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## **The restructuring of the Italian banking system**

Statement by the Governor of the Bank of Italy  
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Italian law sanctioned the entrepreneurial nature of banking in 1985 with the transposition of the European Community's First Banking Directive; in the courts the principle was applied in a judgement handed down by the Court of Cassation in 1989.

Until then the banking system had been marked by a low degree of diversification in terms of markets, intermediaries and instruments; its international openness was limited, a consequence of the exchange controls that balance-of-payments deficits had made necessary for many years.

The banking system is profoundly different today: more competitive, well capitalized and moving towards a configuration better suited to international competition.

In 1985 there were very few institutional investors. The legal framework for investment funds had only been introduced a short time before in Law 77/1983. Direct investment in government securities was the only alternative to bank deposits available to savers.

The structure of the banking system was highly fragmented, with a large number of small banks rooted in local markets. The legal barriers between different categories of banks were an obstacle to the enlargement of the banks operating throughout the country.

The bulk of banking business was carried out by public sector banks, where the granting of credit overlapped with objectives of a public nature; the legal form of such

banks and their limited ability to raise equity capital were an obstacle to mergers permitting the rationalization of corporate structures.

The system had some important strengths in the close links with a myriad of small enterprises and the high level of saving that distinguishes Italy. The separation between banking and commerce acted as a fundamental safeguard of the allocative efficiency of the financial system and the cyclical stability of the economy.

The modernization of the banking and financial system has proceeded rapidly in the nineties.

Parliament and the Bank of Italy have removed restrictions on the opening of banks and their operations; the supervision of individual banks has been based on criteria designed to ensure capital adequacy and respect directors' autonomy in the allocation of financial resources.

Legislative reform aimed at facilitating the privatization of public sector banks was initiated and has been largely completed.

The 1993 Banking Law sanctioned the principle of competitive equality among all banks by eliminating operational specialization.

The Consolidated Law on Financial Intermediation has permitted a high degree of diversification among asset management products and made individual and collective portfolio management more flexible.

The banking system has succeeded in overcoming the serious difficulties created in the South by the stagnation of economic activity and the termination of the programme of extraordinary measures, coupled with weak organizational structures in the leading southern banks. The use of public funds, approved by Parliament, to cope

with the crises of some banks, was a small fraction of the cost that the banking system would in any case have had to incur. The burden borne by the public finances was much smaller than those placed on the budgets of many industrial countries in recent years.

### ***1. Banking systems in the European Union***

In Italy and its main European partners, the same fundamental trends are profoundly modifying the morphology of banking systems. The regulatory framework is shifting in favour of banking despecialization and liberalization; financial and technological innovation is changing the productive arrangements that are economically efficient. The result is increasing competitive pressure in domestic markets and the international arena.

The ratio of gross financial assets to GDP is lower in Italy than in the other main European countries: in 1997 it was 530 per cent, compared with approximately 600 per cent in Germany and Spain and 1,000 per cent and more in France and the United Kingdom.

The volume of bank intermediation is also lower in Italy: although the economy represents 14 per cent of that of the European Union, Italian banks' assets amount to only 9 per cent of the EU total. The market shares of the French, British and German banking systems are larger than the relative weights of their respective economies.

In all the leading European countries, as well as in the United States, the number of banks is falling rapidly as a result of consolidation. The model of the multiproduct bank, able to supply a full range of services to households and the

corporate sector, is spreading. In France and Spain the number of banks has fallen most sharply among those specialized in individual market segments. In the United Kingdom many of the merchant banks have been merged into commercial banks and the range of operations offered by the building societies is expanding. In Italy only 36 of the 91 special credit institutions that used to be in operation have maintained legal personality.

In the five leading European countries as a group, the number of banks fell by more than 2,400, or 26 per cent, between 1990 and 1997. In Italy the number contracted from 1,155 in 1990 to 920 in 1998. The declines in France and Spain were larger than average.

In terms of the prices paid, the consolidations carried out during the period had a high value in Italy, on the order of 45 trillion lire, second only to the figure for the United Kingdom.

The reduction in the number of banks has not been accompanied either by a slowdown in the growth of intermediation, which has continued to outpace GDP, or by a decrease in the number of bank branches. The traditional channels of supply are flanked by a network of automated teller machines that is now as extensive as the branch network and new electronic and telephonic methods of transacting business with customers.

Compared with other countries, Italy occupies an intermediate position in terms of branch density, with 2,276 inhabitants per branch. This is similar to the figure in France, lower than that in the United Kingdom, 3,125 inhabitants per branch, and well above those in Germany and Spain, respectively 1,614 and 1,146 inhabitants per branch.

The introduction of advanced technologies has helped to raise productivity in Europe's banking systems. Labour inputs have decreased by 35 per cent in relation to assets in the five countries as a group, declining most sharply in the United Kingdom and Germany. The number of staff per branch has fallen almost everywhere; in the Italian banking system its level is now low by international comparison.

In Italy the first five groups in terms of assets account for 45 per cent of the national total, a figure in line with those of the other main European countries.

However, owing to the limited overall size of the banking system, Italy's large banks are small when measured on the European scale: Italy's five largest banking groups account for 5.3 per cent of total bank assets in the fifteen EU countries. This is well below the shares of the leading German, French and UK groups, respectively 13, 12 and 10 per cent, and only exceeds the 3 per cent share of the largest Spanish banks.

The Italian banking system is, therefore, quantitatively underdeveloped. Italian banks are relatively small by international standards.

At the beginning of the nineties the share of bank intermediation attributable to public sector banks was high in all the European countries except for the United Kingdom. The intensification of competition and the need for corporate policies to pay more attention to efficiency and profitability contributed everywhere to the start of a process of privatization that is still under way.

In this respect, the Italian banking system does not appear to be lagging behind: two of Italy's ten leading banking groups are under public control, compared with three in France and four in both Germany and Spain. The public sector groups account for 11 per cent of the assets of the principal banks in Italy, a lower proportion than in

the other major European countries, among which Spain and Germany stand out with shares of respectively 21 and 36 per cent.

Foreign ownership of the capital of Italian banks is not inconsiderable. Foreign banks or insurance companies have significant holdings in six of the ten leading Italian groups, which account for half of the Italian banking market. Only in Spain are the figures comparable. In France and the United Kingdom both the number of banks with substantial foreign ownership and their aggregate market share are smaller. In Germany the participation of foreign investors in the capital of the banking system is negligible.

More than 60 branches of foreign banks are in operation in Italy. Foreign intermediaries' volume of business is steadily growing. Their branches and banking subsidiaries account for around 7 per cent of the total assets of the banking system, but their market shares are appreciably larger in some sectors, such as lending to households, trading in Italian government securities and advanced corporate financial services.

Our system is lagging behind in the field of assisting companies in international financial markets, particularly in organizing syndicated loans and the placement of bonds issued by Italian borrowers. Approval of the bill on securitization may give a boost to Italian banks' business in this sector.

In general, the international presence of the Italian bank system is limited. During the nineties the assets of Italian banks' foreign branches and subsidiaries declined in relation to those of their domestic branch networks, in contrast with the trend in the other main European countries. In 1997 the ratio for France and Germany was nearly 30 per cent, following a rapid rise fueled in part by the large increase in exposures to the riskiest Asian countries, with negative feedback effects on these



countries' domestic systems. In Italy and Spain the ratio was much lower, on the order of 15 per cent.

Numerous statistical indicators demonstrate the increased competitiveness of the Italian banking market. The average number of banks in each province has risen from 24 in 1985 to 30. Despite the considerable increase in the incidence of bad debts, the spread between lending and deposit rates has narrowed to 4 percentage points, compared with 6.9 points ten years ago. Bank rates in Italy are now perfectly aligned with those prevailing in the other main European countries.

The increase in competition and the trend toward reorganization and restructuring, at corporate and system level, stem not only from the entry of new competitors in the most highly concentrated markets, a policy first adopted systematically as early as the end of the seventies, but also from the development of the money market, the liberalization of bank and branch openings and the privatization of public sector banks.

Corporate reorganization and the privatization process began with Law 218/1990 on the reform of public sector banks. The law steered these banks towards adoption of the limited company model, facilitated mergers and regulated banking groups.

The consolidations carried out during the nineties have involved 432 banks, not counting intra-group operations and those regarding special credit sections. The banks involved account for a third of total assets.

The intensity of this process can be assessed by means of a comparison with the eighties, when consolidation involved 140 banks accounting for 3 per cent of total assets.

Whereas earlier consolidations had mainly involved banks whose soundness had been compromised, four fifths of those in the nineties have concerned banks with satisfactory profitability and capital adequacy.

In the last few years consolidation has involved banks of major importance. In the two years 1997 and 1998 operations were carried out with respect to the capital of banks accounting for 15 per cent of total assets. Three major groups were created with the mergers between Ambroveneto and Cassa di Risparmio delle Provincie Lombarde, giving rise to Banca Intesa, Istituto Bancario San Paolo di Torino and IMI, giving rise to San Paolo IMI, and a group of northern savings banks and Credito Italiano, giving rise to the Unicredito Italiano Group. A wide-ranging reorganization was carried out among banks in the South, which averted severe instability crises of a potentially systemic nature; Banca Nazionale del Lavoro and Mediocredito Centrale played a part in this restructuring.

Consolidation is still under way and the privatization process has steadily gained pace.

Under the Amato-Carli Law, the authorization of the Council of Ministers was necessary for banks to leave the sphere of public control. This constraint was eased in 1992 with the provision allowing the Minister of the Treasury to issue a general directive; it was subsequently eliminated with Law 474/1994, which laid down rules designed to speed up privatizations.

The first privatizations, carried out in 1993, involved banks controlled by IRI and the Ministry of the Treasury.

As share prices rose, many banking foundations disposed of holdings, partly with the aim of strengthening the capital base and rationalizing the organizational and productive structures of their banks.

In 1997 and 1998 Banco di Napoli, Cassa di Risparmio delle Provincie Lombarde, Banca di Roma, Istituto Bancario San Paolo di Torino and Banca Nazionale del Lavoro were privatized. The share of total assets attributable to banks or groups in which the majority interest is held by foundations, local authorities or the state has fallen to 20 per cent, compared with 68 per cent at the end of 1992. Today the state only controls two banks, Mediocredito Centrale and Credito Industriale Sardo, and the privatization procedure has been initiated for both.

The foundations that still wholly own Monte dei Paschi di Siena and Banco di Sardegna have expressed their intention of opening to private shareholders. Out of 70 savings and pledge banks, 39 are still more than 50 per cent controlled by their foundations, but they only account for 8.6 per cent of the banking system's total assets.

## ***2. Italian banks' profitability***

In the five years from 1993 to 1997 Italian banks' profitability was affected by massive loan losses stemming from the deterioration of corporate finances in 1992 and 1993, the long stagnation of the southern economy, the crisis in the construction and public works sector and the fall in property values.

Between 1990 and 1997 the ratio of profits to capital and reserves fell from 10 to 1 per cent, a figure far below both the return on equity achieved by the banking systems of other leading countries and the yield on bonds.

Provisional data for 1998 point to a recovery in banks' gross income, thanks to exceptionally high revenues from asset management services and securities trading. Operating costs rose further, albeit not by much, despite a reduction of approximately 2 per cent in the number of staff.

As a result of large allocations of profits to reserves and issues of subordinated liabilities, own funds increased considerably in 1998 and capital shortfalls with respect to minimum supervisory capital requirements were almost annulled, even among banks based in the South.

However, now that the process of interest rate convergence has run its course, banks will see a decline in revenues from securities trading, which in the last three years accounted for around 10 per cent of gross income. During the same period, speaking on several occasions in institutional fora, I urged the banking system to proceed resolutely with a drastic reduction in costs, in order to be able to withstand competition at the European level. I called on banks' directors to develop innovative activities and to aim for an increase in corporate size, greater efficiency and an expansion of the product range through agreements or mergers with Italian or foreign banks.

The agreement reached in February 1998 between the Italian Bankers' Association and the trade unions to implement the memorandum of understanding aimed at lowering the incidence of staff costs has still not been translated into a new national labour contract.

Curbing per capita and total staff costs remains a priority objective.

In the absence of adjustments in per capita staff costs, measures to raise efficiency will affect employment levels in the sector.

### ***3. The role of the Bank of Italy***

The supervisory authorities are charged by law with ensuring the stability, efficiency and competitiveness of the financial system.

In this context the choice has been to have an open and competitive market. The Bank of Italy has taken on this responsibility fully and indicated in good time that the indispensable strengthening of Italian banks would have to be achieved through an increase in their size. On three occasions the Bank deemed it necessary to deny authorization to exceed the limit of 5 per cent on holdings of a bank's capital, in order to ensure sound and prudent management or to prevent violations of the letter or the spirit of the banks' bylaws.

The small size of even the largest Italian banks leaves our system exposed to the risk that it will be unable to match the inflow of foreign capital with equally important interests in the capital of foreign institutions.

As I pointed out in my Concluding Remarks to the Bank of Italy's shareholders' meeting in May 1997, it is up to the owners of banks to make the strategic choices; directors must assess the desirability of the various options in the light of each bank's circumstances and market trends.

The Bank of Italy is not indifferent to the directions that the process of restructuring takes; it has a duty to monitor compliance with the regulations and to ensure that their application serves to strengthen intermediation, in the interests of the economy.

The task of monitoring and assisting the process of restructuring entails the assessment of merger projects and plans for the formation of banking groups on the basis of the information the parties are required to submit to the Banking Supervision Department.

With regard to the acquisition of holdings in excess of 5 per cent of a bank's capital, first of all the Banking Supervision Department has to assess the integrity of significant shareholders, verify that there will be no violation of the regulation precluding persons engaged in business activities in non-financial sectors from acquiring holdings above specific thresholds, and carefully evaluate the characteristics of mergers and acquisitions in order to safeguard the principles of sound and prudent management.

In this way the special nature of banking is reflected in the law. Unlike other types of business, banks pursue an activity — the raising and investment of fiduciary funds — that amply transcends the interests of their shareholders.

Banks normally have liabilities towards third parties that are many times their own funds. The balance sheets of Italian banks show deposits and bonds equal to seven times their capital and reserves, which amount to about 200 trillion lire; the total volume of funds that they intermediate, some 3,000 trillion lire, is equal to fifteen times their capital and reserves.

The very substantial volume of intermediation carried out for each unit of capital means that the effects of concentrations on credit and deposits are of macro-economic significance. This is the reason for the detailed regulations governing such operations in the banking sector and the justification for Bank of Italy authorization.

#### ***4. Procedures***

The Bank of Italy's assessment must go beyond the immediate interests of the shareholders of the banks involved in the operation. Its primary objective is the protection of savings, as sanctioned by the Constitution. The evaluation of a concentration involves examining the operation's potential impact on the bank's organization and its ability to generate income and abide by prudential regulations.

Compliance with procedural formalities therefore has a substantive purpose; the Bank of Italy would fail to perform its duty if it did not control this aspect.

In order to allow a preliminary check to be made on the existence of obstacles to a concentration, anyone wishing to gain control of a bank by acquiring a significant shareholding is required to inform the supervisory authority in advance. In particular, the prospective buyer must provide information on its business dealings with the bank and with other intermediaries and describe how the operation is to be financed. If the prospective buyer is another bank, the Bank of Italy will consider the overall corporate structure that would emerge from the operation.

For the operation to be credible, the industrial plan must be fundamentally sound and the financial commitment proportional to the scope of the corporate development strategy. Although the banks involved often incur high consultancy fees,

their plans do not always spell out clearly the technical details of the concentration, the powers and responsibilities of top management, the assumptions underlying expansion programmes and the expected returns and outcome of the operation.

In most cases, the Bank of Italy is forced to request further information in order to obtain a complete picture of the proposed operation.

Particular attention is paid to the ownership structure that would result from the concentration in order to identify the controlling parties, who would share responsibility for setting corporate policies.

The Bank of Italy is responsible for ensuring that consolidation does not distort competition in banking markets. It has approved mergers and acquisitions that help strengthen the competitiveness of the banks involved. On a number of occasions it has made its approval conditional on the implementation of changes aimed at facilitating the entry of new competitors into the markets affected by the concentration. These decisions are taken after obtaining the opinion of the Competition Authority.

Many factors contribute to the success of concentrations: complementary product portfolios and distribution networks, the possibility of selling specialized products on a broad scale, the compatibility of information systems, the scope for centralizing management and operational functions and risk control.

It is difficult to find a statistical association between the manner in which concentrations are carried out and their subsequent profitability: success and failure are possible both for mergers and amalgamations and for acquisitions of control.



It has been the Bank's experience that the success of an operation depends first and foremost on the degree to which the objectives of a concentration are shared by the governing bodies of the banks involved. Despite the massive introduction of technology in productive processes, banking is still ultimately based on the human factor. In some cases, operations that did not have the full backing of the original managements were followed by a lengthy period of corporate fragility marked by internal conflicts, slow decision-making and low profitability.

In the case of public offers to buy, one of the things the Bank of Italy asks the participants is whether the bid is friendly. If it is presented as such, the parties must informally confirm their agreement in advance.

Hostile takeovers are rare in banking. A study conducted in the United States on the period between 1987 and 1992, years in which there were a large number of hostile acquisitions, shows that in 234 cases where the control of banks changed hands, only 4 were hostile takeovers. By comparison, in a similarly sized sample of manufacturing firms, 9 per cent of transfers were the result of hostile takeovers. Since then, only one hostile takeover involving banks of a significant size has been recorded in the United States.

Hostile takeovers have also been rare in the leading European countries. Between 1994 and 1998, only two such operations involving large banks were recorded in the United Kingdom, out of a total of 58 concentrations. Over the same period, only one hostile operation was recorded in Belgium, out of 230 concentrations involving banks and non-financial firms. France has registered one hostile takeover bid involving leading banks, which is still under way, while Italy has seen only one hostile operation, in 1993.

The information asymmetries typical of banking make it difficult to assess hostile takeover bids. An appropriate valuation, for the purpose of determining the purchase price, can only be made on the basis of information in the possession of the target bank, hence the importance of its governing bodies supporting the project. Takeovers that envisage cash payments to the shareholders of the target bank reduce bank capital.

In general, the contestability of corporate ownership is beneficial.

No form of acquisition, including hostile takeovers, is ruled out by Italian legislation or supervisory practice. Nevertheless, hostile operations generally require closer scrutiny.

#### ***5. The role of banking foundations in the diversification of ownership structures***

In recent years, the Bank of Italy has expressed its views on Italy's foundations on several occasions, with special reference to the problems concerning their bank shareholdings. The hearing before the Sixth Senate Committee last June, devoted to proposed enabling legislation, provided an opportunity to return to this topic and examine the potential role of foundations in the non-profit sector.

The Government recently approved the proposed implementing decree, which has been sent to Parliament for the prescribed opinions. The complexity of the matter made it necessary to strike a balance between demands that were not always easy to reconcile. The version of the decree that was approved in the end by the Council of Ministers reflects the need for foundations' divestment of control over their banking businesses to be gradual.

For foundations to be able to operate effectively in fields of social utility, criteria for the management of their assets based on the diversification of investment risk will be needed to conserve the value of their endowments and allow them to earn a return that will ensure adequate and continuous spending in the fields chosen. It is also important that their governing bodies should reflect, in a balanced manner, the needs of the communities and sectors served in order to interpret them better. This can be achieved with a structure that preserves the original institutional characteristics as much as possible and board membership that does not detach the foundation from its tradition and local roots.

The provisions of the enabling law and those of the implementing decree create the conditions for the foundations that were once banks to turn their non-profit project into reality.

On several occasions I have expressed the view that foundations can play an active role in the privatization of the banking system and provide continuity and stability while their ownership role is being reduced. I have also stressed that the disposal of shareholdings by public bodies should be taken as an opportunity to strengthen banks' capital bases by raising new equity capital.

Many foundations have proceeded as had been hoped, moving towards the disposal of most of their equity interests and bringing in small groups of significant shareholders, whose greater familiarity with the market would enable them to take on the task of contributing to the formulation of the strategies for the banks. Within this framework there have also been concentrations with other banks of considerable importance for the consolidation of the Italian banking system.

As for the manner and timing of the divestment of control, in last June's hearing I expressed a preference for the Government to leave the foundations free to set their own timetables. The latest amendments to the proposed decree, especially the provisions concerning the intervention of the supervisory authority in the event of foundations failing to act, have softened the effects of the introduction of a peremptory time limit for the transfer of control. The freedom granted to the special administrator appointed by the Treasury to determine the manner and timing of such transfer allows bargaining strength to be preserved in disposing of the equity and its value to be safeguarded.

The law does not preclude recourse to the solution already adopted in many cases; the provisions avoid abrupt changes in ownership and make it possible to proceed with the restructuring of the banking system and to bring banks into play that had previously stayed on the sidelines. When necessary, foundations will still be able to redefine agreements with other shareholders, from a position no longer of pre-eminence but certainly of equal dignity.