ACRI

Association of Italian Savings Banks

2016 World Savings Day

Address by the Governor of the Bank of Italy

Ignazio Visco

Rome, 27 October 2016

There are mixed signals from the global economy. On the one hand, the most recent data show that economic activity is strengthening in the United States and in China, while Russia is pulling out of recession; on the other, the available data for the third quarter point to a fresh weakening of international trade. Overall, uncertainty prevails: the difficulty of predicting the impact of technological development on the economy and employment and managing that of demographic trends has been compounded by growing political and geopolitical tensions.

Uncertainty in the European Union has been heightened by a number of specific factors. The tensions associated with managing exceptional flows of migrants, at a time when mutual trust is already impaired, are driving deep wedges in relations between the member states. The proliferation of nationalist movements, which are openly hostile to the single currency and plans for further integration, is casting a shadow on Europe’s future, which has lengthened in the wake of the UK referendum. European politics remains mired in short-termism; individual countries tend to favour internal contingent interests over more far-reaching common initiatives.

The outlook for the euro area remains that of stable but moderate growth, with inflation recovering gradually but still excessively low, and elements of persistent frailty in the financial system. Uncertainty is driving firms to increase their liquidity and discouraging investment; it is holding back household consumption while at the same time greater precautionary saving is not going into financing additional business investment.

While averting a deflationary spiral, the exceptionally expansionary measures adopted by the Governing Council of the ECB aim to bring inflation back in line with the objective and support demand. But monetary policy by itself is not enough. The absence of a common fiscal capacity that could be used countercyclically is weighing on the euro area, a situation which is all the more worrying when many countries have scant room for manoeuvre at national level and others hesitate to adopt expansionary policies. In any event, monetary policy cannot serve to raise the area’s growth potential. What is needed instead are policies capable, at a time of major change, of recasting the structural traits of our economies. The reforms underway in several countries must continue apace.

In Italy, the economic recovery continues but remains stunted. After stalling in the second quarter, economic activity appears to have returned to slight growth in the third, according to the latest data on industrial production and recent business surveys. The recovery is having a positive effect on financial stability: the increase in the employment rate is supporting household disposable income; corporate financial vulnerability indices are improving. Investment is still the main weak point, particularly in Italy. Although it has been on the rise since mid-2015, partly thanks to increasingly accommodating lending conditions, it remains modest compared with that of other European countries and with the levels recorded in the aftermath of previous recessions; in real terms investment remains nearly 30 per cent lower than in 2007.

In Italy, the scope for government intervention to support economic activity is limited by the very high level of debt. Our production system has been weakened by the delay in responding to increased competitive pressure in the international markets and to technological innovations. Notwithstanding the improvements obtained with the reforms of recent years, it is still hindered by an environment that is not business friendly, encumbered as it is by excessive bureaucracy, a slow judicial system and illegal activity. Italian banks, like banks in other countries, face a delicate transition, complicated by the need to manage the legacy of the long recession in a still weak economic environment and with regulatory reforms underway.

* * *

An accurate assessment of the conditions and prospects of the Italian banking system should take account of the differences between the various banks and of the measures and reforms adopted so far.

Overall, the results of four of the five major Italian banking groups in the recent stress test coordinated by the European Banking Authority are in line with the average for the main banks of the other countries. Banca Monte dei Paschi di Siena, which failed the test, announced, at the time the results were published, a major recapitalization plan to be implemented by the end of the year, which will allow it to dispose of its entire portfolio of bad loans.

Even among the remaining Italian banks, both the ‘significant’ ones (under the direct supervision of the ECB with the participation of the national authorities) and the others (with assets below €30 billion, supervised directly by the Bank of Italy according to common guidelines), the difficult cases are well-identified.

In the last few years, crisis management has become more complex because of market conditions, which discourage the provision of new capital, and because of changes in the regulatory framework, which no longer allows use of the tools that Italy had long relied on to prevent or resolve bank crises. Nevertheless, the banks concerned are carrying out restructuring operations, taking measures to make managing impaired assets more efficient – where necessary through divestments on the market – and recapitalizing.

The sale of the 'bridge banks', set up during the resolution of four banks at the end of last year, continues in an open, transparent and non-discriminatory manner. The process takes into account European rules on competition and the prudential requirements established by the single supervisory mechanism. In recent weeks, the deadline for completing the process has been postponed, in agreement with the European Commission.

Measures are being taken to overcome crises at 'significant' banks and at other banks directly supervised by the Bank of Italy: the latter number about 460, including groups and stand-alone banks, and account for 18 per cent of the assets of the Italian banking system. Their average size is small, but the dispersion is high: 17 banks have assets exceeding €5 billion, while about 240 banks have assets below €500 million; 355 of them are mutual banks.

Supervision of these banks is intensive; the supervisory review process is based on risk profile analysis methods consistent with European guidelines and on regular on-site inspections (roughly one hundred a year). The bank's overall functionality, its capital adequacy and its asset quality are assessed. Regarding asset quality in particular, inspections include a review of individual credit files to check that loans are correctly classified and the relative valuation adjustments are adequate. At the end of the annual evaluation, the capital ratios deemed adequate for each bank are established, taking the minimum requirement as a basis, and requests to strengthen capital are made where necessary. It is also thanks to this supervisory action that since the end of 2011 the highest quality capital ratio of the banks directly supervised by the Bank of Italy has increased from 11.8 to 15.5 per cent (against an increase from 8.8 to 11.7 per cent for 'significant' banks) and the coverage ratio for non-performing loans (NPLs) has risen from 28.2 to 43.6 per cent (against an increase from 40.6 to 45.6 per cent for 'significant' banks).

The high level of NPLs, a weakness more typical of the Italian banking system than of others, is being assessed by market analysts as well. Some describe the phenomenon as still growing, others suggest that it is underestimated in publicly available data. Given the importance of the questions raised, they deserve satisfactory answers.

In Italy, the deterioration in loan quality, aggravated above all by the long recession, recently came to a halt. The ratio of the stock of NPLs to outstanding loans began to diminish at the end of last year. In June this year it stood at 17.7 per cent including write-downs; net of write-downs it was 10.4 per cent, of which 4.8 per cent related to bad loans. Attention should focus on the net amounts, as writing down the value of NPLs is virtually equivalent to writing them off.

In the first six months of this year, the flow of new NPLs returned to the levels of 2008, at around 3 per cent of outstanding loans. Provisional data on the third quarter show that the improvement is continuing. Moreover, the NPL coverage ratios continue to grow and are now slightly above the average for the main European banks. A large part of these exposures are collateralized; this should be taken into account in any overall assessment, although without disregarding the possible problems in recovering the collateral, especially in today's difficult market.

Also worth noting is the significant difference between exposures classified as bad loans, for which there is actually no possibility of a 'cure', and other non-performing loans (those 'unlikely to pay' and past-due debts or credit-line breaches), in which the debtors may be facing temporary difficulties. Without underestimating the risks associated with the latter exposures, it should be borne in mind that proactive management by the banks may make positive cash flows possible and permit a return to normal conditions.

As regards managing bad loans, in several cases we have found shortcomings in banks' organization and governance. These must be resolved so that the banks can take full advantage of the opportunities that have opened up following the recent enactment of new laws to shorten recovery procedure times, potentially bringing them closer to those in the other main countries. Banks are being encouraged to move in this direction by the guidelines on managing NPLs, recently provided for consultation by the ECB and addressed to 'significant' banks, and the new detailed survey of bad loans requested by the Bank of Italy, which is currently examining the early findings. The availability of systematic, detailed data will not only help to make the internal management of bad loans more efficient, but it will also encourage their sale on the market, where necessary, by ensuring more transparent information.

It should nevertheless be noted that the majority of non-performing loans are held by banks that are healthy overall; because they do not need an immediate sale of bad loans, they can take advantage of generally higher recovery rates than current market prices imply. Moreover, incentives to reduce the ratio of NPLs to outstanding loans, which could have been done quickly had it been possible to set up, with public backing, a company to manage such assets, are now provided by the

measures introduced by the Italian authorities over the last two years. These are designed to foster the development of a market for NPLs, in part by shortening the recovery process.

In the near future, a large volume of bad loans could be sold or securitized, including through recourse to government guarantees for senior tranches. The timeline for this recovery process should not be cut too short, however. The risks that could arise along the way will be smaller, the more efficient are economic policies in supporting the recovery.

* * *

The action taken to reduce the NPL ratio is essential, but by itself it cannot conquer the challenges facing Italian banks. All of them, not just the ones most weakened by the crisis, must improve their profitability, adapting their business models to a market environment that has been profoundly altered by technological advances and regulatory reforms. By drastically cutting costs without delay and significantly raising efficiency it will be possible to free up considerable funds to invest in technology and in improving the quality of human capital. On occasion, sweeping measures may be taken to reduce staff costs; the social repercussions should be cushioned by using existing unemployment and welfare benefits, the resources of the industry's Solidarity Fund (the scope of which has recently been extended), and those that will be made available by forthcoming legislation.

A greater diversification of revenues could benefit from the provision of asset management services which, while fully satisfying the needs of customers, would also emphasize, in particular, the avoidance of conflicts of interest and, more generally, the protection of customers. This is not merely a legal requirement, it is the cornerstone of a fruitful and long-lasting relationship. Clear and fully transparent transactions with customers help to strengthen the trust placed in banks, the ingredient on which their business hinges. These principles should be in place even when contract conditions change, which is only possible for a valid reason; customers should be properly informed of these in order to make reasoned choices.

Mergers and acquisitions, especially among small and medium-sized banks, can certainly facilitate adjustments in business models and a recovery of profitability. Internationally, the authorities are determined to complete the reform of the rules on banks' prudential requirements (Basel III) as soon as possible; their intention is to avoid at the same time significantly increasing overall requirements. Finalizing the reform will help to dispel the regulatory uncertainties that currently hamper the process of consolidation.

The governance reforms introduced recently in Italy facilitate this process; they are starting to bear fruit. Other such operations will follow the important merger of two (former) cooperative banks completed in recent weeks. The transformation into joint stock companies of the cooperative banks affected by the 2015 reform must be completed by the end of this year; it should help them to strengthen their capital, restore profitability and improve credit quality. As regards mutual banks, the reform envisaging the creation of cooperative banking groups makes their strengthening much easier; it should be implemented without delay.

* * *

The difficulties facing the Italian banks will be solved all the more easily the sooner the economic recovery gains a firm footing: non-performing loans will be disposed of more quickly and the recovery of profitability will be less complex. The improved economic outlook would make it possible for saving to fund business investment. For the economy to return to a path of stable growth, however, capital accumulation must, crucially, resume at a more vigorous pace. The measures set out in the 'Industry 4.0' plan announced by the Government will provide further impetus for public support to firms' innovation and investment activity.

This action is part of a broader reform strategy that has been taking shape over the years. Important measures have been implemented and are now yielding their first results. The only option is to continue resolutely along this path in order to provide a better working environment for firms, assist the creation of new job opportunities, and reduce the imbalances weighing down our economy and our society.

Designed and printed
by the Printing and Publishing Division of the Bank of Italy