44th EUROFINAS ANNUAL CONFERENCE

32nd LEASEUROPE ANNUAL WORKING MEETING

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Premise

I accepted with pleasure the invitation to open the proceedings of the annual conference that the European federations of consumer credit (Eurofinas) and leasing (Leaseurope) decided to hold in Italy.

For the Bank of Italy, which performs supervisory controls on the intermediaries active in these markets, the conference is an opportunity to consider their function of providing financial support to firms, especially small and medium-sized ones, which through leasing can make investments without tying up substantial amounts of their own funds, and to households, which use consumer credit to purchase goods and services and spread the payments over time.

The growth of leasing and consumer credit can also help to mitigate the difficulties in gaining access to traditional credit that households and smaller firms often report.

1. Household demand in the euro area and Italy

In the last few years the euro-area economy has been struggling to latch on to the international recovery. Between 2000 and 2003 the area’s gross domestic product grew by 1 per cent per year, 2 percentage points less than world GDP; this weak performance can be attributed largely to the sharp slowdown in household spending. From the beginning of the decade private consumption grew by an average of 1.1 per cent per year, less than half as fast as in the second half of the 1990s. In the United States private consumption grew by 3 per cent per year and was the main driving force in the expansion of economic activity.

In Italy, after picking up to expand by more than 2.5 per cent per year in the second half of the 1990s, private consumption returned to modest growth, rising by an average of 0.8 per cent in the past three years. Only spending on health care and communications services continued to show appreciable gains, in contrast with the weakness of purchases of durable and non-durable goods.

Private consumption was influenced by pessimism about the general economic outlook and conditions in the labour market. The trend of consumer confidence was more unfavourable than in the rest of the euro area.

The protraction of uncertainty contributed to the gradual increase in households' propensity to save, which rose from 11.2 to 12.7 per cent between 2000 and 2003.

As in the rest of the euro area, a recovery in private consumption got under way in 2003 and gained strength in the first half of this year. This was attributable to the growth in households' disposable income, which at constant prices and net of the monetary erosion of financial assets increased by 2.1 per cent in 2003, compared with an average of 1.3 per cent in the three previous years.

2. *Household saving and debt*

Italy's household saving rate, which at around 30 per cent in the mid-1980s was among the highest in the world, fell sharply over the following decade. It is now in line with those of the other major euro-area countries. At the end of 2003 Italian households' gross wealth, arising from both the accumulation of savings and the change in the value of its components, was comparable as a ratio to GDP to that found in the other economically and financially developed countries; it was estimated to amount to €8.2 trillion, or 6 times GDP.

The share of financial assets in total household wealth rose to 35 per cent at the end of 2003, 5 percentage points higher than in the mid-1990s. Between 1995 and 2003 the share of buildings increased by only 1 point, to 59 per cent, despite a 60 per cent rise in property prices; that of other real assets – durable goods and land – contracted.

Bank lending to households has grown rapidly since the late 1990s. Between 1998 and 2003, the average annual increase was 11 per cent, 3 points higher than that in total bank lending. In the euro area in the same period the average annual increase was just above 7 per cent; only in Spain was it higher than in Italy (16 per cent).

The increase in credit to households has helped to narrow the gap between Italy and the other main industrial countries, although the difference is still considerable. At the end of last year outstanding bank loans to households were equal to 23 per cent of GDP in Italy, 67 per cent in Germany, 55 per cent in Spain, 37 per cent in France and 47 per cent in the euro area as a whole.

In Italy the growth in lending to households was long held back by a variety of both demand and supply-side factors.

Until the mid-1990s high interest rates made debt-servicing a heavy burden on households' budgets; the maturity and functional specialization of intermediaries limited the availability of credit, especially in the field of mortgage loans. The scant presence of large retailers offered little stimulus for the rise of specialized financial companies that could assist households' recourse to consumer credit.

The slowness of judicial proceedings for the recovery of amounts due from insolvent debtors made intermediaries more cautious in disbursing credit. In the case of mortgage loans, although the difference between the value of the property purchased and the amount of financing granted has decreased in recent years, it remains larger than in other industrial countries.

Since the late 1990s the reduction in interest rates towards the levels prevailing in the main European countries, in concomitance with the start of Monetary Union, has encouraged Italian households' recourse to credit. The increase in financial wealth has contributed to the market's growth. The introduction of tax benefits for building renovation and first-home purchases has buoyed the performance of the property market and above all encouraged the taking out of mortgage loans.

Financial liberalization and the termination of the regulatory specialization of intermediaries has facilitated the supply of financing to households. The growth in competition, connected in part with the entry into the Italian market of specialized foreign intermediaries, has led to a significant widening of the range of technical forms of financing, increasing customers' choice and reducing the costs. A household's chances of obtaining credit are now appreciably higher than at the start of the decade.

3. Firms' investment and debt

As in the euro area as a whole, in recent years capital formation in Italy has been affected by uncertainty about the outlook for demand.

In 2003 gross fixed investment fell by 2.1 per cent, reflecting the decline in spending on machinery, equipment and transport equipment. Investment was also held back by the persistently modest plant capacity utilization rate, which in 2003 fell to historically low levels for exporting firms.

Investment in construction continued to grow last year; the expansion, sustained above all by residential building, was nonetheless affected by the slowdown in spending on infrastructure.

In the first half of 2004 business investment turned upwards, regaining the level of two years earlier. The climate of confidence among manufacturing firms also improved, thanks to a more favourable outlook for demand.

The debt of non-financial firms, which up to 1998 had fallen from the high levels reached at the start of the 1990s, has recently begun to rise again.

The ratio of firms' financial debt to GDP rose from 49 per cent in 1998 to 62 per cent in 2003, higher than the figures recorded in the 1990s but low by comparison with the other main industrial countries. In 2002, the last year for which comparative data are available, the ratio was 68 per cent in Germany and the United States, 87 per cent in France, 94 per cent in the United Kingdom and 117 per cent in Japan.

The leverage of Italian firms, that is to say the ratio of their financial debt to the sum of their financial debt and equity, fell to a low in March 2000, mainly in connection with the growth of self-financing recorded in the second half of the 1990s. Subsequently, there was a reversal of the trend, owing in part to large-scale mergers and acquisitions carried out with recourse to borrowing.

Italian firms' leverage rose last year to 44 per cent, which was still around 7 percentage points lower than the average for the 1990s.

4. Corporate financing

Even though it has slowed down since 2000, when capital spending increased by 7 per cent, bank lending to non-financial companies has continued to expand faster in Italy than in the rest of the euro area. Last year such lending grew by 6.3 per cent, compared with an area-wide increase of 3.4 per cent and a contraction of about 1 per cent in Germany and France.

In the past few years the growth in lending to Italian firms has involved the medium and long-term component. The shift towards longer maturities has been driven by the narrowing of the differential between short and long-term rates, which was especially marked following the launch of Monetary Union. More recently, the restructuring of financial liabilities by some large corporations has worked in the same direction.

The growth in medium and long-term lending has narrowed the gap between Italy and the other major euro-area countries. In 2003 the share of bank credit to firms at maturities beyond one year was 55 per cent in Italy against 75 per cent in Germany, 73 per cent in France and 72 per cent in Spain.

Bank lending to small firms grew by 7.6 per cent last year, once again faster than lending to other non-financial companies. This reflects both changes in the banks' lending policies and modifications in the demand for credit from large corporations, which resorted more heavily to international bank loans and to bond issues.

In an economy like Italy's, where small and medium-sized enterprises are so numerous and make less use of capital market financing, easy access to bank credit is a major factor in the expansion of economic activity.

The new capital adequacy framework for banks developed by the Basel Committee and approved on 26 June by the Central Bank Governors and Heads of the Supervisory Authorities of the G-10 countries is not unfavourable for the financing of firms, and in particular small and medium-sized enterprises. Under the internal ratings-based approach, banks' exposures to firms with sales of less than €50 million are subject to a lower capital requirement than equally risky exposures to larger firms. Credits up to €1 million are treated in the same way as retail loans. Moreover, in particular circumstances it is also possible to recognize the guarantees provided by loan guarantee consortia (*Confidi*) for purposes of credit risk mitigation, thus reducing the capital charges on banks.

As a consequence, the entry into force of the new rules, scheduled for 2006-07, will neither restrict the supply of credit to small businesses nor increase its cost.

5. The structure of the Italian financial system

5.1 Banks

In the last decade the Italian banking system underwent very significant change that profoundly affected its structure and way of doing business.

The structure of the supply of banking services is much less fragmented now than in the past, owing to a process of consolidation that was very substantial, even by international standards. Holdings of bank capital by the state and other public bodies have been reduced to the minimum, and the Italian financial system has become quite accustomed to the logic of enterprise, pursuing efficiency and profitability while following the principles of sound and prudent management and the supervisory rules laid down by the authorities.

External opening, beginning with the liberalization of capital movements and culminating with the single currency, has helped raise the efficiency of Italian credit markets, which had long been sheltered from international competition.

Despite authorizations to establish some 150 new institutions, since the turn of the 1990s the number of banks in Italy has been reduced by a third, declining to 788 at the end of 2003. During this period there were more than 600 mergers and acquisitions, involving banks that accounted for more than half of the banking system's total assets at the start of the period. The market share of the top five banking groups has risen from 35 to over 50 per cent of total assets, comparable to the level in the leading banking systems.

The banking group has gradually become the organizational form most widely adopted in the Italian financial industry. The 82 groups registered at the end of last year comprised 225 banks and accounted for over 90 per cent of total system assets.

The expansion of the main banking groups has been accompanied by far-reaching reorganization. Some have adopted a "division" model, separating the parent company – responsible for strategic governance, allocation of capital and risk management and control – from the production units, which may be either structures internal to the parent company or legally separate entities.

5.2 Non-bank credit intermediaries

The credit sector in Italy includes a significant presence of specialized intermediaries, most of them belonging to banking groups. At the end of 2003 these specialists controlled 80 per cent of the leasing market and 40 per cent of the consumer credit market. Either directly or through financial subsidiaries, the banks operating in Italy handled 86 per cent of leasing and 79 per cent of consumer credit. The market shares of subsidiaries of industrial firms were smaller than 10 per cent.

The banks have elected to use specialized institutions for leasing and consumer credit in order to concentrate their business and thereby realize not only economies of scale but also higher-quality products and more efficient risk management. The model adopted has contributed to quite rapid growth in both markets starting in the second half of the 1990s.

In terms of structure, the two segments have shown divergent trends of late. In the last five years, as banking groups have rationalized, the number of leasing companies has fallen by more than 30 per cent, from 86 to 59, while that of consumer credit companies has risen from 26 to 31.

Regulations governing banks' permissible shareholdings have played an important role in furthering the growth of the banking-related sector in Italy since the late 1970s. In 1993 the Consolidated Law on Banking subjected to supervision all "systemically important" financial companies as well as those operating in specified fields even if they were not large in size. More recently, in October 2002, the Bank of Italy issued its supervisory instructions concerning organization and internal controls for these companies. The principles are the same as those applying to banks, but the rules have been specially designed and strictly linked to the different types of financial intermediary.

Controls on financial companies also include checks by the Italian Foreign Exchange Office on minor intermediaries, which are subject to just a few basic rules: mandatory entry in a register, minimum capital, the limitation of corporate purpose to financial activities, and integrity requirements for corporate officers.

The Bank of Italy's supervisory activity represents a stimulus to efficiency. It serves to preserve the independence and operational specificity of intermediaries as well as their contribution to the growth and diversity of the market.

6. The leasing market

Leasing activity began to slow down in Europe in 2000; the trend became more pronounced last year, when the volume of new lending fell by about 3 per cent. The Italian market, the third largest in Europe after those of the United Kingdom and Germany, recorded a much sharper fall of 15 per cent.

The stock of financing grew by only 2.2 per cent last year, after growing rapidly in the two previous years, by 15.8 and 12.5 per cent respectively. The performance in 2003 reflected the climate of uncertainty that affected firms' investment decisions and the absence of the tax incentives that had been in force until 2002.

Growing competition in the leasing market has narrowed profit margins and reduced the number of intermediaries. There has been a considerable diversification of supply, with the introduction of innovative products and a broadening of the range of services, which are no longer limited to just the financial aspect. There has been a tendency for the interest rates charged to come down, in line with developments in the rest of the euro area: in 2003 the average interest rate on new business declined by about one percentage point.

Leasing is increasingly becoming a major instrument of medium-term financing. Compared with the more traditional forms of bank credit, it offers borrowers a number of advantages: the deductibility of rental payments for tax purposes and, above all, protection against the risk of obsolescence of leased assets, especially technologically advanced products.

Leaseback, a technique widely used for property, allows firms to realize assets deriving from earlier investments and recover financial resources to be reinvested in the business.

The time taken to examine applications is generally short and the service appears more adaptable to customers' needs as regards the duration of leases, the frequency of rental payments and additional services, such as technical assistance and maintenance.

The rapidity with which recoveries can be made is a major competitive advantage for intermediaries. The fact that the lessor retains ownership makes it easier to terminate the relationship with a lessee in default and to recover and reallocate the leased assets. The percentage of losses is lower than for other forms of financing, especially in the case of property. This is recognized in the lower weighting attributed to property leasing in calculating the capital charges for credit risk under the legislation implementing Directive 98/32/EC (which amended some of the provisions on the solvency ratios of credit institutions and banking groups). The Basel 2 rules also recognize the risk mitigation inherent in the lessor retaining ownership, provided certain legal and procedural requirements are satisfied.

On the other hand, in addition to the typical credit risk connected with the creditworthiness of the counterparty, intermediaries must assess and manage the "operational" risks associated with the asset that is the subject of the leasing contract. They must evaluate a series of factors: the congruousness of the price of the leased asset, its fungibility, its expected useful life and the risk of obsolescence, the scale of foreseeable maintenance work, and the real scope for recovery. The specific nature of these factors explains why most Italian banking groups have preferred to set up dedicated leasing companies.

7. The consumer credit market

In a context marked by an increased propensity on the part of households to take on debt, new consumer credit business grew by 12 per cent in 2003. The fastest rates of growth were recorded by financial companies and specialist banks, with reference in particular to personal loans and the financing of motor vehicle purchases, which alone accounts for half the entire market.

The average size of loans is declining as a consequence of the growing use of consumer credit to buy less expensive goods.

Although the level of households' indebtedness, defined as the ratio of financial liabilities to disposable income, has risen in Italy in recent years, comparison with other European countries indicates that there is room for a further increase. At the end of 2002 the ratio was 34 per cent in Italy, as against 58 per cent in France, 83 per cent in Spain, 112 per cent in Germany and 120 per cent in the United Kingdom.

Consumer credit, if it is provided in a professional manner and efficiently, can help sustain domestic demand. It is up to the supervisory authority to ensure that the intermediaries involved operate efficiently, transparently and ethically, so that the products offered meet customers' needs in terms of quality and price.

In the last few years, against a background of growing competition, there has been a general reduction in the interest rates applied. For earmarked loans granted directly on the premises of the retailer, the annual percentage rate of charge for amounts up to €2,500 is currently 17 per cent, 6 percentage points less than at the end of 2000.

In granting and managing consumer credit, intermediaries employ statistical methods based on the collection and integrated utilization of a quantity of standard data on customers. The use of private data banks and company records in which information on customers' financial behaviour is stored is essential and must be retained, in a balanced relationship with customers' right to privacy.

The automation of consumer credit processes means that the intermediaries involved are well placed to comply promptly with the new Basel rules. The high level of computerization also permits the rapid disbursement of loans and efficient management and recovery procedures.

Community law, which has been effective in Italy since 1992, provides for rules to ensure the transparency of consumer credit transactions and disclosure of the annual percentage rate of charge, which includes every accessory expense. The proposal for a new directive on consumer credit (2002/0222 COD), currently being examined by the European Parliament, is intended to enhance transparency in the pre-contractual and subsequent recovery phases as well.

Transparency, proper conduct and competition are powerful factors fueling the growth of consumer credit. They have encouraged its use, especially in the South of Italy, by categories of customers with a low propensity to take on debt. The definition of clear product and marketing strategies is important; there is further scope for expansion in the spread of credit cards and by means of programmes to increase customer loyalty by offering various types of personal loans.

Growth in volumes of business must be pursued while applying rigorous methods of assessing creditworthiness and making sure that the loans granted are commensurate with borrowers' present and prospective incomes.

Careful attention needs to be paid to the recent deterioration in the quality of the loans disbursed by financial intermediaries. In the twelve months to 30 June 2004 the ratio of overdue amounts to total loans rose from 3.2 to 4.9 per cent.

Conclusions

The intermediaries that engage in leasing and consumer credit are characterized by a high degree of operational specialization and different methods for the management of credit risk from those of traditional credit business.

Strategies are directed towards reducing operating costs and strengthening intermediaries' presence in the markets they serve by developing distinctive skills, offering innovative products and adopting competitive pricing policies. The use of third parties' distribution networks is substantial; while this permits savings and greater flexibility in administrative costs, it also entails significant operational risks.

In streamlined and market-oriented organizational structures, experience in handling the typical risks of the business is not always accompanied by an equally clear perception of the role of "internal controls" as a system forming an integral part of companies' management.

The new discipline developed in Basel will provide regulatory authorities with the basis for the revision of national rules and regulations and intermediaries with a benchmark for the improvement of production processes and organizational arrangements.

It is essential that credit be granted in accordance with principles of prudence, economic viability and efficiency, in order to reduce the cost of the products and services supplied, provide customers with support and earn an adequate return on the capital invested in the business.

Contractual transparency, proper conduct and professional ethics are the foundations of intermediaries' reputations, the full play of competition, the achievement of high levels of efficiency and, in particular, customers' trust. The latter is the financial industry's most valuable intangible asset. Years of correct management are needed to build it up; irresponsible behaviour by a few persons can destroy it just like that.

Sound and prudent management, efficiency and competitiveness are the bulwarks of the system's financial stability in the medium and long term; entrepreneurial autonomy allows intermediaries to allocate savings in the most efficient way in the general interest. These are the objectives that the Italian legal framework entrusts to the supervisory activity of the Bank of Italy, in respect of both banks and other financial intermediaries.

I am sure the participants, and especially those from abroad, will have appreciated the extraordinary beauty of the Bay of Naples. This splendid backdrop will, I hope, make your work all the more fruitful. Thank you.