INTERNATIONAL CENTER FOR MONETARY AND BANKING STUDIES

LIBERALIZATION OF FINANCIAL SERVICES IN THE EUROPEAN COMMUNITY: THE CASE OF ITALY

Geneva, March 14, 1989

The creation of a single European financial market will be a twofold process, consisting, on the one hand, of the full liberalization of capital movements and, on the other, of the implementation of freedom of establishment based upon the principle of mutual recognition. This will allow banks to open branches and provide financial services anywhere within the Community under home-country regulations. Most EC member states will have completely liberalized capital movements by June 1990, and full freedom of establishment must be in effect by the end of 1992.

This Community programme is a milestone in European economic progress, comparable only to the creation of the Common Market itself 25 years ago and to the setting up of the European Monetary System in 1979. In assessing its implications, several prospective advantages must be considered: (i) greater efficiency in the resource-allocation and saving-investment processes; (ii) heightened competition and broader opportunities for financial operators; and (iii) a reduction in the present fragmentation of the European financial system, which will enhance its ability to keep pace with developments in international markets, notably as regards globalization and financial innovation. The great vision of the 1992 project requires - and deserves - a great deal of work if it is to be realized, especially in the financial field.

Yet the process is not without risks for national financial systems and their stability, nor can the benefits be reaped without incurring some costs. There are significant differences today in the structure, degree of concentration and efficiency of the various domestic markets. Moreover, national regulations still differ very substantially and in some instances are not compatible. The Community guidelines call for the minimal harmonization of supervisory regulations to put all competing institutions on an equal footing. Looking ahead to 1992, much remains to be done. At the national level some crucial adjustments are the responsibility of governments and central banks, while others must be undertaken by the private sector.

The development of the Italian financial system

On the question of what is needed in Italy if we are to be ready for 1992, it is, I think, important to recognize that a strong wind of change has already been blowing. Indeed, since the changes stemming from European integration will supplement those already set in motion domestically, the transformation will probably be more rapid in Italy than in most other countries.

The development of the Italian financial system in recent years can be gauged by comparing its present structure with its rudimentary form in the mid-seventies. At that time, bank deposits were virtually the only savings instrument, while bank loans were the dominant source of corporate finance. Correspondingly, administrative controls on banks were the main instrument of monetary policy.

Today, investors can choose between a wide variety of assets. Bank liabilities have declined in relative importance but, with certificates of deposit gaining momentum, alongside traditional deposits, banks are now in a better position to cater their customers' transaction and investment needs. The modernization of the securities markets and the increases in their liquidity and efficiency have been promoted by the Italian monetary authorities. The aim of their action has been to create the conditions needed to attract foreign investors and prevent the liberalization of capital movements from resulting in a net outflow of saving simply because of shortcomings in the markets.

A large and diversified market for government securities offering competitive yields has fostered a new willingness on the part of investors to purchase financial assets. The creation of unit trusts, improved corporate profitability and clearer regulation fueled the strong growth of the stock market in 1985 and 1986. Despite the difficulties that followed the boom, the qualitative improvement in the market has not been lost. This was reinforced by the reorganization of the clearing and settlement system for securities. In turn, last October's reform of Italian exchange controls has greatly increased the scope for investing abroad, with only so-called monetary movements still restricted. Even these will become freely available to Italian investors after June 1990; from then on there will be complete freedom of capital movements, a situation that is almost without precedent in the history of Italy since its unification.

Foreign operators are increasingly active on the Italian market and can now find fertile ground on which to practise their skills, enhancing both their business opportunities and the functioning of the financial system.

The broadening of the range of financial assets available to households has been matched by an increase in the external sources of corporate finance: the stock market has provided a significant amount of new capital; the growth of leasing and factoring has met new needs; and a fledgeling commercial paper market is adding new flexibility to firms' management of their short-term assets and liabilities.

Despite the growing pressure of the budget deficit, this progress has enabled the monetary authorities to rely increasingly on indirect methods of monetary control. Monetary policy is now essentially conducted by regulating very short-term interest rates through the open market operations. The overnight rate and bank liquidity transmit the impulses, thanks in part to the increased flexibility of the 3-month Treasury bill rate, to the segments of the market whose conditions influence private agents' behaviour. This transmission, however, is neither smooth enough nor fast enough, and this is a field in which much work is being done. In particular, measures to enhance the flexibility of the interest rates on 6 and 12-month Treasury bills have just been implemented.

The payments system is also undergoing substantial and much needed change. One of the systemic advantages the reform will bring is a substantial improvement in the interbank market. This currently comprises a small overnight segment, which is very -- indeed often too -- reactive to changes in liquidity conditions, and a large segment made up of bilateral accounts, which is cumbersome and marked by sticky prices. In between, there is little room for a market to spread signals concerning the stance of monetary policy and, at the same time, to absorb erratic liquidity changes. By relieving the market of the dead weight of the large bilateral accounts, the reform of the payments system should remedy this situation.

The volatility of the overnight rate, increasingly regarded as the linchpin of the whole structure of interest rates, will be further reduced by the implementation in coming months of the reform of the compulsory reserve system.

At present, banks have to keep the amount prescribed by the reserve ratio in special accounts with the Bank of Italy on a day-to-day basis. Under the new system they will have to comply with the constraint on a monthly average basis. Accordingly, within limits, they will be able to withdraw funds on some days each month provided they deposit more on others. This will stabilize the very short end of the market since banks will, of course, tend to withdraw funds when rates are high and deposit them when they are low. Furthermore, this will result in some reduction in the implicit costs imposed on Italian banks by the high compulsory reserve ratio (in 1988 the average coefficient was about 21 per cent), which undermines their competitiveness vis-à-vis foreign banks. At the end of 1988 these implicit costs (defined as the difference between the average yield on Government securities and that on compulsory reserves, times the reserve ratio) were estimated to be about 1 percentage point in Italy, as against 0.2 in France and 0.3 in Germany.

The reform of the secondary market for government securities has eliminated an awkward situation: transactions in these securities on the official market represented a small proportion of total trading, yet they were the only ones for which an organizational framework was available. Now, with a screen-based system of dealers for wholesale transactions paralleling the stock exchange, the transparency of the market and its liquidity and depth have been significantly enhanced.

The strengths and weaknesses of the Italian banking system

Since the end of the Second World War the Italian banking 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 supported by a generally acceptable level of profitability. At present, the banking system as a whole has about 15,500 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. Between 1984 and 1986, the most recent year for which internationally comparable data are available, the net income of Italian commercial banks (before provisions and tax) averaged 1.5 per cent of total assets, as against 1.0 per cent in France, 1.2 per cent in Germany, 1.6 per cent in Spain and 1.7 per cent in the United Kingdom.

The structure of the banking system has also been considerably modified since the late seventies. The segmentation based on legal form, location and type of activity has been gradually reduced through the introduction of standard regulations, the revision of banks' statutes of incorporation, and increased competition in local markets as a result of successive plans for the opening of new branches. Recently, banks have been allowed to expand their medium-term lending and fund-raising and to move, through subsidiaries, into new lines of business such as mutual funds and merchant banking.

In practice, Italian banks, which have always been allowed to deal in securities, will be able to operate through specialized subsidiaries to supply any of the wide variety of services covered by the Second Banking Coordination Directive, including the trading of financial instruments on their own account and on behalf of customers, money broking, and portfolio management and advice. We believe that the solution of banking groups with specialized subsidiaries allows all the activities of a universal bank to be performed within a unified entrepreneurial strategy, while providing both organizational and supervisory advantages and making it possible do draw on the valuable experience of the existing specialized credit institutions.

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 defence against the erosion of the system's allocative efficiency and stability. The regulations do not preclude industrial companies from participating in banks' capital, but 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.

These positive developments do not mean, of course, that there are no weaknesses in the Italian banking system nor that a reorganization similar to that already undertaken by Italian industry is not needed.

As European integration advances, profit margins will come under pressure, with two results. First, banks will be constantly faced with the need to improve their efficiency, and second, a strong capital base will be a major strategic resource, quite apart from prudential requirements. Some banks will be faced with the dilemma of whether to increase their capital or reduce their volume of business.

Specifically, banks will be called upon to equal international cost and quality standards. Their ability to compete successfully in the European market and meet the demand for tomorrow's products and services will depend on their possessing advanced technology, efficient procedures and appropriately qualified staff.

At present, however, the efficiency of some banks is too low, especially in the public sector. For instance, the ratio of large banks' staff costs to their total assets is 3.30 per cent in Italy, 2.66 in Spain, 1.93 per cent in the United Kingdom and 1.85 per cent in Germany. 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 been reflected less in lower charges than in higher profits. It also has to be admitted that many banks' supply of non-traditional products is insufficient.

The size factor and the need for concentration

Despite the advances of recent years, the internationalization of banking in Italy is still on a smaller scale than in any other major industrial country. Indeed, there is not even one Italian bank among the world leaders. Several factors have contributed to this state of affairs, 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. According to a recent study, in 1987 the four largest banks accounted for 25 per cent of the total assets of the banking system in Italy, compared with some 40 per cent in Belgium and France. Spain (21 per cent) and Germany (15 per cent) seem to be the only major European countries with a lower degree of concentration, and in the latter, of course, the leading banks are much larger than their Italian equivalents.

Moreover, at the end of 1987, only one Italian banking group was among the top fifty in terms of assets, whereas Japan had 21, Germany 7, France 5, and the UK and the US 4 each. The incidence of Italian banks is closer to that of the other major industrial countries, excluding Japan, 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.

The strategy adopted by the Bank of Italy is designed to remove the obstacles to concentration while fostering competition by abolishing geographical restrictions on banking business, extending the range of permitted operations and liberalizing branch networks.

The main reason for increasing the size of banks is to exploit 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 a bank should have a substantial and solid share of its 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 the market. Experience in Italy shows that a large number of, often very small, banks does not guarantee competition, since market fragmentation may result in the development of local oligopolies.

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

The strategy for the reorganization of banking

The developments under way in the Italian banking industry are not an impromptu response to the challenge of 1992. Rather, as I noted before, the changes described are part of a process that started several years ago. It remains to be completed, and the European deadline makes speed of the essence.

Most of the steps that need to be taken are included in a major bill that was approved by the Council of Ministers in August 1988. These proposals are basically in line with the results of Parliamentary enquiries. The planned reorganization is not only necessary but also ambitious, in line with the economic position Italy 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 establishing the regulatory framework for banking groups. These regulations introduce entirely new principles with regard to the responsibility and unitary management of the parent company.

Exactly how the aggregation being fostered will occur cannot be forecast. There is, of course, a risk of excessive antagonism, with a consequent waste of resources and incipient instability, while 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.

Merger is the fastest way to increase the size of a bank. Indeed, even ahead of the proposed legislation to encourage concentration, several mergers between medium-sized and even large banks have been announced and others are being discussed. In addition, various aggregative solutions are under consideration, especially among savings banks, with the aim of achieving at least a minimum regional dimension.

Another area in which new legislation could pave the way for significant improvements concerns the harmonization of the institutional set-up of public-law and savings banks, which account for nearly half of Italy's banking system, with that of the other banks. A first step in this direction has already been taken by allowing savings banks and public-law banks to issue shares to the public. A bolder step, now under way, is the introduction of legislation to separate the public entity from the banking business, which would be set up as a limited company initially owned by the public entity. This would not alter ownership patterns, but it would separate ownership from management and place all banks on the same legal and organizational footing.

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.

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.

The need for further structural changes

I referred earlier to the advanced stage already reached in the diversification of the Italian financial system, which has been pursued with the aim of improving the balance between intermediation by banks and the securities markets. This diversification means, however, that the authorities must provide a uniform regulatory framework and perform the prudential controls needed to guarantee two basic and interrelated conditions: the stability of intermediaries and the protection of investors.

The simultaneous presence of a variety of intermediaries subject to different controls is a destabilizing factor. With the integration of activities and markets, and the blurring of the distinctions between different kinds of operator, disparities in prudential controls tend to increase the risk of contagion, with the result that crises in less-controlled areas may spread to the whole financial system. Moreover, such inequality of control is bound to tilt the competitive playing field.

But there is a more fundamental reason for standardizing regulations and controls when savings are entrusted to an intermediary under a fiduciary contract: some form of public control to discipline conflicts of interest and prevent abuse is needed to strengthen the credibility of the financial services sector, reduce information costs and, ultimately, enhance the efficiency of the savings-investment process. Here, of course, we are faced with a variety of possible solutions, that range from building Chinese walls to banning firms from engaging in certain operations, to requiring them to disclose situations that could involve a conflict of interest. In choosing how to achieve the necessary uniformity, care will have to be taken to combine adequate investor protection with a high level of operating efficiency. The creation of financial services groups with specialized subsidiaries appears an appropriate way to promote both these objectives.

A regulatory framework based on the principles I have described would conform with the approach adopted by the EEC in its proposed directive and enable the Italian financial system to benefit from the introduction of new intermediaries, such as pension funds and closed-end mutual funds.

With regard to financial markets, there are two areas in which improvement is needed.

The first is the stock exchange; major issues still to be resolved include the reform of the system of trading (currently based on a call auction) and the adoption of measures to ensure the transparency of transactions. A first bill presented to Parliament redefines the operators allowed to trade on the stock exchange, lays down principles to which they must conform and provides for most trading to be concentrated on the exchange. Another bill before Parliament sets out to regulate take-over bids and insider trading, with the aim of protecting investors and ensuring transparency. The latter would also be enhanced if information concerning companies' results were supplied more frequently to shareholders and if the concept of a group of companies were strictly defined in order to support, inter alia, the production of consolidated balance sheets.

The second area concerns options, for which there is already a small market, and futures, for which there is no market at all. The development of these markets can be envisaged along lines similar to those already adopted for the market in government securities and planned for shares.

Conclusions

The agenda is full of demanding problems, some I have treated at some length, others I have only touched upon, and yet others I have not even mentioned. I strongly believe that a solution can and will eventually be found for all of them. The benefits at stake are more than worth the effort.

The creation of the single European market presents a major challenge, especially for the financial systems that were protected from international competition until only a short time ago. Financial intermediaries are faced with the problems of optimal size and organizational flexibility, and they will have to identify and develop activities differentiating them from the foreign competition. The monetary authorities have to ensure that the system of supervision and control is able to combine the protection of stability with the promotion of competition and operational efficiency.

It would nonetheless be a mistake to see 1992 as representing a break in the modernization and diversification of the Italian financial system. The process has been under way for some time now. It was set in motion by the monetary authorities well in advance of the Community initiative and was given momentum by the pressure of market forces. In this context, the single market programme is naturally acting as an accelerator.

The progress made in the last few years means that the Italian financial system is in a position to take up the challenge of 1992 and exploit the opportunities it offers in terms of efficiency and growth. Today's banking system has a more competitive and efficient structure and the securities markets have grown and are both deeper and more liquid, while the action of the monetary authorities has been designed to strengthen market mechanisms through the use of indirect controls and capital ratios rather than administrative constraints. Much remains to be done, but I am confident that adequate solutions can be found.

Recently, Italian industry has again demonstrated its ability to generate and harness the forces required to keep abreast of international competition, with a considerable strengthening of the domestic productive system. Italy's position among the major economies has improved in terms of national income and its share of world markets. Personally, I see no reason to doubt the ability of the financial sector to mobilize the resources needed to cope successfully with the challenge of 1992. However, despite the high level of saving in Italy, the budget deficit and the public debt are a crucial problem and a source of weakness for the whole Italian economy. They threaten to impede the balanced growth of the productive and financial systems and nullify the effects of their recent progress. This obstacle will have to be removed. If it is not, Italy could fail to benefit from a historic occasion and the great opportunities the single market will bring.

For many years now the monetary authorities have been advocating the elimination of the budget deficit net of interest payments as a first step. We must advance with determination along this path, fully aware that the stakes are too high to permit failure.