ACRI

Association of Italian Savings Banks

2014 World Savings Day

Address by the Governor of the Bank of Italy

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Economic activity and world trade are disappointing expectations. Uncertainty over the cyclical outlook has increased. Vigorous recovery in the United States and the United Kingdom is set against a softening in Japan, the euro area and the emerging economies. Given geopolitical tensions and the possible exacerbation of structural imbalances in some of the latter, the risk of further economic slowdown has increased.

Economic conditions in the euro area have started to weaken again, the deterioration now also involving countries that were untouched by the sovereign debt crisis. In the second quarter output diminished slightly in Germany and Italy and stagnated in France. A barely positive contribution from foreign trade was accompanied by the stagnation of domestic demand within the area. While consumption rose marginally, investment fell by 0.9 per cent in the area as a whole and also in Italy. Growth estimates for this year have been lowered for the euro area and for the major member countries; the downside risks have increased.

Consumer price inflation fell to a twelve-month rate of 0.3 per cent in September. The trend was broadly based: inflation was below 1 per cent in fifteen of the eighteen euro-area countries, and negative in five, Italy among them. Inflation expectations for the short and medium term are at historically low levels. Those for a five- to ten-year horizon have fallen significantly below 2 per cent, weakening their anchorage to the price stability target. We are not in a situation of deflation, but we cannot ignore the material risk.

The fears for the macroeconomic outlook triggered a new bout of volatility in the European financial markets. The tensions have now subsided somewhat, but they have made it clear that the opportunities offered by the favourable financial conditions that have marked 2014 so far could evaporate. The tensions indicate that measures to stimulate economic activity and investment are a priority in order to ensure the economic and financial stability of the euro area. Investors continue to be attracted to Italian securities, but our economy needs to show clear signs of recovery in order to prevent low growth from affecting their value.

The measures taken by the ECB Governing Council during the summer, fully in keeping with the Eurosystem's mandate, have resulted in falling yields at both short and longer term and in a depreciation of the euro. They will have beneficial effects on economic activity. We have lowered the official interest rates to all-time lows, introduced new targeted longer-term refinancing operations, and launched programmes for the purchase of covered bonds and securities backed by loans to firms and households, with the express intent of sustaining credit to the economy and expanding the Eurosystem's balance sheet. The Council has reaffirmed its intention to undertake additional unconventional measures if necessary.

The low rate of growth in the euro area has structural causes, differing from country to country, in relation to the radical global changes to which many economies are struggling to adapt. Measures to increase the potential for growth are essential; in a number of cases they have already been adopted; they need to be reinforced. But there is no denying that the cyclical state of the euro-area economy is critical. The monetary policy response has to be joined by a contribution from budgetary policy. As the IMF's recent assessments confirm, the overall fiscal policy stance of the euro-area countries was still restrictive in 2013; it is expected to be basically neutral this year and next.

During the most acute phase of the crisis, fiscal adjustment in some countries was unavoidable in order to bolster confidence among the member states and reassure the markets concerning the euro area's ability to hold up. The reforms of European governance, the actions of the Eurosystem and national policy measures have brought government securities prices more into line with the economic fundamentals. National budgetary stances can now be calibrated as a function of cyclical conditions; incisive action at Community level must be promoted.

In June the European Council emphasized the importance of "making best use" of the flexibility that is already built into the Stability and Growth Pact. European institutional rules allow for temporary deviation from budget objectives in the case of events beyond the control of governments or in severe recessions. These conditions now prevail in a number of euro-area countries. A rate of inflation that is far below the definition of price stability and that is not due just to falling world commodities prices can make literal observance of the debt rules not only more onerous but pro-cyclical. In the current phase, the feedback effects produced by pursuit of a more ambitious budget objective could actually aggravate the very imbalances that the measures are intended to redress.

The rules, if not interpreted in a needlessly restrictive manner, provide scope for reconciling fiscal discipline with support for growth. A coordinated response to the recession can be devised at European level to support aggregate demand, compensating for the lack of a common public budget. Isolated measures taken by individual countries could trigger adverse reactions on the part of the markets; coordination, instead, would demonstrate the area's cohesion and renewed capacity to act.

Common action is urgently needed to sustain public investment in the euro area, which has fallen by a quarter in four years. To proceed with the rapid implementation of the plan proposed by the new President of the Commission, it will be necessary to tap all the sources of finance: the Community budget, the European Investment Bank, private investors, and national budgets as well.

In Italy, given the exceptional length and depth of the recession, the Government has rightly decided to make the adjustment of the public finances more gradual while at the same time pursuing a strategy of reform to raise the country's growth potential. The swift finalization of all the details of this strategy and the implementation of the individual measures on schedule are indispensable to restore confidence in the prospects of our economy.

The recovery in the euro area and in Italy must find support in an improvement in the trend of credit, which has been making little headway. Bank lending to firms has continued to contract this year, albeit less rapidly; the growth in credit to households has been modest in the euro area, slightly negative in Italy. The differences between countries in the cost of loans, mainly connected with the differing incidence of credit risk, have narrowed but are still relatively wide.

Credit conditions will benefit from the completion of the comprehensive assessment of banks' balance sheets. The negative effects of the uncertainty about its outcome will give way to the positive effects of greater transparency concerning the state of the European banking system, which is vital to the credible launch of the new Single Supervisory Mechanism. The exercise focused mainly on the risks connected with the deterioration of loan quality; it also considered exposures to sovereign debt.

The asset quality review, which examined assets as of the end of 2013, was supplemented by a stress test to gauge banks' ability to withstand a hypothetical adverse scenario. Consequently, in addition to the deterioration of loans due to the recession of the past few years, there were the effects of the adverse scenario, characterized by a sharp worsening of global macroeconomic and financial conditions, a new recession in Europe and resurgent tensions on sovereign debt markets. For Italy, the test hypothesized that GDP would fall by over 3 per cent in the three years 2014-16, bringing the cumulative loss since

2007 to about 12 per cent, and that long-term interest rates on government securities would approach 6 per cent, not far from the levels reached at the height of the 2011-12 crisis.

The stress test's three-year horizon is longer than that adopted in the previous tests on European and American banks. The minimum common equity tier 1 ratio, set at 5.5 per cent, is higher than both the regulatory minimum and the minimum used in the similar exercise conducted in the United States. The definition of capital adopted was that in force in each country and thus took account of the different ways in which national authorities have exercised the discretion allowed for in the transition to Basel III (for example, regarding deductions from capital and the application of so-called prudential filters). The sole exception was the decision to phase out the prudential filter on variations in the prices of government bonds classified in the available-for-sale portfolio.

The results show the overall soundness of the balance sheets of the banks tested, which account for more than 80 per cent of the total assets of the euro-area banking system. The potential capital shortfall found at the end of 2013 for 25 banks totalled about €25 billion; to a large extent it has already been made good by the capital increases carried out this year.

This assessment also applies to the Italian banking system. On the basis of the end-2013 situation, the potential capital shortfalls came to €9.7 billion. With the capital increases carried out between January and September 2014, they decline to €3.3 billion and regard four banks. These same capital increases enable all the Italian banks to surpass the 8 per cent threshold set for the asset quality review. Counting the other capital strengthening measures decided in 2014, the capital shortfall connected with the adverse scenario declines further, to €2.9 billion (0.2 per cent of GDP), and involves two banks: Monte dei Paschi di Siena and Carige, with shortfalls of 1.1 and 2.2 per cent of their respective end-2013 balance-sheet assets.

The assessment made a year ago, based on the stress tests conducted by the International Monetary Fund and the Bank of Italy as part of the Financial Sector Assessment Program, stands broadly confirmed. The results of that exercise showed that the system would have been able to withstand the most adverse scenario and that the capital needs of some banks would have amounted to between €6 billion and €14 billion, depending on the definition of capital.

Many commentators have drawn up European rankings, emphasizing not the generally positive outcome but the number of banks with shortfalls based on the end-2013 balance sheets. Apart from the undeniable delays, which we have underscored repeatedly, Italian banks' starting position reflected the handicap of an economy that in the past two decades, and especially in the last six years of crisis, has been one of the poorest-performing in Europe.

The overall resilience of the Italian banking system is the result of the Bank of Italy's supervisory action on the adequacy of provisioning for non-performing loans, the prudence employed by banks in drawing up their annual accounts for 2013, and the further measures of capital strengthening undertaken this year with strong encouragement from the Bank of Italy. In Italy, unlike many European countries, in recent years there have been no significant recapitalizations using public funds.

In the two years 2012-13 the Italian banks included in the exercise wrote down loans by €54 billion. Of the €60 billion of capital increases completed between July 2013 and August 2014 by the European banks subject to the assessment, Italian banks accounted for about €13 billion, or more than 20 per cent of the total. Most of the value adjustments ascertained in the asset quality review had already been incorporated in the provisions banks made in the first half of this year.

The potential capital shortfalls concern two banks whose difficulties are largely the inheritance of past episodes of malfeasance that the Bank of Italy, in close cooperation with the law enforcement authorities, helped to bring to light, leading to a radical change in the management.

The two banks will shortly present capital strengthening plans; the Bank of Italy will follow their implementation closely within the framework of the joint supervisory teams, the Supervisory Board and the Governing Council of the ECB.

By bringing together different points of view regarding the state of the euro-area banking systems, the comprehensive assessment has been a useful exercise, carried out over an objectively short time span and on a very large number of intermediaries. This was possible thanks to the strong, responsible commitment of those who participated, on the part of the authorities and the banks, in a complex dialogue, at times with contrasting views. The exercise makes available important information that serves for careful assessment of the current state and prospects of the European banking system.

The Bank of Italy contributed to the construction of the Single Supervisory Mechanism; it made available the know-how concerning methods and practices that it has developed over decades devoted to safeguarding the stability and proper functioning of the Italian banking system, notwithstanding the difficulties of our economy, in the last few years in particular.

We now trust that the new system of banking supervision will bring benefits to Italy and to Europe. Achieving them will require a joint effort by the ECB and the national authorities. Unity of purpose and the sharing of responsibility are necessary.

Italian banks will have to continue to strengthen themselves in order to finance the economy adequately. Their business model, which emphasizes the direct intermediation of savings rather than investment in complex and opaque financial assets, is well suited to this purpose. But it must be updated and strengthened in order to overcome the limits that have emerged during the crisis.

Measures regarding corporate governance are necessary to improve efficiency and make it easier to raise funds on the capital market. The action to curb costs must proceed. New technologies offer opportunities to revise production and distribution processes. Restoring adequate levels of profitability, needed to remunerate larger endowments of capital, requires a different structure of earnings.

For the entire Italian banking system there remains the need to come to grips with the large stock of non-performing loans, which is still growing, albeit more slowly than in the last few years. The volume can be reduced by active management and recovery procedures, which are undoubtedly more practicable in a better macroeconomic context, and by block disposals of impaired assets, which need to be encouraged by a further increase in their coverage ratios.

Progress also needs to be made by small and medium-sized banks, which were not involved in the comprehensive assessment and have so far been less exposed to market pressures. The banking union, single market integration and greater competition will oblige these banks as well to counter the deterioration in credit quality by strengthening their capital, improving their governance arrangements and risk control processes, and increasing their efficiency and profitability. Business models will have to adapt swiftly to the changes under way. Mergers and acquisitions are likely to make progress easier.

Such actions by intermediaries, though necessary, will nonetheless not be sufficient to reinforce the credit channel unless they are accompanied by a clear improvement in the outlook for growth. In order to reactivate a virtuous circle between economic activity and credit, it is essential to revive investment, in a context made more favourable to it by moving forward with coherent social and economic reforms.

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