Q&A: Visco of Bank of Italy on bank reforms and supervision

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The EU's planned isolation of proprietary trading would complement the region's bank resolution regime, rather than lead to over-regulation, the governor of Italy's central bank says in an exclusive interview

Ignazio Visco, governor of Italy's central bank, acknowledges an overlap between the European Union's proposed bank structural reforms, which envisage forced separation of proprietary trading, and the bloc's Bank Recovery and Resolution Directive (BRRD). But he sees the two sets of measures as reinforcing each other, rather than over-complicating banking regulation.

"There is a complementarity between reforms that aim at separating proprietary trading from core activities and reforms that aim at making a bank more easily resolvable," Visco, who is also a member of the European Central Bank's governing council, says in an interview with *Risk*. "Even if there is an overlap between these two sets of reforms, this is probably a prudent approach to take as this would limit the number of difficulties national authorities may face when implementing their resolution measures."

The BRRD, which came into force this year, aims to safeguard financial stability without recourse to taxpayers' money, via a range of measures including 'living wills', powers for national authorities to intervene in the running of floundering banks and bail-in of failing firms' shareholders and creditors.

The main purpose of the structural reform proposals – put forward by the European Commission in January 2014 and revised in June this year – is to shield banks' deposit-taking businesses from their risky trading activities. The revised version removes the original suggested ban on proprietary trading, focusing instead on the mandatory spin-off of the activity into a separate legal entity within large and complex banks. "Alternatively, member states should be able to choose to ring-fence core retail banking activities in accordance with national law," the document adds. Such a ring-fencing requirement in the UK, due to take effect by 2019, has been heavily criticised by some big banks as costly and disruptive.

The BRRD has helped make the EU financial system much safer, says Visco, speaking in his office in Rome in a nineteenth-century neo-classical building where he has worked since 1972, bar a stint between 1997 and 2002 as head of the economics department at the Organisation for Economic Co-operation and Development. However, he adds: "I think regulation is important but supervision is essential. And if the rules had been implemented with care at the time Basel II was in place, we might have avoided some of the costs."

The Bank of Italy's oversight of the country's financial institutions was brought into question after a scandal at Monte dei Paschi di Siena over derivatives trades the firm had made to hide the extent of its losses before and during the financial crisis. However, Visco defends the Bank of Italy's record. "The issue came out because we had been investigating the practices of Italian banks and we were the ones highlighting it," he says.

In this wide-ranging interview, Visco also discusses the securitisation market in Europe, the EU's newly launched Single Supervisory Mechanism and risk weighting of banks' government bond holdings.

One of the main risks that came to light during the Greek sovereign debt crisis is the co-dependency between southern European governments and their banks. Italian banks hold some €405 billion ($452 billion) of Italian government bonds on their books. Do you ever worry that this co-dependency could jeopardise the stability of the Italian banking system?

Ignazio Visco: The short answer is no. We need to take a few elements into consideration. First of all, the problem around the potential contagion from the sovereigns to the banks is really about reducing the sovereign risk more than discussing banks' portfolios.

Having said that, I perfectly understand that if banks were to hold the majority of their assets in government bonds, this could go to the detriment of lending, which is the primary role of banks. In that sense, we have seen banks increasing their holding of government bonds since 2011, which means they have faced lower demand for loans and they have, at the same time, conducted a more careful evaluation of the credit risk.

There is now an ongoing debate at the Basel Committee level about the size, the positions and the concentration of banks' investments. We have taken part in this debate.

The European version of Basel III allows banks to apply a zero risk weight to a broad range of government debt. But in a report released in March, the European Systemic Risk Board (ESRB) questioned this. Do you think there should be a non-zero risk weighting for some government bonds?

IV: This report was written by a group of experts and I'm a member of the ESRB. One of the points raised in the report is that we must be very careful in the way we approach the issues around sovereigns.

There are two main issues here: one around concentration and the other around valuation. For example, in terms of the valuation, what importance do you give to the credit ratings of a sovereign? We all agree these ratings should be taken with a pinch of salt. But then, what do you say about market prices themselves?

For instance, in 2011, market prices were such that interest rates on long-dated Italian bonds were 5 or 6 percentage points higher than in Germany. Our conclusion is that this issue was mainly linked to an external factor, which is not the sovereign risk itself, but more the potential break-up of the eurozone. So the question at this point is: how do you value the break-up of the eurozone?

On top of it, the question around zero risk weights comes up for countries that are under substantial stress. That's why we are looking at the valuation of the assets banks hold.

So before we take action on risk weighting, there are a lot of parameters to consider, such as which weights to use, appropriate concentration levels, market prices etc. I won't make any comment on whether we should apply non-zero risk weights or leave zero risk weights as they are.

But as you've just pointed out, the question around risk weights comes up for countries that are under substantial stress. Do you see a clear difference between the risk weights banks should apply to Italian bonds versus German bonds versus Greek bonds?

IV: Obviously, there is an issue around countries that may go into default. But when I made my observation earlier that, in 2011, the yield was 500 or 600 basis points higher than for German bonds, we computed fundamental-based measures and found that the spread should have been – given a proper evaluation of the true risk for Italy linked to the government debt position – only one third of that. This is a clear signal that we cannot use market prices as a correct indication to define risk weights because market prices value different sets of risk.

In 2013 the Bank of Italy allowed domestic banks to exclude some of the volatility in government bond prices when calculating Tier 1 capital. Couldn't we argue that exposing banks to the real volatility and capital costs of these portfolios is the best way to encourage them to diversify?

IV: There are two things here. First, our objective has been to avoid the excessive government bond volatility, which would obviously have an impact on Italian banks' capital and would, as a result, make their balance sheet difficult to understand.
Second, if there are [regulatory] discretions at the national level, this will soon be solved as we are in the process of moving towards a unified way of dealing with this issue at the European level.

Daniele Nouy at the EU's newly launched Single Supervisory Mechanism (SSM) has said she will get rid of national discretions. Are you in favour of such harmonisation and what will happen to this bond filter, which allows certain EU countries to ignore some government bond losses when calculating Tier 1 capital?

IV: I think this harmonisation is very important. We have very much supported the SSM as part of an improvement of financial integration in Europe. On the political side, we also supported the SSM as a way to revive the idea around unification, which is the only way to avoid a break-up of the eurozone.

There are differences in the definition of capital, in the application of accounting rules according to each jurisdiction and when it comes to holding liquidity at the subsidiary rather than at the group level. These differences need to go gradually. We must be very careful in how we conduct this exercise.

Do you think big Italian banks will be supervised more effectively from Frankfurt than from Rome?

IV: This was not the objective [of the SSM]. The objective was to supervise all banks in a transparent way across the EU. We are still very close to the banks, we are still involved in the supervision of Italian banks. Obviously, we now share the supervision with other authorities in Europe, so there is a common learning and understanding process. But Italian banks are supervised as well now as they were before.

Moving to resolution, European member states were supposed to translate the EU's Bank Recovery and Resolution Directive (BRRD) into their own law before the Single Resolution Mechanism (SRM) started operating in March this year. The Italian parliament agreed only at the beginning of July to allow the government to enforce the BRRD. Are there any elements in the legislative decree that still need to be clarified?

IV: Yes, this has to do with the type of instruments that can be part of the resolution, the priority we give to some instruments over others and so on.

In the meantime, the Bank of Italy has been designated as the resolution authority, so we created a separate unit within the bank in July. The team, which comprises more than 30 members for now but will be extended to about 45 people in the near future, has already started its operations and is working in close co-operation with both the SSM in Frankfurt and the SRM in Brussels.

Italy currently gives senior bonds the same priority as deposits and other liabilities needed to carry out critical functions. However, under the BRRD, corporate, retail and short-term interbank deposits are given priority over senior bonds. Do you understand the logic behind this?

IV: The BRRD and the Italian law to be passed are broadly on the same page. You have deposits that are guaranteed; then you have all the other deposits, [then] the senior bonds and, finally, the subordinated debt.

There is currently a big discussion in Germany about the priority to give to some particular senior bonds and some structured loans.

So some differences may be relevant when we will discuss the Total Loss Absorbency Capacity requirements later this year, but for the time being we are broadly consistent with the approach set under the BRRD.

Given the new resolution framework at the European level, is there still a need for bank structural reforms?

IV: The two issues are not necessarily linked, even if some complementarities may exist. The BRRD gives the resolution authority the power to evaluate the resolvability of each individual bank. This may lead national authorities to require a change in banks' business activities as well as a change in the structure of the bank itself.

On the other hand, the EU proposal on structural reforms aims to improve the resilience of the financial sector by reducing excessive risk taking related to pure speculative actions. It also aims to protect banks' retail activities from any potential financial risk. The proposal would be applied to the systemically important banks and those holding relevant trading activities.

Could we argue that if resolution works, there is no need to split retail and investment banking?

IV: There is a complementarity between reforms that aim at separating proprietary trading from core activities and reforms that aim at making a bank more easily resolvable.

But I would say two things. First, even if there is an overlap between these two sets of reforms, this [both sets of reforms] is probably a prudent approach to take as this would limit the number of difficulties national authorities may face when implementing their resolution measures. Second, I'm more in favour of the measures envisaged in the EU proposal for structural reforms than an outright ban [on proprietary trading].

Given the resolution framework, do you think the system is safer?

IV: The system is much safer but certainly not only because of resolution. A lot has been done on the prudential side with the discussions around too-big-to-fail, the capital buffers, [the Financial Stability Board's] Key Attributes [of Effective Resolution Regimes for Financial Institutions] and so on.

Having said that, I think regulation is important but supervision is essential. And if the rules had been implemented with care at the time Basel II was in place, we might have avoided some of the costs.

The derivatives scandal at Monte dei Paschi di Siena has actually revealed how essential supervision is. What has the Bank of Italy learned from that?

IV: When the issue came out, it came out because we had been investigating the practices of Italian banks and we were the ones highlighting it.

Now, to answer your question about what we have learned, well, we haven't learned anything we didn't already know.

We have done our job in bringing to light the fact that Monte dei Paschi di Siena used structured financial products as a way to hide some losses. Those products, instead of being valued as they should have been, were valued distributing the cashflows over a number of years.

At the same time, we forced the management team of the bank to resign and to be substituted by new managers. Now the bank is putting its house in order, and is in the process of becoming competitive again.

So the important message we have sent to banks is that they can't have opaque governance and objectives other than the safeguarding of their balance sheet position.

The other issue in the Monte dei Paschi story is whether they did have the capacity to acquire Banca Antonveneta in 2008. Well, it was a particular time with a lot of stress in the market. But the question that has been asked in the past is whether the Bank of Italy did its job in making sure everything would be under control. We did what we had to do. We asked them to have enough capital and liquidity. So the real problem lies in the fact that they did not disclose all the information to the supervisory authorities.

You said Monte dei Paschi is becoming competitive again. But the bank emerged as the weakest lender in the ECB's review of banks last year and was told by the ECB to close the Alexandria trade with Nomura by July 26 this year because its exposure to Nomura breaches regulatory limits. Is the trade closed now?

IV: This is still ongoing. This will be done. The question is how large the exposure is. The bank has reported that it is now below 25% of capital. There is also a court investigation of some potential wrongdoing by Nomura.

The losses recorded by the bank were just the latest in a series of recent derivatives disputes in Italy. Do you see the derivatives market as a net positive or a negative for the domestic financial system?

IV: As far as Italy is concerned, the use of derivatives has been very limited. The risk that could arise would be if banks did not use the right models to value all their derivatives trades. For us supervisors it's not necessarily easy to look at each internal model and the way banks run them.

Now, I think some risks cannot be modelled. All these financial instruments are valued via models that assume a particular distribution of the prices, and this distribution at times may not be necessarily correct. Those models are useful because they force banks to look at the risk they take, but banks as well as supervisors must understand that a model is a model and not the real world, and backstops and constrained discretion should also be applied.

So the use of derivatives has been more a negative for some banks, especially in the US, but we are now moving towards a better control.

The ECB stress tests revealed a €25 billion shortfall at European banks at the end of 2013, and the bulk of this shortfall was in Italy, where nine banks failed to meet the Tier 1 capital requirements. Did you expect such results?

IV: The €25 billion shortfall was for all European banks and was recorded at the end of 2013. When the ECB's test was completed at the end of last year, only two Italian banks recorded a shortfall.

At the time [in 2013], the nine banks were already in the process of raising capital following a push we made at the end of 2012. So when the decision of forming the banking union and launching the SSM was taken, these banks had already started doing some work on that side. In the end, only two Italian banks [in 2014] have failed the test and have recorded a shortfall of less than €3 billion. This €3 billion shortfall represents less than 0.2% of GDP.

Those two banks were supposed to close the gap by July. Have they done so?

IV: They have closed it, yes.

The ECB and the Bank of England are pushing for the Basel Committee's Rating and Securitisation Workstream – which is currently reviewing the rules for the capital treatment of securitisations – to introduce a two-tier market with simple, transparent and comparable (STC) securitisations receiving favourable capital treatment, while more complex transactions would be penalised. Do you support this idea and do you think this is feasible?

IV: The performance of simple and transparent transactions – which are backed mostly or only by loans to the real economy and which show a well-understood relationship between the securitisation vehicle and the issuer – is likely to be easy to identify. This should support investors' demand.

Moreover, most of the transactions eligible as STC have shown strong performance and minimal losses in the recent period of severe financial stress. On the other hand, the toxic assets at the core of the global financial crisis involved transactions with complex and opaque structures, poorly underwritten loans, exotic derivatives and re-securitisation structures. These transactions fall in the non-STC category.

The different structure in terms of complexity and transparency as well as the lower level of risk due to the quality of underlying assets would justify a preferential prudential treatment.

Progress is being made on how to make the STC criteria operational. The regulatory treatment could be adapted and recalibrated. We could envisage a reduction in the capital requirements for both originators and investors taking part in simple transactions, for instance. However, this would only happen if the eligibility criteria for STC – and possible further supervisory criteria, which would relate to the credit quality of the underlying assets – are met. A more favourable capital treatment should help restart the [European securitisation] market and improve market liquidity and depth.

These policy initiatives are welcome and, if carefully designed so as to avoid an expansion of shadow banking activities, can have a positive impact on the ability of firms to access external sources of funding.

Should Europe go its own way if the Basel Committee decides not to support this idea?

IV: Discussions are ongoing at the Basel Committee level but, as I said, the idea of simple and transparent transactions has gained traction.

The idea is very much supported at the European level. I think this is due to some important and fair concerns such as reviving the financing of SMEs, which is also at the core of the Capital Markets Union project.

Italian banks should be transparent about the bail-in of senior bonds when they sell them to retail customers, Ignazio Visco says

Impairing senior bonds when restructuring a failing bank could pose legal problems in Italy where banks sell the bonds to savers.

Italy is in the process of amending its law to comply with the European Union's Bank Recovery and Resolution Directive (BRRD), which gives national authorities the power to impose losses on the shareholders, creditors and depositors of a bank in resolution, to prevent any resort to taxpayers' money.

The incoming Italian legislation is still being finalised but is "broadly consistent with the approach set under the BRRD", Visco said. Under the directive, senior bonds should be bailed in immediately after equity and subordinated debt, and before any corporate, retail and short-term interbank deposits. In contrast, currently Italy affords senior bonds the same protection as deposits and other liabilities necessary to carry out a bank's critical functions such as payment systems.

The treatment of senior debt under the amended law could pose "some legal risk", Visco acknowledged.

"There are always legal issues. You may already be familiar with the problem, but two years ago the Bank of Italy had some doubts about the possibility for these bonds to be bail-inable simply because there wasn't such a clause *ex ante*," he said, meaning a clause that would clearly state whether the bonds can be impaired or not.

The new Italian law, which Visco expects to come into force before the end of September, will provide that clarity. On May 28, the European Commission gave 11 EU member states, including Italy, two months to fully implement the BRRD, saying that if that deadline is not met, it may refer them to the EU Court of Justice.

When financial supervisors implement any new law, they must be "very careful" about the retroactivity of the rule, Visco said without elaborating. "That being said, the treatment of retail instruments versus other debt instruments issued by the banks is a sensitive issue and we have asked banks to properly inform their customers about the bail-in of these instruments."

Compensation claims can also arise under the BRRD due to the 'no creditor worse off' principle, which states that creditors should not sustain greater losses if a resolution authority restructures a failing bank than they would have if the bank had been simply wound up under normal insolvency proceedings. If the losses are greater, affected creditors can be compensated from a national resolution fund, financed by contributions from banks. The directive requires EU member states to set up such funds or equivalent financing arrangements.

Resolution-related legal claims are on the minds of other European countries as well. Germany is discussing a draft law that would subordinate certain senior unsecured debt to other senior liabilities. Earlier this month, the European Central Bank wrote that the proposed subordination should ease the resolution process and "minimise" the risk of compensation claims under the 'no creditor worse off' principle.