Euromoney - The Italy Conference

Advancing European financial integration

Keynote address by the Governor of the Bank of Italy

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I would like first of all to thank Euromoney for inviting me today and I wish a warm welcome to all participants. The conference program is ambitious, spanning from the European economic outlook to key issues for Italy such as public debt, competitiveness, structural reforms and the banking system.

I will start by briefly reviewing some of the most recent economic developments. I will then offer some thoughts on the objective of advancing the integration of European financial markets. Indeed, beyond the current cyclical developments, completing the Banking Union and diversifying the sources of financing for households and non-financial firms by setting up a Capital Markets Union remain the priorities to deepen European financial integration, foster higher and more sustained growth and help prevent the repetition of crises whose very high economic and social costs we are still having to face.

The economic outlook and the ECB monetary policy

The growth recovery in advanced economies is facing the impact of a further slowdown in emerging market economies, hit by declining commodity prices, less favourable external financing conditions and a sudden reassessment of China's growth prospects and subsequent global repercussions. Slower growth in advanced economies in the first half of the year reflected weakened exports and a deceleration in domestic demand. Since the summer, the major correction in Chinese equity markets has triggered a wave of volatility in global financial markets and a renewed drop in commodity prices.

Weakening foreign demand is not just a major concern for exports but can also endanger the tentative recovery of investment, which hinges on the prospects for trade. Further downward pressures on oil and other commodity prices, on top of other supply factors, may also push down inflation and inflation expectations, raising real interest rates.

Global financial markets are also being conditioned by the expectation that the first increase in the federal funds rate is approaching, which would reflect a further strengthening of the US economy. Financial conditions in advanced economies remain accommodative nevertheless and a modest pickup in growth is projected by the IMF this year and in 2016.

In the euro area, the economic recovery is expected to continue, albeit, perhaps, at a weaker pace. Growth is also being held back by the process of balance sheet adjustment that is still undergoing across a number of sectors. But the ECB asset purchase programme exerts a positive impact on the cost and availability of credit for firms and households. Recent sharp fluctuations in financial and

commodity markets are under close monitoring in order to assess their possible impact on the outlook for prices. At its meeting of September 3 the ECB Governing Council recalled that the programme provides sufficient flexibility in terms of adjusting its size, composition and duration; it reaffirmed its willingness and ability to act, by using all the instruments available within its mandate, if necessary, in particular to counter an unwarranted tightening of monetary conditions or a material worsening of the inflation outlook.

In Italy, the recovery is expected to proceed at a moderate pace. More favourable financing conditions, following the very easy monetary policy stance that has resulted from the decisions progressively taken since the summer of last year, and increased confidence would finally also support domestic demand and capital accumulation. Private consumption should also benefit from lower oil prices and stronger household income, boosted by government's measures and by the improvements in labour market conditions. Recent data on economic activity and households' spending go in the direction of confirming the overall improvement in growth prospects.

Credit conditions and credit quality

Credit conditions in the euro area continued to improve, albeit slowly, reflecting an easing in credit standards as well as an increase in loan demand. In July, both the annual growth rates of loans to households and non-financial corporations increased to 1.9 per cent and 0.9 per cent, respectively, while heterogeneity of credit conditions across countries has narrowed.

In Italy, credit demand among firms is picking up for the first time since 2011, while demand among households has also strengthened. However, both credit conditions and loan dynamics remain heterogeneous across sectors of economic activity. According to the Bank Lending Survey for the second quarter of 2015, Italian banks kept easing credit standards for both firms and households, as balance sheet and liquidity conditions have improved and competition among banks has increased. As a result, in July the 3-month annualized growth rate of loans to firms turned positive (0.7 per cent, from -0.2 per cent) for the first time since November 2011 and the growth rate of credit to households further increased.

However, despite improvements prompted by monetary policy measures, bank credit in the euro area remains subdued, partly as a consequence of high levels of non-performing loans (NPLs). This is especially the case for Italy, where the volume of non-performing loans (NPLs) has trebled since the start of the global crisis, largely due to the major fall in economic activity (close to 10 per cent for GDP and 25 per cent for industrial production). It also reflects structural problems, including an inefficient legal system and particular features of the tax system.

As a result, a lasting solution to the NPL problem requires a comprehensive strategy: removing the inefficiencies plaguing the bankruptcy and foreclosure system that prevent a faster recovery of credit as well as kick-starting the markets for NPLs. In August, the Italian government passed a law with two sets of key measures. A first set amends the insolvency and foreclosure system. These new measures will reduce the length of legal proceedings and increase the recovery rate of creditors' claims. A second set of measures allows for the immediate, rather than deferred, fiscal deductibility of banks' write-downs and loan losses, aligning the Italian fiscal rules to those prevailing in the main euro area countries. These new provisions put an end to the long-standing regime of deferred deductibility of loan losses, which created disincentives for banks to provision; as a consequence, no new deferred tax assets in connection with loan loss provisions will be created.

As these measures address some of the root causes of the high stock of NPLs, they are expected to have positive effects on NPL prices, further reducing the price gap between banks and potential buyers and helping the development of a secondary market for these loans. However, this market is still extremely thin and opaque; prices may not be fairly determined. The launch of an Asset Management Company (AMC), which would buy NPLs (specifically "bad loans") from banks, would contribute to kick start the market for NPLs, increase the transparency of banks' assets and improve the conditions at which they raise capital and funding.

The AMC would be different from similar vehicles set up in other countries, where banks were in a state of crisis and were forced to participate. First, in Italy the project is aimed at solvent banks, hence participation would have to be voluntary. Second, unlike previous cases, its design would have to be such that assets are transferred at market prices. This rules out a transfer of losses from the banks to the State, which would trigger the consequences of the European State-aid regulation. These important differences substantially increase the complexity of the scheme, whose feasibility is still being studied. This is the object of the current interaction with the European Commission.

European financial integration and the crisis

Ongoing efforts on several fronts to fully restore the functioning of credit markets in the euro area are relevant not only to support growth via an adequate flow of credit but also, from a central bank's perspective, because diversified and integrated financial markets help to improve the smooth and uniform transmission of monetary policy.

Following the introduction of the common currency in 1999, European financial integration achieved remarkable progress, most notably in those market segments that are closer to the single monetary policy, but also in markets for government and corporate bonds. The unsecured money

market, a key segment of interbank markets, had reached a stage of “near-perfect” integration almost immediately after the adoption of the euro. The standard deviation of the EONIA lending rates across euro area countries had fallen sharply to close to zero and had remained stable until the beginning of the global financial crisis in July 2007.

The global and euro area sovereign debt crisis provoked a sudden reversal of this progress. Reflecting the incompleteness of the euro project, “redenomination” risks materialized through very high credit and sovereign spreads, undoing financial integration and replacing it with financial fragmentation along national lines, which came to represent a hallmark of the euro area crisis.

Over the last three years or so, the European response has brought financial integration back to a level comparable to pre-sovereign debt crisis levels, although some fragmentation still remains. A comprehensive monetary policy response, national efforts towards fiscal consolidation, a reinforcement of euro area banks’ balance sheets and major reforms of the European economic governance, most notably the launch of the Banking Union, have eased financial conditions and greatly reduced financial fragmentation.

The Banking Union

Banks remain the backbone of the euro area financial system: their health is paramount in effectively providing financing for firms, notably small- and medium-sized enterprises, and for the economy as a whole.

The Banking Union is a landmark step towards deeper financial integration. Its first pillar, the Single Supervisory Mechanism (SSM), has been up and running since November 2014. Drawing on the EU single rulebook, it provides a euro-area approach to supervision, as well as better monitoring of cross-border banking groups. The ECB has also been equipped with new macroprudential powers and tools that may complement instruments available to national competent authorities in addressing systemic risks, such as those that may arise from the procyclicality of credit supply, a key driver of many detrimental boom-bust cycles.

The benefits of the SSM became visible even before it came in operation. The comprehensive assessment that preceded it has stimulated a substantial strengthening of euro area banks’ balance sheets, setting the preconditions for their renewed ability to adequately finance the economy. The ECB and the national supervisors are working to gradually remove national discretions and heterogeneities. The final objective should be to further foster financial integration so that banks operate in a full level playing field.

The Single Resolution Mechanism (SRM), the second pillar of the Banking Union, will be fully in place as of January 2016. Ensuring the timely and effective resolution of failed banks is a crucial component of a stable financial system. By promoting better crisis resolution, the SRM will also improve market discipline and reduce excessive risk-taking.

The SRM will make use of the harmonized tools provided by the EU Bank Recovery and Resolution Directive. The inclusion of a bail-in provision in the Directive marks a radically new approach to resolving bank crises, whereby the necessary resources should be drawn first of all from the bank's shareholders and creditors in order to avoid or minimize potential costs for the taxpayers. Let me recall that bank deposits protected by the deposit insurance system are excluded from bail in. Besides these deposits, other deposits held by individuals and by small- and medium-sized enterprises would receive preferential treatment with respect to other instruments.

We are aware that the introduction of bail-in tools may have an impact on the banks' funding costs. In addition, in placing their securities, banks must be most careful to comply with the investor protection rules, since subscribers may be called on to contribute to the resolution costs. Customers must be given exhaustive information on the characteristics of the different instruments, the riskiest of which should be expressly reserved solely to institutional investors.

But resolution is just the final step when a financial institution is undergoing a crisis. Recovery is as, if not more, important. In order to avoid having to resort to resolution – or, should resolution become necessary, to make it efficient and avoid undermining the provision of important financial services – banks are required to be prepared in advance to confront stress, and must make recovery plans readily available – a set of actions that the bank itself would undertake in order to restore or maintain its viability and financial soundness.

It is the responsibility of supervisory authorities to assess the quality and credibility of these recovery plans and to require their implementation as an early intervention measure. On the other hand, resolution authorities will draft resolution plans to identify the resolution strategy that best fits the organizational and operational structure of the bank and adopt measures to improve resolvability, where adjustments are required. Given the need to duly take into account the impact on the ongoing business and the stability of banks, supervisory and resolution authorities should cooperate closely in defining such measures.

Finally, completing the Banking Union requires further steps, including the construction of its third pillar, the proposed European Deposit Insurance Scheme. A common, privately-funded scheme would be consistent with the main idea underpinning the Banking Union, i.e. that effective crisis

management is in the best interest not only of the Member States in which banks operate but also of the euro area as a whole given the interconnections that characterize a financially integrated market.

It is expected that the establishment of the Banking Union will foster structural changes in the European banking sector, for example consolidation via cross-border M&As. The structure of the sector might also be affected by the adoption of the European Commission's proposal that sets limitations for the biggest and most complex banks in risky proprietary trading and the possibility for supervisors to require separation between certain potentially risky trading activities and deposit-taking business in case of threats to financial stability.

Given the impact of the past financial crisis, measures to make the system more resilient are welcome and the structural measures add to the toolkit to address this objective. At the same time, a too-harsh design such as the outright ban on proprietary trading might have unintended consequences on the smooth functioning of markets; therefore, the milder European solution – separation, as opposed to an outright ban for proprietary trading – represents a balanced outcome.

The Capital Markets Union and the complementarities between bank and market financing

The crisis has not only underlined the need for revising and strengthening prudential regulation and aiming for higher standards of bank supervision but has also made evident the limits of a financial system that relies excessively on banks, thus highlighting the importance of diversifying the sources of financing. Going forward, capital markets and non-financial intermediaries will have to take on a larger role in financing investment and economic activity. This goal is even more important given that the crisis-induced reforms of the international regulatory framework impose tighter capital, liquidity and leverage requirements on banks with the objective of building a safer financial sector and with long-term effects on their lending capacity. Overall, banks will become more selective in their credit decisions and will adjust their business models accordingly.

The European Commission proposal unveiled last February to establish a Capital Markets Union (CMU) by 2019 has among its primary objectives the lowering of barriers to accessing equity and bond markets. Obstacles are particularly severe in the case of small- and medium-sized enterprises aiming at raising risk capital. This objective implies that particular attention should be given to the complementarities between bank financing and market financing, rather than considering the two as obvious alternatives. And such complementarities are indeed numerous, both at a macro and a micro level.

At a macro level, the CMU must be seen as a natural complement to the Banking Union in providing macro-financial stability. At the risk of oversimplifying, we may say that the latter addresses the sovereign-bank negative feedback loop that epitomized the euro area crisis while the CMU contributes to tackling another potential circle that can be at least equally vicious: the firm-bank loop, whereby the funding difficulties of banks – or, even worse, pressures to deleverage – translate into more costly or less financing for creditworthy firms; in the reverse situation, when firms face problems in servicing bank credit, non-performing loans increase, weakening banks' balance sheets and impairing their lending capacity.

At a micro level, the CMU can complement the banking sector in fostering innovation while also strengthening firms' financial structures. Research has long documented the fact that, among external sources, equity financing is best suited to foster innovative activities, for a number of familiar reasons. Start-up firms display stronger information asymmetries and have typically low or even no tangible assets to offer as collateral for bank loans; furthermore, private equity or venture capital financiers foster innovation not only by providing capital but also managerial expertise and deeper knowledge of innovative sectors. There is evidence that equity financing spurs innovation also for Italian firms.

The benefits of broader capital markets also extend to those which in principle can be seen as competitors, i.e. banks. High quality securitization, one of the CMU's short-term priorities, can free up banks' regulatory capital and increase their lending while allowing them to manage credit risks more efficiently. And broadening financing sources for SMEs can be beneficial not only for these firms but also for banks. By facilitating firms' access to non-bank financing, notably equity capital, and improving their financial structure, CMU helps make firms more creditworthy, thus safeguarding banks' balance sheets. Besides, banks can increase fee-based revenues by providing consulting services to firms that want to access capital markets.

The CMU project is ambitious and prioritization is the key to advancing it effectively. In the short term, priorities should include: the simplification of the prospectus Directive, so as to facilitate listing for firms, especially SMEs; the standardization of information on credit quality; the development of a market for simple and transparent securitizations, possibly subject to favourable prudential treatment; the promotion of cross-border investments in venture capital; and the creation of a European private placement market, a form of financing that allows firms to place their bonds with one or more institutional investors at a lower cost than that of issuing securities to the public.

Challenges are stronger over the longer term, as a full CMU requires harder tasks such as harmonization of the various countries' company and bankruptcy legislation as well as reduction in

the differences between the tax treatment of capital gains. Legislative harmonization will inevitably be a gradual process; a modular approach seems the most reasonable course of action to follow, starting with the easiest reforms and then gauging where there is room to tackle more ambitious challenges.

I have recently highlighted the distinctive importance of the CMU project for Italy. The country is a case in point as to the risks of relying excessively on a single source of financing, namely bank credit. Several years of financial crisis, a major effort to restore fiscal sustainability and two recessions have severely impacted on the Italian economy and its banking system. In turn, banks' difficulties hit Italian firms strongly as they are generally more dependent on bank credit and less capitalized than their European counterparts.

By favouring access to non-bank financing, CMU can complement legislative measures adopted over the last few years that are underpinning progress towards a stronger financial structure for Italian firms. The introduction in 2011 of an Allowance for Corporate Equity and its further extensions have almost completely eliminated the previous fiscal incentive for debt; this should stimulate firms' raising of equity capital. Also, new stock market listings have increased, the volume of bond issues has gone up, including for medium-sized firms, and the number of mini-bond issuers has been rising.

Obviously a key goal of the CMU is to support and complement the Investment Plan for Europe. Business investment remains sluggish and weaker external and domestic demand is hampering a stronger recovery.

Conclusions

Due to the incompleteness of the European construction, the recent crises dramatically exposed the reversibility of even the major progress towards European financial integration made since the introduction of the euro. Even worse, at one point the sovereign debt crisis threatened the very survival of the euro project itself.

As part of the multi-faceted European strategy to respond to the crisis, the establishment of the Banking Union and the launch of the Capital Markets Union proposal are complementary milestones and are part of the efforts we are all engaged in towards completing the Economic and Monetary Union and making it stronger.

The establishment of the Single Supervisory Mechanism has been an important step towards overcoming the euro area sovereign debt crisis and a key driver in underpinning a major

strengthening of banks' balance sheets. This has paved the way for improving their capacity to finance the euro area economy. In the medium term, however, banks' capital strengthening has to stem from economic recovery. Efforts are therefore needed at all levels – both national and European – to promote growth.

The Single Resolution Mechanism and the Bank Recovery and Resolution Directive are ushering in a new framework for managing bank crises; equally important, they can play a role in crisis prevention by promoting market discipline. By broadening non-bank sources of financing for firms and households, the Capital Markets Union will further advance European financial integration while fostering economic growth and financial stability.