

CHAMBER OF DEPUTIES

VI Financial Committee

Bill C. 1762 and 1774

To Convert Law Decrees nos. 155 and 157 of 2008

30 October 2008

Presentation by the President of ABI

Avv. Corrado Faissola

1. Introduction

I would, first of all, like to thank the Financial Committee of the Chamber and its Chairman, the Honourable Gianfranco Conte, for having given ABI the opportunity to express its views on the two law decrees, currently under examination, on the stability of the credit system in the ongoing international financial market crisis.

I will focus therefore, after a brief general introduction, on the merits of the two measures.

2. 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). 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.

3. Recent past: from the US to 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, the following weekend, the FED and government decided not to save Lehman Brothers which 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 US inter-bank market and the increase in panic engulfing financial operators on both sides of the pond.

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. 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.

4. Financial crisis and Italian banks

Now we come to the issue of how the Italian banks are involved in the ongoing crisis.

I would like to reiterate that the business model that led to this situation is a model that is foreign to Italian banks, which were committed to developing themselves according to traditional businesses. I remember, moreover, 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.

It is useful to review here and now the differences of the Italian banking market, reflections on the different strategies which were adopted over time by each European country, resulting from the combination of multiple factors: business models, social and cultural factors, customer profiles, etc.

For what concerns the composition of assets, it must be noted that 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 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). 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).

5. 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. 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. We would like to review official data on the basis of which 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%).

Naturally the banking industry is taking the concerns that were expressed 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.

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.

I reiterate and highlight that the causes of the financial crisis are foreign to the Italian market. Italian banks are sheltered from the factors triggering the financial crisis: 1) easy credit; 2) depreciation of structured financial instruments; and 3) the crisis of off-balance sheet vehicles.

We are satisfactorily handling the difficulties caused by globalization of the crisis thanks our strengths in 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.

We view favourably the government's rapid response in issuing legislative measures and we trust the ongoing parliamentary procedures that will contribute to restoring trust to the markets. Other risks, in addition to macroeconomic risks, are emerging from this meltdown of the world markets. 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, as in each real crisis, this one will also allow us to return, globally, to greater equilibrium between Main Street and Wall Street and 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.

6. 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:

For what concerns Law Decree no. 155/08

- 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 a further safety net and prudential tool. Any acquisition by the government of capital appears to be appropriate in the case, which we believe is remote, of a bank facing insolvency. Besides this, when the most likely scenario occurs, we will need to allow the use of alternative financial instruments in case the bank asks the government for assistance because this could result in, by strengthening bank capital, guaranteeing the flow of credit to firms and households.
- We'd like to stress the importance of envisaging a system able to guarantee, when the government purchases stakes in banks or strengthens its capital base, the private nature of the Italian banking system. According to this law decree, shares underwritten by the State are recognized as 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.

After all, Law Decree no.155/08 requires certain modifications to make it consistent with what has been illustrated above.

Law Decree no. 157 of October 13, 2008, published on the same date in the Official Journal, issue no. 240, provides for the government to guarantee liabilities of Italian banks, having maturity of up to five years and for transactions performed by Italian banks to temporarily hold securities which may be allocated to refinance transactions within the Euro system or exchange government bonds for financial instruments held by Italian banks or liabilities of the latter, issued after October 13, 2008 and having maturity up to five years.

We are discussing legislation containing certain principles, which outlines a framework of the measures to be adopted and sets out that the ministerial decree must specify the relevant transactions and related costs to be born by banks utilizing the above.

Therefore, an accurate assessment may be done only after the relevant implementing measures are issued.

We are confident that the current rules formulated during the implementation phase guarantee that Italian banks will have a *level playing field* with respect to similar measures already announced by other principle European countries.

7. 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, to other 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 anymore, 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.

8. Conclusion.

In conclusion, although we agree with the government interventions, we believe that:

- For what concerns Law Decree no. 155/08 on injecting capital into banks, this requires integration and modifications that cannot be addressed by the implementing decree and we believe that amendments are necessary to:
 - a) diversify the government's intervention technical modalities aimed at capital consolidation, by markedly distinguishing between full blown crisis situations, for which a measure to purchase shares should be set up and other situations for which alternative assistance should be given;
 - b) Express more clearly the provisions on exercising voting rights which need to be consistent with those set out in the government's proposal in the enactment of the law decree.

- For what concerns Law Decree no.157/08, from a general standpoint, we believe that an accurate assessment can only be made after issuance of the implementing decrees and subsequently we will provide our opinion thereon.

We trust that the government will continue supporting the requests made by Italian investment firms for adjustments in accounting rules on the evaluation of financial instruments to take into due consideration the effects of the unusual market conditions.