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THE ITALIAN FINANCIAL SYSTEM IN TRANSITION

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THE GROWTH OF ITALY'S CAPITAL MARKET

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The far-reaching changes the Italian financial system has registered in recent years are largely the effect of structural reforms launched in the mid-1970s. These began with the development of a money market as an alternative to bank deposits. The instruments created resulted in bank disintermediation on a substantial scale.

Reforms essential to the deepening of the capital market were also enacted: a revision of corporate law, especially in the sphere of disclosure requirements; the creation of the Stock Exchange Commission (CONSOB); the ending of double taxation of corporate dividends; and the introduction of investment funds in 1984. At the same time, rigorous monetary and exchange rate policies helped encourage industry to put its affairs in order.

The most striking development of the last two years has undoubtedly been the growth of the capital market. The recovery in economic activity that got under way in 1983, coupled with falling inflation and nominal interest rates, has contributed to a marked improvement in corporate profitability and earnings expectations. The slowing of inflation and the return to positive real yields on financial assets have also encouraged a shift in investors' preferences from real estate and short-term financial assets to medium-term securities and shares.

These economic factors were slow to influence share prices, but that very delay amplified their eventual impact. The stock exchange index doubled in 1985 and had risen another 60 percent by late 1986. A key factor in this boom has been the increased demand for shares, caused in part by the rapid growth of investment funds and portfolio management services.

By the end of 1985, the assets of Italian investment funds totaled about $15 billion, a figure that more than tripled in the first three quarters of 1986. At the same time, portfolio management services, performed largely by banks, have also expanded rapidly. Their resources totaled $18 billion at the end of 1985 and about $28 billion in September 1986.

In 1985, the net sales of investment funds represented 12 percent of the entire formation of financial assets; when banks' portfolio management services are added, the figure rises to more than 20 percent. Only Treasury bonds and bank deposits, with about

25 percent each, accounted for a larger share.

These developments have brought about a significant change, both in the structure of the financial markets and in the position of intermediaries. Improved profitability has enabled companies to finance a larger portion of their needs internally, and an increasing tendency to turn to the capital market has reduced their reliance on bank lending.

The credit system has thus suffered disintermediation on both sides of its balance sheet. Some of this loss of business has been more apparent than real, however, since banks have built up leasing and factoring businesses as well as encouraged depositors to use their investment funds and portfolio management units. In short, banks are increasingly reorganizing as banking groups, comprising a number of related companies specializing in particular branches of finance. Their prompt adaptation to the transformations of recent years has enabled them to retain their traditionally dominant role in the Italian financial system.

FINANCIAL CONGLOMERATES EMERGE

A parallel development has been the creation of financial conglomerates outside the banking system. Some of these have links with industrial groups whose business has been extended to include an increasing range of services. The strategy of these new financial operators may include entry into banking proper. This possibility has been enhanced by the incorporation into Italian law of EEC Directive 77/780, which ended the ban on the establishment of new banks.

This new, more diversified financial system now needs to mature through a period of consolidation. A revision and modernization of the supervisory regulations and procedures that apply to the financial services industry could be an important contribution to the process. This task is extremely delicate, however, and requires the right balance to be struck between the need to protect customers and ensure system stability while also allowing adequate scope for flexibility and efficiency.

The first step in any revision of the supervisory regulations and procedures is to determine the configuration of the financial services sector and to identify the most suitable forms of discipline for the various parts. "Atypical" securities and investment funds are the latest examples of new activities that have been brought within the regulatory framework. Many others still have to find their place: merchant banking, leasing and factoring, closed-end investment funds, foreign securities funds and real estate funds, and portfolio management services.

Finding the right place for these activities entails the difficult search for appropriate solutions, ranging from prudential regulation to discipline based on disclosure rules that allow customers themselves to assess the risks involved. Moreover, in each case it is necessary to decide whether to regulate one or more categories of operators or the types of businesses regardless of who engages in them. This is an important issue when a variety of operators carry on the same activity – such as portfolio management – which today is being offered by banks, trust companies, finance companies and even private individuals. In such circumstances, it is important, of course, to avoid any disparity of treatment between the participants in a given market to ensure a level playing field.

Innovation is intensifying competition in financial services and will probably reduce the operating margins of banks – which will stimulate them to engage in new types of operations with a potential increase in system risk. The best way to forestall this danger without excessively restricting the scope for intermediaries to adapt is probably to introduce some form of automatic risk-limiting mechanism, such as a minimum capital-to-assets ratio – a step the credit authorities have recently initiated – in line with the international aim of promoting more uniform competitive conditions for banks.

In addition, it will be necessary to introduce consolidation techniques for financial groups that will permit them to be effectively supervised. Regulations also need to incorporate ways of preventing or curbing the effects of the conflicts of interest that can arise in connection with the activities of different companies belonging to the same group.

A related issue is that of the links between industry and finance, which has recently been brought to the fore again by the renewed financial strength of Italian industry, coupled with the lifting of restrictions on entry to the banking sector. Conflict-of-interest considerations suggest that industrial groups should not be able to acquire controlling interests in banks.

Finally, the increasing internationalization and integration of financial markets require closer cooperation between supervisory authorities. In Europe, the Community objective of achieving a unified capital market by 1992 makes such cooperation especially urgent. ■

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