Fabio Panetta: Credit and the financing of firms

Address by Mr Fabio Panetta, Deputy Director General of the Bank of Italy, at the Federazione delle Banche di Credito Cooperativo Lazio Umbria Sardegna, “Reload Banking. La Banca del domani per un nuovo sviluppo dell’Italia”, Rome, 21 June 2013.

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1. The macroeconomic environment and the credit market

Euro-area GDP continued to contract in the first quarter of 2013, with the cyclical weakness spreading across countries. Domestic demand is reflecting the impact of private and public sector deleveraging and the worsening of credit conditions. Exports declined for the second successive quarter.

The cyclical indicators have shown a small improvement in recent months, although the levels are still low. According to Eurosystem forecasts, GDP will fall by 0.6 per cent over the year as a whole.

In Italy the economic situation shows little sign of improving. In the first quarter of 2013 output contracted more than in the rest of the area, mainly owing to the decline in domestic demand. For the first time in four years exports decreased, in response to the reduction in demand from the other euro-area countries and a slowdown in sales outside Europe. Industrial production declined further in April before picking up slightly.

Analysts expect the decline in GDP to ease during the present quarter; economic activity seems likely to stabilize in the second half of the year. According to OECD forecasts, GDP in Italy will fall by 1.8 per cent on average this year; this would bring the cumulative contraction since 2007 to around 8.5 percentage points, larger than that recorded during the Depression of the 1930s.

Credit market conditions are one of the most critical aspects of the macroeconomic situation in Italy. In the first four months of this year lending to firms diminished by just under 4 per cent on an annual basis; lending to households also contracted, although to a lesser degree. The reduction in borrowing costs came to a halt last autumn, and lending rates are still above the euro-area average. Small and medium-sized enterprises face increasing difficulties.

The decrease in lending reflects the weakness of demand for loans, which in turn is associated with the reduction in investment, the deterioration in consumer confidence and the weakness of the property market.

But the reduction in bank credit, and the increase in its cost, can also be ascribed to the tightening of supply conditions. Evidence pointing in this direction comes from surveys of banks and businesses alike. Our estimates indicate that the deterioration in lending conditions, considering both the rise in loan rates and the diminished availability of credit, cut 1 percentage point from GDP growth in 2012.

The main obstacle to loan supply is the increase in credit risk as the recession drags on. In the first quarter of 2013 the annual default rate rose to 2.8 per cent for total lending and to 4.5 per cent for lending to businesses. According to the leading indicators, the flow of bad debts will remain high for the rest of the year.

The present state of the credit market is a well-known case in the economic literature: a situation in which uncertain economic outlook, high default risk and difficulty of assessing the soundness of individual borrowers generate adverse selection and heighten banks’ risk aversion, prompting restrictive lending policies.[1] Unlike the pattern seen in the past, the

[1] J. Stiglitz and A. Weiss, “Credit Rationing in Markets with Imperfect Information”, *The American Economic Review* (1981).

reduced availability of credit is also affecting, albeit to a lesser extent, large firms and firms with balanced financial positions.

The credit market will continue to experience supply-side tensions in the months to come. Past experience has shown that loan quality tends to continue deteriorating long after the cyclical upswing has begun. Moreover, while the new regulations on banks' capital and liquidity ratios will bring stability to the financial system once they are fully operational, in the short term they may act as a brake on loan growth. And market pressure on banks to reduce their reliance on wholesale funding also spurs banks to reduce the size of their balance sheets in a pro-cyclical manner.

The first step towards setting the lending cycle in motion again – in the interest of firms and banks alike – is a firm commitment on the part of the banks to adopt lending policies that take fully into account their customers' growth prospects. Each bank should be aware of the negative externalities for the whole Italian economy, and for itself, of an indiscriminate credit squeeze.

Given the severe tensions that have emerged on the international financial and Italian sovereign debt markets in recent months, the capital strengthening prompted by the Bank of Italy's supervisory action has allowed Italian banks to maintain investor confidence and attract external finance at low cost.[2] However, this may not be sufficient, on its own, to overcome the credit supply bottlenecks.

The "market failure" underlying the malfunctioning of the credit channel must be tackled by strengthening public guarantees in favour of firms without making the taxpayer shoulder too much of the associated risk and creating unfair advantages for the banks.

The Government's decision to reinforce the Guarantee Fund for small and medium-size enterprises is a step in the right direction. In implementing the measures, the Fund's intervention must be made conditional on the actual disbursement of new loans, and more favourable conditions must be given to banks that demonstrate stronger growth in overall lending. Eligible beneficiaries must include firms with competitive potential and sound growth prospects, even if they are under financial strain. The guarantee must lead to a real improvement in the conditions applied to loans, and firms themselves must be allowed to apply directly for the Fund's intervention. The effects on lending could be substantial: a €3 billion increase in the Fund's capital would allow guarantees to be provided for some €40 billion worth of new loans.

2. The financing of firms

The credit market tensions have highlighted once again the main weakness of Italy's financial system: firms' overdependence on bank credit and their inability to raise sufficient funds directly on the markets. The stock market is underdeveloped even compared with other bank-centred systems. The insufficient development of capital markets affects firms' financial structure, which is marked by a fairly high proportion of debt provided mainly by banks; the weight of other financial instruments is correspondingly low.

The recession is putting this model of financing under considerable strain. The reduction in business volumes means that firms are less able to finance investments with internally generated funds. Their reliance on the banks increases the tensions caused by the tightness of lending standards. In other countries, bond issuance serves to counterbalance the

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[2] In order to minimize the pro-cyclical effects, the Bank of Italy has asked the banks to increase internally generated funds while continuing to reduce operating costs, dividends and directors' and executives' pay according to their profitability and capital base. For banks requiring stronger adjustment measures, a contribution must come from the sale of non-strategic assets.

shortage of loans.[3] In Italy, this option is only available to a few large corporations: €35 billion worth of bonds were issued in 2012, of which only €320 million by small and medium-sized firms.

2.1 The stock exchange and equity capital

The underdeveloped stock exchange does not reflect a lack of firms eligible for listing. Italy has a large number of unlisted firms that fulfil the listing requirements as to size, capital and profitability.[4]

On a previous occasion I argued that the small number of companies participating in the capital market is above all the result of the decisions taken by entrepreneurs.[5] Firms are reluctant to open up: growing in size and gaining access to the markets entail costs in terms of greater visibility to the tax authorities, supervisors and minority shareholders, in a situation of excessively heavy taxation, redundant and inefficiently applied administrative regulations and poorly flexible goods and labour markets. In the eyes of entrepreneurs, going public seems to imply a fixed cost in terms of transparency that outweighs the advantages of being able to source funds at competitive conditions from a broader range of investors.

The small number of listed companies inhibits the development of financial instruments and services such as bonds and syndicated loans – financing techniques rarely used by unlisted companies, which by nature are less transparent and have only a small number of shareholders. Instead, once listed, Italian companies resort to bond issuance as often as companies listed in other countries: once they have covered the fixed cost of listing, Italian firms do not seem to have any difficulty turning to the capital market.

Several attempts have been made in the past to increase the number of initial public offerings by offering tax relief for stock exchange listing or share issuance.[6] Their lack of success has been due, at least in part, to their temporary nature and their inability to offset the permanent cost of stock exchange listing.

Tax incentives that favour equity capital raising and listing can be effective if they are sufficiently large and, above all, permanent. The provision of the Allowance for Corporate Equity (ACE) can be supplemented in this direction: the tax deductibility of new equity capital invested in a company could be increased to eliminate the remaining tax advantage of debt.[7] Additional incentives could be introduced for newly listed companies, creating a sort of

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[3] See "Structural Issues Report 2013: Corporate Finance and Economic Activity in the Euro Area", forthcoming in the European Central Banks' *Occasional Papers*.

[4] See the "Documento tecnico programmatico" circulated by the Working Party on the listing of small and medium-sized firms set up by Consob with Borsa Italiana and other public and private associations and institutions.

[5] "Banche, Finanza Crescita", paper given at the conference "Oltre la crisi: quale futuro per le banche italiane?", organized by Associazione per lo Sviluppo degli Studi di Banca e Borsa in collaboration with Università Cattolica di Milano (2013). See also M. Pagano, F. Panetta and L. Zingales, "Why Do Companies Go Public?", *Journal of Finance*, (1998) and F. Panetta, A. Generale and F. Signoretti, "The Causes and Consequences of Going Public. Firm-Level Evidence from Twelve European Countries", paper given at the Bocconi-Consob conference (2013).

[6] Fiscal measures in favour of equity capital and stock exchange listing were introduced under the Visentini Law of 1983, the Tremonti Law of 1994, the Dual Income Tax (DIT) Law of 1997, and the "Tecno-Tremonti" Law of 2003.

[7] To eliminate the tax benefits associated with debt it might be enough, under certain conditions, to set the notional ACE rate equal to the long-term risk-free rate. See R. Boadway and N. Bruce, "A General Proposition on the Design of a Neutral Business Tax", *Journal of Public Economics* (1984) and R. De Mooij, "Tax Biases to Debt Finance: Assessing the Problem, Finding Solutions", *Fiscal Studies* (2011).

"Super ACE";[8] available studies indicate that such a measure would have a considerable impact without necessarily crimping revenue significantly.[9]

The growth of the stock exchange would improve the efficiency of the entire Italian capital market, enhancing firms' ability to finance medium- and long-term investments.

2.2 Non-bank finance

So far, the recent abolition of the tax measures discouraging unlisted firms from bond issuance has had limited effects.[10] The few placements made to date have been by medium-sized firms, largely to replace outstanding loans. This could reflect not only a traditional reluctance to enter the capital market,[11] but also the fact that the smallest firms are still largely unaware of the new opportunities. Placements may therefore increase over time.

The characteristics of the loans also act as a brake on issuance. Even once the system is fully operational, the small size of potential borrowers will tend to translate into bond placements of low amount, low liquidity, high risk and high return. These features make the individual operations unattractive to institutional investors, as well as to the issuers themselves.

These problems can be overcome, or mitigated, by using suitable operators and techniques to diversify the idiosyncratic risks of debt instruments issued by small and medium-sized enterprises. In Italy emerging credit market tensions have led to the launch, in recent months, of several initiatives for investing in bonds, financial paper and loans of unlisted companies, most of them based on the closed-end fund. In general, these credit funds envisage a careful assessment of the issuers and active management of the portfolio over a medium-to-long horizon. The experience of other countries bears out the enormous potential of such funds.[12]

Securitization is another means of aggregating loans to small firms, helping to facilitate their indirect access to the markets. For banks, this instrument is essential in disposing of part of their assets and freeing up funds for new loans.

The success of such initiatives depends on a high level of transparency, enabling final investors to manage the associated credit risk more efficiently than in the case of direct investment in single issues. Simple structures, low leverage and limited maturity transformation are essential. In the case of securitizations, there are advantages to be gained from Italy's past experience, which has been extremely positive.[13]

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8 The Super ACE would be equivalent to the Super DIT, which offered listed firms additional incentives with respect to the ordinary DIT.

9 See A. Franzosi and E. Pellizzoni, "Gli effetti della quotazione. Evidenza dalle mid & small caps italiane", *BIt Notes* (2005); G. Giudici and S. Paleari, "Should Firms Going Public Enjoy Tax Benefits?", *European Financial Management* (2003); M. Geranio and E. Garcia, "Come sarebbe l'Italia con 1.000 società quotate?" (2012), mimeo, Bocconi.

10 The Decree on Development abolishes the limit on the deductibility of interest payments on bonds and the 20 per cent withholding tax for non-resident holders, banks and institutional investors.

11 The new rules also entail greater transparency for the issuing company as, for the tax benefits to be granted, the securities must be listed (if they are not listed, they must circulate among qualified investors). In the case of financial paper the issuer must submit to auditing; small and medium-sized firms must have a sponsor (bank, asset management company, investment firm) who is required to report the issue's rating.

12 For example, in January this year Ireland's National Pensions Reserve Fund announced the creation of new funds for investment in small domestic firms amounting to € 850 million.

13 See U. Albertazzi, G. Eramo, L. Gambacorta and C. Salleo, "Securitization is not that evil after all", Banca d'Italia, *Temi di discussione*, No. 741 and *BIS Working Paper*, No. 341 (2011).

There is considerable scope for institutional investors to expand their investments in private bonds, securitized loans and credit funds. Listed bonds of non-financial companies account for a very small share of the total portfolio of open-end investment funds, and the proportion of unlisted securities is well below regulatory limits; immediately accessible resources are estimated to amount to between €6 billion and €10 billion; much larger amounts would be available with a liquid market for securities. Moreover, large-scale investments may also be made by insurance companies, pension funds and closed-end funds.

Without a sufficient supply of securities of Italian firms, many institutional investors could well turn to foreign markets.

3. Mutual banks

Italy's 394 mutual banks and 3 mutual-bank central credit institutions account for 10 per cent of loans to households and firms, a bigger share than the third largest Italian banking group. This role of mutual banks is even more important in the case of small firms, accounting for almost 20 per cent of total lending.

The mutual banks had greatly expanded their activity prior to the recession. From 1995 to 2008 their market share of lending rose by nearly 9 percentage points for small firms, 5 points for large firms and 3 points for households. As emphasized on previous occasions,[14] underlying this expansion are knowledge of the local markets, experience in assessing the creditworthiness of small borrowers, and an ability to meet customers' needs promptly and efficiently.

Mutual banks stabilized the supply of loans even during the 2008–09 recession: their sound capital base and stable funding enabled them to provide financial support to the small and medium-sized firms subjected to rationing by the large banks.

More recently, the unfavourable economic situation and financial market tensions have altered this scenario. The mutual banks are now experiencing difficulties. In the second half of 2011 their liquidity situation suffered the backlash of the sovereign debt crisis: in October their overall net interbank position turned negative for the first time. The tensions eased in 2012 following central bank intervention, to which the mutual banks had made ample recourse; the good performance of deposits also contributed.

The growth in lending has progressively weakened in recent months, turning negative at the beginning of this year, partly as a result of the tightening of supply conditions. Mutual banks are experiencing a deterioration in loan quality. In 2012 the stock of bad debts rose by 25 per cent, that of other non-performing loans by almost a third; non-performing loans represent 14.4 per cent of total lending, compared with 13.5 per cent for the banking system as a whole. The difficulties are severe for the smallest mutual banks and for those that have expanded rapidly in recent times; the problems have become widespread in a number of regions such as Calabria and Veneto.

These trends have a particularly serious impact on mutual banks, which derive most of their earnings from traditional banking activity.[15] Because of their local vocation, they are deeply aware of the need to choose between supporting the local economy – of which they are part – by continuing to provide loans to firms in temporary difficulty and adopting more selective supply policies in order to safeguard their own stability.

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[14] See the address by the then Governor Mario Draghi "Solidarietà nella crisi Il credito cooperativo nelle economie locali" given on the occasion of the 50th anniversary of Crediumbria, Città della Pieve, December 2009.

[15] In the last four years net interest income has accounted for 70 per cent of gross income, 15 percentage points more than the average for the banking system. In 2012 interest on loans was unchanged from the previous year while funding costs and loan loss provisions increased.

The recession has brought to light the weaknesses of the mutual banks' business model: rigid costs, reliance on income from traditional intermediation, loan concentration. Even the growth strategies pursued in the past that allowed them to greatly expand the areas and customer segments served[16] have been shown in recent years to amplify risk.

The size and the quality of mutual banks' capital are still fairly high. However, the decline in profitability reduces their self-financing, virtually the only channel by which mutual banks can increase their own funds. The gap with respect to the largest banks, a competitive advantage that the mutual banks have long enjoyed, is gradually narrowing.

To achieve the necessary efficiency gains and keep profitability and capitalization levels high over the long term the organizational structures and business models of these banks need to be overhauled. Incisive action must be taken to reduce costs, as is being done in the other banks. In the last four years administrative costs have risen by 5 per cent and staff costs by 9 per cent. These trends are at odds with the prospects of income growth.

Business models must be found that respect the banks' local roots but can diversify their sources of income towards services, thus avoiding overdependence on lending to the local economy. Given the small size of mutual banks, this strategy should make use of their association network. It is essential to maximize the potential synergies created by this network comprising the national federation and local federations and by the industry's structures – three central credit institutions and the various specialized companies.

The services provided by the local federations vary greatly in scope, quality and efficiency. In some areas, the assistance offered to member banks is inadequate; problems of organization of the federations can hinder the resolution of bank crises. The industry's network is also plagued by inefficiencies associated with the highly fragmented supply structure; there is a very pressing need in particular for more highly integrated information systems.

Action must be taken to preserve mutual banks' patrimony of knowledge and their role serving the local economy, to which they are tied by a profound community of interests. The Bank of Italy has already underscored the need to raise the levels of efficiency and has urged the coordination structures of the mutual banks' associations and industry network to play a more active role.[17]

It is crucial to strengthen the system's cohesiveness. The Institutional Guarantee Fund must represent a decisive step in that direction. The project's complexity has necessitated preparatory action on several fronts both within the Fund and as part of a dialogue with the Bank of Italy. The testing phase is about to begin, to devise and put in place effective organizational and operating mechanisms and efficient links with the supervisory authorities. Once the project is fully operational, it will still require a strong commitment to ensure that its objectives are actually achieved in terms of improved crisis prevention, strengthening of the network and dissemination of best practices.

In November Governor Visco, in commenting on the appropriateness of a reorganization of the mutual banking network, stressed that the Fund project, though innovative, could not represent a point of arrival.[18] The need to make the system more cohesive calls for projects

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[16] From 2000 to 2008 a fifth of the growth in lending concerned customers acquired in new districts; moreover, loans to firms with over 20 employees rose from 46 to 61 per cent of the total (a proportion that has since stabilized).

[17] See the speeches "Il credito cooperativo: le sfide di un modello" and "Il credito cooperativo del domani: sviluppo, efficienza e solidarietà" by the then Deputy Director of the Bank of Italy, Anna Maria Tarantola, to, respectively, the Annual Meeting of the Italian Federation of Mutual Banks (November 2009) and the XIV National Congress of Mutual Banks (December 2011).

[18] Ignazio Visco, "Borghi, distretti e banche locali". Presentation of the volume *Civiltà dei borghi: culla di cooperazione*", Rome, 20 November 2012.

of broad conception that take account of the experiences of the mutual and cooperative banking systems in Europe, which are characterized by a high degree of integration. The Bank of Italy is open to a discussion of the different options, including as regards regulation.

Conclusion

The Italian economy is at a difficult passage in which cyclical weaknesses are overlaid on unresolved structural problems. The country's growth potential is diminishing; the loss of jobs, particularly among younger persons, and the reduction in households' purchasing power are breeding discouragement and depleting human capital.

There is no room to support growth through deficit spending. The large burden of the public debt and the tensions in the financial markets do not allow it.

Some measures, discussed in the Governor's Concluding Remarks to the Bank of Italy's Annual Meeting, can assist a struggling productive economy and bolster the prospect of cyclical upswing.

But above all we must resume, with the contribution of all the country's best talents and resources, the reform programme begun in the last two years. We can no longer postpone modernizing our productive structure, our education and research system, the functioning of public administration. The obstacles to competition and innovation must be extirpated in all sectors. The rationalization of public expenditure, its reallocation towards more productive uses, must permit a sharp reduction in the tax burden on our economy.

The banking system must play its part. There can be no enduring recovery without adequate financial support to firms. The effects of the recession on banks' balance sheets, on the availability of credit, must be counteracted with vigorous action to rationalize costs, innovate business models, strengthen the ability to select sound firms with competitive business projects.

The tensions in credit supply increase the incentives for firms' to access and make greater use of the capital market. The diversification of sources of financing demands an important commitment from entrepreneurs to make financial statements transparent, open up to outside investors, strengthen the equity capital base. The markets would be unwilling today to support opaque or undercapitalized initiatives.

The development of the capital markets is in the interest of the banks themselves. By offering advisory services for direct financing, they can reinforce, not weaken, their customer relationships with firms and their own role within a more diversified financial system. And in this way they can trace the path for returning to growth.