ACRI

Association of Italian Savings Banks

2009 World Savings Day

Address by the Governor of the Bank of Italy

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Contents

1. The new regulation of finance

Conditions in the financial markets have been improving steadily since last spring. Banks are again raising funds in the private bond and share markets. The risk premium indicators are coming down. However, neither risk premiums nor funding costs have come back to their 2007 level, and there is no reason to think this will happen any time soon: the market has not forgotten that the crisis was the consequence of its own recklessness.

Nor is it desirable that it should happen. The magnitude of the economic policy response to the crisis testifies to the severity of the trauma. Things will not be the same as before, and all financial market participants, starting with the banks, would do well to recognize this.

The Financial Stability Board is proceeding with the design of new regulatory arrangements that can give us a financial system with more capital, less debt, controls covering all intermediaries that may potentially generate systemic risk, mechanisms to limit the cyclicality of the financial system, and methods of governance and executive compensation designed to reduce the incentive for excessive risk-taking. In a word, a more prudent and more stable financial system better able to sustain the economy.

We need to introduce new rules to improve the quality of capital and to curb the excesses of leverage, including the imposition of a leverage ratio. There will be major corrective measures to mitigate the procyclical tendencies of the system. Banks will be required to build up a capital buffer during the expansionary phases of the cycle to draw on at times of generalized difficulty. It has already been proposed to mandate a significant increase in the capital charges on trading activities and exposures to securitization instruments.

The Basel Committee has begun work on the comprehensive revision of the notion of regulatory capital. For now, the orientation is towards a restrictive definition of core tier 1 capital, which for public limited companies should be limited essentially to common equity and reserves. All deductions, under this approach, would be harmonized according to extremely rigorous criteria and applied exclusively to the highest-quality capital component. Limited derogations to take account of the specific characteristics of cooperative societies are under discussion.

By the end of the year the Committee will present new provisions on liquidity management and supervision, so that banks can deal with unexpected market stress better than in the past and manage maturity transformation more carefully.

This set of rules will be subject to a detailed impact study in the course of 2010. The rules will be phased in gradually enough not to impede the economic recovery.

In the first few months of 2009 the United States conducted a stress test to gauge the ability of American banks to withstand adverse macroeconomic conditions. Thanks to the publication of the results, which reassured the markets, the US banks involved in the exercise have been able to raise some $150 billion on the market since the beginning of the year. Some of them have repaid the funds obtained from the government in advance.

In Europe, the Committee of Banking Supervisors (CEBS), in cooperation with national supervisory authorities, the ECB and the Commission, recently concluded a stress test of its own on the 22 leading European banking groups. Even under the worst-case macroeconomic scenario, all the groups were found to have an adequate capital endowment (a tier 1 ratio of more than 6 per cent, compared with a regulatory minimum of 4 per cent).

Some European banks too have carried out capital increases. Some have repaid, or forgone, the public funds made available to them for recapitalization.

Lowering the probability and lessening the impact of the possible failure of systemically relevant financial institutions and strengthening the financial system's ability to absorb such shocks are now key objectives of regulators worldwide. Once the institutions have been identified, selective measures will have to be drafted to increase their soundness, to limit if necessary their size and range of business, to strengthen the authorities' crisis-management capabilities and to reinforce the infrastructure of the markets. Action is also being stepped up to shift derivatives trading onto central platforms or regulated exchanges.

Proposals to this effect will be presented to the G20 within the next few months.

The new rules on executive compensation presented by the FSB at the latest G20 summit apply to top management and to anyone who has the power to make decisions with a significant impact on the balance sheet of a bank. They provide that a good part of compensation should be variable, dependent on the bank's performance, but with payment deferred for at least three years and in the form of securities, and with a claw-back clause in the event of unsatisfactory performance by the bank or the executive. The aim of these rules is to counter excessive risk-taking, the pursuit of short-term gain and opacity in compensation. They emphasize disclosure and the control function of the board of directors and the shareholders. Above all, they extend regulatory jurisdiction to the sphere of executive compensation. A first check on their application is scheduled for March 2010.

In March 2008 the Bank of Italy introduced principles and implementation guidelines on this matter that apply to all banks, thus in part anticipating international developments. Yesterday additional criteria for application were notified to all intermediaries. The most important banking groups have been asked to adapt promptly to the latest standards issued by the FSB and to plan any corrective measures by the end of the year.

We are now in a decisive phase. The determination shown by international cooperative efforts in conceiving and drafting new rules for the international financial system must be harmonized at international level and implemented rigorously at national level. Protectionism – above all financial protectionism – is no way out of the crisis.

2. The Italian banks

The Italian banking system has weathered the crisis better than many others, but we must not lower our guard because fragility still remains. Italian banks' capital is above the minimum regulatory requirements. Data for June show that the five largest groups had improved their capital positions compared with the end of 2008. Their total capital ratio, the ratio of total capital to risk-weighted assets, rose by 0.6 percentage points to 11 per cent; their tier 1 ratio rose by 0.7 points to 7.4 per cent. Their core tier 1 ratio – excluding hybrid capital instruments and considering only the highest quality components of capital – rose by 0.8 points to 6.6 per cent. Their financial leverage remained low by international standards.

The rigour the Bank of Italy has applied in its prudential supervision of banks' capital has protected them in this critical phase. A more general revision of the entire supervisory process has been under way for some time: stress tests are an instrument that we now use continuously; specialist inspection teams are constantly present at the largest and most complex banking groups, to analyze specific questions and risk profiles.

We must not overlook the dangers inherent in a still delicate economic situation. Credit quality is deteriorating rapidly. In the second quarter of this year the seasonally adjusted ratio of new bad debts to total loans rose to just under 2 per cent, from 1.6 per cent in the first quarter. The increase was especially large for loans to firms (from 2.1 to 2.6 per cent).

The effects of the recession on banks' profits are already significant. For the five largest groups, although their operating income held up well, their first-half profits fell by nearly 60 per cent compared with the first half of 2008 owing to the increase in provisions against credit risk. Since the beginning of 2009, financial analysts have repeatedly revised their profit forecasts downwards. Earnings are expected to recover only in 2011, and even then they will remain below the results achieved in 2008.

It is essential that banks allocate a significant volume of resources to strengthening their capital bases. They must use all the instruments available to increase their capital. They have already begun to do so, with public recapitalizations, the recourse to the private capital market, and asset sales.

Italian tax rules set strict limits on the deductibility of loan writedowns from taxable income, stricter than those in force in other major European countries. This leads to substantial deferred tax assets that, looking ahead, new regulations will not allow to be included in banks' regulatory capital. We hope that the willingness of the Government to re-examine these aspects of the tax rules, in relation to the performance of the moratorium on bank debt, will be translated into concrete measures that will remove this obstacle to the expansion of credit.

The changes on the horizon of the international regulatory and market landscape closely concern Italian banks.

Under the new arrangements that will prevail at global level, much more capital will be needed than in the past. It will have to be attracted and remunerated in an earnings setting that will be constrained by greater competition. This strategic challenge can only be won by banks able to improve the quality of their services and increase their efficiency.

Italian banks have already demonstrated in years past that they can increase productivity. Comparisons made by the Bank of Italy and the Bundesbank show how technological progress and the achievement of economies of scale through concentrations fostered an increase in banking sector productivity in both countries in the decade that began in the mid-1990s. But productivity in Italy, initially lower, grew at a higher average annual rate (about 3 per cent) than in Germany, benefiting among other things from the privatization process under way in that period.

Italian banks must also win another strategic challenge. They came out of the crisis fundamentally unharmed; they must turn this favourable position into an edge over their competitors and a benefit for their customers.

3. Transparency and the protection of savings

The Bank of Italy is responsible for overseeing the transparency of banking products. This responsibility is entrusted to the Bank by law, it is part of the protection that lawmakers have established for savings: entered into the credit circuit, these savings are the fundamental ingredient in the financing of growth. Without customer confidence, based on adequate transparency, this mechanism does not work, growth languishes.

a. The cost of current accounts

The surveys made by the Bank of Italy show that the average cost of bank current accounts has been basically stable. The cost varies considerably around the average, equal in 2008 to €114. Other things being equal, accounts opened more than two years ago cost more than those opened more recently. There is room to improve the conditions to which customers are subject.

b. The cost of credit facilities and overdrafts

The recent legislative measures on the costs of credit facilities and overdrafts have produced some of the desired effects: banks have changed the structure of fees, also with a view to recouping the lost income from items that have been banned by law. The initial results of a survey we recently conducted indicate that the fees introduced this year following the legislative measures are generally less costly than before for customers; nevertheless, in about a quarter of the cases examined, the new fees are higher than those in place at the end of 2008. Banks must rapidly, drastically and definitively simplify the structure of commitment fees.

Since August the new instructions for calculating the average percentage rates for the purpose of preventing usury envisage the inclusion of all the charges borne by the customer for the disbursement of credit, including costs that had previously been excluded, such as the maximum overdraft fee, where it is still applied, commitment fees and some insurance and broking charges.

For some categories of transaction, the explicit inclusion of these new items has a significant impact, producing threshold rates that are higher than in the past and more representative of the economic terms and conditions applied to customers. This will make it possible to counter circumvention of the usury thresholds and also to curb the amount of ancillary costs.

c. New rules on transparency and correct conduct

In July we issued new rules on the transparency of banking services and correct conduct in relations with customers. The use of composite indicators for current accounts will allow customers to compare the costs of the different offers available on the market; the year-end account statements will contain a specific invitation to customers to verify the advantageousness of their existing accounts via the Internet or at their bank. The cost of credit facilities will be made more comprehensible, among other things by enabling customers to calculate and compare in advance the potential cost of the overdraft.

It is not easy to combine simplicity and completeness of information to customers when the products offered are diversified and complex. The new rules pay special attention to the less sophisticated customers: standardized documents that can be read at different levels; costs of services clearly indicated; a "simple current account" for the basic banking customer, with a fixed yearly account fee; an all-inclusive year-end account statement; practical guides showing consumers how to choose the current account or mortgage that best suits their needs.

d. The Arbitro Bancario Finanziario

The Arbitro Bancario Finanziario (ABF) became operational on 15 October when the Bank of Italy appointed the members of the three panels established in Milan, Rome and Naples. This new disputes review body can help to improve the substantive balance between the contracting parties and raise the level of satisfaction of banking and financial service users.

The ABF will examine the merits of the intermediary-customer relationship; orient the conduct of intermediaries towards higher standards of correctness and transparency; and, by well-organized, efficient handling of complaints that is attentive to the customer's reasons, give intermediaries an incentive to pursue preventive settlement of disputes.

Appeals to the ABF can be presented at all the branches of the Bank of Italy; special operating units perform the function of technical secretariat for the panels, evaluating whether the documentation submitted by the parties is complete and proper, and carrying out the inquiry. An information campaign on the ABF is now under way with a dedicated website and widespread distribution of informational material for customers.

In this way, we are completing our array of initiatives for the effective improvement in relationships between intermediaries and customers. The Community Legislation Implementation Law for 2008 delegates powers to the Government for the comprehensive reordering of the legislation on relations between banks and customers. The numerous legislative measures of the past years can be set in a systematic framework that clearly affirms the principles of consumer protection, fills in normative gaps, avoids unjustifiable disparities in the treatment of similar matters, and strengthens the sanction apparatus.

As I recalled in my earlier testimony before the parliamentary committee of inquiry into the mafia and other criminal organizations, during periods of crisis – when firms and the financial system are most vulnerable to criminal infiltration – action against money-laundering must be even more vigilant and vigorous.

Strict compliance with the anti-money-laundering rules is not only a legal obligation; it is also vital to banks' reputation. The Financial Intelligence Unit and the Bank's Supervision Departments have stepped up their controls, including at bank-branch level: the complementary relationship between prudential supervision and the fight against money-laundering is being implemented within the Bank's own organization. Collaboration with the judiciary and the finance police continues to be efficacious.

But only if top management itself fully takes up the aim of combating crime can banks establish the organizational arrangements that provide the chief defence against money-laundering.

In connection with the so-called fiscal shield for the disclosure of foreign assets, an interpretative measure is called for to clear up all uncertainty over intermediaries' obligation to report suspicious transactions and reaffirm the regular application of the anti-money-laundering legislation.

4. The role of the banking foundations

The foundations have been an anchor for Italian banks.

They have accompanied them through the worst storms of the financial crisis, strengthening their capital and reserves; they are supporting them now in the weak recovery that is projected. Many have accepted sacrifices in the short term, thus contributing to the soundness of the system, the ability of banks to supply credit to the economy, and the enhancement of their own investment in the long term.

The crisis has shown how the foundations can go beyond the function expected of institutional investors, which have an authoritative voice while clients are entrusting them with savings to manage, but their voice fades and dies away when savings are withdrawn.

The foundations' voice does not follow the ups and downs of the markets, and their gaze tends to focus on the medium-long term. The crisis has clearly demonstrated the limits of the short-term view, dominated by the rush towards higher and higher returns and exorbitant management fees, which in general have now fallen.

Following the important mergers of two years ago, the Italian banking system needs stability to meet the management and strategic challenges that exiting the crisis will pose. It needs the Foundations to continue to accompany the strengthening of capital and reserves and to persevere in the role of shareholders who are present but do not interfere with management, which has been the basis of their success in recent years.

The Bank of Italy hopes that the Foundations will continue to demonstrate the same farsightedness that kept them tied to their traditional strategic values at the height of the crisis, and that they will be able to take the long view and contribute to the development of a sound banking system ready to face the challenges of international competition.

5. Overcoming the recession and returning to growth

Thanks to the powerful support provided by economic policies, the world economy has resumed growing, albeit at modest rates that vary regionally. According to the latest IMF forecasts, world output, after falling by more than 1 per cent this year, should increase by around 3 per cent in 2010; the expansion will be fairly moderate in the advanced economies, robust in the emerging and developing countries.

The downward spiral of our economies in late 2008 and the early part of this year has halted. We are less certain that a truly lasting recovery is under way, one that rests on more than the extraordinary support of economic policies.

In Italy, industrial production has contracted by a quarter since March 2008 and GDP by 6.5 per cent; we are back to the level of twenty years ago in the first case, almost ten years in the second. But the most acute phase of the crisis is now past: GDP resumed growth in the third quarter after falling constantly for over a year. Although, opinion polls have suggested a more favourable outlook since the spring, the signals coming from the quantitative indicators, particularly domestic demand components, remain weak.

Household consumption decreased by 2 per cent in the year to September, owing to the contraction in real disposable income and the deterioration in labour market conditions. Over the same period employment fell by 3.3 per cent (650,000 jobs), while the ratio of hours of Wage Supplementation to total hours worked rose from 1.5 to 10 per cent of total hours worked. Presumably, more jobs will be lost in the closing months of this year.

Investment fell by 15 per cent in the same period. Firms' opinions regarding the conditions for investing, although less pessimistic in our September survey than a few months earlier, do not indicate a strong upturn.

None of the contractions in output recorded during the various recessions that Italy has experienced since World War II was as large as on the present occasion, and yet it never took less than two years re-gain the pre-recession levels. This time, the recovery could take even longer.

Economic history teaches that recessions caused by financial crises are longer lasting. Today, we in Italy have the advantage of a lower level of private debt than other economies and a banking system that has not been damaged directly by the crisis. However, we do need to tackle the structural weaknesses of our economy in order to build a lasting recovery that is not founded on exports alone.

A year ago, on this same occasion, I stressed that the sudden worsening of the crisis necessitated to introduce measures to support demand and the income of the worst-hit social groups, but always with an eye to the constraints imposed by our large public debt. Now, the most urgent need is to resume the path of reform to bring the country back, in the years to come, to a high rate of economic growth, which is also the best guarantee of financial stability.

6. Financing the Italian economy

There is no sign of a turning point in lending, as yet. In Italy, lending to business decreased by 3 per cent on an annual basis in the third quarter of this year; lending to households continued to expand, but slowly. The deceleration was particularly sharp in the case of the leading banking groups, the main users of the international wholesale liquidity markets.

The refinancing difficulties experienced by the banks have been attenuated, partly thanks to government support and Eurosystem operations, and their liquidity situation is returning to normal, according to the latest results of the weekly monitoring exercise instituted by the Bank of Italy in the autumn of 2007.

A difficult economic situation reduces the demand for credit, while its supply also becomes tighter. This phenomenon was very evident during the worst of the crisis, but now shows signs of easing similar to those found for the euro area as a whole in the ECB's latest Bank Lending Survey.

The reduction of Eurosystem interest rates led, in Italy, to a generalized lowering of the rates applied to households and firms, similar in scale and pace to the rest of the area. In September, the average cost of short-term loans to business was 4 per cent, almost 3 points lower than a year before; variable-rate mortgages for households was cut by more than half, to 2.3 per cent. The average cost of fixed-rate mortgages fell by one point, to 4.9 per cent. In some sectors, however, notably consumer credit, the cost of borrowing in Italy continues to be higher than in the rest of the euro area.

In exceptional situations such as the present, variations in creditworthiness are considerable, especially among firms. The banks' ability to make the right selection of borrowers becomes crucially important.

The crisis overtook our productive system at a time when certain sectors were undergoing a laborious reorganization, begun in the middle of this decade. This process must now resume, more intense and widespread than before, so that the Italian economy can at last make up the ground lost over the last fifteen years. The firms forced to break off the process by market and financial difficulties and those pondering whether to begin it must not be deprived of the intelligent, prudent and selective support of credit. This is the greatest contribution that the banking system is called upon to make in order to re-launch our economy.