10th ABI Convention

The role of Italian banks in developing the economy

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Contents

Introduction

The Italian Banking Association's Annual Convention has established itself as a regular occasion for supervisory authorities, banks and the business community to discuss the problems of the Italian economy.

As in the past, the Bank of Italy is taking part in the event to make a contribution both to the general debate and to specialist discussions during individual sessions. It was therefore a great pleasure for me to accept the invitation to make this the venue of my first public speech since returning to the Bank of Italy.

The Convention takes places only a few days after World Savings Day, when the major issues of economic policy affecting the financial system were analyzed in depth. Today, I will take up only some of the matters discussed on that occasion which have a bearing on today's theme. I will consider, in particular, the prospects and risks for the world economy and how finance influences the one and the other, the structure of Italy's banking system, and the relationship between banks and the corporate sector.

The economy and international finance

The world economy continues to enjoy the expansionary phase under way since the beginning of this decade. Growth has become more balanced in the various regions of the world and has hardly been affected by the rise in raw material prices. This year it is projected that output will increase by around 5 per cent; in 2007 it could be affected by the downturn in the United States.

The development of finance has contributed to the prolonged period of growth. More liquid capital markets and soundly capitalized, world-level intermediaries are channelling resources into the most productive uses; they reallocate savings among the various regions, they divide and diversify risk. Globally integrated financial systems can absorb shocks more easily and limit their impact on income and employment.

Liquidity conditions on the markets are still satisfactory overall, despite the more restrictive monetary policy stance adopted in the main regions to counter inflationary pressures.

The situation is not without risk. The leading international organizations fear that the United States' growing external debt may jeopardize global growth. The volatility of oil prices is another source of weakness, given today's grave geopolitical tensions. Concerns about an acceleration of consumer price inflation could cause turbulence on financial markets, as occurred in May and June of this year. The high prices quoted for financial and real assets are based on expectations of strong growth, large profits, and low insolvency rates; they are vulnerable to changes in expectations and in investors' risk propensity.

The arrival on the world scene of new intermediaries and new instruments, such as hedge funds and credit derivatives, reinforces the role of finance in economic growth, but creates new challenges for stability. The estimated global net assets of hedge funds is $1.2 trillion; the notional value of credit default swaps in the G10 countries is $21 trillion.

Hedge funds supply the system with liquidity; they allow regulated intermediaries to select more suitable risk/return profiles for their portfolios. In many countries, institutional investors are allocating larger and larger proportions of their portfolios to these funds. However, their high leverage and management methods could make asset prices more volatile should tensions develop on the markets.

Credit derivatives serve to transfer risk from banks to a broader range of intermediaries and investors. Unless exposures become overly concentrated, the market for these instruments can help to make the financial system less vulnerable. However, their novelty and complexity is also a cause for concern. The performance of the credit derivatives market has not yet been tested in more difficult liquidity and interest rate conditions.

The leading international institutions and supervisory authorities agree that oversight of these market segments should not stifle innovation and competition. Regulatory action must focus on the decisions of the intermediaries financing hedge funds or offering prime brokerage services; it must ensure that their internal systems for the measurement and management of risks capture those associated with over-exposure to these funds.

For credit derivatives, there is consensus on the need for greater cooperation at international level both among supervisory authorities and between them and intermediaries, to foster the efficient working of the market and its underlying infrastructure and attain a better knowledge of the magnitude of transactions.

In Italy the size of the innovative segments of finance, though growing swiftly, is still limited. The hedge fund industry has developed only recently. In June of this year Italian hedge funds had some $24 billion of assets, equal to about 3 per cent of the total assets managed by Italian investment funds and 2 per cent of the global hedge fund market.

With regard to credit derivatives, at the end of 2005 Italian banks had purchased CDSs, to obtain protection from credit risk, for a notional value of €62 billion and sold CDSs, to provide protection, for $63 billion. Italian banks account for less than 1 per cent of the total volumes traded by intermediaries of the G10 countries.

Our system is faced with smaller risks in the innovative segments than are the more advanced markets, but it does not reap all of the benefits that come with the growth of innovative finance.

The risk factors deriving from the more traditional segments of activity also appear limited. Though expanding rapidly, household debt is equal to 44 per cent of disposable income, half the euro-area average.

In other sectors of international banking considerable progress has been made. Several of Italy's largest banking groups have seized the opportunities offered in Central and Eastern Europe by the privatization of banking systems and the growing presence of

Italian firms. Foreign operations generate an already important and rapidly rising share of earnings for these intermediaries. Set against the advantages in terms of profitability, there are the risks stemming from a transition to the market economy that is still in course and from the existence of significant macroeconomic imbalances.

The Italian banking system

The structural changes that the Italian banking system has undergone since the mid-1990s are well known. Mergers and acquisitions have involved some 80 per cent of the system's total assets. Compared with 1994, the average size of Italian banks and banking groups has almost tripled.

After slowing in the first years of this decade, the process of consolidation has regained momentum, thanks in part to foreign banks. The international opening of the Italian banking system must lead to an increase in the operating efficiency of the banks acquired. The benefits will be the greater, the more the foreign banks are able to reduce costs and improve the quality of services offered to households and firms. In this way the presence of large intermediaries can provide a stimulus to the growth of the financial system and contribute to economic development.

The managements of the new banks created through mergers and acquisitions have the complicated task of integrating, rationalizing and running complex organizations. Achieving the efficiency gains indicated in business plans requires a considerable and prolonged effort. Multi-country empirical studies show that the largest cost savings are realized through the diffusion at group level of the management techniques employed in the most efficient divisions of the individual banks. However, the greatest benefits of mergers and acquisitions come from the expansion of earnings.

The supervisory authorities will follow the consolidation and restructuring of groups paying attention also to the governance arrangements proposed in light of the challenges posed by integration.

The profitability of the main Italian banking groups today is comparable with that of their euro-area competitors; sharp disparities persist with respect to profitability in the Anglo-Saxon countries, where the breadth of the financial markets makes for greater sources of earnings. Their operating efficiency, gauged by the ratio of costs to earnings, is in an intermediate position, lower than that of the Spanish banks and higher than that of the German and French banks. According to preliminary data, in June of this year the capital ratio of the main groups was 10.2 per cent, slightly higher than at the end of 2005.

Competition has increased above all in the business loan and the deposit markets, where profit margins have narrowed significantly. But in some retail markets, such as low-value payments and consumer credit, the prices and fees charged to customers are still quite resistant to competition.

Measuring the cost of banking services to customers is a controversial matter, especially where international comparisons are involved. Looking beyond the specific problems relating to computation procedures and methods, it is necessary to remove the obstacles to the full unfolding of competition. Consumers must have full access to exhaustive information on the price and quality of the services offered, so that they can compare the different banks' terms and conditions for similar contracts. The direct and indirect costs of closing bank accounts should be eliminated, thus fostering customer mobility.

The efficiency of the banking and financial system also depends on the quality of the rules governing the operation of the economic system and on their application. In Italy, as in other advanced countries, a process of regulatory adjustment intended to reconcile stability with allocative and operational efficiency is under way.

Italian supervisory regulation is now in the process of incorporating the New Basel Accord and the related European directives. The new provisions achieve closer correspondence between intermediaries' risk profile and their endowment of capital and foster the use of best practices in risk measurement and management methods. This will make it possible to eliminate the many rules that indirectly pursue the same objective of bank stability by imposing restrictions on particular business segments. The banking system will gain enhanced flexibility to adapt to the needs of the economy.

Credit and corporate finance in Italy

This year the Italian economy has returned to a growth rate of nearly 2 per cent, thanks principally to the recovery in exports and gross fixed investment. Firms have increased their recourse to credit both to sustain the acceleration in production and for corporate actions. The abundant supply of credit has kept the rate of growth in lending well above that in nominal GDP with no strain on interest rates. Plentiful credit is flowing to firms in the South, thanks in part to the strengthening of supply structures in years past, even though the signs of the economic upturn in that part of the country are more uncertain.

Elasticity of the credit supply with respect to demand is especially important in an economy like Italy's with so many small and medium-sized enterprises. For the vast majority of smaller businesses, banks are the main source of external finance.

The increased degree of concentration of the banking industry at national level has not resulted in a diminution of competition. Indeed, the average number of intermediaries in local credit markets, where the smaller businesses deal with their banks, has risen sharply. In 1996, there were 29 banks operating in each Italian province on average; now the figure is 36.

The quality of bank-firm relations too has improved. In the mid-1990s only about one quarter of loans to businesses had an initial maturity of more than five years, but now the share is close to 40 per cent. Although this is still far from the euro-area average, which exceeds 50 per cent, the increase reflects a shift towards more stable relationships. There has been a steady reduction in the practice of borrowing from multiple banks. Since 1998, the share of firms dealing with more than one bank has fallen from 43 to 36 per cent, while the share of total credit granted by the prime bank has risen from 40 to 51 per cent. The vast majority of small firms have only one bank. Statistical analysis confirms that the concentration of credit relations is not simply the automatic effect of the reduction in the number of banks but instead reflects a real change in behaviour.

The decreased fragmentation of relations with banks has helped to stabilize sources of finance, lowering the cost of coordination between creditors. In unfavourable cyclical phases this has furthered a lengthening of firms' debt maturities and prevented transitory difficulties from degenerating into insolvency.

Relationships on a long-term footing, in which both sides have an interest in sharing information and an incentive to cooperate, assist companies' growth and diminish the risk for banks.

In this positive development, small banks have played a major role. Rooted in the local economy, they have been able to understand and serve the needs of firms even in the face of slow growth and declining competitiveness.

Large banks have given priority to strategic choices aimed at developing the most innovative sectors. This has led to significant losses of market share in more traditional lines of business and in dealings with smaller firms. In the case of loans to firms the market share of the ten main banking groups was 60 per cent at the end of 2005, some 13 percentage points less than in 1996. Only recently have signs emerged of this trend reversing.

The competition between banks having different characteristics and offering a wide range of services contributes to the overall efficiency of the credit market. Small banks, which can exploit comparative advantages deriving from their closeness to firms and their greater knowledge of local economies, must nonetheless not abandon the search for innovative ways to support the growth of their customers.

Large banking groups, the channel for the dissemination of innovative forms of financing and the supply of services needed for the strengthening of firms' equity, must nonetheless pay greater attention to promising small and medium-sized businesses and help them to gain access to the capital markets.

The relationships between banks and firms are affected by institutional and legal factors that influence the working of credit markets. The Bank of Italy has repeatedly drawn attention to the lengthiness and costliness of loan recovery procedures, which impose a larger burden on banks and customers than in other countries.

The size of the underground economy is a further obstacle to the expansion of banking and financial activity, especially in some of the regions in the South, with adverse effects on growth. It is estimated that an increase of 1 percentage point in the proportion of unreported employment reduces the ratio between loans to firms and value added by 2 percentage points. The underground economy also decreases households' demand for credit and the demand for other banking and financial services.

The Government has prepared a series of measures to reduce the size of the underground economy. It is in businessmen's interest to provide banks with reliable and comprehensive financial information. It is up to banks to assess the creditworthiness of firms that regularize their positions and to supply the financing they need in order to grow.

The ability of small and medium-sized firms to obtain credit will not be adversely affected by the New Basel Accord nor by the EU implementing directives. The impact analysis carried out recently by the Basel Committee shows that the new capital requirements for loans to small and medium-sized firms are generally lower than those currently in force, especially for banks that adopt the most advanced approaches to the measurement of credit risk.

The Bank of Italy has analyzed the change in the relationship between firms and banks with the entry into force of the new regime. As part of a national survey, a sample of industrial and service firms were asked about their knowledge of the new rules, their awareness of the possible repercussions on their businesses and the steps they had taken to be well positioned in the new context. The results show that 40 per cent of firms, and nearly half those with more than 49 workers, have assessed the effects of Basel II on their operations. A sizable proportion of the sample held that the most suitable strategies for the new regulatory framework consisted in making better information available, bolstering their equity and strengthening their relationships with a small number of banks.

Conclusions

As matters stand in Italy today, the top priorities are to increase the rate of growth of potential output and revive the competitiveness of the economy as a whole. The financial system is called upon to contribute to achieving these goals. Important progress has been made; it is necessary to move ahead along the path taken.

More efficient credit markets together with stable relationships between banks and firms are important for the financing of economic activity. For some categories of firms the sources of external finance cannot be limited to bank credit, however. Equity and bond markets are the second pillar of an advanced financial system.

Removing the obstacles that hinder recourse to the capital markets by more firms and limit the scope for using innovative instruments to finance the most viable business projects must be a priority for economic policymakers. It is up to businessmen to adopt medium-term growth strategies and to make the best use of the instruments offered by the financial system.