

**SALOMON BROTHERS INTERNATIONAL LIMITED**

**INTERNATIONAL FINANCIAL INSTITUTIONS CONFERENCE  
DEREGULATION IN 1992: STRATEGIES AND OPPORTUNITIES**

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## DEREGULATION IN 1992: STRATEGIES AND OPPORTUNITIES

In line with the specification in the invitation to speak to you today, I shall describe the strategy the Bank of Italy is following for the development of the Italian banking system and the steps that remain to be taken in preparation for 1992.

The creation of a unified European financial market will be the result of two parallel processes: the complete liberalization of capital movements and the application of the principle of mutual recognition to allow banks to establish offices and provide financial services throughout the Community in accordance with the prudential regulations of their country of origin.

At the same time a programme of minimal harmonization of national supervisory systems is envisaged that will ensure stability and competitive equality.

The agreement on mutual recognition will make competitive market mechanisms more powerful as well as broadening the range of financial instruments available to individuals and enterprises in Europe. Inevitably, this will lead to changes in the structure of banking markets.

The corpus of Community legislation is being built up with measures that are consistent with the strategic aim of integrating markets and liberalizing the supply of services. These objectives are being pursued in an institutional context in which the responsibilities of supervisory authorities are clearly defined and their powers strengthened.

The Second Coordination Directive will lay down the minimum requirements for banks to operate cross-border under the mutual recognition regime and provide for home country control for banks operating abroad. Two other Directives will define capital for prudential purposes and set minimum adequacy requirements in relation to banks' risk-weighted assets.

In formulating its strategy, the Bank of Italy has taken full account of both the actual and the foreseeable effects of Community initiatives. Starting from the basic assumption of a competitive European-wide market with powerful players lined up on the field, the interventions needed to enable Italian banks to operate profitably have been studied in the light of the characteristic features of Italy's banking system.

I shall briefly describe its strengths and weaknesses and then discuss the steps that need to be taken to overcome the latter.

## The strengths and weaknesses of the Italian banking system

Since the end of the Second World War the Italian financial system has displayed considerable stability: both the number and the scale of banking crises have been small. Despite Italy having more than 1,100 credit institutions, only 79 have been compulsory wound up in the last 25 years; the great majority of these were very small rural, cooperative-type banks and only two cases involved intermediaries of any size.

This stability has been accompanied by a generally acceptable level of profitability. Overall, the banking system has 5,000 billion lire of capital in excess of the amount corresponding to the minimum requirements, fixed at 8 per cent of risk-weighted assets and 4.4 per cent of total assets. Over the last fifteen years the ratios of operating profits and pre-tax income to total assets have averaged respectively 1.5 and 0.65 per cent.

In contrast with the situation in other countries, the Italian banking system has always been allowed to do both credit and securities business and thus already has a great deal of valuable experience in this field.

I think it is also worth emphasizing the steps the supervisory authorities have taken to prepare the ground for

banks to expand their traditional business and engage in new activities. The special regulations governing the different legal categories of bank and the geographical restrictions on operations have been gradually lifted. The traditional maturity specialization that had underlain the distinction between short and medium and long-term intermediaries has been considerably attenuated.

In addition, banks are now operating through subsidiary companies in forms of financial intermediation such as leasing, factoring and mutual funds. They also hold a leading position in securities trading and portfolio management. Most recently, they have entered the field of merchant banking.

On the other hand, the separation between banking and commerce introduced in the 1930s has been maintained in practice, despite the lack of specific legislation. This principle is seen as an important defense against the erosion of the system's allocative efficiency and stability. The regulations do not, however, preclude industrial companies from participating in banks' capital; they are intended to prevent them from acquiring positions of control. In pursuance of this aim strict regulations on connected lending have recently been introduced.

Apart from certain minimum requirements, there are no restrictions on the establishment of banks in Italy, and

foreign operators are free to set up businesses on the same legal and operational footing as local banks. Furthermore, we are moving towards the complete liberalization of branch networks.

Italians' propensity to save and the scope for developing the payments system and providing new services mean that opportunities for intermediaries to make good profits will not be lacking.

The focus of the Bank of Italy's supervisory activity has shifted towards the regulation of aggregates, with a substantial reduction in the cases in which individual operations have to be authorized. The preventive control function is increasingly performed through the analysis of prudential returns and on-site inspections. The operations of both individual banks and banking groups are constantly monitored by means of a powerful information system.

I would also include among the strengths of the Italian banking system the wide acceptance in recent years of the view that public and private sector banks are really the same animal, and that both should have the same degree of operational autonomy and seek to maximize their profits through the pursuit of internal efficiency.

These positive developments do not mean, of course, that the Italian banking system is without any weaknesses, and a reorganization similar to that already undertaken by

Italian industry clearly needs to be put in hand.

The efficiency of some banks is too low, especially in the public sector. There is still too little competition in banking markets and its effects are not felt either widely or fast enough. The progress made in cutting costs has not so much led to reductions in the prices charged for services as to increases in profits.

It also has to be admitted that many banks' supply of non-traditional products is insignificant and, despite the advances of recent years, the internationalization of Italian banking is still on a smaller scale than in any other major industrial country. Indeed, there is not one Italian bank among the world leaders.

#### The size factor and the need for concentration

Several factors have contributed to this situation, but one of the most important is undoubtedly the low degree of concentration of the Italian banking industry and the relatively small size of even the largest Italian banks. In 1983 Spain and Germany were the only major European countries with a lower degree of concentration, and in the latter, of course, the leading banks were much larger than their Italian equivalents. In the same year, in Italy the ten largest banks accounted for 40 per cent of the total assets of the banking

system, compared with 61 per cent in France and 68 per cent in Belgium.

Moreover, at the end of last year, only one Italian banking group appeared among the top fifty in terms of assets, whereas Japan had 21, Germany 7, France 5, and the UK and the US 4 each.

Excluding Japan, the incidence of Italian banks is closer to that of the other major industrial countries only when the top 100 banking groups are considered.

Size is thus a problem even for the largest Italian banks, and this suggests that amalgamations among them could well be desirable. Further evidence in support of this conclusion is to be found on the liabilities side. At the end of 1987 the deposits of the top four banking groups totaled \$245 billion in Italy, compared with \$320 billion in the US, \$410 billion in Germany, \$435 billion in the UK and \$600 billion in France.

Another aspect of the size problem is that, in contrast with the pattern in other countries, the ranking of Italian banks by market share does not show any significant breaks, which denotes the absence of clearly distinguishable categories.

The strategy adopted by the Bank of Italy is designed to remove the obstacles to concentration while fostering competition by abolishing geographical restrictions



on business, extending the range of permitted operations and liberalizing branch networks.

The main arguments for increasing the size of banks are that it provides opportunities for economies of scale and scope. The latter stem from the joint production of services, and there is evidence that the ability to manage such processes increases with company size.

The proportion of operating costs covered by net income from services is about twice as high for the larger Italian banks as for the smaller ones. Increasingly, moreover, such services are both innovatory and complex, requiring advanced equipment, sophisticated procedures and skilled staff.

In addition, any realistic attempt to enter the international market requires that the bank should have a substantial and solid share of the domestic market.

Rather than discouraging competition, greater concentration is likely to enhance it, insofar as it depends on there being a real choice between similar products in each market. A banking system with a smaller number of larger banks offering a broad range of products will involve more overlapping and competition than one comprising units of widely differing size, each aimed at a particular segment of market.

Experience in Italy clearly shows that a large

number of, often very small, banks does not guarantee competition. In most cases the result has been the development of local oligopolies marked by a low level of efficiency.

The remaining territorial fragmentation that still exists in Italy will have to be reduced. This too, will be possible if oligopolistic markets are entered by banks supplying a wider range of products and able to compete across most of the board.

Merger is the fastest way to increase the size of a bank. Many aggregations, especially among savings banks, will be designed to meet the need to achieve at least a minimum regional dimension.

#### The strategy for the reorganization of banking

The developments under way in the Italian banking industry and the blueprint for the reorganization of the industry are not an impromptu response to the challenge of 1992.

Rather, the changes I have described are phases of an evolution that started several years ago. Building on the foundation provided by a basically sounder and stronger credit system, the aim is to raise the threshold for the survival of its individual components. It remains to complete

the process and the European deadline makes speed of the essence.

Most of the provisions that need to be introduced are included in a major bill that was approved by the Council of Ministers last August. These proposals, which are basically in line with the results of recent Parliamentary enquiries, will allow the transformation of public sector banks into joint-stock companies and the comprehensive regulation and supervision of banking groups. The bill also contains tax provisions designed to encourage aggregation.

The planned reorganization is not only necessary but also ambitious, as behoves the international position Italy has acquired as a result of the economic advance it has achieved during the eighties.

The aim of developing a more highly concentrated banking system is one of the strands running through the whole package of Government proposals. It is not only promoted by the tax provisions but is also reflected in those that lay down the regulatory framework for banking groups. These regulations introduce entirely new principles with regard to the responsibility and unitary management of the parent company.

The reorganization of public sector banking will also involve forms of amalgamation that will result in a distribution of the mass of own funds already available in

the sector and permit recourse to private sector capital.

It is not possible to foresee how the aggregation being fostered will actually occur. On the one hand, there is the risk of excessive antagonism, with a consequent waste of resources and incipient instability. On the other, the achievement of higher standards of efficiency could be held back by inertia in some quarters.

The regulatory system puts the authorities in a position to counter the danger of destructive competition by subjecting mergers to authorization. Because a large part of the banking system is in the public sector, it is also possible to envisage direct encouragement of amalgamation, including the creation of diversified groups, to promote the desired increase in the size of individual units.

Further legislation will be needed to create legal certainty with regard to the separation between banking and commerce. Following the example of other countries, a procedure for the authorization of transfers of significant holdings of bank shares may prove desirable. Outside the credit sector proper, there will have to be some regulation of the activities of non-bank intermediaries, while the reorganization of the payments system is being pressed ahead by way of administrative measures.

More generally, the Bank of Italy is committed to doing all that is needed within its own sphere to ensure that

the outcome of the reorganization will be a banking system that is more efficient and competitive, both at home and abroad.

Two facts make me fairly optimistic about the results we can expect. First, it is now over ten years since the authorities developed the strategy of enhancing market mechanisms, and the implementation of the related reforms is gathering pace. Second, the debate on the working of the banking system and on the changes needed to improve its performance has now caught up practitioners, academics and politicians and is producing solutions enjoying a wide degree of consensus.