ABI

Italian Bankers' Association

Annual Meeting

The Italian banking system
Competition, efficiency, growth

Address by the Governor of the Bank of Italy

Antonio Fazio

Rome, 23 June 1999

Contents

On several occasions, and most recently in my Concluding Remarks to the shareholders' meeting of the Bank of Italy on 31 May, I have dwelt on the evolution of the Italian banking system, its ability to cope with competition in Europe and the global economy, and the essential contribution it can make to Italy's economic stability and growth.

Consolidation is under way as a consequence of the competition that has been stimulated, at the national level, by deregulation and despecialization and, at the international level, by complete capital mobility and the emergence of a global financial market. The privatization of ownership has made rapid progress. Foreign investors are increasing their shareholdings in Italy's largest banks.

Competition

Banking competition has been one of the primary objectives of credit policy since the end of the seventies. As long ago as the early eighties the Bank of Italy removed a series of restrictions on public banks' operations. The entry of competitors into the more highly concentrated credit markets has been progressively facilitated. Supervisory activity has come to be based on prudential rules that respect the freedom of banking enterprises to allocate financial resources according to market logic.

The liberalization of branching and of the opening of new banks at the beginning of the nineties and the despecialization sanctioned by the 1993 Banking Law have further increased the scope for competition between intermediaries having different origins and features. With effect from this year banks can market their products through insurance companies and provide consumer credit via retail stores.

The presence of foreign banks has provided a stimulus to competition and product innovation. The market share of their branches and subsidiaries has risen, in terms of assets, from 3 to 7 per cent during the nineties; it is now in an intermediate position with respect to the figures recorded in the other main banking systems of continental Europe: 12 per cent in France and Spain and 4 per cent in Germany. Foreign banks in Italy have particularly high shares of certain markets, such as lending to households, trading in government securities and the supply of advanced corporate finance services.

Foreign banks own a higher percentage of the capital of large banks in Italy than in the other main European countries. At the end of 1998 foreigners held more than 10 per cent of the equity of each of the five leading Italian banking groups. Only in Spain is the level of foreign penetration comparable. In Germany, direct investment in banks is virtually non-existent.

By international standards, the public ownership of banks in Italy is limited. Only two of the ten largest banking groups are still publicly owned; they account for 7 per cent of the system’s total assets. Large public banks are more numerous and of greater importance in France, Spain and Germany.

The market share of banks controlled by the State or by banking foundations was 68 per cent at the end of 1992 and fell to 42 per cent in 1996. It has contracted rapidly in the last three years, since rising share prices have encouraged disposals, and now stands at 17 per cent. The resulting market scrutiny and increase in the contestability of control have spurred banks into placing more emphasis on efficiency-oriented strategies.

The search for business structures that can withstand the mounting competition has led in Italy to a very large number of acquisitions and mergers between banks. During the nineties, under the rules and procedures in force, authorization has been given for concentrations involving 457 banks and 35 per cent of the system's total assets. The proportion of bank capital that has changed hands is one of the highest to be found in any country.

Following the launch of the single currency, the priority objective for Italy's major banks is to increase their ability to compete with the intermediaries of the other leading industrial countries. They are seeking to attain a size that will enable them to invest massive resources in developing innovative products and expanding and diversifying their channels of distribution.

Until the early nineties, consolidation mainly involved small banks. The process has intensified in recent years and now increasingly involves leading banks. The assets of the banks acquired or merged in the three years from 1996 to 1998 amounted to 540 trillion lire, compared with 320 trillion in the preceding three years.

The major banks, whose reference framework is global finance, need to consolidate further in order to achieve higher operating efficiency and competitiveness.

The five leading groups now control 43 per cent of total assets, compared with 37 per cent in 1992. The Bank has been informed of an important operation between two large banks, to which we have found no impediments; its completion will result in a group that ranks among the top ten in the euro area.

Mergers and acquisitions contribute to the acquisition of a high level of professional expertise; they prompt banks to renew their business techniques and management methods.

The Bank of Italy analyzes changes in the structure of markets and the behaviour of intermediaries on the basis of its regulatory and supervisory experience, the large volume of data it collects from the banking system and the knowledge it gains about local conditions through its branch network and continuous contacts with banks.

Concentrations between banks with overlapping branch networks may diminish competition at the local level; where this occurs, measures designed to facilitate the growth of competitors are imposed, including the disposal of branches by the banks involved.

The average number of banks doing business in each province rose from 20 to 27 in the eighties. In the nineties it has increased further, to 30. Seventy-six per cent of the population can choose between at least three banks in the municipality they live in.

The Bank of Italy adopts its decisions taking account of the opinion of the Antitrust Authority.

As the Treasury Minister recently recalled, the collaborative relationship between the two authorities is based on the memorandum of understanding signed in March 1996, which identified territorial and product markets for the purpose of protecting competition and defined the procedures for exchanges of information and their content. The new system has shortened the response time to notifications and simplified banks' reporting obligations.

The agreement provides a vital and viable basis for the work of the two authorities.

The choice made by the Italian parliament is justified by the intimate knowledge of banks and markets and how they operate acquired by performing supervision.

In the United States, which has the longest tradition of antitrust legislation, the Federal Reserve and the Office of the Comptroller of the Currency are responsible for assessing the anti-competitive effects of mergers and acquisitions for the banks they supervise.

The cost of bank credit in the main countries of the euro area has converged. With interest rates generally declining, the fall in Italy was larger than elsewhere. In the last quarter of 1998 the simple average of rates on current account overdrafts of between 1 and 5 billion lire was in line with the cost of comparable credit in Germany. Short-term lending rates were lower in France, owing to the ban on interest-bearing current accounts.

Bank lending rates came down by 2.3 percentage points in Italy in 1998. They continued to decline in the first five months of 1999. In May the average short-term rate was 5.5 per cent and the minimum rate 2.8 per cent. The average rate on medium and long-term loans was 4.1 per cent for firms and 5.6 per cent for households. Lending rates in Italy are now at their lowest level in fifty years.

In May the spread between short-term lending and deposit rates narrowed to less than 4 percentage points; in 1993 it had been equal to 6.1 points. For longer maturities, rates on new loans exceeded funding rates by 1.6 percentage points; in the fifties and sixties, an era of faster economic growth, the difference was 3 points.

There is still a gap between lending rates in the South and those in the Centre and North. Since 1995 it has fluctuated around 2 percentage points for short-term credit. According to a new survey conducted by the Central Credit Register, the differential for medium and long-term rates was less than 1 point in 1998.

The disparities are attributable to the greater risk of lending in the South, where the proportion of loans classified as bad debts each year is higher, the related recovery ratio lower and enforcement lengthier. The average lending rate applied in the South by southern banks is in line with that applied by banks based elsewhere in Italy.

Loans and loan quality

The proper allocation of credit is the contribution that the banking system can make to the choice of productive investments and the growth of the economy.

In 1998 the growth in outstanding loans exceeded that in both GDP and fund-raising. The increase in credit facilities was even larger.

The ratio of new bad debts to total loans dropped from 2 to 1.6 per cent.

The need for appropriate techniques and procedures to screen potential borrowers is increasing, partly because of the rise in the proportion of lending to small customers, who normally entail greater risk. This tendency is common to the banking systems of all the leading countries and reflects households' growing demand for credit and corporations' substantial recourse to self-financing and the capital market.

In Italy, the proportion of outstanding bank loans granted to consumer households and small businesses rose to 44 per cent in 1998, compared with 32 per cent in the mid-eighties. The sharpest increase was in those to households, which rose from 10 to 17 per cent of the total.

Risk control is especially important for banks doing business in areas of slow economic growth and limited product diversification.

Over the years, we have called on banks' managements to take action to ensure that their loan selection and management procedures provide effective control of the risks assumed. In accordance with guidelines agreed at the international level, the Bank issued supervisory instructions last October to promote the use of suitable internal control systems. Special attention was paid to the roles of the board of directors, the board of auditors and top management in setting risk management policy.

Portfolio diversification is increasing and counterparty risk and market risk are becoming more closely intertwined. It is necessary to raise the skill levels and efficiency of the units charged with assessing customers' creditworthiness.

Major foreign banks have developed new methods of measuring credit risk that take account of the correlations between the riskiness of individual customers. The Bank of Italy has conducted preliminary evaluations of these techniques, using data on the accounts of non-financial companies and their bank borrowings.

In the Basle Committee's revision of solvency ratios, the in-house models of individual banks, including those operating internationally, were not deemed to be sufficiently reliable as yet. Nevertheless, they offer a useful point of departure for the development of better techniques of risk control. A recent Committee consultation document proposes basing the calculation of capital requirements not only on rating agencies' evaluations of borrowers but also on the methods for classifying counterparties developed by banks themselves.

Several major Italian banks that have undertaken projects to develop client evaluation systems are taking part in international experimentation. The reduction in the cost of capital that such procedures may bring is especially important for banks that do business in markets, such as Italy, where formal rating is comparatively rare.

Intermediaries that have appropriate systems for classifying customers will have an advantage in the competition for corporate loan business.

The results for 1998

Italian banks staged a very strong recovery in profitability last year. Profits amounted to 7.8 per cent of capital and reserves, a figure close to those recorded in the early nineties. Between 1993 and 1997 banks' return on equity had fluctuated around 2 per cent.

The improvement was general. The proportion of total assets held by loss-making banks fell from 15 to 3 per cent, while that held by banks with returns on equity of more than 10 per cent rose from 6 to 39 per cent. Retained earnings increased from 900 billion lire to 6.9 trillion and own funds from 212 to 229 trillion.

The return to a level of profitability comparable with that of the rest of continental Europe was made possible primarily by a change in the structure of income. Whereas in 1990 net interest income had been equal to nearly 3.3 per cent of total assets, last year the ratio was 2.1 per cent. The decline was particularly pronounced in the last three years, in parallel with the increase in competition and the fall in market interest rates. Net income from activities other than lending and securities and foreign exchange trading amounted to 1.1 per cent of total assets and 31 per cent of gross income in 1998, compared with 0.6 and 17 per cent in 1995 and 0.5 and 12 per cent at the beginning of the decade.

Strategies for curbing costs have focused mainly on staff reduction. Since 1993 the number of bank workers has fallen by 22,400. In the last two years 13,400 employees near retirement age voluntarily left their jobs ahead of time under incentive schemes. To date these have cost banks 1.34 trillion lire; they will cost an additional 500 billion over the next few years. Excluding the effects of tax changes, per capita staff costs rose by 2.2 per cent in 1998.

Consolidation of the strong profit performance necessarily depends on further increases in income from services, especially those with a high value added, and more incisive cost-cutting measures. Provisional data indicate that income in the first quarter of this year was down by 4 per cent compared with the first quarter of 1998. The decline in net interest income and profits on securities trading was only partially offset by higher revenues from services.

Rapid growth in income from services, the first effects of restructurings and improved asset quality have enabled larger banks to outperform the system as a whole.

The return on equity of the eight banks classified as “major” rose to 8.1 per cent last year and that of the sixteen “large” banks to 8.3 per cent; for the rest of the system it was 6.3 per cent.

For the major and large banks, fee income amounted to 34 per cent of gross income, 8 percentage points more than for the rest of the banking system. The differences between the ratios of net interest income to total assets of the various size classes narrowed significantly; in the past smaller banks had achieved much higher returns.

Last year’s performance narrowed the gap in profitability between large Italian banks and the leading intermediaries in other countries; the disparity with respect to British and American banks remains substantial.

American and British banks benefit from the buoyant growth of their domestic economies, from doing business in more highly developed financial markets and from having adjusted to the new, more competitive economic environment in the early nineties. In Britain and the United States the ratio of the largest banks' operating expenses to gross income is 67 per cent, about 6 percentage points lower than in continental Europe.

For the largest Italian banks, the contribution of services to overall earnings remains limited, despite the rapid growth recorded in recent years.

One of the main reasons for bank mergers and acquisitions is to increase fee income.

The role of the stock market

The total indebtedness of Italian firms is not out of line compared with that of their counterparts in other countries, but it is skewed towards short-term bank loans.

Listed companies had a ratio of financial debt to shareholders' equity of 58 per cent at the end of 1997, compared with an average of 108 per cent for all the non-financial firms covered by the Company Accounts Data Service; they also had a smaller proportion of short-term bank loans. Stock exchange listing is associated with a reduction in indebtedness and the achievement of a more solid financial structure.

Listing also makes it possible to lower borrowing costs, by improving firms' standing and transparency for banks as well as the market. The advantages deriving from access to regulated markets are confirmed by empirical studies.

The capitalization of the Italian market, at 45 per cent of GDP, is considerably lower than that of the main foreign markets. The growth since 1994, when the value of listed shares was equal to 18 per cent of GDP, is essentially attributable to the rise in prices. The contribution of new listings has mostly been the result of privatizations. At the end of 1998 there were 223 listed companies, as in 1994. During the same period the number of listed national firms rose from 423 to 740 in Germany, from 489 to 754 in France and from 2,070 to 2,399 in the United Kingdom.

Non-financial firms accounted for 54 per cent of the capitalization of the Italian stock market in 1998. In France, Germany and the United Kingdom the figures were between 70 and 85 per cent. Banking shares account for almost 30 per cent of those listed on the Italian stock exchange, a far higher figure than in other markets.

Between 1994 and 1998 turnover on the exchange rose from 60 to 100 per cent of market capitalization; trading in derivatives also expanded strongly, with positive effects on the efficiency of the spot market.

The limited size of the stock market reflects the peculiar structure of production in Italy, where small firms play a dominant role. Among the key factors holding firms back from listing are the fear of losing control and the costs associated with increased visibility.

The still inadequate development of the Italian securities market limits the range of services and growth in income banks can achieve in their business with firms.

When Italian issuers sell securities domestically, the placement syndicates are normally led by Italian banks, which have played a major role in the placement of all the public offerings of shares made in the last five years. Their involvement in advisory services and international placements nonetheless remains unsatisfactory.

The development of banking and the capital market must proceed hand in hand. Firms will be able to count on a wider range of fund-raising instruments; banks will benefit from new opportunities to provide services and advice to companies seeking a listing, to place debt securities and to participate in restructuring operations. In performing these activities they can benefit from the relationship of trust built up with customers.

In the context of the global market, corporate governance plays an important role in attracting domestic and foreign investors.

Last year, at the same time as leading companies were being privatized, the enactment of the Consolidated Law on Financial Intermediation completed a reform of the rules on the corporate governance of listed companies aimed at reconciling the interests of all the parties involved in firms' fortunes and in particular at strengthening the protection of minority shareholders.

A general overhaul of company law should now be accomplished in order to foster the growth and competitiveness of Italian firms by radically simplifying regulations, considerably broadening companies' autonomy in drawing up their bylaws, and placing a higher value on the entrepreneurial nature of firms while respecting the need for transparency, especially in the case of unlisted firms that seek to raise funds in the bond market.

It is crucial that the new rules be sufficiently flexible and not impose additional operating and organizational costs on small and medium-sized firms.

Italy is rich in entrepreneurs and people with plans for setting up businesses and the desire to compete. In a context marked by increasing international integration and the curbing of protectionist practices, it is necessary to ensure that firms are subject to simpler rules and operate in an environment conducive to growth.

The fundamental contribution that credit policy can make to the stability and growth of the Italian economy is to continue to strengthen the banking system by enhancing its soundness and efficiency.

Small and medium-sized banks serving local economies must exist alongside larger banks able to compete in the European and world markets.

Competition brings lower unit costs, encourages innovation and acts as an incentive to achieve the best size to compete successfully with the large international banks.

Considerable progress has been made in the last three years. The average size of the largest banks is growing, but further consolidation is necessary. There is a pressing need for the banking system to render its use of labour significantly more flexible. For the sake of the stability and growth of banks and of the persons employed in the sector, the objective of containing unit labour costs and broadening the range of services must be pursued more resolutely to bring conditions in the Italian banking system more closely into line with those in European and international markets.

The measures taken in the southern regions, at a limited overall cost to the public purse, have averted the risk of systemic instability and enabled banks to return to full operation. Governing bodies have been replaced and internal causes of inefficiency removed while safeguarding the value of accumulated savings and business with creditworthy customers.

The efficient allocation of credit and proper procedures are necessary to the stability of banks. Even more importantly, they bring benefits for the economy and for firms by ensuring the most viable and profitable investment projects are selected.

The prospects for the banking system depend crucially on a recovery in investment, both public and private, in the less developed regions and in the Italian economy as a whole. Italy has both the resources and the potential for faster growth, but if they are not exploited profitably at home they will take the form of capital outflows and investment abroad.

An institutional and economic environment conducive to growth and an increased propensity to invest require a stable economic policy leading to an incomes policy focused on the relationship between wages and productivity; a start on reforms that, by curbing the growth of current expenditure, make resources available for investment in infrastructure and a gradual reduction in the tax burden; laws that foster the development of small firms; and additional efforts to bring about a real improvement in the machinery of government.

The determination shown by the Government in proposing and implementing policies to overcome the difficulties the economy faces, coupled with confidence that Parliament — albeit with the necessary dialectic between legitimately different viewpoints — will work to achieve these objectives, suggest it may be possible to make full use of the resources available and return to the higher growth rates needed to reduce unemployment and irregular employment.

For our part, in supervising the banking system we shall continue to orient market forces and stimulate the system to achieve the scale and efficiency that will enable it to enhance its contribution to the nation's stability and economic and social advance.