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Cyclical conditions and the economic outlook

In Italy, as in the other main advanced economies, economic activity slowed in the early months of 2018, with the signs of deceleration continuing in the spring. The confidence of households and firms has nonetheless remained high, with positive indications also coming from the expansion of bank lending and improvements in the labour market. Although unemployment is still above 10 per cent, employment has surpassed the peaks observed prior to the double-dip recession. In more recent months, both the fixed-term and, to a lesser extent, permanent components have recorded increases.

In most of the forecasts made by national and international institutions, Italy's growth is expected to exceed 1 per cent on average in the three years 2018-20. This scenario assumes monetary policy will continue to be accommodative and financial conditions relaxed, and that there will be a favourable economic environment worldwide. In recent months, however, there has been a notable increase in the risks connected with the United States' protectionist policies and with disagreements on various fronts in relations between EU countries.

Last June the Governing Council of the European Central Bank recognized the progress that had been made towards a sustained increase in inflation rates in the euro area – progress associated with increased employment, greater use of productive capacity, accelerating wage growth, and the recovery in inflation expectations. Though acknowledging that there are still ample margins of uncertainty, it was decided to recalibrate the asset purchase programme and in any event to maintain an ample degree of monetary accommodation in order to achieve the objective of price stability.

If cyclical conditions in the area remain consistent with the current medium-term outlook, from October net asset purchases of securities will be reduced from the current €30 billion a month to €15 billion and will cease at the end of the year. The principal payments from maturing securities will continue to be reinvested for an extended period of time after the end of the net asset purchases. The Governing Council also said that it expects to keep interest rates at their present low levels at least through the summer of 2019. This prudent approach is also necessary to counter the risk of sudden surges in long-term yields and of volatility in the financial markets.

Given the prospects of growth and of a steady rise in inflation, Italy is in a position to weather the gradual changes in the tone of monetary policy. The high average residual maturity of the public debt, low household debt, reduced business debt, and the fact that banks are sounder and have only limited exposure to the effects of any interest rate rises, will make it possible to contain the risks connected with the structural fragilities of Italy's economy.

The achievement of a satisfactory and stable growth rate is, however, hampered by continued weak productivity growth, the inefficiencies and rigidities of the business environment and the high debt-to-GDP ratio. Addressing these vulnerabilities means continuing to implement systematic reforms and balanced fiscal policies, which are also necessary to maintain the confidence of households, firms and investors.

Recent tensions in the Italian financial market demonstrate the importance of a prudent and balanced economic policy stance. Between mid-May and early June, with very low market liquidity, yields on government securities increased across all maturities. Yields on ten-year bonds surpassed 3 per cent for a few days and the spread with respect to the equivalent German bond rose above 300 basis points, while the spreads vis-à-vis the government bonds of the other euro-area countries also widened. The performance of premiums on credit default swaps on government securities shows there were moments when fears of a redenomination of Italy's debt grew among financial operators. Contrary to what happened at the height of the sovereign debt crisis in 2011-12, the markets did not perceive this to be associated with an increase in the risk of a euro break-up.

Pressures eased in the following weeks, when the sharp rise in volatility partially subsided and short-term yields declined, restoring the more usual, positive slope of the term structure. The spread between yields on ten-year Italian and German government bonds has fallen to around 240 basis points; however, it is still more than 100 points higher than the levels prevailing in the first half of May.

Maintaining orderly conditions on the government bond market is essential to defend the stability of the financial system and effectively protect the savings of Italians. During the tensions at the end of May, share prices in the banking sector declined sharply. The financial situation of the public sector can influence that of the banking sector through multiple channels. The reduction in the value of government securities held by banks directly affects their assets; it also diminishes the amount of collateral that banks can use in Eurosystem refinancing operations. The challenges for the public finances can lead to an overall deterioration in the creditworthiness of firms, impairing the quality of bank loans.

It would be illusory to think that the link between sovereign risk and banking risk can be broken with measures that push banks to drastically reduce their direct exposures. Moreover, in the most difficult years of the crisis, Italian banks, like those of other countries, swam against the tide, and made a profit, buying government bonds when tensions rose and yields increased. When the conditions changed, they began to sell them. Last May, Italian banks held slightly more than €300 billion worth of domestic government bonds in their portfolios, compared with the €400 billion reached at the beginning of 2015.

Loan quality

The continued economic growth has led to a gradual improvement in the quality of bank credit. The ratio of non-performing loans, net of loan-loss provisions, to total loans system-wide, which had fallen by about 4 percentage points between the peak of 2015 and the end of last year, decreased by almost 1 percentage point more in the first quarter of this year, to stand at 5.3 per cent. The total amount of net NPLs fell to just over €110 billion, down from €200 billion at the end of 2015. About half of the amount comprises exposures classified as unlikely-to-pay, some of which could become performing again. For the less significant banks the share of all NPLs (7.1 per cent) remains higher than that recorded by the significant banking groups (5.1 per cent).

The development of the secondary market is making an important contribution to reducing the number of NPLs. This market in turn benefits from the state guarantee on senior debt issues deriving from the securitization of bad loans (GACS). The gross value of the bad loans securitized under the GACS system was approximately €32 billion and it is expected to increase considerably in the months to come. In the last few days, the Government has asked the European Commission to extend the possibility of using GACS beyond the current deadline of September.

The improvements made thus far should be consolidated and strengthened. More active NPL management on the part of banks remains fundamental, including in the light of the regulatory changes proposed by the European Commission and the new supervisory expectations of the Single Supervisory Mechanism supplementing the guidelines on NPL management published in March 2017. The strategies proposed by the banks will be assessed on a case-by-case basis as part of ordinary supervisory activity and the measures best suited to reduce the level of NPLs further and to gradually and sustainably adjust the level of provisioning will be adopted. Account will be taken of the fact that the containment of a credit portfolio's inherent risk must be compatible with the ability to absorb any potential losses from sales.

The number and size of firms specialized in credit recovery are increasing, but the level of competition in this sector remains unsatisfactory. Some banks have set up ad hoc units. Progress in developing a liquid secondary market for NPLs and advances in the efficacy of recovery procedures depend on a marked improvement in the quality of the information needed for due diligence purposes and the timely monitoring of the status of the procedures. The analytical reporting on bad loans launched two years ago by the Bank of Italy is making significant strides in this direction. There is still ample room for improvement, however, especially for small banks and with regard to data on real estate appraisals. Every effort must be made to catch up.

Measures to increase the probability that likely-to-fail exposures return to performing status must be stepped up. Their success requires different technical skills and operating procedures from those used to manage bad exposures. A market for this type of exposure should also be established and banks should actively seek agreements with turn-around funds to offer firms the managerial and financial resources needed for a re-launch.

In recent years there have been improvements in the length of judicial credit recovery proceedings as well. Data on the initial phases of foreclosure proceedings indicate that the 2015-16 reforms are working towards reducing their duration: the length of the pre-sale phase has fallen by about a tenth (from 27.5 to 24.5 months), while that of the sale phase has been nearly halved (from 41.5 to 23.5 months). Nonetheless, overall recovery times remain long. Additional regulatory reforms may be needed to prevent the accumulation of NPLs on banks' balance sheets and to ensure the necessary flow of loans to households and firms.

The enabling law reforming the regulations on corporate crisis and insolvency approved by Parliament redistributes the competencies of judicial offices in the context of bankruptcy proceedings in order to increase the level of specialization of judges. It overhauls the court-based liquidation procedure: priority must be given to significantly reducing the length of the proceedings by simplifying the process and offering appropriate incentives to the parties involved.

The judicial system can also be improved by introducing organizational changes, as the wide variations in the duration of foreclosure proceedings in different courts suggest. The guidelines approved last October by the Superior Council of the Judiciary, designed to encourage the spread of best practices, could make an important contribution in this regard. Additional benefits may come from the imminent launch of the electronic register for foreclosure and insolvency proceedings and crisis management tools. These projects, to which the Bank of Italy is contributing, are at an advanced stage.

In addition, the value of extrajudicial credit recovery instruments should not be underestimated. In 2016 the Marciano Pact was introduced in Italy, which provides for the transfer of ownership of real property serving as a guarantee to a business loan in the event of default. However, recourse to this instrument remains limited. The agreement entered into by ABI and Confindustria at the start of this year may encourage its use. The Pact's importance has been confirmed by the initiatives under way at European level as well. The European Commission recently presented a draft directive which, among other things, provides for an expedited procedure for the out-of-court enforcement of real property guarantees in the context of business loans that is similar to the Marciano Pact.

Recent reforms

In recent years, the difficulties faced by some small banks have been resolved through acquisitions by other banks, with Italian or foreign financial intermediaries and investors participating in the capital and with the contribution of the voluntary scheme of the Interbank Deposit Protection Fund. In a market in which technological innovations make bank branch networks less attractive to potential investors, crisis resolution has become more difficult. European regulations preclude the use of the resolution tool for small banks, on the assumption that it is not in the public interest to do so. Therefore, in the absence of interested purchasers, there would be no alternative but to liquidate these banks. The impact, even reputational, on the entire category of small banks would be significant.

Good corporate governance and access to the capital markets are indispensable for avoiding a crisis. In turn, adequate skills and rigorous monitoring of conflicts of interest are needed for high-quality governance. It is a short step from being a bank that 'supports local interests' to being a bank that is 'trapped by the region'. Virtuous examples of local banks are possible, but they call for high-quality organizational structures and thorough and prudent credit assessments. Recent experience has shown that these operational models can be achieved if local expertise is accompanied by the use of adequate quantitative instruments (such as credit scoring systems) and if high levels of productivity are maintained.

Different forms of integration can help in strengthening small and medium-sized banks: outsourcing and sharing certain functions and services, creating specialized purchasing consortiums, and using institutional protection schemes. For small banks, however, the merger or creation of a banking group remain the most effective tool for improving efficiency and guaranteeing market access for recapitalization purposes.

In recent years, the governance structure of cooperative banks has been the subject of major reform measures. The reform of the *popolari* banks has allowed institutions that had grown significantly in size – some of which listed – to take on the legal form that best represents their actual business structure. The governance problems inherent in the cooperative model would have continued to hamper their access to the financial market, especially when it is necessary to rapidly strengthen capital. The transition to joint stock company makes it possible to carry out mergers that would otherwise be difficult to execute, with benefits for the entire banking system. The reform must be seen through to the end so that the remaining large *popolari* banks can make the necessary improvements regarding the transparency of their governance structure, the ability to access the market, and the possibility to participate in mergers.

Italy's smaller *popolari* banks, whose transformation into joint-stock companies was not mandatory under the reform, could also benefit from increased integration in some areas such as the pooling of production processes and marketing of their products. Some headway is being made in this direction and must continue. In this year's *Concluding Remarks* I also raised the possibility that these banks could take advantage of special institutional protection schemes based on agreements to provide reciprocal guarantees on the solvency and liquidity of their members, along the lines of similar schemes in other European countries, with benefits when it came to calculating capital requirements. This is an opportunity that merits serious consideration.

The reform of the mutual banking sector (BCC banks) is proceeding as the law requires. In the next few weeks, the supervisory authorities will adopt measures authorizing the creation of the new cooperative banking groups. Within ninety days of obtaining authorization, the shareholders of the BCCs must approve the amendments to their by-laws and sign the cohesion contract regulating the degree of business autonomy of each individual bank by means of a system of risk assessment. The process of drafting the reform, which garnered broad consensus throughout the sector, took almost two years to complete. The discussions between the supervisory authorities and future parent banks on preparing the applications to create the new banking groups have been intensive. The reform preserves the banks' cooperative and mutualistic spirit, even within the new regulatory and market environment. Precisely in order to pursue these objectives the law envisages that the BCCs will be majority stakeholders of the new parent banks.

As members of a banking group, BCCs can tap capital markets in times of need, warding off potential crises. They can share best practices and centralize key oversight and production functions, with cost and revenue synergies that individual members can exploit while maintaining a relatively small scale of operations. The pooling of horizontal functions means BCCs could focus on developing their regional presence, with benefits for local economies and customer bases. Even the most 'virtuous' of these banks could raise their current efficiency levels; businesses and shareholder/customers could gain access to a broader range of products and services. The system of joint and several guarantees would allow the weakest BCCs to take effective and timely action to overhaul their business models, both in terms of their capital positions and the range of services offered to firms and households.

Capital adequacy and profitability

During the crisis, even when market conditions were especially harsh, Italy's banks undertook significant capital strengthening. The CET1 ratio, which today stands on average at just below 14 per cent, has almost doubled since 2008. The increase was achieved together with the introduction of stricter rules on minimum capital requirements (Pillar 1) and supplementary requirements by supervisors (Pillar 2) to counter risks not covered under the first pillar.

The conclusion, to all intents and purposes, of the Basel III agreement at the end of last year reduced the regulatory uncertainty surrounding the long and complex process of drafting the measures that were first announced and then gradually adopted by the Basel Committee. The progressive application of the rules over a period of five years, from 2022 to 2027, allows banks to plan the necessary changes well ahead of time. The transposition into European law of the agreement finalized a few months ago in Basel has just begun. The Commission has called for the EBA's technical advice in setting out the procedures for implementing the new international rules, taking account of European specificities and of the need to uphold the principle of proportionality in their application to small banks.

The impact of the new rules on Italy's banks appears modest overall. Recent estimates on a sample of the largest banks suggest that once fully implemented, the CET1 ratio will be lower by around 70 basis points, as against the EBA's estimate of 140 points for the leading European banks. The impact would mostly derive from the treatment of operational risk; the rule on the minimum requirement for banks that use internal models (known as the 'output floor') is expected to have a very limited impact in Italy. This could be reduced further by the steps that the banks will certainly take to adapt to the new rules during the long transitional period prior to full implementation. Banks must make good use of the time available before the introduction of the new rules. Measures to strengthen their balance sheets and improve profitability are fundamental, continuing the action undertaken in recent years.

In the first three months of this year, the profitability of Italy's largest banks improved, continuing the trend observed in 2017. For the significant institutions, annualized ROE rose to 8.4 per cent, from the 5.1 per cent recorded in the first quarter of last year; the cost-to-income ratio fell by around 5 percentage points, to 65 per cent. The average profitability of the less significant institutions is lower: in 2017, the last period for which complete data are available, their ROE amounted to 1.3 per cent, against 4.7 per cent for the significant institutions.

For all the banks, and especially for small banks, successfully meeting the challenges posed by stronger competition, regulatory pressures and new technologies, requires incisive action to increase operational efficiency. The reform of the mutual banking sector, which I mentioned earlier, is one of the responses to these challenges. But undoubtedly more must be done, especially in relation to technological change.

With the advent of Fintech, marking the marriage of high tech and high finance, the framework of reference is changing rapidly. New players are creating alternative and more efficient business models, often superseding functions traditionally carried out by banks, such as the provision of payment, asset management and securities investment services. Based on market analyses, traditional banks believe that, over a five-year horizon, a number of their activities, corresponding to around a quarter of profits, are at risk.

Compared with the new entrants, incumbent banks enjoy advantages stemming from stable relationships with customers and the wealth of data collected over the years. By exploiting these advantages better through the use of new technologies, they can expand the range of services offered, improve the quality of relationships with customers and manage risks more effectively. Investment in this area remains low and is mostly made by the largest banks. This is due to difficulties in adapting organizational arrangements and operational processes, identifying the necessary skillsets and integrating systems with pre-existing technological infrastructures. If the potential of Fintech is not exploited in full, banks run the risk of rapidly losing ground with respect to new operators that are often subject to lower regulatory requirements and to the technology giants that have already emerged in the fields of banking and finance.

Against this background, the banks now have to restore efficiency ratios and bolster profits by diversifying their sources of revenue and reducing administrative and labour costs, particularly those associated with a widespread network of branches located around the country. In what is now a mature market, in Italy as in the other European countries, a new phase of banking concentration could help to exploit economies of scale and absorb excess capacity.

Efforts to realign the structure of the market have been under way for some time: in the last two years the number of banking groups and independent banks has diminished by about 100, to a total of just over 400, and it will fall further with the creation of cooperative banking groups. By the end of last year, the number of bank branches was down to 27,000, from 29,000 in 2016 and 35,000 at the end of 2008. Between 2008 and 2017, employee numbers have dropped from 338,000 to 282,000. The process of restructuring the market must go on; in 2017 the number of bank branches per 10,000 inhabitants averaged 4.2 in the Eurozone and 4.5 in Italy and their productivity, measured by the ratio of balance sheet assets to number of employees, was €15.2 and €13.2 million respectively.

Efficiency and profitability also need to be restored in order to meet the new requirements for loss-absorbing liabilities in case of failure (MREL), as these could lead to a sharp increase in the cost of wholesale funding at a time when the size of renewals could be significant. Indeed, about half of the present stock of outstanding bonds, amounting to almost €150 billion, will mature before the end of 2020. It is important to take into account, as well, the implications of the on-going review of internal models for measuring solvency capital within the Single Supervisory Mechanism, which could lead to higher requirements.

Sufficient profit margins and suitable capital cushions have also become necessary in view of the periodical stress tests that the banks are required to run and that the supervisory authorities use to assess the institutions' ability to withstand adverse macroeconomic scenarios. A new stress test is now being conducted in Europe on the leading banks, coordinated by the EBA and run by the SSM in the countries of the banking union. The results will be published at the beginning of November.

The other measures that banks should take to improve efficiency and diversify sources of revenue – and which include offering a broader and better defined selection of asset management services – cannot be governed by opportunistic considerations or shaped by the temptation to exploit privileged positions. Customer centrality, which underpins EU legislation on financial investments (MiFID II) and the guidelines issued by the European regulatory authorities, is key to ensuring the sustainable development of the banking industry. Banks should be encouraged to create and market products and services geared to meeting customers' new demands or improving the response to existing needs, taking advantage of the possibilities offered by new technologies. Compliance with the rules introduced to promote customer relations based on transparency and probity, on the one hand, and constant monitoring of potential conflicts of interest, on the other, continue to underpin the protection of savings.

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The reforms launched in Italy and in the rest of the EU to reduce the elements of fragility exposed by the global financial crisis and the sovereign debt crisis have yet to be completed. Willingness to pursue the path taken has gradually weakened; in Europe, some countries have become concerned about the distribution of the costs and benefits of the measures needed to improve the EU's economic governance; in Italy, the reforms have lost impetus owing to fears about their cost, often borne in the short term, and doubts about their benefits, which will emerge gradually and only in the fairly long term. In such conditions, if faced with a new crisis, we will be far more vulnerable now than we were ten years ago.

There remain some fundamental aspects of the banking union that need to be finalized, such as the resolution fund – still without sufficient coverage – and the deposit insurance scheme – yet to be instituted. The new rules have eliminated the national tools for managing banking crises, but they have not replaced them with effective common mechanisms. A similar situation overshadows the public finances: individual countries saw their scope for manoeuvre further reduced when their debt increased after the recession, but no start has been made on creating a pan-European macroeconomic stabilization capacity.

Europe needs to overcome the division between those who believe the risks should be reduced and those who maintain they should be shared more equally, a division that has a poor analytical background and serves little political purpose. We can in fact reduce the risks by sharing them: the completion of the banking union and the introduction of a real union of capital markets are a precondition for eliminating financial fragmentation and allowing private capital to act as a shock absorber as it does elsewhere, for example in the United States. A European budgetary capacity would limit the impact of recessions in single member states without weighing on national public finances, thus reducing the risk of sovereign debt crises and the need for rescue measures, which, as experience has taught, are extremely costly.

At the same time, it is essential to continue resolutely and visibly reducing the risks in each country in order to win the trust of savers and markets alike. This process needs to be carried out carefully and gradually, however, to avoid creating a breeding ground for new crises, particularly given the lack of a common safety net, and so oblige the countries concerned to adopt overly restrictive budgetary measures while making it impossible for the banks to adequately support the economy.

We must not cease our efforts to strengthen Italy’s banking system, particularly the smallest institutes, and to eliminate the structural impediments to realizing our economic growth potential. The banks should provide the financial services that will allow firms to grow and innovate, but a system that is able to grant credit justly and efficiently, even in adverse economic conditions, needs its residual competitive disadvantages to be removed. This is one of the objectives of the action being taken to improve the efficiency of judicial and administrative procedures; we must not stop now.

The obstacles to business, innovation and the correct allocation of resources caused by rigidities and delays in public services should also be eliminated. And there is clearly a need for public investment, chosen and carried out with the utmost efficiency, just as there is also need for sweeping and balanced fiscal reform to increase employment and promote economic growth.

In such a situation, demand-side policies should be carefully gauged, focusing on public accounts balance and the importance of monitoring the debt-to-GDP ratio. It would be dangerous to rely on such policies alone to help Italy escape the trap of low growth in which it has been confined for so long and resume a path of strong and lasting development. Caution and farsightedness are essential to avoid tensions or potential crises and to prevent Italy’s future generations from inheriting higher debt and lower income.

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