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Speech by the Governor of the Bank of Italy

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Economic developments

Economic activity in Italy has been virtually stagnant since the early months of 2018, in part owing to the slowdown recorded at European and global level. The latest cyclical indicators have provided conflicting signals. Our business surveys continue to point to expectations of an expansion in demand. Conditions on the financial and credit markets have improved, and investors' confidence has risen, as shown by the sizeable purchases of public sector securities made by non-residents and the considerable reduction in their yields, and the significant narrowing in the ten-year spread with the German Bund. However, Istat's preliminary estimate indicates that GDP declined by 0.3 per cent in the fourth quarter of last year, in part likely reflecting especially unfavourable developments in the most erratic components of final demand.

Our projections reported in the most recent Economic Bulletin, which were formulated before the release of Istat's preliminary estimate, suggest that GDP growth will still be very low this year, after remaining virtually unchanged in 2019, but will be higher in the next two years. This scenario is subject to significant downside risks. Much will depend on the performance of the global economy and of our main European trading partners. International trade disputes have abated but geopolitical tensions have risen, though with limited repercussions on oil prices so far. The terms of the future economic relations between the European Union and the United Kingdom, which formally left the Union on 31 January, still have to be worked out during the transition period that will last until the end of the year. An additional risk factor has emerged in the form of the possible repercussions of the spread of the new coronavirus, especially for the Chinese economy, which in recent years has been one of the main drivers of world growth.

On the domestic front, for the time being the financial markets are benefiting from diminished political uncertainty. However, it has still not been possible to defeat the chronic vulnerability connected with the medium-term prospects of the public finances and of economic growth. The yield spread between Italian ten-year public sector securities and the corresponding German securities, which is now below 140 basis points, remains almost double the spread recorded for the public sector securities of countries such as Spain and Portugal, which were also hit hard by the global financial crisis and the euro-area sovereign debt crisis.

The situation is still affected by the unknowns regarding the implementation of, and possible alternatives to, the increases in indirect taxation provided for by the safeguard clauses in 2021 and 2022 (equal to 1.1 and 1.4 per cent of GDP respectively) and by ongoing concerns about certain trends in our current expenditure. These are compounded by signs of disaffection with the European project and pessimistic assessments of the growth potential of our economy that assume a lack of ability to make the reforms needed to unlock the country's productive resources. These perceptions must be countered by making the economic environment more conducive to business and innovation, by reducing uncertainty, including around regulation, which acts as a brake on private investment, by grounding changes in taxation in a holistic vision for the tax system, and by implementing in full the government's public sector investment plan.

Slow and fragile economic growth in the euro area continues to affect inflation, which remains well below 2 per cent. In January, price growth increased slightly (to 1.4 per cent), but the core component decreased (to 1.1 per cent, and to 0.5 per cent in Italy) and inflation expectations – not only for the short term – are at very low levels. The ECB Governing Council remains convinced of the need to maintain for a prolonged period of time the current expansionary stance reinforced last September and confirmed in full at its January meeting.

The transmission mechanism of monetary policy continues to be effective in supporting investment and consumption. The reduction in the deposit facility rate was passed on to short-term market interest rates and the recovery in the net purchases of financial assets exerted renewed downward pressure on long-term rates. The introduction of a two-tier system for the remuneration of banks' reserves in excess of the minimum requirement, which took place without generating tensions, is intended to preserve banks' ability to provide credit to firms and households.

An increase in aggregate demand – by supporting labour market conditions, which are still uneven between euro-area countries, and by strengthening wage growth – could facilitate a rise in inflation towards levels consistent with the price stability objective. However, greater support from the other economic policies remains essential to sustain growth in the euro area and to avoid the perpetuation of the extraordinarily low level of market yields, which reflects above all insufficient demand for investment compared with the supply of savings.

The Governing Council has launched a review of its monetary policy strategy. As announced, this will be based on a thorough analysis and an open-minded approach. It will have to assess whether there are aspects that require an adjustment, given that, in a context of profound structural change in the world and in the euro area, the challenges connected with the current low inflation levels are different from those historically posed by high inflation.

Banks, non-bank intermediaries and market infrastructures

In the banking sector, the quality of credit continues to improve. Notwithstanding the weakness of the economy, the flow of new non-performing loans remains low. Net of loan loss provisions, last September the ratio of non-performing loans to total loans averaged 3.7 per cent, against 9.8 per cent at the end of 2015. Actions to reduce the volume of non-performing exposures and to improve their management must continue, above all by smaller banks that tend to have relatively higher NPL ratios and lower coverage ratios compared with those of the largest groups.

Market conditions have improved in recent months and banks have reduced the quantity of government securities on their balance sheets. At the end of December, excluding securities held by Cassa Depositi e Prestiti SpA, these holdings amounted to €313 billion or 9.8 per cent of total assets; in early 2015, they peaked at €403 billion. Notably, since last May, intermediaries have made net disposals of almost €40 billion worth of government securities. The role of banks as contrarian investors has been confirmed.

In the first nine months of 2019, profitability rose compared with the same period in the previous year. Net of extraordinary components, ROE increased on average from 5.8 to 6.6 per cent, although it is still lower than the cost of equity. The capital base continues to strengthen: in September, the CET1 ratio averaged 13.6 per cent, compared with 13.3 per cent at the end of 2018.

Nowadays the traditional banking model offers low returns, for reasons not only linked to cyclical economic developments. Small and medium-sized banks are the most affected and struggle to strengthen their balance sheets owing to high costs and difficulties in gaining access to the capital market; significant economies of scale and scope are needed to successfully fund the real economy. Intermediaries specializing in asset management tend to fare better, as do those distributing financial products through a network of salespeople or those operating primarily in the leasing, factoring and consumer credit sectors. The cost-to-income ratio of the small traditional banks, equal to 72 per cent on average, is higher than that of both the large significant groups (66 per cent) and of the specialized intermediaries (64 per cent).

For all intermediaries, the process of restructuring and adapting to the new economic, regulatory and market landscapes, as well as to technological advances, must proceed with determination. Stronger balance sheets and greater efficiency can be achieved if the industry is reshaped in various ways, in terms of size, ownership structures and business models. As I have often pointed out, initiatives to expand the scale of operations of small banks such as mergers or greater integration of business areas across banks can prove beneficial to the extent that they reduce cost ratios, increase and diversify earnings, and enhance banks' ability to compete on the market.

The reform of the mutual banks (BCCs) was designed to achieve the necessary efficiency gains and economies of scale to meet the challenges associated with the transformation of the banking sector, whilst preserving these banks' original mutualistic spirit. The establishment of two new mutual banking groups brings the number of groups now operating in Italy to 54, comprising 310 banks, while there are 100 stand-alone banks. At the end of 2008, there were 81 groups and 499 stand-alone banks. The two new groups, which this year will be subject to the ECB's comprehensive assessment, must take swift action to cut costs and rationalize their distribution network by tackling the cases of individual BCCs in difficulty.

The financial conditions of the mutual banking groups, their operating model, organizational arrangements and governance must ensure their long-term sustainability. The Single Supervisory Mechanism does not expect these banks to achieve the same profitability as the other intermediaries, but it must be sufficient to maintain adequate capital levels, which are indispensable to continue carrying out their work of funding the economy effectively.

Households' financial assets amount to around €4.4 trillion, two and a half times GDP, a considerable sum by comparison with the countries of mainland Europe, though still below that recorded in the United Kingdom and the United States. Around one third of household wealth is held in cash and deposits, one third in managed assets, and one third is invested directly in shares and bonds, both public and private, and in other assets. The share of cash and deposits, which had declined to 23 per cent in 2000, has gradually increased, reflecting the fall in market rates and the uncertain economic outlook. In the same period, the share of managed assets, which offer instruments that enable a greater degree of risk diversification than that typically offered by direct investment in the markets, recorded a comparable increase.

The portion of household financial assets entrusted to asset management institutions is nonetheless still 10 percentage points below the euro-area average and the share for the United States, and some 30 points lower than in the United Kingdom, something that the greater role of public pensions in Italy goes some way to account for. In Italy, around 11 per cent of households' financial assets are in investment funds, 18 per cent in insurance policies, and 2.5 per cent in pension products.

In recent years, the sector has benefited from new regulation. Long-term individual savings plans were introduced by the 2017 budget law and have encouraged households to put their money into investment funds specialized in Italian corporate equity and debt instruments. The first European Long-Term Investment Funds (ELTIFs) have been created. These closed-end funds are dedicated to both professional and retail investors, which invest in both equity and debt instruments.

Investment in funds specialized in securities issued by non-financial companies, such as private equity and venture capital funds, remains low by international standards. In the past few years, however, there has been growing investor appetite for this sector: since 2016, the Bank of Italy has authorized the establishment of approximately 70 asset management companies (SGRs) and closed-end investment companies (SICAFs), most of which invest in these assets.

The Bank of Italy is responsible for the prudential supervision of most of the components of the non-bank financial system. Specific provisions regulate the activities of asset management companies (SGRs and SICAFs), securities investment firms (SIMs), financial intermediaries included in the Single Register provided for in the Consolidated Law on Banking ('financial companies'), and payment service providers such as payment institutions (PIs) and electronic money institutions (EMIs). In addition to the companies belonging to the major banking and insurance groups, numerous entities are controlled by industrial groups and private equity funds, and by various intermediaries of a public nature or with a strong public profile (regional finance companies, infrastructural or strategic funds). At the end of last year, there were 159 SGRs operating in Italy, together with 32 SICAFs, 69 SIMs, 202 financial companies and 48 PI or EMI payment service providers.

The Bank of Italy's supervisory activities, which it carries out in tandem with its branches, aim to strengthen intermediaries' organizational and corporate governance arrangements and internal risk-control systems; the Bank also intervenes in cases of difficulty, requiring financial and balance-sheet restructuring and other strategic and organizational changes. In the most serious cases, the Bank imposes supervisory sanctions and issues restrictive measures, and can even adopt special measures. When managing a crisis, the objective is to prevent disorderly market exits that could have serious repercussions on investors and counterparties.

We do not, and cannot, supervise those who offer financial services illegally, without requesting authorizations and by breaking the rules. However, the Bank's website contains a section with lists of both authorized intermediaries and also of those taken off the list and those found to have operated illegally. There is constant interaction with the authorities and institutions that combat illegal practices and counter the distribution of financial instruments designed solely to evade regulation, including in ways that exploit the opportunities provided by new technologies.

The proper functioning of the financial system also depends on the legal and technical-operational efficacy and robustness of its infrastructures, which include trading platforms, central counterparties, and securities settlement systems. The organizational choices and business models of these operators influence the conditions of access, ease of placements, and efficiency and liquidity of trading.

The companies that manage Italy's financial market infrastructures (Borsa Italiana, MTS, Cassa di Compensazione e Garanzia, and Monte Titoli) belong to a group that is controlled by the London Stock Exchange, now situated outside of the European Union. This group is the subject of a major acquisition – whose completion is expected in the second half of this year – which will extend its sphere of activity to include the provision and analysis of financial data. The new group will be among the leading operators in the sector at global level. In exercising the prerogatives assigned to them by law, the Italian authorities are closely monitoring each step of the acquisition. Its implications for the subsidiary companies, in terms of governance, organizational arrangements, financial equilibriums and strategic guidelines, must not endanger the safeguarding of objectives of general public interest.

Challenges for intermediaries

Italy's financial sector must continue to face up to the challenges linked with the changes in the macroeconomic context, the regulations and technology, as well as those stemming from climate change. The variety in terms of business models, scales of operation and legal forms may play a useful part in the functioning of the banking industry, but it must be made compatible with these changes and with the basic conditions for the sound and prudent management of intermediaries.

As I have pointed out, low interest rates are mainly the result of underinvestment compared with the supply of savings and, more generally speaking, of the weakness in demand following unfavourable trends, both long term and cyclically. In response to the cyclical trends, monetary policy aims to boost demand and avoid triggering a downward spiral in economic activity. It is likely that we will have to live with low yields for some time to come.

In Italy, the low yields have so far had practically no effect on financial intermediaries. For banks, the negative impact on net interest income has been offset by the favourable impact on the quantity and quality of credit, together with an increase in fee income. The latter must always reflect the usefulness and effectiveness of the services provided to customers rather than shortsighted rent-seeking behaviour. Insurance companies have also been affected to a limited extent by the low market rates; their adoption of prudent strategies in the past for matching asset durations with those of liabilities limited the effect on their balance sheets. In the longer term, they could counter risks through a greater diversification of portfolio assets and by continuing to adapt their commitments to policyholders to the new market environment.

As regards the changes in the regulations, intermediaries will have to make an effort on various fronts, and plan capital needs and the necessary funding ahead of time. As far as non-performing loans are concerned, a calendar provisioning approach to writing down new loans classified as NPLs has been in force in the European Union since last year; it flanks the plans to reduce NPL stocks that banks must submit yearly to the supervisory authorities. By the end of this year, some changes will have to be made that also aim to harmonize at European level the thresholds for classifying loans as having gone into default if instalments are overdue.

In a country like Italy, where credit recovery procedures are particularly lengthy, the new European practices for NPLs have encouraged the rise of a non-banking industry for managing them. This new sector must be efficient for the benefit of those investing in it and of the banks. Care must be taken in the phases following the sales and securitizations of bad loans. The professionalism, integrity and organizational and capital strength of the servicers entrusted with these operations are essential. The Bank of Italy recently started an in-depth analysis to evaluate servicers' performance and to check the overall effectiveness of the current regulatory and supervisory framework. In the case of sales of unlikely-to-pay loans, it is important to encourage the recovery of firms in difficulty as much as possible. As I have already noted on other occasions, benefits may accrue from interventions by operators specializing in company restructuring (turnaround funds) that can provide new funding and specific entrepreneurial skills.

The setting-up of buffers for liabilities that can absorb losses and recapitalize intermediaries continues, as per the regulations on crisis management (minimum requirements for own funds and eligible liabilities – MREL). Over the last few weeks, several banks have placed a considerable amount of bonds at lower costs than in the past, including subordinated bonds, taking advantage of the favourable financial conditions. Through this process, we expect that bonds eligible as part of minimum requirements will be held by investors that are able to fully evaluate the risks, in line with the provisions of the regulations for the markets in financial instruments (MiFID).

Over the next few months, the European Commission will present a proposal for the transposition of the prudential standards adopted by the Basel Committee at the end of 2017 (Final Basel III). The new rules, which include the setting of an output floor on the capital requirements calculated using internal models prepared by the banks, will gradually come into force in 2022 and will be fully in place in 2027. In order to cope with the impact of applying these standards, which is expected to be lower than the average estimated for European intermediaries as a whole, Italian banks will need to be decisive and continue to seek better organizational and cost-related conditions.

Although almost all intermediaries provide basic products and services using digital channels, more can be done in the way of adopting new technologies. The opportunities provided by the digital revolution to the financial industry are as much for reducing costs as for investing the resulting savings in developing products and services that meet customers' needs better. While fully observing the principles of correct and transparent conduct, this commitment means that, above all, IT security and the control of cyber risks will continue to be necessary; substantial investment is still required to ensure this. Accordingly, adequate instruments and professionalism must be acquired; joint initiatives may be useful here for smaller intermediaries.

Lastly, with reference to the impact of climate change, there is increasing debate over how to adapt risk control and management practices to the exposure of assets to extreme natural events, also with longer timeframes than now. Yet the challenges posed by climate change may also prove to be significant opportunities. A decisive acceleration in decarbonization policies, such as that heralded by the European 'Green Deal', will foster the supply of 'sustainable' products, shown by market surveys to be potentially in great demand.

Challenges for the supervisory and crisis management authorities

The regulatory and macroeconomic framework that has come into being over the last decade has made finding solutions for the difficulties experienced by the smaller banks a more arduous task. On the one hand, injections of fresh capital, especially in less attractive local areas and markets, are hindered by structurally lower profit margins than before, by the serious legacy of the crisis in the real economy, and by governance mechanisms that are self-serving and lacking in transparency. The response of intermediaries to these latter issues has been slow and inadequate; the related legislative reform process has been difficult and has encountered opposition. On the other hand, the rules existing today rightly put limits on the use of public money for bailouts, though there is some room for flexibility, which was exploited in Italy not without difficulties, when public confidence and the stability of important parts of the banking system were considered to be at risk.

Supervision is intensive, including on the smaller banks. It is carried out using the powers allocated to the supervisory authority and in full compliance with the business nature of banking and with the provisions of the law, with no collusion or ‘dirigiste’ intentions. As far as possible, it takes account of the economic and market context in which intermediaries operate, as well as of the difficulties in both the restructuring and recovery processes for banks and in managing crises. As I have pointed out on more than one occasion, with the entry into force of the new European regulatory framework and in the absence of investors interested in purchase and assumption transactions, the only way forward in the event of a crisis is a piecemeal liquidation, resulting in a loss of value and in contagion risks.

When dealing with difficult situations, the instruments that the law puts at the disposal of the supervisory authorities are used with great care. The intensity of the corrective measures imposed on intermediaries is strictly proportionate to how far a bank’s financial situation has deteriorated. The press is not aware of successful interventions; most of the interventions are successful, but not all of them can be.

Recourse to special administration – the most intrusive of supervisory interventions – occurs as soon as the seriousness of the situation so requires. Nowadays this is an ‘early intervention’ measure: unlike in the past, when searching for possible solutions was an essential part of the special administrators’ work, this measure can only be taken when there is a prospect of recovery; otherwise liquidation is inevitable. This is a very fine line, and we are extremely careful as to how we tread it. Experience shows that in most cases, special administration is an effective instrument that can help relaunch an intermediary or avoid traumatic solutions for crises. Since

2007, around 80 intermediaries have been placed under special administration, more than half of which have subsequently returned to business as usual. When liquidation has been necessary, the support for purchase and assumption transactions provided by deposit guarantee schemes has made an orderly exit from the market possible, usually with no losses for current account holders and savers.

Preventive interventions by deposit guarantee funds to avoid the emergence of crises have also been and continue to be an important tool for preserving stability. European legislation explicitly provides for this type of intervention and also establishes a wide range of safeguards to avoid using resources that are compulsorily earmarked for covered deposits (up to the European ceiling of €100,000), which would breach State aid rules. The private nature of Italian funds is a further guarantee of a thorough and prudent assessment in compliance with the least-cost test, according to which interventions other than reimbursing deposits can only be implemented if the cost is lower for the funds than it would be in the event of liquidation. In most cases, preventive intervention has made it possible to manage difficult situations successfully.

We have underscored on more than one occasion that the European framework for bank crisis management needs to be equipped with procedures that allow an orderly exit from the market of intermediaries for which the activation of a resolution is not justified by public interest. The specific reference here is to the orderly liquidation adopted by the US Federal Deposit Insurance Corporation (FDIC), which has dealt with the crises of over 500 intermediaries since 2008, thereby averting risks to the overall stability of the banking system.

We regularly give an account in our Reports of our supervisory work and of the measures we adopt in this sphere, as we do in other Bank of Italy publications, in the testimonies made before Parliament, and in our public speeches and interviews. We are committed to informing the public more clearly about both our powers and the constraints on what we can do, and we are open to discussion and dialogue. We are continually learning from experience, and we keep abreast of and adapt to the changes taking place in the financial industry.

The events that have affected some banks in difficulty over the last few years have brought the topic of the protection of consumers of banking and financial products to the forefront of the debate. It is important that – alongside the legislative action and the supervisory interventions to improve the quality of the information given to customers on the features, costs and risks of the products being sold – intermediaries prioritize the needs of customers when drawing up their placement strategies. The quest for yields by investors and for financial resources by small and medium-sized firms is leading to a wider range of investment instruments that also target non-professional investors, who need to be made fully aware of the higher risks they carry, including their cost structures.

The rules in force today identify different responsibilities for the various supervisory authorities. The Bank of Italy is in charge of customer protection for banking and payment products and services, Consob is responsible for this in investment services, IVASS covers the insurance sector, and the Antitrust Authority is responsible for consumer protection in general. The closeness of the functions and powers of the various authorities requires us to strengthen cooperation and exchanges of information. This is essential in a context in which the characteristics of financial instruments tend to change rapidly and their very nature can be difficult to classify, making the precise definition of rules and spheres of control a complex process. We must move beyond the view that sees prudential supervision and conduct supervision as antithetical objectives: providing quality services and maintaining good relations with customers are key factors to strengthening trust in intermediaries and hence their competitiveness, profitability and solidity. This is a clear lesson we have learnt from the experience of these recent and difficult years.

The supervisory action carried out by the authorities must be accompanied by measures to improve the public's financial literacy. To a certain extent, this issue is common to all the advanced countries, in which the multiplication of financial products and investors' search for yield collide with the sometimes very limited knowledge of financial mechanisms and concepts. The problem is more acute in Italy. According to the latest survey conducted by the Bank of Italy in 2017 based on the methodology developed by the OECD/INFE, only one third of the adult population possesses a sufficiently high level of basic knowledge, compared with half on average for G20 countries (and two thirds for OECD countries).

Since 2014, a Bank of Italy directorate has been in charge of customer protection with the objective of strengthening the Bank's analyses and interventions on supervised intermediaries in areas such as transparency and fair conduct, usury, money laundering, combating the financing of terrorism, and in stepping up initiatives to increase financial education for the general public; these initiatives have involved more than 600,000 students over the last few years. Thanks to the contribution of our branches, we have improved our management of complaints – we processed more than 10,000 of them last year alone. The support provided by the technical secretariats to the seven panels of the Banking and Financial Ombudsman made it possible to look into more than 27,000 appeals in 2019, of which 15,000 ended with decisions in favour of the customer. The Bank of Italy attaches the utmost importance to these tasks. We are determined to commit all the resources necessary for these tasks and we will continue to step up these activities, including by making changes to our organizational structure in the coming months.

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The challenges I have described and the commitments that stem from them concern each and every one of us. Supervisory authorities must facilitate and accompany the financial system's adaptation to the new economic and regulatory environment and to technological advances and climate change. In Europe, we must complete the banking union, above all by providing adequate instruments for an orderly management of crises applicable to all intermediaries; a road map must be laid down for the introduction of a genuinely common deposit insurance scheme. Initiatives that could have procyclical effects or jeopardize financial stability must be avoided. As I have observed on previous occasions, to complete the Economic and Monetary Union and make the Eurosystem's action more effective, greater integration in the capital markets and a pan-European fiscal policy are also needed. A decisive role in achieving these objectives could be played by the introduction of a common risk-free debt security, as is the case in the other major advanced economies.

In Italy, intermediaries must be resolute in upgrading their governance structure, their technological assets, and their business models. They must pursue levels of efficiency and profitability that can guarantee their ability to attract capital from the market and support economic activity. However, neither intermediaries nor central banks alone can create growth. In order to achieve a higher path of stable expansion, economic policies are needed that look beyond the one-year horizon of the government budget. Setting out a systematic reform framework encompassing all the individual measures can in itself provide an expansionary boost by reducing the trust deficit, which weighs on government bond yields and private enterprise even more than the public finance deficit does. A return to enduring growth must be pursued in full respect of environmental, financial and social considerations.

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