and the recent initiatives undertaken by the Government and the Italian Banking Association have laid the foundations for the actual convertibility of loan contracts within banks and their external portability. Banks must implement these initiatives without delay, provide the necessary assistance to customers and seize the attendant competitive opportunities.

Steps should be taken to replace the maximum-overdraft fee with transparent forms of remuneration commensurate with the size of the loan commitment.

I believe that by now banks are fully aware of the need to act promptly and effectively on these two fronts, not least to safeguard the system's reputation.

The present rules on the transparency of contractual conditions for banking customers were instituted by the Bank of Italy in 2003; in recent years they have helped to increase the correctness of banking relations. We will hold a public consultation on a revised set of regulations, which will take account of past experience, the evolution of the market and legislative developments. We are determined to overcome operational rigidities, make informative documentation clearer, simpler and more effective and improve the comparability of the conditions offered by intermediaries. As in the past, consumer associations will be involved in the process.

The drying up of wholesale supply channels has led banks to place new issues primarily with retail customers. The more complex and atypical forms of fund-raising are at times associated with scant transparency and high costs: they must be offered to selected customers only, who should be made fully aware of the characteristics and risk profiles of the issues. To avoid legal and reputational risks, banks must adhere scrupulously to this principle; it is essential that the compliance functions initiate their operations.

In recent years in Italy, as in the rest of Europe, banks and other intermediaries have turned increasingly to credit brokers and financial services agents, above all to establish initial contacts with potential customers. In some cases this activity can lead to irregular practices and weigh heavily on transaction costs. The correctness and professionalism with which it is performed is crucial for the reputation of intermediaries that use these services; the objective of extending the sales network must go hand in hand with that of providing appropriate services and assuring transparency and economy. We have already drawn the attention of banks to the need to activate all the necessary safeguards. There is, however, an equally pressing need for the adoption of legal measures to raise the standards of professionalism and transparency of brokers and agents, so as to address the considerable rise in their number and avoid any risk of proximity with usury and other illegal activities. Here, the transposition of the European directive on consumer credit represents an opportunity for legislators.

Between 2003 and 2007 we completed over 4,000 controls of transparency at branches of banks, financial intermediaries and Banco Posta. Last year these inspections were intensified in frequency (their number increased by over 20 per cent), and in the criteria applied, which focused to an even greater extent on verifying substantive compliance. In addition to imposing the fines for non-compliance, where appropriate the Bank of Italy called on intermediaries to reimburse any charges that had been improperly debited to customers.

From 2007 onwards a much more dynamic approach has been adopted to the handling of complaints sent to the Bank of Italy by bank customers who believe they have been treated incorrectly. There are nearly 5,000 such complaints per year. The Banking Supervision Department checks that the banks involved respond promptly and adequately.

However, for the protection rules to be fully effective, it is necessary to create the conditions for an increase in bank customers' knowledge of the characteristics of the financial products in which they invest their savings, the yields they can expect, and the nature and size of the risks they run. Several surveys have shown the existence of gaps to be filled. Recently, authorities, trade associations – including ABI – and consumer associations have taken initiatives in this field. As of last year the Bank of Italy has devoted a section of its website to financial education; in addition, we have launched, in cooperation with the Ministry of Education, a training programme for school teachers, so that economic and financial education can be included in the syllabus.

The governance of banks

On the basis of the rules the Bank of Italy laid down in March, banks must submit a governance plan and approve the necessary bylaw amendments by June 2009.

The Bank of Italy does not prefer one or another of the board models provided for by civil law; it nonetheless takes a firm line in ensuring that, no matter which mode is chosen, the principles of sound and prudent management are complied with in the bylaws and in practice.

To the same end, the rules that we have adopted require banks to introduce limits on the positions that their corporate officers can hold on other governing bodies; they also prohibit members of control bodies from having operating responsibilities in other group companies or strategic affiliates. The presence of persons on more than one board of directors is to be considered natural within a group. Responsibility for assessing any competition issues arising from the presence of directors on the boards of more than one company lies with the Antitrust Authority, with which we are ready to cooperate, so as to coordinate interventions in the matters for which we are respectively competent.

The prevention of conflicts of interest is also achieved through limits and conditions for banks' assumption of related party risks. A set of rules has just been submitted to the Interministerial Committee for Credit and Savings. For its part, Consob is drawing up rules, applicable to all listed companies and companies with shares widely distributed among the public, which assign a key role to the independent directors in transactions with related parties. Together with Consob, we shall ensure that the rules are coordinated and limit the compliance burden on intermediaries.

Overcoming the asset management crisis

The group that we established with asset management companies, and with the participation of the Government and Consob, to propose measures to counter the decline of the Italian asset management industry, is about to complete its work.

A first conclusion is that it is necessary to intervene on the tax distortions that penalize Italian investment funds. As is the case elsewhere, they should be taxed on distributed profits and realized capital gains, not on their accrued results.

The distortions produced by transparency legislation, which is particularly stringent for investment funds, must be eliminated. It is not a question of reducing the safeguards applicable to investment funds, but of increasing, substantively and not just formally, those applicable to other financial products. In particular, for insurance policies of a financial nature, more information must be disclosed on their liquidity; for bank bonds, customers must be given clearer and more complete information on the costs, risks and liquidity of the investment and on the yield of the instrument compared with that of other securities. The fair value determined by the issuer bank must be reported periodically to the purchasers, especially for unlisted instruments for which the issuer’s commitment to buy them back is the main guarantee of the possibility of liquidating the investment. New rules on fairness and transparency for the distribution of illiquid financial products have been announced by Consob; intermediaries will have to comply with them without delay.

The independence of asset management companies is essential. The reduction of conflicts of interest must be furthered by a self-regulatory code of conduct that strengthens this characteristic. It is indispensable that independent directors hold the majority of seats on these companies’ boards. By the autumn, using our powers, we will adopt measures to separate the running of bank-controlled asset management companies more completely from that of the banking group to which they belong, by clarifying the limits and purposes of the parent company’s powers of guidance.

Lastly, and I come to the hardest task, it is necessary to upgrade the manner in which financial products are offered to investors, in order to realize in full the principle contained in the Consolidated Law on Finance that intermediaries must act in the customer’s interest. The service of providing financial advice must be defined more sharply and made more professional, promoting competition and transparency. The provision of investment advice must be clearly distinguished from the placement of own products, carried out in the customer’s interest and not be limited to pushing house products. Savers who do not intend to incur the cost of advice must nonetheless be given, in the course of placement activity, a simple but effective explanation of risks, costs and returns, with a check, calibrated to the complexity of products, on their suitability to the characteristics of the customer. An appropriate degree of professional competence must be ensured not only for financial salesmen but also for counter staff. The role of self-regulation is essential in this field, too.

New rules are necessary but not sufficient. The renewed growth of the financial industry depends ultimately on the competitiveness of operators, on the promptness with which they grasp the opportunities offered by innovation and respond to the challenge of the ever-increasing integration of the sector’s markets and productive structures, including by means of mergers. It is necessary to look far ahead. It has been clear for years that defending a local niche, a captive clientele, is no longer a winning strategy. Today, it is not even an effective means of defence.