ACRI
Association of Italian Savings Banks

2008 World Savings Day

Address by the Governor of the Bank of Italy
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The global financial crisis

With the failure of the Lehman Brothers group in September, the crisis that had begun in August 2007 became systemic, propagating its repercussions with increasing speed. Worries about the solidity of counterparties grew acute. It became even harder and more costly to raise capital in the markets. The growing distrust was accompanied by the evaporation of liquidity. Share prices fell dramatically, owing in part to apprehension over the effects of the crisis on the real economy.[1]

The reaction of the governments and monetary authorities has gradually gained strength and capacity for international coordination. There is increasing awareness of the benefits of a vigorous, common response that takes account of the interactions between national policies and reduces the different measures initially adopted by the governments to a consistent framework.

In this period the monetary authorities have made up for the freezing of the interbank markets with injections of liquidity unprecedented in both scale and method, acting in close coordination. On 8 October the main central banks carried out a concerted reduction of interest rates, the first in the history of monetary institutions. Today the central banks' exceptional efforts n the liquidity front are beginning to bear fruit.

Decree Laws 155/2008 and 157/2008 issued by the Italian government responded effectively to the emergency, reflecting the guidelines agreed at European level.

[1] A full account of the causes of the crisis and its course in the last twelve months can be found in my testimony before the Finance and Treasury Committee of the Senate on 21 October.

They strengthen depositor protection and empower the Treasury to subscribe for or underwrite equity issues by banks, guarantee newly-issued bank liabilities and increase the availability to banks of eligible securities for Eurosystem refinancing operations.

To prevent the tightening of borrowing conditions for households and firms and the deterioration of the economic cycle from reinforcing one another in a downward spiral is the challenge that the authorities must deal with in the short term.

The effects of the crisis on the real economy

The acute phase of the financial crisis caught the economies of the advanced countries in the midst of a slowdown, after they had already been weakened by the surge in commodity prices in past months. Repercussions are also beginning to emerge among the emerging countries, which had seemed immune until now. For some of these countries an intervention by the International Monetary Fund is expected to counter capital outflows, debt refinancing difficulties and exchange rate strains.

In step with the deterioration of the world situation, the expansion of the euro-area economy has continued to slacken in the course of the year. The growth in credit, though remaining robust, has slowed appreciably; looking ahead, the latest surveys point to a further tightening of lending conditions.

Like the other large countries of the area, Italy is being affected by the adverse international situation. The weakening of world demand is putting a brake on our exports, which had sustained the economy during the last expansion. It is accompanied by the weakness of domestic demand. Consumers' behaviour is affected by the modest pace of growth in real disposable household income and by uncertainty, itself aggravated by the worsening of the economic climate. They are reining in expenditures, especially those most easily postponed. Purchases of durable goods, motor vehicles in particular, are down sharply.

Expectations of declining demand and greater risk aversion have affected investment decisions. The cyclical surveys of the Bank of Italy and other research institutions have found that actual investment this year will be less than had been planned, and expectations for 2009 are for a further contraction compared with the outturn for 2008.

Based on the main international organizations' forecasts of world demand, the current stagnation will last at least until the middle of next year.

Totally offsetting the repercussions of the crisis is not a realistic objective today, but attenuating them and paving the way for a quicker and more durable recovery through appropriate economic policy measures is possible. National economic policies do count.

First of all, the crisis must be prevented from translating into a sharp contraction in the flow of credit to the real economy. Second, effective support measures must be taken to counter the recessionary tendencies. This need can be served by a budgetary policy that exploits the scope for flexibility provided by the Treaty and the Stability and Growth Pact, as set out in the European Framework for Action presented by the Commission on 29 October. The policies that have put the Italian public finances on a credible path to consolidation form a good point of departure.

Our economy is not lacking in strong points on which to base an effective response to the crisis. The industrial restructuring of recent years is supplemented by Italian households' still high saving rate and low debt.

Households' and firms' savings and financial assets

One fifth of Italy's gross national income is saved every year. In the United States, the proportion is less than one seventh. Italian savings are generated by both firms and households. The latter's saving rate is among the highest in any advanced economy, about 10 per cent of disposable income. And in the last decade the public sector has almost always produced at least modest net savings, after nearly three decades in which it had constantly destroyed savings, by as much as 8 per cent of national income in some years.

This capacity to save remains one of our country's great assets. It enables Italy to sustain high investment rates without jeopardizing the external balance of payments. Last year, gross fixed investment was more than two percentage points higher than in the United States and Germany.

In general households' savings have been invested in more liquid and less risky assets in Italy than elsewhere, especially in recent years. With the onset of the crisis, caution increased. Between mid-2007 and June of this year Italian households made net disposals of shares, investment fund units and life insurance products amounting to €75 billion, or more than 2 per cent of total household financial assets. New investment of over €100 billion went into bank deposits and bonds, postal savings instruments and government securities.

Italian households are among the least indebted in the advanced world, by comparison not only with Britain and America but also with the rest of continental Europe. Their financial debt comes to less than 50 per cent of disposable income, compared with a euro-area average of 90 per cent.

Homeowners make up 70 per cent of all Italian households. Households with home mortgages are less than 15 per cent of the total. The rapid growth of mortgage lending in the past decade has mainly involved higher income and wealthier households, which are better able to sustain the burden of debt service. However, for indebted households mortgage payments are taking a growing share of annual income. The increased resort to variable rate mortgages in the last two years has resulted in a rising ratio of installments to disposable income, to above 20 per cent by the middle of this year. The lowest income households, which make up 1 per cent of the total, have mortgage payments estimated at nearly 40 per cent of their disposable income.

The number and total amount of bad loans to households continue to be very low and are in line with the figures recorded in recent years.

Banks must nevertheless be particularly careful in their dealings with households, especially with those that are most financially vulnerable. The renegotiation of some contractual conditions can ease current expenses and redistribute repayments over time. The measures introduced under the agreement between the Government and the Italian Banking Association provide a useful reference framework. However, the difficulties encountered by borrowers in assessing the entity and distribution of the debt service associated with the new contracts in the years to come appear to discourage recourse to these procedures. It is in the interest of the banks themselves to adopt a pragmatic and flexible approach, including a bilateral assessment of the most appropriate solutions for curbing debt servicing costs for the most vulnerable households and thus safeguarding their solvency.

It should also be borne in mind that the reference rate for a large proportion of variable-rate mortgages in Italy is the Euro Interbank Offered Rate (Euribor). Today, due to the tensions on interbank markets and with the contraction in trading, this rate no longer adequately reflects the cost of fund-raising. Looking ahead, banks should use parameters for mortgage indexation that are more closely connected with the actual cost of funds.

Banks

Credit

To prevent the crisis from further damaging the growth prospects for the real economy, it is vital that a sufficient supply of credit continue to flow to households and businesses on reasonable terms. The effective allocation of credit is the very *raison d'être* of the banking system; a prudent assumption of risk is intrinsic to banking.

Thanks to sound balance sheets and a lower degree of exposure to the instruments and markets most affected by the turbulence, Italian banks have largely succeeded in maintaining an adequate supply of financing to the economy. In the year to September, lending to Italian firms (counting securitizations) rose by 13 per cent; that to households by 10 per cent.

Today, however, the risk of a credit contraction has grown. Eurosystem surveys of Italian banks have signalled a tightening of standards for lending to businesses and households compared with the past and an extension to consumer credit of the restrictions already in place for home mortgages.

Liquidity

The primary cause of the slowdown in the growth of the credit aggregates today is to be found in the difficulties in the interbank deposit market. Restoring confidence and depth to the interbank market is both necessary and urgent. While banks must continue to pay attention to their liquidity positions, it is equally important that they reopen interbank credit lines.

Spreads on transactions between Italian banks on the interbank market continue to be unjustifiably high. In normal circumstances, the spread between the rate on three-month interbank deposits and that on risk-free transactions of the same duration is around 10 basis points. Following Lehman's failure, this spread – the most direct measure of the market's lack of confidence – exceeded 200 basis points on more than one occasion. There was a contraction in the volume of transactions; in October daily business was less than half the 2007 average.

The Eurosystem has made unlimited amounts available to banks at fixed rates in the main weekly refinancing operations; it has extended the same availability to operations in currencies other than the euro at various maturities; it has further enlarged the range of assets that can be accepted as collateral. For the first time, it has just carried out a fixed-rate operation with no limits on quantity at three-month maturity; in November there will be a similar operation at six-month maturity. These operations with longer maturities will be repeated as often as necessary. Italian banks have only made modest recourse to them so far.

The Bank of Italy has recently strengthened the ability of banks operating in Italy to access Eurosystem credit and enhanced the liquidity of their assets, by making €40 billion of government securities available from its own portfolio to exchange with other securities held by banks.

The project that we will be proposing to the banks in the next few days to create a new exchange system to remove counterparty risks and restore fluidity to the market will be crucial for the recovery of the interbank market.

In the most recent period, interbank market conditions have been less tight. The Euribor rate began to fall after peaking at 5.39 per cent on 8 and 9 October and reached 4.79 per cent on 30 October. On the same day, the spread with respect to risk-free operations was 180 basis points, still very high but below the peak of 207 points reached on 12 October. The improvement remains fragile, however.

Under Decree Law 157/2008, the government will guarantee new issues of bank securities. The law will enter into force once the implementing ministerial decree has been enacted. I expect the banks to make full use of the tools at their disposal. A return to normality in managing bank liquidity is in the interest not only of individual banks but also of the entire system and of the economy as a whole.

In the light of the present situation, it is also appropriate to reconsider the tax disadvantages for deposits, which weigh on savers and put Italian banks' fund-raising at a competitive disadvantage compared with banks in other European countries.

Capital

I have called attention on several occasions to the strengths of the Italian banking model and the system in which it works: good asset quality; low incidence of operations highly exposed to the international financial crisis; a solid base of retail fund-raising; moderate private sector debt; a financial sector that is not excessive in relation to the real sector; and strict regulations and prudent supervision.

At 30 June, the total capital ratio of the banking system was 10.7 per cent, compared with 10.4 per cent at the end of 2007 and a minimum requirement of 8 per cent. For the five largest groups the ratio was 9.9 per cent, compared with 9.5 per cent at the end of 2007. The financial leverage of these groups, measured as the ratio of total assets to Tier 1 capital, was less than 30, against an average of 40 for the 13 leading European groups.

Partly because their business is more strongly oriented to traditional banking activity, Italian banks enjoy sounder balance sheets. On consolidated data, at the end of 2007 funds raised from non-bank customers were equal to 42 per cent of total assets, against an estimated European average of 38 per cent. Loans amounted to almost 60 per cent of assets, compared with around 50 per cent in the other countries. There is no reason for the mechanical application of identical criteria in widely divergent situations, as some groups of analysts and rating agencies now appear to be demanding.

As international experience has shown, it is illusory to believe that higher capital ratios mean better stock exchange prices. However, we should not forget one of the most important lessons of this crisis, that the financial system of the future must have less debt, more rules and, of course, more capital. We must also consider the need for measures to cope with future necessities stemming from the weakening of the real economy.

It is important that Italian banks, their shareholders and their managers should adopt a pragmatic approach to recapitalization. They must take all possible actions and seize all opportunities to strengthen their capital base: disposals of non-core business, rigorous and realistic decisions on dividend policy, recourse to the market, and use of the resources made available by the Government. All these measures are, in the opinion of the Bank of Italy, consistent with sound and prudent management in the present situation.

Banking foundations

Although the old links have weakened, the banking foundations continue to be major shareholders in Italian banks. They have significant holdings in five of Italy's leading ten groups and own more than 5 per cent of over fifty banks or parent companies.

In the relatively brief span of time since the legislative framework regulating them was consolidated, many foundations have successfully re-interpreted their original mission and managed to establish a role for themselves as attentive institutional investors, vaunting a definite long-term perspective. They have focused on achieving their traditional objectives of social utility and development. They have maintained and strengthened their links with the local community; they have made choices, administered, experimented and innovated. Their shareholdings in banks have supported their profitability and helped them to work towards their institutional goals.

No investor, large or small, is immune to today's crisis. The foundations' wise management during the years of plenty and the precautions written into the regulatory system to safeguard the value of their capital can now help them overcome these difficult times with only limited sacrifice.

As shareholders in banks, the foundations are called upon to show dynamism and foresight in performing their role. They have the chance to accompany Italy's banks on their journey of growth, providing them, as before, with firm roots in the variegated local realities of the country.

Investment funds

The financial crisis has also struck the asset management industry worldwide, causing generalized losses in the value of funds, liquidity strains, problems in evaluating portfolio assets, and substantial redemptions.

In Italy the effects of the financial turmoil have compounded the structural defects of the asset management industry, which I have denounced on many occasions. The Bank of Italy and Consob are taking the necessary steps to implement the measures called for last summer by the working party on the revival of the asset management industry.

There is an urgent need to revise the tax regime. The taxation of accrued gains, instead of realized gains as elsewhere, is a permanent competitive disadvantage that must be eliminated; at a time of large market falls the distortion is especially pronounced. The taxation of accrued gains leads to the accumulation of tax credits, an illiquid and non-earning asset item, constrains the investment of portfolios and reduces their liquidity.

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The crisis has hit a world in which information has never been so detailed and readily available. Today we see that this abundance of information has not brought transparency; rather, it has often hidden opaqueness. Financial intermediaries themselves are aware of a lack of visibility with respect to their counterparties. The effects are paralyzing.

This crisis has upset the paradigms of normal regulatory activity. It calls for pragmatic and courageous solutions, because of its scale, the speed with which it has suddenly spread and grown worse, and its potential repercussions on the real economy.

Important measures have already been adopted in all the leading countries, with a rapidity and degree of international coordination that are without precedent.

The emergency requires the authorities to adopt more interventionist policies than in the past, *inter alia* by acquiring temporary capital interests in financial institutions. The desirability of public intervention to combat a systemic crisis stems from the fundamental characteristics of the financial system: the widespread use of third-party capital; the central role of trust; and the vast impact a malfunctioning financial system is likely to have on the real economy and savers. Government intervention must be temporary and non-intrusive.

Macroeconomic policies must also adapt to the crisis. The prompt easing of monetary policies has helped to diminish the impact of the financial turbulence on the real economy. These efforts are continuing, but, considering the minimum level reached by US official interest rates and the abundant liquidity injected by central banks, the room for monetary policy manoeuvre is shrinking. Supporting demand may require, at global level, anticyclical budgetary policy action.

The measures adopted in Italy have allayed savers' fears and are easing the strains in the interbank market. The solidity of banks' accounts and the clear commitments of the authorities guarantee the stability of the system.

Bank depositors are safe. The commitment to reducing the public debt has not been abandoned. With the temporary support provided to banks in the form of capital, the state will acquire incoming-earning assets; their value will be realized when they are restored to the market.

All the instruments needed for the Italian banking system, much healthier than many others, to return to normality have been prepared. Not in the interest of the banks but in the general interest of households and firms.

Even at the height of the crisis, economic policy must not forget the fundamental problems concerning growth or the structural policies we have long said are necessary. The rapid worsening of the economic cycle makes them all the more urgent; firms, even in these difficult times, must proceed with the restructuring of production.

The Italian economy will suffer from the consequences of the crisis, as will all the other advanced economies. If it exploits its strengths – high savings, low private-sector debt, a lively industrial sector, and a basically solid and efficient financial system – it will come through the crisis relatively unscathed and with good prospects of recovery.