ACRI
Association of Italian Savings Banks

2007 World Savings Day

Address by the Governor of the Bank of Italy
Mario Draghi

Rome, 31 October 2007

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Financial turbulence

Originating in a peripheral segment of the US financial industry, subprime mortgages, the recent turbulence spread rapidly to the world financial system. Loss of confidence in the ratings system suddenly made the market keenly aware of the complexity of structured products, which had come to make up a considerable portion of the portfolios of many investors; the ability to price these assets evaporated; the markets in them became illiquid, further exacerbating the difficulty of determining their value. Investors sought to reduce the risk of their portfolios in a hurry. The unwinding of positions did not come about gradually; volatility rose rapidly, increasing every measurement of risk and therefore provoking further attempts to dispose of assets. The illiquidity of the markets for structured products created major strains in the money market.

Many large banks showed a reluctance to provide liquidity to counterparties whose solvency had become uncertain; they also doubted the ability of the financial vehicles that they themselves had sponsored or implicitly supported to obtain refinancing, mostly at short term and in the form of commercial paper. Liquidity preference rose abruptly; the willingness of these banks to maintain lines of credit to the rest of the system diminished.

The European Central Bank intervened promptly to satisfy the increased demand for liquidity and succeeded in preserving orderly conditions on the market. Starting on 9 August it conducted numerous fine-tuning operations, increased the supply of funds in main refinancing operations and carried out extraordinary three-month operations.

These interventions averted a liquidity crisis; together with those of other central banks, they helped to dispel the risk of the strains in the money market leading to a crisis of the world financial system. This was done without modifying the stance of monetary policy, oriented to the objective of price stability. Quite the contrary, for the solid anchoring of the market's medium-term expectations is especially important in a period of volatility on the financial markets and generalized uncertainty.

The turmoil in the markets has abated in the last few weeks. Volatility has diminished. However, the situation remains fragile. The interbank market is still relatively illiquid at longer maturities.

In mid-October the indexes for tranches of mortgage-backed securities, ordinarily very liquid, traded at discounts of between 30 and 70 per cent to their nominal value. Substantial amounts of commercial paper are nearing maturity. Interest rates on subprime mortgages are expected to move higher for a considerable volume of loans.

Between August and October the total amount of asset-backed commercial paper fell by $250 billion, according to available estimates. In the absence of market financing, the exposure of the special-purpose vehicles is reappearing on banks' balance sheets. It is added to the roughly $300 billion of syndicated loans that banks had expected to sell to the market and that they are now forced to hold onto.

Credit risk premiums have returned to levels more consistent with underlying economic conditions and past experience. It is likely that the rise will be permanent. Greater transparency, radical changes in the rating process, forms of standardization of structured products and, where necessary, more effective supervision of lending at its origin will be essential for the model of intermediation based on the transfer of loans to third parties to make a comeback.

These strains will have repercussions on the securitization of bank loans. According to recent studies by the Bank of Italy and the European Central Bank, in the past few years securitization has given important support to the growth in lending for consumption and investment in the euro area, to the extent that in 2006 it covered one fifth of new loans; it has contributed about two percentage points to the growth in the total supply of bank loans in the area. The effect of a fall in securitization on the supply of loans might not be negligible.

At the end of September, on the occasion of the Eurosystem's periodic bank lending survey, banks reported increased difficulty in raising funds on the interbank market, on the bond market and by means of loan securitization. They also indicated that they were tending to be more cautious in granting loans, especially to large companies and for the financing of mergers and acquisitions; this tendency is likely to concern loans to households for house purchases to a lesser extent.

The real economy will be affected by these developments, although for the time being the expected effects are limited. The International Monetary Fund still forecasts a high growth rate for world GDP in 2008, nearly 5 per cent. The reduction with the respect to the Fund's forecast in July is about half a point; the risks of results below the central estimates have increased.

Every crisis leaves policymakers shaken by the poorness of their forecasting ability. While it is sometimes possible to see the risk factors clearly, it is nevertheless impossible to predict the precise moment that the market will choose to trigger the crisis, the exact forms this will take or the links decisive for its propagation. The recent episode is no exception. For some time the supervisory authorities had been drawing attention to the mounting strains. In this year's Concluding Remarks among other things we stressed the rise in sub-prime mortgage defaults in the United States and warned that investors' perception of risk might change suddenly and that an abrupt portfolio adjustment could have destabilizing effects. But the interaction between market players' inability to determine the value of the assets in their portfolios, the lack of liquidity and the attempt by all market participants to reduce their exposure to risk at the same time could not be foreseen, nor could the dramatic speed with which the crisis spread.

Every episode of turbulence is a lesson for the authorities on the limits of the information available to them; a stimulus to persevere in the action to make markets and intermediaries inherently more robust, regardless of the specific form the next crisis may take.

The strategy of the Financial Stability Forum is based on these principles. The management of risks, and especially liquidity risk, by the institutions subject to regulation; appropriateness of capital requirements; immediate application of the Basel II rules; full consolidation of the assets and liabilities currently kept off banks' balance sheets; transparency and valuation of structured financial products: these are the main items of the report that the Financial Stability Forum will present to the G7 Finance Ministers next April.

Recent experience offers material for reflection. The European banking system, though it reveals some fragilities, has benefited from the prompt intervention of the monetary authorities and coped successfully with the tensions. In their quarterly reports the leading global financial institutions disclosed losses that are very large in absolute terms but with an overall impact on their balance sheets that has so far been limited, thanks to the diversification of their assets and liabilities and the large volume of capital and liquidity available. In Europe the crisis has been most severe at small and medium-sized banks whose off-balance sheet risks were totally out of proportion to their capital or whose fund-raising was not sufficiently diversified.

Repercussions in Italy

The Italian banking system has been less affected than others by the recent turbulence and consequent money-market strains. The major role of deposits among the sources of fund-raising, the limited exposure to US financial markets and products, and adequate capital and a generally satisfactory level of operating profits have prevented the formation of the conditions at the root of the problems that have affected some banks in other countries.

I should nonetheless like to draw attention, especially for the banks most exposed to market risks, to the need to constantly improve liquidity management, with reference to liabilities no less than assets. The experience of other countries shows that the stability of deposits may be open to question. The spread of funds managed over the Internet, still on a relatively small scale today, is likely to permit an unprecedented degree of mobility in the future. The leading groups have adopted advanced liquidity management practices and monitor the situation continuously, including by means of stress testing; these efforts, closely followed by the supervisory authority, must be intensified and continually adapted to market developments.

The direct exposure of the leading Italian groups to the US sub-prime sector is limited; no group has reported loans to US counterparties with low credit ratings. Nor in the case of indirect risks does the Italian banking system appear to have incurred significant losses in relation to its capital. The Bank of Italy is conducting continuous checks.

Transparent information on risk exposure is a key condition of stability. The balance sheet valuation of complex and potentially illiquid instruments must be prudent and take all the risk factors into account. Particular attention must be paid to the obligation to consolidate the accounts of financial vehicles, even if not affiliated, whenever banks exercise substantial control and bear the risks.

In order to take account of the effective risk for prudential purposes, vehicles that in substance are controlled should also be consolidated for the calculation of capital requirements. This is the approach we have advocated in international fora, where our aim is the adoption of agreed solutions that ensure competitive equality between banking systems.

A relatively small proportion of Italian banking income derives from the most innovative and risky products. The degree of maturity transformation is lower than in other systems. Banking legislation and the action of the supervisory authority have aimed at achieving a very close correlation between banks' exposure to the most complex risks and their organizational ability to govern them.

The securitization of real-estate loans began to develop only very recently. Although it is growing, household debt for home purchase remains low. In relation to GDP it is little more than one third of the European average. The ratio between the value of mortgages and properties is low. Mortgage agreements similar to those in the US sub-prime market are not common.

Mortgages, however, are growing rapidly. Between 2002 and 2006 those to households grew almost twice as fast as the European average. The loan-to-property-value ratio is increasing. Banks have started offering tailor-made solutions to new categories of mortgage holders, such as people without permanent full-time jobs and non-EU workers. There has been a large increase in the business of specialized lenders, including foreign intermediaries. While still low, the proportion of bad debts in house-purchase loans is starting to show signs of rising. The Bank of Italy has increased the banking system's awareness of the risks involved.

For households and firms, the rise in interbank rates will be reflected in an increase in the cost of variable rate loans, which account for three quarters of total medium and long-term loans. If market tensions continue, the additional burden on borrowers could become considerable. For households whose mortgages are pegged to three or six-month Euribor, a permanent rise of 50 base points would increase the average debt service by around 0.6 per cent of disposable income; this figure would be even higher for less affluent households.

Looking ahead, the cost of banks' funding is the main channel through which worsening financial conditions could affect the supply of loans to households and firms. The widening of the yield spread on bank bonds denominated in euros has been pronounced. The value of euro-area banking groups' Euromarket issues almost halved between September 2006 and September 2007; Italian banks' issues on this market also dropped considerably. In recent years bonds have been the main source of funds used by banks to finance the robust growth of medium and long-term loans; a large proportion of issues were placed on the international market. Demand also fell for securities deriving from securitizations, an instrument that greatly contributed to the recent expansion of household credit: in 2006 and the first half of 2007 the sale on the market of loans to households covered almost one third of new medium and long-term lending to the sector.

The banking system and supervision

In exercising its powers relative to the transparency of banking products, the Bank of Italy recently concluded a sample survey of the costs of current accounts. The survey covered a total of 4,500 accounts held in over 130 banks, distributed to ensure the data were representative. Over 70 per cent of the accounts were held by individuals.

Based on the survey's initial findings, the average annual cost of maintaining a current account is now €130. While the cost fell on average compared with a similar survey carried out in 2005, albeit with somewhat different methods and aims, it continues to vary widely. This is partly due to different operational profiles: the 25 per cent of accounts with the lowest number of annual transactions cost €70 on average, as against €218 for the 25 per cent with the highest number of transactions.

The findings of the survey are still preliminary and we will return to them in the future. We can, however, make some initial observations. A larger proportion of customers have opted for "flat-fee" accounts, less costly for the great majority of client profiles than "pay-per-transaction" accounts. However, customers do not always choose the cheapest option; in fact there are plenty of examples of "pay-per-transaction" accounts with a high level of operations and therefore very high costs.

Banks must continue to improve the information they provide to customers. Transparency of conditions, competition between banks, customer care, and better-informed customers all help to reduce costs; they can and must stimulate further progress.

Italian banks are increasing their derivatives business. Including the significant number of contracts brokered by the foreign subsidiaries of Italian banking groups, at the end of June 2007 the exposure of banks to derivatives valued at market value had reached €150 billion, 6 per cent of their overall exposure. Most of the counterparties of these contracts are financial companies and foreign intermediaries; the share of Italian firms and general government bodies is on the rise, however.

The development of innovative instruments is all for the good but it calls for a careful evaluation of the risks, especially counterparty risks**.** In the face of adverse movements of market variables and of contractual mechanisms that worsen their effects, clients may have difficulty in meeting their obligations and intermediaries can suffer considerable losses. Complex derivative transactions must be reserved for qualified investors, conducted in absolute transparency and guarantee a perfect match between products and clients' needs and risk profiles. Any inadequacies on this front can greatly harm a bank's reputation. Banks' organizational structure and internal control systems must guard against these risks; the compliance and internal audit functions have an extremely important role to play.

Controls on banks' derivatives business are divided between Consob and the Bank of Italy, with the latter responsible for supervising stability. Between the end of 2005 and the beginning of 2006, we increased our supervision activities in the face of growth in this sector. With the onset of market turmoil, we asked the control bodies of the banks involved to make a self-assessment of the suitability of their organizational structure, operating processes and system for measuring derivative related risks. We will be publishing the results shortly. We have reiterated that banks unable to measure and manage derivative related risks correctly must refrain from dealing in them.

We have launched targeted inspections of the most active intermediaries. Where we have found behaviour that is not in line with sound and prudent management, we have taken action.

At the end of August, local authority debt in relation to derivative transactions with Italian banks was about €1 billion; however, since the largest local authorities often deal with foreign intermediaries, this is undoubtedly a conservative figure. The Bank of Italy has called on the banks to verify that local authorities' transactions fully comply with the relevant regulations, under which derivatives can only be used to cover risks and debts incurred for specified purposes. Local administrators, for their part, must act knowingly. Derivatives are useful for managing given financial risks; they should not be used to improve cash flow temporarily, while placing a burden, in a non-transparent manner, on future administrations.

The Bank of Italy has published a consultation document on the rules of corporate governance in banking. Following the criteria adopted throughout the revision of supervisory regulations, the new rules will not specify rigid solutions but dictate general principles, such as: a clear division of responsibility between strategic supervision and management functions; an effective contribution of non-executive and independent directors; enhancement of the control function; provision for prompt and complete data flows; and consistency of the remuneration and incentives system linked to company performance, such as stock options, with banks' long-term strategies and risk control policies. Each bank will have to adopt its own governance plan; the Bank of Italy will evaluate its adherence to the principles.

Savings

Now that MiFID has entered into force across the European Union, the world of financial services is open to far-reaching change. The new rules will increase transparency, promote greater knowledge of investment choices and encourage intermediaries to cultivate and strengthen their relationship of trust with clients. By facilitating the supply of services throughout the area, European harmonization will intensify competition. It will be possible to offer new services, such as investment advice and trading in competition with the stock exchange, by internalizing orders or managing alternative trading systems.

Drawn up in consultation with the industry, the Bank of Italy and Consob implementing regulations were issued two days ago. Red tape has been cut to the minimum. On the basis of the proportionality principle, disclosure requirements and rules of conduct have been graded according to the type of service, financial instrument and client. Here too, regulation is based on general principles. Intermediaries will have to define organizational solutions suited to the services they intend to offer; evaluate the new operational and reputational risks; and fine tune their control systems. The adequacy of the organizational and capital solutions will have to be constantly monitored by the competent corporate bodies. The Bank of Italy will check whether the solutions adopted are capable of ensuring stability.

The increasingly close coordination between the Bank of Italy and Consob is reducing the costs and uncertainties for those being controlled. This afternoon a memorandum of understanding will be signed setting out the responsibilities of the two authorities. In the investment services field the protection of savers and the stability of intermediaries are very closely interrelated.

Open-end funds have not performed satisfactorily for some time. While the assets of European funds increased by 76 per cent between 2002 and 2006, those of funds offered in Italy grew less than half that amount, by just 31 per cent. Italian open-end funds dropped by 8 per cent, and even more sharply in the period 2003-07. The decline has not been offset by the small growth in foreign funds managed by Italian firms, which also came to an end in the early months of this year. The only funds that have grown rapidly are hedge funds and open-end funds offered in Italy by foreign firms: their assets have quadrupled in four years. In June, for the first time the assets of foreign funds exceeded those of their Italian counterparts.

Foreign funds enjoy considerable tax advantages. They are taxed on a realization basis rather than an accrual basis. This is a serious handicap, and one that needs to be tackled. The corporate income tax levied on management firms is also much lower elsewhere than in Italy.

While the tax disadvantage goes some way towards explaining the downturn in Italian funds, it cannot account for the slow growth of the market as a whole. Competition from other financial products, ranging from life insurance policies to securities and structured products, has also played a role. However, Italy's mutual fund industry should give thought above all to the elements that are directly within its control. Not infrequently, the quality of fund management is unsatisfactory in relation to the costs. It is not surprising, therefore, that bond and money-market funds have made the least progress, as their fees are particularly high in proportion to the returns they provide. A further factor is the structure of the industry, based on a close connection between product manufacturers and banks' distribution networks, which play a crucial role in augmenting the volume of managed assets and distributing dividends. Whatever merits this structure may have had in the past, in more recent years it has impeded mergers between Italian manufacturers of products, thus making it hard to pursue economies of scale; it has encouraged the offer of complex and hard-to-assess products that often guarantee a quick and substantial return in the form of fees; it has generated large flows of resources back to the banks' networks, subtracting them from firms for investment in fund management; and it has made it difficult for Italian manufacturers to develop their own growth strategies.

There is no reason why Italy's asset management industry cannot play an important role in Europe and help to create value for the groups participating in it. There is no lack of "raw material", i.e. the country's savings, which could indeed be expanded by developing a supplementary pension system.

If asset management firms are independent of the banks, they will be encouraged to adopt development strategies, backed by the necessary investment; the centres of production will be able to grow, including by merger, and to succeed even outside the group network and on international markets. A step in this direction could be taken by ensuring that the majority of board members are independent. While a number of asset management firms have begun this process, on 30 June of this year the proportion of independent board members was still only 25 per cent of the total.

The legislative decree transposing the 2004 European directive on takeover bids is about to be passed. Appropriately, the new rules confirm the principles that underpin the present law, which places heavy emphasis on the protection of minority shareholders. The passivity rule remains in place, as does the minimum threshold requirement for mandatory tender offers, although the new method of calculating the price will raise its level. The inclusion of a reciprocity clause guaranteeing equal competitive conditions in observance of shareholders' rights is to be welcomed.

There are some doubts about the requirement to introduce a neutralization rule, according to which some protective measures will no longer be available in the event of a takeover bid. This rule could prevent access to the ownership of companies; it might encourage recourse to less transparent methods of separating ownership and control that would not come within the field of application; it might put public tender offers at serious risk of legal action in order to set a figure on the indemnification envisaged.

It is to be hoped that the question will be given further consideration. The right to recede from shareholders' agreements during a tender offer, a possibility that the new rules retain, achieves the same end at less cost. It would be preferable to allow the decision about the neutralization rule to be incorporated in the bylaws at the firm's discretion, as the directive allows. It would be up to the shareholders to evaluate the advantages and disadvantages as the case dictates.

We believe that since this summer's turmoil the markets have begun to return to a situation in which liquidity is less plentiful than in the recent past and volatility not as low. The international financial system has approached this transition with the leading banks displaying greater strength than expected at the start of the turbulence.

Italy's banking system has been affected less than those of the other European countries. As things stand, its predominantly Italian customer base has proved to be a source of strength. We must acknowledge the value of this, and take further steps to build a transparent relationship that benefits all the parties concerned.

Good governance, well-balanced boards of directors, effective internal controls, and farsighted shareholders will always provide the basis for the solidity and growth of our banks.