Mario Draghi: Economic overview and banking supervision reforms

Address by Mr Mario Draghi, Governor of the Bank of Italy and Chairman of the Financial Stability Board, at the Italian Banking Association Annual Meeting, Rome, 15 July 2010.

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In the life of the Italian Banking Association (ABI), today's gathering marks the handing over of the baton to a new President.

To Corrado Faissola, I would like to convey my personal appreciation, and that of the Bank of Italy as a whole, for his competent, level-headed and decisive leadership of ABI through one of the most difficult periods in the history of economies and financial systems.

To Giuseppe Mussari, I wish success in his new undertaking. He will accompany our banking system during a phase fraught with perils but also offering excellent opportunities for a financial system that is able to interpret and serve the real needs of households and firms.

The state of the world's economies

The global economic recovery is uneven and of uncertain resilience but it is going ahead. The International Monetary Fund estimates growth in global output at around 4.5 per cent this year and next: 8 or 10 per cent in some large emerging economies and scarcely 1 per cent in the euro area. Here in Europe the recovery, driven by the expansion of world trade, remains exposed to risks: the persistent weakness of domestic demand in our countries; turmoil in still-fragile financial markets that overreact to the heightened perception of sovereign risks; and possible inflationary pressures in the emerging countries, which would lead to more restrictive policies.

The Italian economy is now benefiting from the renewed vivacity of world trade. The Bank of Italy's Economic Bulletin, published today, presents a scenario in which the volume of exports expands by 9 per cent this year and 5 per cent in 2011. Consumption and investment will remain weak because real incomes are stagnant and employment prospects uncertain.

Economic policy bottlenecks

The consequences of all nations' economic policies are ever more interwoven and interdependent. An acceleration in the adjustment of imbalances in the public finances is indispensable; the effect on the economic recovery will be positive if the adjustment helps to reduce yields on sovereign debt, which often constitute banks' benchmark in determining the cost of credit. But if the cloud of uncertainty hanging over bank balance sheets is not removed, funding difficulties will persist.

Monetary policy in the euro area remains strongly expansive.

The Governing Council of the ECB has continued to satisfy the entire demand for liquidity. Inflation expectations, by contrast with some other countries, are firmly anchored. This fact must not be forgotten: it is the credibility built up by the ECB over the years that has enabled monetary policymakers to exploit the full scope for flexibility in dealing with the crisis.

The Securities Markets Programme for the purchase of the securities of euro-area countries under financial pressure injected liquidity into markets in a state of crisis, averting the collapse of the European financial system and preserving the monetary policy transmission mechanism. The resolute commitment to sterilize the liquidity so created remains.

Once the solidity of the economic recovery is confirmed, the phasing out of unconventional monetary measures will need to be resumed. Although temporarily suspended in recent weeks because of the severe strains originating in the Greek government securities market, this process has been under way since the end of 2009.

No twelve-month refinancing operations have been offered in 2010. The operation that resulted in the unprecedented liquidity injection of over €400 billion a year ago reached maturity on 1 July. In the auctions held in the past two weeks banks requested far less than the amounts maturing, resulting in a significant reduction of excess liquidity. Because some banks are still having difficulty in accessing market funding, this has translated into a moderate rise in money market rates of about 10 basis points. The monetary policy stance must not be altered by the condition of these marginal intermediaries. Their problems need to be dealt with by the relevant national authorities using appropriate instruments.

In Italy, a three-year budgetary adjustment package was approved in late May – ahead of the usual schedule in view of the financial market tensions provoked by the Greek crisis. The measures are designed to reduce net borrowing by €12 billion in 2011 and €25 billion in both 2012 and 2013. Two thirds of the adjustment is to come from reductions in expenditure, above all current expenditure. On the revenue side, the measures focus mainly on combating tax evasion.

Notwithstanding the short-run costs of the budgetary adjustment in terms of economic growth, prompt action was unavoidable: the projected scenario was not sustainable. We are still paying the price of the slowness with which Italy's public debt-to-GDP ratio was reduced in the decade following the inception of the European monetary union.

Whether the adjustment measures will effectively succeed in attaining the net borrowing objectives can only be determined in the course of the next few months, taking account among other things of macroeconomic developments and their feedback impact on the public accounts. The estimated revenue effects of the measures to curb tax evasion are subject to uncertainty, both upside and downside. Curbing expenditure growth will necessitate a sharp change of course with respect to the tendencies of the past decade. The limits on the resources at the disposal of central and local government will require, if service cuts are to be avoided, a serious overhaul of organization and territorial coverage. Trade payables of government bodies and their public service firms must not be allowed to serve as an instrument for circumventing budget constraints.

Public financial adjustment and economic growth, together, are essential conditions for financial stability, which is in turn the pilaster of sustained growth. The indispensable modification of the overall composition of the public budget must be directed to stimulating growth. The reforms under way in the public administration and those that will raise the retirement age move in this direction. The curtailment of tax evasion can be a major factor for growth if it corresponds to the lowering of the rates levied on honest taxpayers.

With the economic upswing, global payments disequilibria will tend to widen once more, heightening the connected risks to the sustainable growth of the world economy. The International Monetary Fund is fully committed to ensuring macroeconomic stability, but these imbalances, in being for more than a decade now, will persist for an extended period, and they will have to be funded. This is a titanic enterprise in both size and duration, and one that will only be feasible – without growth-threatening tempests – with capital markets that are far more robust, more transparent and better regulated than in the past.

Reform of the rules of finance

The recent G20 Summit in Toronto observed that the agenda of essential regulatory reforms is proceeding on schedule.

Some aspects of the Summit's final Declaration deserve special emphasis. First, the importance attached to the reform of Basel 2 in order to increase the solidity of the system, including ambitious requirements on banks' capital levels and the definitions of capital.

Second, the affirmation of the need for further intensification of supervision, the extension of regulation to the shadow banking system, and the reinforcement of the derivatives market infrastructure. Third, the resolution to reach an agreement at the time of the next Summit in November.

The new prudential rules will significantly increase banks' capital and improve its quality, limit financial leverage, contain liquidity risk and attenuate the procylicality of intermediation. Capital will have to comprise resources that can effectively absorb loses; its level will be set by assessing its capacity to deal with stress situations similar to those observed during the crisis. Deductions from capital will be harmonized and applied to core capital. Banks with more capital and less risk will have lower probability of default; they will be able to fund themselves on the market at lower rates and reduce the cost of credit for customers.

In addressing the concern that the reforms could slow down the economic recovery, the G20 chose not to lessen their scale but instead to carefully evaluate the timeframe for their implementation. Taking account of the initial conditions of financial institutions in the different countries, adaptation may proceed at a faster or slower pace, but it must be completed by the end of the transition period, whose length is the subject of negotiations at the Basel Committee meeting that concludes today.

A crisis management and resolution system built on a sure, agreed legal foundation is essential to an approach that can reduce systemic risk and thus the moral hazard generated by large banks. Generally speaking, then, the orderly management of a crisis requires access to sources of financing. In the first place, resources must be procured by capital writedowns, the sale of assets and the reduction of exposures to unsecured creditors. This can be followed by recapitalization through the conversion of debt into equity. These methods can be usefully supplemented by a deposit insurance system or crisis resolution fund, which should be privately financed, pre-funded, and subject to very stringent conditions for utilization.

The introduction of additional prudential requirements and more incisive supervision of systemic institutions can help to limit the build-up of risks; in some countries structural constraints are also being considered. To avoid the propagation of situations of instability, market infrastructure must be designed so as to reduce the possibility of contagion, and derivatives transactions must be brought back into the regulated markets. The specific instruments will necessarily differ from country to country, given the variety of financial systems, but suitable, shared criteria for evaluating the different measures will ensure their efficacy and guarantee a level playing field internationally. The Financial Stability Board (FSB) will draft a first report on these issues for the next G20 Summit in Seoul.

But even the best rules are useless if their implementation is not full, if supervisors' powers are limited. Countries will submit to peer reviews of their supervisory standards, coordinated by the FSB.

The impact of the new Basel rules on Italian banks

The Bank of Italy's selective standards for admitting hybrid instruments in the calculation of regulatory capital have been reflected in the comparatively high quality of Italian banks' capital, which should facilitate their adaptation to the new, stricter Basel standards. The instruments already issued based on the current rules will nonetheless continue to be eligible for a sufficiently long period. The level of attention paid to the quality of capital must be raised further. We have already invited banks to refrain from issuing instruments that will no longer be recognized under the new standards.

Since the Italian banking system remains anchored to the core business of traditional lending, the tougher capital requirements for trading and the introduction of financial leverage caps will have a lesser impact than in other countries.

The various proposals to deduct deferred tax assets from regulatory capital are likely to have greater effects. Their value is high in Italy owing to uncommonly severe constraints on the tax deductibility of loan loss provisions. If it is deemed appropriate in order to avoid the further penalization of Italian banks, Parliament might consider eliminating the limits on the deductibility of loan losses in favour of a tax that is equivalent in terms of revenue but has a less distortionary impact.

The crisis has demonstrated that rules on liquidity are also indispensable. We have already urged banks to prepare for the new standards.

European supervision

The reform of the European supervisory architecture envisages: a new macroprudential supervisory body, the European Systemic Risk Board (ESRB), entrusted with the prompt identification of vulnerabilities and risks to financial stability and with recommending policies for containing them, and three sectoral supervisory authorities assigned to apply the rules and institute common supervisory practices.

Beyond the rules, uniform and incisive controls are also essential. When one national supervisory authority adopts a lax approach, a dangerous breach is opened, through which potential vulnerabilities may be quickly propagated to other systems. Supervisory models and methods continue to display marked differences across countries: in data availability, in the use of on-site and off-site controls, and in the instruments for intervention. Convergence must be ensured by capitalizing on the experience of the countries that have withstood the crisis best.

The European Parliament is rightly pushing for the supranational authorities to be endowed with the requisite powers of coordination. A leading role within the ESRB must be secured for the ECB and the national central banks: this would boost the Board's technical capabilities, fully exploiting the synergies between monetary policy and macro-prudential policy.

Stress testing of banks' balance sheets

In the spring of last year, the stress tests at the major US banks revealed, under the responsibility of the prudential authorities that had conducted them, the scale of the risks of individual banks, above all those in connection with the "toxic" assets on their balance sheets. This transparency drive was amply repaid by the markets: these banks, several of which had been assisted initially by public money, succeeded in raising over $200 billion in private capital, an unthinkable figure prior to the publication of the test results. Stock exchange assessments and fund-raising also benefited from the release of the results.

Now Europe, albeit in less severe market conditions, has decided to proceed down the same road and will confront the US exercise.

But the European tests examine more risk factors than those contemplated in the American case. In addition to adverse macroeconomic conditions, they also assume an increase in the market's perception of sovereign risk.

The stress test hypothesizes: GDP growth three percentage points lower than that currently estimated by the European Commission for the two years 2010–11; and a larger rise in medium- and long-term interest rates than that recorded during the Greek crisis in the early days of May of this year.

Compared with the US exercise, which involved 19 banks and three supervisory authorities, the European stress testing is much more complex, involving 91 banks in 20 countries. It is being carried out by national supervisory authorities in accordance with common guidelines and coordinated by the Committee of European Banking Supervisors with the participation of the ECB. The effort made by the authorities and the banks themselves has been exceptional.

We hope that communications will be marked by a high degree of transparency. The results of the tests will be published on 23 July.

By that date European governments will need to be ready to adopt appropriate measures if the results point to capital weaknesses and market solutions are not available.

The Italian banks

The tests on the Italian banks participating will inevitably produce a range of different results, but I am confident they will show individual banks' capital to be adequate.

In the first quarter of this year the ratio of new bad debts to total bank lending remained stable at 2 per cent, a high value by comparison with the last ten years. We expect the flow of new bad debts to remain substantial in the coming months.

The conditions of the markets and the economy continue to impinge on banks' profitability. The low interest rates compress the margins on traditional banking business. In the first quarter the operating profit of the five largest Italian banking groups was the same as in the first quarter of 2009. Loan losses absorbed more than half of this aggregate.

In this newly delicate phase on the markets Italian banks' ability to raise funds has not diminished. Their one-month liquidity position continues to be more than satisfactory, thanks among other things to their ample endowment of assets eligible for refinancing operations with the ECB.

Bank credit is showing signs of recovery. In the three months ending in May, lending to firms grew by an annualized 2.1 per cent on the three preceding months and that to households by 5.0 per cent. Firms' demand for credit is on the rise.

Customer protection

To protect retail customers, who represent the strength of the Italian banking system, is an objective the Bank of Italy is pursuing with great determination. In the last few years we have issued radically new rules in this field, laid the foundations for banks to supply simpler and cheaper products that make it easier for weaker consumer to access financial services, and prepared guidance that helps even the least expert customers to make choices consistent with their needs. Where – as in loans and overdrafts – the risk of opacity is greatest, we have introduced additional defences, carried out investigations and put forward proposals to improve the law.

The Banking and Financial Arbiter (ABF), for which the Bank of Italy provides the resources for its operation, has ruled in favour of the customer in 60 per cent of the cases it has examined. The customers who incurred losses have been indemnified. The ABF's rulings strengthen the protection of customers not only in individual cases but also more generally because they guide banks towards correct behaviour.

The checks made at banks' branches, head offices and websites assess not only formal compliance with the new provisions on transparency but above all the degree to which customer relations are correct in substance.

The checks on non-bank intermediaries and their distribution channels are more severe today, and the requirements for entry in the register referred to in the Consolidated Law on Banking are stricter. We have intervened in the situations where the anomalies were most notable: loans secured by pledge of salary, revolving credit cards, the issue of guarantees, foreign exchange dealing and money transfers abroad. We have stepped up cooperation with the Finance Police, especially in the sectors most involved in criminal investigations.

Additional safeguards for consumer protection are now being discussed. We have worked with the Government on the transposition of the European directive on consumer credit. The intention, properly, was to take this opportunity to carry out a broader reform, one that would also tackle the regulation of non-bank intermediaries and their channels of distribution. The reform bill is now before Parliament: it is essential that the proposed self-regulatory bodies have the tools and the means to work to good effect; that only reliable intermediaries inhabit the market; and that the granting of credit be restricted to institutions subject to supervision, with extremely limited exceptions.

The crisis has shown the importance of promoting the acquisition of adequate financial knowledge. In this area, too, the Bank of Italy has stepped up its activity. The experimental financial education programme for schools developed together with the Ministry of Education, Universities and Research has continued during the past academic year; the considerable improvement in knowledge that has been observed encourages us to pursue and expand the programme.

Measures to combat money laundering

The infiltration of criminal elements into economic activities has become diffuse, partly as a result of the crisis.

The banks are the cornerstone of the battle against this degeneration. They must have a thorough knowledge of each customer and assess the risk of their involvement in illicit dealings.

The Bank of Italy has tightened the application of rules and controls further. The inspections performed at numerous bank branches – 120 in late 2009 and early 2010 – have brought to light widespread shortcomings in the scrutiny of clients, the training of personnel, and the procedure for reporting suspicious transactions.

The role of the senior management of banks is crucial: combating money laundering must be made part of corporate culture, including suitable systems of incentives and compensation.

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The path for economic policy today is narrow and arduous. There is no alternative but to consolidate the public finances, unwind the monetary expansion, recapitalize the banking system, and return to a culture of stability, which is the founding characteristic of the euro area.

But there is also no alternative to a resumption of economic growth, without which these very objectives become unattainable. Growth that is not driven either by debt or by monetary policy but whose engine, especially in Italy, is reform and corporate technological innovation.

The banks have a special role to play in sustaining growth. If they are strong they will be – they are – a pillar of growth. But we also want banks that are once again close to the productive economy, as they were before the crisis. There is only one way to do this: “know how to discern a creditworthy firm even when the numbers are against it”.

The whole agenda is ambitious. It demands an extraordinary capacity for analysis, exceptional know-how, great willingness to innovate and change. If undertaken resolutely and equitably, this programme will have the wholehearted support of markets and the entire population.