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Speech by the Governor of the Bank of Italy
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Recent economic developments

The moderate acceleration in global growth under way since the summer may continue this year and the next, bolstered by the expansionary stance of the fiscal policies announced in the United States and by the effects of those enacted in China and in Japan, where monetary policy is also highly accommodative. The outlook, however, remains subject to a high degree of uncertainty.

The scale and components of the new US administration's policies remain unclear. So far, the increase in medium/long-term interest rates in the United States, also spurred by anticipation of such policies in an economy with close to full employment, has been transmitted to the other main countries to a limited extent owing to divergent monetary policy stances. Adverse effects on the world economy could arise were a further increase in yields, linked to higher risk premiums, not to be accompanied by a parallel improvement in growth prospects and were capital outflows from emerging economies to become more intense. The US administration's declared intention of slowing down or reversing trade liberalization processes, and the steps it has already taken in this direction, risk triggering tit-for-tat measures in other countries, with negative repercussions for world growth.

In the euro area the economic recovery is proceeding slowly. The measures adopted by the ECB Governing Council have greatly curtailed the risk of deflation and paved the way for a gradual return to monetary stability. The rise in inflation in December is, however, largely ascribable to the energy components of the HICP and to other highly volatile items; there are as yet no clear indications of any inversion of trend in the core components driving developments in consumer prices and wage growth, even in countries where unemployment is lower. The Eurosystem's projections put inflation at barely above 1.5 per cent in 2019.

To bring inflation back to a path consistent with medium-term price stability, monetary conditions must continue to be highly accommodative. The Governing Council accordingly decided to extend the expanded asset purchase programme until end December 2017, or beyond, if necessary, and to trim monthly purchases back to €60 billion starting in April. At the end of this year these purchases will amount to around €2,300 billion. The Council expects official rates to be held at levels equal to or below the current ones for a period that extends well beyond the programme's horizon.

The Bank of Italy is continuing its purchases of public-sector bonds, ensuring orderly conditions on the secondary market, including through securities lending operations; for covered bank and corporate bonds we also intervene during the placement of new issues, thereby increasing the availability of funds. There has been intensive and increasing interaction with market operators; since April purchases of asset-backed securities, previously also concluded by external asset managers, will be made entirely by national central banks.

In the euro area too, uncertainties abound regarding developments in the real economy. Growth in productivity continues to be insufficient. Capital investment still needs reinforcing. Strengthening output and at the same time addressing the effects – though positive overall – of new technologies on employment requires the contribution, not only in Italy, of other policies and interventions in addition to monetary policy measures.

In Italy the production of goods and services continues to increase, though the pace of the recovery is slow and lags behind average rates in the euro area. Labour market conditions have improved; business confidence remains solid while the decline in consumer confidence came to a halt in the autumn. The data for the last two months largely confirm our projections. In the most recent scenario outlined in last week's *Economic Bulletin*, gross domestic product is forecast to grow by around 1 per cent on average per year in 2017-19.

Nevertheless, the scenario is susceptible to risks. It assumes, aside from favourable conditions worldwide, that medium and long-term yields will remain low and that the pace of growth in lending will continue to pick up in an economy in which alternative forms of financing to banks are struggling to gain a foothold.

The maintenance of orderly market conditions, consolidation of growth, recovery of investment and further improvement in the labour market assume above all that Italy will press on with its reforms of recent years. The consequences of greater uncertainty over the political will to pursue an indispensable modernization agenda must not be underestimated. So far, and notwithstanding the less favourable assessments of credit rating agencies, the effects on the financial market have been limited. However, the spread between the yield on ten-year BTPs and the corresponding German Bund is around 50 basis points higher than the average observed in early 2016 and has widened considerably with respect to Spain.

Banks and credit risk

The economic recovery is being reflected in the indicators of credit quality, which continue to show an improvement. In 2016 the flow of new non-performing loans (NPLs) reached its lowest level since 2008; from the end of 2015 the stock of outstanding NPLs also began to diminish, albeit gradually. Nonetheless, they continue to weigh heavily on the balance sheets of Italy's banks and there have been repeated calls for better, firmer and more comprehensive management of these exposures.

Last June bad loans and other NPLs on the balance sheets of Italian banks amounted to €191 billion net of write-downs, that is 10.4 per cent of total loans. Including write-downs, NPLs came to €356 billion, a figure frequently quoted in debates, which refers to the face value of the exposures and accordingly does not represent their actual weight in banks' balance sheets. Out of €191 billion of NPLs, net bad loans, i.e. exposures to insolvent debtors, amounted to €88 billion or 4.8 per cent of loans. The remaining €103 billion pertained to situations in which regular repayments may resume, especially if the recovery gains momentum.

The bad loan recovery rate effectively recorded by Italian banks averaged 43 per cent over the ten years 2006-15, a proportion largely in line with banks' balance sheet figures. Our studies point to a wide dispersion of recovery rates: for many banks the margin for improvement is considerable and must be rapidly exploited. The first two rounds of new bad debt reporting received and analysed by the Bank of Italy last year revealed that there is still some way to go in creating detailed and easy-to-access databases.

In the two years 2014-15, recovery rates dropped to an average of 35 per cent. This was partly due to an increase in the number of positions closed following 'en bloc' market sales to specialized investors: in the ten years considered, the average recovery rate for these sales was 23 per cent, against 47 per cent for positions closed following standard procedures. The market prices of exposures should be assessed bearing in mind that they reflect the very high yields demanded by oligopolistic buyers, which also factor in the possibility of long recovery times; in some cases the existence of a large proportion of long-standing bad debts, already amply written down, explain the particularly low selling prices.

The large volume of Italian NPLs has drawn the close attention not only of the supervisory authorities but also of international markets and observers. It requires careful management. The majority of bad loans are held by banks in a sound financial position that therefore do not need to sell them immediately. For the more problematic banks, ridding themselves of a legacy of bad loans is an essential step towards recovery. The best trade-off between sales on the market and internal management is a matter for individual assessment. From this perspective, the draft guidance on NPLs recently issued by the ECB's Single Supervisory Mechanism advises banks to actively manage these exposures and calls on those with a large proportion of NPLs to draw up suitable plans to reduce them.

Numerous well-known factors have contributed to Italy's high level of NPLs. The most important by far, however, is the long and deep recession, which has undermined many firms' ability to repay debts, which were not always granted with sufficiently careful assessment. The length of credit recovery procedures has also played a part: if recovery times in Italy were in line with the European average, the ratio of bad debts to total outstanding loans would be about half what it now is.

Furthermore, setting up an asset management company with public funding, as other countries have done in the past, has now become impossible owing to the new European rules on State aid introduced in 2013 and their rigid interpretation. Previously, during the sovereign debt crisis, given serious market concerns about the sustainability of Italy's public debt, any action by the State was unlikely to be successful. Moreover, in contrast to the situation in countries where real estate bubbles burst, the deterioration in bank lending was not confined to specific sectors of the economy; the international institutions and leading forecasters projected a far more rapid exit from the crisis than was actually the case.

Many of the necessary conditions for solving the problem of non-performing loans are now in place. As I mentioned earlier, the economic recovery is being reflected in the quality of credit; as it gradually gains pace, the banks will be able to repair their balance sheets. The reforms of the last two years should also improve the credit recovery process. It is still too early to see the full results as the greatest impact will be on 'new' bad loans. However, some of the measures, especially those relating to out-of-court solutions for corporate debt restructuring and the transfer of ownership of real guarantees, are already in place and could make a difference to the stock of NPLs: they should be activated without delay.

Recovery procedures could be further speeded up by implementing the other tools offered by the new rules: the portal for public auctions (now being trialled); the online register of non-possessory liens and that of foreclosures and bankruptcy proceedings; the extension to consumers of the Marcian Pact forfeiture clause. Further improvements might include additional specialization of judges in bankruptcy proceedings and reducing regional differences in courts' performance.

An important contribution on the European front could come from a regulatory provision eliminating or limiting the measures that discourage banks with advanced internal ratings-based (A-IRB) models from selling their NPLs 'en bloc'. Including the impact of such sales in estimates of the loss given default (LGD) parameter automatically raises capital requirements considerably on all performing loans and consequently reduces capital ratios. Analyses based on a sample of Italian banks show that this reduction could be significant. The measure would take account of the exceptional nature of the present economic situation and the need to combine supervisory with macroprudential objectives.

Banks' capital and support measures

An exceptionally deep and protracted recession such as the one experienced by the Italian economy has undoubtedly had serious repercussions for the banks. Nevertheless, at the origin of the worst crises we also find corporate decisions that were undermined by misconduct and distortions in the allocation of credit. The fact that the greatest difficulties involve banks which taken together account for a relatively small share of the industry's total assets is an indication of the overall resilience of the system. Since the onset of the financial crisis, and partly as a result of pressure from the supervisory authorities, Italy's banks have almost doubled their CET1 ratios and are continuing to increase them, including by raising funds on the market.

The national and European supervisory authorities have been monitoring the most critical situations for some time. The measures adopted were designed to reach orderly solutions and avoid repercussions for the stability of the banking system, within a rapidly changing regulatory environment that precluded any recourse to the instruments successfully used in the past and before the new instruments became fully available. Various measures were taken to deal with the different situations.

With the help of the National Resolution Fund, to which all banks contributed, four banks at risk of failure were placed under resolution at the end of 2015, thus avoiding any need for a publicly funded recapitalization, although to cover the losses it was also necessary to reduce the value of subordinated bonds to zero. The only alternative to resolution was to wind them up, which would have cost their creditors even more and involved others in addition to shareholders and subordinated bond holders. Different types of protection were introduced for the subordinated bond holders according to their individual situations and the Interbank Deposit Protection Fund has started disbursing compensation.

Despite the difficulties of the current regulatory and market environment, there have been important developments in recent days as regards the sale of the four bridge banks. The agreement for the sale of three of these banks to UBI Banca has been signed and the negotiations for the sale of Nuova Cassa di Risparmio di Ferrara to Banca Popolare dell'Emilia Romagna are at an advanced stage. The sizeable cost of these operations has been borne by the National Resolution Fund and therefore by the banking system. The greatest care has been taken to keep costs down, including by means of an open and transparent sales process conducted in close collaboration with the Ministry of Economy and Finance and the European Commission, which assessed all valid offers on the table from Italian and foreign interested parties. The special purpose vehicle that bought the bad loans of the four banks is continuing its efforts to arrange a sale at the best possible terms and conditions, with the help of independent experts; this requires the information on the loans to be vastly improved.

The experience gained in the months since the start of the resolution procedure for the four banks should, however, also lead us to reflect on the potential systemic significance, in a closely interconnected market, of regional banks with a limited catchment area.

The measures taken in Italy in 2016 have made it possible to deal constructively with other crisis situations, with the contribution of both the public sector, including as a facilitator, and the private sector, through recourse to various instruments: precautionary recapitalization by the State (recently requested by Banca Monte dei Paschi di Siena); private funds specifically raised to buy NPLs and to strengthen the capital of banks in difficulty, used in the case of two banks (Banca Popolare di Vicenza and Veneto Banca); and the voluntary component of the deposit guarantee funds (to support smaller banks).

In full compliance with European rules and to guarantee financial stability, public resources have recently been allocated (up to €20 billion) to support the liquidity and capital positions of solvent banks which, despite achieving a positive result in the baseline scenario of a stress test, must deal with shortfalls found in a hypothetical adverse scenario that is part of the same test. This measure is an important one for Italy as it emerges from the crisis that buffeted its economy and banking sector.

State intervention is much more limited in Italy than in almost all other European countries, helping to remove the market's perception of a risk considered high for the entire banking system. The costs for the public purse will be reduced by burden sharing among equity holders and subordinated bond holders. It will be possible to offset them against the proceeds of future sales of shareholdings. A necessary condition for benefiting from public precautionary recapitalization is the approval by the European Commission of a restructuring plan drawn up by the bank.

The injection of public funds into Banca Monte dei Paschi di Siena will presumably use up about a third of the €20 billion set aside by the Government. There is more than enough room to address the recapitalization needs of any other Italian banks that meet the conditions laid down in the decree, in the first place those relating to the results of a stress test. However, for other measures to be implemented the banks must be willing to apply for public support and to deal with the ensuing commitments.

Following the capital strengthening carried out under the Fondo Atlante, the senior management of Banca Popolare di Vicenza and of Veneto Banca have been drawing up an industrial plan for their further recapitalization and relaunch, which will soon be presented to the supervisory authorities. The feasibility of a merger will be examined with a view to achieving cost savings and synergies capable of ensuring a return to profitability.

The challenges for the banking system

Aside from the difficulties of some banks in particular, the banking system as a whole is called on to face new and demanding technological and market-related challenges, on which we have often reflected. This is not only a necessity for Italy: a return to higher and lasting profits is a must for all European banks. The way in which branch networks are structured, services provided, and technologies used, must all be reviewed in a bold and innovative spirit. Value creation in the banking industry has changed and continues to do so; Italian banks can no longer put off much needed restructurings and strategic reviews. Only in this way can they continue to successfully attract investors; only then can they continue to compete effectively and maintain their stability.

In some cases capital strengthening on the market will need to continue, as is already happening for some large banks; experience has shown that if requests for new capital are based on clear, ambitious and, at the same time, credible plans, then they are likely to be successful, even in tough market conditions. In other cases, especially for medium-sized banks, mergers are necessary to achieve cost savings and increase operational efficiency. The success of these mergers crucially depends on the ability to streamline banks' organizational arrangements and to improve corporate governance, also in terms of market perception.

The reform of cooperative banks (*banche popolari*), which pursues the goals of efficiency, transparency and stability, is almost complete: eight out of ten of those with assets exceeding €8 billion – the threshold established by law – have become joint stock companies. The merger of two of them has created a banking group of significant size. Other mergers can be achieved and may act as catalysts for the restructuring of the entire banking system.

Last December the State Council requested that the Constitutional Court rule on a number of questions regarding the reform's constitutionality; the deadline of end 2016 for compliance with the new rules was suspended, as were some parts of the implementing provisions issued by the Bank of Italy as mandated by law. The reform is necessary as it will facilitate capital strengthening for the banks concerned and contribute to improving their governance. The limitation of the right to reimbursement in the event of withdrawal aims to preserve the integrity of capital levels and draws inspiration from the European rules, which are not currently under consideration by the Court.

At the beginning of this month the supervisory authority sent a communication to the mutual banks (*banche di credito cooperativo*) and their central institutions urging them to carry out the reform of their sector rapidly and effectively. Only a swift transition to the new set-up will enable mutual banks to strengthen their capital position where necessary and continue to provide their traditional support to local economies in the best way possible, also in view of banking union.

Returning to a level of profitability that enables stable capital strengthening is a fundamental objective for banks, particularly those currently on a weaker footing. A determined and incisive approach to keeping administrative and labour costs down, including for management, must be adopted using all the tools currently available.

The density of Italy's banking network and its productivity do not diverge greatly from those of other euro-area countries. According to the latest ECB data on 2015, average assets per bank employee in Italy (€13.1 million) are lower than the euro-area average (€15.3 million). In Italy there is one bank branch for every 1,993 inhabitants, against an average of 2,170 for the euro area; there are slightly fewer branches in Germany, with one for every 2,397 inhabitants, but more in France and Spain, with one for every 1,770 and 1,493 inhabitants respectively. There is considerable scope for rationalization across the board: though the financial system in the United States has different characteristics from the European one, there are still far fewer branches per inhabitant there (one for every 3,900). It is vital to continue reviewing the network and increasing its productivity, by exploiting rather than being a victim of changes in technology, the market and customers' habits.

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The recovery continues in Italy, albeit gradually, thanks to the improvement in the global economy and to the expansionary stance of monetary policy. Credit quality is benefiting as a result. All the banks need to take decisive steps to tackle the problem of NPLs: the solutions should be assessed individually. The foundations have now been laid for solving the particularly serious problems of some banks, thanks to the instruments developed and the measures adopted by the authorities.

To improve their profits and contribute efficiently to financing the economy, banks must make further progress in containing costs, upgrading technologies, and streamlining their organization and branch network. Updating their business model is also essential in order to provide customers with a broad and innovative range of services for asset management and corporate finance.

A stronger recovery and sounder banking system are closely connected and also depend on firms, households and international markets' confidence in Italy's ability to carry forward the reforms begun in recent years. To prevent this confidence from being undermined, the country must continue resolutely on this path: by improving the efficiency of the State and of the entire public sector in lawmaking, administration, and the delivery of services to citizens; by creating a business-friendly environment; and by promoting research and innovation.

Stability and reform are essential for development. There are no shortcuts, particularly for a country burdened with such a large public debt and such persistent structural problems. Second thoughts, delays and resistance, not uncommon in some sectors including banking, risk affecting market conditions and undermining the progress achieved during the long economic crisis from which we are now, though slowly and laboriously, emerging.

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