Fabio Panetta: The transition towards a more stable financial system

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1. Introduction

The powerful stimulus of monetary policy, the depreciation of the currency, and the fall in oil prices are fueling economic recovery in the euro area. There are still risks in connection with the crisis in Greece, geopolitical tensions and the cyclical slowdown in the emerging economies. One of the factors that are impeding investment is the uncertainties surrounding economic agents'expectations.

The signs are favourable in Italy too, but the strength of the recovery will depend to a great extent on the proper working of the credit market and the availability of a sufficient volume of finance for the real economy.

The latest data show an improvement in credit availability. Banks report that they have eased their lending conditions, the share of firms complaining of lack of finance has diminished, and the decline in lending to firms has moderated. A decisive contribution to the improvement has come from the monetary policy action of the Eurosystem, in particular the programme of quantitative easing.

The normalization of the credit market is not complete, however. The terms of access to loans are still uneven. The flow of business credit has increased above all for the least risky borrowers, i.e. the largest and most strongly capitalized corporations. Smaller firms, especially those whose economic and financial balance is more fragile, continue to have problems obtaining outside finance.

The performance of the credit market is conditioned by national and international regulatory changes, which are transforming the market's size, structure and operating model. Moreover, banks are burdened with a very substantial volume of non-performing loans accumulated in the course of the protracted recession. The effects in both the short and the longer term warrant thorough analysis.

2. The financial system and the impact of regulatory reform

The recent regulatory reforms in the financial sector are designed to reduce the probability of systemic and solo banking crises and to limit their possible repercussions on the economy. The principal force for change comes from the new capital adequacy provisions. The Basel III rules raise capital requirements, set a minimum leverage ratio (of capital to assets not weighted for risk), and establish minimum liquidity requirements. An additional increase in capitalization has been introduced for "systemically important" banks and, for macroprudential purposes, for the entire system.[1] The regulatory revision is still under way; rules on total loss absorbing capacity are being finalized, to require global systemically

[1] For global systemically important banks (G-SIBs) there is an additional requirement for core tier 1 capital, variable between 1 and 3.5 per cent of risk-weighted assets depending on the bank's systemic importance. Specific requirements can also be introduced for national systemically important banks. Among the measures applicable to the entire system, the provisions for a countercyclical capital buffer can be activated at times of excessively rapid growth of the credit aggregates.

important banks to maintain an adequate amount of devaluable or convertible instruments in case of failure.

Another major innovation is the Bank Recovery and Resolution Directive (BRRD). The Directive, which is being transposed into Italian law, shifts the burden of bank crises from the public sector to the banks' creditors (shareholders and holders of other liabilities). This marks the switch from a regime in which big banks were salvaged with public money (bail outs) from one that involves investors in banks' losses (bail ins).

Some countries have instituted explicit rules to separate credit business from the banks' proprietary financial and trading activity. The purpose is to eliminate indirect subsidies for these riskier activities, setting them apart from such socially valuable activities as provision of credit and payment services.[2]

The effects on credit – First of all, these reforms produce a force for the contraction of banks' balance sheets. The tougher capital and liquidity requirements, the higher funding costs that will stem from the BRRD (which increases the risk of liabilities other than deposits covered by protection schemes), and any direct limits to operations will decrease the supply of credit. Market forces are pushing in the same direction: the increase in credit and sovereign risks has made medium- and long-term wholesale funding more onerous for banks, constituting one more factor reducing the profitability of credit intermediation.

The banking system forged by these reforms, then, will be characterized by a greater "safety margin" in terms of both capital and liquidity, but at the same time by lower profitability and a smaller role in financing the economy. What are the likely consequences of this transformation, for the Italian economy in particular?

A substantial empirical literature indicates that in equilibrium (that is, once the transition to the new regime is completed), stronger capitalization of banks will have a positive impact on the supply of credit.[3] During the transition, however, the capital increases required by the stronger capital adequacy rules tend to adversely affect lending growth. And the same applies to increased liquidity requirements. Evaluations conducted before the new rules were introduced support this thesis, even while indicating that the adjustment costs will be moderate, not so great as to compromise the net long-run benefits.[4]

On the whole, internationally the adjustment to the new standards is being achieved essentially through increases in capital and liquidity, with no substantial impact on the provision of finance to the economy.[5] However, the effects of banks' deleveraging differ from country to country depending on both structural characteristics – such as the degree of development of the capital markets – and on cyclical factors, such as the stance of monetary and fiscal policies, the cyclical state of the economy and the financial conditions of firms.

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2 "Separation" rules have been enacted in the United States, where the Dodd-Frank Act introduced the "Volcker rule"; in Britain, where the Banking Act made the proposals of the Vickers Commission into law; in France, with the Loi de Séparation des Activités Bancaires; and in Germany with the Gesetz zur Abschirmung von Risiken. Within the European Union discussion on the need for similar measures was initiated by the Liikanen Report, which was followed by a Commission proposal for a regulation, presented in January 2014 (the Barnier proposal). The forms of separation differ from country to country. The Volcker rule and the Barnier proposal prohibit banking groups from engaging in certain types of business (such as proprietary trading), while the French, German and British laws only require that they be done by separate units within the group.

3 For the United States, see J. Peek and E.S. Rosengren (1995), "The Capital Crunch: neither a Borrower nor a Lender Be", *Journal of Money, Credit and Banking*, Vol. 27, No. 3; for Italy, U. Albertazzi and D.J. Marchetti (2010), "Credit supply, flight to quality and evergreening: an analysis of bank-firm relationships after Lehman", Bank of Italy Working Papers, No. 756, April.

4 Bank for International Settlements, *Assessing the macroeconomic impact of the transition to stronger capital and liquidity requirements (Final Report)*, December 2010; *An assessment of the long-term economic impact of stronger capital and liquidity requirements*, August 2010.

5 S. G. Cecchetti (2014), "The jury is in", *CEPR Policy Insight*, No. 76, December.

The leverage of the main US banks has been reduced by 50 per cent since 2007.[6] The possible repercussions of a credit restriction were moderated by firms' recourse to the capital market and the shadow banking system, as well as by large-scale corporate self-financing. The transition was facilitated by the increase in the public debt and the exceptional monetary expansion, which increased the amount of resources available to the private sector.

The banks' deleveraging was significant in Europe as well. At a sample of 43 large banks in eleven countries, the leverage ratio came down from 26.0 in 2011 to 21.2 in 2014. Two thirds of the reduction stemmed from capital increases, the other third from a decrease in assets. However, the context of the balance-sheet adjustment was different from that of the United States. In Europe the capital market is a less important source of finance for businesses; the economy consists largely of smaller firms that depend on bank credit. In addition, the capacity of the public sector to sustain the economy and the banks is limited by ongoing fiscal consolidation in many countries and by the European budget rules.

In Italy, the difficulty of adapting banks' balance sheets to the new regulatory and market environment is more acute than in the rest of the euro area, despite lower initial leverage ratios. Firms' direct recourse to the capital market accounts for an almost negligible share – around 5 per cent – of total finance to the productive economy. The drawn-out recession has undercut firms' self-financing, especially for smaller businesses. And the margin for intervention by the public sector is narrow indeed, notwithstanding the recent measures to stimulate a rebalancing of firms' financial structure.

Now that signs of economic recovery are emerging in the euro area and in Italy, it is essential to learn the lessons of the crisis and to avoid pro-cyclical policies. The transition to the new equilibrium marked by more strongly capitalized banks with greater liquidity must be gradual and perspicacious. The risks of sudden adjustment must be carefully assessed.

The return to growth and the easing of the interest burden will help to increase firms' profitability and improve credit quality. Banks need to accommodate rising loan demand while maintaining strict control of risk, and of credit risk in particular. In this phase a further stiffening of capital and liquidity requirements could impede the supply of credit, delaying the economic upturn. Such a course would not only heighten macroeconomic risk but would also actually increase the risks for the financial system, the exact opposite of the desired outcome.

Microprudential supervision must engage with macroprudential necessities. The targets must be set in such a way as to endow the financial system with more than ephemeral strength, combining the need for bank stability with the need for a recovery in economic activity.

At the same time, we must recognize that European integration, which has been revitalized by the project for Banking Union, necessarily entails major changes and constraints on economic agents. The pressure for higher levels of capitalization, which in the current phase has required a considerable effort on the part of Italian banks, derives largely from market forces, from a comparison with other European banks.

The impact on crisis management – The BRRD will bring in a new paradigm for the management of banking crises. The Directive requires the formation of a national Resolution Authority, which, in collaboration with the European Single Resolution Board (ESRB) in Brussels, will deal with resolution of "less significant" banks and implement the steps in the resolution of "significant" banks as decided by the SRB.

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6 For a sample of ten large banks, financial leverage, calculated as the ratio of total assets to shareholders' equity, was lowered from 25.2 in December 2007 to 11.8 in June 2014; see P. Bologna, M. Caccavaio and A. Miglietta (2014), *EU Bank Deleveraging*, Bank of Italy Occasional Papers, No. 235. For an analysis of deleveraging in the US, see L. Buttiglione, P. R. Lane, L. Reichlin and V. Reinhart (2014), "Deleveraging? What Deleveraging?" *Geneva Report on the World Economy*, No. 16, September.

Even at times of ordinary bank activity, the so-called “going concern” phase, the new rules on resolution require completely new activities. The Resolution Authority will simulate the effects of crises, prepare resolution plans, identify solutions to guarantee the continued performance of critical functions. The Authority can intervene – observing the principle of proportionality – to impose changes to banks’ operational, legal and organizational structure, in order to reduce their complexity or to isolate the critical functions with a view to maintaining their operability. In the case of failure, the Authority will determine how costs are shared and how the corporate units without systemic importance will be liquidated.

Last year the Bank of Italy provided technical advice to the Government and the Parliament concerning the transposition of the Directive. This transposition must now be completed with the designation of Italy’s national Resolution Authority.

The effects on bank-customer relations – As I observed earlier, the main effect of the BRRD will be to limit public intervention in banking crises by requiring creditors to contribute to resolving the banks’ difficulties through devaluation of their assets or conversion of their financial instruments into shares.

This change will require banks to pay drastically increased attention to correct relations with customers. Savers must be made fully aware of the risks they run in the event of the bank’s failure. The investments that banks propose to their customers must be perfectly consistent with the investors’ propensity for risk and their financial sophistication. Banks must make sure that their customer relations officers apply the rules on transparency in substantial and not merely formal terms.

Substantial efforts have been made in the past to improve the quality and transparency of communication between banks and customers. The Bank of Italy has laid down forceful rules and checked compliance in special on-site inspections. Progress has unquestionably been made. But there is still a great deal of room for improvement, not only in the process of adaptation to the broad, detailed provisions of the regulations but also in truly partaking in the spirit of the transparency and correctness regulations.

Even these actions could prove insufficient, however, in the light of the changes introduced by the BRRD. We shall need to consider requiring that retail customers be directed mainly or exclusively to the least risky products – that is, those that under the BRRD will benefit from “depositor reference” in the “pecking order”[7] – and reserving other forms of funding to professional investors.

3. The role of the banks and supervision during the transition

In recent years the Italian banking system has strengthened its capital position. Since 2007 core tier 1 capital has been increased from 7.1 to 11.8 per cent of risk-weighted assets, and financial leverage has been considerably reduced. The ECB’s comprehensive assessment of bank balance sheets confirms the resilience of the system as a whole in the face of the exceptionally severe recession afflicting the Italian economy. Nevertheless, changing over to the new rules will require banks to intensify their efforts. In particular, three issues need to be addressed by consistent policies on the part of banks and authorities alike. These concern banks’ efficiency, the management of nonperforming loans, and the adaptation of banking governance to European competition.

7 Bail-ins exempt certain liabilities, such as deposits up to €100,000, bonds backed by the bank’s assets, and short-term interbank debt. In special cases the Resolution Authority can also exempt other liabilities for the purpose of safeguarding systemic stability. The allocation of the losses must follow the preferential ranking laid down by the Directive, which provides among other things that deposits above €100,000 held by individuals and SMEs are not to be drawn on until after other uncollateralized credits.

Efficiency – Raising the level of efficiency is necessary to increase profitability, which is now too low to remunerate the capital invested. For a good part of the banking system, efficiency gains can be attained via mergers. The potential benefits of such operations are substantial, on both the cost and the revenue side. But they are not automatic: realizing them requires decisive organizational measures in the rationalization of distribution systems, in risk management, in the exploitation of technology.

Mergers may require banks to adapt their level of capitalization to their new mode of operation. Recent experience has shown that international investors are willing to take part in ambitious, credible plans that can transform today's regional banks into more competitive, better diversified intermediaries operating on a larger scale and serving the financial needs of their customers.

The bigger, more efficient banks that will result from mergers can make the inevitable expansion of the capital market an opportunity to increase their revenues. First of all, the prolonged period of low interest rates that looms for the European economy will spur households' search for relatively higher returns, increasing the demand for asset management services. Moreover, firms' recourse to the market offers substantial opportunities to provide high-value-added services that absorb relatively little capital and liquidity.

Banks can meet these needs by capitalizing on their relations with customers and their knowledge of the economic fabric. This will necessitate the reinforcement of the safeguards against the conflicts of interest stemming from their joint roles as lender, promoter of market access, and asset manager.

Non-performing loans – Within the next few years the banks will have to procure from savers and from the international markets the resources they need to repay the very substantial loans they have had from the ECB. At the same time they will be called on to sustain the real economy: lack of a sufficient volume of credit would throttle the recovery.

The attainment of these objectives is impeded by the large volume of non-performing loans accumulated during the long phase of recession. The dead weight of these impaired assets reduces the transparency of balance sheets and hinders banks' recourse to international markets for funding. It also heightens the risk aversion of banks and reduces their willingness to lend.

The development of a market in non-performing loans is blocked by several factors. First, the slowness and uncertainty of credit recovery in Italy swells the risk premium that economic agents demand for investing in these assets, driving their price down below their "fundamental" value. And Italian banks, which as a group are now well capitalized, are loath to sell off these non-performing assets at the fire sale prices imposed by this time of exceptional economic weakness. The situation of our banks, in fact, is quite different from that of banks in other countries that have been obliged to resort to systemic solutions for the disposal of non-performing assets. What is more, the simultaneous sale of large volumes of impaired assets by the entire banking system (or a good part of it) would provoke a collapse in prices and thereby, as a practical matter, prevent the conclusion of the sales.

If left to market forces alone, the disposal of non-performing loans threatens to be a very long-drawn-out affair. In this kind of scenario, intervention by the authorities can resolve problems of coordination between banks and speed up the disposal process, preventing a "market failure" from ultimately blocking the recovery of the economy. International experience suggests that reducing the weight of non-performing loans on banks' balance sheets sustains lending growth and helps to create a virtuous circle of economic growth and improving credit quality.

The transfer of bad debts would benefit households and firms by increasing the availability of credit and spurring the economic upswing. It would benefit the banking system by reducing the balance-sheet incidence of impaired asset items, thus lowering operating costs and the cost of funding. And it would benefit the public sector, with expanded tax revenues thanks to the cyclical upturn.

The measures for the transfer of bad credits now under study centre on market-based solutions. Their precise features will be determined within the next few weeks, in dialogue with specialized operators and with the banks. The intensity of government involvement may be of varying degree, and it is the subject of talks with the European institutions to assess the measures' compliance with the Commission's rules on state aid. The European legal framework has changed in the last two years, and measures such as those taken in the past in other countries are no longer practicable. For one thing, those solutions entailed the massive use of public resources, which in our case would also raise questions of budgetary propriety.

Significant benefits would also accrue from measures, these too under study, to shorten the duration of credit recovery proceedings, which is much longer in Italy than on average in Europe and constitutes one of the main causes for the build-up of non-performing assets carried on banks' balance sheets.

Last year's amendments to the Civil Code have removed some of the structural causes of this problem. Hopefully, additional reforms in the near future can shorten or eliminate some of the terms for foreclosure procedures and streamline asset sale procedures, possibly via electronic instruments.

Governance – The Bank of Italy has long seen and signalled the need for substantial progress in banks' governance. Within the limits of our powers, we have acted to strengthen the cooperative banks and induce them to make changes considered indispensable. We have asked them, like all the other banks, to upgrade the membership and improve the functioning of their boards of directors, so as to improve their capacity for governance. We have introduced rules on executive compensation, based on European regulations. We have also asked the cooperative banks to encourage shareholders' participation at meetings.

Notwithstanding the new rules, the improvements achieved have not been decisive. Nor could they have been, given the legislative framework. Our rules could not alter the legal limits to share ownership, the one-person-one-vote provision, or the constraints on the voluntary transformation of cooperatives into other corporate forms.

The recent government provisions on cooperative banks permit more thorough monitoring of directors and administrators; they make the banks more attractive to investors, strengthening their ability to raise capital on the market. The most capable managers will succeed in exploiting these opportunities to improve efficiency, move into new markets, and support the best firms.

Now the need is to reduce the fragmentation that prevails in the system of cooperative and mutual banks, allowing for forms of integration that preserve these institutions' local roots and capitalize on individual banks' membership of banking groups. The solutions must be guided by the essential aim of enabling these banks too to turn readily to the market in order to raise capital, as well as by the purpose of improving the quality of their management.

The cooperative banking systems of other European countries are much less fragmented than the Italian system. The prevailing models centre on banking groups, in which the parent company exercises functions of direction and oversight over the banks in the group and, where necessary, can recapitalize them by recourse to the capital market. This model does not denature the cooperative form of the individual banks but allows them to maintain their characteristic mutuality and their community roots.

Integration of the system of cooperative credit is in the interest of the cooperative banks themselves, to ensure that cooperative and mutual banks can continue to operate independently in an environment requiring rapid provision for the needs for recapitalization and efficient management, and in the light of the narrower margins for intervention at troubled intermediaries.

4. Conclusion

In recent months the European Central Bank, in keeping with its mandate, has dealt effectively and flexibly with the pressures towards the fragmentation of the European markets and with the emerging threat of deflation, preserving the stability of the euro area. Now this kind of flexibility, without prejudice to the rules we have instituted, is necessary at national and at European level in order to wed the objective of soundness of banks with the needs of economic recovery. Where market failures occur, public intervention cannot be ruled out a priori.

In their own interest the banks, despite the transition to the new set of European and global regulations and the likely gradual diminution of their role to the advantage of the capital markets, must enhance their capacity to provide financial support to the real economy. I have mentioned the priorities of the current phase: regaining efficiency, managing credit risk and strengthening governance. Mergers can help in attaining these objectives.

The financial system cannot solve such problems of the real economy as poor competitiveness and low productivity, on which I have not dwelt today. But it does have an indirect role to play in facilitating the transformation and growth of firms. Banks can play this role while accompanying the development of the capital market and drawing significant advantages from it. It is up to firms to continue their action for a better balanced financial structure, all to the benefit of their ability to stay in the market.