ABI

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The Italian banking system in Europe

Address by the Governor of the Bank of Italy

Antonio Fazio

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Contents

Since the end of the eighties Italy's banking and financial system, like those of other countries, has been undergoing rapid changes prompted by deregulation, innovations in information technology and finance, and the globalization of markets.

Competition between banks increasingly involves competition between national systems. The single European currency will strengthen this tendency.

Banks that do not assess creditworthiness accurately, that fail to reduce costs, raise productivity and improve the quality of services to match those of their direct competitors will not be able to withstand the challenge of the market for long. A high level of profitability is crucial.

The outlook for growth will depend on the ability to broaden the range of services in response to customers' needs. Capital spending is required in order to defend markets, upgrade information systems, improve methods of evaluating risks and develop the professional skills needed to manage financial innovation.

The supply of banking services

In the leading European countries banking as a whole continues to grow faster than GDP.

Branch networks have grown to the point where the number of inhabitants per branch is now 1,100 in Spain, 1,700 in Germany and 2,300 in France and Italy.

Within Italy, reflecting the disparities in economic development, each branch serves an average of 1,900 inhabitants in the North and Centre and 3,600 in the South and Islands. Following the removal of the restrictions on branching, banks considerably expanded their distribution networks, thereby narrowing the gap with other countries; some of them have recently started to reorganize their networks by closing or moving branches.

Channels of distribution that permit remote transactions and the supply of on-line services are rapidly being developed in all the leading countries. Recourse to automated teller machines is rising rapidly; in the last five years the number installed in Italy nearly doubled, exceeding that of branches in 1997. More and more banks offer the possibility to carry out transactions directly using information technology; at the end of last year more than 300 banks were providing services of this kind to some 150,000 corporate customers. A large number of banks provide telephone banking.

It is necessary to exploit the growth potential of the different segments of the market. Undiscriminating expansion of the various networks could result in an increase in costs unjustified by a sufficiently large and stable volume of revenues. The rationalization imposed by technological innovation and competition must lead, both for individual banks and for the system as a whole, to an appropriate mix of supply in terms of distribution channels and types of institutions.

Consolidation, accompanied by the rationalization of branch networks and production processes, enhances the competitiveness of banks. Competition is in full swing in wholesale markets and international finance, as well as for larger customers.

The pressure of competition is pushing banks into searching for ways to increase their size.

At the end of 1997 there were 3,578 banks in Germany, 1,299 in France and 416 in Spain, a reduction of respectively 24, 36 and 40 per cent compared with 1990. Over the same period the number of banks operating in Italy fell from 1,156 to 935.

On the basis of banking groups' consolidated balance sheets for 1996, adjusted to take account of the mergers that have since been implemented or announced, the assets of the five largest German groups amounted to 11 per cent of the total of the banks of the 15 EU countries, an increase of 4 percentage points on 1990. Over the same period the market shares of the five largest French and Spanish groups also rose, whereas that of the five largest Italian groups remained unchanged at 4 per cent.

More than 350 mergers and acquisitions of control were carried out in the Italian banking system between 1990 and 1997; the ownership of banks accounting for 25 per cent of total assets at the start of the period changed hands. The process of consolidation has gathered momentum this year and involved some of the largest banks.

Against a background of monetary stability, the intensification of competition and the increase in the size of banks have led to the conditions applied to customers converging both domestically and across national markets: Italian banks' lending and deposit rates are now close to those found in the other leading countries of continental Europe.

In the past, most of the savings of the private sector were invested in government securities, which offered high yields and low risks. The progress made in budgetary adjustment and the commitment to achieve a rapid reduction in the public debt have created conditions conducive to the development of the private capital market and financial intermediation. Banks can take advantage of these opportunities to broaden the range of their income-earning activities.

Bank lending to the private sector is equal to 60 per cent of GDP in Italy, as in France. The ratio rises to 70 per cent in Spain and to 100 per cent in Germany. At the end of 1997 the market capitalization of the stock exchange corresponded to 31 per cent of GDP in Italy, as against 41 per cent in Germany, 50 per cent in France and 57 per cent in Spain.

The low value of the ratio of bank credit to GDP in Italy reflects the limited volume of lending to households to finance purchases of houses and consumer goods.

The share of credit granted to households is rising, but there has also been a pronounced increase in non-performing loans. At the end of last year the ratio of bad debts to total loans for the household sector was 11.5 per cent, 2 percentage points higher than the figure for bank lending as a whole.

The riskiness of loans to the household sector and the sharp reduction in spreads as a result of both domestic and foreign competition call for the use of advanced techniques for assessing creditworthiness and transferring part of the risk to the market. Extensive geographical coverage is not sufficient to ensure that this type of lending is profitable; investment in technology and professional skills is required.

Progress in the supply of services to households is discernible above all in the asset management field. Growth has been particularly rapid for investment funds and portfolio management services, where around 80 per cent of the business is handled by the banking system directly or via subsidiaries. A growing number of banks have agreements with insurance companies for the marketing of policies through their branch networks.

On several occasions the Bank has stressed the scope offered by the Italian economy for growth in the supply of banking services to small and medium-sized enterprises, which are efficient as regards production but weak in terms of financial structure. The borrowing of smaller firms is predominantly short term. More than two thirds of their bank loans have a maturity of less than one year; the proportion is lower in Germany, Spain and especially France.

The return to a low-inflation environment is conducive to the reduction of firms' financial leverage and the lengthening of the maturity of their debt, with positive repercussions on the time horizon of investment projects.

The complete integration of Europe's markets is increasing the propensity of firms to raise funds beyond their national borders. At the international level syndicated loans are growing very rapidly in view of the favourable conditions that firms are able to obtain and the possibility such lending gives banks to diversify their risks. In this segment of the market the ability to exploit the information deriving from close working relationships with firms is especially important. In 1997 Italian banks acted as lead managers for loans totaling $12.5 billion, no more than 5 per cent of the volume handled by banks of the leading European countries; most of the operations were among those carried out on behalf of Italian companies and, more specifically, among those denominated in lire.

Italian banks play an even smaller role in the Eurobond market: in the three years from 1995 to 1997 only 3 per cent of the issues handled by major European intermediaries were lead managed by Italian banks, which appear to be competitive in this market exclusively as regards Eurolira issues.

With the introduction of the single currency, the advantages banks have in carrying out operations in their national currencies will no longer exist; the possibility of acquiring a larger share of these markets, which are likely to grow rapidly, will depend on the ability to provide high quality services and build stronger relationships with firms.

By accompanying their customers in foreign markets, Italian banks can strengthen their business ties and improve their ability to manage the risks associated with activities carried out in other countries, thereby putting themselves in a position to compete with banks that possess extensive international networks.

Italian banks' traditional banking business abroad is also limited. Their share of the total international activity of banks reporting to the BIS is around 5 per cent, compared with 16 and 10 per cent respectively for German and French banks. The activity of their foreign networks is on a particularly small scale.

In contrast, foreign banks now play a major role in Italy. Their presence has been continuously encouraged by the Bank of Italy since they bring competition, new products and new professional skills. Foreign banks hold equity interests of more than 5 per cent in 18 Italian banks; in 8 cases they exercise control. In addition, there are 55 branches of foreign banks operating in Italy and an even larger number of banks and financial companies provide services without an establishment.

Foreign banks occupy an important position in the wholesale market for government securities, where they account for one third of turnover, and in innovative activities such as derivatives trading and the securitization of loans.

Between 1993 and 1997 European banks increased their share of the finance provided to the Asian developing countries from 36 to 47 per cent in the search for high yields at a time of growing competition in their domestic markets. Their exposure to the five countries affected by the crisis — Korea, the Philippines, Indonesia, Malaysia and Thailand — amounted to around $100 billion at the end of 1997, which was more than that of Japanese banks ($87 billion) and much more than that of their US counterparts ($22 billion).

German, French and UK banks accounted for respectively 31, 25 and 18 per cent of Europe’s total exposure, as against 1.6 and 1.2 per cent for Italian and Spanish banks.

The increasing riskiness of financing emerging countries and the complexity of the international environment have prompted the Bank of Italy, in cooperation with the banking system, to revise the methods for measuring country risk. The new system makes greater use of information derived from the markets, which are quick to register changes in the perception of individual countries’ solvency, and gives greater weight to the institutional aspects of their economies. Heightened awareness is required on the part of banks of the need for careful screening of borrowers and adequate provisioning.

A lively debate on the criteria for determining capital requirements and the way these affect banks' behaviour is under way at the international level. Many banks already use advanced techniques to measure and manage the risks associated with movements in exchange rates and the prices of securities; new models for the analytical evaluation of credit risk are being prepared.

The supervisory authorities of the Group of Ten countries are following the development of the market closely with a view to strengthening the defence of stability. Increasing importance is being attached to internal risk control procedures and the organizational aspects of banking business. International regulatory agreements already permit the use of internal models to compute the capital charges for market risks. The possibility of amending the rules governing the solvency ratio is being studied with a view to taking advantage of the innovations in risk-measurement techniques.

The ability to take full account of risks and allocate capital efficiently will be an increasingly decisive factor in global competition.

Profitability and costs

Under the pressure of domestic and foreign competition margins in European banking systems have progressively declined. In the four years from 1993 to 1996 the ratio of gross income to total assets in the four leading countries of continental Europe averaged 3.05 per cent, a fall of around 40 basis points compared with the four previous years. The contraction in revenues was more pronounced in Spain and Italy than in Germany and France, where margins were already considerably lower.

The more efficient banks have reacted to the squeeze on margins by rationalizing their organizations, increasing the flexibility of their use of staff and freeing resources to invest in the development of new services and the application of information technology. In 1990 the ratio of Italian banks' operating costs to gross income was 62 per cent, some

4 percentage points lower than the average for German, French and Spanish banks. In Italy the ratio rose to 67.5 per cent on average in 1995 and 1996, whereas in the three other countries it fell to 64.8 per cent. In 1997 only one Italian bank in three had a ratio lower than the average for the other European countries.

The rigidity of operating expenses at a time of declining profitability is largely attributable, in an industry that is still highly labour intensive, to the cost of staff and the other terms of their employment. Since the beginning of the nineties banks' staff costs have fallen in relation to gross income in Germany and France and remained stable in Spain; in Italy they have risen and the ratio now stands at 43 per cent, as against an average of 38 per cent in Germany, France and Spain.

The number of employees in banking in the leading European countries rose to a peak at the beginning of this decade; it has subsequently shown a generalized tendency to decline.

The Italian banking system was slow to react. It has suffered a loss of competitiveness. In the absence of action to reduce per capita payroll costs, the measures to curb staff costs have focused on reducing the number of employees, which has fallen by 5 per cent from the peak in 1993; large banks have been responsible for most of the reduction.

Last year saw profit margins continue on the downward trend that had begun at the turn of the decade. Substantial loan losses by some large banks aggravated the contraction in profits of the banking system as a whole.

The deterioration in the profitability of the banking system has been accompanied by an increase in the dispersion of the results of individual banks. Those with a return on equity of more than 6 per cent account for 40 per cent of total assets; higher taxation in Italy affects the results of international comparisons. Staff costs in these more profitable banks are equal to 39 per cent of gross income.

The understanding reached last year between the banks and trade unions established the objective of closing the competitive gap with the rest of the European banking industry.

It is necessary that the national labour contracts under negotiation be concluded rapidly and allow the competitive gap to be closed.

As provided for in the agreement reached in February 1998, the outcome with regard to determining pay levels, reducing the impact of automatic mechanisms, increasing the variable component of earnings and redefining the scope of labour contracts must be compatible with this goal.

In order to ensure stability, the size of the variable component of earnings and the related benchmarks must be determined in a way that will reduce the incidence of staff costs for banks making inadequate profits.

In redefining the application of labour contracts their scope must be restricted to persons who are engaged in banking activities in the strict sense of the term. The proposals to make greater use of part-time employment and, more generally, to increase the flexibility of working hours and branch opening times are commendable.

The outlook

The acceleration in economic activity and stockbuilding that occurred last year contributed to the recovery in bank lending, which returned to growth in real terms. The increase of 6.3 per cent in the twelve months ending in April of this year consisted mainly of short-term lira loans; it was fostered by the particularly low interest rates applied to prime customers, who used part of the funds they raised to make financial investments. At the end of May the minimum rate on lira loans was 5.2 per cent, in line with the 3-month interbank rate.

The upturn in the demand for credit is attenuating the effect on banks of the narrowing of the spread between lending and deposit rates. The granting of loans must remain subject to rigorous assessment of borrowers’ creditworthiness.

In 1997 and the early months of this year banks’ fund-raising slowed in comparison with 1996 and was marked by a contrasting pattern: the twelve-month increase in short-term deposits was substantial; in April it was equal to 12.5 per cent. On the other hand, the volume of medium and long-term funds contracted in absolute terms.

Banks have continued to pay positive real interest rates on current account deposits and broadened the range of accessory services they provide. In order to meet the rising demand for loans, they have increased their net foreign liabilities and run down their securities portfolios.

After slowing down in the last quarter of 1997, monetary growth has accelerated again; in the twelve months ending in May it was more than 10 per cent. Strong growth has occurred in other leading industrial countries, fueled by the abundant supply of international liquidity and changes in investors’ portfolio preferences.

On 15 June some 25 trillion lire of compulsory reserves were released with the aim of gradually aligning this aggregate with the level the European System of Central Banks can be expected to establish. For the purposes of monetary base control, the effects of the measure were offset by a reduction in the Bank of Italy’s supply of temporary financing to the banking system.

The modest growth in bank lending in the last five years compared with the rapid expansion in the second half of the eighties was correlated with the contraction in investment in relation to firms’ gross operating profits.

Gross fixed investment grew by only 0.6 per cent in 1997, depressed by the fall in that in construction. This year the consolidation of expectations of stronger demand and the lower cost of capital should lead to its growing faster. According to the results of the Bank of Italy’s annual survey of manufacturing firms, the recovery in investment should extend to the country’s southern regions; it will benefit from the incentives introduced for restructuring residential buildings and wider use of those already approved for the South.

Banks can contribute to the recovery of the southern economy by selecting the most deserving projects, adapting loan maturities to borrowers’ income-earning prospects and helping firms to raise funds in the capital market. The outlook for the South and the banks operating there hinges on the implementation of the structural changes in the working of the economy that I discussed in my Concluding Remarks to the annual meeting of the Bank’s shareholders.

In the new environment of monetary stability and adoption of the single currency the banking system will need to be efficient and adequately profitable if it is to support growth in economic activity and an increase in employment. The procedures for granting credit and the forms in which finance is provided must be suited to an entrepreneurial system marked by a large number of small and medium-sized firms; they must help to improve companies’ financial structure and foster their expansion in foreign markets.

Although the Italian banking system has made significant progress, in several important sectors it still does not appear fully competitive with those of the other continental European countries and above all with those of the Anglo-Saxon countries. The competitive gap is especially large in the supply of innovative services; this is confirmed by the growing presence of foreign banks and financial intermediaries in Italy and by the still modest role of the Italian banking system in international markets.

In order to meet these challenges, it is necessary not only to reduce costs and develop innovative products but also to achieve adequate size in terms of own funds and scale of operations.

These are the conditions that must be satisfied to ensure the stability and growth of our banking system and enable the country to continue to benefit, in terms of output and employment, from the high level of saving of Italian households.