POLITICO

Q&A with Bank of Italy Governor Ignazio Visco

Visco's first interview following the European Banking Authority publishing results of its recent bank stress test.

By Silvia Sciorilli Borrelli

Ignazio Visco, the governor of the Bank of Italy, has managed to keep his trademark poise though the last year on the job has been the most challenging of his career.

Visco, who has been at the helm of the central bank since 2011, was tasked with finding a delicate balance between the European Central Bank's supervisory requests, EU-rules and the Italian government in the middle of a growing banking crisis in his country. At the beginning of 2015 the now-famous four regional banks (BancaEtruria, CariChieti, Carife and Banca Marche), were placed under Bank of Italy's control but there was little it could do to save the troubled lenders from their fate. They defaulted later that year.

When the small banks saddled with bad loans were put into resolution after the government had cranked up a plan to rescue them that was considered as state-aid under EU rules, Italian banks became the source of EU-wide anxiety.

In his first interview after the European Banking Authority published its stress test results last week, Visco talked to POLITICO about the health of Italian banks, plans to shed their bad debt, the JP Morgan plan to rescue the floundering Monte dei Paschi di Siena and why Italy's banking crisis isn't as serious as international media portray it to be.

What weaknesses, and perhaps strengths, of Italian banks did last Friday's European Banking Authority's stress tests highlight?

The results of the EU-wide stress test show that notwithstanding the long and deep recession of the Italian economy, most of the largest Italian banks would be resilient to further hypothetical shocks to macroeconomic conditions. However, given its initial conditions and some of the methodological assumptions of the exercise, the performance of a single bank, Monte dei Paschi di Siena, was unsurprisingly poor. Rather than a pass/fail exercise, the stress test results will be taken into account, with other qualitative and quantitative assessments, in the next supervisory review and evaluation process (SREP). From this perspective, Monte dei Paschi has appropriately decided to take immediate and bold actions.

Overall, the results provide a fair picture of the current state of affairs of Italian banks: many institutions with robust fundamentals, and a few, well-identified cases of serious but manageable weakness, which must be tackled and solved, as required by bank supervisors.

What do you think of JPMorgan's plan to rescue Monte dei Paschi di Siena?

The measures undertaken by the bank seek to overcome once and for all its current weaknesses. Indeed, by selling all of its bad loans ("sofferenze"), increasing the coverage ratio on the other non-performing loans and turning to the market to raise the capital needed to finance these measures, the bank will be in a position to substantially improve its profitability (also thanks to a lower cost of funding) and its ability to compete and to lend to the economy.

Is there a chance the plan (which includes the capital increase and sale of the non-performing loans) might fail?

The plan is challenging, and inevitably so, as it is designed to solve difficult issues in a testing environment. I am confident that it will be carefully and effectively implemented in the coming months, and execution risks will be minimized.

Unlike previous exercises, these stress tests had no pass or fail mark so they are open to interpretation. Some Italian economists and bankers, as well as Prime Minister Matteo Renzi, have stated that in the event of an economic shock, French and German banks are more at risk than Italian institutions to failing. Is he right?

In the absence of a clear pass/fail mark it is not possible, nor advisable, to use this year's stress test to draw mechanistic implications for banks' future capital requirements. The exercise is addressed to individual, significant banks, not to national banking systems. Drawing general conclusions would, therefore, be misleading, as there is considerable variation. For instance, among the five Italian banks included in the sample, as I said, MPS does poorly, but Intesa Sanpaolo is one of the best performers.

So in the absence of obvious conclusions, what is the main message resulting from these stress test?

I agree with the assessment given by both the EBA and the SSM (the single supervisor in the euro area): European banks have made substantial progress in strengthening their capital in recent years, and they are today better able to withstand further severe macroeconomic deterioration. Nonetheless, there are a few cases for which it would be advisable that further measures be taken to address and overcome specific vulnerabilities.

According to the international press, Italy is saddled with €360 billion in bad loans. But the figure has often been contested by Italian officials. Where do the discrepancies come from and what is the actual amount according to the Bank of Italy?

The figure of €360 billion refers to the whole category of "non-performing loans" (NPLs), while "bad loans," the so-called "sofferenze," are much lower. Of the €360 billion of gross NPLs outstanding at the end of 2015, bad loans accounted for €210 billion; while the remaining €150 billion loans were classified, alternatively, as "unlikely to be repaid," past-due, restructured or "in breach of overdraft ceilings." Obviously, these two broader categories of NPLs have different requirements in terms of coverage and write-downs. Both types of loans must be booked with due prudence, but not at values corresponding to their immediate liquidation. Indeed, a significant number of past-due and other NPLs actually returned to the category of performing loans even in the extremely difficult macroeconomic conditions of recent years.

Furthermore, gross NPL figures should not be considered in isolation: Write-downs are already accounted for in banks' balance sheets, and the value of underlying collateral should be taken into account. Net of write-downs, the end-2015 amount of bad loans drops to €87 billion, of which €50 billion backed by collateral worth an estimated €85 billion, and the remainder backed by personal guarantees estimated at €37 billion or unsecured. The value of the real-estate collateral was carefully assessed during the euro-area asset quality review of 2014, which was conducted using independent, comprehensive and prudent estimates.

Finally, the large majority of bad loans are booked in the balance sheets of banks that are financially sound, notwithstanding the impact of the long and deep recession.

What is the impact of this situation at a systemic level?

As I said on a number of occasions, market concerns about asset quality for Italian banks are to be taken seriously and should not be casually dismissed. But there are good reasons to believe that they are somewhat overstated.

The deterioration in credit quality has been recently abating. In terms of flows, in the first quarter of 2016 the ratio of new (non-performing loans) to outstanding loans fell to slightly less than 3 percent, the lowest level since 2008; according to our baseline economic forecasts, the default rate is projected to decline further this year.

Is the European Central Bank (through the Single Supervisory Mechanism) pressuring EU-lenders to get rid of non-performing loans?

In recent months there has been a perception in the market that the SSM is pushing banks to rapidly dispose of their NPLs. This perception is wrong. Indeed, an accurate and effective supervisory policy on NPLs must assess the situation of each specific bank. A policy that instead pushes banks across the board to rapidly dispose of their NPLs in the market would result in a massive transfer of wealth from banks to private investors that base their choices upon very high-risk premiums and related returns.

How can Italy effectively tackle its non-performing loans issue?

Dealing with systemic NPL issues in Italy necessarily requires a comprehensive strategy that includes improving banks' operational environment to manage NPLs, removing inefficiencies in the judicial and extra-judicial procedures that make loan recovery times longer than in the rest of Europe and kick-starting the NPL market. Italian authorities have been working hard on this, enacting important "structural" reforms that are starting to bear fruit.

The changes to the judicial recovery procedures are of pivotal importance as is the so-called "Gacs," the public guarantee on senior tranches of securitized bad loans. Important initiatives have also been taken by the private sector, with the set-up of Atlante. (That's the private equity vehicle backed by the main Italian banks, including Intesa, which was tasked with buying up part of the troubled lenders' NPLs and saving a couple of regional banks that failed to raise capital on the market.)

As for supervisory authorities, they have been strongly pushing banks to further improve their on-balance sheet management of NPLs.

All of these measures will contribute to solving the NPL issue, which has primarily resulted from a prolonged and very deep retrenchment of economic activity. It will take some time, but the process has clearly started.

Should Italy be a source of concern for Europe and international investors?

While growth certainly needs to be further strengthened, Italy is now completing its second full year of steady and gradually broadening recovery after the deepest and longest recession on record.

In the past few decades, the Italian economy was slow to respond to the challenges of globalization and technological change and was then hit hard by the global financial crisis, especially the euro area sovereign debt crisis of 2010-2012. However it is now responding to the multi-pronged structural reform effort that has been carried out in the last few years. This is leading to improvements in a number of areas, which are expected to contribute to increase potential output growth.

For example?

For example, the conditions of the labor market have been progressively improving since the beginning of last year, beyond initial expectations. This has in turn resulted in a rise in disposable income, which is supporting a steady recovery of consumption and hence of economic activity at large.

The country is also in the process of addressing its imbalances on the one hand, since 2010 Italian exports have been systematically gaining market shares. This has contributed to the return of the current account balance to a surplus, and there is a consensus that the improvement is here to stay. On the other hand, public finances are overall under control: Italy maintains a sizeable primary surplus and the public debt is expected to start to decline in the near future, after having virtually stabilized last year. At the same time the overall debt-to-income ratio of households is comfortably low, and that of firms is at about the EU average.

What do you think of the international press coverage of the crisis of Italian banks in recent months?

In the current macro-financial environment, the high level of NPLs and the low profitability of Italian banks are challenges that have to be forcefully addressed. And a significant improvement in the business environment is very much needed. From this perspective, the pressure from the international financial press is certainly a stimulus — for the banks and the authorities — to continue to do their best to overcome the current challenges.

This said, however, there is no doubt that most Italian banks are capable of dealing with the still fragile cyclical conditions, lending to the economy and competing efficiently on the market. Sometimes this is not properly acknowledged in the press.

For instance, a number of assessments made in the last few weeks — which put the recapitalization needs of the entire Italian banking system at somewhere in the order of tens of billions of euros — are based on the assumption that the total stock of bad loans, and possibly even some of the loans that are “unlikely to be repaid,” must be sold at once by all banks at a price equal to approximately half the value of the bad loans recorded in banks’ balance sheets. This is hardly a realistic assumption.

All Italian banks have suffered from the effects of the recession. For some of them these effects have been compounded by weaknesses stemming from their ownership and governance structures, and regrettably, in a few cases, by fraudulent conduct. In respect of these banks the supervisory authorities — both Italian and European — have acted effectively, calling for restructuring plans, which have been drawn up, and are now closely monitoring their implementation. It will take time to achieve the objectives. A firming up of the economic recovery with a positive spillover on banking activity will prove to be decisive.

How have the role and functions of central banks changed in recent years and how difficult is coordinating with the ECB?

Central banks have changed a lot since the outbreak of the global financial crisis in 2008. Their set of tools has significantly broadened. New objectives, necessary for a smooth and effective transmission of monetary policy, are being pursued alongside traditional ones. There is renewed focus on maintaining financial stability. Overall, these changes have significantly widened the scope for central banks’ involvement in the economy.

All over the world in the last decade, central banks have adopted a number of strong and bold measures that would have been simply inconceivable a few years earlier. In the euro area, a wide array of unconventional, often innovative, monetary policy measures have been adopted. They have supported a homogeneous and smoother transmission of monetary policy impulses in the euro-area economies, providing an unprecedented degree of monetary accommodation. However the changes faced by central banks in the euro area were much deeper and broader than is suggested by the expansion of the set of tools that have been used. Indeed, the Eurosystem has explicitly taken up financial stability, macroprudential and supervisory responsibilities; the banking union has had a head start with the creation of the Single Supervisory Mechanism, housed at the ECB, and, more recently, of the Single Resolution Mechanism.

All of this would have been impossible without a smooth and most fruitful coordination between the ECB and the national central banks at all levels in the Eurosystem, starting from the Governing Council and going all the way down to all staff members. To mention just one example, the rapid and successful establishment of the SSM would not have been possible without close coordination among all euro area central banks and national supervisory authorities.

There is always, of course, room for improvement; but there is no doubt we are starting from an already good position.