46th Day of Credit

Banks and insurance companies: a common path for growth

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The evolution of the world financial system

The international debate on financial systems features an apparent paradox: throughout the world there are complaints about the lack of financial support, especially bank credit, for infrastructure and for small and medium-sized enterprises; at the same time there is alarm about the heightened commitment of entities other than banks to financing the real economy. The alarm stems from the fact that, compared with banks, many of these entities are subject to less regulation and supervision or none at all.

The two concerns arise in different contexts and for different reasons, but they are often found together in the international fora in which the conditions of the global economy are discussed; this gives the impression of conflicting objectives. The impression is false, but it is important to spotlight the way in which the two lines of analysis can be reconciled in a single, harmonious economic policy prescription.

The latest meeting of G20 Finance Ministers and Central Bank Governors ten days ago in Cairns, Australia, provides a good example of the joint presence of these two apparently conflicting concerns.

The final Cairns communiqué clearly expresses the unanimous belief among the twenty countries, which produce more than 80 per cent of world GDP, that in the present phase the critical variable for stimulating demand and increasing economic growth is investment: investment in infrastructure, in public-private partnership; and investment by firms and especially SMEs. If there are difficulties, as there may be, in financing the desired additional expenditure via the markets and traditional intermediaries, it will be necessary – the world's leaders maintain – to promote other financial channels, such as a transparent and efficient market for securitizations, with a greater role for institutional investors, including insurance companies.

Another crucial passage of the communiqué was devoted to the progress of the work that the G20 commenced immediately after the outbreak of the global crisis with the aim of constructing a new framework of rules for the financial system, to make it more resilient and less exposed to crises. In this context, so-called shadow banking has always been seen as a worrisome source of risk. Shadow banking means financing of the real economy intermediated by entities that are not banks but act, at least in part, as if they were. This is undoubtedly the case of funds channeled to firms by an institutional investor through securitized instruments created, for example, by a special purpose vehicle, exactly the type of non-bank financing invoked by the previous passage.

Can the two requirements be reconciled? As in every trade-off between risk and opportunity, it is a question of curbing the former without sacrificing the latter.

By weakening banks, the crisis has shifted the axis of the financial system in the advanced countries from credit intermediation to the markets, from a bank-based to a market-based structure. The partial withdrawal of the banks, forced by more stringent rules and the cyclical downturn to deleverage, has not only prompted an increase in firms' direct funding in the markets, through bond issues, but has also made room for other intermediaries, driven in turn by the need to provide their investors with acceptable yields in a world of very low or nil interest rates.

This development certainly entails a danger for financial stability. If part of the traditional credit function is diverted in practice to channels that are "in the shadows" with respect to supervisors; if the actors are willing to take greater risks to achieve higher yields than those corresponding to today's highly accommodative monetary conditions; if they are free to do so because they are untrammeled by rules and controls, the experience of the global crisis of six years ago teaches that systemic instability is just around the corner.

Nevertheless, the real economy does need finance. Above all when it is a question of getting stagnant economies moving again, any financial instrument or institution that can effectively deliver funds to entrepreneurs with technological and business projects, especially innovative ones, is welcome. The Eurosystem recently announced a vast programme of purchases of asset-backed securities based in part on bank loans to SMEs.

The obvious solution to the dilemma lies in extending the perimeter of supervision to institutions not now encompassed. This is an arduous task, necessitating a high degree of international cooperation, given the cross-border interconnections and the associated opportunities for regulatory arbitrage, and requiring regulators to keep up with incessant financial innovation motivated in part precisely by the desire to escape controls. This is the task that the G-20 assigned in 2009 to the Financial Stability Board, whose past achievements and likely future progress were discussed in the meeting in Cairns.

"Finance for growth" in Italy

I come now to the implications of these global trends for Italy.

How to ignite a cyclical recovery in Italy? And once the upswing is under way, how to get our economy back onto a path of lasting growth? These are questions we ask ourselves repeatedly.

In the longer term the problem is one of production structure, competitiveness, technology; it requires a transformation of our society to enable it again to produce income and widespread prosperity: profound changes, twenty years overdue, admitting no further refusal or delay. Economic and social policy in Italy has set objectives which are generally consistent with these needs; it is pursuing them amidst the difficulties posed by a society many of whose members are reluctant to recognize the paths of the future.

In the short run the problem is to lift firms' investment decisions from the shoals, so that they drive a recovery of demand. After six years of nearly uninterrupted recession, Italian firms are in generally poor shape. Still, a not insignificant number, especially among the export-oriented, are profitable and have investment plans on hold as they wait for the uncertainties about the future to dissipate. Others are in greater difficulty, more concerned for the moment with surviving than investing, but they preserve a potential for recovery. Still others are inexorably outside the market. Finally, entrepreneurial energies outside the ranks of existing firms are pressing to take form: new cells that could replace the ones that are no longer vital.

An efficient financial system should: help persuade the sound firms not to put off the necessary investments any further; distinguish between the firms with potential and those without it, supporting only the former; encourage nascent firms and start-ups to strengthen themselves and grow quickly. To achieve all this, a diversified and differentiated supply of finance is obviously preferable.

On a recent occasion I recalled that the Italian financial system is, instead, still strongly centred on bank intermediation.[1] I cited some statistics: At the end of last year bank loans accounted for 40 per cent of the total financial liabilities of households and firms (financial debt plus corporate equity), compared with 15 per cent in the United States, 23 per cent in France and 30 per cent in the United Kingdom. Only Germany, another bank-centred" economy, had a share comparable to Italy's. Equity investment by venture capital and private equity funds, which specialize in assisting the growth of firms, amounts to 0.2 per cent of GDP in Italy, as in Germany, or half as much as in France and a fifth as much as in Britain.

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[1] "Finance for growth", speech delivered in Sondrio at Banca Popolare di Sondrio, 12 September 2014.

Italy's financial system needs to evolve towards a structure in which firms are less dependent on bank credit and markets and institutional investors play a greater role as channels and providers of external financing for the productive economy.

The process is a difficult one, impeded by the reluctance of Italian SMEs to open up to the capital markets, either in terms of ownership control or even just of transparency of information. Progress along this path, which is already under way in other economies, is particularly arduous in Italy because of the anomalies of its SMEs compared with those of the other advanced countries, starting with their considerably smaller size.

Insurance and banks: strangers or companions?

The need to revive private sector investment and cut the cord that often binds the livelihood of SMEs to the availability of bank credit has led the Italian Parliament to intervene several times in the last two years: first with the Monti Government's "Development Decree" in June 2012[2] and then with the Letta Government's "Destination Italy Decree" in December 2013.[3] The two laws had a common objective: to create a market for mini-bonds. On the supply side they introduced legal and tax incentives for the issuing firms, while on the demand side they broadened the possibilities for insurance companies and pension funds to invest in them.

The "Competitiveness Decree"[4] passed by the present Government in June is a further step in promoting channels of finance for SMEs alternative to bank credit,

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[2] Decree Law 83/2012, amended and converted into Law 134/2012. The decree was recast in October by the second Development Decree (Decree Law 179/2012, amended and converted into Law 221/2012).

[3] Decree Law 145/2013, amended and converted into Law 9/2014.

[4] Decree Law 91/2014, amended and converted into Law 113/2014.

including securitized instruments with bank loans as underlying assets to be placed with institutional investors and direct lending to SMEs by the latter. In short, this would appear to be a move in favour of shadow banking, albeit a limited and controlled one.

I have just two comments to make on this point, one of a general nature, the other concerning the specific instruments chosen.

On a general level, we should not delude ourselves as to the immediate stimulus to private investment that can be achieved by increasing the supply of finance to firms. Most of the investment plans ready but now on hold have been halted not by a lack of funds but by uncertainty and cautiousness. Above all, what can unblock the plans is the dissipation of those causes by sound and efficient policies.

My second observation concerns the new form of cooperation between insurance companies and banks prefigured by these recent laws.

Insurance companies and banks (I am talking here about traditional retail banks) perform quite distinct functions within the economy, but they nevertheless share some important features that have led several countries, Italy included, to group them under the same supervisory umbrella. Both raise funds from the general population in exchange for services rendered: transfer of risks, in the case of insurance companies; deposit and payment, in the case of banks; in both instances the relationship with the customer is essentially fiduciary. Both types of institution must invest the funds gathered so as to earn income with which to meet their commitments. Where they differ is in their time horizon: insurance companies collect premiums on long-term contracts, whereas banks take a large number of demand deposits. This means that an insurance company’s investment assets should preferably be at long term; those of banks may be as well, but where they are, the bank runs the risk implicit in every maturity mismatch.

Insurance companies and banks have already developed some forms of collaboration, mainly based on agreements following the bank insurance model (*bancassurance*). However, these are partnerships of a purely commercial nature: the bank makes use of its branch network and customers in order to sell the partner company's insurance products in return for a fee. But each party continues to engage in its own line of business.

What we are talking about today, particularly in Europe and even more so in Italy, is a different type of collaboration, in which insurance companies actually supply credit, for the most part to comparatively risky and opaque customers like SMEs. In short, the two lines of business are intertwined. Is this reasonable? Is it proper?

The insurance supervisor Ivass, which has to turn the provisions of Government and Parliament into operative regulations, has had to reflect on this issue strictly from the point of view of its mandate – the prudential supervision of insurance companies in the interests of the insured. The question we asked ourselves was whether our rules to safeguard the prudent investment of the companies' technical provisions were not perhaps preventing, in the light of the evolution of the market and the regulatory framework, greater diversification of risk, which is the first prudential line of defence, not to mention preventing the achievement of profit levels sufficient to cover the companies' guaranteed obligations. We answered: possibly so; and especially considering that the imminent Solvency 2 regulatory framework will sweep away all the old mechanical rules and replace them with methods for assessing the risk of each investment.

Accordingly, already with the implementation of the Destination Italy decree, we created new asset classes to accommodate both direct investment in mini-bonds and commercial paper (up to 3 per cent of the technical provisions), and investment via securitization (again, up to 3 per cent of the technical provisions). In addition, we have raised the limit on exposure to a single fund within the class of "alternative investments” from 1 to 3 per cent for funds that invest in mini-bonds and securitized instruments. The potential for using these wider limits, in effect since last March, is equivalent to almost €30 billion. Although the market for these instruments has already started to grow, interest on the part of insurance companies has so far been negligible.

The Competitiveness decree represents a sea change, allowing insurance companies to make direct loans (but not to individuals or micro enterprises), and to use them to cover technical provisions, together with the related securitizations.

Ivass participated in the preparatory technical work for these new regulations, conducted by the Ministry for the Economy and Finance and the Ministry for Economic Development. We worked in the best spirit of collaboration, always pursuing, as was our duty, our prudential aims. In this case as well, we felt that the proposed opening could work in the direction of sounder and more prudent management of insurance companies, providing them with a new “asset class” that would enable them more easily to reach the point on the efficient risk/return frontier most consistent with the obligations deriving from insurance liabilities.

One aspect we insisted on was that the insurance company should be accompanied by a bank both in the initial phase of borrower selection and at the later stages. This point was included in the text of the decree.

However, in the decree’s conversion into law the requirement that the bank and the insurance company should form a partnership, and in particular the provision that the bank should hold a significant economic interest until maturity, was almost completely voided; prudential concerns were overridden by the urgent desire to supply the economy with new credit from new institutions. As currently formulated, the law entails a risk of “adverse selection” and “moral hazard”: at worst, that is, a bank could foist its most impaired loans on an insurance company and then withdraw from the partnership. To keep this from happening, insurance companies will have to equip themselves adequately to assess the creditworthiness of a business, as if they were themselves banks. This is no easy task: it means having an additional technical unit, specialized in a task that has never been typical of insurance companies. Very big companies could possibly do it easily enough, but the smaller ones will be exposed to the danger of being left in the lurch.

Ivass will have to authorize insurers that want to venture into this business; it will do so by verifying the presence of technical-organizational arrangements that enable them to form an independent judgement on the loans to be acquired or granted.

Two days after the decree's conversion into law, Ivass held a public consultation on the implementing rules, which can be summed up as follows.

The insurance company will have to submit to Ivass a business plan that is wholly contemplated within the framework resolution on investment and that contains sufficiently detailed information to enable the Authority to make its own evaluation and verify that the criteria set out in the law are met. In these assessments special attention will be paid to the extent and duration of the partner bank's participation. If the insurance company does not intend to avail itself of the support of a bank it must describe the organizational arrangements taken for the screening and monitoring of borrowers and, using best banking practices, demonstrate its ability to understand and manage credit risk.

Within the macro class of "loans," different investment classes are envisaged, to which specific caps and procedures are applied within the upper limit set by Community law (5 per cent of the technical provisions). The criteria introduced by Ivass to distinguish between the various classes are, first, the presence and permanence of a partner bank together with a number of requirements relating to the borrower (credit rating and the certification of the accounts).

The class of securitizations has been broadened to include "loan securitizations" which, along with others, can admit total investments of up to 5 per cent of the technical provisions.

We shall see in the months ahead whether or not insurance companies show significant interest in this new business. From our occasional contacts to date, some interest has emerged in the funding of major infrastructure projects but little in lending to SMEs. Given present cyclical conditions, insurance companies are certainly driven to seek higher yields than those prevailing in traditional investment classes, but they are well aware of the cost of equipping themselves to take on new and very risky tasks. For higher yield means higher risk; and no one more than insurance companies has this maxim, frequently ignored by others, inscribed in their DNA. One way of encouraging them could be to offer a government guarantee on the assets to be acquired. I have already said elsewhere that this would be a rational move on the part of the public sector, because it would remedy a potential "market failure" at a cost that will be both modest and deferred in time.[5]

But insurers could also help in another way to ease the residual tensions in credit supply, especially to SMEs, namely simply sticking to their traditional business and increasing their coverage of the risks to which SMEs are typically exposed (fire, theft, liability). It is no secret that the better-insured businesses – size, location and sector of activity being equal – find it easier to access credit and at more favourable conditions.

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[5] "Finance for growth", *op. cit.*

The insurance and the banking communities can both contribute to the transformations of Italy’s financial landscape that are now indispensable if this country is to return to growth. I am aware that the issues I have dealt with are small ones. But I will not yield to the temptation to say “it will take a lot more than that”. Let us all start with the small things within our ken. Let us avoid the danger of confusing two different trades like the insurer’s and the banker’s, but at the same time let us not be held back by fear of the new.