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ADDRESS TO THE MEETING OF THE CONSULTATIVE COMMITTEE OF THE INTERNATIONAL SAVINGS BANK INSTITUTE

Milan, October 8, 1990

1. The European monetary and financial system of the nineties is rapidly taking shape: the legislation required to implement the single market for banking and financial services is nearing completion; capital movements have been fully liberalized; and attention is now being focused on the design of a new framework for the conduct of economic and monetary policy in the Community. In December the Intergovernmental Conference will meet to modify the Treaty of Rome and create the conditions for economic and monetary union among the member countries.

2. The changes under way pose a major challenge to both market participants and public authorities across Europe, who will have to adapt their strategies and policies to the new situation. On the other hand, the changes will also bring opportunities and advantages to the Community as a whole.

The single market

3. The single market will lead to greater efficiency in the resource allocation and saving-investment processes; it will enhance the ability of the European financial system to keep pace with developments in international markets, notably as regards globalization and financial innovation. 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, concentration and efficiency of the various domestic markets. Moreover, national regulations still differ substantially and in some instances are not comparable. While the process of

harmonization of supervisory regulations is well under way at the Community level, much remains to be done ahead of 1993. At the national level some crucial adjustments are the responsibility of governments and central banks, while others must be undertaken by market participants.

4. Freedom of establishment within the Community is setting the stage for greater efficiency in the banking industry; it is increasing competition, broadening the range of financial instruments available to individuals and enterprises and reducing the segmentation of markets. Increasingly, banks find themselves facing competition not only from other banks but also from non-bank operators, with a consequent reshuffling of market shares and changes in the structure of banking markets.

5. The competitive success of banks in the European market will depend on their ability to adjust rapidly and efficiently to the new environment. In particular, they will have to exploit the short time left to ensure that they have the necessary resources, in terms of adequate capital, advanced technology, efficient procedures and appropriately qualified staff.

In this process larger banks may have a greater potential for diversification and the joint production of services. Conversely, regional and local banks may be the most affected by the ending of domestic market segmentation, since some of the conditions on which their profitable operations have been based are progressively being removed. A two-pronged strategy is required if they are to thrive in the new environment: on the one hand, they will need to reinforce their links with local customers; on the other, they will have to offer a wider range of financial services without incurring excessive start-up and running costs. To this end, alliances with other national or foreign banks may be necessary.

6. The creation of an integrated financial market will result in competition between national legislations and tend to reduce the disparities in rules and practices. However, the process of harmonization cannot be left only to the interplay of market forces if the erosion of essential prudential rules is to be averted. In fact, the Community guidelines call for the minimal harmonization of supervisory regulations to put all competing institutions on an equal footing: they lay down the basic conditions for banks to be allowed to operate cross-border in accordance with the principle of mutual recognition, define capital for prudential purposes and fix minimum capital requirements in relation to banks' risk-weighted assets. New Directives are being drafted that will provide common rules for large exposures, deposit guarantee schemes and the supervision of banking groups on a consolidated basis. This legislation will provide the regulatory framework for uniform supervision in the Community.

7. The need to ensure the stable and efficient functioning of the Community financial market also calls for relatively uniform regulation of activities that are increasingly carried out by different types of intermediaries, whose business specialization varies from country to country. This applies in particular to securities investment and trading activities, which are performed by both banks and securities firms and are the subject of two proposed EC Directives, on capital adequacy and freedom of establishment and access to stock exchanges. These Directives will complement those applying to credit institutions and provide a common corpus of legislation that should ensure the subjection of each type of risk to uniform prudential regulation, while not impairing the ability of the European financial system to compete with Asian and US financial centres.

8. The progressive approximation of the various financial systems does not represent adjustment to a predetermined model; rather it is an empirical search for the most appropriate solutions in the current phase. In the course of this search, there has generally been considerable openness to change in all countries. For instance, at a conference in London Governor Pöhl recently expressed the opinion that in reorganizing the central banks within the future European System of Central Banks, they "should be made responsible for bank and stock exchange supervision where this is not already the case, as, for example, in the Federal Republic of Germany".

The Italian financial system

9. The Italian financial system is often said to be hopelessly inefficient. Yet, in judging a financial system's adequacy to the needs of the economy, one must bear in mind not only its present condition but also the direction and the speed of its evolution. Indeed, looking beyond the short run, the crucial variables from a structural standpoint are precisely the nature and pace of change.

The Italian banking system is endowed with great solidity and a proven ability to provide financial support to the economy even in times of acute crisis; however, it is still behind in a number of spheres, most especially in supplying high-quality services to today's more demanding customers and in restructuring to adapt to the requirements of the new market conditions. The fact that its exposure to international competition has come later than that of other industries was due to reasons beyond its control. Some problems of market segmentation and non-economic behaviour remain, and must be eliminated.

For at least a decade now, however, the stream of innovation has been flowing strongly and swiftly. Indeed, the pace of change in the operating environment for credit intermediaries has accelerated steadily. The lag with which the full consequences of these changes unfold sometimes results in underestimation of the impulses imparted to the system.

10. Allow me to be more specific on the strengths and weaknesses of Italy's banks and capital markets.

11. At present, the banking system as a whole has about 26,000 billion lire of capital in excess of the minimum requirements, fixed at 8 per cent of risk-weighted assets and 4.4 per cent of total assets. Moreover, only a few banks now fail to meet their capital ratios.

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 60 have been compulsory wound up in the last 20 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. Between 1984 and 1988, the most recent year for which internationally comparable data are available, the net income of Italian commercial banks (before provisions and tax) averaged 1.4 per cent of total assets, as against 1.0 per cent in France, 1.2 per cent in Germany, 1.8 per cent in Spain.

12. The structure of the banking system has also been considerably modified since the late seventies. The segmentation based on legal form, area of operations 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 operate through subsidiaries in new lines of business such as mutual funds and merchant banking.

13. 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 to draw on the valuable experience of the existing specialized credit institutions.

14. The separation between banking and commerce, one of the fundamental principles underlying the reform of the Italian Banking Law introduced in the thirties, has been fully upheld by the "anti-trust" legislation approved by Parliament on 27 september 1990. This legislation makes the acquisition of all significant interests in credit institutions subject to authorization by the central bank and sets an upper limit of 15 per cent on the interests that may be acquired by non-financial companies. This new law is seen as an important defence of the system's stability and allocative efficiency. It does not preclude industrial companies from participating in banks' capital, but is intended to prevent them from acquiring control or a controlling influence.

15. Apart from certain minimum requirements, there are no restrictions on the establishment of banks in Italy; foreign operators are free to set up business on the same legal and operational footing as local banks. Italians' high 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.

16. These positive factors and 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.

17. 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.

At present, the efficiency of some Italian banks is too low, especially in the public sector. For instance, the ratio of large banks' staff costs to their total assets is 2.14 per cent in Italy, 2.10 per cent in Spain, 1.10 per cent in France and 1.33 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.

18. 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 concentration of the Italian banking industry and the relatively small size of even the largest Italian banks. At the end of 1989, only two Italian banking groups were among the top fifty in terms of assets, whereas Japan had 22, Germany 7, France 6, and the UK 5. The proportion 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.

19. The development of a more highly concentrated banking system is one of the strands running through the various new laws approved or under examination by the Italian Parliament. The recently enacted law on the transformation of public-law banks and savings banks into limited companies opens the way to private sector participation in their capital; it will make it easier for banks to strengthen their capital bases, and, at the same time, it will encourage concentration, especially among banks operating in contiguous segmented markets and those supplying complementary financial services in local and international markets.

20. 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.

21. 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, several mergers between medium-sized and even large banks are under way and others are being discussed. In addition, various other forms of aggregation are under consideration, especially among savings banks, with the aim of achieving at least a minimum regional dimension.

22. 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.

23. Much effort has also been put into fostering and strengthening the markets in Italy's traditionally bank-dominated financial system. The development of a broad and efficient capital market serving the private sector would fill a major gap. A number of preliminary conditions have long been identified: rules guaranteeing the transparency of transactions, the presence of institutional investors and tax neutrality with respect to alternative financial assets. In these fields some significant advances have been made in recent years and the time is now ripe to bring this work to completion. The bill on financial intermediaries, which is expected to become law shortly, redefines the operators allowed to trade on the stock exchange, lays down the principles with which they must comply and provides for most trading to be concentrated on the exchange. Draft legislation has also been proposed for the creation of pension funds and other forms of intermediation of savings, for rules on insider trading and takeover bids and for the modification of tax provisions.

24. Once the capital markets are in a position to function more effectively, their relative importance in the financing of enterprises will be able to vary with the needs of the economy. It is quite possible that they will continue to play a subordinate role, reflecting the peculiar size structure of Italian firms. There would be nothing anomalous in this; the real anomaly is the present almost complete lack of an alternative to bank credit.

The European monetary union

25. The economic and financial integration of the Community cannot be completed if it is not supported by monetary stability. This has been recognized since the start of the Community. However, the Treaty of Rome contained no specific provisions on monetary matters since at the time all the member countries were part of the Bretton Woods system, which no one expected to collapse. The real shocks of the seventies and the accompanying currency instability gave new impetus to the idea of the construction of a European monetary identity. The Giscard-Schmidt initiative of 1978 led to the creation of the EMS, which has made a major contribution to EC exchange rate stability, thereby promoting price stability in the Community. Inflation differentials have steadily narrowed, while economic growth has remained strong for eight years in a row.

26. Today the liberalization of capital movements and the creation of the single market call for an even stronger commitment to price stability. This commitment cannot be adequately supported simply by an exchange rate agreement; it must be based on a new institutional framework for the conduct of economic and monetary policy in the Community. It is with these and other broad political objectives in mind that the European Council has formulated the objective of economic and monetary union.

27. The preparatory work on the changes required to the Treaty of Rome to be considered by the Intergovernmental Conference starting in December has produced a broad consensus on the main features of the final stage of monetary union. In particular, it is recognized that EMU involves the implementation of a single monetary policy by a central institution, in which the national central banks participate.

The fundamental principle underlying the creation of the ECB is that its overriding objective must be the maintenance of price stability. This objective will be laid down in its Statute, which will be part of the new Treaty and have constitutional validity. To enable it to perform its tasks, the new institution will have to be independent as regards its functions, finances and personnel, while of course, being accountable to democratically elected Community bodies such as the European Parliament. This principle of independence is a crucial one: the European Central Bank will be independent of governments and external forces or it will not come into being at all.

It is also recognized that if the ECB is to promote stable monetary conditions, it will be necessary to establish a general set of rules and procedures for national fiscal policies to avoid the emergence of excessive deficits that could jeopardize the Community's financial and macroeconomic stability. In particular, national budgetary authorities will no longer have access to monetary financing.

28. According to the draft Statute that is being drawn up, the ECB will be entrusted with all the instruments necessary to conduct a single monetary policy in the Community. All decisions will be centralized, but they will be implemented in part by the existing national central banks, much as in other federal systems. For instance, commercial banks will still have access to national central banks' discount windows, but conditions will be standardized throughout the Community and decided at the centre by the main governing body of the European central bank.

29. In the last stage of monetary unification it is envisaged that a single currency will replace the existing ones. By eliminating the information and transaction costs involved in having to deal with a multiplicity of currencies, economic agents will reap the full benefits of monetary

unification. A single currency will be consistent with the maintenance of stable monetary conditions, but in substituting the existing currencies, account will have to be taken of the need for market agents to adjust their monetary habits. Close interaction between the European central bank and commercial banks will be necessary to ease the transition. Commercial banks should prepare in advance for the change and be ready to provide efficient services in the new currency. Those that do so are sure to enjoy a competitive advantage.

30. The transition to monetary union requires a high degree of economic convergence among member countries, especially with respect to inflation and budgetary discipline. The Community must evolve towards the final stage of monetary union in a cohesive way. This requires the adjustment of existing imbalances, especially in the larger countries with disequilibria that could affect the stability of the whole system.

31. The adjustment of the Italian economy is a key condition for unification to proceed uniformly and not break down. The Italian inflation rate must be reduced to the lowest levels of the Community. Since 1980 the differential with respect to Germany has come down from over 15 per cent to about 3 per cent. This improvement shows that the gap can be closed further by maintaining a rigorous monetary policy and a stable exchange rate of the lira against the other ERM currencies.

Monetary policy must not be overburdened, however. Fiscal policy must focus on restoring sound public finances. The deficits of the past have fueled a continuous increase in domestic demand that has weighed heavily on the external current account and pushed up real interest rates in Italy. The burden of the public debt has become excessive, and, net of interest payments, surpluses must now be generated, as provided for by the three-year program approved by Parliament for 1991-93. The Italian authorities are fully aware that the stakes are too high to permit failure on this important score.

32. Drastic adjustment must be achieved in the next two years or so, in order to keep the Italian productive and financial systems on a sustainable growth path. The Italian economy grew stronger during the eighties and I believe that is now in a position to sustain this adjustment and cope successfully with the challenges of the nineties.