Ignazio Visco: 2013 World Savings Day

Address by Mr Ignazio Visco, Governor of the Bank of Italy, at the 89th World Savings Day, organised by the Association of Italian Savings Banks (ACRI), Rome, 30 October 2013.

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After a prolonged decline, in Italy there has been a slight recovery in saving in the last two years, from under 17 per cent of national income in 2010 to almost 18 per cent in 2012. The increase reflects a reduction in the negative contribution of the public sector. Private sector saving has continued to fall, but more slowly.

With the continuation of the recession Italian households, which initially had buffered its impact on their spending behaviour by reducing their saving, revised their spending plans downwards, adjusting them to lower permanent income. A factor was the acute uncertainty over the valuation of wealth, in turn linked to the prolonged strains in the financial and real-estate markets. In 2012 consumption fell sharply, in line with disposable income, and it remains weak, notwithstanding the first signs of improvement in households' purchasing power.

In the first half of 2013 GDP continued to decline, albeit at a more moderate pace. In the context of a euro-area recovery that is both slow and uneven, the latest indicators for Italy are consistent with GDP stabilizing in the third quarter and returning to modest growth in the fourth. Uncertainty remains high. In the summer the contraction in industrial production eased. About half of the firms surveyed by the Bank of Italy reported that the worst of the crisis had passed; smaller firms and those exporting less are still in greater difficulty.

The trend in capital formation also seems to be turning round. In the second quarter purchases of machinery and equipment recorded their first increase in more than two years. The prolonged decline in construction is slowing. An acceleration of investment in the remaining part of this year and next year is indispensable for renewed economic growth.

Savings must flow to businesses through a revival of bank lending but also through greater direct access to the capital markets to reduce firms' dependence on the banks. This means overcoming a structural lag of our financial system, manifested in the small number of listed companies and the limited level of stock market capitalization in relation to the size of the real economy.

Business loans have decreased by almost 8 per cent (more than €70 billion) since the end of 2011 when the first, sharp contraction occurred. As a proportion of GDP they have fallen from more than 59 per cent in November 2011 to about 55 per cent in September 2013. The unfavourable macroeconomic conditions continue to restrain credit demand and supply; loan supply is affected by the increase in firms' credit risk and the related adverse selection effects.

Italian firms' financial leverage is high by international standards: in 2012 the ratio of financial debt to the sum of that debt and shareholders' equity at market prices was 49 per cent in Italy against 34 per cent in France and the United States, 39 per cent in Germany and 42 per cent in the United Kingdom and in the euro area as a whole. Analyses of firms' financial statements indicate that these differences are due only in part to dissimilarities in sectoral and size composition. Italian households invest only a small amount in listed shares (2 per cent of their total financial assets, against 4 per cent in Germany and on average in the euro area). Only a small proportion of Italian investment funds invest widely in shares.

The current financial situation should spur banks and firms to overcome this state of affairs. Difficult credit conditions necessitate recourse to alternative channels of funding for sound businesses with good growth prospects. By providing the necessary services to accompany these businesses on the capital markets, the banks can sustain their own earnings and at the same time reduce their risks, although conflicts of interest must be avoided.

Inflows of foreign capital could help to improve firms' funding conditions. After the substantial outflow between the summer of 2011 and the first four months of 2012, foreign portfolio investment is picking up; the easing of financial tensions, assisted by the unconventional monetary policy measures taken by the Eurosystem, has contributed to this. The maintenance of balanced public finances and the continuation of reform actions to support growth – accompanied by progress towards the completion of the European Union – can improve confidence and reduce the perception of investment risks in our country, allowing us to consolidate the recovery of capital flows from abroad.

The Italian banking system

Italian banks have weathered the global financial crisis, a double-dip recession, and the sovereign debt tensions. The capital strengthening carried out in the course of the last, difficult years has been substantial; in Italy, unlike other countries, it was achieved virtually without recourse to public funds. For the system as a whole, between the end of 2007 and June 2013 core tier 1 capital increased by €39 billion, to almost €180 billion. The core tier 1 ratio accordingly rose from 7.1 to 10.9 per cent; for the top five banking groups it reached 11.2 per cent, in line with the average for the main European banks.

Banks' liquidity position benefited from the Eurosystem's three-year refinancing operations, which enabled them to offset the fall in international funding owing to the sovereign debt crisis and to build up bond redemption reserves. The increase in banks' exposure to Italian government securities – from €220 billion at the end of 2011 to €415 billion in June 2013 – reflected the economic advantage and necessity of temporarily investing the liquidity obtained from the Eurosystem in a setting of increased riskiness of lending. In the third quarter this exposure decreased by almost €10 billion. With the economic recovery and the attendant improvement in firms' prospects, it is likely that banks will review their fund allocation policies.

Aside from government securities, assets eligible as collateral in refinancing operations include own-use government-guaranteed bank bonds that will mature over the next few years and, in any case, as of 1 March 2015 can no longer be pledged directly by the issuer. Sufficient collateral must be maintained to replace the assets that are no longer eligible, in order to make up for any falls in value.

The Bank of Italy is currently developing new ways of facilitating the use of certain types of loan that are especially widespread in our country, such as current account credit lines; some contractual changes will be required to ensure consistency with the ECB standards. The procedures for accepting loan portfolios are also being defined. The adoption of the Bank of Italy's internal assessment model, authorized last July by the ECB, will enable small banks in particular to avoid penalizations in terms of valuation haircuts.

Efforts to regain full access to the international markets must continue. Massive recourse to central bank liquidity cannot be a permanent mode of funding for banks.

The view that Italy's banking system stands in dire need of recapitalization is unfounded. Only recently the International Monetary Fund published the results of its latest Financial Sector Assessment for Italy. I have already had occasion to point out that the IMF's stress tests, and similar exercises conducted by the Bank of Italy, show that the system can withstand not only the macroeconomic weakness posited in the baseline scenario for 2013–15 but also a less favourable scenario in which GDP growth is cumulatively more than 4 percentage points lower in the same three years. In this case, the additional capital required by some intermediaries in order to meet the minimum regulatory requirements would be limited; depending on the definitions used, it would amount to between €6 billion and €14 billion. These are – it is worth emphasizing – hypothetical capital needs that would arise only in an improbable scenario.

The Financial Sector Assessment Program's findings dovetail with the analyses that the IMF itself has conducted at aggregate level in its recent Global Financial Stability Report, which estimates the losses on loans to firms that the Italian banking system could face in an adverse economic scenario at €125 billion for the two years 2014–15. Considering the write-downs already taken, this amount is reduced to €53 billion, less than the gross profits banks are expected to make in the same two years. The losses, therefore, should not affect the system's total capital.

Italian banks have been protected first and foremost by business models that remain rooted in traditional retail banking business. In part thanks to the attentive supervision of the Bank of Italy, the system avoided the kind of massive investments in "toxic" securities seen elsewhere, often with recourse to off-balance-sheet vehicles.

The depth of the crisis faced by our country nonetheless weighs on the outlook for banks. Compared with the third quarter of 2007 gross domestic product has fallen by almost 9 per cent and industrial production by roughly one fourth. It should surprise no one that banks are encountering difficulties and struggling to support the economy fully. They suffered as a result of the sovereign debt crisis and the ensuing deterioration of funding conditions in international markets. The protracted recession continues to have repercussions on the quality of loans, above all to firms. In some instances difficulties have arisen from transactions that are incompatible with sound and prudent management, at times even fraudulent. The supervisory action of the Bank of Italy has been intense; when necessary, special administrative measures have been imposed.

In the second quarter of this year the annualized ratio of new bad debts to total bank loans reached 2.9 per cent. Supervision – both off- and on-site – is closely monitoring the evolution of credit and its quality. The objective is to make sure that the coverage ratios for non-performing loans remain adequate and are raised when necessary. Far from harming the banks, our action will strengthen them, reassuring markets about the soundness of their balance sheets. Bad debts amount to about €75 billion net of write-downs and are more than covered for the system as a whole by collateral and personal guarantees. Other net non-performing loans (substandard, restructured and overdue loans), whose expected loss rates are significantly lower than those of bad debts, amounted to about €110 billion.

Partly as a result of the checks carried out by us in late 2012 and early this year, the coverage ratio for the aggregate of non-performing loans has stabilized. In June of last year it was 39 per cent for the whole of the system and 41 per cent for the top five groups. The average for the largest European banks is slightly higher (43 per cent), but the criteria for the classification of impaired loans are less stringent than those adopted in Italy.

The measures contained in the draft Stability Law to reduce the time horizon over which write-downs and loan losses are deductible remove some of the tax disadvantage that has long penalized Italian banks compared with foreign competitors and that becomes even more significant from the perspective of the Single Supervisory Mechanism. The new legislation, in line with the recommendations issued on several occasions by the International Monetary Fund, will encourage banks to adopt the most conservative practices when writing down bad loans, thus improving the transparency of their balance sheets.

The gross profits of the banks amounted to €32 billion per year on average in 2011–12 and to €17 billion in the first half of this year. Loan losses continue to absorb most of this, however. If this situation were to persist for a long time, the low level of net profitability would inevitably weigh on their financial situation.

The need to counter the effects of the crisis makes it urgent to address the structural problems of the banking system, including those relating to governance. These are issues on which I have already spoken in the past, but must return to because they remain largely unresolved. The failure to solve them has a negative impact on banks' efficiency and profitability and ultimately on the correct allocation of savings in the economy.

The ratio of operating costs to gross income, which amounted to 62 per cent in the first six months of this year, is about 5 percentage points higher than the average for the leading European banks. Taking into account the growth rate of lending, reduced unit margins and weak demand for asset management products, in the current situation it is difficult to foresee a significant increase in banks' revenues. In the short term the recovery of profitability requires decisive action on costs, including labour costs, which represent more than half of the total. Some progress has been made on this front, but we need all parties to participate, and take responsibility, in an action not unlike the one successfully launched in the second half of the 1990s to reduce the gap with the leading foreign banking systems. A major part of this effort must consist in a rigorous review of executive compensation.

Cost containment requires a radical rethinking of the distribution channels to make full use of the opportunities offered by technological innovation. Standardized and low-value-added services can be distributed at lower cost through remote channels, and the traditional distribution network should be reviewed to concentrate on the supply of more complex products. It is not an easy task, and it requires a profound transformation of banks' organization and operating structure and considerable investment in staff training. Targeted mergers and acquisitions, based on robust economic premises, may facilitate the restructuring and the recovery of efficiency.

The process of financial integration in the euro area is encouraging a wider use of technology. The transition to the new payment standards under the Single Euro Payments Area, which will be completed by 1 February next year, is an important element. It affects firms, consumers, banks and other payment service providers. The availability of efficient services will benefit the economy as a whole; according to studies sponsored by the European Commission, the efficiency gains resulting from the transition to the new standards will be in the order of 0.2 per cent of European GDP. The Bank of Italy is committed to ensuring that all those involved in the initiative put in place the necessary organizational, technical and procedural arrangements within the time limits.

Corporate reorganization, including within groups, and more streamlined boards are needed in order to improve the chain of decision-making, by making directors more accountable and eliminating unnecessary costs. Mechanisms must be adopted to prevent a misinterpretation of banks' relationship with their local area from steering lending and investment activity in the wrong direction, putting the soundness of banks' balance sheets at risk and hindering the efficient allocation of resources.

In addition to disbursing credit, Italian banks often participate directly in firms' capital. Such equity links must not be a source of distortions in lending decisions or give rise to attempts to prevent debtors' difficulties from emerging. These risks, like all others deriving from relationships with counterparties closely linked to banks, must be appropriately monitored by banks' governing bodies. The supervisory authority cannot intervene preventively with regard to individual transactions, even if they are with related parties. It will, however, continue to exercise its control activity, carefully assessing the ways in which transactions are carried out and their impact on banks' risk profiles and their sound and prudent management; it will require any shortcomings to be corrected.

The business of the large cooperative banks is no longer restricted to a limited local area. Their original corporate structures must not be an obstacle to the strengthening of their capital bases. The stability of banks' ownership structure is of value, but it must be due to good results and to high-quality governance arrangements, not to practices or rules aimed at hindering the entry of new shareholders. Less fragmented share ownership can strengthen the assessment of the performance of directors; the principle of one person, one vote can remain a salient feature of small cooperative and mutual banks. For these reasons, as I have argued on earlier occasions, it is desirable for large cooperative banks to adopt legal forms open to assessment by the market.

Banking foundations should have diversified their portfolios to reduce their dependence on the results of their reference bank. Some have not done so, they will have to adapt, taking market conditions into account. All of them must be careful not to interfere in banks' corporate structures and their business decisions, not to hinder the necessary renewal of governing bodies, and not to influence directors' choices on the basis of criteria other than experience and competence. Transfers from the top of foundations to the top of banks must be avoided. Prompt and significant progress is needed on these fronts.

Banking Union

Banking Union is a milestone in the completion of the European Union. The Single Supervisory Mechanism, comprising the ECB and the national authorities, constitutes the first element. It will be accompanied by a single mechanism for the resolution of banking crises and a harmonized system of deposit insurance, both of which are essential to align supervisory responsibility with crisis management and resolution, in order to sever the link between sovereign borrowers and banks. Work on these fronts needs to be accelerated.

The Single Supervisory Mechanism is expected to be operational in November 2014, one year after the entry into force of the relevant regulation. It is a vast innovation that will require a complex organizational effort at least equal to that needed to introduce the single currency.

The delicate start-up phase is taking huge investments in human resources and technical infrastructure. The preparatory work is proceeding with the maximum possible speed; the workloads of national supervisors will grow with the need to harmonize systems which are very different. In November, the ECB will launch a comprehensive assessment of the situation of the banks that will be supervised centrally (of which 15 are Italian); these banks' assets represent 85 per cent of the euro-area banking system total. The exercise is a prerequisite for the coming into operation of the Single Supervisory Mechanism and will last twelve months; it will be carried out in collaboration with the national authorities and with the support of independent third parties.

The evaluation includes three closely interlinked elements: a preliminary analysis of the banks' risk profiles, an examination of the quality of their assets and a stress test. It will be carried out using as a benchmark a ratio of 8 per cent between the banks' highest quality capital (defined on the basis of the rules that will be introduced next year) and their risk-weighted assets. This is a threshold that ensures the availability of sufficient resources to cope with possible difficulties.

The ECB and the EBA will conduct the stress test in close collaboration. The methods and scenarios to be used for this exercise will be agreed and announced at a later time. Prior to conducting the stress test, in fact, it is necessary that the results of the asset quality review are suitably incorporated into the banks' financial statements.

The assessment is a critical juncture in the management of the crisis in the euro area and in European integration. It represents a fundamental exercise of transparency, designed to strengthen confidence in the banks' soundness and reliability and, where necessary, define the appropriate corrective measures. It will be conducted rigorously, guaranteeing absolutely equal treatment of all banks, which are now subject to highly heterogeneous supervisory systems and accounting practices. The definition of non-performing exposures used will be that recently adopted by the EBA, which is in line with the one used in Italy. Where data are lacking, estimates will be employed.

The analysis will cover all types of risk and be based on current prudential rules. The risks of highly opaque instruments will be assessed with special care. Account will be taken of the diversity of methods by which banks using internal rating models calculate risk-weighted assets.

The methodology of the exercise will be clearly explained, and the market will be informed of the results and supplied with the information needed to evaluate them properly. The involvement of outside experts, avoiding potential conflicts of interest, will enhance the credibility of the exercise.

Together with the results of the assessment, the corrective measures required will also be specified. Any capital shortfalls will have to be made good primarily by drawing on banks' own resources, not distributing dividends, selling non-strategic assets, and curbing costs. Where necessary, fresh capital will have to be raised on the market. The success of the exercise depends crucially on having adequate national financial backstops, to be utilized in conformity with European rules and the legal framework defined by national constitutions for the ultimate purpose of ensuring financial stability.

Once the system is fully phased in, the rules for the operation of a European backstop will be defined, to avoid a situation in which measures taken at national level could reaggravate the vicious circle between sovereign risk and national credit market conditions. At present the European Stability Mechanism cannot directly recapitalize banks; its funds can be used indirectly for loans to member states. These loans, however, would increase their public debt. Direct intervention is envisaged only once the Single Supervisory Mechanism is fully operational. The implementing details are now being finalized.

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The problems of the Italian economy stem from long-neglected structural weaknesses. They have been exacerbated by the global financial crisis and the European sovereign debt crisis. The reform action undertaken in the last two years must be continued resolutely and set within a comprehensive framework, giving Italian citizens and domestic and foreign investors alike the prospect of a country that can change and return to growth.

The efficient allocation of savings is a necessary condition for our economy to regain the path of sustained, balanced growth. It requires a vital financial system that can support entrepreneurial initiative and innovation and fuel a virtuous circle between economic growth and saving.

The banks have a decisive role to play. The Bank of Italy's supervisory action – which we perform in full observance of our powers and duties under the law – is directed to protecting the savings of depositors and investors, to ensuring that their use is not distorted by inappropriate corporate structures or misplaced local allegiance. But rules and controls are no substitute for conduct guided by the principles of correctness and transparency, which banks must also ensure through a suitable internal organization.

The exceptional monetary policy measures taken by the ECB Governing Council during the crisis, and even before that the supervisory action of the Bank of Italy, have protected the banks and the real economy against potentially catastrophic consequences. They have helped to preserve the confidence of savers and investors. Banking Union, in the framework of the broader process of completion of the European Union, can further stabilize conditions in European markets if it is instituted rigorously and in its entirety. It will help to safeguard savings by countering the sovereign risk component engendered by fears of euro reversibility.

Italy's banks are feeling the repercussions of a financial and economic crisis for which they bear no responsibility. But they are also suffering the consequences of slowness or failure to adapt their business operations, efficiency, service quality and organization to the evolution of the markets. They must continue to do their part with a courageous effort of renovation.