

ABI
Italian Bankers' Association
Annual Meeting

**Innovation and growth
in the Italian banking system**

Address by the Governor of the Bank of Italy
Antonio Fazio

Rome, 23 June 2000

Contents

<i>Savings</i>	<i>1</i>
<i>The supply of banking services</i>	<i>3</i>
<i>The structure and organization of banking groups</i>	<i>7</i>

Savings

In 1996 foreign investors' purchases of Italian securities amounted to 125 trillion lire, compared with 188 and 173 trillion respectively in 1998 and 1999. At the end of last year foreign investors held 40 per cent of the Italian public debt and 8 per cent of listed Italian shares, compared with 13 and 7 per cent respectively at the end of 1994.

The limited assortment of financial instruments available in the domestic market, the decline in yields on government securities and the tendency of investors to diversify their portfolios have fueled the outflow of capital. Portfolio investment abroad by Italian households and firms rose from 52 trillion lire in 1996 to 190 trillion in 1998 and 251 trillion in 1999.

The surplus on portfolio investment amounted to 73 trillion lire in 1996; it subsequently contracted. In 1998 the flows were in balance and in 1999 a deficit of 78 trillion was recorded.

At the end of last year foreign assets, held largely through mutual funds, made up 18 per cent of Italian households' financial wealth, compared with 5 per cent in the mid-nineties. In 1998 foreign assets accounted for 15 per cent of German households' financial wealth.

In 1998 Italy recorded net outward direct investment of 21.7 trillion lire; last year the flows were in balance, following an operation in the telecommunications sector and the growth of inward investment in the banking and financial sector.

Italian direct investment abroad grew during the decade. In each of the three years from 1997 to 1999 it was equal to 1 per cent of GDP.

Foreign direct investment in Italy remained modest during the nineties; it averaged 0.3 per cent of GDP in 1990-98 and rose to 26 trillion lire in 1999.

Italian firms tend to diversify their production geographically with investment in advanced economies as well as emerging countries.

Owing to the high costs involved at the start, company size is decisive in the decision to extend activity abroad. Italian firms as a whole have a smaller overseas presence than those of the other leading industrial countries.

In 1999 the current account of the balance of payments showed a surplus equal to 0.8 per cent of GDP, compared with 1.8 per cent the previous year. The reduction was not due to the growth in domestic consumption and investment; merchandise exports fell by 1.5 per cent, imports rose by 4.1 per cent.

In the last two years, marked by rapid growth in lending, banks increased their borrowing abroad. The number of banks issuing Eurobonds increased from 13 to 28 and the amount of such issues from €4 billion to €12 billion; in the first four months of this year a total of €11 billion was raised. Fund-raising abroad mainly involved banks that recorded a contraction in funds deposited by households.

The bank liabilities held by households fell by 4.2 per cent in 1998 and 2.4 per cent last year, in part as a result of the growth in the asset management sector, which channeled the bulk of its investment abroad.

The formation of saving in the private sector has gradually diminished in conjunction with the improvement in the public finances and the slowdown in the growth of the Italian economy. In recent years outflows of funds have tended to expand faster than inflows.

The supply of banking services

A contribution to the growth of productive investment, to innovation and to the formation of saving and its investment in Italy is needed from the reorganization of financial intermediaries and markets and improvements in their efficiency.

Italian banks are closing the operational and efficiency gap with those of the other main European countries. It is necessary that conditions in the economy evolve in a way more favourable to the growth of production and investment.

In the past few years Italian banks have made growing use of the new technologies, at first to rationalize administrative and accounting procedures and then to decentralize decision-making and operations.

Attention has focused on the scope information and communications technology offers for improving interbank exchanges and the provision of customer services. The growing range of activities carried out on-line and the number of intermediaries involved testify to the effort being made to upgrade product quality and boost banks' efficiency.

The delays in integrating company systems with the new information and communication technology infrastructure and the scant inclination of customers to use on-line services constitute weaknesses in this otherwise generally positive picture.

Fuller information increases competition. Customers can readily compare products and terms; they benefit from the lower cost of services and the higher quality of products. The certainty and security of transactions become an important element of the fiduciary relationship between intermediaries and customers.

The expansion of the traditional branch network has been accompanied by a rapid growth in the number of ATMs and POS terminals.

There are now 420 banks offering remote access; the facilities are used by 250,000 firms. Telephone banking services are growing rapidly.

Use of the Internet is spreading; nearly 150 Italian intermediaries allow transactions by this means. More than 90 per cent of the customers who use it are households. The proportion of securities trading carried out on-line is growing.

Concentration in this field is high. The top five banks account for around 70 per cent of the total volume of business and fees.

It is widely believed that winning large customer bases will produce lasting benefits. The banking system's spending on information technology rose from 7.2 trillion lire in 1997 to 7.8 trillion in 1998 and 8.5 trillion in 1999; significant outlays are forecast for this year as well. In planning their investments, banks must be fully aware of the intense competition in the market and the progressive narrowing of margins.

Use of the new technologies is not free of risk.

For banks, mastering technology is made more complicated by innovations in system architecture, products and distribution channels.

The reduction in opportunities for contact with customers and the need to outsource some production functions heighten operational, legal and reputation risks. Points of access to services are no longer concentrated inside banks; information is transmitted over open networks. System and transaction security may be violated.

The confidentiality of transactions and customer relationships must be safeguarded. The protection of security and confidentiality must also be guaranteed by service providers and system managers.

Effective measures must be designed to counter fraud and avert the risks of less-than-cautious use of automated procedures by the increasingly large number of people involved. Customers are required to enter and check data that will become part

of the bank's data base. Technology itself offers the means for limiting risks and avoiding mistakes.

Within a broad statutory framework, intervention by the supervisory authorities to determine the methods for controlling operational risks in the banking sector does not restrict the scope for further innovation.

Regular consultation with the banking community on these questions has been initiated at the international level. The initiatives in this field will also help in the search for the most appropriate ways to strengthen the Italian financial system.

As competition has intensified, banks have developed innovative forms of intermediation. Derivatives and securitization offer opportunities for greater portfolio diversification.

The experience of the nineties teaches that using derivative products for speculative operations can jeopardize the stability even of large and highly respected intermediaries.

Italian banks, operating chiefly through their branches abroad, use credit derivatives to establish positions with customers that they would otherwise find it difficult to do business with directly and to reduce their exposure to particular sectors. At the end of 1999 the contracts concluded by Italian banks in the United States had a notional value of more than \$23 billion and accounted for 6.9 per cent of that market.

These instruments involve special risks owing to the complexity of the transactions; they call for advanced systems of risk measurement and control.

Securitization has grown rapidly in all the main markets in recent years. In the United States the annual average volume of operations in the last three years was nearly \$200 billion. In Europe the volume of securities issued expanded by 60 per cent

between 1997 and 1999, when there were 147 securitization operations for a total of \$73 billion.

In Italy, less than 2 trillion lire of bank loans were securitized in 1997-98. Securitization surged following the passage of Law 130/1999; the 23 operations carried out last year involved loans totaling 23 trillion lire and were intended to improve asset flexibility through the disposal of non-performing loans. The growth of the market will depend on the ability of banks to securitize higher-quality claims with the aim of diversifying their sources of funds and broadening their product ranges.

Credit risk must be managed, in accordance with standards of corporate efficiency and organizational specialization, by separating the lending and control functions. This principle is enshrined in the supervisory regulations governing this matter.

The development of internal risk-measurement systems, in accordance with the proposed international revision of the capital adequacy rules for banks, should make an important contribution to risk management. Under the proposal individual banks will be able to use internal rating systems instead of scores awarded by rating agencies; they will need to make better use of their information on customers and improve their ability to assess creditworthiness and manage loans. Measuring the probability of counterparty default and estimating the unrecoverable portion of loans are essential functions.

A survey of thirty international banks has found that there is no uniform method of constructing risk-measurement systems. Some large Italian banks have taken action that is consistent with the proposed regulatory framework; many others will need to reorganize on a major scale.

Increasingly, banks lend to smaller firms, with their higher average riskiness. The growth of lending to new types of customers and the search for profit opportunities abroad are likely to involve risks.

Banks must develop robust risk measurement systems to avoid finding themselves at a competitive disadvantage. The ability to manage risk efficiently is a key element of competitiveness.

Italian banks must capitalize on the detailed knowledge of small and medium-sized firms they have accumulated through their presence in local markets. They have access to a wide range of statistical sources, such as the Company Accounts Data Service. Last April we began to publish system-wide information based on Central Credit Register data that will help to improve the assessment of creditworthiness.

The structure and organization of banking groups

In the last three years consolidation has proceeded mainly through acquisitions. At the end of last year the 79 registered banking groups comprised 267 banks and controlled 89 per cent of the system's total assets. On average there were 11 companies in each group, two more than in 1992. Over the same period the average number of foreign companies in each group rose from 2 to 3; in several cases they are banks that are major players in their respective national markets. One third of the groups' auxiliary companies are in the EDP sector.

The key feature of groups must be the centralization of the operational functions that offer the greatest scope for achieving economies of scale. Asset management is playing an increasingly important role: more than 90 per cent of mutual fund assets and 16 of the 20 open-end pension fund management companies are controlled by banks. The consolidated financial statements of Italy's banking groups show that 30 per cent of their total income derives from services, mainly asset management.

Within groups, closer links are being forged with insurance companies, especially in the life sector. The risks typical of the insurance industry are being combined with those common to banking. The Bank of Italy is taking part at the international level in the conduct of analyses and the formulation of proposals to safeguard the stability of such conglomerates. The focus is on defining prudential requirements and regulating intragroup positions.

In 1998 the average return on equity of the three largest Italian banking groups was about 10 per cent, one percentage point below the average for the 15 leading groups in the euro area. In 1999 it rose to 15 per cent, about two points above the average for the euro-area groups and four points below that of the 10 leading commercial banks in the United States and the United Kingdom.

The marked improvement on 1998 was partly due to non-recurring items related to the recognition of tax benefits accrued in previous years and gains on the disposal of shareholdings. An additional factor was the reduction in tax as a result of the incentives introduced to help banking foundations to dispose of their controlling interests and banks to restructure.

Operating costs rose further last year; income did not increase. Lowering risk and improving banks' earning capacity will require additional productivity gains and organizational improvements. Priority must be given to increasing the integration and functional effectiveness of the groups that have already been created.

The foundations must continue to dispose of their holdings in banks, thereby fostering the formation of stable groups of core shareholders.

With a view to promoting stability and efficiency, the Bank of Italy monitors and encourages full integration within groups, especially the larger ones, where the problems are more complex.

The goal of completing the reorganization of the system in order to achieve higher levels of efficiency in the European market can be accomplished within two or three years. It must be pursued with determination.

Profitability and efficiency have not improved throughout the system.

The profitability of banks that have not been involved in mergers and acquisitions, usually smaller institutions, is low. In 1999 the return on equity of these banks, which account for one fifth of the system's total assets, was 4.4 per cent. The result reflected the rise in operating costs caused by the expansion of branch networks, which has not yet produced an adequate volume of business. These banks have rapidly expanded their lending to households and small firms. It is essential that their control of risks and costs be made more stringent and that they capitalize on their presence in local markets, especially in the distribution of services.

The Bank of Italy has taken effective action to increase competition in the credit sector by liberalizing the establishment of banks and the opening of branches, supporting the privatization programme, enhancing the entrepreneurial role of corporate bodies and improving disclosure.

Competition has increased considerably in the last few years, not least in areas such as the South where the market was initially more concentrated.

The presence of an increasing number of banks in local markets has been reflected in a rapid transfer of market shares. In each of the last three years 4 per cent of lending has been redistributed; in 1999 alone the most dynamic banks gained 8 per cent of the market for mortgage loans and other household lending.

Mergers and acquisitions, the widespread use of group structures and the size of the intermediaries involved have increased the market shares of individual banks and groups in local lending and deposit markets.

The creation of dominant positions has been avoided, thanks to the entry of other banks and intermediaries in local markets, the development of a variety of channels of distribution, and the compensating measures imposed by the Bank of Italy in the exercise of its function of safeguarding competition. The banks resulting from mergers have sometimes been required to close or sell branches or forbidden to open new ones in specific locations and for given periods.

The extent to which the leading banking groups' networks overlap would nonetheless accentuate the effect of additional mergers on local markets.

In several markets mergers would only be acceptable if far-reaching corrective measures were taken that would have a major impact on the structure of the supply of banking services and significantly affect the economic rationale for the operations.

The analysis of the degree of competition is based on a variety of factors: the size of the banks concerned, their market shares, concentration indices, economic barriers to entry and the levels and trends of interest rates and fees.

In the case of mergers and acquisitions, an inquiry is opened if the information collected points to the possible creation of a dominant position. Particular attention is paid when the market share of the banks concerned exceeds 25 per cent.

Italy's largest banking group has a 16 per cent share of the lending and deposit market; the three largest groups have a 33 per cent share. The concentration of the Italian banking system is higher than Germany's, in which the leading bank has 9 per cent of total assets; it is similar to that of France.

Mergers and acquisitions will mainly have to involve small and medium-sized banks, whose efficiency is often low.

Banks' local roots are an asset that has not been devalued by consolidation. Even for the largest groups they constitute a competitive advantage to be exploited not only in traditional banking activities.

In assessing borrowers' creditworthiness and the validity of their plans, banks increase their stock of knowledge. The information they possess on productive processes, local economies and domestic and foreign markets can be used to improve other projects and foster the development of new ideas. Banks can contribute to the diffusion of knowledge across the country.

The experience that banks accumulate can be used to accelerate the spread of new technologies, especially among small and medium-sized firms. Some banks have launched projects designed to foster business-to-business e-commerce in goods and services.

More effective relationships between firms and productive sectors improve the allocation of resources and raise productivity throughout the economy.

o o o o o

In the first quarter of this year GDP was 3 per cent higher than in the same period of 1999, thanks to the strong recovery of exports and with a significant contribution from the increase in consumer demand, particularly for durable goods. The economy has continued to grow since then: after falling in April, industrial production recovered strongly in May and data on electricity consumption in the first fifteen days of this month indicate that the growth should continue in June.

Surveys of firms and households point to a prolongation of the recovery.

Inflation is a cause for concern: the twelve-month increase in consumer prices rose to 2.7 per cent in June, causing a further small erosion of Italy's competitiveness vis-à-vis the other euro-area countries.

The recovery currently under way offers an opportunity to intensify investment, especially in innovative sectors.

A preliminary agreement has just been reached within the European Union with the aim of harmonizing the taxation of interest paid to non-residents. National differences in the tax treatment of savings and firms must be eliminated in order to avoid distorting investment location decisions.

Capital outflows have been accelerating in recent years. Italian investors' shift into foreign securities is partly due to the underdevelopment of the Italian financial market.

Banks must facilitate access to the stock market for small and medium-sized firms with growth potential, thereby channeling towards them the flows of savings made available by the reduction in the government's funding needs and investors' willingness to hold risky assets. Intermediaries have made considerable progress in improving their efficiency; further decisive action is needed in the fields of product innovation, structural integration and cost-containment.

The difficulty of attracting investment from abroad and keeping domestic savings in Italy should act as a spur to create conditions that are more conducive to firms' activities and growth, to the benefit of employment.

Advantage must be taken of the present positive phase of the economic cycle to overhaul the statutory rules governing the budget and the markets for factors and products. Structural reforms and more intensive and wider use of new technologies will boost the competitiveness of Italian industry and the economy as a whole; they can put Italy back on a higher and sustainable growth path.