ACRI

Association of Italian Savings Banks

2015 World Savings Day

Address by the Governor of the Bank of Italy

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Rome, 28 October 2015

Since the beginning of this year the cyclical improvement has spread throughout the euro area, benefiting from the expansive measures adopted by the ECB Governing Council. The cyclical indicators confirm the continuation of the upswing in the third quarter in the area as a whole and in Italy, with growth rates similar to those of the two previous quarters.

Italian GDP has returned to growth for the first time since the inception of the sovereign debt crisis, at annualized rates of around 1.5 per cent. The initial stimulus from foreign demand has been flanked by a boost from domestic demand components with the consolidation of the recovery in private consumption and a gradual revival in investment. Business surveys confirm growing optimism about demand, favouring the propensity to invest. The significant expansion of employment, which has also benefited from government measures, will continue to sustain household consumption. In 2015 economic activity could grow by close to 1 per cent, faster than our July forecast indicated.

Looking ahead, however, the euro area and Italy face risks in connection with the Chinese economic slowdown and, more broadly, developments in the emerging economies. The repercussions on world trade and commodity prices are delaying the return of inflation to levels nearing 2 per cent. The Governing Council of the ECB is determined to use all the instruments available within its mandate in order to achieve the most appropriate degree of monetary accommodation under the current circumstances. We will assess the need for additional monetary stimulus at our meeting in early December.

1. Credit access and cost

Credit dynamics have improved in the course of the year, benefiting from the economic recovery and the plentiful liquidity made available by monetary policy measures. The volume of lending to households has increased, albeit slightly, compared with the previous year. Credit to manufacturing firms was up by 1.8 per cent in September, and the contraction of lending to service firms moderated significantly; for construction firms, which are still penalized by an uncertain outlook for the housing sector, the attenuation was less pronounced.

The monetary policy measures had an even greater impact on the cost of credit. The average interest rates on credit to firms and loans to households for house purchase in the euro area dropped to their lowest levels since 2003 (when the collection of harmonized data began); in August they were at 1.8 per cent and 2.3 per cent respectively. Differences between countries, which had increased greatly in 2011-2013, narrowed considerably. The average interest rate spread between Italy and the euro area for new floating-rate mortgage loans and new financing to firms dropped to around 10 basis points.

In Italy, the heterogeneity in lending terms and conditions for firms according to size and risk profile is also gradually diminishing, following a sharp increase during the recession. Since the middle of 2014 the decrease in banks' lending rates, which had initially only benefited the largest and financially soundest firms, has gradually spread to the rest. The reduced dispersion of interest rates is related to the improvement in the macroeconomic picture, which has been reflected in a generalized improvement in the outlook for earnings. This is confirmed by business surveys: the share of firms that expect to post a profit for the year is the highest in a decade. Interest rate dispersion is still historically high, but there is scope for a further decrease as the recovery firms up and the quality of credit consequently improves.

The harmonized interest rates on new loans to firms and households are the best gauge of the effectiveness of monetary policy, as they react most quickly to changes in monetary conditions. However, their information content as regards the terms and conditions of lending to single borrowers is only partial, because the harmonized rates are calculated as weighted averages based on loan amounts, exclude non-performing loans and, for almost all types of financing, are net of fees and other charges.

Further information on the lending conditions for different categories of Italian borrowers may be drawn from other data collected and published by the Bank of Italy, and in particular the data supplied to the Ministry of Economy and Finance for the purposes of the anti-usury law. These rates are calculated as simple averages, and they include non-performing loans (but not bad debts) and bank fees. They may therefore be higher, and in some cases considerably higher, than those calculated by the harmonized method. The impact of bank fees is greatest on current account overdrafts, which are commonly used in Italy, particularly by small firms, which also rely on this instrument for liquidity management services, which are remunerated by the fees. As the fees are, at least partially, fixed, they have a larger impact on small loans.

The widespread use of overdrafts in Italy, much greater than in almost all the other euro-area countries, should prompt a rethinking of their utilization. Firms need to consider more efficient and less costly methods for managing liquidity; they should also weigh the advisability of greater resort to fixed-term loans. Banks must guarantee that the liquidity management services embodied in current account overdrafts do not cost more than their effective value, and they must also take account, in their pricing, of the indirect advantages they reap from the provision of these services. In fact, when the counterparties are small firms, the information asymmetry between banks and firms is more severe, and managing the firms' liquidity enables banks to gather further information, thereby attenuating the risks connected with difficulties and uncertainty over the timing of credit recovery procedures.

In August the Bank of Italy opened consultation on a draft of the resolution to be submitted to the Credit Committee on the implementation of the newly revised Article 120 of the Consolidated Law on Banking, which governs accrual of compound interest on banking transactions.

Our proposal – prepared as required by the law – is intended as a clarification in the interests of transparency of the rules. It is based on a reading of the law that is shared by the Ministry of Economy and Finance. The solutions set out implement the principle established by the law, namely the ban on compound interest on banking transactions, in keeping with the economic substance of contractual relationships and avoiding uncertainty and any effect on debtors that is contrary to the intentions of the legislature.

The most technically complex case to regulate is the current account overdraft, which, as I just now noted, is a much more common form of credit in Italy than elsewhere. Since the law states that banks cannot require the automatic settlement of the interest due on overdrafts, we have had to create a framework of legal certainty to cover situations in which the customer lacks – even temporarily – the liquidity needed to pay the interest on the due date. The proposal settles this issue by forbidding banks from taking immediate action. It allows the payment of interest by debiting the account, after a period of 60 days has elapsed, only at the request of the customer, who has an interest in allowing payment in order to avoid the legal and practical consequences of non-performance that he could otherwise suffer, including default penalties and revocation of the credit line where the requisite conditions apply. Finally, in accordance with the law's purpose, the draft proposes that interest be calculated only once a year and not quarterly, as is the usual practice.

The consultation document envisages that the resolution be applied only after it enters into force, in accordance with general legal principles. It does not take a position on how the law should be applied prior to action by the Credit Committee. We hope for clear guidance on this delicate issue, which will continue to be evaluated in light of the case law, in order to ensure certainty in the law and in banking transactions.

The consultation was concluded a few days ago. We received numerous comments from an ample cross-section of participants. We will analyse them carefully and consider the suggestions for improving the text to be submitted to the Credit Committee.

2. Savings and the management of banking crises

Starting next year the new European banking crisis resolution system will be fully operational with the transposition of the EU Bank Recovery and Resolution Directive (BRRD). The system forms part of the broader process of reforming international financial rules to reduce the probability and the impact of bank failures by strengthening capital requirements, setting limits on financial leverage and instituting new minimum liquidity ratios. Banks deemed to be systemically important are subject to additional safeguards, and further measures are being discussed at the international level.

It must be understood that the new rules will tend to diminish both the profitability and the size of banking systems, shifting a portion of the financing of the real economy to the capital market and increasing the relative importance within the credit market of institutional investors other than banks. In Italy, a shift of this kind in the financial system has long been desirable to accompany the transition of the economy towards a more modern structure, with less bank debt and more equity and bond issues.

Under the new European system the Single Resolution Board and the national resolution authorities will be responsible for handling bank crises, with a division of competences that takes account of the type of intermediary involved and the possible need for recourse to the Single Resolution Fund. The Bank of Italy, designated as the national resolution authority, has created a special unit that reports directly to the Governing Board and is independent of the Directorate General for Financial Supervision and Regulation, as required by European legislation.

The European regulatory framework envisages a variety of tools to help failing banks restructure or exit from the market without interrupting the provision of critical functions and jeopardizing the overall stability of the financial system. The primary innovation is the bail-in procedure, which requires shareholders and creditors to directly bear the losses incurred by banks in difficulty and to shoulder the burden of recapitalizing them.

This tool, which is entirely new for Italy, was requested specifically by those EU countries that had to intervene heavily to support their banking systems during the recent global crisis. In the euro area, these measures weighed on the public debt to the tune of around 5 percentage points of GDP in Belgium, the Netherlands and Spain, more than 8 points in Austria and Germany, over 10 points in Portugal and over 20 points in Greece and Ireland. In Italy, although the economy was hit harder by the recession than most of these other countries, the system required practically no public intervention.

Now, notwithstanding the undeniable success of our model of banking supervision and crisis management in containing and resolving cases of failure, with extremely marginal use of public resources, this model must be adjusted to bring it into line with the new European rules.

In applying the bail-in procedure, we must take into account the need to protect creditors while at the same time safeguarding financial stability. We must act to make sure the procedure is applied only in limited and extreme circumstances. The priority ranking of creditors will, in any event, be respected, and no creditor will have to bear losses greater than those that they would suffer if the failing bank were liquidated under ordinary bankruptcy procedures ('no creditor worse-off' principle).

Bail-ins will not affect deposits up to €100,000, which in no case will be called upon to contribute to the costs of resolution. Deposits above this threshold, going by the current wording of the legislation transposing the Directive, will get preferential treatment over other liabilities of the bank; consequently there is little chance that they will be hit by the resolution of a crisis.

Unsecured bank bonds may be subject to the bail-in tool, after regulatory capital instruments and subordinated debt. It is essential, therefore, that banks, bearing this risk in mind, fully discharge their obligations of transparency and correctness in the issuance, placement and trading of these securities with retail clients. The authorities will monitor compliance with the rules. Banks, for their part, will have to consider how to direct less sophisticated customers towards more secure forms of funding, those better protected in case of crisis.

To avoid the possible adverse effects of bail-ins, the resolution authorities will make sure that banks carry the right amount and type of liabilities to ensure the absorption of losses and recapitalisation; they may require that a part of the minimum requirement for liabilities eligible for the bail-in tool consists of subordinated debt. In a resolution, where necessary to safeguard systemic stability and the continuity of essential business functions, the resolution authorities may exclude additional liabilities and resort instead to the resolution fund once at least 8 per cent of the liabilities of the bank in crisis have been bailed-in.

In recent years we have managed a number of crisis situations, without losses for depositors, costs to the Treasury, market distortions or interruption of essential services provided by the banks. These objectives continue to guide the actions of the Bank of Italy, in a context that is complicated by the transition towards the new resolution system and the increased importance of the intermediaries involved. Recourse to certain instruments widely used in the past, such as the support provided by deposit guarantee funds, has been called into question by the recent European Commission stance on state aid; this field is often marked by uncertainties, which may hinder the rapid action indispensable in crisis management. The European authorities would do well to favour coordination and certainty of law in the application of the competition provisions and the rules on bank resolution.

3. The state of Italian banks

3.1 Non-performing loans

Italian banks' large stock of non-performing loans is a legacy of the long and deep recession. Their rapid reabsorption would facilitate a recovery in lending and a lowering of the cost of credit. Parliament's recent measures to shorten credit recovery times are a step in the right direction and are helping to rekindle interest in investing in the non-performing assets of Italian banks. It is estimated that if Italian recovery time had been as short as those of France and Germany, the ratio of bad loans to total loans would be less than half what it is now.

What matters now is to implement the measures rapidly. The efficacy of the bankruptcy procedures could be further enhanced by strengthening the organizational and independence requirements for curators and special administrators; significant impetus could come from the institution, as in other jurisdictions, of a publicly accessible national electronic register containing all the information and relevant documents relating to foreclosure and bankruptcy proceedings.

In the three years 2012-14, Italian banks sold or securitized bad loans amounting to about €11 billion (around 2 per cent of their outstanding bad debt). In the early months of this year, the sales continued to be for small amounts. For the most part the transactions involved the major groups and foreign banks operating in Italy. The smallness of the transactions to date can be ascribed to information asymmetry between buyers and sellers relating to poor data management at many banks and the objective difficulty of assessing the conditions of many indebted small businesses. Public intervention, obviously in compliance with the regulations on state aid, could facilitate the development of this market, serving as a catalyst for private sector initiatives.

While the discussion continues on this matter between the Italian government, assisted by the Bank of Italy, and the European Commission, further studies are being conducted to ascertain the actual interest of both potential investors and banks in a company to purchase and manage impaired assets, operating at market conditions. Public participation in this asset management company would be marginal or nil; there could be a state guarantee for the senior liabilities it issues to finance its asset purchases.

Over the next few weeks the feasibility of the project will be definitively determined. Regardless of the outcome of the verification, banks burdened by large non-performing exposures will still have to identify, in accord with the supervisory authorities, the best procedure for efficiently managing those assets in order to gradually work off the overhang.

3.2 Governance, cooperative (popolari) banks and mutual banks

Change to the banking system has been given significant impetus by the reform of Italy's main cooperative (popolari) banks. The first steps provided for by the law for their conversion into joint stock companies have been taken: the presentation of the plans laying out the steps required and the timeframe within which the operations will be completed, which in many cases could be by the middle of next year. In recent days the project for the conversion of one large cooperative group – directly subject to the Single Supervisory Mechanism – was approved by the shareholders' meeting. As I have often had occasion to observe, a change in the legal form provides a golden opportunity for strengthening corporate governance to permit more rapid access to capital markets and facilitate mergers that could help to increase profitability.

It is not for the authorities to suggest or impose any merger plans, which must be identified and decided by the corporate bodies themselves. Merger projects developed by the market will be carefully appraised in terms of their current and future financial soundness and the effects on the banks’ situation.

For some unlisted cooperative banks, conversion into joint stock companies will be part of a broader transformation of governance also comprising stock exchange listing. These interventions will greatly enhance access to capital markets and help overcome the problems with the current process of share price determination, which the law reserves to the shareholders’ meeting. Stock exchange listing will also ensure the liquidity of the investments of shareholders who wish to dispose of their holdings.

The Banca Popolare di Vicenza is one of the cooperative banks that have embarked on this process as part of the measures required by the supervisory authorities. As the explanatory note published on our website yesterday describes in more detail, in 2014 evidence emerged that this bank had committed irregularities in share buybacks. In agreement with the new European supervisory bodies, which were about to start operating, we scheduled a targeted inspection for immediately after the European Comprehensive Assessment. This intervention, conducted by Bank of Italy inspectors as part of the Single Supervisory Mechanism, revealed other practices not in compliance with the rules. As soon as the initial findings of the investigations begun last February started to emerge, the Bank of Italy and the ECB concurred fully on urging the Banca Popolare di Vicenza to adopt immediate corrective measures. The top executives and almost all of the senior management were replaced; a capital strengthening plan was drawn up, the success of which is ensured by the presence of an underwriting consortium; and a radical reform of corporate governance is planned for the cooperative’s conversion into a joint stock company and its simultaneous stock exchange listing.

A reform of the mutual banking sector is also needed now. Self-financing, the main source of funds for increasing these banks’ capital, has essentially dried up as a result of the recession. In the absence of any decisions, the necessary increase in provisions to cover non-performing loans would lead to a further reduction in the capacity for self-financing; a significant part of the mutual banking system would incur negative evaluations by the supervisory authorities and might not be able to meet the need for a larger capital endowment. This could give rise to situations that would be difficult to manage within the new crisis resolution framework, also considering the constraints of the regulations on state aid.

Mutual banking systems in other euro-area countries have long since instituted highly integrated organizational structures capable of realizing economies of scale, unitary risk control mechanisms, and safety nets for the liquidity and solvency of the participating banks. Some of these arrangements are already in place among Europe's major banking groups.

We have followed the recent discussion within the mutual banking sector over plans for self-reform. A point on which there is still open debate is whether there should be just a single mutual banking group or more than one. The idea of a single group, if agreed upon within the category, certainly has positive aspects, but the possible lack of consensus on a single group should not be a reason for blocking the reform. Greater capitalization, greater efficiency and improved corporate governance could also be achieved by a limited number of groups.

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If economic activity falters and incomes shrink, as has happened in Italy for seven long years, it then becomes difficult to protect savings. The first response is macroeconomic policies and decisive and forward-looking structural reforms to promote strong and balanced growth, efforts to which we are strongly committed as part of our mandate as the central bank.

A long and deep recession weighs heavily on the banking system. Recent years have also seen serious instances of malfeasance, compounded by the economic problems in themselves. We are active in countering situations of serious difficulty or crisis by means of supervision, strict enforcement of the rules, and verification of organizational adequacy, prudence in lending, and transparency and correctness in funding. When a crisis does occur, action must be taken to resolve it and limit its repercussions. This is no easy task, it is a constant challenge, yet those episodes of malfeasance that have occurred in these difficult years came to light also thanks to the usually decisive if not always publicly known contribution of the Bank of Italy.

Notwithstanding the recession and notwithstanding instances of misconduct, the system as a whole has held firm. I am confident that the banks, good credit and sound finance, will contribute significantly to the economic recovery, which needs to be consolidated and strengthened. Our economy must make up for its accumulated lag in adapting to the transformations of the global economy, technology and demographics, a process in which finance and the banks will play a vital role.

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