Associazione per lo Sviluppo degli Studi di Banca e Borsa
in collaboration with Università Cattolica del Sacro Cuore of Milan
"Beyond the crisis: What lies in store for Italian banks?"

Banks, Finance, Growth

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Perugia, 23 March 2013

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The Italian economy is going through a very difficult period, in which structural weaknesses have been compounded by adverse cyclical conditions. In the last five years, we have had to deal with the financial crisis, instability in the sovereign debt market and a severe double-dip recession. Since the start of the crisis, GDP has fallen by 7 per cent and 600,000 jobs have been lost.

Thanks to sound initial conditions, the Italian banking system has been able to withstand the succession of real and financial shocks, benefiting from prudent supervision, which has reassured international investors as to the quality of banks' balance sheets and averted the destabilizing surge that has hit other European financial systems.

Nonetheless, Italian banks could not avoid the indirect repercussions of the crisis: the recession affected loan quality; the deterioration of sovereign debt ratings dried up the sources and increased the cost of funding; profitability fell dramatically. This affected the supply of credit, which has tightened in recent months. The latest data, for January, indicate a twelve-month contraction in lending to firms of around 3 per cent.

The exceptional measures taken by the Eurosystem in 2011 and 2012 stopped the liquidity crisis from turning into a credit crunch, with ruinous consequences for the real economy. Tensions are now concentrated on loan quality: bad loans account for 6.9 per cent of total lending, while all deteriorated credit amounts to 12.8 per cent (3.3 per cent and 8.4 per cent, respectively, net of value adjustments). The impact on earnings is substantial: in the three years 2009-11 write-downs and loan losses absorbed 60 per cent of operating profit on average.

The economic cycle forces banks to take high lending risks, which must be covered by their reserve assets. The Bank of Italy is checking, including by means of on-site controls, the adequacy of the value adjustments made by a great number of large and medium-sized banking groups and, where necessary, requiring corrective action. The preservation of a satisfactory level of provisioning allows banks to maintain investor confidence and attract low-cost external funding. This is essential to continue to guarantee an adequate flow of credit to households and firms.

In order to avoid procyclical effects, in connection with this action the Bank of Italy has asked banks to increase internally-generated resources by cutting costs, selling non-strategic assets, and adopting dividend policies consistent with their individual income and balance-sheet position. The criteria for the remuneration of directors and executives must also be consistent with the aim of capital strengthening, giving a clear indication of company strategy.

Beyond the short term, the recovery of banks' profitability and the strengthening of their capacity to serve the real economy will require profound changes to their business model. In the following pages I will examine two topics of particular importance for the Italian banking system.

The first regards the need to encourage firms to access the capital markets directly. Conditions are now favourable for both banks and firms to work for this objective to their profit.

The second regards the need to shift more decisively, through technology, the traditional distribution channels towards more advanced systems, achieving a substantial reduction in operating costs.

* * *

In the last few weeks uncertainties over prospective developments in the Italian economy have resurfaced. The quite moderate recovery forecast for late this year is now threatened by the unpredictability of the domestic political situation and the resurgence of financial turmoil in the euro area, which could undermine confidence and investment.

In order to preserve the prospective recovery, action to support business activity is necessary. If taken promptly, the measures now under discussion for the payment of general government debts to suppliers will be of considerable help.

However, there cannot be an enduring recovery without adequate financial support. Banks are called on to make an essential contribution: to continue providing the credit needed to sustain economic activity; to accompany firms with good growth prospects in raising funds on the market; to serve, once more, as a focal point for revitalizing the Italian economy.

The structure of the financial system and the financing of firms

The Italian banking system is comparatively small with respect to the real economy. Its total assets amount to 2.7 times GDP, significantly less than in the other major countries except for the United States (Figure 1). Nevertheless, the banks play a pre-eminent role in the financing of firms. Bank loans made up over two thirds of Italian firms' financial debt, compared with about a third in France, Britain and the United States and half in Germany. Italy is the only major country in which this share has increased since the onset of the crisis (Figure 2).

By contrast, the Italian capital market plays a limited role in financing enterprises. Firms' equity endowment in Italy is not unlike that in other countries. Financial leverage,[1] at about 50 per

[1] The ratio of financial debt to financial debt plus shareholders' equity at market prices.

cent, is broadly on a par with that of firms in Japan, Germany and the United Kingdom and higher than in the US and France.

But about four fifths of shares are held and traded outside the official markets. Stock exchange listing is circumscribed to a few large firms. Considering non-financial corporations only, in 2012 Italy counted 230 listed firms, compared with about 700 in France and Germany. The median firm in Italy had a market capitalization of about €90 million, twice as much as in those two countries. The total market value of Italy's non-financial corporations is less than 20 per cent of GDP, compared with 75 per cent in France and 45 per cent in Germany (Figure 3).

Bond financing is also limited, outstanding issues now amounting to less than 8 per cent of firms' total financial debt (Figure 4). Just a few Italian corporations make bond issues on the capital market (an average of ten a year over the past decade). Here, again, Italy lags significantly behind, and in recent years the gap has widened (Figure 5).[2] The same pattern holds for other instruments of direct or indirect recourse to the market, such as asset securitizations.

This type of financial system – bank-dependent, lacking well-developed equity and bond markets, incapable in practice of offering the productive economy any resources other than bank credit – is especially disadvantageous in the present cyclical phase. It penalizes firms, especially the smaller ones, because it prevents them from coping with the tightening of credit supply by replacing bank loans with other instruments. And it penalizes banks as well, saddling them with very high costs and risks. What is more, the strains in credit supply aggravate the difficulties of firms and feed back onto the banks' own balance sheets through heightened credit risk and defaults.

The scant presence of Italian firms in the capital markets is a well-known problem, rooted in the structural weaknesses of the economy. First of all, it reflects the response to the incentives of firms themselves. They are, in fact, reluctant to open themselves to outsiders. Expansion and access to the markets entail potentially significant transparency costs owing to increased visibility (to the tax authorities, to regulators, to minority shareholders), an excessive tax burden, a plethora of inefficiently applied rules and regulations, and the poor flexibility of the goods and labour markets.[3]

One consequence of the small average size of Italian firms is low demand for such financial services as listing assistance, securities issues, and syndicated loan placement. These are services that are used heavily by large corporations but very little by small firms, which are inherently less transparent, have few shareholders and are generally not present in the capital markets. In the past, repeated efforts have been made to draw Italian firms to the stock market by reducing the cost of listing, offering tax breaks for listing or share issues, and instituting stock exchange segments

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[2] In the four years from 2009 through 2012 bond issues by Italian non-financial corporate groups on the international markets were negligible, while those by French and German groups were large and growing.

[3] M. Pagano, F. Panetta and L. Zingales, "Why Do Companies Go Public?" *Journal of Finance*, LIII, No. 1, 1998, suggest that the relative underdevelopment of the Italian stock market depends on firms' unwillingness to accept the obligations of transparency that listing entails.

dedicated to small and innovative businesses. Action has been taken to raise disclosure standards, enhance the liquidity of securities and improve the quality of governance. The results have been disappointing.

At times, banks too have imagined that they could profit from the underdevelopment of the markets. Firms' dependence on credit reduces their bargaining power, enabling banks to impose better terms for lending. The limited empirical evidence on this point suggests that listed firms and firms that issue bonds on capital markets pay lower interest rates. These findings apply also to large corporations, which are the least likely to be "captured" by their banks.[4]

Growth of the markets: a possible change

An under-developed capital market and the productive system's reliance on bank lending have thus been the short-sighted response of Italian firms and banks to incentives. Accordingly, they have been a typical feature of our financial system. The financial crisis, the sovereign debt tensions, and the economic recession are changing those incentives, however, and may initiate a shift in the methods of financing Italian business.

On the one hand banks are being forced to reduce the overall size of their balance sheets in response to both cyclical and structural factors, such as the new capital and liquidity regulations, market pressures to reduce leverage, the high cost of funding, large credit risk, and low profitability. The credit supply tensions that have arisen on several occasions in recent months are a reflection of these factors. On the other hand firms have seen their scope for self-financing diminish and the volume of overdue payments from general government sky-rocket. In such a situation, even healthy businesses need to be able to count on the availability of sufficient external sources of financing.

This dangerous stalemate – the combined effect of a reduced supply of credit and the productive system's increased dependence on external finance – can be overcome by enlarging direct recourse to the markets, with considerable benefits for firms and banks alike.

In the present phase of the cycle, the benefits for firms of being able to access otherwise unavailable funds outweigh the costs of disclosure. The advantages of diversified sources of funding, greater negotiating power in raising bank loans, and the reputational gain that comes with access to the markets are another inducement towards openness and transparency.

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[4] The impact of listing on the cost of credit is studied in Pagano, Panetta and Zingales, op. cit. The effect of bond market access on the interest rates on bank loans is studied in F. Panetta, 2001, "Le banche e i servizi finanziari alle imprese", address to the conference *La concorrenza nell'offerta di servizi finanziari: mercati, banche e altri operatori*, Associazione per gli studi di Banca e Borsa, SADIBA.

Expanding the sources of funding requires a major commitment by businesses to increase the transparency of their financial statements, take concrete steps to open up to outside parties, and strengthen their capital base as a sign of confidence in the company's soundness. It is unrealistic to suppose that today's markets would be willing to support opaque or under-capitalized projects.

The potential benefits are considerable for banks as well. To begin, chaperoning businesses in the market would allow banks to avoid the deterioration in credit risks that rationing their clientele might otherwise entail and to increase income from business services, which remains under-developed. By providing the consulting services that are crucial for firms' direct funding and that imply low capital and liquidity absorption, the banks could strengthen, not weaken, their relationships with firms, as well as their role in a more articulated financial system.

For greater recourse to the market to be possible banks must enter into long-term relationships with firms and improve their ability to evaluate the latter's economic and financial prospects. The task is not an easy one, and in the past it was not carried out in full.

Steps must be taken to improve staff training and increase their ability to help firms access the markets, and to prevent conflicts of interest within the banks stemming from their combined role in granting credit, promoting market access and (directly or indirectly) managing household savings. Fears that the banking system plans to transfer the cost of past lending errors to the market must be dispelled. Even the riskiest borrowers can be helped to access the market if potential financiers can rely on the transparency they need to make informed decisions. Unless these conditions are fulfilled, banks' reputations and their clients' confidence will be undermined.

Banks and firms are not the only ones responsible for developing the Italian capital market. To achieve this objective the whole economic and financial system must undergo changes to stimulate long-term investors such as pension funds, provide incentives for investment in venture capital, and eliminate the fiscal and administrative constraints that discourage firms from growing in size.

Banks and firms have a crucial role to play, however. It is up to them to pave the way for change.

Technology and banks' distribution costs

Italian banks' profitability has fallen significantly during the crisis. Between 2006 and 2011 their annual profit declined by more than 30 per cent as a result of a steep drop in income together with a slight rise in costs (Figure 6). The deterioration was concentrated among the largest groups,

which saw their annual profit decline by 46 per cent as they recorded a reduction in operating costs (down by 9 per cent) but an even sharper contraction in gross income (Figure 7). The other banks registered a slight rise in profits (up by 1.6 per cent), despite an increase of 17 per cent in costs. Profitability remained low in 2012 as well.

The current levels of profitability are insufficient to remunerate capital adequately. In the absence of incisive action, they threaten to weaken banks' capitalization, their capacity to finance the recovery of the real economy.

In the 1990s the rebound in bank profitability came about principally through an expansion of income, with only modest interventions on costs (Figure 8).[5] In the present circumstances, an increase in revenues appears unlikely considering the stagnation in lending, narrow profit margins, the downward trend of asset management and the penalization of trading activity implicit in the new capital rules. Overall, the Italian banking system seems to have an excess of capacity, which drives down the overall volume of business. In the short term, therefore, raising profitability requires energetic action on the cost side, with an unflinching review of the combination of production factors and distribution channels.

While the demand for banking services has grown slowly in the last twenty years, the number of bank branches has nearly doubled. Gauged against the euro-area average, it is excessive in relation both to total bank assets (€111 million per branch in Italy against €170 million in the euro area) and to the volume of loans (€59 million against €67 million).[6]

Until the start of the financial crisis, the increase in the number of branches went together with an expansion of virtual distribution channels (Figure 9), rapidly growing investment in information and communication technology (ICT) (Figure 10) and stable staff size. The crisis has only attenuated these trends. The use of technology and remote distribution has thus largely overlapped, not replaced, the utilization of labour and the traditional branch network. The cost-income ratio has not come down; on the contrary, up to 2011 it increased.

Massive recourse to ICT can reverse these trends through synergistic use of the different distribution channels (branches, telephone, call centres, ATMs and the Internet), according to the practices followed by the intermediaries that have become international success stories.

Remote channels can be used for the distribution of highly standardized, low-value-added transaction-based services, such as liquidity management and consumer finance products, especially to the more technologically or financially advanced customers. This would permit the drastic pruning of the traditional distribution network and would free up the resources needed to strengthen

[5] D. Focarelli, F. Panetta and C. Salleo, "Why Do Banks Merge?", *Journal of Money, Credit and Banking*, Vol. 34, No. 4, November 2002, pp. 1047-66.

[6] It is in line with the euro-area average in relation to population (one branch per 1,800 inhabitants).

the remaining branches, focusing their activity on more complex or advisory-intensive products, such as corporate banking, mortgage lending and wealth management, that can generate more value added and reinforce customers' preference for one-stop shopping. Recent analyses suggest that the result could be a reduction in costs of as much as 30 per cent in the medium term.[7]

A transformation along these lines is no easy task. It will require changes to banks' organization and operating arrangements in order to acquire the necessary technological knowledge, ensure integration among the different distribution channels and train staff to perform new tasks.

The business plans of the main listed banking groups do not always appear to be consistent with the above-mentioned objectives. In a number of cases, efficiency gains and productivity increments are based on restructuring of the territorial network and containing the number of staff, without envisaging progress towards multi-channel distribution. For the few groups that publish complete information on the subject, investment in ICT is limited in amount and allocated mainly to optimizing existing information systems rather than developing virtual channels. In many cases the resources devoted to staff training are modest as well.

Large-scale use of remote channels requires, above all, full confidence on the part of customers. Its absence precludes, for example, the distance marketing of high-unit-value products such as mortgages and retirement savings products. In recent years significant efforts have been made to improve the quality and transparency of communications between banks and customers. The Bank of Italy has laid down rigorous rules, checking compliance in part through inspections at bank branches. Progress has been made, no doubt, but there is still considerable room for improvement, not only in the process of compliance with the large and diversified body of rules but also in actually partaking of the spirit that animates the regulations on transparency and correct conduct.

Going forward

Greater recourse to the market by firms and cost cutting are in banks' interest; they are essential for the financing of the real economy. However, they are not the only measures needed to adapt intermediaries' business model to the changes brought about by the financial crisis.

Looking ahead, we must ask what will be the impact of the radical changes that have occurred in the regulatory framework, the financial system and the behaviour of investors. The events of recent years have clearly (though sometimes tardily) revealed the elusive nature of economies of scale and scope in banking,[8] giving renewed impetus to the debate on the optimal size

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[7] See McKinsey&Company, "Day of reckoning for European retail banking", 2012.

[8] Doubts about the existence of economies of scale and scope are raised in D. Amel, C. Barnes, F. Panetta and C. Salleo, "Consolidation and efficiency in the financial sector: A review of the international evidence", *Journal of*

of intermediaries and the range of activities that can be performed simultaneously by any one banking group.

The rules adopted or under discussion in the main countries, designed to separate traditional credit business from investment banking,[9] are likely to lead to a radical change in the operating structure of the largest groups. Their application deserves to be carefully assessed.

Faced with growing recourse to the markets and globalization, it will be necessary to find innovative ways to establish lasting credit relationships with customers, to follow firms in their international expansion and support their success in outlet markets, and to strengthen the supply of products and services to households at conditions that are advantageous for both savers and banks in an environment of low interest rates.

To provide answers to these and other questions, it is essential that there be a continuous exchange between authorities, practitioners and scholars to compare theoretical precepts and institutional knowledge with experience in the field. It is to be hoped that this meeting will make a significant contribution to this search for understanding.

Banking and Finance, 28, pp. 2493-2519, 2004. For a survey of the recent literature, see also R. DeYoung, "Modeling Economies of Scale in Banking: Simple versus Complex Models", mimeo, University of Kansas, 2012.

9 The reference is to the Volcker rule in the United States, the Vickers report in the United Kingdom and the Liikanen report in Europe.

FIGURES

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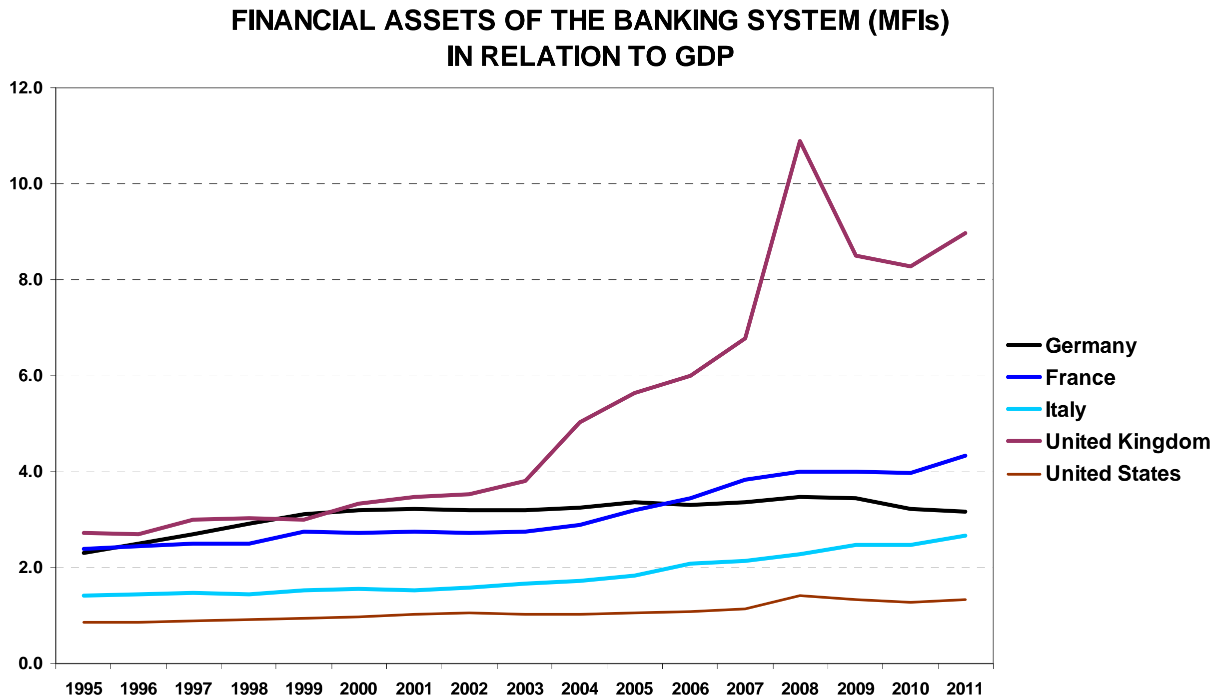
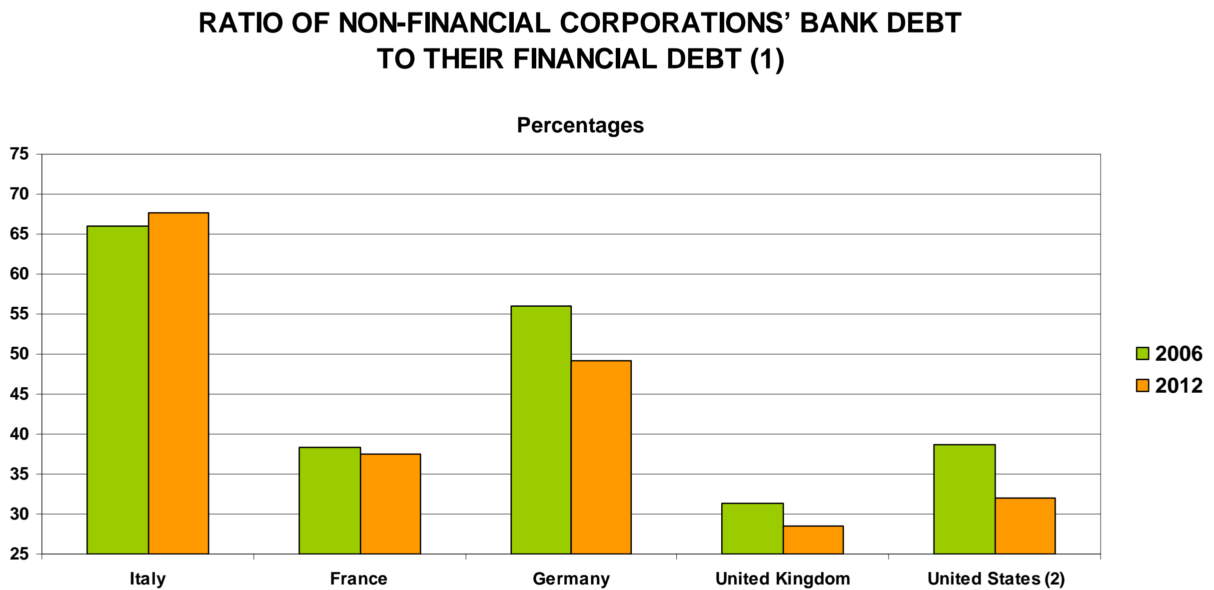
Figure 1



Sources: Bank of Italy and Istat for Italy; Eurostat and ECB for the euro-area countries; Central Statistical Office and Bank of England for the United Kingdom; Federal Reserve System and Bureau of Economic Analysis for the United States.

Figure 2

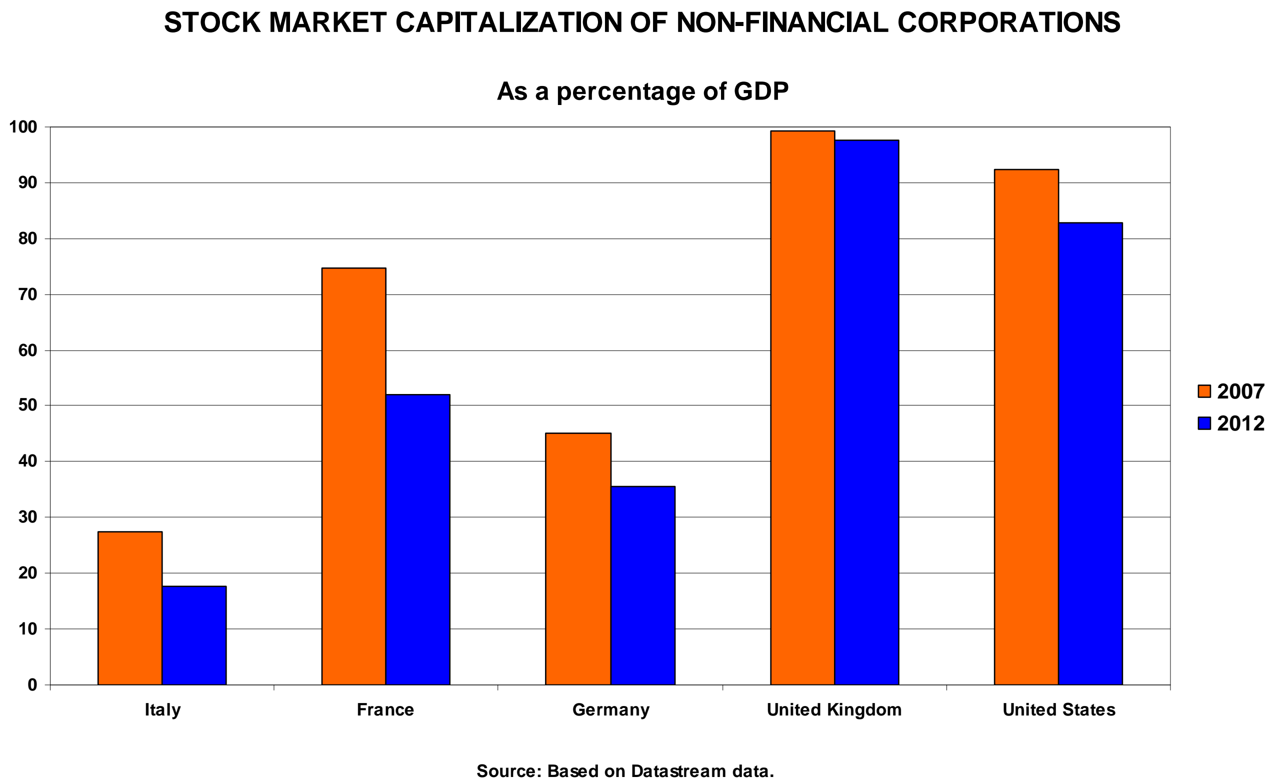


Sources: Bank of Italy for Italy; Eurostat and ECB for the euro-area countries; Bank of England for the United Kingdom; Federal Reserve System for the United States.

(1) Bank debt comprises only the loans disbursed by the banks resident in each country.
(2) 2011 data.

Figure 3

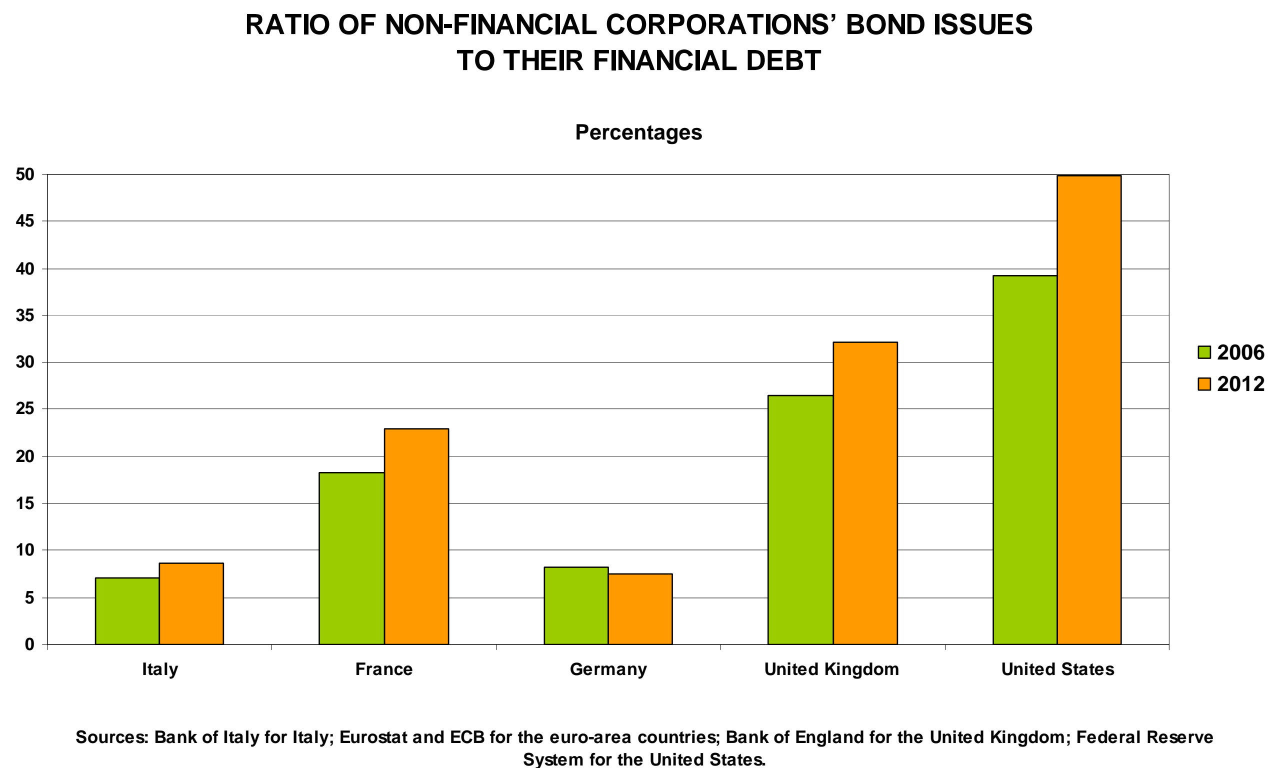
STOCK MARKET CAPITALIZATION OF NON-FINANCIAL CORPORATIONS



Source: Based on Datastream data.

Figure 4

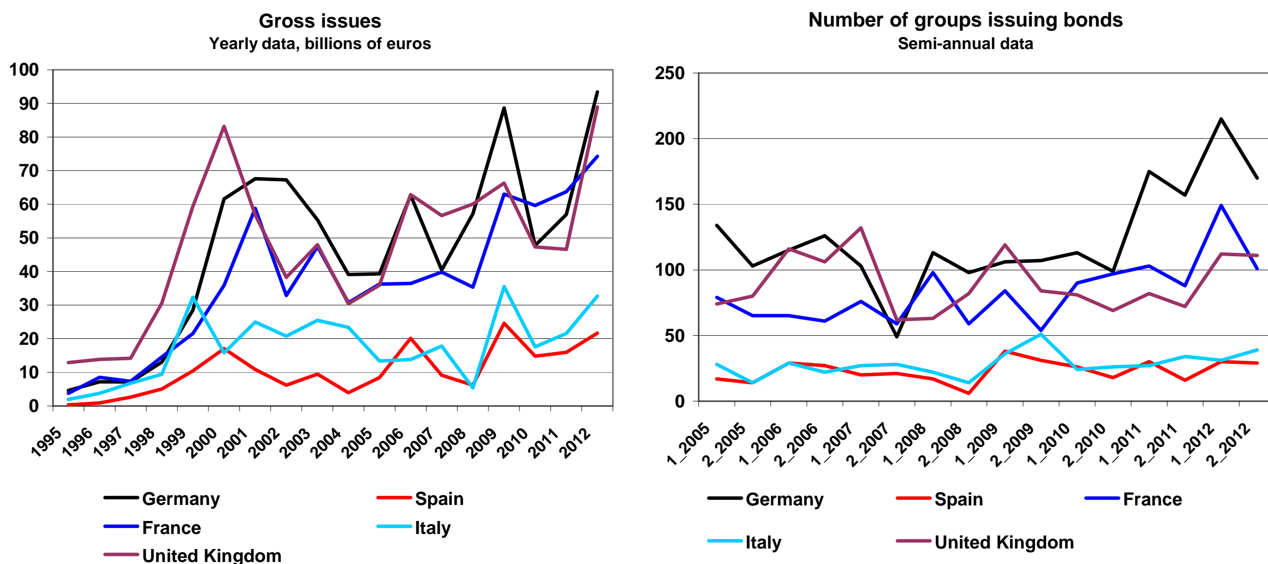
RATIO OF NON-FINANCIAL CORPORATIONS' BOND ISSUES TO THEIR FINANCIAL DEBT



Sources: Bank of Italy for Italy; Eurostat and ECB for the euro-area countries; Bank of England for the United Kingdom; Federal Reserve System for the United States.

Figure 5

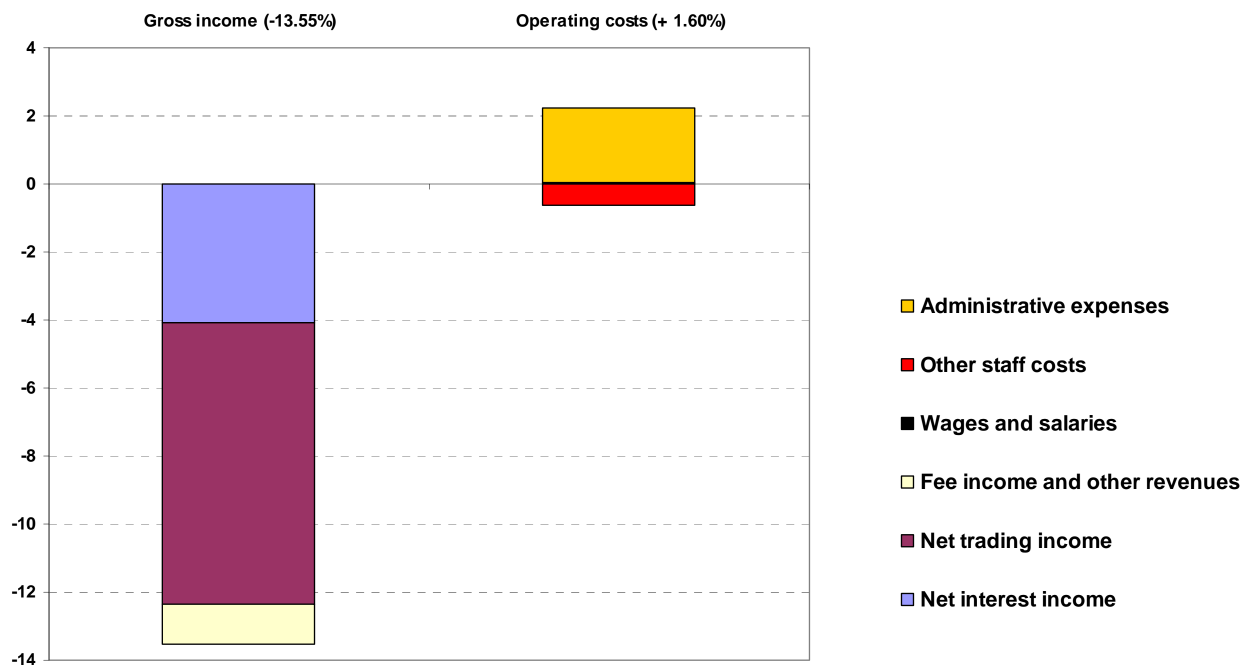
NON-FINANCIAL GROUPS: RECOURSE TO THE INTERNATIONAL BOND MARKET BY COUNTRY OF RESIDENCE OF THE PARENT COMPANY



Source: Based on Dealogic data.

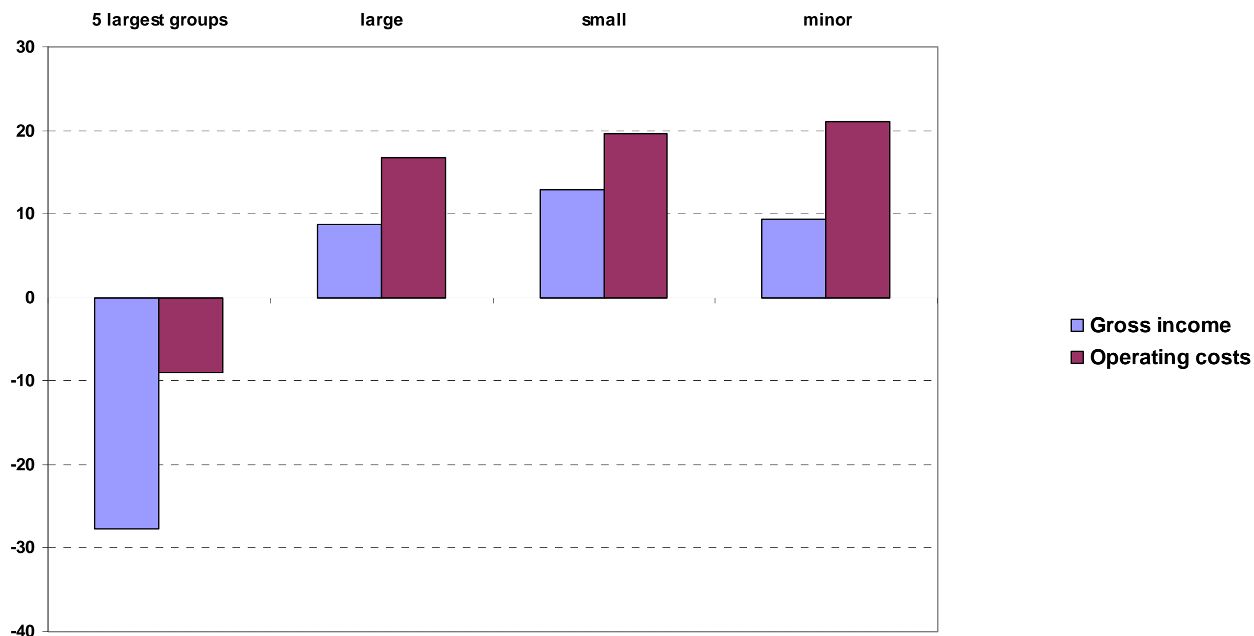
Figure 6

BANK INCOME AND COSTS: CONTRIBUTIONS TO GROWTH 2006-11



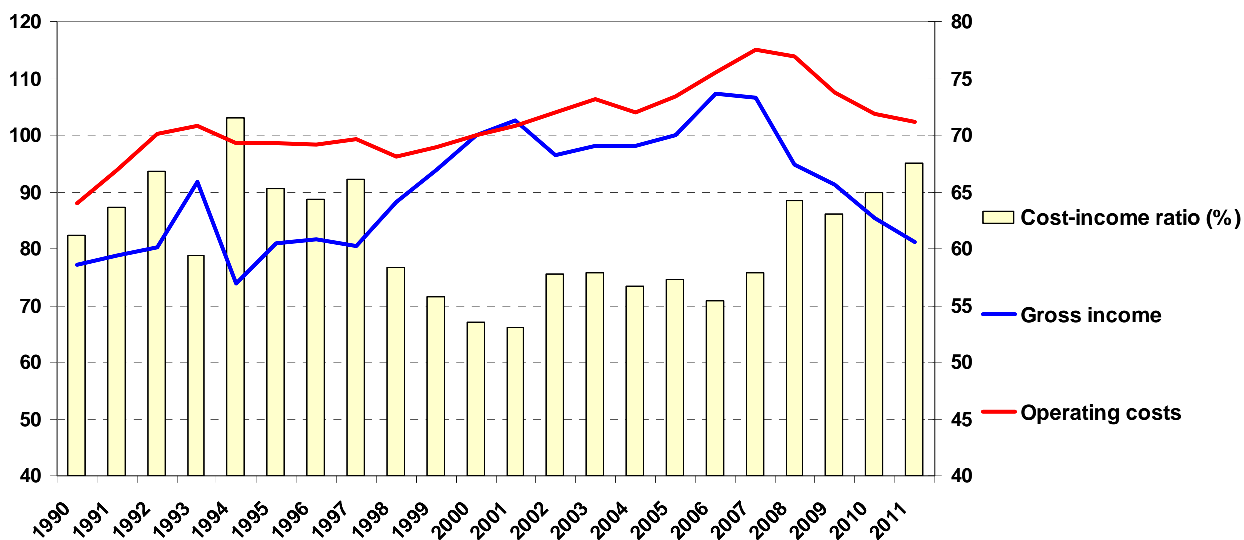
Source: Bank of Italy, supervisory reports.

Figure 7



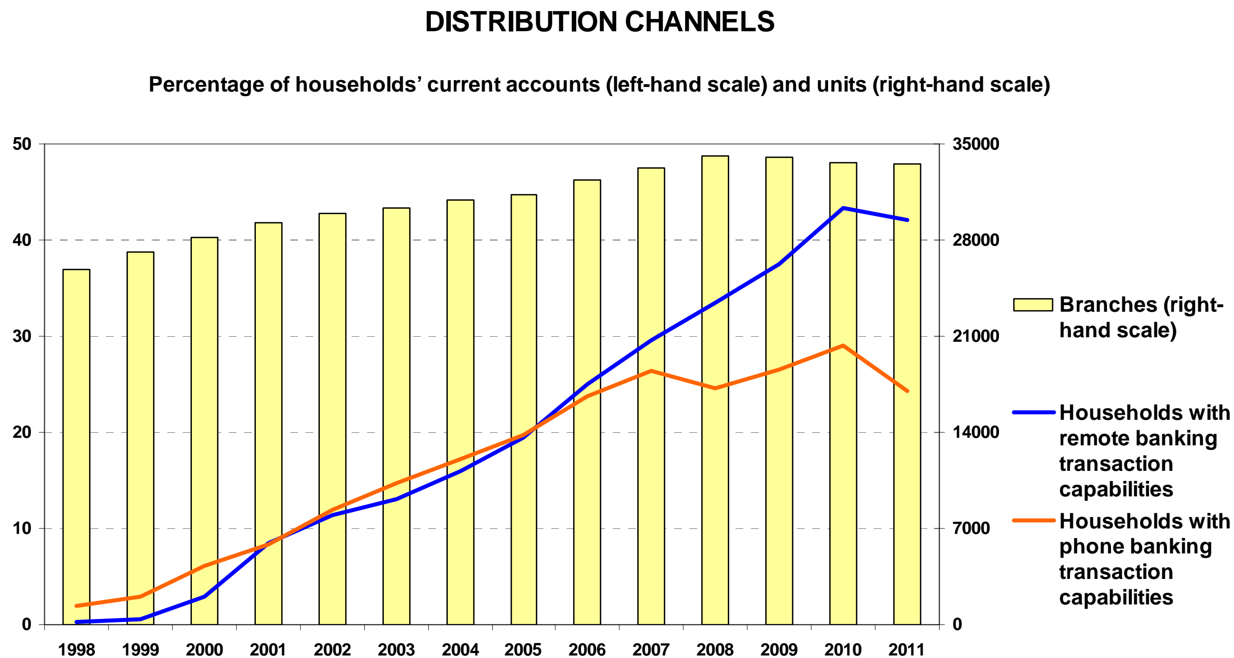
Source: Bank of Italy, supervisory reports.

Figure 8



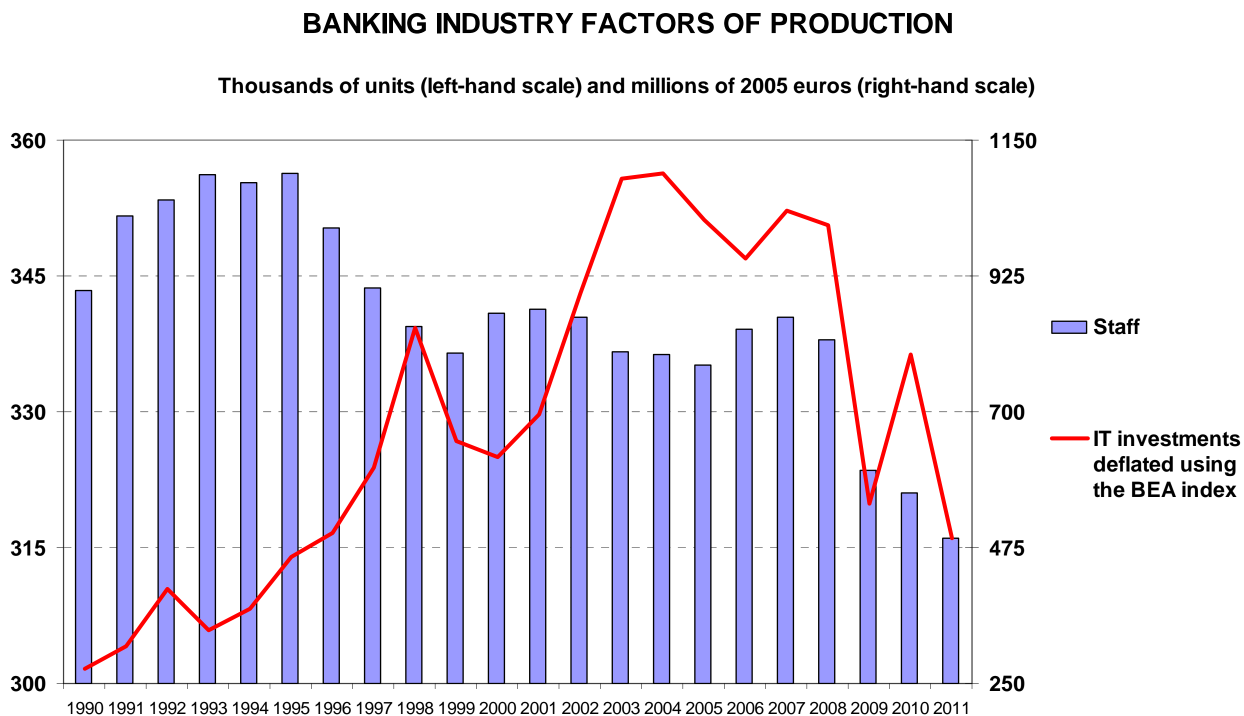
Source: Bank of Italy, supervisory reports.

Figure 9



Source: Bank of Italy, supervisory reports.

Figure 10



Source: Bank of Italy, supervisory reports.

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