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Financial savings in Italy: instruments, intermediaries and markets

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to the conference on

The New Economy and its impact on finance and insurance

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1. Introduction

This gathering is an opportunity to reflect on the developments and far-reaching changes affecting the savings market and financial intermediaries in Italy.

The experience of the United States in the nineties clearly shows the importance of efficient and developed financial markets for the growth of the economy, income and employment.

In Italy the propensity of households to save, albeit declining, remains higher than in the other leading countries. Demand for financial assets has shifted from bank deposits and short-term securities to equities and long-term bonds.

The asset management industry has grown enormously in the past few years and drawn close to the levels found in the most advanced economies. Macroeconomic trends and legislative reforms have contributed to this progress.

Intermediaries have stimulated and accommodated the inclinations of savers by widening their product ranges and creating new channels of distribution. Intense competition has spurred them to improve the quality of services, brought a lowering of commissions and encouraged internal reorganization designed to enhance operating efficiency and develop specialized expertise.

Greater use is being made of the Internet in order to market financial products, reach new categories of customer and participate in electronic commerce initiatives. The opportunities offered by on-line activities are accompanied on a growing scale by several typical risks of intermediation, particularly the operational and reputational risks connected with distance activity.

Growing demand for equity instruments increases the resources available to finance industrial projects, including those, typical of the high technology sectors, that carry a high risk and offer a deferred return.

The massive purchases of foreign shares by specialized Italian intermediaries have not been balanced by equally large capital inflows to Italy. Foreign investors have tended to prefer Italian government securities.

Italian intermediaries' ability to compete effectively in foreign markets and the need to upgrade our economy's technological level require a further strengthening of the private capital market and the development of corporate finance services comparable to those already widespread in the most advanced financial markets.

2. Financial savings in Italy

The Italian economy's saving rate in 1999 was equal to 21.5 per cent of national income. This was in line with the average for the nineties and compares with the average of 22.5 per cent for the eighties. Today the rate is close to the European average (21.8 per cent) and slightly higher than that for the Group of Seven countries (20.9 per cent).

In the second half of the nineties the improvement in the financial balance of the public sector was accompanied by a decrease in households' propensity to save. In 1999 the proportion of disposable income saved was 13.2 per cent, compared with 16.6 per cent in 1993 and 21 per cent in 1983.

The fall in households' propensity to save can be attributed to the prolonged weak growth in disposable income, and in fact it has been accompanied by a very small rise in consumption. According to recent empirical analyses, the decline has been mitigated by the spread of expectations of smaller pensions, which appears to have encouraged households to step up their accumulation of real and financial assets.

Italy’s household saving rate nonetheless remains high by international standards. It is much higher than those of Germany, the United Kingdom and the United States; among the main industrial countries, it is second only to that of France.

The decline in real interest rates, the reduction in the supply of government securities and the expansion in that of asset management services contributed in the second half of the nineties to a major reallocation of households’ financial portfolios in favour of equity securities. The progressive integration of financial markets and the elimination of currency segmentation in the euro area have stimulated purchases of foreign securities.

The change in investment choices has been managed by institutional investors. According to the Bank of Italy’s survey of household income and wealth, between 1995 and 1998 the proportion of households entrusting their financial savings to investment funds or portfolio management services rose from 5 to 11 per cent, while the proportion of those investing in life insurance products increased from 21.5 to 23.3 per cent.

Ownership of risky financial assets is generally widespread among wealthier households but not everywhere to the same extent. In the United States 87 per cent of the households in the highest quartile of the distribution of wealth held shares either directly or indirectly in 1998. In Italy the corresponding figure was 39 per cent.

Italian households also stand out by international comparison for the low level of their debt. The ratio between households’ financial liabilities and assets was 6.6 per cent in Italy at the end of 1999, similar to the figure in Germany but far lower than those in France, Spain and the Anglo-Saxon countries. In the past few years sharply falling interest rates have encouraged vigorous growth in loans to households, primarily for the purchase and renovation of properties and for specific items of consumption.

3. The growth of asset management in Italy

Between the end of 1996 and the third quarter of 2000 assets under management in Italy in individual and collective investment portfolios nearly tripled to 1,940 trillion lire.

Investment funds accounted for 58 per cent of the increase and took on a central role in the management of savings.

Households' growing demand for individual and collective asset management services was abetted by the reform of the legislation governing the credit and financial sectors.

The legislative innovations helped new products to succeed, promoted greater efficiency in the financial industry and strengthened the competitiveness of Italian intermediaries in a context of markets open to international competition.

The 1998 Consolidated Law on Financial Intermediation was of fundamental importance to this process.

The new institution it created, the asset management company, constitutes the organizational model for all intermediaries authorized to operate in the different market segments: from individual portfolio management to collective investment vehicles, pension funds and advisory services. It has introduced an element of organizational flexibility allowing banking and financial groups to rationalize their presence in the various sectors of activity and to centralize management functions and separate them from distribution.

The 99 asset management companies operating at the end of 2000 accounted for 74 per cent of the assets under management in individual and collective investment portfolios. A growing number of banking groups delegate these companies to operate their individual portfolio management services and they are also entrusted with a large part of the portfolios of Italy's main insurance companies.

The removal of the procedures for creating new categories from the realm of statute law, with responsibility for establishing their characteristics assigned to the Treasury Minister in July 1999, has fostered product innovation and made new management instruments available.

The formalities have been simplified and the time taken to approve investment fund rules has been appreciably shortened. A set of standard rules has been defined and their adoption by fund management companies will make it possible to minimize the supervisory checks by the Bank of Italy, which is committed to issuing its authorization within twenty days instead of the maximum of four months provided for by law.

In December 2000 the assets of Italian investment funds totaled 880 trillion lire, four times more than at the end of 1996. Units of Italian investment funds, which represented 2 per cent of households' total financial assets at the start of the decade, accounted for 18.5 per cent at the end of 1999.

In the last four years investment funds initially recorded a surge in net subscriptions, followed after 1998 by the ongoing phase marked by more moderate increments and, above all, by a pronounced reallocation of assets among the different categories of fund.

Initially, banks sought to expand their sources of non-interest income by encouraging customers to invest in money market and bond funds that were better able than individual investors to realize capital gains from the convergence of Italian interest rates with those prevailing in the leading European countries.

In 1999 and 2000 the fall in bond prices encouraged a shift of savings into equity funds. In November 2000 equity funds' assets had grown to 38 per cent of the total, a value close to the European average.

Foreign funds, especially Luxembourg and Irish funds, largely established by Italian intermediaries, have become widespread in Italy, partly owing to the difference in tax treatment. In 2000 the net inflow that they recorded, equal to around 72 trillion lire, more than offset the net outflow from Italian funds.

At the end of 2000 there were around 1,000 funds in operation, twice as many as at the end of 1996. The shape of the Italian market is different from that of the other European countries, where the average size of funds is relatively small; for instance, total investment fund assets are only slightly greater in France than in Italy, whereas the number of funds is six times higher.

The larger average size of the funds marketed in Italy is partly a reflection of the still limited extent of product diversification, but this is changing as intermediaries seek to respond better to the needs of different categories of investor.

The product range is also tending to widen with the introduction of highly specialized instruments, to be used in complex portfolios or as components of portfolios modeled on specific goals pursued by individual investors.

Today investment funds often constitute the "raw material" for further forms of asset management, such as insurance policies and individual portfolio management accounts. For the latter, the phenomenon is becoming highly significant; the proportion invested in funds has risen rapidly, reaching 55 per cent last September. Investment fund returns act as the principal parameter in unit-linked insurance policies, which have lately recorded significant rates of growth.

Funds of funds, which foster broader risk diversification by improving the distribution of the investment, are becoming popular and are positioned to compete with unit-linked policies. Some 40 of them were established last year and had assets totaling 9.7 trillion lire at the end of December.

Funds reserved for qualified investors, targeted to institutional customers willing to take on more risk in order to obtain higher returns, are making headway. They are permitted to derogate from the prudential rules for diversifying and limiting risks and allowed greater autonomy in establishing their investor entry and exit procedures. About 20 of these products have been offered so far, although most are sub-funds of just one fund.

Speculative or hedge funds, characterized by particularly high risks and returns, are a third type of innovative product. Unlike the general run of finds, they may take out loans and engage in short-selling. Although only two asset management companies specializing in this sector have been authorized up to now, the market is seeing a spate of initiatives especially on the part of intermediaries that are not members of banking or insurance groups.

Pension funds are gaining ground as a form of collective portfolio management.

"Contractual" pension funds, restricted to specific categories of workers, have significant enrolment considering the short time they have been in operation. At the end of 1999 their members numbered more than 700,000, although their assets were still not much more than 1 trillion lire, since only 6 of the more than 30 funds authorized had gone live. Most of the 17 authorizations issued for management agreements regarded asset management companies and investment firms.

"Open" pension funds have attracted fewer members; the number enrolled does not exceed 140,000. By the end of 1999 authorization had been granted for 88 funds, mainly established by insurance companies and asset management companies, and 61 funds were in operation.

The growth of pension funds could be stimulated by the fiscal measures introduced with Legislative Decree 47 of February 2000, which raised the ceilings for the tax deductibility of contributions for individuals and equated the taxation of the net operating result with that in effect for investment funds, but with a rate reduced from 12.5 to 11 per cent.

Individual portfolio management accounts, which were born as an instrument for higher income investors, have gradually spread to a wider customer base in forms ranging from the specialized and personalized accounts reserved to wealthier investors to those set up on predetermined lines, largely involving investment funds, for smaller amounts. The composition of portfolio management accounts has also changed as government securities have made room for a growing proportion of shares and corporate bonds.

At the end of 1999 individual portfolio management accounts held 7.5 per cent of households' financial assets, compared with 3.2 per cent at the beginning of the nineties. Their growth slowed down in 2000. In September their value exceeded 750 trillion lire, 56 per cent of which under management by banks and one third entrusted to asset management companies.

4. Competition in the Italian asset management market

In the international panorama, Italy's asset management market has attained significant size. Italy is the fourth-largest "producer" in the world, following the United States, Japan and France. Investment funds directly or indirectly controlled by Italian groups account for 18 per cent of the investment fund market in Europe. Two of the five largest European groups are Italian.

At the end of 1999 the Italian market had a high degree of concentration: 10 groups, including 2 headed by insurance companies, controlled 71 per cent of total assets under management. In September of last year Italian banks' market share was 83 per cent, while that of foreign intermediaries was around 10 per cent.

Product innovation is being stimulated as competition grows and investors pay more attention to returns, fee levels and service quality. Use of the Internet threatens the primacy of traditional distribution networks and makes it easier to compare competing offers.

The leading operators are offering an ever-expanding menu of products, including financial instruments issued by other intermediaries, in order to attract customers and secure their loyalty.

The increase in competition has been reflected in pricing. In the investment fund sector, entry fees have dropped substantially: in 1999 the total amount of such fees fell by 11 per cent compared with the preceding year in spite of the increase in subscriptions.

The major investments necessary to acquire a significant position in the asset management market and the importance of marketing networks favour the formation of large intermediaries, particularly bank-related ones with extensive potential customer bases.

Foreign companies are stepping up their efforts to expand in Italy and seeking to overcome the handicap of limited distribution networks. Entry strategies centre on marketing agreements with local intermediaries and on-line distribution. The number of foreign funds sold in Italy jumped from 1,200 to 1,800 last year.

Portfolio reallocation to the benefit of foreign securities is tending to reduce the comparative advantage Italian asset managers derive from their knowledge of domestic issuers. This could affect their ability to compete if it were not accompanied by the acquisition and development of specific skills. The Italian managers of a growing number of funds are engaging major foreign intermediaries to handle specific sectors of investment.

Italian intermediaries' presence in foreign markets is still limited. The decision to locate management activity abroad is often motivated more by advantageous tax treatment than a strategy of international growth. Investment funds established abroad by Italian firms collect nearly all their funds from savers in Italy.

An important step in the direction of a common regime of taxation of non-residents' investment income within the European Union was taken by the Ecofin Council meeting of last November, which agreed a draft directive on the matter. For a transitional period of seven years, twelve countries would implement an information-exchange system, while three (Austria, Belgium and Luxembourg) would apply a withholding tax (equal to 15 per cent for the first three years and 20 per cent thereafter), with three-quarters of the resulting revenue being rebated to the investor's country of residence.

In the Italian market, where competition is now intense, banks still play a central role in the development of investment funds and portfolio management accounts.

In the last three years the banking system has recouped profitability by expanding the supply of services. Income from asset management and securities custody accounts amounted to 12 trillion lire in 1999, an increase of 47 per cent on the preceding year. The rising trend continued in the first half of 2000, when, despite the upturn in net interest income, the share of total gross income attributable to asset management rose to 13 per cent, compared with 10 per cent a year earlier.

In order to increase their ability to compete, Italian banking groups have launched a far-reaching effort to reorganize their production and distribution processes with a view to achieving economies of scale and capitalizing on in-house professional resources.

The amount of assets involved and the growing complexity of management activity have led to a growing separation between portfolio management and the activity of the sales networks, which are focused on helping customers to identify the most appropriate risk-return profile.

Not infrequently, administrative, accounting and internal audit functions are entrusted to specialized arms of the group.

Crucial organizational factors include the ability to define strategic objectives, pursue them consistently with adequate resources, exercise full control over operational and reputational risks, and maintain effective control over outsourced functions.

The Bank of Italy has placed the monitoring of asset management companies' organizational structures at the centre of supervisory action, requiring companies to have the controls and human and technical resources needed to ensure correct performance of the mandates conferred on them by investors. This aspect is particularly important in the case of companies managing innovative funds. Supervisory scrutiny covers the entire production process, from the formulation of management strategies to the valuation of fund units.

5. Banks in the market for insurance products

The share of households' financial assets managed by insurance companies rose to 6 per cent in the nineties. Banks play an important role in this market. Growing ownership links between banks and insurance companies, especially in the field of life insurance, and cross-selling of products are to be found in all the leading countries. The aim of both banks and insurance companies is to diversify the range of products available to households and reduce the incidence of the fixed costs of sales networks.

Bancassurance developed in Europe under the impetus of deregulation in the eighties in France and the United Kingdom; in the United States the legislation prohibiting commercial banks from producing or selling insurance products was repealed in 1999.

Business combinations involving banks and insurance companies have frequently been cross-border and have given rise to some of the largest European conglomerates. Banks have acquired substantial market shares in the distribution of insurance products in Germany, Spain, Portugal and the Nordic countries.

Under Italian law banks can acquire control of insurance companies and vice versa. Cross-selling is permitted, provided the products are standardized and it is carried out under agreements that clearly define the contractual liabilities and risks associated with the instruments being sold.

In Italy bancassurance involves some of the country's biggest intermediaries, including five of the ten largest life insurance companies. In September 2000 banks owned interests in 72 Italian insurance companies, of which 34 engaged in life business and 24 in mixed business; some smaller banks are controlled by insurance companies.

The role of banks in the insurance industry is clearly revealed by their share of total life premium income, which rose from 5 per cent at the beginning of the nineties to 50 per cent in 1999. In that year, according to a survey conducted by the Bank of Italy, life premium income deriving from new policies sold by the banking system amounted to 41 trillion lire; about two thirds of the premium income was generated by large banks that accounted for 56 per cent of bank deposits and bonds. Some 84 per cent of the premium income came from policies issued by insurance companies in which banks owned an interest; the remainder referred to policies sold exclusively under distribution agreements.

In line with Community law, insurance companies are not included in banking groups in Italy nor are their accounts consolidated with those of banks; the same approach has been adopted for the consolidated accounts of insurance companies.

Attention is being drawn in international fora to the need to avoid the dilution of the capital of conglomerates made up of banks and insurance companies as a result of its being used to cover the risks of more than one group company at the same time (a phenomenon known as double gearing). The protection of intermediaries' stability is entrusted to the prudential rules of each sector and the supervision carried out by the competent authorities. Italian law provides for full cooperation between the two authorities involved based on the exchange of information needed to maximize the effectiveness of supervision.

6. The new economy and financial intermediation

The flow of private Italian capital channelled to foreign markets by specialized intermediaries is growing. For the most part the funds are used to buy shares: in September 2000 Italian investment funds held 292 trillion lire of foreign shares, more than three times the value of their holdings of Italian shares, as against a ratio of less than one in 1996.

The inflow of capital from abroad has mainly been invested in government securities. Between the end of 1996 and September 2000, the proportion of public debt securities held by non-residents rose from 16.3 to more than 40 per cent. The proportion of Italian shares held by non-residents remained small, at around 10 per cent.

The pattern of capital movements to and from abroad reveals an inadequate supply of equity and debt instruments on the part of Italian private-sector issuers.

The low market capitalization of the stock exchange is a feature of Italy's financial system, although the value of listed companies has increased considerably in the last few years owing to privatizations and the rise in share prices. At the end of September 2000, the market capitalization of the Italian stock exchange was equal to 73 per cent of GDP, in line with the figure for Germany but less than those for Spain and France, respectively 94 and 118 per cent.

The gap with respect to the other euro-area countries in terms of the number of listed companies continues to widen: in the first 11 months of last year, 11 new companies were listed on the main board and 28 on the Nuovo Mercato. These are large increases compared with the past, but when delistings are included, the number of Italian listed companies rose by only 21, compared with 123 in Germany and 54 in France.

Numerous studies have sought to identify the reasons for the limited growth of the stock exchange and assess its consequences for the efficiency of resource allocation and the transfer of corporate ownership.

It is widely held that the limited presence of institutional investors cannot be invoked as the main reason for the small size of the market and the tax regime has been ruled out as a factor discouraging the ownership of shares. The changes made to the organizational aspects of the stock exchange, stimulated by the competition between financial centres, have increased the liquidity and transparency of transactions.

The studies stress the limited supply of shares; businessmen’s fear of losing control and reluctance to disclose the information laid down for listed companies discourage them from going public.

It is necessary to create conditions conducive to the listing of companies with good growth prospects. The objective is to channel the savings made available by the reduction in the government’s borrowing requirement and by investors’ greater propensity to hold risky assets towards the most dynamic and innovative companies.

New economy firms and those operating in high-tech sectors are marked by high risk-return ratios and their greater difficulty in raising finance by traditional means.

In the United States these companies can obtain adequate financial support by sharing ownership with venture capital companies. These have detailed knowledge of the markets in which the companies they finance operate, have a voice in the most important company decisions, make the release of funds subject to progress in the implementation of corporate plans and obtain resources from closed-end investment funds and institutional and private investors. In 1998 about 60 per cent of the funds raised by such companies came from pension funds, which have a very long time horizon for their investments.

In Europe venture capital business has grown rapidly in the last few years; however, compared with the United States, it has focused less on investments in innovative sectors and newly-born companies.

Closed-end investment funds constitute a vehicle of fundamental importance for the financing of this activity. In Italy a decree issued by the Minister of the Treasury in July 1999 removed some of the restrictions on the maximum equity interests that could be held in each company receiving finance and made it easier for investors to enter and exit such funds. Funds reserved for qualified investors enjoy even greater freedom. The outcome has been an expansion in activity in this field: the number of funds in operation has almost doubled and innovative initiatives have been launched.

In the two years 1998-99, venture capital companies carried out more than 600 transactions in Italy, but less than 20 per cent were in high-tech sectors such as information technology, electronics, communications and biotechnology.

Firms are making increasing use of the bond market in order to lengthen the average maturity of their debt, diversify their sources of financing and reduce the overall cost of their borrowings.

The start of the single currency has boosted the Eurobond market, which issuers find attractive in view of the wide range of investors, the absence of withholding tax on interest income, and the depth guaranteed by the participation of leading banks and important institutional investors.

In 1999 Italian non-financial companies made 32 Eurobond issues for a total of 24 billion euros, with one company accounting for 16 billion. In the first three quarters of 2000 there were 31 issues for a total of 9 billion euros.

The role played by banks in the bond market consists in certifying the creditworthiness of issuers, providing liquidity and placing securities through their branches, which also brings in additional and steadier revenues.

The processes involved in the production and distribution of financial services are undergoing profound changes connected with the increasingly widespread application of information and communication technology. The Internet is accelerating the changes taking place in the financial system.

The situation that is emerging is highly diversified and offers many opportunities, but it is also beset with risks.

Banks and other intermediaries can make extensive use of the Internet to collect, process and transmit information, expand the range of services they supply and participate in the development of e-commerce.

The Internet makes it possible for banks to consolidate and expand their business with existing customers, but even more importantly it allows them to pursue expansion policies in new catchment areas, thanks to the reduction in establishment and transaction costs. On the other hand, it allows operators in the communications and software industries to develop products similar to those offered by the financial sector and thus increase competition in the field of intermediation.

The changes occurring in the ways services are produced and supplied, in the distinguishing features of customers and in the structure of the markets accentuate some of the risks typical of financial intermediation.

Strategic risks are especially important in view of their size and the rapid obsolescence of investments; operational and reputational risks, related to the scope for fraud and procedural inefficiencies, also stand out. Difficulties in performing contracts and malfunctioning of IT systems affect the continuity of services and the certainty of transactions and can jeopardize the relationship of trust with customers.

Today's increased customer mobility makes the management of interest rate and liquidity risk more complicated; the assessment of creditworthiness is more difficult for distance lending.

Intermediaries' first line of risk control is provided by their internal checking systems, which must be consistent with the volume and special features of business conducted over the Internet.

The supervisory authorities of the United States and several European countries have adopted ad hoc measures in this field. Particular importance is assigned to the role of intermediaries' boards of directors, which are required to establish the objectives for Internet business, identify the related risks and put the necessary organizational bulwarks in place.

These criteria are analogous to those underlying the regulations concerning banks' internal controls issued by the Bank of Italy at the end of 1998, which call on managements to assess entry into new sectors very carefully, especially where these are highly innovative and complex, and to ensure the proper working of their information systems.

7. Conclusions

The Italian financial system is becoming more and more like those of the other leading countries. The lengthening of average life expectancy, the reform of public pension systems, and more widespread familiarity with financial instruments are tending to strengthen the preference for managed assets, encourage investors to look for a high degree of diversification even for small amounts, and stimulate the demand for increasingly complex and sophisticated financial services.

The new economy, taken to mean primarily the innovation in production and distribution brought about by the major changes that have taken place in technology, can increase the efficiency of economic systems, enhance competitiveness, improve the allocation of resources and sustain growth in the long run. At the same time, however, it exposes intermediaries to particularly insidious risks: lending to new economy firms requires highly specialized skills and thorough examination of applications in order to make correct assessments of projects based on expectations that are far from easy to interpret in sectors marked by very variable profitability and rapid technical obsolescence. Prudence appears all the more necessary in the light of the signs of crisis at important e-commerce companies and the high volatility shown by technology stocks.

The share of equity capital in households' portfolios is increasing, as is the share of savings entrusted to specialized managers, and greater use is being made of technologically advanced channels for the distribution of financial instruments.

The central role of innovation and modern technologies in competing successfully in international markets calls for far-reaching changes in the financial management of firms and in the business of intermediaries.

The spread of new technologies is altering the relationship between intermediaries and users of financial services. Customers are better informed and more active; the contractual relationship is becoming more equal; and the importance of personal acquaintance and previous dealings is likely to decline. The competitive challenge is in terms of the degree of customer "satisfaction", in terms of quality of service, product differentiation, the transparency of contractual terms and conditions, and the level of technical security.

In a context marked by fierce competition in international markets firms must innovate in their activities, products and processes.

The key to Italy's growth prospects lies in reconciling a fabric of small and medium-sized enterprises with the need to develop sectors based on advanced technologies and higher capital intensity, which presuppose very large investments with long paybacks.

Banks are required to make good use of the wealth of information they have acquired in years of profitable cooperation with businesses, in order to increase their ability to provide financial market advice and assistance. In their lending, they must combine their knowledge of customers with careful evaluation of the latter's investment projects, in order to select those that deserve to be financed and the most appropriate forms of support.

Intermediaries and firms must be able to operate in a legal and economic context that is certain and provides the security needed to enter into long-term commitments and carry out projects with a long time horizon.

Measures are needed to foster the organizational and operational flexibility of firms, especially small and medium-sized enterprises, and to remove all the restrictions on competition.

Such action is essential in a country called upon to make a special effort to modernize its economic system, so as to put households' savings to good use, raise the potential growth path and increase employment.