ACRI

Association of Italian Savings Banks

2012 World Savings Day

Address by the Governor of the Bank of Italy

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1. Savings and the financial system

Savings constitute a fundamental raw material for the balanced development of a country, making it possible to finance investment without running an external deficit. Savings make households less vulnerable to cyclical downturns, so that they can look to the future with confidence.

In Italy the saving rate – traditionally one of the industrial world's highest – has been diminishing for over twenty years. Since the onset of the crisis the decline has sharpened. The share of national income saved is now below the European average: under 17 per cent, about 4 percentage points less than in the middle of the last decade, compared with 22 per cent in Germany and 18 per cent in France.

The decline in the saving rate is due above all to decreasing saving on the part of households. Households can rely on bank loans more than in the past. At the end of 2011 outstanding consumer credit was equal to 11 per cent of households' disposable income and mortgage loans to 32 per cent, about three times the values recorded in the late 1990s. A second major factor in the diminishing propensity to save is a fall in real household income of 9 per cent over the last five years, after rising modestly in the decade preceding the financial crisis. Italian households have buffered the impact on their consumption habits by drawing on their accumulated savings and reducing new saving. In France and Germany, by contrast, households' disposable income and consumption have risen, if only slowly, over the entire period.

Households are finding it harder to set aside the amount of resources they would like to in order to cope with the risks to jobs and future income. Istat's surveys have found that since the first half of the last decade the share of households wanting to save has risen by 15 percentage points to 90 per cent, while the share of those able to do so has fallen by 10 points to 26 per cent. The gap is widest for the older and the younger households, and among the latter above all for the better educated, those with fixed-term jobs, and tenants.

There is the risk of a vicious circle: economic growth is slow, saving capacity is reduced, households are more uncertain and discouraged, growth weakens further. In the past year the decline in household and business confidence has come on top of the direct effects of heightened sovereign risk and the consequent tensions in the credit market, the public finance adjustment measures and the slowdown in world demand. For the economy to return to its potential growth path, to the benefit of saving capacity, the gradual easing of these effects must continue and strengthen.

The state of saving and its function within the economy also depend on the health of the financial system, which is central in putting its formation in relation with its utilization, in distributing funds from place to place and from today to tomorrow, ensuring that funds reach those who deserve them and removing liquidity constraints.

The Italian financial system has not suffered from the hypertrophy, the periods of tumultuous expansion, that in other countries were conducive to improper behaviour and generated uncontrollable imbalances. In 2011 the assets held by financial institutions were worth 3.5 times GDP in Italy, 6 times GDP in the euro area as a whole, 14.5 times in the United Kingdom and 23 times in Ireland. Between 2001 and 2011, the nominal value of these assets increased by nearly 90 per cent in Italy, 110 per cent in the euro area, 160 per cent in the UK and 240 per cent in Ireland. The Italian financial system is far removed from the excesses that have marked other countries as regards the interconnection of financial institutions, a characteristic that may entail high risk.

Episodes of improper conduct, however serious, have not dented the stability of the system. The Bank of Italy is intransigent with respect to mismanagement; it uses all the instruments at its disposal, including extraordinary measures, to avoid irregularities, to contain their repercussions on consumer confidence and the soundness of banks, and to favour the optimal allocation of savings.

The reform of financial intermediation that was initiated in 2010 for non-bank institutions providing credit, financial agents and loan brokers is designed to favour the market presence of professional operators, reliable and diversified distribution channels and more effective supervision through specialized entities. The primary legislation in this field is now complete. The full rationalization of the sector and effective supervisory action now depend on the issue of the necessary ministerial measures.

The financial system’s main counterparties – households and firms – are not suffering from serious imbalances in Italy. The net wealth of Italian consumer and producer households is high by international standards and is associated with low debt. The ratio of households' financial debt to disposable income is 65 per cent in Italy, above 80 per cent in France and Germany, and nearly 100 per cent in the euro area. The vulnerability of the 2 per cent of Italian households that have to sustain debt service of more than 30 per cent of income depends strictly on cyclical developments and the state of the labour market, and it has been attenuated by programmes of support for households in difficulty, such as the debt moratorium agreed on by the Italian Banking Association and consumer organizations and recently extended to January 2013.

The financial debt of Italian firms amounts to about 80 per cent of GDP, some 10 percentage points more than in Germany but over 20 points less than in France, almost 30 points less than in the UK and over 50 less than in Spain. However, corporate balance sheets are suffering from the impact of two recessions within the span of just four years and the consequent decline in profitability to a twenty-year low. Despite low interest rates, financial expense now absorbs over one fifth of internally-generated resources.

In the course of the year some faint signs of improvement have emerged. The lengthening of payment terms between businesses has ceased, and large corporations have resumed issuing bonds. Financial analysts' forecasts and the most recent business surveys point to an attenuation of the pessimism over the outlook for economic activity, especially exports.

In very difficult times the Italian financial system has continued to function as a fundamental infrastructure for the economy. In the early part of the crisis the Italian system was less severely affected than those of other countries, having practically negligible recourse to government support, far less than other banking systems. The latest survey by the European Commission found that as of last June public capital injections into Italian banks amounted to 0.2 per cent of GDP, against 5.2 per cent in the Netherlands, 4.3 per cent in Belgium and 1.8 per cent in Germany. Here, in contrast with other countries, the banks suffered from, did not cause, the deterioration in the public finances. The sovereign debt crisis is still limiting their access to wholesale funding.

The Bank of Italy's controls and supervisory practices, banks' low exposure to structured finance products, and the absence of a real estate bubble are what underlie the stability of the Italian banking system. These factors explain the lesser need for government intervention. However, the banks are suffering from the protracted economic recession. To preserve their ability to finance the economy, they must take full advantage of the scope for increasing efficiency.

2. Credit and the banking system

The deleterious spiral linking the sovereign debt crisis, banks' access to funds, credit availability and economic growth must be broken once and for all. The measures decided by the ECB Governing Council, together with those adopted by governments at national and European level, are already having positive effects. But we still have not reached a definite turning-point.

The growth of bank lending remains negative. In the three months to September the annualized contraction in loans was 3.5 per cent for firms and 0.8 per cent for households. The weakness of demand has weighed increasingly on the recent trend in credit. Firms are cutting back on investment, given the unfavourable economic prospects, while households are cautious in the face of the uncertain trend in the housing market and the difficulties for income and employment.

But supply-side conditions that are still restrictive, though an improvement on the exceptional tensions registered in late 2011 and early 2012, also continue to be factor. In the bank lending survey conducted at the start of October for the third quarter of this year, the banks relate the tightening of supply to the poor economic situation and the consequent increase in credit risk. The surveys of firms give mixed signals of the speed at which the credit tightening is unwinding. In the quarterly survey carried out by the Bank of Italy together with *Il Sole 24 Ore*, the percentage of firms indicating a deterioration in their conditions of access to credit declined to about 26 per cent in September, from 33 per cent in June; whereas the monthly Istat survey showed a new increase.

The reduction in official rates in July has had positive effects on the cost of credit. Bank lending rates came down over the summer by 0.3 percentage points both on new loans to firms and on new mortgage loans to households, to 3.5 and 3.9 per cent respectively in September. A contributory factor was the narrowing of the yield spread between Italian and German government bonds following the announcement of new interventions by the ECB on the sovereign debt market.

However, the cost of business loans is still higher than in Germany and in the euro area as a whole (by 1.1 and 0.8 percentage points respectively); before the summer of 2011 the differential was practically nil. The gap reflects the sovereign debt tensions and the consequent unevenness of monetary policy transmission in the diverse economies of the area. Other conditions being equal, an increase of 100 basis points in the yield spread between ten-year Italian and German government bonds tends to be reflected in an increase of about 50 basis points in the average rates on loans to firms in Italy after one quarter and fully after a year.

In September, the banks' total funding, excluding Eurosystem refinancing, was down by 2.6 per cent from twelve months earlier. The difficulty of raising funds, particularly acute between the summer of 2011 and last spring, has regarded foreign deposits – almost entirely interbank deposits – and bond issues on international wholesale markets. In recent months, however, we have begun to see signs of a recovery, including in the uncollateralized segment; total issues have amounted to €11 billion, of which €8 billion unsecured.

In periods of strain the decline in fund-raising on the market has been offset by greater recourse to Eurosystem refinancing (which has increased by €250 billion since May 2011), thanks to which Italian banks can cover the wholesale bonds falling due in 2013-14. In more recent months, with the general improvement in market conditions, central bank lending to Italian banks has stabilized.

Retail funding remains a strong point of Italian banks. Italian households' deposits grew by 3.7 per cent in the twelve months to September, and substantial subscription of bank bonds by retail investors continued.

Loan quality is worsening. In the second quarter of this year, the ratio of adjusted new bad debts to loans outstanding rose to 2.1 per cent, returning to around the end-2009 level. The deterioration involved loans to firms, the default rate on which reached 3.2 per cent, with a high of over 6 per cent for construction firms. Preliminary data indicate that the deterioration has not halted in the last few months. By contrast, the default rate on loans to households remained stable at 1.2 per cent, relatively low by the standards of the past.

In June of this year gross impaired loans (bad debts, substandard and restructured loans and overdue positions), three quarters of which involved firms, amounted to 12.3 per cent of total bank lending; in 2007 the figure had been 5.1 per cent. Taking into account the write-downs already made, the ratio falls to 8.1 per cent.

These numbers are still far below the peaks registered in the early 1990s, but they could cause concern if set against those of other advanced economies. But international comparisons are difficult. The accounting criteria used by banks in Italy to classify loans as impaired are dictated by particularly severe prudential rules. Added to this is strict prudential and on-site supervision by the Bank of Italy, which requires even more stringent assessments of loan quality. For example, on-site inspections in the first half of 2012 resulted in the reclassification of 20 per cent of the loans examined. Furthermore, the extreme length of credit recovery proceedings, due to the slowness of the justice system, obliges banks to keep impaired loans on their balance sheets longer than in other countries, which works to Italy’s disadvantage in international comparisons.

Even if banks have increased their value adjustments, the ratio of these write-downs to the total amount of impaired exposures has fallen since 2007 from more than 49 per cent to just over 37 per cent. It is higher for banks belonging to the top five banking groups, lower for smaller banks. Focusing on bad debts alone, the coverage ratio is above 54 per cent; for those not backed by collateral or personal guarantees it is naturally higher, at 68 per cent.

Coverage ratios need to be raised. The Bank of Italy regularly monitors their adequacy, bank by bank, in relation to the credit risks deriving from economic and financial market developments. We expect banks to devote the greatest care to taking this aspect into account in their balance sheets.

Although the setting is unfavourable, the banks have strengthened their capital position very substantially. This action must continue, both in order to cope with the worsening of loan quality and to satisfy the new, higher capital ratios required by the Basel III rules. Supervision of capital adequacy is particularly stringent for banks whose impaired loan coverage ratios are low.

Smaller loan volumes and larger value adjustments to loans have had repercussions on banks’ earnings. On an annualized basis and net of goodwill impairments, ROE fell to 3.2 per cent in the first half of this year, compared with 4.1 per cent in the first half of 2011. A recovery in profitability can support the necessary further improvement in banks’ capital position. It must come from an improvement in efficiency both in supplying products and in curbing costs.

Encouraging signs can be glimpsed with regard to costs, which decreased by 1.2 per cent in the first half of this year compared with a year earlier; the decline was sharper for labour costs, which fell by 1.8 per cent. It is necessary to continue containing staff numbers and curbing personnel costs, not just for new employees as envisaged by the new national labour contract, but also managers' and directors' compensation. Dividend distribution must be weighed carefully, especially where there is a need to maintain or strengthen capital ratios.

The rules on banks' compensation systems are producing their effects. The aim is to relate the pay of top managers and directors to effective performance and make it reflect the risks assumed. In 2011 the compensation of top executives in the five largest banking groups decreased by an average of 25 per cent compared with the previous year; for the first fifteen listed groups, the decrease came to 20 per cent, net of severance packages. The Bank of Italy is subjecting banks where compensation has risen to special scrutiny, and inquiries are under way on the mechanisms for determining the variable pay components.

In the event of the early conclusion of employment relationships, the rules lay down that a significant part of compensation must be deferred for a sufficient period of time or subject to claw-back clauses. These provisions must be such as to discourage mismanagement and to protect banks even after the termination of employment. Directors must guarantee their effectiveness.

Banks must rationalize their distribution networks, by making more efficient use of information and communication technologies. The number of bank branches rose in the last decade, despite the sharp increase in the share of telephone and on-line banking services. An overlapping of distribution channels may be justified in part by differences in banks' customer base and commercial strategies, but efficiency gains are certainly possible and necessary. Non-strategic assets need to be sold off.

In the immediate, cost-cutting must be relied on in order to avoid severe imbalances in profit and loss accounts. Beyond the short term, however, this will not be sufficient. It is time now to realistically assess the opportunities for greater diversification of income, for a reorganization of business processes, especially in the granting of credit. Greater support must be given to creditworthy borrowers, accompanying them in strengthening their financial structure and expanding in international markets.

3. The stability of the euro area and the European banking union

The crisis in the euro area reflects two risk factors: the weaknesses of several member states, which fuel doubts about the sustainability of their public debt, and the incompleteness of the European construction, which is the source of broader fears that the single currency may be reversible.

To address the first risk, the authorities in the countries most exposed to the crisis have taken resolute action to adjust the public finances and mend structural shortcomings. In Italy the measures taken since the second half of 2011 to consolidate the public finances and the major package of structural reforms now being enacted have helped stanch the loss of confidence in our economy. The budget measures could not but have negative repercussions on short-term economic developments, but they averted far bleaker scenarios than the current one.

In the medium term, the structural reforms will sustain the country’s growth potential. It is vital that the announced budget targets be met, the reform programme implemented in full and its scope widened even further. To definitively dispel fears about the solidity of monetary union, it is essential to proceed, with the necessary gradualness, from economic and monetary union towards political union, via reform of economic governance and banking and fiscal union. This is a project for the long term. The persistence of tensions in the sovereign debt markets during its implementation could compromise the uniformity of monetary policy transmission, as the experience of recent years has shown.

To avert this risk, the Governing Council of the ECB approved Outright Monetary Transactions (OMTs). This has already had important effects, as is attested by the signs of renewed interest in Italian government bonds on the part of foreign investors and the consequent narrowing of the spread between BTPs and Bunds. Given that the fears of euro reversibility are bound up with those for the sustainability of the public finances of member countries, the start and continuation of OMTs is conditional on the assumption and respect of specific commitments regarding the public finances and structural reforms.

As I noted, we are mindful that a definitive solution to the euro-area crisis requires the completion of the European construction. Much has been done with the reforms of economic governance aimed at strengthening budget coordination and extending multilateral oversight to macroeconomic imbalances. Banking union represents a further, important step in breaking the link between the conditions of sovereign states and those of banks and in consolidating the financial stability of the area. Banking union will mean a single mechanism for banking supervision and a European blueprint for the resolution of banking crises, in addition to a common deposit insurance scheme.

The inception of the single supervisory system will help reassure the markets that the European institutions and member states are determined to strengthen monetary union. A few days ago, the European Council called on national legislators to give absolute priority to the talks under way so as to define the new legislative framework before 1 January 2013, to be implemented in the months that follow. Implementation must necessarily be gradual but there must be, from the very beginning, a clear vision of what the final mechanism will look like and a detailed calendar for the intermediate steps.

This is a challenge that carries important institutional and operational implications. The responsibility for common supervision will be centralized at the Governing Council of the ECB, of which the national central bank governors are members. A special body for planning and carrying out supervision will be established at the ECB. National authorities will be required to be fully engaged, both in the day-to-day conduct of supervision and in decision-making.

Given the large number of small banks operating in the area, it is unrealistic to imagine centralizing every task. The ultimate responsibility for all the banks in the euro area will lie with the ECB, but to a varying degree and with modalities differentiated according to the banks' characteristics. It will have full and direct responsibility for decisions concerning systemically important banks and those that receive public support. For the other banks, supervision can be carried out more effectively by the national authorities. In any event, the ECB will take decisions on the banking sector as a whole, with reference for example to supervisory recommendations and guidelines, including stress testing.

Uniform regulatory and supervisory standards will have to be guaranteed for all banks, in order to avoid segmentation and arbitrage and to preserve the integrity of the European banking market. It is vital to avoid any lowering of supervisory standards; on the contrary, we must seize the opportunity to ensure convergence towards the most rigorous practices among those adopted by the various national authorities. Supervisors will require a comprehensive and detailed dataset, as well as methodologies of risk analysis capable of providing timely indications of emerging instability at individual banks and at systemic level.

The European blueprint for the resolution of banking crises must have shared financial resources. The authorities must have the power to order the conversion of debt instruments into equity or the reduction of a bank’s liabilities, imposing losses on some classes of creditor (through bail-ins). The proposed Bank Recovery and Resolution Directive is a step in this direction.

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The efforts being made in Europe and in the countries worst hit by the crisis can succeed only if all the parties involved keep full faith with their commitments. In the end, budgetary adjustments without structural reforms would inevitably be counterproductive.

However, the reforms will be unable to work their effects in full if doubts and uncertainties about the future of the single currency were to keep sovereign spreads far above the levels consistent with each country’s economic fundamentals. Monetary policy can constitute an effective bulwark against such distortions. But its benefits can be lasting only if budgetary discipline and national and European reform proceed with the necessary determination.