Italian Banking Association
Annual Meeting

Economic developments, financial markets and banks

Address by the Governor of the Bank of Italy
Mario Draghi

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I wish to thank the Italian Banking Association, for extending its traditional invitation to the Governor of the Bank of Italy to take the floor on the occasion of your Annual Meeting.

I convey my greetings to the President, Maurizio Sella, who has successfully piloted the Association in recent years. I particularly recall the initiatives he took during his term of office to establish the Association's role in promoting the transparency of contractual conditions and, more generally, of customer relations – a field in which banks are and increasingly will be called on to make a special effort.

Economic developments and financial markets

In contrast with the slight slowing of the world economic cycle, a recovery is under way in the euro area, and the rate of growth, more than 0.5 per cent in the first quarter, is approaching its potential level. The climate of confidence among firms has improved steadily and is now close to the peak levels recorded in the spring of 2000.

There has been a resumption of growth in Italy as well, although at a slower pace for the moment. Exports are expanding faster, but the gap with the other euro-area countries has not narrowed. Consumer confidence is not showing a clear trend, but the qualitative signals on the supply side are positive. In June Italy's industrial cycle turning-point indicator was consistent with an upswing in output; the climate of confidence among firms has been improving since the middle of 2005. GDP growth this year is likely to be close to 1.5 per cent.

The repeated large increases in the prices of oil and other raw materials have so far not had any impact on inflation expectations. The reduction in idle capacity in the United States and Europe and the abundance of liquidity increase the risk of this occurring. Central banks, firmly committed to containing inflation expectations, have been following developments closely and raising official rates.

Volatility and risk premiums are now increasing again in the financial markets. At the beginning of June there was a jump in the volatility implied by options on Federal fund futures, while that implied by derivatives on the Standard & Poor's 500 index has increased by 5 percentage points since mid-May. The risk premium on corporate bonds and on bonds issued by emerging countries has risen.

A re-pricing of risk is under way. Inevitably, it is accompanied by price adjustments on world stock markets, with larger reductions in the emerging countries. Good corporate results and stable macroeconomic trends in the United States and Europe are globally reassuring, although the rises in interest rates and risk premiums are bringing to light, sometimes quite suddenly, the weakness of the most heavily indebted countries and institutions.

The public finances and economic policy

It was seven years ago that Italy became part of the euro area. Since 1998 the average cost of servicing the public debt has fallen by 2.6 percentage points, while in relation to GDP interest payments have declined by 3.4 points. We have missed the opportunity to stabilize the debt; in 2005 the debt rose in relation to GDP for the first time in ten years. The budget surplus net of interest payments has almost completely disappeared.

The deterioration can be ascribed mainly to the performance of primary current expenditure. Between 1999 and 2005 this increased on average by 2.4 per cent a year in real terms; the local government component grew by 4.2 per cent. In particular, outlays on pensions rose at a rate of almost 2 per cent and current spending on health care by almost 5 per cent. In the same period GDP growth averaged 1.2 per cent.

In the decree it issued on 30 June the Government signalled its intention to renounce the use of tax amnesties as a tool of budget policy and introduced measures principally designed to restore eroded tax bases and recoup evasion. To this end it included a reform of the regulations governing the sale and renting of property; changes to certain technical aspects of the decree would make it possible to avoid the adverse side effects signalled by the markets and return the provision to its primary purpose.

The Government has also enacted measures to introduce or reinforce market mechanisms in certain services. In many cases the effectiveness of the new rules will depend entirely on their practical application by local authorities.

In the Economic and Financial Planning Document for 2007-11 the Government has confirmed the objective of 2.8 per cent of GDP set for net borrowing in 2007 in the July 2005 Document, even though the trend in the public finances has been less favourable than was expected a year ago. If the target is met, it will be possible to respect the commitments of the Stability and Growth Pact and put the public debt back on a sustainable track. The amount of the adjustment, to be achieved through structural measures, is set at €20 billion in 2007.

The stock market

The development of the stock market, which remains quantitatively small in Italy, is essential for the modernization of our financial system and the progress of high-tech firms with substantial growth potential. According to a survey conducted by Borsa Italiana among the 127 medium-sized non-financial firms that were listed between 1995 and 2002, it was their admission to the stock market that enabled them to continue expanding. Nearly 80 per cent of the respondents stated that otherwise they would have grown at a slower or much slower pace.

Experience has taught that entrepreneurs use the stock market to raise capital mainly at the time of listing, as a means of re-balancing their financial structure after a period of rapid expansion. Yet the stock market performs many other functions that are important for a firm's growth: it makes equity securities liquid; it allows shareholders to diversify their investments; it reduces the informational asymmetry between the company and those who finance it, helping in particular to reduce the cost of bank loans; and it improves the company's image among customers, suppliers and investors.

Stock market listing also facilitates growth by means of mergers and acquisitions – an essential method of expansion when economies of scale are present, as in sectors where there is massive investment in technology or in R&D. Data released by specialist companies indicate that between 1995 and 2005 more than 90 per cent of the value of mergers and acquisitions in the leading countries involved at least one listed company. Italy's productive system, with its small number of listed companies, faces greater obstacles than others to the concentration of production.

The operational efficiency, breadth and liquidity of the stock market are important for reviving the economy. This is the yardstick we should use in evaluating the consolidation of securities trading and settlement that are being mooted at European and international level.

In Europe the costs of settling domestic transactions are up to four times higher than those in the United States. Cross-border transactions are up to six times more expensive than domestic transactions.

The consolidation of stock exchanges, notably on a federal basis, is a decisive factor in the integration of markets: together with a lower cost of managing lists and increased liquidity, it brings economies of scale and network economies. An essential consideration in assessing plans for consolidation is their ability to reduce transaction costs. Competition can and must be guaranteed: trading infrastructures are not a natural monopoly. By eliminating the requirement to trade on regulated exchanges, the

MiFID directive creates the conditions for more competition between regulated markets and other forms of trading, such as multilateral trading facilities and the in-house systems of large intermediaries.

Competition between intermediaries in securities trading brings benefits to investors in the form of lower fees and narrower bid-ask spreads, and hence a lower cost of capital for listed firms. Competition stimulates technological innovation. The mind goes back to the mid-1980s, when the London screen-based market SEAQ International stimulated the restructuring of all the continental stock exchanges, including Italy's. The adoption of electronic continuous-auction trading platforms fostered the rapid growth of trading volumes, lowered costs and enhanced the reliability of transactions for users. The presence of alternative trading facilities and methods responds to the needs of investors (pension funds on the one hand, individual investors on the other) and issuers (large and small firms) whose volume and frequency of trading and operating practices differ widely.

As for post-trading activity, reaping the benefits of substantial network economies has to be reconciled with maintaining an adequate degree of competition. Full freedom of access to trading, clearing and settlement services is indispensable, if necessary by unwinding the ownership relationships between the companies that manage those services. Integration must be pursued by removing the present obstacles to cross-border trading, enhancing interoperability and eliminating access barriers in clearing and settlement. The objective of a European-wide integrated market must not entail the formation of a monopoly, nor must it jeopardize cost reduction. This is the sense of the Eurosystem's recent decision to consider offering services of securities settlement in central bank money.

Banks

In the 1990s the Italian banking system carried out a rapid and far-reaching transformation: privatizations and wide productivity differentials between banks led to mergers and restructurings. With the reduction in the number of banks, their average size and the overall concentration of the industry increased, but so did competition, thanks to the extension of the main groups' branch networks and the diversification of distribution channels. The curbing of costs, especially staff costs, the diversification of sources of income and, in recent years, reduced loan losses permitted substantially improved profits. Notwithstanding the higher tax rates in Italy, the profitability gap with banks in the other main euro-area countries was closed completely.

Today, this drive has weakened. The Italian banking industry appears to be suffering from strategic inertia. It would be illusory to imagine that the current level of profits, sustained by earnings on products other than traditional banking intermediation, can be maintained in the face of increasingly sharp domestic and foreign competition.

Competition has had an evident impact on traditional lending business. In the space of ten years the spread between the average lending rate and the average cost of funds to banks has narrowed from 5.8 to 3.3 percentage points, in line with the euro-area average. The contribution of net interest income to gross income has fallen from 76 to 55 per cent. After reducing the spread on loans to large firms, competition is now producing comparable effects in the market for small and medium-sized firms.

Returns remain high in asset management, some segments of the payment system and consumer credit, where prices are less vulnerable to competition; however, pressure from foreign institutions is building up in these markets as well. The standardization of products permits substantial economies of scale; the elimination of the costs associated with transferring deposit accounts will lead to greater customer mobility. In 2005 the net assets of investment funds managed by foreign-owned companies or marketed by foreign intermediaries rose from 9.6 to 25 per cent of those of all investment funds marketed in Italy. In the consumer credit market foreign institutions hold a 29 per cent share.

The consolidation of the banking industry should be resumed. There is still ample scope for mergers in which the synergies outweigh the complications. What is asked of Italian bank management is that it rise to this challenge with the commitment, specialist expertise, and experience in the reorganization of large, complex structures that are required. The Bank of Italy does not have a blueprint for the process. Our guiding principle is that consolidation is an opportunity for the industry and its management to grow, a necessity to cope with international competition, and the base for subsequent, more complex cross-border mergers.

Allow me to stimulate your awareness. It is you, chairmen and managing directors, who hold the key to initiating, promoting – or hindering – these consolidation initiatives. It is up to you whether you will create European players capable of exploiting the opportunities offered not just by the domestic market or leave them to be seized by foreign operators.

In the integration of the European banking market, it is up to the Community institutions to create a level playing field for competition, not only by ensuring compliance with common rules but also by exercising oversight to prevent the use of instruments that, though legal, in practice restrict the contestability of markets.

In Italy, the planned abrogation of the requirement to notify the supervisory authorities of merger plans before they are submitted to the board of directors is intended to increase the transparency of the procedures and better coordinate banking supervisory regulations with those governing listed companies. Naturally, this does not do away with the need for the authorization of mergers. Control over banks' ownership remains an essential supervisory tool, serving to verify acquirers' satisfaction of minimum requirements concerning reliability and financial soundness, their correctness in business dealings, the nature of their relationship with the bank, the governance arrangements, operating results and financial condition of the institution that will emerge from the transaction and, in the case of acquisition of control, the content of the business plan.

Regulation

The transposition of the new Basel Capital Accord will provide an opportunity for a general revision of supervisory regulations. In a prudential system in which intermediaries are free to choose the risks they will assume, provided the total is proportionate to their capital, there is no place for imposing constraints on individual activities in order to limit risks. It is also necessary that the tools used by the banking supervision authority reduce the regulatory burden and allow intermediaries to act rapidly.

The Bank of Italy is progressively issuing the consultation documents on the introduction of the new rules into the legal system. Their production in comprehensive and detailed form, not only makes it possible to explain the reasons for the regulatory choices and give market participants ample time to plan the necessary action but also serves to encourage comments and suggestions. At this stage regulatory decisions are being taken that will apply for a long time to come; it is important for banks and the ABI to participate actively in their formulation.

Consultations have also been launched for other legal innovations. In the case of covered bonds the ABI was consulted late in 2005 and the proposed regulatory framework was amended; broader consultations will begin in the next few days. Another forthcoming consultation concerns loan guarantee consortia (Confidi), whose role in helping to finance smaller firms will be recognized in the prudential rules.

Since the beginning of this year the supervisory regulations have been amended to eliminate the obligation to notify the Bank of Italy of the acquisition of equity holdings in companies in difficulty, remove the constraint of a minimum duration for certificates of deposit, and repeal the limits on medium and long-term financing of firms and the restrictions on maturity mismatching. A proposal providing the basis for a new regulation of the equity interests banks may hold has been submitted to the Interministerial Committee for Credit and Savings. If it is approved, it will allow the procedures for acquiring holdings in the capital of financial and insurance companies to be simplified and the limits on equity investments in non-financial corporations to be considerably enlarged. The financial risks associated with such investments will be dealt with by the new rules on capital adequacy, which more accurately reflect the riskiness of the different ways of allocating resources. The risks of commingling of operations and conflicts of interest will be addressed by corporate governance mechanisms and transparency requirements. The rule preventing banks from investing more than their capital in real estate and shareholdings of any kind will remain in force.

The system of prior authorizations of individual transactions will be further pruned, starting with collective investment undertakings, where the risks of instability are less and there is greater need for rapid implementation of decisions. The revision of the rules will be based on two principles. Transactions that conform with predetermined standards will not have to be authorized; accordingly, a set of guidelines descriptive of approved models rather than prescriptive will be laid down in addition to the rules themselves. Once a transaction has been recognized as appropriate for a particular intermediary, its subsequent transactions of the same type will not need to be examined; on the other hand, the principle whereby intermediaries may not engage in new activities without first consulting the supervisory authority will be applied systematically.

The entry into force of the new capital adequacy rules and the international accounting standards requires a revision of the prudential supervisory reports based on European formats. As regards accounting data, the structure of the information will be that of the financial statements, while the information of a prudential nature will mainly concern risks and the different components of capital, so as to permit the analysis of capital adequacy. The check on advanced methods of quantifying risks will be based on models similar to those that banks themselves use for operational purposes.

The requirements laid down by the international rules on capital adequacy for the use of advanced methods are stringent; they are likely to involve costs that are too high for small and medium-sized banks. However, such banks can also apply quantitative risk-measurement techniques on a partial basis and in accordance with less demanding standards that, although not permitting reductions in capital charges, involve lower costs and offer operational and competitive advantages.

For large banks, now that the issue of measuring capital adequacy has been settled, the question is rather how best to manage liquidity risks. In a global financial environment of high and rising levels of debt and increasing volatility, these risks can appear very rapidly and on a major scale. Nor should banks be reassured by the greater liquidity that some previously illiquid assets now have in ordinary market conditions. The types of events that banks must be able to cope with and the prudential rules and principles that will need to be adopted are matters that banks and supervisors should start to examine together.

The transformation of banking business is giving rise to new types of risks, notably legal and reputational risks. Considering their importance, the supervisory authority must check that banks have put an organization in place capable of ensuring compliance with the rules, proper handling of conflicts of interest and maintenance of customer confidence. Over and above what the law prescribes, banks must set themselves the objective of making it easy for customers to perceive the riskiness of financial products; the ABI has an important role to play in this respect.

A consultation document will shortly be published on the rules requiring banks to establish a compliance function. In drafting the document, the Bank of Italy was assisted by the ABI, the leading Italian banking groups and the Italian subsidiaries of foreign banks. The supervisory regulations will lay down principles of a general nature concerning the aims and tasks of the function, while leaving banks broad discretion to choose the most effective organizational solution for their achievement and performance.

The decree law passed on 4 July contains some rules concerning banks intended to increase the transparency of contractual conditions and the safeguards for customers. Although some not unimportant aspects may need to be adjusted, the objective is commendable. Transparency increases competition; it is the foundation of banks' reputations; it is a means of limiting the costs incurred by customers. I have already had occasion to note that the fees customers are charged to close an account differ from all the others because they directly hinder the working of competitive mechanisms. The time has come to abolish them, even where the right of withdrawal free of charge is not already recognized by law, and to find ways of ensuring – as for other services – the effective portability of accounts and all the related functions. Banks must be pro-active in this respect. Customer protection should not be based on rules that are dirigiste, of uncertain effectiveness and with a high potential to cause distortion.

The evolution of regulation and supervisory practices requires a larger number of better qualified human resources. The integration of markets and technological innovation are forces driving change for central banks no less than for banking systems. The meeting with the trade unions on 4 July initiated a review of the structure of the Bank of Italy, at the Head Office, in the branch network and in the relationship with the UIC. The review will probably see the activity of some areas expand and that of others contract. But the Bank of Italy has already been silently adjusting to the new scenario for some time now. Since the introduction of the euro its staff has decreased in number by 10 per cent; between 1996 and 2005 the number decreased by 1,443 or 15 per cent. An opportunity to alter the composition of the staff will be provided by the departure of about 1,600 members of the staff expected by the end of 2010.

Growth is essential to make the weight of the public debt bearable. Without financial stability the country's future dissolves into uncertainty. My remarks today are devoted, as were those of a few weeks ago, to this complementary relationship. The first economic policy measures adopted by the Government are aimed at it, at strengthening the market.

A banking and financial system that makes all its potential contribution to the return to economic growth; this is the goal, general and not sectoral, towards which the action of the Bank of Italy is directed in the performance of its duties.