Istituto Affari Internazionali and Council on Foreign Relations
Council of Councils Regional Conference
Europe and the Future of Global Governance
Italian Ministry of Foreign Affairs

The Exit from the Euro Crisis: Opportunities and Challenges of the Banking Union

Speech by the Governor of the Bank of Italy

Ignazio Visco

Rome, 10 September 2013

The euro area has suffered two recessions in the last five years. GDP contracted for five consecutive quarters starting in the spring of 2008; the fall came to more than 4 percent in 2009. The subsequent recovery was short-lived: the outbreak of the sovereign debt crisis in mid-2011 was followed by six quarterly declines. In 2012, GDP was still 1.3 percent less than in 2007.

The signs now are that the contraction is drawing to a close. GDP resumed moderate growth in the second quarter of this year, reflecting the expansion of exports and progress in domestic demand, and the confidence indicators improved somewhat over the summer. Actual and expected inflation remain subdued, well below 2 percent.

However, the timing and strength of the recovery are still highly uncertain. The resolve with which European and national authorities continue to implement the reform strategy devised to deal with the crisis will be decisive for financial conditions and for business and consumer confidence. Externally, the slowdown in the emerging economies and the recent geopolitical tensions in the Middle East threaten to undermine the prospects for world demand.

The crisis did not hit all the euro-area countries in the same way, and the recovery is correspondingly asymmetrical. In Italy the recession has been longer and deeper than in most other countries. Last year’s output was almost 7 percent less than in 2007. In the first half of 2013 GDP diminished again, but at a slower pace, with exports still providing the main stimulus. The latest indicators are consistent with gradual improvement: the decline in output should come to a halt in the coming months. The downside risks to this scenario are compounded by investors’ concerns about possible political instability.

The spark that ignited the sovereign debt crisis in the euro area at the end of 2009 was the unveiling of the dramatic state of the public finances in Greece. But the tensions soon fed on the economic weaknesses of other member states – macroeconomic imbalances, real-estate bubbles, distressed financial systems, high public debt. The crisis became systemic in the summer of 2011 with the announcement of the involvement of private investors in restructuring the Greek debt, which made the markets suddenly aware of the implications of the no bail-out clause in the EU Treaty. These events laid bare the incompleteness of the European construction, the euro being a “money without a state”. The spreads between the government bond yields of the fiscally weak countries and the German Bund soared.

A serious crisis of confidence in the very survival of the single currency ensued, with adverse consequences for the real economy. The situation deteriorated most severely in the banking systems of the countries most directly affected by the tensions, whose perceived credit standing soon aligned with that of their sovereigns; wholesale funding conditions deteriorated sharply, cross-border interbank lending all but dried up. There emerged a perverse loop between fragile public finances, weak economic performance, and deteriorating bank conditions.

Given the risk of a severe credit tightening, the Governing Council of the ECB took resolute action. With two special refinancing operations in December 2011 and February 2012 the Eurosystem supplied banks with a trillion euros in three-year funds (over €500 billion net of the volume of funds reimbursed in other refinancing operations). The liquidity injection was effective: sovereign spreads dropped and the wholesale markets revived.

Europe's response to the sovereign debt crisis has been twofold. Domestically, to rein in the risks from unsustainable public finances, individual countries have committed to prudent fiscal policies and structural reform to enhance competitiveness. At European Union level, to dispel the fears of euro break-up and "redenomination risk", a reform of economic governance has been undertaken.

National action on the sovereign debt crisis has been heterogeneous. Fiscal adjustment was indispensable in the more economically fragile countries, including Italy, to ward off the risk of losing access to the market, which would have precipitated the crisis. Its negative short-term effect on economic activity was the price paid for averting more serious consequences.

With the benefit of hindsight it is clear that the reform of European governance was long overdue. The long-dormant process was effectively set in motion by the sovereign debt crisis. Despite hesitancy, overlaps and redundancies, within a very short span of time definite progress has been achieved.

Together with the efforts at national level, the reform of European governance has begun to rebuild trust among member states. The strengthening of the budgetary rules, which has reinforced existing commitments and made them more credible without imposing more demanding targets, and the extension of multilateral supervision to macroeconomic imbalances have accompanied the institution of mechanisms for managing sovereign debt crises and paved the way for discussion with a view to deepening European integration.

Until recently, Europe lacked the tools for managing a sovereign crisis. Between 2010 and 2012 EU countries disbursed some €280 billion in loans to their partners in difficulty, either directly or through the newly established common financing instruments (the European Financial Stability Facility, EFSF, and the European Stability Mechanism, ESM). Italy's contribution amounted to €43 billion, which according to official estimates will rise to more than €60 billion in 2014.

The European reforms are still in the making. Their full pay-off, as well as the reward for national efforts, will come in the medium term. In the meantime, the distortions still affecting the financial markets could undermine the transmission of monetary policy and jeopardize the entire process. This risk materialized in the spring of 2012 when sovereign spreads started widening again. By July the differential between 10-year Italian BTPs and the equivalent German Bunds had once more exceeded 500 basis points, against the value of about 200 points then estimated to be consistent with the two countries' economic fundamentals.

The ECB Governing Council reacted by announcing Outright Monetary Transactions (OMTs), a new method of intervention on the secondary market for government securities whose purpose is to counter excessive increases in sovereign yields where they stem from redenomination risk and distort monetary policy transmission; as such, they are fully within the Eurosystem's mandate. The announcement of OMTs produced immediate benefits: medium- and long-term yields in the countries under pressure decreased and the fragmentation of markets along national lines was attenuated.

OMTs were made possible not only by the credibility of the Eurosystem but also by the very process of reform they intend to protect. The fears of euro reversibility are linked in the first place to concerns about the sustainability of the public debt and the competitiveness of some member countries. For this reason the activation and continuation of OMTs are subject to specific commitments regarding the public finances and structural reform, as part of assistance programmes. The financing of the programmes with the ESM's resources is an incentive to strengthen the governance of the Union further. Monetary policy can guarantee stability only if the euro area's economic fundamentals and institutional architecture are consistent with it.

Confidence in the irreversibility of the euro is the key. In the short term, the effective use of ESM resources will preserve the progress made and safeguard the rights and the efforts of those who have helped to develop the instruments of financial support. The OMT announcement prevented a financial collapse with potentially ruinous consequences for the European economy: all the member countries benefited, not just those at the centre of the sovereign debt crisis.

Towards deeper European integration: the Banking Union

To ensure stability over the longer run, the effort to reform the European governance has been stepped up. The subsequent stages are outlined in the report *Towards a Genuine Economic and Monetary Union* (presented in June 2012 and updated in December by the President of the European Council, working closely with the Presidents of the European Commission, the Eurogroup and the ECB) and in the *Blueprint for a Deep and Genuine Economic and Monetary Union* published by the Commission last November. Both documents envisage a banking union, the introduction of autonomous fiscal capacity for the whole euro area, and a common budget; they set the scene for the eventual political union.

A keystone of institutional reform, Banking Union is crucial to break the perverse feedback loop between sovereigns and domestic banking systems. It has three key components: a single supervisor, a single bank resolution mechanism, and a single deposit insurance scheme.

In the summer of 2012 the European leaders decided to give priority to the construction of the first component, the Single Supervisory Mechanism. The SSM comprises the ECB and the national supervisory authorities. For the largest banks it will be based on strict integration of European and national structures. For the others, it will involve the direct responsibility of national authorities, under common guidelines; the ECB will retain the right to take over direct supervision responsibilities where circumstances warrant. This far-reaching institutional innovation will require an organizational adaptation as far-reaching and at least as complex as that leading to the single monetary policy. The delicate launch phase will require substantial investment in human resources and technical infrastructure. The national supervisory authorities' workload will not diminish, as we strive to build a unitary new mechanism from frameworks that differ in many respects. The preparatory work is proceeding at the greatest speed compatible with the challenges of the task.

Building on the technical experience and reputation of national authorities, the SSM will have to ensure a supranational vision. Supervisory practices within the euro area are quite heterogeneous. It is vital to avoid any lowering of standards and instead to converge on the best practices in supervisory methodology, modelling and assessment of banking risks. This will ensure early warning of emerging instability at individual banks and at systemic level. We attach special importance to aspects that are a fundamental part of the tradition of the Bank of Italy, such as the central role of on-site inspections, methodologically robust quantitative analysis, and close interaction with banks.

If successfully managed, the SSM will bring substantial benefits to the single market: it will improve the effectiveness of monetary policy transmission, counter the ring-fencing trends observed in the last years, thus fostering financial integration, facilitate comparison between banks and banking systems in different countries, and in this way improve the monitoring, control and mitigation of vulnerability factors.

Work is also continuing on the single resolution mechanism (SRM), the second component of the banking union. This is indispensable to align the responsibilities for supervising banks and handling crises. The Bank Recovery and Resolution Directive is intended to harmonize the heterogeneous national practices, rules and tools for bank crisis management and keep rescue operations from being financed with public funds. The Directive lays down a number of preventive measures, together with rules for timely intervention and resolution, including the bail-in of bank creditors. A fund to be financed by the banks themselves will be earmarked for bank resolution. The European Commission recently issued a proposal for a Regulation – which should be fully operational in 2015 – to institute an SRM under a single resolution authority and with pooled resources. Concerning the third component of the Banking Union, a draft directive has been prepared to implement a common network of national deposit guarantee schemes by the end of this year.

The institution of the SRM must proceed expeditiously, with appropriate negotiations between national and Community authorities. Once the mechanism is fully operational, the availability of adequate resources will allow the cost of crises to be divided between the bank's shareholders, creditors and the banking system as a whole.

During the transition to the SRM, the risk of a vicious circle between a fiscally weak sovereign state and its fragile domestic banks persists. The ESM will only be able to directly recapitalize banks – with the aim of restoring their viability and obtaining a remuneration of the capital invested – after the effective entry into operation of the SSM. There remains the possibility of using ESM funds indirectly, by means of loans to member states, but this would bear on the public debt of the countries concerned, bringing the bank-sovereign loop back into the picture.

The comprehensive assessment of the main European banks …

With a view to the launch of the SSM, the ECB and the national supervisory authorities are working to undertake a comprehensive assessment of the soundness of the significant

euro-area banks, those that will fall under the direct supervision of the SSM. This assessment consists of thorough analysis of each bank's risk profile, comprising an overall balance-sheet assessment (BSA), including an asset quality review, and a stress test. The exercise will also cover other relevant aspects of banks' business, including leverage, corporate governance and organization.

The comprehensive assessment is designed to make sure that the area's main banks are managed in a sound and prudent manner, helping to dispel market concerns over their soundness and risk profiles. Significantly, from the outset the assessment will also foster confidence in the SSM itself, reinforcing mutual trust among participating countries. It will therefore be a fundamental step in normalizing wholesale markets and restoring the banking system to its principal, fundamental role of supporting economic activity and growth.

In order to attain these objectives, the comprehensive assessment must be completely transparent, as regards not only results but also process and methodologies. The appropriate involvement of external reviewers may enhance the credibility of the exercise. Attention must obviously be paid to potential conflicts of interest and problems of confidentiality. Also, level-playing-field issues among participating banks must be avoided.

The design of the balance-sheet assessment must recognize that national accounting and supervisory practices differ radically, especially in the definition and measurement of non-performing loans (NPLs). The European Banking Authority (EBA) is working to make definitions uniform across systems and has recently issued a consultation paper on the matter. This is a step in the right direction and should be finalized in time for its results to be used for the BSA. In any case, the BSA requires a de facto harmonization of NPL definitions.

National practices also differ substantially in the measurement of risk-weighted assets, the denominator of regulatory capital ratios. Differences in the models used by banks to compute capital requirements – or in the approaches adopted by supervisors for validating them – may undermine the comparability of banks' capital, so the BSA will have to pay close attention to the way in which these models compute the risk weights of different categories of assets, including off-balance-sheet items and "level 3" assets (non-traded assets whose fair value is estimated through internal models). Again in this case, de facto harmonization is necessary.

Furthermore, in order to be fully credible and to be perceived as a confidence-building exercise the comprehensive assessment must be rigorously designed and carried out, with

clearly defined and well motivated thresholds for gauging any capital shortfalls. If, as observed earlier, one of the objectives of the Banking Union is to break the perverse feedback loop between banks and sovereigns, then an essential prerequisite is the presence of adequate backstops against the capital shortfalls that may emerge from the BSA. Also, to avoid pro-cyclical effects, clear and extensive communication of the process and its results is necessary. The mistakes of the past in the sequence of the actions taken by different policy makers should not be repeated.

… and a perspective on the Italian banking system

The Italian banking system offers a few illuminating examples of the problems and challenges of the comprehensive assessment. In the international comparison Italian banks appear to have a high NPL ratio and a low coverage ratio (i.e., the ratio of loan loss provisions to gross non-performing loans). But it is clear by now that the comparison is vitiated by disparities in accounting and supervisory practices, which must be taken into account in order to obtain a fair assessment.

A case in point is the treatment of collateralized loans. Some major European banks do not classify fully collateralized loans as NPLs, while in Italy loans are classified on the basis of the borrower's creditworthiness, irrespective of collateral or guarantees. Both practices are fully consistent with international accounting standards enforced in Europe, but the Italian method makes the bank's balance sheet more transparent for investors. If Italian banks used the same definition as some foreign banks, their stock of non-performing loans would fall by about a third, decreasing their average NPL ratio significantly and raising their coverage ratio; at the same time, the rise in the NPL ratio in the recent years would be less accentuated, reflecting the sharp increase in collateral demanded by Italian banks in reaction to the deteriorating economic outlook.

Let me be clear: I am not suggesting a relaxation of the Italian definition of NPLs – which, by the way, is broadly in line with the one proposed in the EBA consultation paper. I am arguing that the BSA needs to take this and other sources of heterogeneity into account.

Similar considerations apply to leverage. Italian banks have lower leverage than their international competitors, partly because of their relatively small volume of business in derivatives. Arguably, their operational risks are also comparatively low: Italian banks have not been involved in any of the serious episodes of malpractice or the market-rigging

schemes that have damaged the reputation of some foreign intermediaries and cost them expensive legal settlements. These and other sources of heterogeneity, which tend to bias international comparisons against Italian banks, have been documented by the Bank of Italy in its *Financial Stability Report* as well as by market analysis. They will have to be duly taken into account in the comprehensive assessment.

These arguments are intended simply to support a fair approach to the forthcoming BSA; they are not meant to downplay the risks that the Italian banking system faces. While Italian banks have demonstrated good resilience overall, thanks to their sound fundamentals at the outset of the financial crisis, the sovereign crisis and two long and deep recessions have put their balance sheets under severe stress. NPLs have been rising steadily since 2008, depressing profitability and raising concerns over provisioning among analysts and market operators. And even though I have set out the reasons why we need to quickly enhance comparability among European banks, we take these concerns seriously. Indeed, we have taken decisive action to address these risks, and we are confident that this will improve the outlook for the Italian credit market.

Apart from episodes of malfeasance, which are relevant but circumscribed, serious difficulties mainly concern a handful of medium-sized and small banking groups. This class of banks has been particularly hard-hit by the recession, owing among other things to lesser diversification of risks and revenues. Additional challenges have sometimes been raised by weak ownership and corporate governance structures, which may complicate capital strengthening and adaptation of business models. Intense supervisory actions have been – and continue to be – taken on these banks. In some instances special administration has been necessary to allow a clear recovery and return rapidly to ordinary management.

The Bank of Italy regularly reviews banks' asset quality as part of its standard supervisory activity, assessing the risk exposure of each institution. The quality of banks' assets is assessed continuously off-site, on the basis of detailed monthly supervisory reports. In particular, the information contained in the Central Credit Register includes the exposure of each bank to each individual firm: this enables us to assess the consistency of the different banks' classifications of the same borrower, checking that non-performing debtors are not classified as performing by some intermediaries. Moreover, the Bank of Italy monitors the adequacy of loan classification criteria through extensive on-site inspections, among other things in order to curb the forbearance risk typical of economic slowdowns.

In the second half of last year, against the backdrop of an exceptional and largely unanticipated macroeconomic deterioration, the Bank of Italy launched an ad hoc supervisory review of the adequacy of banks' NPL provisioning policies. This involved simultaneous on-site inspections at 20 large and medium-sized banking groups whose coverage ratios either were lower than average or had fallen significantly. The main findings were published in a note posted on our website. Overall, the coverage ratio for the entire NPL portfolio of the 20 groups rose from 41 to 43 per cent between June and December 2012, notwithstanding the sharp rise in NPLs themselves (the denominator of the ratio) in the same period. In other words, the downward trend in coverage ratios since the beginning of the crisis (2007-08) has come to a halt. The intelligence gathered in the course of the review will also be used for the application of second-pillar capital add-ons.

Our supervisory action continues. We are closely monitoring the implementation of the corrective measures that the banks were asked to adopt, while assessment of banks' asset quality and provisioning levels is still ongoing and has been extended to other banking groups in the course of regular on-site inspections. Any capital shortfalls that may emerge will have to be met through proper actions within the banks' perimeter of decisions and with recourse to the market.

At the same time, we are taking care to minimize the pro-cyclical impact of banks' actions on the availability of credit to the economy. This is why we have called on banks to increase their internally generated resources by curbing operating costs as well as dividends and executive and directors' compensation.

Our current assessment is that notwithstanding specific difficulties, the challenge will be met and market concerns will abate. But the state of the banking system is not independent of the general economic environment. Action to revitalize the Italian economy and raise its growth potential is thus as important as ever.

The move to the SSM must not blur our focus on the conditions of the banking system. Supervisory standards and practices must be kept at the highest level of quality. This will permit us to perform a homogenous and comprehensive assessment of euro-area banks, with full disclosure of differences in business models but also with a common mandate to build on existing strengths and to counter and shrink the areas of weakness.

° ° °

The crisis has constituted a fierce challenge for the European construction. The threat of a break-up of the euro, never taken seriously by the markets before, increasingly distorted asset prices across the euro area. The economic and social costs have been severe. Unemployment, especially youth unemployment, has soared. In the worst-hit countries poverty levels have risen sharply, and social tensions have surfaced.

The responsible reaction of national and European authorities has averted the worst. The recovery is now at hand, but downside risks remain significant. If we are to seize the opportunity, we cannot relax our efforts. Ultimately, our economies must restructure to become more competitive in order to rise to the challenges of technological, demographic and geopolitical change. We must press on with structural reform. The key to success will be a shared determination to advance towards a fully fledged European Union. In the current stage, the test of our resolve is the building of an effective Banking Union.

Stampato presso
la Divisione Editoria e stampa
della Banca d'Italia