Italian Banking Association
Annual Meeting

Address by the Governor of the Bank of Italy
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The breakdown of the negotiations between Greece and its international creditors and last Sunday's referendum results have had a relatively modest impact, so far, on the euro area's financial markets. Certainly, the availability of viable, credible European instruments for intervention has helped. The significant progress made in recent years by the other countries struck by the sovereign debt crisis has been important. However, future developments remain fraught with uncertainty: what is at issue in Greece is not just the public debt that has been accumulated but how to put the public finances back on a sustainable path and above all how to make the economy competitive and capable of growth. On a different scale, these are the same challenges that face the euro area as a whole.

The day before yesterday the Governing Council of the ECB decided to keep the emergency liquidity assistance that the Bank of Greece can provide to the country's banks at its current level. The Greek authorities extended the closure of the banks and the limits on cash withdrawals for two days, until this evening. Consultations between Greece and the European authorities are ongoing. The Governing Council is closely monitoring financial market developments and the implications for monetary conditions and price stability in the area; it stands prepared to deploy all the instruments available.

Even in a worst-case scenario, the immediate impact of the Greek crisis through trade and financial channels would be modest for Italy and for the euro area. But the crisis may have more serious repercussions if it revives international investors' fears that the euro may not be irreversible. In that case, coordinated countermeasures by both national and European authorities will be indispensable.

To date the tensions have not significantly undercut the effects of the Eurosystem's expanded asset purchase programme. The rise in long-term interest rates since the middle of April is largely the consequence of the improved prospects for inflation and growth, due in turn to the purchase programme itself, and possibly also of a correction of the initial overreaction. The Governing Council is determined to carry out the programme in full in order to bring inflation back into line with the medium-term objective. Any undesirable tightening of monetary conditions will be forcefully countered.

Credit conditions and credit quality

The monetary expansion is gradually being transmitted to credit conditions. In Italy the interest rates on new business loans and home mortgage loans were down to 2.2 and 2.7 per cent in May, from 3.1 and 3.3 per cent in mid-2014. For firms, the spread with respect to the corresponding German and French rates has narrowed by about half a percentage point. And since the middle of last year the improvement in credit cost conditions is no longer limited to the largest and financially soundest corporations.

The contraction in lending to non-financial corporations has nearly ceased. In the three months ending in May the annualized decline came to half a percentage point, compared with a much faster decrease of around 3 per cent in the middle months of 2014. Lending to households has begun to grow again, if only modestly. The timing and strength of the upturn vary by sector and by individual firm. Lending to manufacturing and non-real-estate service firms that have no debt payment arrears has expanded, but credit to firms in construction and real-estate services, sectors where the overall risk remains high, is still diminishing.

In the first quarter of the year the flow of new bad debts eased to 2.4 per cent of outstanding loans, from an average of 2.6 per cent in 2014 and 2.9 per cent in 2013. The improvement was due to loans to firms, for which the new bad debt rate fell by 0.6 points to 3.9 per cent. The decrease involved all sectors of economic activity. Credit quality remains poorer for construction firms and firms located in the South.

At the end of March banking groups' bad debts amounted to 10.2 per cent of outstanding loans and total non-performing exposures to 17.9 per cent. The large volume of non-performing loans continues to restrain the supply of credit and puts Italian banks at a disadvantage with respect to their European counterparts. Apart from the long recession, it reflects constraints and rigidities that oblige Italian banks to keep impaired assets on their books much longer than banks in the other main countries.

Measures taken by the Government last month will increase the speed and efficiency of bankruptcy procedures and property foreclosures. They make loan losses immediately tax deductible. In this way they act directly on some of the causes of Italian banks' large stock of non-performing loans.

Accurate assessment of the measures' impact is hindered by the lack of official statistics on the length of the procedures involved. For bankruptcy procedures, market sources indicate an average duration of about six years. Preliminary estimates, which are subject to considerable uncertainty, suggest that in a favourable scenario this time could be halved, but a series of organizational and operational factors could reduce the effect. For foreclosures, the duration might be shortened, on average, from four to three years.

Speeding up these procedures will have a positive effect on banks' balance sheets. First of all, it should raise the market price of impaired assets. Some simulations show that a reduction of two years in credit recovery times could increase the value of collateralized non-performing loans by as much as 10 per cent, and market estimates appear to be largely aligned with this valuation. Moreover, the stock of non-performing loans should shrink, by as much as half in the longer run.

The measures taken by the Government include the immediate, rather than deferred, deductibility of write-downs and loan losses, so as to freeze the creation of new deferred tax assets in connection with loan loss provisions. The changeover to immediate deductibility eliminates a significant competitive disadvantage for Italian banks in the Banking Union, making it less onerous to write down loans when necessary, and it attenuates the pro-cyclicality of their tax treatment. Deferred tax assets stemming from loan losses already entered in banks' balance sheets, equal to around €25 billion, will be gradually reduced and will completely disappear over the next few years. The set of measures entails no cost to the State.

All in all, these measures can, in time, lead to a significant reduction in the risk-weighted assets of Italian banks and make way for new loans capable of largely offsetting the lending reduction of recent years. But relieving banks' balance sheets of the large stock of non-performing loans will require action on a series of fronts, since the reasons for their existence are multiple. The value appreciation of non-performing loans brought about by the reform will spur the creation of a secondary market for these assets, but may not be enough to ensure this market is sufficiently large.

This is the proper framework in which to view the planned creation of an asset management company specializing in the purchase of non-performing loans. On this front the dialogue between the Italian authorities and the European Commission is producing useful and necessary analyses. As I have clarified on other occasions, the project is designed to reactivate market mechanisms, not to remedy the difficulties of individual banks at taxpayers' expense. It can also help restore an adequate flow of credit and thus support the economic recovery.

The dialogue must be brought to a conclusion rapidly; protracted uncertainty over this matter can discourage the completion of market transactions. Banks must also take steps to improve the data on non-performing loans. The analyses on this subject have brought to light informational gaps that could dissuade potential buyers. Data are also needed in order to improve the banks' own management of these assets.

Banks' corporate governance

The reform of the cooperative banks is now in the implementation phase. The supervisory instructions issued by the Bank of Italy that complete the reform and enable the launch of the operations needed to ensure that cooperative banks with assets of above €8 billion comply with the new legislation came into effect on 27 June. Once it is ascertained that this threshold has been exceeded, the bank's executive bodies must, within a given deadline, draw up and transmit a plan to the Bank of Italy listing the initiatives to be undertaken within the 18-month time limit envisaged by the law. In exercising its powers of authorization, the Bank of Italy will verify that the corporate operations proposed by the banks do not have the effect of perpetuating, under a new guise, the ownership and management arrangements that the law is meant to abrogate.

Another important step that must be taken is the reform of the mutual banks. While the cooperative bank reform takes account of the emergence of large, often listed, banks whose original links to their local communities had been severed, in the case of mutual banks the issue instead is to create the conditions for them to continue to fulfill their specific function, even in the current context, maintaining their mutualistic connotations and local community links. Integration in banking groups is needed to favour access to capital markets in view of high credit risks, as well as to improve the quality of management, increase efficiency and keep costs down. This would not constitute a diversion from the mutual banks' original purposes but on the contrary would strengthen their ability to serve their members and their communities, among other things by providing a broader range of services adapted to their customers' needs.

The completion of the reform will necessitate legislative interventions that promote forms of integration based on membership of banking groups, based on models that have been adopted in other European countries. The Bank of Italy is monitoring the discussion on these issues and is engaged in dialogue with the competent institutions. Our hope is that shared solutions can be arrived at, capable of guaranteeing these banks' continued presence on the market.

Supervision and crisis management

In this phase the Single Supervisory Mechanism, in operation since November, is acting to ensure that the playing field in which the supervised banks do business is as level as possible. Initiatives to review the ways in which banks that adopt internal models measure their risk-weighted assets can contribute to the attainment of this objective. The analyses conducted by the supervisory authorities at international level demonstrate, in fact, that differences in the riskiness of bank portfolios do not fully account for the differences found in the way the various banks' capital requirements are quantified.

Significant changes are being made to the legal framework for managing bank crises. At European level plans are being prepared for the resolution of possible banking crises. Last week the Italian Parliament approved the enabling law for the transposition of the Bank Recovery and Resolution Directive (BRRD), to be completed by the promulgation of the mandated legislative decrees. The Bank of Italy has been designated as the Italian resolution authority, and we will shortly make the organizational changes required for the most effective performance of these functions.

Under the new European rules, if supervisory interventions cannot prevent the failure of a bank, the resolution authority must consider whether to follow the ordinary insolvency procedure – under Italian law this means compulsory administrative liquidation – or whether instead it would serve the public interest to initiate the special resolution procedure in order to maintain systemic stability, while holding public support to a minimum and protecting depositors and customers in general.

The European Commission's 2013 Communication on the application of the state aid guidelines already foresees the involvement of a bank's shareholders and subordinated creditors before any public support is provided. With the transposition of the BRRD, regardless of possible public intervention, shareholders and holders of capital instruments will be called on to contribute to resolution. Starting next year, what is more, a bank's senior creditors can also be 'bailed-in'. Deposits up to €100,000 will continue to be fully protected by the national guarantee schemes, which have been reviewed at European level to harmonize levels of coverage and to ensure that they have adequate and readily available funds. In any case deposits beyond €100,000 held by individuals and by small and medium-sized enterprises will receive preferential treatment in respect of other instruments.

In placing their securities, the banks must be especially careful to comply with the investor protection rules, since subscribers may be called on to contribute to the resolution costs. Customers must be given exhaustive information on the characteristics of the different instruments, the riskiest of which should be expressly reserved to institutional investors only. Today the Bank of Italy, as part of its financial education programme, has posted on its website an account of the rules that will soon enter into force in our country.

With the implementation of the BRRD, under the Single Resolution Mechanism for banking crises, a Single Resolution Fund will be established, to which euro-area banks will progressively transfer resources to finance resolution procedures. In particular circumstances, such as when the bail-in might entail risks for financial stability or compromise the continuity of critical functions, the authorities may, at their own discretion, exempt some categories of creditors from their obligation to contribute to the costs of the resolution.

A backstop at European level still has to be designed, using public money to supplement the resources of the Single Resolution Fund in order to deal promptly with any crises involving the largest banks. The recent report by the 'five presidents' on Completing Europe's Economic and Monetary Union indicates, opportunely, that such a backstop is a priority, along with a comprehensive single deposit guarantee scheme that goes beyond the mere harmonization of national schemes.

The capital market and finance to the economy

The capability of the banks to take on risks has diminished and they have become more selective as regards borrowers. We need a more diversified financial system if we want to support investment and economic growth.

Some signs of change have emerged. New stock market listings are increasing, there is a growing volume of bond issues, including by medium-sized firms, the number of mini-bond issuers is rising, and the average volume of issues is declining. This last year has seen the introduction of various funds geared to investment in the debt instruments of small and medium-sized enterprises: at the end of June there were 23 such funds under the aegis of Italian asset management companies, 15 of them already operational. Other funds have been instituted by foreign managers. However, the capital raised by the Italian funds is still scanty – under €2 billion.

These changes, which stem partly from firms' difficulty in obtaining bank credit, were encouraged by public interventions, such as tax incentives for capital increases and the new rules on bond issues by unlisted companies. Direct funding to the private sector, in the form of shares, bonds and loans, is still relatively small: these instruments account for just 16 per cent of the financial assets of insurance companies and pension funds in Italy, compared with 23 per cent in the euro area as a whole.

Nevertheless, even a more favourable regulatory environment may not be enough to induce investors to diversify their assets, although the decline in the returns on traditional instruments has encouraged the search for higher yields. Investment in securities issued by firms, typically riskier and relatively illiquid, calls for specific professional skills. Many investors lack these skills and thus need services and infrastructures to acquire and analyse the information necessary for risk assessment; they also need specialized funds to which to entrust their assets, and financial instruments for the efficient diversification of risks and profit opportunities.

Closer financial market integration at the European level is essential for the development of new financial instruments. This is the aim of the proposal of the European Commission, which in February presented a green paper on building a capital markets union in the EU by the end of 2019. The suggested reforms are intended to overcome the obstacles to raising risk capital and debt capital, particularly for small and medium-sized enterprises; they may also help to support asset diversification by institutional investors. The finance ministers have asked the Commission to submit a detailed plan of action by the end of September of this year.

In the short term, the priorities are to simplify the prospectus directive, making it easier for firms, especially small and medium-sized ones, to obtain listing; to standardize information on credit quality; to develop a market for simple and transparent securitizations, possibly subject to favourable prudential treatment; and to create a European private placement market, a form of financing that allows firms to place their bonds with one or more institutional investors at a lower cost than that of issuing securities to the public.

Over a longer period, for full capital markets union the various countries' company and bankruptcy legislation needs to be harmonized and the differences between the tax treatment of capital gains reduced, notably as regards the method of calculating the tax base. Legislative harmonization will be a gradual process; it will therefore be best to follow a modular approach, starting with the easiest reforms and then gauging where there is room to tackle more ambitious challenges.

The project is of major importance for Italy. The creation of broad and efficient markets would offer firms, even the smallest of them, new opportunities for borrowing and for growth and investors a wider array of options. The issues of establishing credit ratings and standardizing corporate information are especially important. The availability of private placement in Italy would be extremely useful, particularly for small and medium-sized firms, which have very limited access to the bond market at present. Its development in Italy too will be furthered by standardizing the rules and practices at European level.

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The lengthy, and still unresolved, Greek crisis has cast new light on the limits still encumbering the governance of the Economic and Monetary Union despite the efforts of recent years. The stability of the Union cannot be undermined by one country's difficulties. If a member state finds itself in a financially untenable position, then there must be the means to arrive at a rapid and orderly solution.

In strengthening European integration, not only in the economic sphere, effective methods of handling emergencies must be identified and adopted. Ultimately, in order to absorb cyclical and structural shocks the euro area must have a common budget, based on autonomous taxation capabilities and direct recourse to financial markets. The resilience of member states' economies can be improved by introducing institutions that facilitate labour mobility and by making more rapid progress towards unifying the capital markets. The ability of national budgets to counter adverse cyclical phases must also be safeguarded.

Individual countries must continue their efforts to enhance the soundness and the growth potential of their economies. Italy has taken several important steps that are now beginning to bear fruit. Had we not done so, the Greek crisis would have had serious repercussions. But our task is not complete; reform must continue in all sectors of the economy and in the public administration. Our financial system must become more competitive and regain its capacity to fully support economic activity. The measures bearing on the quality of credit and the governance of banks constitute a major advance in this direction.

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