

49th Credit Day

*Banks, other financial intermediaries and firms:
what needs to be done for Italy's development*

Finance and development

Speech by the Senior Deputy Governor of the Bank of Italy and
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INDEX

Italian finance has begun to change	4
Yet this is not enough	5
Firms	6
Institutional investors.....	8
The rest of the financial market	10
The outlook	11

The theme of this year's Credit Day is not new, but the Italian economy's current status makes it relevant and topical once again. What role can finance play in transforming our economy's cyclical growth into real, long-lasting, structural growth? The type of growth that Italy hasn't seen for the last 20 years, though it alone can help us lower unemployment levels, improve the quality of labour, and raise living standards in a stable way? In other words, put Italy at the top of the list of advanced countries, as it was in the past?

By finance we mean all the financing activities on the part of families and firms, undertaken by financial intermediaries such as banks or other non-bank professionals or entities working directly in the financial and capital markets. We will look at it in terms of both supply and demand, and will then assess both the behaviour of those needing financing and the products offered to satisfy those needs, including the manner in which they are offered.

For some time now we have been saying that Italy's financial structure must change if we also want the productive economy to move towards greater growth. We would like firms to make greater use of the markets and to rely less on financial intermediaries, especially banks. Paradoxically, by downsizing their role banks may find a path towards greater profitability, offering higher returns on their growing capital. In essence we would like a virtuous cycle, one that fosters greater growth for the economy and more stability for the banking system.

The reasons behind this wish are well established so I will not dwell on them: most important of all is the fact that growth feeds on innovation, which is a riskier proposal than proven, traditional productive activity, and it is best to finance innovation with capital rather than loans, especially bank loans,

because banks are, and must be, more risk averse than the rest of the financial community.

Two weeks ago in Courmayeur I focused on the glass being half empty, that is, the road that still separates us from this objective. Today I would like to look first at the glass being half full, focusing on the progress that has been made over the past few years.¹ My analysis will focus on firms and their demand for financing.

Italian finance has begun to change

Since 2011, private-sector firms' leverage has fallen by more than 7 percentage points to 42 per cent (excluding banks and other financial professionals, calculated as the ratio between debt and debt plus net capital).

This reduction has affected firms of all sizes. In large firms (those with more than 250 employees or with assets or turnover above €50 million) this was mostly due to an increase in net capital, thanks to the positive effects of the recovery, which has favoured both higher market value for capital and the reinvestment of profits in firms. The allowance for corporate equity (ACE), a measure enacted in 2012 which finally gave risk capital and debt the same tax treatment, also played a part.² However, the weakening of this measure as of this year will greatly limit its effects going forward.

Leverage has decreased in the other size classes too, though mainly due to the decline in bank loans: many small firms, already greatly in debt, have left the market or found it difficult to renew their credit lines.

¹ See I. Visco, Address by the Governor of the Bank of Italy, Italian Banking Association, Annual Meeting, Rome, 12 July 2017.

² On the effects of the ACE, see N. Branzoli and A. Caiumi, 'Tax incentives and financial stability', Banca d'Italia, Questioni di economia e finanza (Occasional Papers), forthcoming.

Recourse to the stock market has increased, especially in recent years. Between 2014 and 2016 over 60 firms were quoted on the stock exchange, mainly on the Alternative Investment Market (AIM), a market segment with lower entry costs. In the same period, investments by private equity and venture capital firms in risk capital returned to pre-crisis levels of around €5 billion a year. Despite the positive contribution from various public schemes, such as the Italian Investment Fund and the Business Register for innovative start-ups, the share of investment in start-ups or in high-growth firms is still modest by international standards: in 2016 it stood at 15 per cent, against 23 per cent in Germany and almost 40 per cent in France and Spain.

During the crisis, not only did the relative weight of debt and risk capital change, but so did the composition of firms' sources of debt, with a growth in bonds to the detriment of bank lending.

Since 2011 the share of bonds in overall financial debt has risen by 5 percentage points to 12 per cent; that of loans granted by Italian banks has fallen in equal measure to 61 per cent.

During the most acute phases of the credit restriction triggered by the global financial crisis and then by the European sovereign debt crisis, recourse to the financial market proved to be feasible only for a few large industrial groups that were already active in that market. However, the number of issuers has grown in recent years, also among small firms, thanks to the removal of tax burdens and legal constraints on unlisted companies: for example, around 140 firms have issued minibonds worth over €10 billion since the relative measure came into force in 2012.

Yet this is not enough

Now we come to the half empty glass. The progress made is undeniable, but there have not been sufficient changes to the Italian financial structure. Our system still puts too much emphasis on financial debt and not enough on risk

capital, and banks continue to play too big a role in it, which then backfires, making them more vulnerable during the negative phases of the economic cycle. This makes life more difficult for those who want and are able to invent, to paraphrase the historian Carlo Maria Cipolla, 'new things that please the world', which is the only way to create solid economic development.

This slow progress is explained by the particular characteristics of Italian firms, which influence demand, and those of financial entities, which influence supply. Let's look at some of them. I must warn you that I shall be focusing on insurance companies, regardless of their current importance in corporate financing, for reasons connected not only with my role but also with the future prospects for this issue.

Firms

Let's begin with the demand side, or rather with firms asking for loans. I don't think anyone will be surprised if I remind them that Italian firms are smaller than those in the other advanced countries. It is a well-known fact, the causes and consequences of which have been widely debated. In a recent book written by Anna Giunta and myself, which cites official Istat data for 2012, the issue is summarized as follows:

... our economy ... has a great many firms with a very low average number of staff: more than 4,426,000 firms in industry and services average 3.7 employees each (9.2 in the manufacturing sector) ... in Germany micro-firms (up to nine employees) make up 84% of the total, in Italy 95%; 39% of employees in German industry work for large firms (250 employees and over), in Italy 22%.³

³ A. Giunta and S. Rossi, *Che cosa sa fare l'Italia. La nostra economia dopo la grande crisi*, Laterza, Bari-Roma, 2017.

Company size and type of governance are inter-related and here we can see another characteristic of our firms from an international point of view: they are family firms not only as regards ownership and top management but also as regards the second and third lines of command.⁴ Recent analyses show that between 2008 and 2015 this tendency increased.⁵

Small family-owned firms where there is a strong presence of family members in management are less productive, more poorly managed and less inclined to innovate – and there is plenty of empirical evidence to support this.⁶

This is already sufficient to explain why this kind of firm tends to approach a bank when it needs external financing rather than issuing bonds to be traded on the market or selling its own shares privately to a fund or publicly on the stock exchange. I would like to quote a couple of recent research papers on the Italian market, written by Bank of Italy economists, according to whom, in line with findings in the international literature, firms' recourse to the bond market essentially depends on three factors: the need to fund new investments; the company's reputation and transparency vis-à-vis investors; and balanced financial and capital conditions.⁷

For our companies to want and be able to obtain funds from non-bank financial institutions or directly on the market, they need to: increase the level of management transparency; improve the quality of governance; produce balanced and credible financial statements and industrial plans; and undergo a profound cultural shift, including by acquiring new financial skills and

⁴ A. Giunta and S. Rossi, *op. cit.*

⁵ M. Bugamelli and F. Lotti, 'Productivity growth in Italy: a tale of a slow-motion change', forthcoming.

⁶ M. Bugamelli, L. Cannari, F. Lotti and S. G. Magri, 'Il gap innovativo del sistema produttivo italiano: radici e possibili rimedi', *Questioni di Economia e Finanza (Occasional Papers)*, 121, 2012. For an international comparison see N. Bloom and J. Van Reenen, 'Why do management practices differ across firms and countries?', *Journal of Economic Perspectives*, vol. 24(1), 203-224, 2010.

⁷ M. Accornero, P. Finaldi Russo, G. Guazzarotti and V. Nigro, 'First-time corporate bond issuers in Italy', Banca d'Italia, *Questioni di Economia e Finanza*, 269, 2015; N. Branzoli and G. Guazzarotti, 'Il mercato dei private placement per il finanziamento delle imprese', Banca d'Italia, *Questioni di Economia e Finanza (Occasional Papers)*, 262, 2015.

developing relations with investors whose needs are very different from those of a traditional bank. All this is already within the reach of many medium-sized and large firms. This needs to extend to other companies too.

Institutional investors

On the supply side, the first requirement of a thriving economy is to have a large number of active institutional investors: insurance companies, pension funds and other asset management entities involved in managing savings, which facilitate the flow of resources to innovative firms with high growth potential.

In Italy, the share of managed assets in households' total financial assets remains below the average for euro-area and English-speaking countries, despite strong growth in recent years (in 2016 the total volume managed by institutional investors exceeded €1.4 trillion and reached 85 per cent as a proportion of GDP). More importantly, only a small share of these resources currently flow into the productive system. Institutional investors hold just over one tenth of corporate bonds. In France, where the capital market is more developed, the share is over 40 per cent.⁸ And that is in a context where total bond issues are at much lower levels than in Italy. Investors are certainly deterred by the limited development of pension funds and of intermediaries specializing in the placement and underwriting of corporate debt instruments, such as private debt funds, but there are also more wide-ranging reasons.

Let's look at the insurance sector. Insurers' investments to cover technical reserves focus on Italian government securities, with little appetite for corporate bonds, much less equity. So far, insurance companies have

⁸ M. Accornero, P. Finaidi Russo, G. Guazzarotti and V. Nigro, 'The Italian corporate bond market: missing investors or missing issuers?', Banca d'Italia, forthcoming.

shown limited interest in the legislative and regulatory changes made to encourage investment in productive firms.

Prudential regulation on own funds obviously influences this approach. As we know, Solvency II introduced the principle that insurers' assets – on which the solvency capital requirement is calculated – must be valued according to riskiness, instrument by instrument. The metrics are very granular and complex even when using the simplest of the three permitted methods, i.e. the standard formula.

Non-rated bonds and unlisted shares are seen as very risky instruments with high capital absorption; however, it is precisely these instruments that small and medium-sized enterprises (SMEs) can issue, and it is these, alternative to traditional bank loans, that we would like Italy's numerous SMEs should make use of.

At IVASS we conducted a survey of insurance companies' investment policies one year after the launch of the new regulatory framework. They have not changed much. So the marked preference for government securities, especially Italian ones, and corporate bonds with a high rating is not new. Solvency II added the strong argument of capital absorption to insurers' deep-rooted reluctance to invest in securities that are not perceived as very safe.

The issue of financial support for SMEs, and the part that insurance companies can play in this, is not just an Italian problem, but rather a European one. The project for a capital markets union must take into account any regulatory obstacles posed by Solvency II. The European Commission has recently sent a Call for Advice (CfA) on the matter to the European Insurance and Occupational Pensions Authority (EIOPA), which shall reply by the end of February 2018. Among the points which EIOPA will have to address are insurance companies' investments in non-rated bonds, unlisted equity and strategic interests, and how these are treated in order to calculate the solvency

capital requirement. The idea is to reduce capital absorption without sacrificing anything in terms of the prudence needed in assessing a company's capital adequacy – in short, to rationalize rules rather than soften them.

At IVASS we observe these possible developments at EU level with great interest, aware that Italy's economic and financial structure badly needs to evolve. We are supervisors, of course, and our mission is to guarantee that insurance companies are sound in the best interest of the insured. We must never forget that. But we are always ready to step in when reason and common sense must be added to the rules that we are called upon to set at European and national level.

The rest of the financial market

If further progress is to be made in overcoming the difficulty of matching the demand and supply of funds then it is important that markets, technologies and stakeholders develop the capacity to 'bundle' corporate risk into financial instruments that meet the needs of final investors, such as insurance companies, pension funds and households.

An example of this is venture capital funds, which use their ability to evaluate young and highly innovative firms to reduce the very high idiosyncratic risk of individual firms for their investors. Similarly, securitization companies can offer investors bonds with different risk/return profiles bundled into portfolios of assets not individually negotiable.

Banks play a crucial role in this evolution of the productive system's model of financing, a role that affects not only firms but investors and infrastructure as well. Banks can exploit their knowledge of the country's entrepreneurial fabric and their key position in the distribution of savings products, and they can provide valuable financial advisory services, helping those firms that can gain access to the stock market or to forms of financing other than loans; they remain at all times an indispensable reference point for

small firms. Offering a broader range of services can in turn help them to diversify their sources of income.

The outlook

Opening up firms to external investors and developing a non-bank financial industry are among the objectives of Europe's capital markets union project. The European Commission recently published a report taking stock of progress so far and relaunching the whole project.⁹ It is the most promising international scheme in this area, despite the uncertainty and lengthy negotiation times typical of European projects.

In the meantime, Italy needs to make a move.

In an attempt to increase the share of savings invested in the productive system, the Government has recently set up individual savings plans (Piani Individuali di Risparmio, PIR), asset management products that are eligible for reduced taxation. Just a few months after their introduction, the amount of funds collected, over €5 billion, is more than the Government itself had projected. This is good news, although the risks should not be underestimated, particularly as regards investor protection.

Another instrument that is fairly new to Italy and is proving increasingly successful is the SPAC (Special Purpose Acquisition Company). Basically, it is a small private equity firm that gathers funds from few investors on the basis of the promoters' personal reputation. The money is then used to gain control of a single target firm, which must be acquired within a stated period of time of having set up the SPAC. A SPAC is listed and it in turn speeds up the target firm's listing.

⁹ Communication from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions on the Mid-Term Review of the Capital Markets Union Action Plan, COM(2017) 292 final.

These are all interesting signs, and they need to take firm hold. Italy's entire financial system must change to address the best and most innovative firms, helping them to grow. The whole of Italy's economic future depends on it.

