Italian Banking Association
Annual Meeting

Speech by the Governor of the Bank of Italy
Ignazio Visco

Milan, 12 July 2019

The economic situation and outlook

The world economy is struggling to regain momentum. According to the main international institutions, GDP growth this year will be at its lowest since the contraction of 2009. In the Economic Bulletin that will be published this afternoon, the pace of international trade growth is estimated to be 1.5 per cent, more than two and a half points lower than in 2018. Downside risks linked to protracted trade tensions, the slowdown in the Chinese economy, and the unknowns surrounding the timeframe and arrangements for the United Kingdom's exit from the European Union, are weighing on the economic outlook.

Growth remains weak in the euro area. The uncertainty regarding the world economy is having a negative effect on exports, manufacturing production, and firms and households' expectations. According to the projections made in June by the Eurosystem, GDP is expected to increase by 1.2 per cent in 2019, while the forecast for 2020 has been lowered to 1.4 per cent. The growth in prices remains modest and financial markets' inflation expectations are particularly low.

At the beginning of June, the ECB Governing Council confirmed its strongly expansionary monetary policy stance. If there is no improvement in the macroeconomic outlook, further measures will be needed. Over the next few weeks, the Council will continue to consider how to recalibrate the tools at its disposal.

Despite the slight improvement in the first quarter of this year, economic activity is stagnating in Italy, owing above all to the slackness of the industrial cycle. According to our surveys, firms expect a slowdown in demand over the coming months and very modest growth in investment over the year as a whole. The central projection included in the Bulletin puts GDP at 0.1 per cent in 2019 and at just under 1.0 per cent on average for the following two years. These estimates are subject to risks connected with both international developments and domestic demand. The confidence of households and firms could be affected by the uncertainties surrounding the budget, which have been dispelled for this year but not for the next.

At a time of a generalized reduction in risk premiums, reflecting expectations of greater monetary accommodation in the euro area, tensions on the Italian government securities market have abated. Thanks to the European Commission's decision not to recommend the launch of an excessive deficit procedure, following the reduction in expected net borrowing for the current year, the yield spread between Italian and German ten-year government bonds narrowed further and yesterday was below 200 basis points.

To build on these results and reduce the cost of public debt further, the prudent budget policy stance must be confirmed over a longer time horizon. The yield spread compared with the corresponding German Bund is still around 70 points above the not low levels prevailing in April 2018. The yield spread with respect to Spain, which, like Italy, was severely hit by the sovereign debt crisis, is over 120 points; it had been around half a percentage point in April of last year. If the spread continued to narrow and were the cost of debt to fall below the nominal GDP growth rate, as has already happened in the other euro area countries, it would be easier to lower the debt-to-GDP ratio.

Narrowing the spread would also attenuate the risks for credit access conditions. The tensions over public debt securities have pushed down private bond prices and the corresponding issue prices, especially for banks. There has been little effect so far on interest rates on loans, in part thanks to high levels of liquidity and the improvement in banks' balance sheets. Nevertheless, signs of a tightening of credit access conditions have been emerging since mid-2018, especially for smaller firms and for those in the Centre and South; at a time of weak credit demand, this has led to a moderate contraction in loans to non-financial corporations since the beginning of this year.

The conditions of Italian banks

Italy's banking system has progressively strengthened over the last few years, and credit quality has improved. Cautious lending policies, together with the albeit modest economic recovery, has kept the new non-performing loan rate down; prudent provisioning, more effective recovery processes and increasing recourse to NPL sales have driven the reduction in the stock of non-performing loans. Compared with the peak of 2015 and net of loan loss provisions, NPLs have more than halved, falling from €196 billion to €88 billion last March; their ratio to total loans has gone down from 9.8 to 4.2 per cent.

Profitability has shown signs of recovery, linked to the reduction in loan loss provisions and the gradual decline in operating costs. Return on equity has been positive since 2017. Liquidity conditions have also progressively improved; some banks have resumed bond issuance on the wholesale markets since the end of last year, though at costs that are still higher than those recorded in the spring of 2018. Capital ratios, which up until last September had been affected by tensions on the government securities market, increased again; last March, the CET1 ratio averaged 13.2 per cent.

In the first quarter of this year, the ratio of new non-performing loans declined for firms as a whole, but increased slightly in some sectors (construction and manufacturing); net interest income, which was already low, fell further. The prudent lending policies implemented by banks could mitigate the impact of the cyclical slowdown on the flows of non-performing loans compared with those observed in the past. Operating costs need to come down further so as not to penalize banks' profitability again.

Tensions in the government bond market affect the value of the assets that are eligible as collateral in the Eurosystem, push up funding costs, and have a negative effect on banks' capital, given the losses on portfolio securities calculated at fair value. In the second quarter of 2018, for example, the increase in yields on government bonds reduced the capital ratio by about half a percentage point on average. Compared with April of last year, the market rates for bank bonds are now higher by about 15 basis points in Italy, while they are 45 basis points lower in the rest of the euro area. The rating agencies are maintaining their negative – or at best stable – outlook as regards any shifts in Italy's credit rating. This is also why there is an urgent need to define a strategy to support investment and innovative enterprises within a credible framework for public debt reduction.

The situation of the less significant banks other than mutual banks (BCCs) is still characterized by specific weak points. For most of these banks, profitability continues to be lower than that of the significant groups and their NPL ratio is higher. Some are affected by inadequate corporate governance and risk control structures. The problems tend to be worse for banks in Italy's Mezzogiorno, mainly because this region faces greater economic difficulties. Their balance sheet assets are, on average, half those of banks in the Centre and North; their legal form is most commonly that of a *banca popolare* (9 banks out of 16, against 12 out of 78 in the rest of the country); the assets attributable to the *popolari* account for more than 90 per cent of the total, compared with 10 per cent in the Centre and North. As we have often pointed out, it is more difficult for *popolari* banks to turn to the market for the funds they need to strengthen their capital and to finance business growth and innovation.

In the past few years, the Bank of Italy has introduced a series of measures covering all smaller banks, in part to prevent the emergence of critical situations. Action was taken to encourage new investors in banks' capital and, where necessary, mergers with other intermediaries. Banks have been urged to reduce their credit risk and strengthen NPL management and recovery. They have been asked to adopt appropriate measures to reduce operating costs and diversify income flows, for example by using consortium-based initiatives, reorganizing branch networks and containing staff costs.

The most problematic situations have been managed through market solutions that safeguarded financial stability and protected depositors. Until the first few months of last year, also thanks to greater confidence in the economic outlook for Italy and the euro area, the involvement of qualified investors made it possible to relaunch a number of banks, whose business models were completely overhauled and adapted to the new competitive scenario. However, in the current market environment, investing in the capital of smaller banks is considerably less attractive. Restructuring operations have become more difficult, partly due to the perception that their possible outcomes are much less certain.

In this context, and given the limitations imposed by the European rules for managing crises at smaller banks, the less significant banks must work together to identify solutions to secure their business and relaunch their activities. On the one hand, links with their local area cannot be the only factor in their development; knowledge of markets and operators must be accompanied by more intensive use of new technologies to increase operational efficiency and to make the supply of customer services more competitive. On the other hand, banks must reap the benefits that being larger can bring in terms of economies of scale and a strong capital position. We are mindful that consolidation is a complex process, but preparatory work must begin at once to move in that direction, defining projects of common interest in areas such as technological innovation, the pooling of auxiliary activities and their related costs, and the development of synergies in service provision. It is fundamental to establish balanced governance structures that avoid conflicts of interest and meet the objective of financing the real economy in conditions of full efficiency and adequate profitability.

In the last few months, the two new mutual banking groups that are now classified as significant for supervisory purposes have started operations. Most of the BCCs (224 out of 263) have joined these two groups. Fully reaping the benefits of the reforms of this sector will largely depend on the effectiveness of the interaction between the parent banks and the individual BCCs in raising efficiency and profitability, harnessing economies of scope and improving credit management processes, including on the basis of the Single Supervisory Mechanism's Comprehensive Assessment. The necessary streamlining measures will have to be carried out promptly, particularly in relation to the profitability of the branch networks and their size. The capacity of the BCCs to continue to serve their territories of reference requires risk management and control systems that converge rapidly towards high standards, mostly to prevent the emergence of improper business relationships or conflicts of interest. The parent companies must act decisively when exercising their powers of intervention under the new regulatory framework and when tackling the problems of BCCs with structural weaknesses.

Full compliance with the rules on transparency and adequate customer protection are necessary conditions to foster trust in banks and preserve their reputation; such conditions contribute to financial stability. The Bank of Italy is committed to strengthening regulatory defences; supervisory action is aimed at both individual banks and at particular problem areas. The work of the Banking and Financial Ombudsman strengthens individual protection, but a decisively proactive approach on the part of the banks is needed, turning organizational measures aimed at ensuring compliance with rules and provisions into an effective strategic choice.

The significance of the risk posed by the financial sector's possible involvement in criminal activity in connection with money laundering is confirmed by recent events at some major European banks. Targeted initiatives have been launched to strengthen oversight in the individual EU member states, to set up mechanisms for cooperation among national authorities, and to integrate money laundering risk assessments into prudential profiles. It will be possible to assess the effectiveness of these measures in the near future. In Italy, our supervisory activity makes a significant contribution to ensuring that banks are not vulnerable to criminal infiltration; one of our strengths is our proximity to and close cooperation with the Financial Intelligence Unit. In this area too, it is essential that banks remain highly vigilant with respect to the monitoring of risks.

Over the years, cooperation with the judicial authorities has been intense: in the three years 2016-18, the Bank of Italy awarded more than 350 technical consultancy contracts, answered almost 700 requests for information, and issued more than 280 communications. Support for the public prosecutor offices most heavily engaged in combatting financial crime has been stepped up. One tangible symbol of this is the memorandum of understanding that will soon be signed with the public prosecutor's office in Milan, where a team of our experts has already been working since 2009.

The challenges posed by regulatory developments

The European Banking Authority recently published the methodology to be used for the next round of stress testing, which will begin in early 2020 and involve 50 intermediaries, of which four are Italian. As in the past, the test is not a pass-fail exercise; its goal is instead to support the Supervisory Review and Evaluation Process (SREP). The consultation phase that has just begun is intended to allow banks to prepare for the stress test.

The perception that the costs of the stress tests have become high with respect to the benefits has led to a discussion on how to improve this tool. The Bank of Italy is actively involved in this debate. A study we published in recent weeks advocates for two separate tests: the first, to be conducted by the supervisory authorities, for microprudential purposes; and the second, to be carried out by the European Banking Authority in cooperation with the European Systemic Risk Board, for macroprudential purposes. This distinction would be consistent with the regulatory tasks assigned to the different European authorities.

Adopting a bottom-up approach, the microprudential exercise would focus on specific risk areas identified as a priority by the supervisors; it would combine static and dynamic assessments based on stress tests carried out by the banks and subject to rigorous quality assurance by supervisors. The top-down macroprudential exercise would instead assess the resilience of the entire European financial sector to systemic shocks, using tests devised directly by the authorities and minimizing the costs for the banks concerned. We hope that there will be a wide-ranging and open discussion on these issues over the next couple of months.

In Europe work has begun to adopt the standards approved at the end of 2017 by the Group of Central Bank Governors and Heads of Supervision (Final Basel III). The measures seek to reduce excessive variability in the calculation of risk-weighted assets. The introduction of an output floor for the requirements calculated using internal models and the new rules on market risks approved at the beginning of this year to rebalance the relative weight of credit and market risks in the capital requirements (Fundamental Review of the Trading Book – FRTB) will be of critical importance.

There will be a long transition period before the standards enter fully into force. Based on the information available, the effects of the new rules on Italian banks, while not negligible, appear less significant than for the banks of the other major European countries. However, Italian banking groups would do well to seize the opportunity offered by the transition phase to prepare effectively, honing their operational strategies and balancing profitability and capitalization needs.

In recent years, episodes of market manipulation and a significant reduction in interbank transactions have jeopardized the integrity and representativeness of the money market reference rates. To counter these risks, a process to review the financial benchmarks has also been launched at European level, in line with the recommendations of the Financial Stability Board. Starting on 2 October 2019, the ECB will publish an index of the unsecured overnight borrowing costs of euro area banks (euro short-term rate, €STR), which going forward will replace Eonia in the indexation of financial instruments. Moreover, it is expected that before the end of the year, Euribor, an important benchmark for indexed mortgage loans and other financial contracts, will complete its migration to a new calculation methodology which, where possible, will use data on the actual transactions of a sample of banks.

The use of benchmarks in the financial system is widespread; in Italy a large amount of the banking system's assets and liabilities is indexed to Euribor. It is essential that intermediaries identify and promptly implement the necessary measures to ensure an orderly transition to the new reference rates, both for dealings with customers and in terms of organizational and operational setups.

The objective of the rules on managing banking crises introduced in Europe since 2014 is to enable failing banks to exit the market while minimizing the impact on financial stability and the public accounts. This is a valid objective, whose actual achievement has nonetheless been hindered by factors that require further reflection.

Some resolution tools, such as the bail-in, cannot be applied in the absence of dedicated bank liabilities (TLAC and MREL) subscribed by qualified investors and capable of absorbing the losses and recapitalizing the intermediary. It would take until at least 2024 to build up the full stock of these liabilities, also due to the significant costs that banks must incur in issuing them. In the meantime, in order to manage bank crises solutions must be found that make it possible to draw on external sources of funding even in derogation of the bail-in principle. Consistent with the IMF's recommendations, when there are risks to financial stability these solutions should remain available even after the stock of dedicated liabilities has been fully established.

Precautionary recapitalization should be more readily available to address any market failures that restrict the ability of solvent banks to self-finance and to head off the risk of contagion. Regulatory constraints that discourage investors from participating in bank recoveries should be removed; these include, for example, envisaging forms of protection for the financial contributions they provide and strengthening the early intervention tools available to supervisory authorities, including special administration.

The resolution procedure established at European level is only applicable to a very limited number of large banks; in the event of a crisis, all the others would be subject to liquidation in accordance with national laws, with no guarantee of this taking place in an orderly manner in a way that avoids any impact on systemic stability. There is an urgent need for European measures establishing a liquidation framework that will not lead to business discontinuity, fire sales of assets, and negative consequences for unprotected depositors, customers and the economy as a whole. One reference model is that of the US Federal Deposit Insurance Corporation (FDIC), under which deposit guarantee systems intervene to facilitate the *en bloc* disposal of the assets and liabilities of the bank being liquidated (in an institutional framework in which the deposit protection limit is higher than that in Europe and the FDIC is not a super senior creditor).

More generally, the relationship between the regulatory framework on banking crises and that on State aid must be reviewed. In addition to eliminating the overlapping of jurisdictions and to clarifying uncertainties as to application, there is a need for discussion and reconsideration of the principle whereby the protection of competition, which underpins the rules on State aid, always takes precedence over arguments for protecting financial stability.

Appropriate revision of the European bank crisis management framework could help solve the problem of having failed to provide for an adequate transition phase which the new system would have required. Such a revision would make it possible to take better account of the fact that banks are, by their very nature, exposed to the risks of contagion, unlike, as a rule, companies that operate in other economic sectors. Legislative action on the part of the new European Commission to revise the BRRD could provide an opportunity to rethink the current rules in order to make the European regulatory framework more flexible and more at one with the nature of banking.

In the European Union all banks are subject to many regulatory standards which, in reality, were conceived with international banks in mind. While this ensures fair competition within the Single Market and creates a robust framework that safeguards stability, it imposes high compliance costs on smaller banks (despite the simplified rules they benefit from, even on very important parts of the regulations, such as market risk, employee compensation and reporting obligations).

Complex risks cannot but require detailed rules. However, an excessively complex regulatory system can itself become a source of risk: it can generate uncertainty as to the application of the rules, can serve as an incentive to conduct business outside the scope of application of the rules, and may result in a disproportionate burden on smaller or more specialized banks.

The opportunities and risks presented by technological innovation in the financial arena

The challenges posed by technology are inescapable, for banks, for businesses, for each and every one of us. Closing the gap that has accumulated over the last thirty years in economic and financial innovation and in the skills of adults and students requires a collective effort. Banks are expanding the range of traditional services available online but have not yet begun to invest significantly in the latest technologies. In industry, the recovery of competitiveness in the international markets witnessed in recent years must be supported by policies that encourage firms to innovate and expand. However, further progress can only be made if we all recognize the importance of investing in culture and knowledge to provide an education that encompasses not just the student years but people's entire working lives.

Digital technologies make it possible to increase financial inclusion, leading to more efficient resource allocation and supporting investment and economic growth. New ways of collecting large volumes of heterogeneous data and new methods for analysing them (including artificial intelligence and machine learning applications) make it possible to assess customer credit ratings more accurately and the terms and conditions at which loans will be granted. The benefits of using new technologies are greater in the payment segment and in that of loans to firms that operate in sectors and areas in which lending is riskier. The advantages of exploiting digital technologies tend to be greater for smaller banks, whose customers are mainly small firms.

Nowadays, a number of crowdfunding platforms put firms in direct contact with both retail and institutional investors, increasing access to funds. The use of distributed ledgers for trading shares of unlisted SMEs, which are currently being tested, reduces the costs of accessing capital markets. These technologies, which are experiencing rapid growth abroad, can also make inroads in Italy, where corporate financing mainly depends on the banking system.

Coping with the competition of new digital operators requires that banks lose no time in investing, with adequate safeguards against cyber risks, in both the latest technologies and in the formation of the human capital needed to apply them successfully. In a market in which customer characteristics and habits change rapidly, it is not enough to rely on maintaining trust in traditional intermediaries.

The possible introduction of a virtual currency that could make the settlement of some retail and financial transactions cheaper and faster was recently announced; according to its architects, its value would be kept stable with respect to a basket of the main world currencies. The fact that a private currency can originate in a digital context may change the way in which traditional liquidity, market and solvency risks manifest themselves, but it cannot eliminate them altogether. These risks come with others, certainly no less important, linked to the security of savers' resources, the protection of personal data, its possible use for the purposes of tax evasion, recycling and terrorist financing and, given the potentially vast application of this new means of exchange, to the potentially adverse effects on monetary and financial stability.

The attention of regulators, central banks, supervisory authorities and the other institutions involved is at a maximum. The information available still does not permit a complete analysis of the risks associated with this type of proposal and the measures required to counter them. It is important that all the parties involved keep engaging in dialogue and stand ready to intervene to ensure the application of the principle whereby the same activities are subject to the same regulatory safeguards, regardless of who performs them, the necessary security standards are upheld for the proper functioning of financial transactions, and everything possible is done to maintain the trust of savers and to prevent abuses of authority. Account must also be taken of the findings of assessments, still to be completed, of how best to safeguard monetary and financial stability. In any event, the introduction of private virtual currencies may entail risks of a different nature to those directly connected with technological innovation, which in itself is desirable owing to the significant advantages it offers. In this regard, even for the legal tender issued by the central banks, assessments are under way of how best to exploit the opportunities provided by advances in digital technologies.

* * *

The Italian Banking Association was established on 13 April 1919. In the one hundred years since then, Italy has lived through the difficult interwar years, the economic miracle of the 1950s and 1960s, the decline of growth between the collapse of Bretton Woods and the early 1990s and, finally, a long period also marked by two very severe crises, in which the economy's growth rate has disappointed and production has stagnated.

In this latter period, Italy has paid the price for its delayed reaction to the opening up of global markets and to technological change. It is a delay that has also concerned banks, which are now called upon to make profound changes to deal with competition, including from non-bank intermediaries, and to resume in full their principle role as financers of the economy. Strengthening the solidity and competitiveness of banking systems, in Italy as in Europe, calls for mergers to raise efficiency levels and to improve banks' ability to make the necessary investments in technology. At this critical juncture, ABI can encourage banks to anticipate these changes as much as possible, by promoting, including at international level, initiatives that favour innovation, the revision of business models, and the strengthening of trust in the banking system.

Developments in finance and in the real economy are interdependent; the more efficient financial intermediation is, the more possibilities firms will have to develop their business; economic conditions affect the quality of banks' credit and their profitability and capitalization. Economic policy must recreate the conditions to ensure this interaction is beneficial and avert negative spirals.

Preserving the trust of households, firms and investors requires concrete, resolute action to tackle Italy's structural weaknesses, accompanied by persuasive, goal-oriented, and unequivocal communication. An organic plan with clear, comprehensive measures, designed to boost firms' investment and growth, above all of innovative firms, must go hand in hand with a credible strategy to reduce the public debt. The markets have reacted positively to the recent decisions of the Italian government and European Commission, proof that it is possible to trigger a virtuous cycle between budgetary policies and financial conditions capable of conveying a strong and lasting stimulus to economic activity.

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