

ASSIOM FOREX

Speech by the Governor of the Bank of Italy  
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Parma, 18 February 2012

Last November the spread between the yield on ten-year BTPs and their German equivalent reached 550 basis points; yesterday at the close it stood at 365 points; in the first six months of 2011, it had been mostly below 200 basis points. Tensions remain high in the international financial markets. The difficulty in resolving the Greek crisis, evident again in recent days, is transmitting turbulence to the entire European market. Investor uncertainty over Italian government securities has eased with respect to the worst moments of the crisis, but has not disappeared.

The markets' attention is now focused on Italy's ability to make further determined progress in the restoration of its public finances and simultaneously stimulate its economic growth potential through structural reforms. The path has been set with clarity of purpose; international public opinion acknowledges as much; it must now be followed with perseverance and resolution. But no-one can succeed on their own. To lower the risk premiums on the government securities of the countries engaged in financial stabilization and the revival of output, decisions must be taken by common accord. The determination of all to reinforce the European construction is essential.

In recent months Italy's economic policy has taken steps towards financial sustainability which were once deemed inconceivable, for example regarding the pension system. Equally bold steps are expected on other, decisive fronts, to which the Government is already committed: the efficiency of the taxation system and the fight against tax evasion; the public sector spending review, which will analyze every item to identify possible redundancies and savings; and the simplification of laws, institutions and practices that are blocking the country's energies, reducing firms' competitiveness and frustrating the expectations of the younger generations.

## **1. The sovereign debt crisis and the outlook for Italy**

For two years now the global financial crisis has found a new and dangerous focus in the euro area. The turbulence was initially confined to Greece, whose budget situation had long been obscured by the official statistics; it then spread to Ireland, which suffered the consequences of the profound crisis in its banking sector, and to Portugal, penalized by its foreign trade deficit.

The limits of euro-area governance have become apparent. Multilateral monitoring of national economies failed to ensure sufficiently prudent budgetary policies in good times, and underestimated the macroeconomic imbalances of several countries. The initial lack of satisfactory

instruments for managing and resolving sovereign debt crises has been compounded by the faltering and scarcely effective progress of the Greek aid programme and the drawn-out negotiations for governance reform.

Tensions in the financial markets assumed systemic proportions from the summer onwards, following the announcement of private-sector involvement in the proposed resolution of the Greek crisis, despite this being presented by the Eurogroup as a unique and exceptional case. The turbulence spread to Spain, which suffered the consequences of a fall in property prices, and Italy, with its high public debt and weak growth prospects in the medium term.

The financial markets, which had long underestimated the possibility of default by a sovereign issuer in the euro area, to the point of tacitly ruling it out, now began to give excessive credit to this scenario, involving countries whose fundamentals warranted less negative assessments. The markets – operators, analysts – clearly struggle to produce a sound interpretation of all the available information, which is sometimes incomplete or lacking in transparency; above all in the phases of acute uncertainty, operators tend to engage in the kind of herd behaviour that fuels financial contagion. In turn economic policy – particularly in the institutional context of the single currency – is hard put, in its regulations and interventions, to respond rapidly to fluctuations in the prevailing opinions in financial markets, to curb excesses, and to channel its response towards a stable and effective equilibrium.

To assess sovereign risks in a timely and independent fashion, taking account of the conditions and prospects of the public finances, the level and trends in private sector debt, and countries' growth prospects, is clearly no easy task. It requires the commitment of very substantial resources and the rating agencies have not always been up to the mark. Appropriate standards must be defined; there is a need for transparent working relations between the agencies and independent, national and supranational institutions, charged with carrying out analogous assessments.

The measures adopted by Italy during the summer to bring budget balance forward to 2013 and the acceleration of the EU governance reform process with the definition of the “Six-Pack” in the autumn, did not succeed in alleviating the tensions in the financial market. Instead, the concerns over the adequacy of the European financial support mechanisms and the fears over the weakening of the international economy prevailed.

There was a sharp worsening of wholesale funding conditions for banks in Italy and the other countries exposed to tensions, whose creditworthiness has been treated as equal to that of

their respective governments. US money market funds basically stopped buying commercial paper; unsecured bond issues dried up. Strong fears were aroused by the large volume of bank bonds maturing in the first part of 2012. In Italy, as in other euro-area countries, funding difficulties were increasingly affecting credit supply conditions. There was a real risk of a severe restriction of funding for the economy.

The Governing Council of the European Central Bank lowered the rate on the main refinancing operations rate by 25 basis points in November and again in December, bringing it down to 1.0 per cent. In December, the Council also introduced three-year refinancing operations, announced an expansion of the range of assets eligible as collateral, and halved the compulsory reserve coefficient. Carrying out its function as supplier of liquidity to the banking system with determination, the ECB countered the banks' fund-raising difficulties and the restriction of credit.

The action of the ECB, the incisive budget measures taken in the countries suffering from the worst financial turmoil, and the reaching of an agreement for stronger cooperation under the fiscal compact have succeeded more recently in easing the strains in the government securities market and in banks' balance sheets.

Monetary policy alone cannot resolve the crisis. Along with a consolidation of public finances there must be structural reforms for vigorous and balanced growth; the rules of the fiscal compact must be rapidly implemented. The financial support mechanisms at European level must be made to work with greater agility and more effectively; the adequacy of their intervention capacity must be ensured. The threat of dangerous contagion must be definitively dispelled by resolving the problem of Greece.

In Italy the three budget correction packages passed between July and December 2011 should lead to a primary surplus on the order of 5 per cent of GDP in 2013 and a reduction in the debt ratio. The adjustment will come mainly from an increase in revenue but expenditure savings will increase over the three years 2012-14. The pension reform will immediately reinforce the financial sustainability of the pension system by setting stricter requirements.

In the medium term the Italian economy's capacity for strong and stable growth must be restored, by making firms more competitive. GDP is still 5 points below the level reached in 2007, before the crisis; households' real disposable per capita income is down by 7 points and industrial output by a fifth. The deficit on the current account of the balance of payments remains large.

The reforms decided must be rapidly completed and put into effect, in particular those to make the regulatory and administrative structure favourable rather than unfriendly to economic growth: the liberalization of important service sectors, the effective simplification of administrative acts, the better functioning of the labour market, special attention to human capital and innovation, and faster responses by the judicial system. Even if the effects of individual interventions will arrive gradually, a comprehensive and wide-ranging plan can have a positive influence on expectations in the short term and so stimulate aggregate demand and a recovery in investment.

The point is to create favourable conditions for those who invest and create jobs in Italy not with subsidies but by furnishing suitable intangible infrastructure; not through the shadow economy but by cracking down on tax evasion. Society pays a high price for corruption and crime in general in the form of deteriorating civic life and lost economic development. Combating them, and especially their financial implications, will remove one of the brakes on growth.

Economic growth favours the consolidation of the public finances, which in any case are already on a sustainable path, even under unfavourable assumptions concerning growth and interest rates. With modest real growth of around 1 per cent and a spread on ten-year government bond yields stable, if high, at 300 basis points, primary surpluses of 5 per cent of GDP, as forecast for 2013, will reduce the debt ratio by more than is required by the new European budget rules.

This year will be a year of recession. As we indicated in the forecasting scenarios set out in our *Economic Bulletin* in January, we expect a year-on-year decline in gross domestic product of about 1.5 per cent. But it is important to look ahead, to act in such a way that as conditions in the financial and credit markets return to normal it will be possible to stabilize economic activity in Italy already by the second half of 2012 and return to growth next year.

## **2. Bank liquidity, the extraordinary measures of the Eurosystem and credit to the economy**

Italian banks are sound, but they have been especially hard hit by the sovereign debt strains. Since last summer short-term fund-raising in dollars and funding on the bond market have slowed to a trickle, while the fall in government securities prices and the raising of margin requirements by the main lenders have limited the banks' access to repos.

One factor in market instability and the consequent funding difficulties has been the operation of automatic mechanisms. This occurred, for instance, on 9 November, when the French central counterparty, LCH Clearnet SA, drastically raised its margin requirements against positions in Italian securities, in line with the sovereign risk framework of the British member of the Clearnet Group. Italy's Cassa di Compensazione e Garanzia, linked to Clearnet through an interoperability agreement, had to adapt in order to avoid jeopardizing the orderly functioning of the market. Afterwards, the competent authorities asked the two central counterparties to review the decision and to develop a common methodology for assessing sovereign debt risks. The process must be based on an adequate statistical base, avoid automatic links with rating agencies' assessments, and curb the potential pro-cyclical effects.

In the course of 2011, while residents' deposits and bonds held by households remained stable, Italian banks' overall fund-raising from customers and the markets slowed and from November started to contract. For 2011 as a whole, it declined by 2.8 per cent. At the same time, the banks' recourse to Eurosystem refinancing increased considerably. A real risk was emerging that the difficulties of raising funds in the international markets would result in a contraction of lending, aggravating the cyclical downturn and inevitably triggering feed-back effects on the banks' balance sheets.

Until November Italian banks' lending to the non-financial private sector continued to expand, although at diminishing rates. In December, however, loans to firms contracted by about €20 billion. The decline is very large by historical standards, although it may have depended in part on the usual volatility of end-year data. Lending to households diminished only slightly. Preliminary data indicate a slight further contraction in credit in January.

Certainly firms' demand for credit has declined, given the poor state of the economy, but surveys of banks and firms indicate a tightening of credit supply terms as well. The Italian banks participating in the Eurosystem's quarterly Bank Lending Survey confirm that the rise in lending rates and the strains on credit supply are due mainly to serious difficulties in raising funds in the markets as well as to growing credit risk.

Firms are now facing the second tightening of lending terms within just a few years. Once again the banks' ability to assess creditworthiness correctly and not withdraw financial support from solvent, creditworthy customers will be crucial. Adequate and stable lending volume is essential to the banks themselves.

In its first three-year refinancing operation on 21 December, the Eurosystem supplied banks with a total of €490 billion. Considering the contraction in the volume disbursed through other operations, the net increase in the resources provided to the banking system amounted to about €200 billion. This liquidity is circulating. Most of the funds re-deposited with national central banks did not come from the same banks that had obtained them from the Eurosystem.

With this first three-year operation, Italian banks received gross funding of €116 billion, corresponding to net refinancing of €60 billion. The inflow of long-term liquidity substantially eased the funding tensions. The second three-year refinancing operation, scheduled for 29 February, will further sustain the supply of credit.

The operations of the Eurosystem are currently on a full allotment basis; banks' refinancing capacity accordingly depends on the availability of collateral. In recent months Italian banks have significantly increased the collateral pool at the Bank of Italy, to about €280 billion at the end of January. Their eligible uncommitted assets on the same date are estimated to have amounted to €77 billion after the application of haircuts. Since the total exposure to the Eurosystem amounted to about €200 billion, the Italian banking system's capacity for further refinancing can be estimated at more than €150 billion.

Following the recent decisions of the ECB's Governing Council, we have joined other national central banks in announcing measures aimed at further expanding the range of assets banks can use as collateral for refinancing operations. In just a few days Italian banks will be able to deposit a broader range of bank loans meeting clearly defined eligibility criteria, with the Bank of Italy bearing the related risks.

To reconcile the objective of increasing banks' access to refinancing with the need to preserve the solidity of the central bank's balance sheet, the new eligible collateral will be selected rigorously. In particular, it will include bank loans with a very low probability of default, not exceeding 1 per cent. As a result of the above changes, once haircuts have been applied, Italian banks' total eligible assets will increase by another €70-90 billion to a little under €450 billion. This may permit a progressive reduction in the importance of government-guaranteed bank bonds, the volume of which is about €60 billion after the application of haircuts.

The introduction of new collateral eligibility criteria and the ample supply of long-term liquid funds are helping to restore a uniform transmission of monetary policy in the various euro-area countries.

The injection of three-year liquidity has already helped to attenuate the tensions on the money market. Compared with the days preceding the operation, three-month and one-year Euribor rates have fallen by about 40 and 30 basis points respectively, largely owing to the reduction in risk premiums. After rising to as high as one percentage point, the differentials between the overnight rates on the interbank markets of the countries most severely affected by the tensions and the euro-area average have fallen to zero.

The spreads on credit default swaps for Italian banks have also fallen significantly, although they remain higher than they were up to the middle of 2011. At the end of January a large Italian bank returned to the international market with an issue of unsecured bonds that was favourably received by investors; the yield was not significantly higher than that on Italian government securities.

### **3. Banks' profitability and capital strengthening**

In 2009 the financial crisis and the recession caused a sharp fall in Italian banks' profits. In contrast with what happened in the other main European countries, the recovery in 2010 and 2011 was modest and the outlook for this year is not good.

Banks' profit and loss accounts are affected in the first place by the difficulties facing a large part of Italian industry. In addition to these cyclical problems, Italian banks are faced with others of a more structural nature related to the relatively limited diversification of their sources of income and the high level of their costs.

Low profit margins reduce the resources with which to strengthen banks' capital and make it more difficult to raise funds on the market, thus diminishing the ability of the banking system to support the economy. Profitability can be increased by improving the quality of the services supplied, thus permitting revenues to be expanded and diversified. The progress of technology and the public's growing ability to use it can foster a rationalization of production processes and distribution networks; significant cost savings can also be achieved by simplifying corporate governance.

The medium-term objectives for profitability must be revised taking into account the far-reaching changes that have occurred in recent years. Profit levels such as those seen in some parts



of the international banking industry before the crisis are not compatible with the stability of the financial system. More efficient and stable banks can raise capital more cheaply.

Basel III requires banks to operate with more and higher quality capital than in the past; in periods of rapid credit expansion it requires them to build countercyclical capital buffers; it sets a limit on their leverage ratio; and it introduces new liquidity ratios, so as to make banks' balance sheets more resistant in the short term and better balanced in the medium term. Additional capital requirements are now planned for banks that could pose a threat to global systemic stability if they were in difficulty; effective and credible resolution mechanisms in the event of a crisis, including clear provisions on burden sharing, are likely to avoid costs being charged to the public or reduce them to a minimum.

The new regulatory framework confirms the favourable treatment of loans to small and medium-sized enterprises already established by Basel II. In many cases such firms have opportunities to grow. Lending to well-capitalized firms deemed to be able to exploit economies of scale or scope carries lower capital charges for banks that use internal rating systems, so that loans can be granted at relatively low interest rates.

In the years leading up to the crisis we saw just how damaging a race to the bottom between financial systems in both regulation and supervision can be. Therefore, when Basel III is transposed and implemented in the EU and in the other G20 countries, its objective of creating a level playing field for all banks must be fully respected.

We have asked Italy's leading banks to strengthen their capital considerably in recent years. They have complied, even in difficult times, mainly by raising funds, to a value of almost €20 billion, on private capital markets.

Much ground has been covered in just a few years. The core tier 1 ratio of the five largest banking groups has reached an average of 9.5 per cent of risk-weighted assets, compared with 5.7 per cent at the end of 2007, on the eve of the crisis. The gap, now narrower, that remains between the capitalization of our leading banks and the average capitalization of their main foreign competitors partly reflects differences in the way risk-weighted assets are calculated in the various systems. Work to reduce these differences, which we strongly support, is now under way at international level and will include peer review mechanisms. In Europe, the adoption of the single rulebook will be a step in the same direction.

When evaluating banks' capital adequacy we also take account of their overall leverage. From this point of view, Italy's banking system is extremely sound. The ratio of total balance-sheet assets to tier 1 capital of our leading banks is less than 20, against an average of 33 for the principal European banking groups.

The Recommendation on banks' capital issued by the European Banking Authority on 8 December as part of a broad package of measures approved by the European Council at the end of October aims to enhance the system's ability to withstand the high sovereign risk tensions and potential additional shocks. It does not change the current prudential and accounting rules; it does not discourage investment in sovereigns as the capital buffer against sovereign risk relates to exposures at the end of September. The EBA's Recommendation calls for a strengthening of capital, not a reduction of assets.

The measure was decided in exceptional circumstances, necessitating a difficult trade-off between dispelling, firmly and promptly, any market doubts about the soundness of European banks and avoiding pro-cyclical effects. The EBA and the national authorities have repeatedly emphasized that the Recommendation is a temporary measure and will not be repeated. The EBA has decided to postpone the next stress test exercise on the European banking system to 2013.

The optimal sequence for the measures taken by the European Council would have been to strengthen the EFSF and make it fully operational and to activate the system of European public guarantees for new medium- and long-term bank liabilities before or at the same time as the EBA issued its Recommendation. Had Europe's intervention capacity been reinforced immediately, this would have reduced uncertainty over the course of the sovereign debt crisis in Europe and thus improved both the valuation of sovereign bonds and the banks' ability to raise funds on the market. The EBA has agreed to re-examine the need for a sovereign buffer once the EFSF is up and running and sovereign bond prices are picking up.

The Italian banks that took part in the EBA exercise can strengthen their capital base as required without reducing their lending to the economy. One leading bank has already successfully completed a large capital increase, which alone will cover nearly all its capital requirements and make good almost half of the Italian banks' overall capital shortfall. The capital strengthening must proceed, however. We expect the banks' forthcoming decisions regarding their dividend policy and executive compensation to take account of this. The Bank of Italy is about to issue guidelines to the banks in this regard.

It is important that the banks prepare for the introduction of Basel III, which will be phased in between next year and 2019. Experience of recent years has shown that it is within the banking system's capacity to achieve a reasonable strengthening of the capital base.

#### **4. Banking competition and customer protection**

In a legal order that recognizes the entrepreneurial nature of banking, competition is the most effective means of protecting savings and safeguarding customers, to the benefit of the system's stability. In addition to prudential supervision, the Bank of Italy is entrusted with tasks and responsibilities concerning transparency and correctness in bank-customer relations as regards banking products. In recent years we have significantly stepped up our commitment on this front.

In the face of inefficiencies, it is necessary to shun the temptation to impose price caps or prohibitions on banks; however commendable the intent, these would merely scratch the surface of the problems, determining non-optimal pricing policies, impeding innovation and in some cases even reducing competition. Competition develops if the market is transparent, supply is diversified and switching costs are low – all necessary and mutually reinforcing factors.

This is the thrust of the measures introduced by law in recent years: cost-free withdrawal from all contracts of indeterminate duration with banks, hence including current accounts; portability of real-estate mortgage loans; simplified procedures for transferring mortgages.

The rules laid down by the Bank of Italy in exercising its powers of customer protection have the same thrust. We have demanded greater clarity and comparability of the information provided by banks, especially on the costs of their products. Measures have been introduced to make the costs of loans and current account overdrafts more transparent and comparable. Banks have been warned on more than one occasion that they must comply with the substance of these rules, and enforcement action has followed.

Among the latest legislative measures, the prohibition on simultaneously holding corporate office in competitor firms is intended to prevent the risk of collusive conduct in boards of directors; the measures that favour the use of electronic payment instruments aim at reducing the use of cash, as in the other European countries; the terms and conditions applying to loans and breaches of overdraft ceilings will be more transparent. The Bank of Italy is in full accord with the spirit of

these measures and is prepared to do its part for their implementation by rapidly overcoming any doubts of interpretation regarding the exact scope of some prohibitions.

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The Eurosystem will continue to counter the malfunctioning of the markets and provide support to bank liquidity and lending. But to bring government securities prices back to levels consistent with the fundamentals of the euro-area economies, thereby eradicating the chief cause of the difficulties of the banking system, it is essential that national policies continue to be directed to stability and growth, which are not conflicting objectives, and that the reforms of European economic governance be implemented swiftly.

The abundant liquidity made available by the Eurosystem in December and with the upcoming end-of-month operation, though not a cure in itself, is nevertheless crucial in the present phase. It has averted the imminent risk of an acute funding crisis with repercussions on credit and severely destabilizing consequences; it makes it possible to maintain a high level of financing for the economy.

Banks will have to demonstrate that they are able to perform their credit allocation function well, under conditions of sound and prudent management, with keen discernment. Their very *raison d'être* demands it; it is essential that the economy not be starved of credit, allowed to waste away, dragging down the prospects of the banking system with it. At the same time, it is necessary to intensify the efforts to strengthen balance sheets and eliminate the structural problems that weigh on the efficiency and profitability of the Italian banking system.

We firmly believe that we both can and must have confidence in the ability of our banks to rise to this challenge; and we are equally confident that an economic policy aimed at financial stability and directed to promoting an environment conducive to balanced growth will allow greater opportunities for investment and a rapid return to creating new permanent jobs.