

Centesimus Annus Foundation

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Question 1: Why is financial system vulnerability a concern and what makes the system vulnerable?

Thank you, Dr. Bolzetta.

I would like to begin by thanking the Chairwoman of the Fondazione Centesimus Annus Pro Pontifice, Professor Anna Maria Tarantola, for inviting me to take part in this important ceremony. It is a great honour and pleasure for me to be here to discuss such a challenging and stimulating topic in the presence of His Eminence Cardinal Reinhard Marx and the Secretary of State, His Eminence Cardinal Pietro Parolin.

I found Arianna Cravero's quote, with which Professor Carolina Montero Orphanopoulos opened her speech, extremely interesting: "*The term 'vulnerability' - writes Cravero - 'signifies the **perpetual potentiality of injury**, always imminent and contingent upon circumstances ...*".

It seems to me that **this definition well describes the reality of financial markets**: in less than twenty years, we have seen the Great Financial Crisis of 2008-09, with the subsequent sovereign debt crisis in Europe in 2011-12; the Covid-19 pandemic; a series of bank failures in the US and Switzerland; the outbreak of conflicts in Ukraine and the Gaza Strip.

Vulnerability (in the sense of: "*exposure to potential injuries*") **is endemic to the financial system**. It must therefore be managed.

To clarify the reasons why financial system vulnerability is a concern, I would start with two considerations:

- first, the banking system is a **critical transmission channel** for monetary policy and for the propagation of the effects of micro- and macro-prudential policies
- second, through their intermediation activities, banks (and the financial system in general) play a **critical role in supporting economic growth and development**.

This dual role (monetary and prudential policy and credit intermediation) can **only be played effectively if intermediaries are stable and sound** - which is why their vulnerability is a potential cause for concern.

Let us go back for a moment to the 2008 Financial Crisis. It is no exaggeration to say that it was a real “nightmare” for some banks with low available liquidity: the interbank market came to a complete standstill, producing a widespread liquidity crisis. It was said, at that time, that: “... *liquidity is king*”.

As a result, banks' ability to lend to the economy collapsed, leading to a credit crunch. What caused this dramatic situation? The reason lies in the **sudden loss of confidence** that followed the bankruptcy of Lehman Brothers: in an instant, the markets realised that the rescue of an intermediary could no longer be taken for granted. Those who had liquidity kept it for themselves and were increasingly reluctant to lend it to other intermediaries.

“Trust” is probably the keyword to explain the vulnerability of the financial sector. If “trust” prevails in the relationships between economic agents (between depositors and the bank and between the bank and the borrowers; between bank and bank in the interbank market), the system is stable and well-functioning; **if not, it breaks down**.

When we speak of **“crisis”**, we are not only referring to the “failure” of the production system and the markets. Economic crises also have **negative effects** in terms of social disintegration, accentuation of inequalities, precariousness, disorientation in economic and investment choices. There is also a relevant political implication: the response to people's growing unease can take the form either of “alienation” (i.e.: the abstention from voting, or the rejection of institutional forms of representation) or of extreme protests (see, for example, the rise of populism). **The economic crisis turns into a crisis of people and society**.

From the point of view of consolidating confidence and preventing new crises, **it is certainly good news that the Italian banking system is now much more solid** than it was 10-15 years ago.

- Banks' **capitalisation** has doubled since the Great Crisis. The Common Equity Tier 1 ratio (CET1) - an important indicator of the degree of capitalisation of banks - was in the region of 7.5-8% in 2007-2008; in June 2023 it was around 16%.
- Much progress has also been made in terms of **credit quality**. During the Great Crisis, the incidence of non-performing loans (NPLs) in Italy was around 17% for the largest

banks: in other words, one sixth or more of total loans were non-performing. Currently, the ratio is 2.4%, very close to the European average.

- Moreover, Italian banks enjoy a **strong liquidity position**. Many of us probably remember the Silicon Valley Bank case: the bank's liquidity position was not monitored, due to the different threshold introduced by President Trump in the supervision of small and medium-sized banks in the US. In Italy, the average liquidity coverage ratio now stands at 166%, well above the regulatory minimum (100%) and higher than the average ratio achieved by significant banks in the Banking Union and in the major European countries.

Question 2: Is it possible to reduce the vulnerability of the financial system? Is it only a matter of rules or is there also room for intervention by the intermediaries?

This question raises a complex issue, that can be approached from different angles.

First of all, I would like to stress that **Italian banks have changed their business models over the years, introducing a greater degree of diversification**: this has allowed them to maintain a satisfactory level of profitability even in the presence of zero or negative interest rates.

With the entry into new business sectors (such as insurance, asset under management, mutual fund management, etc.) the weight of commissions in revenues has gradually increased, balancing the interest margin (namely, the difference between interests earned on loans and interests paid on deposits). Of course, the latter also improved as interest rates rose - but when rates were zero or negative, there was a problem in terms of profitability. **Diversification and a high degree of operational flexibility reduced banks' vulnerability and ensured a better ability to respond to shocks.**

Incidentally, I would like to add that the profitability of banks is not only important for their shareholders: as mentioned earlier, it's also an essential prerequisite for banks to play a supportive role in the economy and society.

Back to the question, I think it can be argued that the reduction in the degree of vulnerability of the banking system over the last 10-15 years is the **combined effect of better (and stricter) regulation** (we mentioned this earlier, when discussing the improvement in indicators) **and good management of intermediaries** - as well as "exceptional" factors, such as expansionary monetary and fiscal policies and the availability of ample liquidity.

Going a small step further, stability also requires a **well-diversified financial system**: not only sound banks, but also strong institutional investors and well-functioning financial markets.

Well-informed investors and efficient markets **allow companies to diversify their sources of finance and increase their resilience**: this, in turn, reduces the riskiness of bank lending. Promoting a diversified financial system is something the authorities have been working on for many years, with the **two complementary projects of the Banking Union and the Capital Markets Union**.

Finally, it is important to recognise that banks - and intermediaries in general – **operate in an inherently risky business**: historical experience shows that the probability of potentially destabilising events cannot be reduced to zero.

What can be done is to **reduce the likelihood of their occurrence**, so as to prevent individual events from becoming systemic, with negative consequences for economic and social development.

Without going into the details of possible interventions, Governor Fabio Panetta's recent invitation to intermediaries to **start asking themselves today what risks they might face tomorrow** is certainly to be welcomed. To quote the Governor: *"... it is in periods of relative calm that imbalances are built up, which then emerge in periods of economic weakness"*.

So, to return to the question, the answer is a **double "yes"**. To sum up: it is certainly possible to reduce the degree of vulnerability of the financial system, through the joint operation of "good rules" (dictated by the supervisory authorities) and "good practices" (exercised by intermediaries).