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**Parliamentary hearing on the international financial crisis
and its impact on the Italian economy**

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0. Introduction

I believed it would be useful to structure reflections and data that I will show you at this hearing – an initiative that I believe is very important and for which the banking industry thanks all of you, honourable deputies and senators – **into four major sections.**

The first briefly reviews the reasons behind the crisis and the most notable features. The second reviews the timeline of the most recent events and comments on how the crisis in the US has recently spread to the whole of Europe. The third is entirely dedicated the situation of Italian banks: I will explain with a wealth of data and empirical evidence, the differences of our institutions, their sound financial position as well as recent business practices, practices, I would like to say upfront, that do not indicate the risk of a credit crunch, a real risk for the Anglo-Saxon countries and the United States above all. The fourth and last section of the paper retraces the actions taken in the first (long) phase of the crisis to try and evade the turmoil and I will illustrate later on what we believe are the necessary measures to take today in conjunction with the measures already taken by other EU countries and specifically our government. Some summary notes will conclude this contribution.

1. Roots of the crisis

Approximately 15 months after the start of the financial crisis, the implications related thereto are clear: this is not just any setback but the worst crisis since the 1930's. It is the result of an accumulation of grave abnormalities in the business model (*originate to distribute*), moreover not merit less, (distribution of risk, market growth, lower capital absorption and therefore making it less expensive to get credit which in turn led to more access to credit). In a macroeconomic environment characterized by low interest rates, by a situation with abundant liquidity and a hunt for yield,

incentives were created to lend to parties with low creditworthiness. This was done with the full knowledge that the risk would not remain in the single portfolio but be fragmented and distributed to a vast number of market players. This is what essentially happened in the United States. A great deal of information can be given on the rapid growth of these transactions in the US; I remind you that only between 2000 and 2006, the *subprime* market grew at an average annual rate of approximately 40%!

Who are the primary culprits of this crisis? The first clearly is the housing market, which enjoyed a speculation bubble with prices significantly higher than they should have been if based on market fundamentals (increase in production costs, population growth, increase in incomes, etc). However this crisis is a global crisis. There are many market participants to blame including not only the banks and financial institutions (regulated and non-regulated) that originated the credit and securitized the loan which today are referred to as "toxic", but also credit rating agencies that ranked the bonds deriving from the original credit, *standard setters* that were in charge of examining the correct accounting methods as well as oversight and supervisory authorities. This was true, above all, in the countries where the phenomenon started. The clearest symptoms of the market diseases are now well known: an excessive increase in *leverage*, a very deep crisis in the inter-bank market and liquidity (with the actual disappearance of certain markets such as trade bills and the freezing of others), the consequent widening of the undesirable difference between the interest rate set by policies (those governed by the central banks) and that of the monetary market (those that immediately impact on the cost of credit for households and firms) as well as the generalized *repricing* of risk, whose sometimes exorbitant prices of the so-called *credit default swaps* are more revealing signs. These factors I briefly outlined thus far above are the global characteristics with which we have become familiar until the end of August of this year. Thereafter, everything suddenly collapsed.

2. The recent past: the US, the disaster and its effect on Europe

The effects on the European economy became evident and suddenly worsened at the beginning of last September, in the wake of important decisions taken by the FED and US government as they tried to contain a crisis that risked degenerating further. In the first weekend of that month, the US Treasury nationalized Fannie Mae and Freddie Mac, state-controlled giants that together held more than 5 trillion dollars of home loans (approximately 50% of the total). The following weekend, the FED and government decided not to save Lehman Brothers, a venerable investment bank that, particularly exposed to the real estate market through derivative instruments, filed the largest bankruptcy in US history with 613 billion dollars in debt. The decision not to save Lehman Brothers had serious repercussions: we witnessed the drying up of the already arid US inter-bank market and the increase in panic engulfing financial operators on both sides of the pond. A further worsening of the financial markets occurred soon after the inevitable bailout by the FED of the colossal insurance giant AIG with a loan of 85 billion dollars. Soon thereafter, Merrill Lynch, on the brink of bankruptcy, was taken over by the Bank of America and the US *investment bank* sector lost its last two players when Morgan Stanley and Goldman Sachs asked and received authorization to become bank holding companies and, therefore, under the supervision of the FED.

It soon became clear that an intervention to solve the root of the problems was needed, and not *ad hoc* measures. To this purpose, the US Treasury Secretary, H. Paulson, on 19 September, proposed a bailout, approved by Congress several weeks thereafter, for a total amount of 700 billion dollars (approximately 5% of the US GDP).

On 29 September, the epicentre moved to Europe. Distrust among market players, scarce liquidity and risks of default attacked the core of the European financial system. After two days of the markets plunging, the

governments of Belgium, Holland and Luxembourg saved the financial group Fortis, while the British government nationalized Bradford & Bingley, the second national financial group specializing in *"buy to let"* mortgages.

3. The crisis and Italian banks

Thus far, these were the recent and very recent events. Now the **third section**, the most important from the Italian standpoint and the reasons why we are here today: the issue of Italian banks' involvement in the ongoing crisis.

I would like to take this opportunity to reiterate that the business model which led to the current situation is a model that is foreign to Italian banks, which were committed to developing themselves according to traditional businesses (I must point out that in the past years we were sometimes criticized for it). I remind you that while financial innovation assumed a deadly character, which today is criticized by all, our system was deeply committed to consolidating itself and increasing its influence on the European markets, particularly in Eastern Europe. Italian banks are, therefore, impacted indirectly by the crisis (securities held in portfolios) and this is due to their participation in the markets, such as liquidity markets, which are global. This however unfortunately did not prevent Italian banks operating in a fully globalized market from being impacted, in terms of losses in the stock markets and therefore on market capitalization.

3.1 The differences of Italian banks: assets and liabilities

It is useful to review here and now the differences of the Italian banking market. The differences, in each country and the Euro Area, are naturally reflections on the different strategies which were adopted over time by each European country, resulting from the combination of multiple factors including, among others, the prevailing business models in each country, social and cultural factors, customer profiles, etc.

For what concerns the composition of assets, it must be noted that in the first place, the majority of Italian bank assets are constituted in funding to customers residing in the Euro Area, which accounts for almost 50% of total assets, higher than the average Euro Area (36.2%) and the average of the main 4 countries examined (Germany, France, Spain and Holland 43.1%). Only Spain is higher (exceeding 60%).

Just as remarkable are the differences in the composition of liabilities. With respect to the Italian banking market as well as for that of Germany, Spain and Holland, we note a percentage exceeding 50% on the total liabilities of direct deposits (resident deposits and bonds). France is positioned at 34.6% and 45.4%, within the average of the Euroland. Italian and German banks are those that resort to issuing bonds more often in an amount approximately equal to 20% (15.2% is the average in the Euro Area, scarcely 14% in France and Holland).

3.2 Funding to firms

The gravity of this financial crisis forces us to legitimately ask ourselves what will be the actual consequences for the general macroeconomic environment, which also had been showing signs of a slowdown. We fear specifically a freeze on granting credit to businesses. Actually, the aggregate data in our possession, leads us to believe that currently there are no indications of tightening neither with respect to the amount of funding nor the prices related thereto.

Naturally the banking industry is taking the concerns that were communicated by individual entrepreneurs to the press in these days seriously on the presumed tightening of credit flows and the increase in costs related thereto. We will examine this in-depth from every aspect. A productive meeting was held between the high level representatives of the banking industry and business world to examine these issues and, as always, we are dedicating to acting and finding the right solutions.

Generally, we would like to remind you, here and now, of the official data, processed together with the principal business associations during meetings held with the “Banks & Companies” Task Force (Osservatorio Banche-Imprese).

According to recent data, in the trimester May to August 2008, the long-term growth rate of lending rates to firms was on average approximately 11.5%, a slight reduction with respect to the highs (+14.5%) recorded at the end of 2007, but notably higher than that recorded in the period January 2004 – July 2008 (+8.8%).

In the last five-year period, the ratio between credit used and credit granted, a typical indicator of the amount of resources that the firms draw on from the amount granted, appears to be relatively stable. This data, valid for all firms, is even valid for small and medium-sized enterprises.

When we go from supply of funding to the conditions applied and one considers the dynamics of the applicable interest rates, we note that despite increase in the interest rates, brought on by trends in the monetary market and by the whims of the ECB’s monetary policy prior to the coordinated rate cut last week, the difference between the average rate and the minimum rate – also recognized as an indicator of credit market conditions - fell, therefore not showing signs of a tightening of credit. The differences also decreased between the rate applied to lending to companies for a limited versus higher amount. This confirms that in the last few months, small and medium-sized enterprises were not penalized.

6. 4. Escape routes: actions taken and actions to take

Going backwards and trying to list the various measures that were adopted starting from the fall of 2007, therefore immediately after the start of the turmoil, we note the following:

- Initiatives designed for the future, that is to create a new financial system and to “fix” the system so as to ensure that what happened does not happen again; and
- Initiatives designed to resolve the current problems.

Within the first category, we find those adopted by the European financial industry and above all those advanced by the *Financial Stability Forum*. It should be recognized that until a few weeks ago, when we discovered that we were dealing with a firestorm that would indiscriminately attack markets and market players all over the world, focus on the second category – solving today’s problems – was insufficient.

4.1 An analysis of the recent European and Italian initiatives

Europe

The decisions taken in the recent European summits rejected the idea of creating a European fund to help banks in need but agreed to derogations of European law concerning State aid where individual governments may decide, like in the cases in which they have decided, to intervene and support their own banking sector. The European banking industry, in addition to the Italian one, immediately welcomed the possibility of the public sector intervening in the capital of certain banks for the period of time deemed necessary. Interventions include increasing and enhancing schemes guaranteeing/protecting deposits as well as interventions over a broad range of financial activities.

On Wednesday, 8 October, the British government made available 500 billion pounds to help banks in need. RBS received 20 billion pounds in exchange for 15 billion ordinary shares and 5 preferred shares; while HBOS

and Lloyds received a total of 17 billion pounds. The bailout provides for loan guarantees in the amount of 250 billion pounds and short-term loans by the Bank of England for 200 billion pounds. In the days following, urged by a number of economists led by 2008 Nobel Prize winner Paul Krugman, many European governments launched bailout plans inspired by Gordon Brown's guidelines. In France, Sarkozy allocated 320 billion to cover inter-bank loans and 40 billion to save credit institutions facing difficulties. In Germany, Merkel announced 400 billion to guarantee bank lending and 80 to save German banks. In Spain, Zapatero decided to use 100 billion euros to guarantee inter-bank loans, but does not believe that recapitalization of credit institutions is necessary.

Italy

For what specifically concerns our country and the measures issued by the our government (Law Decrees nos. 155 and 157) we believe it would be appropriate to take this opportunity to reaffirm a position already firmly expressed:

- We agree with the decision to accompany deposit (and current account) protection provided by the inter-bank fund (already in line with the levels indicated by the recent proposed amendment of the relevant European Directive) with the one provided by the government. This is in order to protect customers further and to restore trust in the banking system that, in our opinion, has never diminished;
- For what regards the measures pertaining to increased capital, we believe that, owing to the solidity of the Italian banking system, it should not be necessary to utilize the opportunities under the measure issued by the government which we consider well structured and a further safety net and prudential tool. On the other hand, the State should be able to further

diversify its available financial instruments to help strengthen banks' capital base, if necessary;

- On the matter, we'd like to stress the importance of envisaging a system able to guarantee, even when the government purchases stakes in banks, the private nature of the Italian banking system. According to this law decree, shares underwritten by the State are recognized a preference in the payment of dividends and it seems that they should also carry voting rights (as set out in the provisions addressing the matter with regard to cooperative banks), whose actual sphere has not yet been specified thereunder. We therefore believe the ministerial decree implementing the law decree should specify the sphere of exercising such right, as previously stated by esteemed members of the Italian government, in the sense that the latter does not intend to exercise its rights.

"Further urgent measures to guarantee stability of the credit system" have been set out in Law Decree no. 157 of October 13, 2008, published on the same date in the Official Journal, issue no. 240.

Provisions came into force immediately, starting from the publication date, October 13, 2008.

This decree follows the approach adopted by Eurozone leaders at the summit held in Paris on October 12, 2008, aimed at improving banks' liquidity, ability to finance and their solvency, in order to guarantee Main Street's necessary funding flows.

The measures set out in the decree are illustrated below.

Up to December 31, 2009, the Minister of Economy and Finance shall be authorized to:

- Grant a government guarantee for liabilities of Italian banks, having maturity of up to five years and issued after October 13, 2008 (date the law decree came into force), in accordance with market terms.

The abovementioned provision broadly refers to bank “liabilities” having durations within the limits envisaged. Therefore, they certainly include liabilities acquired by issuing securities (for example, for the purpose of refinancing upcoming maturities).

- Perform transactions to temporarily exchange government bonds for financial instruments held by Italian banks or liabilities of the latter, acting as counterparties to the Ministry of Economy and Finance, issued after October 13, 2008 and having maturity up to five years. Government bonds pertaining to the abovementioned transactions and public debt bonds (those referred to in art. 7, letter (d) of Law Decree no. 155 of October 9, 2008) may be issued as an exception to the limits imposed by regulations in force. Costs incurred by banks acting as counterparties to perform such transactions shall be determined by taking market conditions into account.

Therefore, these transactions involve substituting financial instruments in portfolios as well as swaps, by which the Ministry of Economy and Finance exchanges government bonds for CD accounts or other debt securities issued by banks and having the abovementioned maturity dates. Such transactions are in line with the approaches adopted by Member States and governments participating in the summit held in Paris, which were made public after the summit.

- Grant a government guarantee for transactions performed by Italian banks to temporarily hold securities which may be allocated to refinance

transactions within the Euro system, in accordance with market terms. Such transactions are in line with the approaches adopted by Member States and governments participating in the summit held in Paris, which were made public after the summit.

Therefore, these transactions are aimed at favoring the sale of securities, which may be used as collateral within the Euro system, to banks (for example, by other institutional investors). Transactions shall be performed in accordance with market terms also in this case.

The Bank of Italy shall, with regard to all transactions mentioned above, assess the requesting bank's capital adequacy and ability to meet its obligations.

Moreover, according to the law decree, the Ministry of Economy and Finance may perform the abovementioned transactions also with those banks of which it has underwritten capital increases, in accordance with Decree no. 155 of 2008

Any costs associated with government guarantees shall be paid – in line with the provisions of Decree no. 155 of 2008 – in accordance with art. 7, paragraph 2, point 2, of Law no. 468 of August 5, 1978 (Reserve fund for mandatory and tax administration collection expenses).

Since the abovementioned guarantees are of a financial nature, they shall not be taken into account when calculating Public Administration debt.

On the other hand, for what concerns issuing government bonds to finance, for example, the underwriting of capital increases of banks, it must be noted that this would lead to an increase in public debt, although in gross terms rather than in net terms. For what concerns net debt, actually, the

increased public debt is offset by the assets which consist of bank capital. In terms of whether this is relevant for the Maastricht criteria or not, it must be noted that there should be no deficit increase even with an increase in gross public debt.

The criteria, conditions and modalities concerning the abovementioned transactions, government guarantees, as well as implementation of this decree, shall be defined by decrees of a non-regulatory nature issued by the Minister of Economy and Finance after having consulted the Bank of Italy. Regulations do not envisage any date by which these decrees must be issued – unlike with regard to Decree no. 155 of 2008.

Therefore, these decrees may be accurately evaluated only after the relevant implementing measures are issued.

4.2 Other crisis issues: *accounting* and supervision

Due to market uncertainty, international bodies are carefully considering whether to take effective corrective measures aimed at restoring trust in markets. Among the corrective measures under discussion at the international level, special attention has been paid to initiatives aimed at harmonizing IAS/IFRS accounting rules with US accounting standards – US GAAP, at updating regulatory rules and strengthening cooperation between regulatory authorities, especially at times of crisis.

Accounting rules

The Financial Stability Forum (FSF), in its paper issued in April 2008, underlines that there is an urgent need to address evaluation and information issues associated with the measurement at *fair value* of illiquid and complex products, in case of deep turmoil in financial markets.

Actions calling for changes in accounting principles both in the US, where the crisis began, and in Europe, move in this direction.

Two fields of action have been identified:

- Methods for measuring the fair value of financial instruments;
- The possibility of reclassifying financial instruments that may no longer be traded in the short term, owing to changed market conditions, by moving them from firms' trading books.

Methods for measuring fair value. First of all, we must clarify that abandoning fair value measurement and IAS/IFRS application on a general basis would not be reasonable, and may have negative effects with regard to the trustworthiness and transparency of financial statements and disclosure of information thereof.

With regard to fair value measurement methods, it must be noted that US GAAP and IAS/IFRS standards talk about "fair" and not "market" value; "fair value" requires the assessment of the price that is fair according to the assumptions that the majority of market players are able to make; "fair value" is equal to "market value" only under normal market conditions. Under strained market conditions or in case of financial stress, suitable valuation models shall be used to measure fair value, not necessarily based on market prices.

On the matter, accounting bodies provided consistent guidelines aimed at allowing companies (only US ones, for now), in case of markets that are not active any longer, to use suitable corrective measures with regard to valuation models, so as to take into account any fact or circumstance affecting the market. In a recent press release, IASB stated that it considers

FASB's approach appropriate and compatible with IAS/IFRS standards and that it will work on correcting existing "misalignments", if any.

Business associations are currently working on identifying unresolved problems at both a national (with OIC, the Italian accounting body) and international level, specifically referring to the valuation of equity instruments and the accounting treatment of impairment. The sharp drop in share prices, under current circumstances, is not the proper basis for the valuation of instruments and for impairment measurement. For example, the reduction in value may be based on company profitability, by using valuation models based on expected financial flows.

Reclassifying financial instruments. On October 13, 2008, IASB approved amendments to IAS/IFRS with regard to the reclassification of illiquid financial instruments, in line with US GAAP, to ensure that international firms applying IAS/IFRS standards are not disadvantaged vis-à-vis their US competitors. These amendments have been approved by the European Union.

This is a good result, since these amendments allow for a reduction in the volatility of the value of those instruments that, owing to the crisis, are not liquid any longer, and that, therefore, reflect values that are no longer reliable. Accordingly, firms applying IAS/IFRS standards will not have to charge reductions in value resulting from exceptional market circumstances to their profit and loss account (in case of assets held for trading) or to equity (in case of available for sale – AFS - assets).

Moreover, it must be noted that the amendments pertaining to the reclassification of financial instruments do not regard shares, with regard to which corrective measures shall be taken in connection with fair value measurement principles in case of market crisis, as mentioned above.

Supervision

On 1 October, the European Commission published its proposal to review the Capital Requirements Directives CRD – 2006/48/EC and 2006/49/EC) to reinforce financial stability. The proposal is currently under the examination of the European Parliament and Council and should be adopted within April 2009.

The suggestions in part are a response to the recent recommendations of the FSF and are aimed at improving the agreements on supervision of cross-border banking groups and cooperation amongst national authorities, as well as strengthening risk management practices for securitised products, for hybrid capital instruments and for large exposures.

This crisis has proved that national barriers within the single market are a serious obstacle in situations of crisis. Increased cooperation amongst monetary and supervisory authorities, also desired by the FSF, is a key element to handling the cross-border crisis; one of the greatest difficulties the European Central Bank (ECB) faced during this recent crisis was the absence of consolidated information to support the Eurozone monetary policies. This is due to the following:

- Supervisory information is collated at the national level by the different authorities;
- The reference Community law, the CRD, contains numerous national discretions and has been transposed inconsistently in the different Member States;
- European reporting schemes have been implemented in different ways, and above all do not use a common language, even if inspired by the

international accounting principles IAS/IFRS. Not all of the Member States allow application of the IAS/IFRS on an individual basis due to related fiscal implications.

The first step should be that of achieving full convergence of the supervisory practices and rules, by removing national discretions contained in the CRD and favouring the consistent implementation of the guidelines published by the European committee uniting national supervisory authorities (Committee of European Banking Supervisors – CEBS).

The amendments proposed by the Commission favour the further strengthening of the legal supervisory framework (Basel 2) whose potential has not yet been achieved, as banks are still in the process of completing the complex implementation. Substantial overhauls are not necessary but simple improvements are, these must be aimed at resolving the problem of pro-cyclicality and the conflict of interest of credit rating agencies.

For this purpose, the Commission's proposals are particularly useful. They are aimed at better centralizing supervisory functions; the crisis highlighted the necessity of having a comprehensive overview of cross-border banking groups in order to better proceed to reliable supervision over systematic risks and solvency in the European single market of financial services. This concept has always been present in banks' approaches and it was not random that the Basel Committee, since it was created in 1974, has always focused on the consolidated dimension of banking groups.

The second step should be that of, on the other hand, harmonising financial reporting at the EU level. Preparing the standard supervision statement reports at the EU level could prove to be insufficient if they are not accompanied with definitions using one language that would guarantee a consistent information framework, at least in Europe.

5. Conclusions

In the conclusion I would like to address two points: one general and one specific.

The financial crisis that we are going through has a structural and global character: unfortunately there is not just one culprit since it resulted from a financial innovation cycle involving various players. The necessary global responses are finally coming. The real effects on the global economy are potentially serious; to minimize them, a combination of instruments are necessary: fiscal and monetary policies, structural and regulatory reforms. There are many risks brought on by this crisis but there are also opportunities that the crisis has exposed. We need to minimize the former and seize the latter.

Naturally the first risk consists of the consequences arising from the *spillover* onto Main Street. For what concerns the cost arising from the decreased growth that the world economy will be called to pay, is difficult to estimate. One can consider, referring to the macroeconomic estimates prior to the crisis and those of today, that the loss in real terms corresponds to approximately 2.5 GDP points in only the two-year period 2008-09. This loss, measured like the growth rate that presumably should have occurred with the rate that will presumably occur, amounts to approximately 3% in the US, Europe and Italy. For China and India, always measured in terms of the inferior growth which will occur against that envisaged to occur, amounts to slightly less than 2 percentage points. Naturally this estimate does not take into account that a part of the slowdown would have occurred regardless of the financial turmoil and due to normal cyclical patterns.

There are other risks in addition to macroeconomics'. *Over-regulation* is one of them and should be avoided. Another risk to avoid is that of threatening financial innovation which, instead, is an asset. It is wrong to throw the

baby out with the bath water. This crisis teaches us a general lesson on the importance of avoiding excesses.

As to opportunity, I believe as in each real crisis, this one will also allow us to return, globally, to greater equilibrium between Main Street and Wall Street, to reduce the level of debt that in these years has increased exponentially and to increase the level of capitalization of companies all over the world. This will allow us to redraft, with equilibrium, a system of rules which proved to be inadequate and, above all, to identify measures that make these rules binding, more so than they have been to date.

For what concerns the crisis and Italian banks, i.e., the second point, I would like to conclude my testimony by reiterating and highlighting the principal aspects that I have addressed thus far.

The original causes of the financial market crisis appear to be external to the Italian banking market. Italian banks are sheltered from the factors triggering the financial crisis: 1) easy credit; 2) depreciation of structured financial instruments; 3) the crisis of off-balance sheet vehicles. We are satisfactorily handling the difficulties caused by globalization of the crisis thanks to the strengths of the Italian banking sector and the national economic system. Here I would like to point out: 1) absence of subprime investments; 2) traditional model of retail banking; 3) low level of financial leveraging; 4) low debt load of Italian consumers; 5) sub-penetration of banking products; 6) relatively healthy real-estate market; 7) good quality assets.

These factors combined contribute to explaining the favourable outlook that international analysts have on Italian banks (in absolute and in comparison with their major European competitors) and that the same markets express daily; the analysis comparing the trend of CDS spread of major European banks shows how, as the financial crisis deepens, the markets have

progressively recognized the capacity of Italian banks to defend themselves, also assessing them as less risky with respect to others from this aspect as well.

Also thanks to these strengths, we will work in the next weeks and months to be a fundamental point of reference for our enterprises and to ensure that they receive the credit they need as has always been the case to date.

We completely agree with the measures issued by the authority and believe they will contribute to restoring trust in the markets. Therefore, all the initiatives combined must be favourably viewed and prove that we can be optimistic about the future; optimistic in a constructive way: according to reason, rather than just based on will, which, nonetheless, is useful.