Assolombarda
Stati Generali del Credito

Financial regulation, crises and credit

Speech by Carmelo Barbagallo
Director General of Financial Supervision and Regulation
at Banca d'Italia

Milan, 12 November 2018

1. The oscillation of the regulatory ‘pendulum’: introduction

The relationship between financial regulation and economic development is both fascinating and complex. It is useful to address it from a historical perspective, coming quickly to the present day.

Financial regulation has changed over time, swinging on a ‘pendulum’ between constraints and freedom of enterprise. Unsurprisingly, economic crises have often been the root cause of these changes. Throughout history we can see the ultimate intent of the legislator, at times liberal or authoritarian, to favour the development of the economy. The results have not always lived up to expectations.

2. From the banking laws of 1926 and 1936 to the banking laws of the 1980s

Retracing the history of our country from the unification of Italy, the first swing of the ‘pendulum’ can be traced back to the banking laws of 1926 and 1936. In fact, even after the enactment of the 1882 trade code, the exercise of banking activity had been substantially unfettered.

The two banking laws were passed to address the crises following the First World War and the ‘Great Depression’ respectively. In both cases, the crisis in industry spread to credit institutions, first on account of bank loans to firms that were overwhelmed by the post-war reconversion process and then for having operated as ‘mixed banks’, that is, intermediaries characterized by the significant presence of upstream and downstream ownership interests in industrial firms which later faced difficulties.

The response of the legislator is well-known. To remedy the substantial absence of limits on risk assumption, in 1926 banks became subject to the Bank of Italy’s supervision and to capital-based restrictions. In 1936, there was a separation between short- and long-term credit and between banking and industry, and banking was deemed an activity of public interest. The outcome of this wide-reaching intervention was a credit supply based on a pluralistic and segmented banking system, one which was essentially publicly-owned and subject to official scrutiny.

The 1936 law was particularly effective and for more than 50 years the ‘pendulum’ was still. Article 47 of the Constitution confirmed and strengthened the philosophy underpinning that law. After the Second World War, the banking laws made it possible for the banking system to support the financial burden of the reconstruction efforts without significant repercussions on banks’ conditions.

Between the end of the 1970s and the start of the 1980s, some banks were affected by serious mismanagement problems. In order to avoid a recurrence, the Bank of Italy developed a rather intrusive system of supervision (defined as ‘structural’) based on very detailed reports (the ‘matrice dei conti’) and on the wide use of authorization powers, inspection tools and sanctions. It is in this context that the Central Credit Register and the survey of substandard and bad loans were created.

Faced with these 50 years of overall stability, the Italian financial system gradually became rigid, shielded from competition, with pockets of inefficiencies.

In the 1980s, international developments, especially those in Europe, started to gain importance for financial regulation in Italy. The regulatory framework slowly began to change (the entrepreneurial nature of banking was formally recognized in 1985) in the wake of European legislation which, in 1973 and 1977, had already limited the restrictions on freedom of establishment and laid down the first harmonized rules on banking legislation in the Member States.

3. From Basel I to Basel II

During the 1980s, at international level, the preference given by the regulations to stability progressively declined. The new paradigm was one which favoured competition and efficiency; excessive risk assumption was discouraged by focusing on capital requirements, which were raised to a minimum level for all internationally active intermediaries in order to limit the risk posed by some large banks that had become overly leveraged.

Basel I (1988) and the Second Banking Coordination Directive (1989) exerted a strong push in this direction. In the 1990s there was a Copernican revolution in Italy and in other European countries. The specializations imposed by the 1936 banking law were dropped; universal banks returned; banks were privatised; supervision became prudential; the consolidated laws on banking and finance included among the supervisory objectives both competitiveness and the proper functioning of the financial system.

On account of the unfavourable stance taken towards public intervention, which maintained that the market was capable of finding equilibrium on its own, in some countries the liberal tide resulted in a loose approach to supervision (the 'light touch'). In these countries, openness to competition caused some banks to take risks that were not hampered by the capital requirements, which were fairly rudimentary and largely focused on credit risks and, starting from the early 1990s, on market risks.

The same cannot be said for Italy, where in the 1990s – partly to address the 1992-93 crisis – banking supervision was strengthened further. Increasingly frequent and in-depth inspections, together with off-site controls, allowed us to intervene effectively on weaker banks, even large ones, which gradually merged into more robust and better organized groups. In addition, the Italian legislator extended public checks to non-bank intermediaries, suggesting that it did not want to allow indiscriminate shadow banking into our country.

At the start of the 2000s the liberal stance continued to influence national legislators and to fuel a widespread process of deregulation. Basel II (2004), implemented in Europe in 2006 with two directives, is the point of convergence for this trend, based on the conviction, on the one hand, that banks are capable of calculating their risk exposure better than the supervisory authorities and, on the other, that banks' incentives are always consistent with supervisory objectives; unfortunately, this theory was belied by the facts.

The internal models for calculating the Pillar I capital requirements were therefore recognized, subject to approval by the supervisory authority, and the internal capital adequacy assessment process (ICAAP), part of the supervisory authority's prudential review of capital adequacy (Pillar II), was enhanced. The EU directives defined a minimum harmonization framework, leaving the Member States with ample room for manoeuvre in the transposition process. The adoption of internal models was uneven: some countries made very limited use of them, while others, even under pressure from the intermediaries, used them on a larger scale.

4. The last ten years: the Great Recession and the changes in supervisory rules

Thus we arrive at 2007-08, i.e. the years when the financial crisis, which began in the United States with the bursting of the real estate bubble and the bankruptcy of Lehman Brothers, became a global phenomenon, giving rise to what we now call the ‘Great Recession’.

In 2007 Basel II had not yet been implemented; it would therefore be wrong to ascribe even partial responsibility for the crisis to this agreement. Such responsibility should instead be placed on the long phase of deregulation and weaker public controls described above, a phase which was particularly pronounced in the United States, and which led, among other things, to the abuse of risk-transferring activities (the ‘originate-to-distribute’ model), not often used in our country, through ‘toxic’ structured finance products, the first vectors of contagion.

It should also be noted that Basel II – which allowed for significant capital savings through the recognition of internal models – is certainly not the right remedy to the problems the financial system has faced since 2007.

In the years that immediately followed, there was a growing conviction at international level that a clear change was needed. Partly due to prompting by supranational organizations such as the G7/G20 and the Financial Stability Forum (which later became the Financial Stability Board), the regulatory response was particularly intense: the economic-financial crisis again marked a strong swing in the regulatory ‘pendulum’. Regulators again turned their attention to stability, maintaining the paradigm of prudential supervision.

The international response to the Great Recession took two directions: a gradual tightening of the rules and, in Europe, a thorough review of the institutional structure of supervision.

The first step taken towards changing the rules was the revision of the market risk regulations (Basel II.5) in July 2009. A second, more decisive step was Basel III in December 2010, which coincided with the euro-area sovereign debt crisis that started in Greece and then spread to Ireland, Portugal, Spain and Italy. In 2013 Basel III was implemented in Europe, partly in the form of a directly applicable regulation (CRR) and partly in the form of a directive (CRD IV), implemented in Italy in June 2015. With this body of legislation, the rules of the banking sector became decidedly more stringent.

The interventions ranged from capital measures to measures on liquidity and leverage. The long transitional period meant that the effects of these interventions, which were in fact quite significant, were felt gradually, starting with the increase in capital requirements. In fact, the Pillar I requirements (minimum CET1 ratio of 4.5 per cent and total capital ratio of 8 per cent) were joined by numerous buffers: the capital conservation buffer, equal to 2.5 per cent, and other macro-prudential buffers (the countercyclical capital buffer and that for systemically important institutions, on a national and international basis). The interventions also included the discretionary requirements of micro-prudential supervisors, which were binding (Pillar II requirements) for risks that were not addressed in Pillar I, and non-binding (Pillar II guidance) for risks that emerged as a result of the stress tests. This process substantially increased the amount of minimum capital required of banks, which doubled on average.

5. Crisis management framework

Bank bail-outs have had a profound impact on the public finances of many European countries: at the end of 2011, the impact on GDP was as high as 48 percentage points in Ireland, 11 in Germany, 7 in the Netherlands and Belgium, and 4 percentage points of GDP for the European loan requested for this purpose by Spain in 2012. In Italy state intervention in the banking sector was minimal, for an amount equal to only 0.2 per cent of GDP.

In 2013 and 2014, two important regulatory measures closed the door to state aid for banks. As a result of these measures, among other things, it was no longer possible to establish an NPL management company supported by the State, a company which could have facilitated the rapid disposal of these loans (which reached their peak in Italy in 2015), putting the most vulnerable institutions in difficulty.

The first of the two ‘closure’ measures was issued in August 2013. The European Commission released a communication restricting the scope of state aid to banks in order to minimize possible distortions of competition. According to the interpretation of the Directorate-General for Competition, state aid also includes interventions by national deposit guarantee funds for purposes other than repaying depositors. The provision of state aid is subject to approval by the Directorate-General and only after the contribution of the bank's shareholders and subordinated bond holders ('burden-sharing').

The second measure was the Bank Recovery and Resolution Directive (BRRD) issued in May 2014 and transposed into Italian law in November 2015. It introduced a new philosophy regarding banks' crises according to which their costs must no longer be borne by taxpayers, but by the bank's creditors that would be bailed in and not by depositors protected by the national deposit guarantee scheme. To avoid the involvement of uncovered deposits, the Directive contains a minimum requirement for own funds and eligible liabilities (MREL) subject to bail-in, similar to the requirement proposed by the FSB for globally systemic banks (TLAC). Another important feature is the 'failing or likely to fail' determination, which serves as a condition for applying the resolution procedure to a bank provided that doing so is in the public interest, or else the bank is liquidated.

The introduction of the 'likely to fail' determination as a condition for a bank's exit from the market and the increase in capital requirements mark a significant departure from the previous regulatory framework for both banks and supervisory authorities. A high level of prudence is required of both parties: banks must be cognizant of the importance of maintaining capital levels that are much higher than the regulatory minimum, and supervisory authorities must exercise their power (to declare that a bank is failing or likely to fail) with great care. The crisis management framework is still incomplete. The premature entry into force of some tools (including the bail-in) was met with worrying delays in the implementation of others (the MREL and the single euro-area deposit insurance scheme).

International acceptance of the bail-in principle, while necessary to discourage moral hazard and excessive risk-taking by banks, managers, shareholders and creditors, marked a radical break from the past. It should have been introduced more gradually, in order to give intermediaries, authorities, market operators and especially retail banking customers adequate time to adapt to the innovative scope of the tool. The decision of the European legislator to make the bail-in tool immediately applicable after the entry into force of the new regulatory framework was not one that was shared by the Bank of Italy;[1] today that decision is coloured by the fact that

---

[1] See I. Visco, 'Italy non-paper on bail-in', Italian delegation proposal of 12 March 2013 on a targeted approach to bail-in.

many of the problems that arose with the tool’s implementation had been underestimated.

The MREL framework is still the subject of discussion. In negotiations taking place at European level, there are two opposing views: on the one hand, the MREL level and the subordination characteristics of the liabilities that comprise it must be able to ensure the full resolvability of banks; on the other, excessively severe calibrations which may encourage intermediaries to reduce their lending and contract the supply of credit to the economy must be avoided. It is essential that the European legislator balance these two needs, also in light of the market’s limited capacity to absorb the potentially large amount of new liabilities that European banks will have to place. A sufficiently long transitional period is needed, as is the balanced adjustment of the requirement once it is fully operational.

The need then emerges to revisit the relationship between the European rules on state aid and the rules on banking crises. Recent experience has, in fact, highlighted how the protection of competition pursued by the former and the protection of stability, a prerogative of the latter, can sometimes come into conflict. It is necessary to strike a better balance between these objectives by finding a solution which serves as a point of equilibrium in the trade-off between the risks of moral hazard and those of financial instability.

Problem areas also emerge in the management of crises of non-systemic banks. In fact, at European level, it was established that only systemically important intermediaries (about fifty) would have access to resolution proceedings in the event of a crisis, while all other banks would remain subject to national insolvency procedures (in Italy, liquidation), procedures which are very similar to those applicable to non-financial companies.

In the absence of interested buyers, liquidation risks being ‘atomistic’: the Interbank Deposit Protection Fund would be called upon to repay deposits under €100,000 within a very short time period (seven working days); the company in crisis would be dismantled and sold in pieces, typically at prices much lower than those obtainable from a sale on the market, putting the repayment of unprotected liabilities at serious risk. This scenario occurs because, as mentioned above, the European framework strictly limits the interventions which may be made by deposit guarantee schemes. In fact, apart from ‘voluntary’ schemes, deposit guarantee schemes are no longer allowed to implement the solutions traditionally used in Italy to preserve the integrity of a company in crisis. The resulting destruction of value may generate losses for bank creditors, including uncovered depositors, and have serious repercussions on the economic and social environment of the market in which the liquidated intermediary operates.

The introduction of a two-tiered system with different safeguards (one for large banks, which are eligible for resolution, and one for all the other banks, which are subject to liquidation) risks fragmenting the banking system and triggering inefficient responses such as customer relocation and disintermediation on the part of small and medium-sized banks. Instead, resolution and liquidation should be part of an integrated system capable of minimizing the destruction of value caused by a bank failure and of preserving the stability of the financial system.

One step in this direction is the recent approval by the European Commission of a general scheme of liquidation aid for small Italian banks with total assets below €3 billion. Under this scheme, which has a duration of one year, the intervention of a deposit guarantee scheme to support the transfer of the assets and liabilities of a failing bank is deemed compatible with the European rules on state aid under certain conditions. However, the temporary nature of the scheme and its limited scope of application make it necessary to continue the search for other suitable solutions.

In short, common rules should be adopted at European level which make it possible to pursue protective solutions even within the context of liquidations ('orderly liquidations'), solutions capable of: ensuring service continuity; reinforcing public confidence; preserving stability; and reducing the social and indirect costs of the crisis.

6. The supervisory institutional structure

During the sovereign debt crisis, criticisms grew concerning the adequacy of the supervisory institutional structure in Europe and in the euro area, under the assumption that, given its fragmentation at national level and the high level of integration of banking systems (global tigers vs. domestic tamers), the structure made it difficult to ensure adequate supervision of the system's risks and stability. In the midst of the sovereign debt crisis, fuelled by the widespread perception of the single currency's fragility, it also became necessary to send a strong message about the willingness of European countries to continue along the path of integration. In response to these problems, the institutional framework of financial supervision was overhauled. This process unfolded in two fundamental stages.

Between 2010 and 2011, the European System of Financial Supervision (ESFS) was created, which carries out macro-prudential supervision through the European Systemic Risk Board, and micro-prudential supervision. The ESFS has ambitious objectives: to define uniform rules applicable to all financial intermediaries operating in the EU and to further the harmonization of supervisory practices.

The European Systemic Risk Board is tasked with monitoring systemic risks for the European Union's financial system as a whole. Micro-prudential supervision is carried out by three supervisory authorities: the EBA for the banking sector, the ESMA for the financial markets and the EIOPA for the insurance and pension funds sector.

The second stage of the overhaul concerns the euro-area countries, with the creation of the banking union, operational since 2014. The Single Supervisory Mechanism, composed of the ECB and the national supervisory authorities, and the Single Resolution Mechanism, in which the Single Resolution Board and the national resolution authorities participate, were created.

Initially, the banking union project also provided for the creation of a European deposit guarantee scheme; as mentioned above, this scheme is slow to come to fruition and for the time being has been limited to the adoption of a European directive which establishes common rules for national deposit guarantee schemes and which aims to remove competitive distortions caused by the different levels of protection and the different types of interventions which may be made by guarantee funds.

The institutional framework described is characterized by the complex interaction between numerous institutions and authorities with different powers and responsibilities. It is a multi-layered structure that envisions both national and supranational components with 'variable geometry' since, in some cases, its operations are limited to the euro area while in others it extends to the entire European Union. This institutional complexity, further complicated by the fact that the anti-money-laundering, fairness and transparency checks of intermediaries still fall within the remit of the national authorities, creates coordination and cooperation problems among the authorities involved.

No less complex is the process of drafting the rules, a process which involves many entities: the role played by European institutions such as the Commission, the Council and the Parliament in drafting primary legislation is flanked by the power of the EBA to issue regulatory and technical standards. Even the implementation of the rules involves the simultaneous presence of multiple entities; in fact, it has partly moved to supranational level, due to the ECB's power to apply both European law and the national legislation implementing it in the exercise of its supervisory functions.

In its first few years of operation, the new supervisory structure has performed positively overall, especially given the short amount of time taken to establish the new configuration. Proportionality and subsidiarity are core principles which underpin the European framework. In light of these principles, there must be limited overlapping of the tasks carried out by each component of the current supervisory structure. A clearer division of the roles and responsibilities of each component and a more valuable role of the national authorities would help to minimize overlaps. Doing so would increase the efficacy and timeliness of supervisory activities and avoid the imposition of duplications and additional burdens on supervised entities.

The recent proposal to review the regulations establishing the three European regulatory authorities, currently under discussion at the EU Council, is included in this context. The most recent developments in the negotiations are headed in the right direction. Among other things, the idea of giving the EBA the power to indirectly supervise the regulatory activities of the competent authorities was abandoned.

7. Financial regulations: latest developments

Moving to the present day and to the latest swing in the regulatory 'pendulum', the process of adjusting the European rules to international standards is now focused on implementing the changes contained in Basel III, a package of reforms endorsed by the governors and the heads of supervision of the G20 countries at the start of this year. The reforms in Basel III aim at reducing the excessive variability of the risk measures and at making them more transparent and comparable so that all stakeholders may correctly assess a bank's risk profile. In so doing, the reforms aim to provide the right incentives to strengthen the banking system and its ability to support the real economy.

The approved measures aim at restoring market confidence in the calculation of risk weighted assets by: i) limiting the use of internal models; ii) improving the robustness and risk sensitivity of the standardized methods for calculating the requirements for credit risk and operational risk; and iii) introducing backstop measures, such as a leverage ratio and a floor for risk weighted assets. On some points it was necessary to reach a compromise, as is inevitable, but the agreement that was reached is satisfactory overall.

The impact of the Basel III reforms on Italian banks seems tenable overall: recent estimates on a sample of Italy's largest banks suggest that, once fully implemented, the reforms will have an average effect of 120 basis points on the CET1 ratio. However, this does not take account of the corrective actions that banks will implement to adapt to the new rules during the 5-year transitional period, starting in 2022, provided for by the Basel Committee.

In modifying the rules, various elements were factored in that take into account the specific features of the Italian banking system and, in particular, the economic context and the productive environment of our country. I would like to touch upon two of them.

One aspect relates to the possibility of applying a preferential prudential treatment for loans to small and medium-sized enterprises (SMEs), an option provided for under European regulations but which had no equivalent in the Basel standards and was therefore considered an unjustified deviation from the international standards. Now the principle on which this preferential treatment is based has been implemented in the Basel standard, thus eliminating the deviation.

The second aspect refers to the possibility of applying variable risk weights to mortgage loans, based on the mortgage's loan to value ratio. Traditionally, the Italian banking system has had a loan to value ratio of about 60 per cent, much lower than that of other European countries. The ability to apply a lower weight to less risky mortgages could provide a stimulus to the recovery of the Italian real estate market.

After a decade of regulatory reform, it is now time to assess its impact and effectiveness. The Financial Stability Board, the Basel Committee and the EBA are conducting in-depth assessment programs. The Bank of Italy is actively involved in this process.

In short, it is undeniable that in recent years regulators have 'set the bar' significantly higher than before and that the supervisors have made use of all the available tools to raise it even higher, albeit for legitimate prudential purposes. The response is and will be different from bank to bank and from country to country, owing to the many factors at play. If on the one hand there is no doubt that a system based on the new regulatory framework will be much safer and more stable once fully implemented, on the other hand it is equally evident that, during the transitional phase, problems will arise that should not be underestimated. The main problem has to do with the fact that European banks must be profitable in order to accumulate capital (on the market or through self-financing), while today, for many reasons, the profitability of most of the significant banks is lower than the average cost of capital. To avoid risks to financial stability and to ensure an adequate flow of financing to the economy, regulators and supervisors are called upon to closely monitor the evolution of the structure of the financial system.

8. Bank credit in the new regulatory and market context

At the end of this long regulatory *excursus*, I would like to return to the heart of the problem, a question I raised at the start of my speech. What impact have the regulatory reforms and the changing supervisory practices had on the supply of credit to the economy?

Focusing my attention on the last ten years, I think it is undeniable that banks' credit supply standards became tighter after the sovereign debt crisis. It remains difficult for smaller firms to access credit, regardless of the state of their balance sheets. The SSM's expectations as regards NPL coverage levels (the Addendum) and similar regulatory proposals under discussion at European level will most likely result in banks being even more selective in assessing customer creditworthiness.

Moderate growth in bank loans is not necessarily bad, as long as lenders are able to ensure an adequate flow of credit to financially sound companies with good growth prospects. For this to happen, however, all the players involved must work in the same direction and in the common interest: European legislators must commit to completing the banking union and to simplifying the current institutional structure, carefully evaluating, and possibly correcting, the reforms adopted over the past ten years; supervisors must avoid measures that increase the negative consequences of cyclical fluctuations when interpreting and implementing the rules.

There is now solid empirical evidence to show that strengthening the capitalization level of banks increases the stability of the financial system in the long term but tends to tighten the supply of credit and therefore entails short-term costs for the economy, especially in periods of low growth. Recent studies conducted by the Bank of Italy confirm that in some cases increases – sometimes sudden – in banks' capital requirements can slow the recovery of lending to firms and households and that of economic activity.[2]

In this context, in order for banks to continue to play an important role in providing credit to the real economy, it is essential that they continue to rebalance their balance sheets and restore profitability. Much has been done, but much remains to be done. A particularly difficult challenge stems from the need to adapt business models to a constantly changing landscape, especially as regards technological progress. Competition from new operators, characterized by a high reliance on new technologies and low operating costs, will force intermediaries to consider adopting new tools and new ways of maintaining customer relationships.

The stringent regulatory and supervisory requirements to which traditional intermediaries are subject, together with the development of innovative technologies and the increasing digitization of the economy, are encouraging the entry of new players in the financial markets (such as big tech and Fintech operators). Compared with these entities, the traditional banking industry still enjoys significant benefits, among which their broad customer base.

The entry of these new players in the financial industry increases the competitive pressure on the European banking sector, which is already suffering from insufficient profitability. At the same time, it should be noted that this pressure may have positive effects, such as: encouraging the development of alternative finance channels; improving the quality and price of services for customers; and providing opportunities for new forms of cooperation and synergy between Fintech firms and banks, if banks make good use of them. Strong competitive pressures are already being felt from the

---

2 Conti A.M., A. Nobili and F.M. Signoretti, 'Bank capital constraints, credit supply and economic activity', Banca d'Italia, Temi di Discussione (Working Papers), 1199, 2018.

entry into the market of large over-the-top ('OTT') companies (e.g. Google, Amazon, Apple, Facebook, etc.), which have extremely high liquidity and a large base of loyal customers. The investments and acquisitions made by major banks in this sector show that the path that lies ahead is not only marked by a stand-alone outlook, rather, it may also include the integration of traditional intermediaries and new Fintech firms ('Fintegration').

But non-financial firms will also have to do their part. Since the sovereign debt crisis, the financial condition of firms has improved significantly. Between 2011 and 2017, financial leverage, defined as the ratio between financial debts and the sum of these with equity, decreased by 10 percentage points. The reduction of the debt and the increase in own funds was met by a greater level of diversification in funding sources. In the same period, the share of bank loans in total liabilities decreased significantly.

These are important steps forward in a process that must not be interrupted. Firms with high levels of own funds can more easily obtain credit for financing current activities and, above all, growth projects. Firms that are less dependent on credit institutions are in a position to better absorb possible shocks and can significantly contribute to strengthening the resilience of the entire system.

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