Sixth Committee (Finance) of the Chamber of Deputies

Inquiry into the recent increases in mortgage lending rates

Statement by the Director General of the Bank of Italy

Vincenzo Desario

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CONTENTS

Introduction

In the last few years the adjustment of the public finances and the firmness of monetary policy enabled Italy to comply with the parameters of the Maastricht Treaty; they have fostered the convergence of Italian interest rates and inflation with those of the main euro area countries, superseding behaviour patterns still determined by Italy's inflationary past.

The advent of Economic and Monetary Union in January transformed the institutional framework for monetary policy. Regulating of the money supply is now the responsibility of the Governing Council of the European Central Bank; its mandate is to guarantee price stability within the entire area of the euro.

The role of the national central banks in setting and conducting monetary policy is fundamental. First of all, they contribute to the decisions of the Governing Council, which consists of the governors of the eleven participating central banks plus six members of the Executive Committee.

The national central banks are assigned to implement the Council's decisions, executing monetary policy operations. Thus the need for a single monetary policy stance for the entire area is reconciled with the principle of subsidiarity that governs the Statute of the European System of Central Banks.

In the new policy context, the markets of the euro countries all have the same short-term interest rate. Thus all intermediaries within the euro area operate, in the short term, under identical market conditions. The convergence of short-term rates was complete within days of the introduction of the euro in January, showing just how quickly the European interbank market had achieved integration and efficiency.

Given equal short-term rates, the possible transnational differences in medium and long-term rates reflect the characteristics of the individual loans, i.e. maturity, liquidity, borrower risk and administrative costs. Differences in the cost of funds can be observed even between highly creditworthy borrowers. For example, the yield on Italian government securities is now about 20 or 30 basis points higher than that on German paper.

In raising funds in the form of savings, which is to say procuring the raw material of intermediation, banks compete with governments, large corporations and other financial intermediaries. They offer an instrument — deposits — that assures the customer of liquidity, certainty as to the nominal value of the investment, and accessory services. Consequently, the rate on current account deposits is lower than the short-term money market rate. In some countries, such as France, current accounts carry no interest.

For longer-term financial instruments, such as bonds, there is a high degree of substitutability between those of banks and other issuers.

Competition within the banking system

The Italian credit market is now a highly competitive one, thanks to a series of regulatory reforms beginning in the eighties.

Market access has been liberalized, the principal requirements now in force for the exercise of banking business being capital endowment and the experience and integrity of shareholders and corporate officers. Intermediaries' permissible scope of business has been extended. Supervision, based on prudential rules, now respects the entrepreneurial nature of banking business and the laws of the market.

In March 1990 the Bank of Italy liberalized branching, abolishing administrative controls on this aspect of banks' activity. The 1993 Banking Law sanctioned the operational despecialization of banks, significantly increasing the occasions for competition within each market segment.

The heightening of competition received additional impetus from the reorganization of banks' ownership structure. Privatizations increased the contestability of control, directing managers' choices towards pursuit of greater efficiency.

The share of Italian banking system assets held by publicly owned banks has dropped to 17 per cent, from 68 per cent in 1992, and is now among the smallest in Europe. Public control prevails in four of the ten largest banking groups in Germany and Spain, three in France, and two in Italy.

Further spurs to competition have come from the liberalization of capital movements in 1990, the formation of the single European market in banking services and, most lately, the start of Stage Three of Economic and Monetary Union, which has eliminated exchange rate risk, historically a crucial factor in European financial market segmentation.

The foreign presence within the Italian financial market has increased. The share of assets controlled by branches or subsidiaries of foreign banks has risen from 3 to 7 per cent in the course of the nineties, and is much higher in such segments as consumer credit, corporate finance, and trading in government securities.

The participation of foreign banks in the capital of Italian credit institutions is substantial. Their stake, at over 10 per cent in each of the top five Italian banking groups, is significantly greater than that held by foreign intermediaries in the other leading industrial countries.

The growing competition triggered a process of concentration involving the entire banking system; it has been especially rapid in recent years, involving the largest Italian banks. This process has the potential to produce cost savings and economies of diversification; if Italian banks are to increase their ability to compete in the global market, it must continue.

Since 1990 the number of banks in Italy has dropped by more than a third, yet the average number present per province has risen from 27 to 30, following a strong rise in the course of the eighties. Now, about 80 per cent of all Italians can choose their banks from among at least three located in their municipality of residence.

Law 287/1990 assigns the Bank of Italy to safeguard competition in the credit market. In performing this function it must judge whether bank concentrations, agreements between intermediaries, or dominant positions in given market segments may diminish competition and damage consumers economically. Since the law went into effect, the Bank has conducted ten formal investigations into agreements potentially restrictive of competition. In most cases, even before its conclusion the Bank's intervention resulted in modifications of the agreements to avoid the adverse impact on competition. Two investigations are currently under way: one, initiated in January, against the Italian Banking Association for modifications of banks' charges for foreign exchange transactions; and one initiated in April of thirteen of the country's leading banks to inquire into agreements in restraint of competition (the so-called "group of friends" among bankers).

In 1996, following generalized increases in interest rates, an investigation of banks' pricing policies was conducted to determine whether practices of coordination were in place. It was found that the changes in rates were based on developments in the money and financial markets; they had not been instituted uniformly, either in amount or in timing. The findings ruled out the need for an intervention by the Bank pursuant to Law 287.

Competition and bank rates

Heightened competition has quickened the decline in the cost of bank loans stemming from the restoration of monetary stability.

In 1995, banks’ short-term lending rates were above 12 per cent; today they are around 6 per cent (Figure 1). The decline of medium and long-term rates has been even more pronounced, from 13 to 5 per cent (Figure 2).

Italian banks’ lending rates are currently aligned with those in the rest of the euro area (Figure 3). The latest available data, for the second quarter of this year, show Italian rates on current account overdrafts of between 1 and 5 billion lire averaging 6.3 per cent, compared with 7.4 per cent in Germany. At the beginning of 1997, the Italian rate was three full percentage points above the German.

In the short-term segment, the spread between lending and borrowing rates has narrowed steadily, from six percentage points early in the decade to four points this year (Figure 4).

The differential between medium and long-term lending rates and bond yields was 3.7 points in 1997; this year, it is less than 2 points. For household loans beyond the short term (largely home mortgages), the spread has narrowed even more sharply, from 4.8 to 2.4 points.

More than 80 per cent of bank’s medium and long-term lending is funded by bond issues or long-term CDs. Maturity matching is necessary in order to contain the financial risk of maturity transformation. Bond yields are strictly related to yields on comparable government securities.

Given that the average risk on loans, though decreasing, remains high, the narrowing of spreads denotes the sharpening of competition within the market.

Banks' profitability and efficiency

Stepped-up competition has affected the profitability of Italian banks. Income from their traditional lending business has declined sharply. The proceeds from intermediation fell from 65.2 trillion lire in 1993 to 59.2 trillion in 1998, despite an increase rise in lending.

Countermeasures by the banks have enabled them to compensate for the loss of net interest income with a sizable rise in income from services and to begin to rationalize their operating costs. Profits have benefited, coming into line with those of the banking systems in the main countries of continental Europe, with a return on equity of 7.8 per cent in 1998.

Financial innovation and the broadening range of services have served the burgeoning demand on the part of Italian households for portfolio diversification to counter the rapid fall in nominal and real yields on the public debt. Since the turn of the decade the assets administered by mutual funds and asset management services have increased tenfold to 1,100 trillion lire, and from 5 to 23 per cent of total household financial assets.

Non-interest income rose from 24 per cent of total income in 1990 to 40 per cent in 1998, which is in line with the main European countries (Figure 5). Higher percentages are found at British and American intermediaries, which benefit from faster-growing economies and highly advanced financial systems.

Italian banks have invested in the extension and diversification of their distribution networks. The economic benefits, already appreciable, will become more substantial in the next few years.

Technological development has affected customer relations. The use of computer and remote equipment is quite widespread. Home banking and corporate banking services are expanding; telephone or Internet contacts are increasingly common.

The financial sales force employed by banks to market products and services, especially in the asset management segment, has increased notably, counting more than 15,000 persons at the end of last year. The increase has been favoured by the flexibility of contractual relationships between banks and the financial salesmen.

Confirming the improvement in efficiency, operating expenses, consisting mainly of staff
costs, dropped to 61 per cent of banks' total revenues last year, the lowest figure of the decade. There remains a gap vis-à-vis foreign competitors, but it is narrowing; the action undertaken must be continued.

In 1997, in exercising of our supervisory responsibilities, we called on bank managers to work to contain staff costs.

Last summer's collective bargaining agreement for the banking industry is a major stride towards increased efficiency. Greater flexibility in personnel management and closer correlation between employee compensation and banks' performance will help to improve profitabilty.

Measures to contain expenditure have relied mainly on staff cuts. After peaking in 1993 the number of Italian bank employees declined by 6 per cent, or by more than 22,000, by the end of 1998. The early departure of employees nearing retirement age was encouraged with economic incentives, at a total cost to banks of 1.5 trillion lire in the past two years.

Labour productivity has increased in the course of the nineties. At constant prices, total assets per employee increased at an average annual rate of 5 per cent between 1996 and 1998 and 4 per cent in the preceding four years. Productivity actually increased even faster, considering the growth of financial services which, while not forming part of balance-sheet assets, nevertheless absorb substantial human resources.

Further advantages stem from the coordination of the distribution networks of intermediaries belonging to banking groups.

Household credit and the mortgage market

In the second half of this decade, bank lending to households accelerated sharply. Households' share of total bank lending has risen by nearly four percentage points in the last five years to over 19 per cent in June of this year. In the first half of the nineties it had risen by just 0.4 points. At the end of August, bank lending to households amounted to 287 trillion lire.

Household lending by financial companies, most notably consumer credit, has also expanded rapidly.

Home mortgage loans account for a considerable portion of lending to households: about two thirds of total household credit and 90 per cent of medium and long-term credit. They have grown especially fast, propelled by low interest rates and the introduction of a wide variety of technical forms meeting the needs of different types of customers. The rate of growth of mortgage lending rose from 5 per cent in 1996 to 24 per cent in the year to August 1999, compared with 9 per cent for total bank lending.

Competition in the mortgage market has intensified greatly. Customers now have available a broad range of bank interest rates and conditions, disbursement and repayment procedures, and types of variable rate among which to choose the solution that best corresponds to their economic needs.

Competitive pressures have led the banks to refine their borrower selection and risk control techniques in order to curb administrative costs, which are very high in a business segment distinguished by the small average size of transactions: over two thirds of all mortgage loans are smaller than 150 million lire.

Additional evidence that competition has intensified is provided by the significant redistribution of market shares, by the aggressive pricing policies of banks, and by the entry of foreign intermediaries.

Variability in the market shares of individual banks has increased greatly by comparison with earlier years, and this mobility now involves a larger portion of total bank lending. In the twelve months ending in June, 8 per cent of the entire mortgage loan market, by volume, changed hands; if bank mergers and acquisitions were taken into account, the percentage would be much higher (Figure 6). For total bank lending, the overall change in market shares was smaller, even though this lending is primarily at short term and thus by nature subject to greater mobility.

Competition in this segment is attested to by rapid gains in market shares stemming from individual banks' cuts in interest rates. In the twelve months to June those banks that expanded their market presence charged rates that averaged nearly half a percentage point lower than the rest of the system.

In part the sharpening of mortgage loan competition in recent years derives from the entry of specialized foreign institutions. Their experience has helped to refine mortgage lending techniques. Foreign banks have been particularly active; two of them are now among the top 20 institutions in terms of the annual flow of new mortgage loans.

The risk on loans to households is no lower than the average for all borrowers. For home mortgages, the guarantee constituted by real property is offset by the extremely slow and cumbersome procedures for foreclosure and credit recovery. This results in substantial costs and the immobilization of the funds lent.

At the start of the nineties the ratio of uncollectible credits to total household lending was comparable to that for all bank customers together (Figure 7). In June, the ratio for households stood at 9.6 per cent, 1.5 points higher than for other lending. The banks' overall bad loan ratio has been declining recently, thanks to out-of-court settlements, transfers of title to credits and write-offs. In 1998, new bad debts deriving from lending to households amounted to 1.6 per cent of total outstanding lending to households, compared with 1.3 per cent for industrial firms.

In addition to the risk of insolvency, fixed-rate mortgages are also subject to financial risk, since their duration is much greater than that of banks' bonds. In 1999 the average maturity of bank bond issues was 62 months.

Interest rate developments in 1999

In the course of 1999 the downward trend in domestic and international interest rates was reversed first in the long-term and more recently in the short-term segment.

Long-term euro yields turned upwards in May (Figure 8). The rise had begun in the United States towards the end of 1998, in connection with continuing rapid economic growth and fears of a pickup in inflation. Its transmission to the euro area was fueled by good forecasts on the pace of economic activity, which became still more optimistic in the summer months. Another factor was fear that the rising prices of raw materials, especially oil, and the decline in the exchange rate of the euro might rekindle inflation, which is still quite moderate. Between the end of April and 11:00 this morning, the rates on ten-year Italian Treasury bonds rose from 4.1 to 5.6 per cent, approaching the long-term yield on US dollar securities.

The timing of changes in short-term rates was different. In a situation of very modest inflationary pressures, on 8 April the ECB Governing Council lowered its main refinancing rates by half a point to 2.5 per cent. Money market rates adapted promptly: the three-month interbank rate, which had held at around 3 per cent since the beginning of the year, dropped to 2.6 per cent by mid-April. In the months that followed, however, the strengthening signs of an economic upturn in the euro area helped to extend the rise in rates to the short-term segment as well. The three-month interbank rate bottomed out in April and has moved upwards again in the last few weeks. It now stands at 3.5 per cent, 0.9 points above last spring’s low.

The evolution of the domestic and international financial markets has been reflected in bank rates.

On the liability side, the average rate on deposits, which had been 2.3 per cent at the start of the year, declined by 1.5 percentage points over the first seven months and then stabilized (Table 1). The spread between the average short-term lending rate and the deposit rate narrowed from 4.4 to 3.8 points, the smallest it has been since the early sixties.

The cost of bond issues diminished until June and then rose by more than 0.9 points to 3.7 per cent at the end of September, about the same level as at the beginning of the year.

On the asset side, the short-term lending rate declined during the first quarter from 6.7 to 5.9 per cent, and by another 0.6 points between April and August in response to the ECB’s lowering of the official rates. During this phase the Italian rate came down more sharply than the euro area rate, which declined by 0.4 points. Over the first eight months the reduction in the cost of short-term funds to the banks amounted to 1.4 points in Italy and 0.8 points in the euro area. The decline in Italy was more pronounced than would have been expected in view of monetary conditions, the performance of the main macroeconomic variables and past behaviour patterns.

In the first half of 1999 the rates on medium and long-term lending to households, in various technical forms, came down by 0.7 points in Italy, more than twice as much as in the euro area. And while the cost of such credit in the rest of the euro area rose by 0.25 points in both July and August, in the wake of the general rise in long-term rates, in Italy the decline persisted through July (a decline of a further 0.2 points), before rising by 0.36 points in August and holding essentially steady in September. In business lending, the fall in long-term rates during the first half of the year was fully offset by the increases in July and August both in Italy and in the euro area.

As required by the supervisory istructions on transparency, between the end of July and 12 October some 260 Italian banks publicized rate increases with announcements in the *Gazzetta Ufficiale*, almost all referring to the whole range of lending rates. The announcements display very considerable dispersion both in amount and in timing. In the sample studied, the rises range from a minimum of 0.2 to a maximum of 2 percentage points; 67 per cent of the banks announced increases of less than half a point. The average increase was 0.6 points (Figure 9).

As to timing, 44 per cent of the announcements were published between 28 July and the end of August, 49 per cent in September, and 7 per cent in the first twelve days of October (Figure 10). In August and September the announcements were spread fairly evenly; in no ten-day period were fewer than 10 per cent of the month's announcements issued.

Conclusion

For some time now the Italian banking system has been experiencing a sharp increase in competition, which has helped to reduce the spread between lending and borrowing rates by a third, bringing it to its narrowest since the sixties.

Banks' policy response to the fall in income from traditional lending business brought an increase in income from services and the rationalization of production processes and branching.

In the home mortgage segment, borrowers can choose from among a wide variety of contractual forms and a growing number of intermediaries. Competition has levered interest rates downwards and produced an intense redistribution of market shares.

In the first part of this year, during the downswing in interest rates, competition helped to make the reduction in the cost of loans to Italian households more pronounced than the fall in yields on medium and long-term securities, and also more pronounced than the fall in equivalent interest rates in other countries.

In recent months market interest rates have been rising in Italy and abroad. In a highly integrated financial system in which information is disclosed instantly to investors and banks, changes in market yields are promptly reflected in most bank rates.

In Italy the upward pressure on long-term rates was first manifested in a rise in the yield on banks' bond issues. After falling by a point to 2.7 per cent, they rose by 0.9 points between June and September.

The average rate charged for long-term loans to households, which consist mainly of mortgages, continued to decline through July, falling to 5.2 per cent, nearly a full point lower than at the start of the year. The upturn came in August, with a rise of 36 basis points. This increase reflects, in part, the decision announced by many banks to raise lending rates across-the-board. Yet the increases differed in amount from bank to bank and were effected at different times.

On the basis of the analysis conducted, the policies followed in determining the rate of interest on mortgage loans prove to be consistent with domestic and international financial market developments. Nevertheless the Bank of Italy, as the guarantor of competition in the credit market, has begun a more thorough preliminary examination, which is still under way.

Finally, let me add that the Bank constantly monitors changes in the interest rates charged by banks to check for possible violations of the competition rules.

ANNEX

FIGURE 1

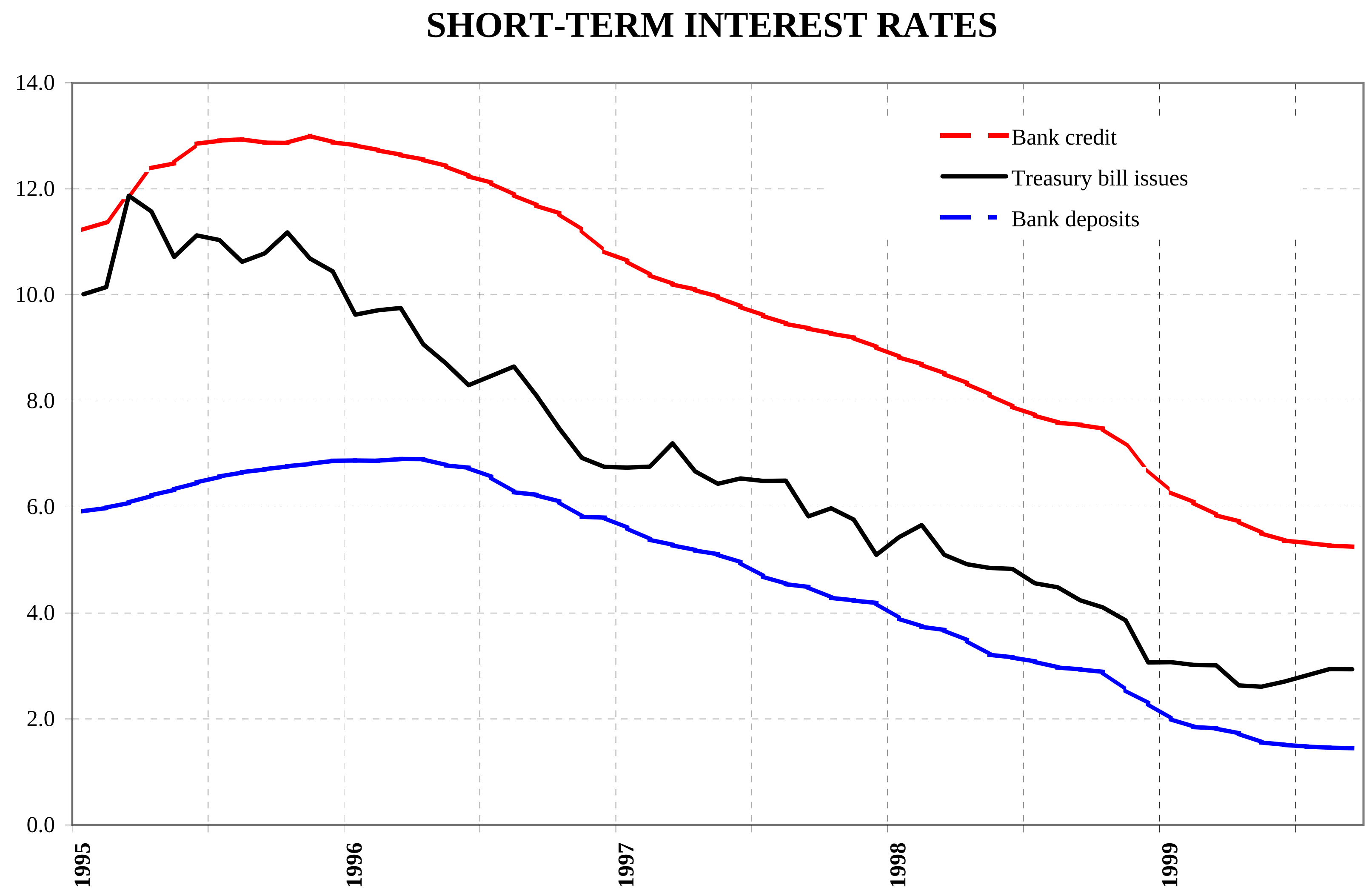

SHORT-TERM INTEREST RATES
14.0
12.0
10.0
8.0
6.0
4.0
2.0
0.0
Bank credit
Treasury bill issues
Bank deposits
1995
1996
1997
1998
1999

FIGURE 2

MEDIUM AND LONG-TERM INTEREST RATES

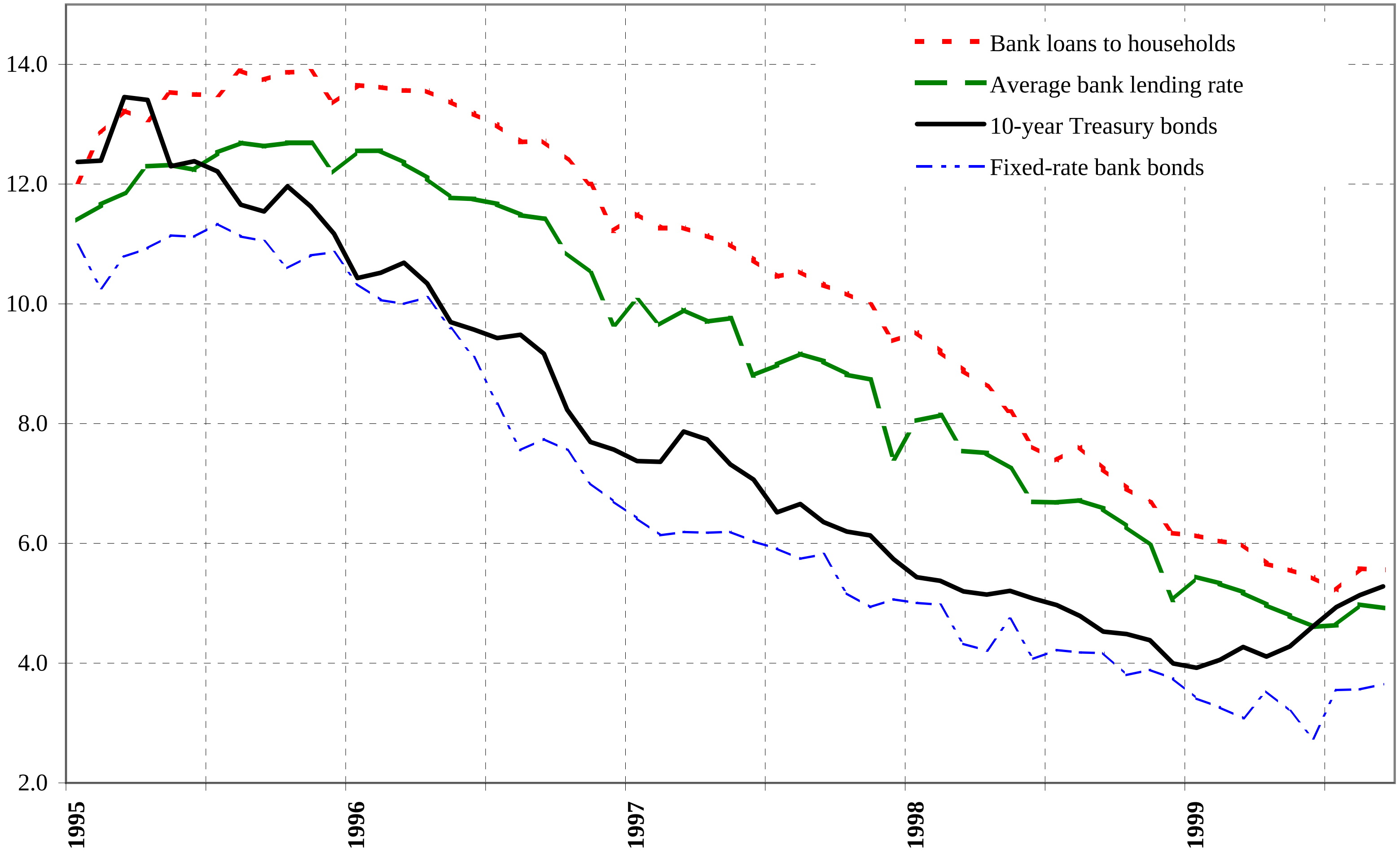


FIGURE 3

BANK RATES IN ITALY AND THE EURO AREA

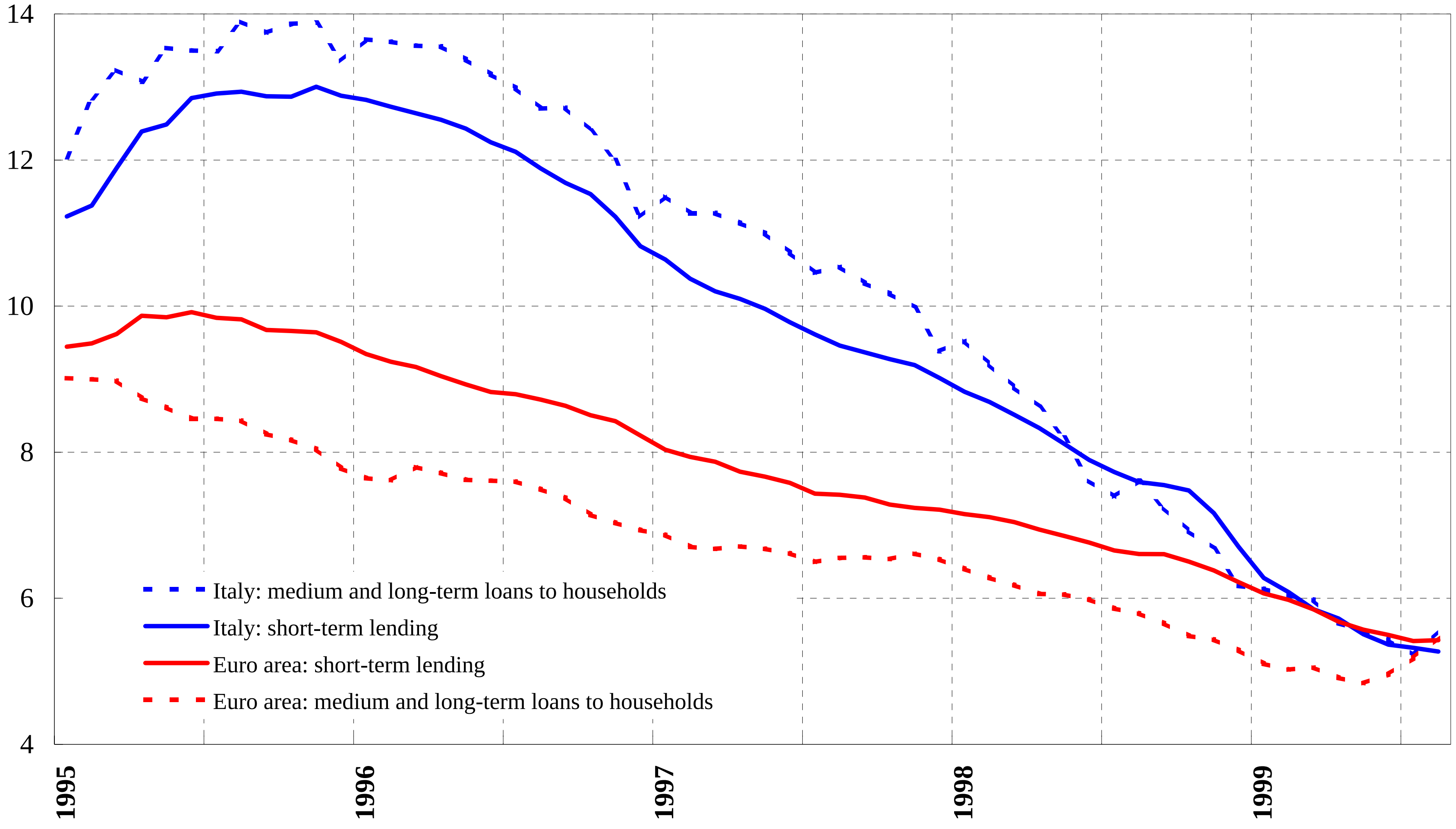


FIGURE 4

BANKS' INTEREST RATE SPREADS

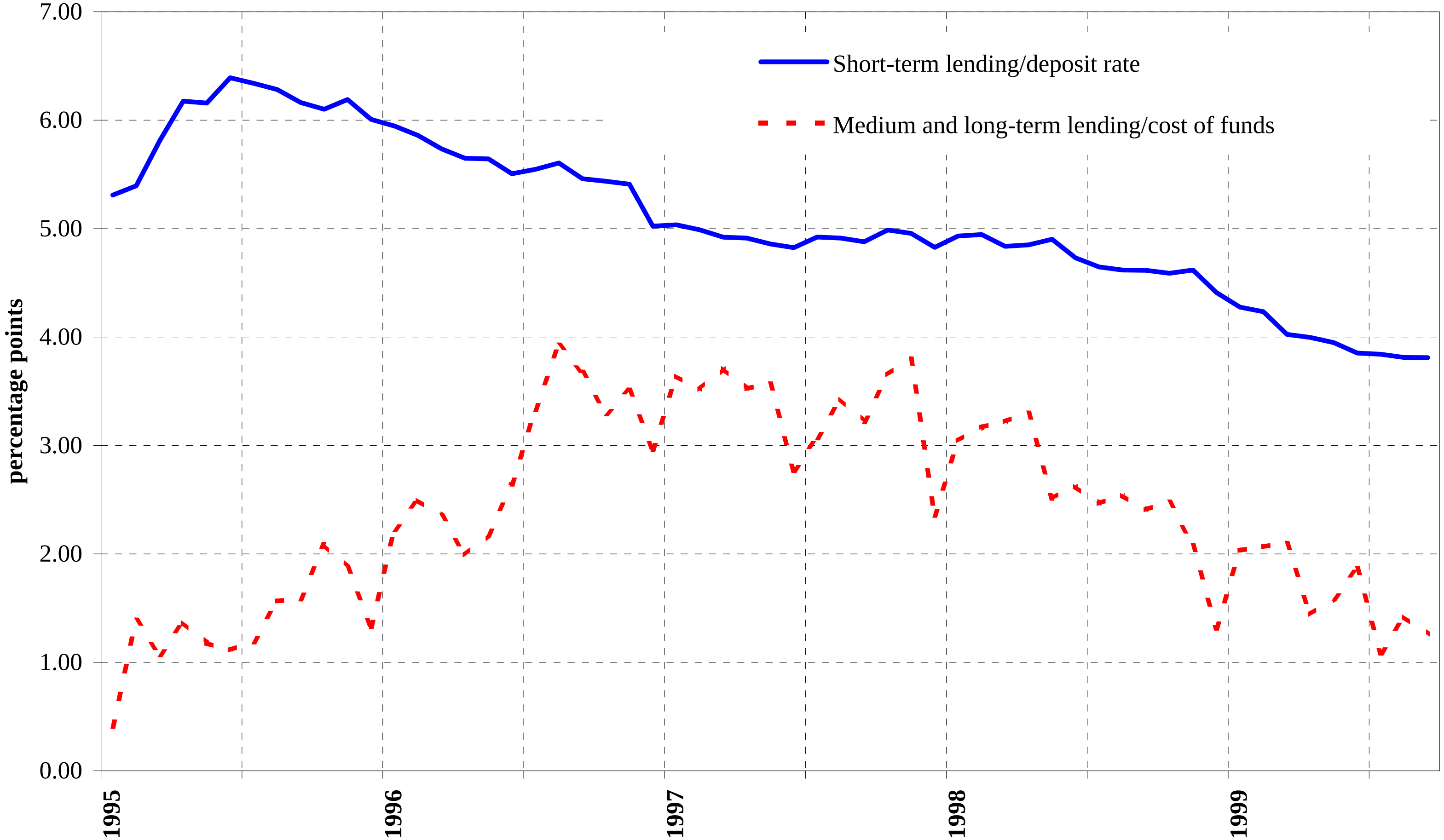


FIGURE 5

COMPOSITION OF BANKS' INCOME

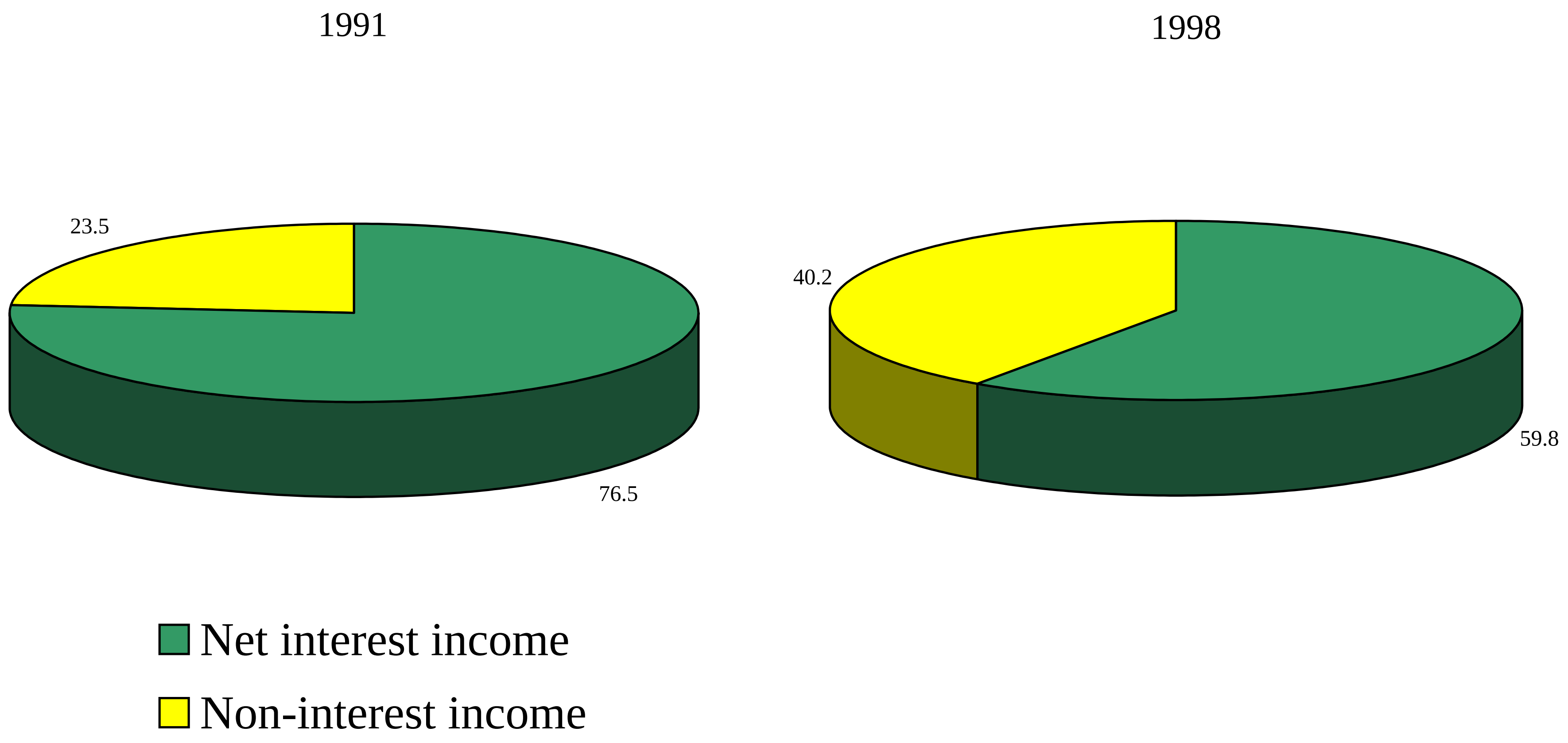
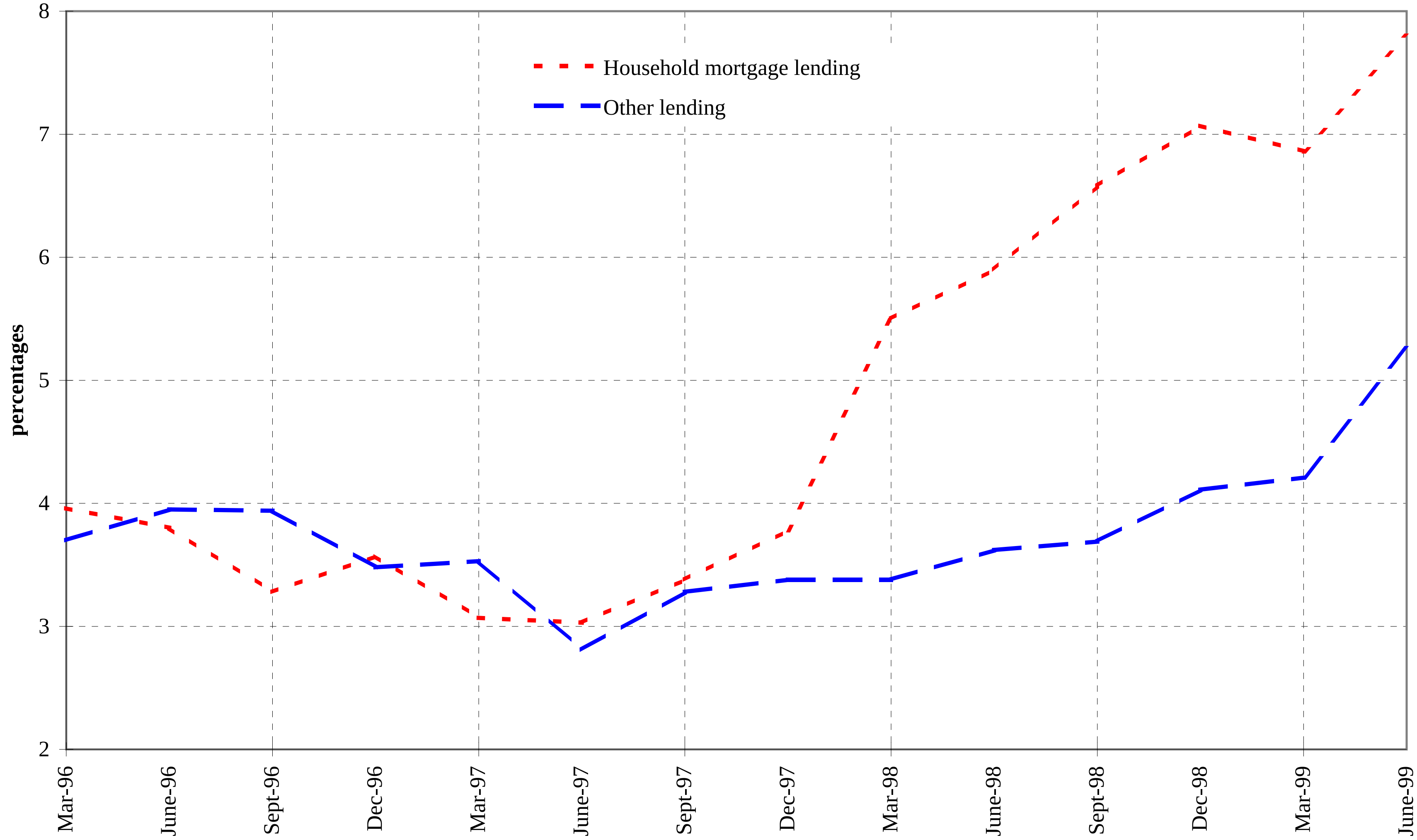


FIGURE 6

VARIATIONS IN MARKET SHARES FOR BANK LENDING (1)



(1) Sum of the market shares lost by some banks and gained by others.

FIGURE 7

BAD LOAN RATIOS

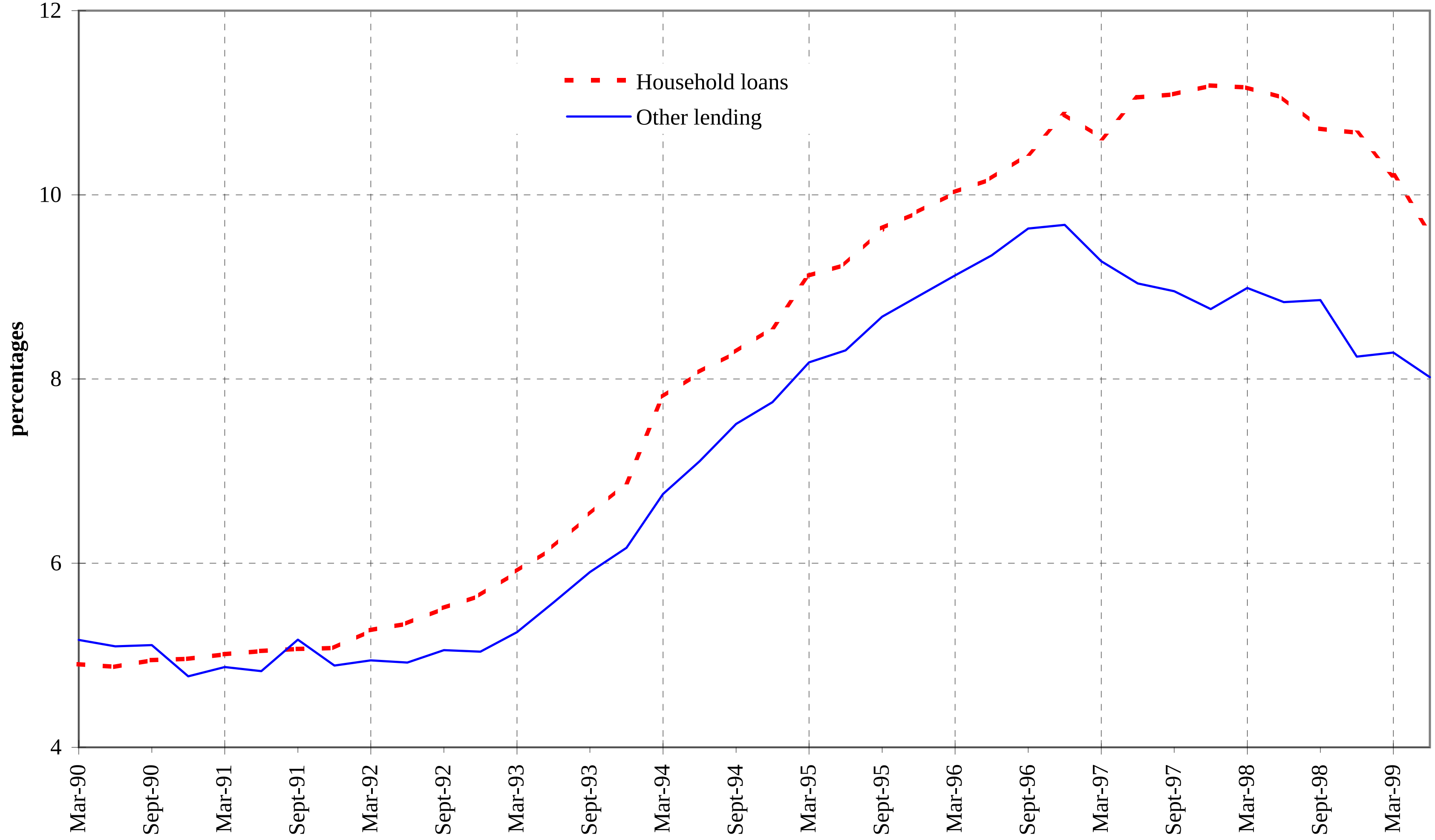


FIGURE 8

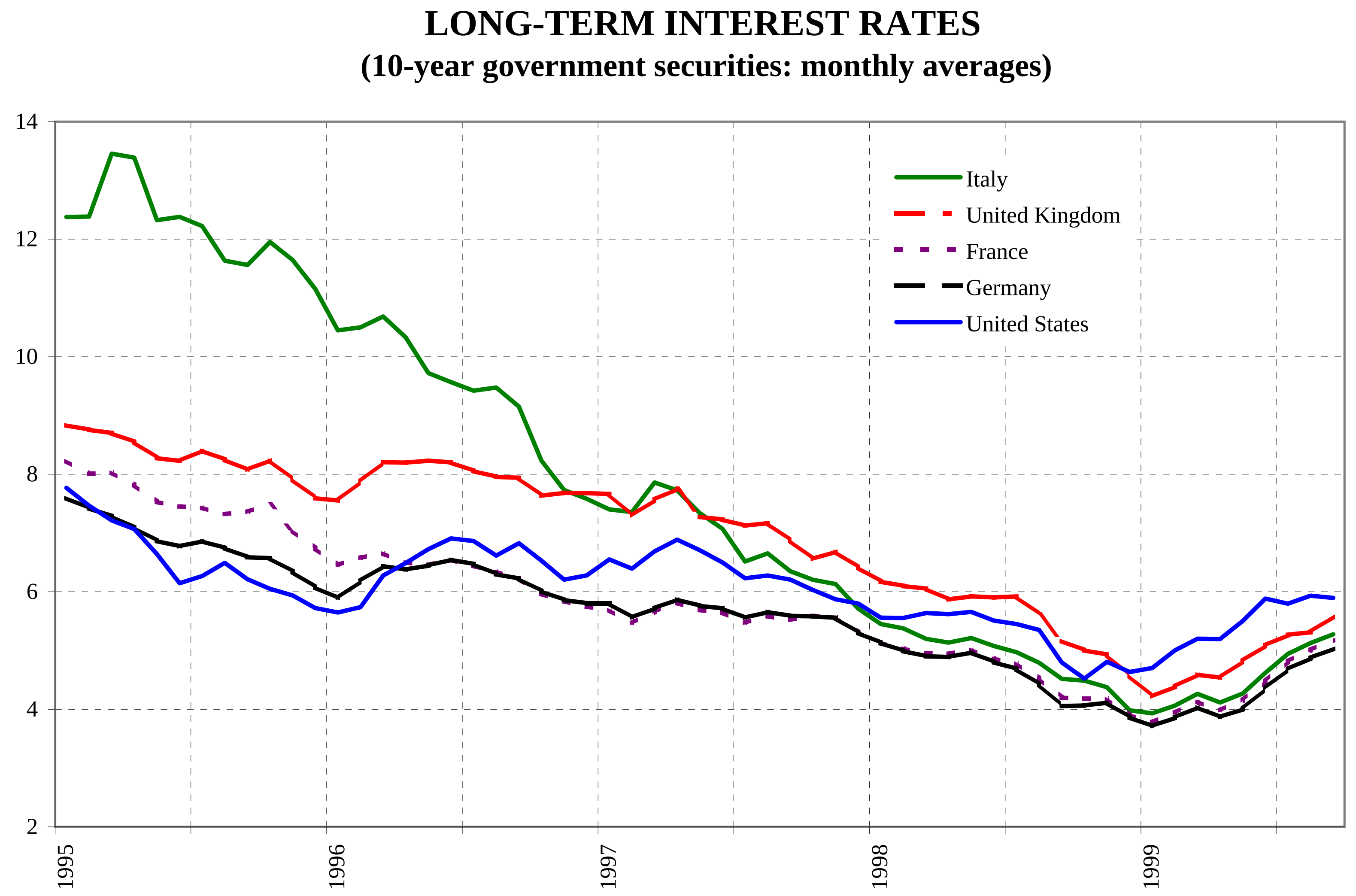

LONG-TERM INTEREST RATES
(10-year government securities: monthly averages)
14
12
10
8
6
4
2
1995
1996
1997
1998
1999
Italy
United Kingdom
France
Germany
United States

FIGURE 9

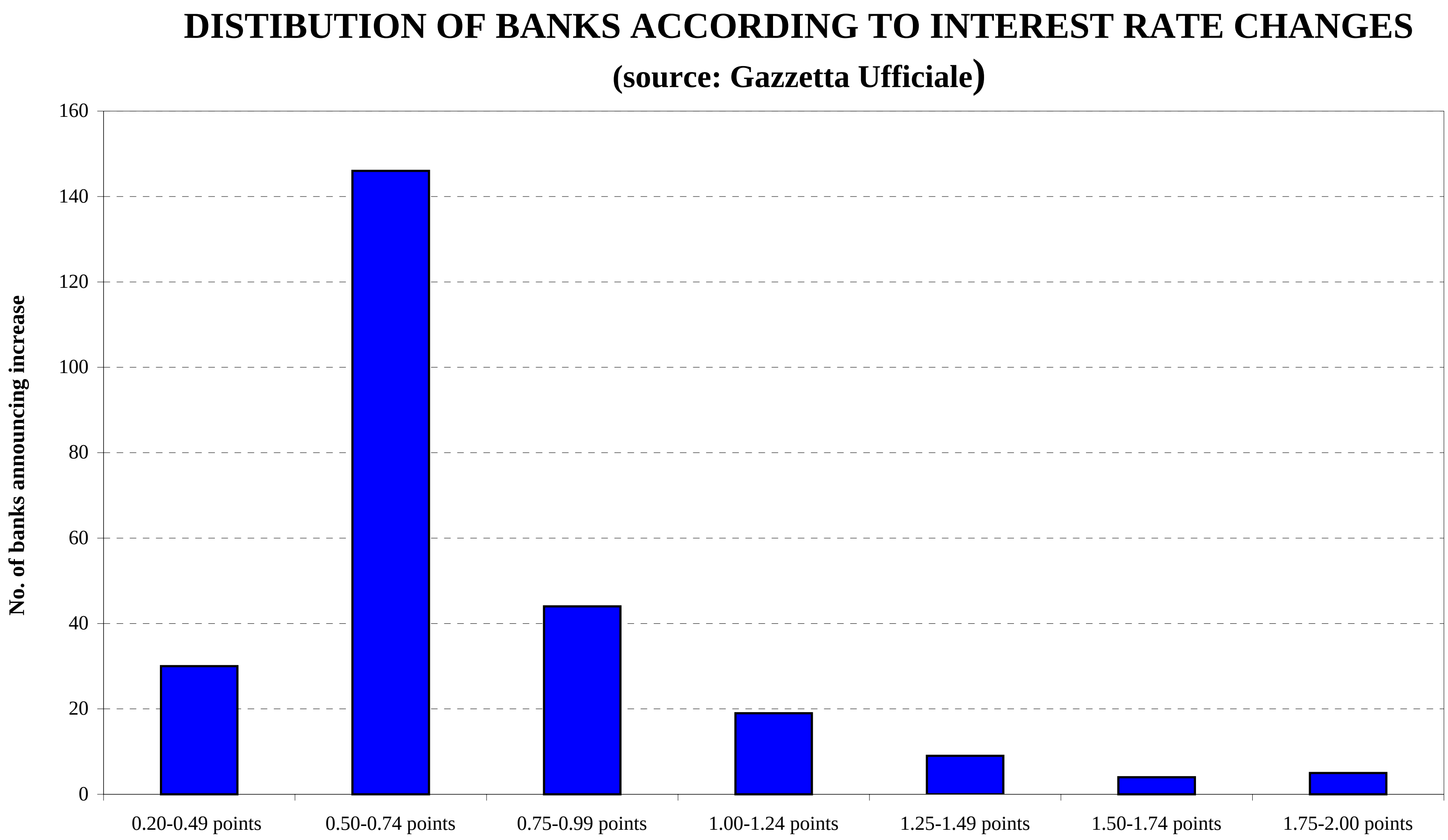

DISTIBUTION OF BANKS ACCORDING TO INTEREST RATE CHANGES
(source: Gazzetta Ufficiale)
No. of banks announcing increase
0
20
40
60
80
100
120
140
160
0.20-0.49 points
0.50-0.74 points
0.75-0.99 points
1.00-1.24 points
1.25-1.49 points
1.50-1.74 points
1.75-2.00 points

FIGURE 10

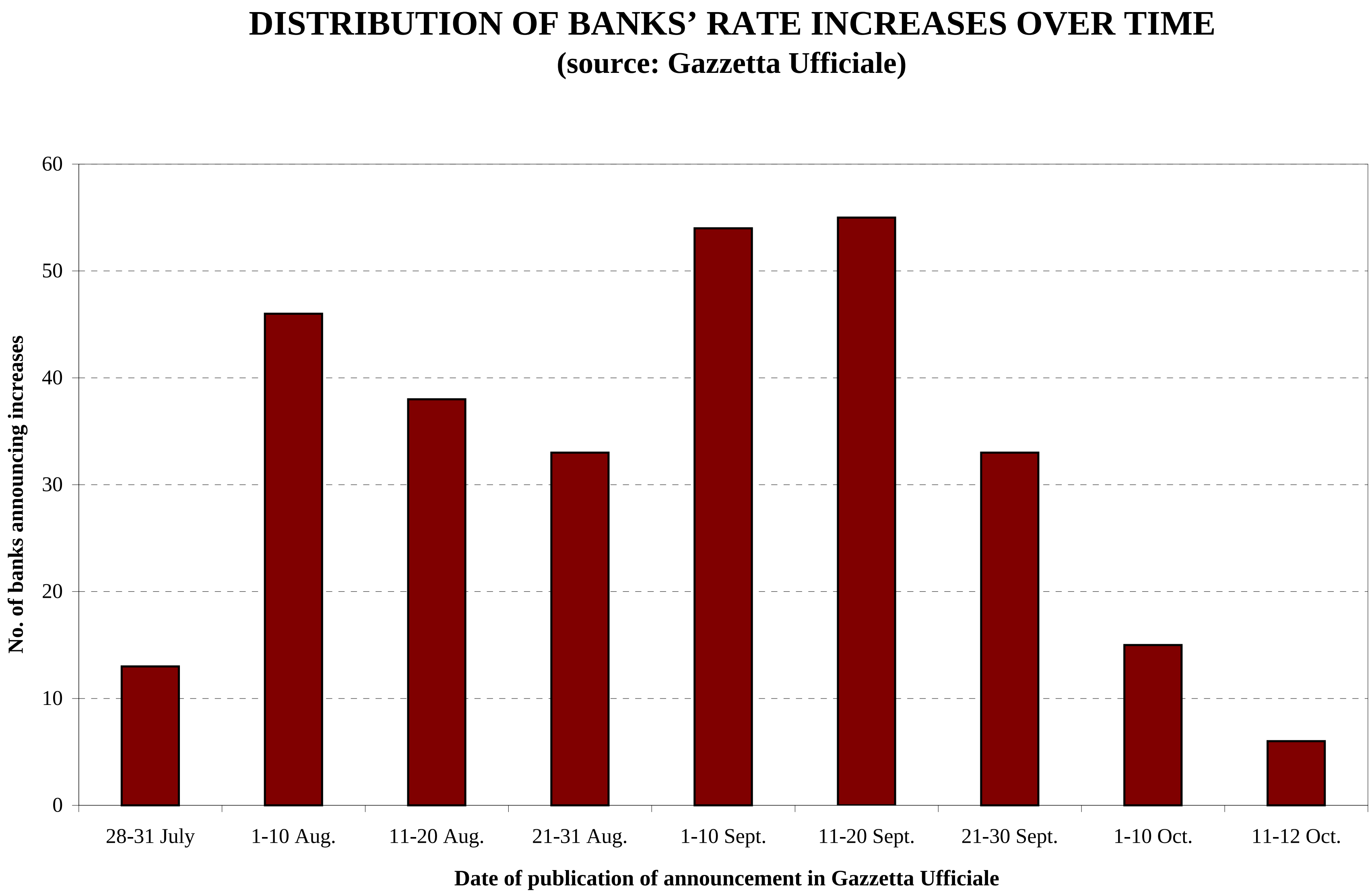

DISTRIBUTION OF BANKS' RATE INCREASES OVER TIME
(source: Gazzetta Ufficiale)
No. of banks announcing increases
60
50
40
30
20
10
0
28-31 July
1-10 Aug.
11-20 Aug.
21-31 Aug.
1-10 Sept.
11-20 Sept.
21-30 Sept.
1-10 Oct.
11-12 Oct.
Date of publication of announcement in Gazzetta Ufficiale

TABLE 1

BANK RATES IN ITALY

MONTH	Short term		Medium and long term		
	Loans	Deposits	To firms	To households	Fixed-rate bonds
Jan. 1996	12.82	6.88	11.67	13.65	10.33
Feb.	12.73	6.87	11.70	13.62	10.06
Mar.	12.64	6.90	11.49	13.57	10.00
Apr.	12.55	6.90	11.31	13.56	10.11
May	12.43	6.79	10.89	13.38	9.60
June	12.24	6.74	10.87	13.17	9.11
July	12.11	6.56	10.68	12.99	8.34
Aug.	11.89	6.28	10.54	12.70	7.56
Sept.	11.69	6.23	10.45	12.72	7.74
Oct.	11.53	6.10	9.83	12.40	7.56
Nov.	11.22	5.81	9.67	12.00	7.00
Dec.	10.82	5.80	9.10	11.22	6.70
Jan. 1997	10.64	5.60	8.84	11.50	6.42
Feb.	10.38	5.39	8.74	11.27	6.14
Mar.	10.20	5.28	8.84	11.27	6.19
Apr.	10.10	5.18	8.66	11.14	6.18
May	9.96	5.10	8.67	11.00	6.19
June	9.78	4.95	8.04	10.73	6.03
July	9.61	4.69	8.12	10.46	5.91
Aug.	9.46	4.55	8.35	10.54	5.74
Sept.	9.37	4.49	8.13	10.32	5.82
Oct.	9.27	4.29	7.98	10.17	5.17
Nov.	9.19	4.24	7.92	9.98	4.93
Dec.	9.01	4.19	6.90	9.38	5.07
Jan. 1998	8.83	3.90	7.18	9.53	5.01
Feb.	8.69	3.74	7.29	9.20	4.97
Mar.	8.51	3.68	6.77	8.89	4.32
Apr.	8.33	3.48	6.66	8.62	4.21
May	8.12	3.21	6.46	8.20	4.74
June	7.89	3.16	6.19	7.61	4.07
July	7.73	3.08	6.15	7.39	4.22
Aug.	7.59	2.97	6.06	7.61	4.18
Sept.	7.55	2.94	6.01	7.24	4.17
Oct.	7.48	2.89	5.81	6.92	3.80
Nov.	7.17	2.55	5.57	6.68	3.89
Dec.	6.70	2.29	4.53	6.17	3.74
Jan. 1999	6.28	2.00	4.78	6.13	3.41
Feb.	6.08	1.85	4.61	6.04	3.26
Mar.	5.85	1.83	4.49	5.98	3.08
Apr.	5.72	1.73	4.37	5.66	3.53
May	5.51	1.56	4.16	5.56	3.20
June	5.37	1.51	4.06	5.43	2.74
July	5.32	1.48	4.11	5.22	3.55
Aug.	5.27	1.46	4.51	5.58	3.56
Sept.	5.25	1.45	4.39	5.56	3.68