Italian Banking Association
Annual Meeting

Address by the Governor of the Bank of Italy
Ignazio Visco

Rome, 10 July 2014

Growth in the euro area remains very weak; inflation, running at 0.5 per cent in June, is still well below the levels consistent with price stability. In Italy, the recovery is struggling to make headway and the rate of increase in consumer prices has slowed to 0.2 per cent.

The decisions taken on 5 June by the ECB's Governing Council aim to further ease monetary conditions and sustain the supply of credit. For the first time we have introduced a negative interest rate on banks' deposits with the Eurosystem. We have decided to conduct, from September, targeted operations in which the amount of refinancing granted to each bank is linked to the volume of loans it provides to the economy.

We have issued clearer forward guidance regarding monetary policy and reaffirmed that, if necessary, we will take further measures to counter the risk of too long a period of low inflation. In the coming months we will evaluate the results of the decisions taken so far. We are ready to consider new measures, including a large-scale securities purchase programme.

The credit market and the financing of the economy

Credit market developments are reflecting with some delay the signs of slow improvement in the economic situation. Business surveys indicate that supply-side tensions are easing. Small and financially fragile firms continue to face difficulties, especially those with high debt levels. Lending is affected by banks' concerns about the soundness and prospects of potential borrowers. In some cases, it may be held back by caution prompted by the ongoing comprehensive assessment at major banks. The demand for credit, especially for new investment, also continues to be weak.

The volume of non-performing loans, net of loan loss provisions, reached 10 per cent of total loans in March, compared with 9 per cent a year earlier. Bad debts alone amounted to slightly more than 4 per cent. The ratio of new bad debts to outstanding loans is diminishing, however, and has dropped to 2.6 per cent from a peak of 3 per cent in mid-2013.

A reduction in the volume of impaired loans is essential for the recovery of the credit market. Disposals effected in the first months of 2014 and those at an advanced stage of negotiation will bring their amount down by about €5 billion. Additional transactions involving significant amounts were recently announced to the market. Like the measures to rationalize the management of non-performing loans through dedicated units, most of these transactions have so far been conducted by large credit institutions.

The fading of the sovereign debt crisis and the consequent reduction of risk premiums are prompting specialized investors to offer higher prices than in the past for non-performing loans. At the same time, the increase in loan loss provisions is lowering the prices that banks are willing to accept. The completion of the comprehensive assessment may also facilitate the development of the market for impaired loans.

The solutions adopted for small banks should aim for closer coordination between intermediaries and seek to generate a critical mass of impaired assets. Public intervention, provided it is compatible with budget constraints and the European rules on state aid, could make it easier for banks to free their balance sheets of the burden of non-performing loans and reactivate the supply of credit to households and businesses.

The new Targeted Longer-Term Refinancing Operations will provide liquidity to intermediaries on condition that it be used to finance economic activity. The funds obtainable will be proportional to the level and growth of lending to businesses and households, not counting loans for house purchase. The cost of the funds, now 0.25 per cent, is more than one percentage point lower than Italian banks' average funding cost. In the first two operations, scheduled for September and December, banks can borrow funds equal to 7 per cent of their stock of loans outstanding at the end of April. In the six subsequent operations, which will be conducted quarterly until mid-2016, they can get additional liquidity equal to three times the value of new loans, calculated net of a specific benchmark. The funds must be repaid in full if lending subsequently falls below that benchmark. The amount potentially available to Italian banks is substantial, possibly exceeding €200 billion over the entire horizon of the programme.

The set of measures adopted in June could have significant effects on the Italian economy. If the changes in interest rates and exchange rates following the announcements of the measures persist over time, this would result in an increase in GDP estimated at about half a percentage point between now and the end of 2016; consumer prices would increase by a similar amount. If the banks fully exploit the financing allowed under the new operations, adjusting the terms offered to borrowers to the lower cost of funding and removing any remaining restrictions on the supply of credit, there could be further positive effects on GDP of up to an additional half point through 2016.

The Bank of Italy is about to extend the range of loans eligible as collateral for Eurosystem refinancing, in ways that provide incentives for lending to small and medium-sized enterprises. The assets that could be involved in this initiative are estimated at €120 billion net of haircuts. The new collateral that will be available will encourage participation in the new operations and stimulate lending; it will be additional to the collateral already deposited with the Bank of Italy and to the other immediately available assets, totalling more than €530 billion, in relation to a volume of refinancing now amounting to €170 billion.

Bank lending cannot be the sole source of funds for the productive economy, however. As I have observed on other occasions, the law instituting an allowance for corporate equity has provided new opportunities for increasing capital that a good number of firms have taken up. In June, to sustain the strengthening propensity for stock market listing, Decree Law 91/2014 on competitiveness increased the equity allowance for newly-listed enterprises.

Increased capitalization will allow greater diversification of businesses' sources of funding. During the crisis large companies in particular had resort to the bond market, using the funds so raised in part to repay their bank loans. Issues by non-listed companies were spurred by the incentives that accompanied the introduction of "minibonds", but the smallest businesses continue to have trouble raising funds in the market, due to the limited size of their issues and difficulties in assessing their creditworthiness.

The decree law favours solutions in which banks originate the loan and then transfer it to specific classes of investor, including insurance companies, thus sharing risks and returns. The insurance supervisory authority (Ivass) has recently submitted to public consultation some new regulations to foster greater diversification of insurance companies' assets, including into some instruments of SME financing.

The decree law also extended the range of assets that insurance companies can use to cover their liabilities, to include a broader group of instruments deriving from securitizations. A recovery in the securitization market could contribute substantially to the reactivation of lending to the economy. To enable an informed evaluation of these instruments, their transparency and standardization must be enhanced, encouraging the diffusion of the simplest products, whose risk and yield can be more easily assessed by potential investors.

The measure also allows the establishment of “credit funds”, which can provide direct financing to the economy; securitization vehicles will operate along similar lines. As part of the work for the transposition of the European Directive on Alternative Investment Fund Managers, the Bank of Italy recently launched a public consultation on the prudential rules for these funds; we will also draft the secondary legislation governing securitization vehicles. With adequate risk safeguards, extending the range of corporate finance instruments and operators is a positive factor for economic growth. The effects of these measures will be felt gradually as issuers and potential investors adapt their behaviour to the new business opportunities.

The dearth of funding for growth afflicts the entire European economy; bank lending to non-financial corporations is contracting in two thirds of the euro-area countries. In March, the European Commission announced a package of measures to meet the long-term financing needs of the European economy, including the strengthening of Community instruments and programmes for financing businesses and infrastructure and rules on investment funds specialized in long-term financing. Like the measures taken in Italy, these interventions are founded on recognition of the complementarity between banks and institutional investors in financing the economy.

Banks' capital and the comprehensive assessment

In the difficult years of the crisis Italian banks strengthened their capital position significantly. In contrast to what happened in many other developed countries, this strengthening involved almost exclusively private capital. Direct financial support from the Italian government has been very limited; greater assistance has come from forms of guarantees on bank liabilities. The coupons earned on capital instruments and, to a greater extent, premiums in respect of the guarantees have netted the State about €2 billion in revenue.

Capital strengthening is proceeding, as is required by the new rules on bank capital (Basel 3) in force in the European Union since January. This creates the optimal conditions for banks to resume adequate financing of the economy. The asset quality review carried out as part of the comprehensive assessment is nearly complete at national level; the stress test is under way. We are working in close cooperation with the banks and with the ECB.

The comprehensive assessment is a response to a decision taken by the governments of the euro area; it will increase transparency regarding the conditions of the main intermediaries and, where necessary, lead to capital strengthening. In order to be credible it must be rigorous and must be perceived as such. A number of elements increase the assessment's severity: the threshold values of the capital ratios are higher than those set by Basel 3, the evaluation models for the asset quality review are more stringent than those generally employed by banks, and the stress test is based on particularly adverse macroeconomic scenarios and projects losses over an extended time horizon.

The results of the entire exercise will be announced in October, before the launch of the Single Supervisory Mechanism. Exercises conducted in the past can provide a qualitative judgment on the possible effects for Italian banks. The analysis conducted by the International Monetary Fund in the summer of 2013 reaffirmed the soundness of the system; under the adverse macroeconomic scenario it detected the need for capital strengthening by some medium-sized banks.

Any needs for capital will have to be met in the first instance out of private resources. But the success of the exercise and the maintenance of orderly market conditions when the results are announced require public backstops, as agreed by the European Council and later reiterated by Ecofin.

The timeframe for recapitalization is six months if the capital shortfall emerges from the asset quality review or the baseline stress test scenario, nine months if it derives from the adverse scenario. This differentiation, while small, is consistent with the different nature of the outcomes.

Measures to deal with any capital shortfalls must be commensurate with the actual situation of the bank under examination, avoiding excesses that could transform the exercise into a source of strain for banks and for the system as a whole. The practical application of these principles will be scrutinized in relation, among other things, to the rules on state aid. The Commission's position, shared by a number of countries, is that the utilization of public resources should be made conditional on the involvement of junior debt holders even where the capital shortfall emerges only in the highly improbable adverse scenario of the stress test. The measures cannot but adhere to the fundamental principles of the national and European legal systems.

Beyond the comprehensive assessment, strengthening banks' capital and attracting new investors will necessitate increasing profitability. In the last few years, under difficult circumstances, progress on rationalization of the branch network, assisted by new technology, and the curbing of administrative and staff expenses have succeeded in keeping costs constant in proportion to revenues. These actions must not be interrupted.

In the present economic situation it would be imprudent to rely solely on the increase in revenues foreseen by the banks' business plans. Structural reform must proceed in order to cope with a more highly competitive environment that is no longer confined within national borders.

Banks' capacity to assess creditworthiness must be enhanced. This ability cannot depend only on the automatic results of quantitative models but instead must draw on the skills of expert, competent staff with long-standing, thorough knowledge of customers that must be built on and nurtured.

Governance, transparency, correctness

With the recession, the number of distressed intermediaries increased. Since 2009, 45 of Italy's 700 banks have been placed in special administration. Most of the procedures involved small banks; five involved intermediaries operating interregionally. The credit institutions currently under special administration account for about 1 per cent of the banking system's total assets. In addition, there are some instances of less severe difficulties, which the Bank of Italy is monitoring carefully.

The recession has revealed inadequate, imprudent, and at times improper conduct on the part of banks' directors. In the great majority of cases of difficulty or full-blown crisis, the deterioration of the bank's accounts was due to shortcomings in governance and in lending procedures. A third of the supervisory interventions made in 2013 focused on these areas.

We take all measures falling within our competence to remove the anomalies and dysfunctions detected, including the levying of sanctions. Insofar as it lies within our powers, in the most problematic cases we encourage a change of management. Often, episodes of malfeasance are uncovered thanks to supervisory action and cooperation with law enforcement authorities, investigative bodies and, as regards money laundering, the Financial Intelligence Unit. In the last five years we submitted nearly a thousand reports to the judicial authorities of conduct that potentially constituted criminal behaviour, and in another 2,400 cases we responded to requests for information from the Finance Police or public prosecutors. In a further 200 cases we supplied technical advice.

Special importance, within the credit allocation process, attaches to the intermediary's relationship with the local community and with individual borrowers. A strong relationship with the community is a positive factor if it reinforces banks' ability to assess creditworthiness. At the same time, however, if wrongly interpreted, localism can undermine business choices and bring about crisis situations. Without sufficient safeguards, indiscriminate support to major borrowers, including shareholders and other related parties, and to the local community can distort the allocation of credit. In the worst cases of such distortion we have ordered a management change and adopted measures to restrict the bank's lending.

A well-functioning board of directors is the best guarantee of correct choices in the allocation of credit. Our recent provisions on governance are designed to make sure that board members possess adequate professional capacities, that they are aware of the strategic implications of their decisions, and that they are named through a rigorous and transparent procedure. With a view to coping effectively with conflicts of interest, we have strengthened the role of independent directors and required strict specification of their professional qualifications. The new provisions also enhance the role of the chair, whose duty is to safeguard the distinction between the strategic oversight function and the management function. In the new configuration of governance, even more than in the past, the chair needs to be authoritative and equidistant from the various stakeholders.

Improper conduct, such as the recently revealed misdoings at some large foreign banks, and irregularities in financial transactions can cause large losses and reputational damage for intermediaries and result in sanctions. We examine this matter very carefully. We ask banks' internal control bodies and top managers to prevent and eliminate anomalous behaviour. The rules on internal controls, which come into force this month, seek to ensure that decision-making bodies are fully aware of the risks; they enhance the tasks, independence and authority of the control functions; and they require banks to adopt a code of conduct. In the coming months we shall ask banks to introduce arrangements to encourage whistle-blowing by employees who discover practices that violate the rules and the company's standards.

The recent regulatory innovations are intended to fortify the governance of the cooperative banks, so as to make them stronger and better able to serve the areas in which they are located, make it easier for them to strengthen their capital bases and enable them to face the challenge of Banking Union. The Bank of Italy recognizes the value of the cooperative model. But we have made no mystery of our belief that the largest cooperative banks, listed on the stock exchange and operating at national or even international level, should adopt a different legal form. The IMF and the European Commission have also deemed this to be desirable on several occasions. We have done as much as is within our power. Further, more effectual steps would require legislation.

The financial system must regain the public's trust. It must show that it knows how to perform its functions to the full, not leaving deserving customers without credit and supporting the real economy. It is a task that requires transparent behaviour by intermediaries and their defence of legality.

Within the Financial Supervision and Regulation Directorate General we have created a new directorate devoted to safeguarding the transparency and correctness of customer relations. Our controls seek to verify compliance with the rules and the suitability of banks' organization. They can lead to sanctions, orders to refund customers and requests for corrective action.

Customers' reports and the complaints submitted to the Banking and Financial Ombudsman, which are examined case by case, provide indications of conduct that systematically fails to comply with the principles of transparency and correctness. Last year the Ombudsman received nearly 8,000 complaints, 39 per cent more than in 2012. Of the cases decided, 70 per cent were in favour of the customer.

These instruments of ex ante and ex post protection produce much greater effects if customers have sufficient knowledge. However, the OECD’s report on students’ financial literacy, presented yesterday, puts Italy towards the bottom in the international rankings.

The banking system recognizes that the fight against money laundering also protects banks against the risks they face, although conduct differs from bank to bank. In particular, it is necessary to improve the timely detection of suspicious transactions in advisory relationships, such as private banking. As noted by the Financial Intelligence Unit in the report it presented yesterday, the number of suspicious transaction reports has quintupled since the Unit began operations; in 2013 there were about 65,000, of which more than 80 per cent submitted by the banking system. The large increase in the Unit’s operations has required increased organizational efforts, human resources and ICT endowment. Its establishment at the Bank of Italy has facilitated its enhancement.

° ° °

From November, banking supervision will be conducted at European level. Banks identified as “significant” will be subject to centralized supervision, with the coordination of the ECB and the participation of the national authorities, in an approach based on shared responsibility. Supervision of the other banks will remain in the hands of the national authorities and be based on common standards established at European level. Cooperation among the participants in the Single Supervisory Mechanism is necessary to ensure the highest standards of supervision for all euro-area banks. The European supervisory manual assigns a central role to inspections, always a major element of the Italian system.

Joint supervisory teams will be the chief vehicle of cooperation between the ECB and national authorities. Each team will comprise supervisory experts of the

ECB, partly with coordinating functions, and, in greater number, of the national competent authorities. The latter will perform a key role both at the technical level, helping to design and implement supervisory strategies, and within the Supervisory Board. Decisions regarding individual banks will be submitted to the ECB Governing Council for approval by tacit consent. Like the other national authorities, the Bank of Italy will contribute to the decisions on foreign banks and banking systems. All this will entail greater responsibilities, workloads and commitment.

Alongside European supervision, the Single Resolution Mechanism will be fully operational starting in 2016. The management of bank crises will be based on the activity of the Single Resolution Board, in which both national and European authorities will participate. The Board will be responsible for defining the internal rules and promoting cooperation agreements between the authorities involved in the resolution process; the competent resolution authorities will be identified at national level. The creation of a single resolution fund, financed by contributions from the banking industry, is envisaged.

Lastly, with the start-up of the Single Supervisory Mechanism the ECB will flank the national authorities in exercising the powers of macro-prudential supervision, directed to ensuring the stability of the financial system as a whole. The Bank of Italy is strengthening its analysis of the wide set of information on which assessments of the sources of systemic risk are based, and is designing appropriate mechanisms of interaction among the entities involved in carrying out any necessary interventions. The approval and subsequent implementation of the enabling law on the Italian macro-prudential authority will respond to the European Systemic Risk Board’s recommendation that an authority responsible for safeguarding the overall stability of the financial system be established in every country of the Union.

The centralization of supervisory functions overlays a set of rules composed of provisions some of which are common to all the Union, some national, and some subject to minimum harmonization. It is essential to work so that the new supervisory system operates in a complete, clear and uniform legal environment. In Italy, the consolidated laws on banking and finance drawn up in the 1990s have provided a legislative framework that avoids regulatory arbitrage and competitive disparities, safeguarding the stability of individual intermediaries and of the system as a whole. Producing this framework was a difficult exercise requiring time and effort, but it was indispensable. A similar process is inevitable in Europe: a truly integrated banking system presupposes uniform rules; there must be an unequivocal definition of banking, so as to avoid divergent national interpretations that could jeopardize the level playing field and the integration of national markets. We are aware of the difficulties that this entails, some deriving from the differences between national legal systems, but the objective is fundamental to the success of the Banking union.

The inception of the Single Supervisory Mechanism and further progress in European integration will help to consolidate the improvement in financial markets recorded in the last two years. The completion of the structural reforms already begun in Italy and the further measures envisaged, in the context of a consistent and highly visible design, will create a more favourable environment for business, encouraging entrepreneurs to commit resources of their own and facilitating the raising of equity capital at home and abroad.

Printed by the Printing and Publishing Division
of the Bank of Italy