Italian Bankers' Association

Annual Meeting

Progress in the Italian banking system

Address by the Governor of the Bank of Italy
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In the last few years concentrations have given birth to six large banking groups whose assets are equal to 59 per cent of the industry total. In total, there are 74 banking groups comprising some 1,000 undertakings: banks, other financial intermediaries and instrumental companies. More than 200 Italian banks, accounting for 90 per cent of total assets, are members of these groups.

The improvement in loan quality and the rapid expansion in the demand for asset management services have enabled banks to increase their income. The growth in costs has been curbed. The return on equity has risen to values well above those of the past.

The creation of the large groups has been marked by a diversity of approaches and carried out in stages. In some cases strategies have been revised a number of times. Different organizational models have emerged, in part reflecting the specifics of the individual operations.

It is now necessary to consolidate strategies.

The restructuring process is not finished yet.

In recently formed groups, consolidating and improving current levels of profitability requires further measures to achieve unitary management and rationalize costs. The complexity and uncertainty that mergers inevitably introduce into the definition of corporate objectives, risk management systems and operational procedures must be overcome. Capital bases must be made commensurate with the risks implicit in complex organizational structures by means of multi-year programmes.

The recovery of efficiency must be consolidated within a framework of stable group structures.

Integrating the different companies' information systems is essential for group coordination and the centralized control of risks. It requires decisions on the use of technology and absorbs human and financial resources; it is complex for the more diversified groups and those with structures abroad.

Studies of the leading banking systems indicate that efficiency gains are fully achieved several years after the conclusion of concentrations. At times there is a considerable gap in the timeframe and scale of benefits between what is envisaged by advisors and announced at the time of the merger and what is actually achieved.

It is necessary to arrive at organizational arrangements that can increase the supply of high-value-added products, further reduce costs and strengthen the capacity to compete in the domestic and international markets.

The new technologies in the banking system

Information and telecommunications technologies are contributing to productivity gains, cost reductions and the development of innovative products.

Investment in data processing systems, calculated on a constant quality basis, rose at an average annual rate of 12.5 per cent in the nineties. At the end of 2000 the stock of IT capital per employee was more than four times that available in 1990.

Banks' assets grew by 25 per cent at constant prices between 1995 and 2000. In the same period the number of staff fell by 4 per cent. Labour productivity increased by 6 per cent a year.

It can be estimated that two thirds of the growth in productivity derives from technological progress and the remaining one third from the increase in capital per employee.

Banking ranks among the leading sectors in total spending on the new technologies. Their utilization in production processes has reached high levels in all banks, but the results are uneven. There is room for progress.

Appropriate skills and constant adaptation of production procedures are necessary. The benefits of technological innovation in terms of productivity are large where workers are more highly skilled and corporate restructuring measures more far-reaching.

The number of intermediaries whose customers can obtain information and carry out transactions over the Internet has grown rapidly. At the end of last year 462 banks offered their customers the possibility of carrying out transactions, often in connection with e-commerce initiatives. Use of the Internet brings lower fees for customers.

Around 2 million customers access banks' websites; more than half of them carry out transactions. Most Internet transactions involve securities and derivatives trading. The value of those connected with payment services is still small.

Just a few years ago it was widely expected that the Internet would become the prevalent channel for the distribution of a wide range of services. The experience to date in the countries where electronic commerce is most widespread suggests more prudent forecasts concerning the sector's possible growth.

Studies of American banks that operate exclusively via the Internet indicate that they encounter greater difficulty than intermediaries that also carry on business through branches. The investments in technology and advertising absorb massive resources. The range of services offered appears to be limited to standardized products. It is uncertain whether pure Internet banks will be able to achieve adequate profitability in the medium term.

A close complementary relationship is emerging between different channels of distribution. Customers show they want to maintain a direct contact with banks. The support of personalized service seems irreplaceable for a significant part of banking transactions.

The use of the new technologies requires companies' production processes to be redesigned. In diversifying supply over a variety of channels, it is necessary to avoid duplicate costs and excess capacity. The risks connected with outsourcing phases of operations and with the rapid changes of technology must be evaluated.

Banks' capital

A strong capital base is necessary to undertake investment, avoid rigidity in lending policies, and maintain a bank's high standing in the financial markets. Internationally, a broad consensus has been reached on requiring banks to hold more than the minimum amount of capital. This recommendation is addressed in particular to large banks active in international markets in view of the systemic repercussions of any trouble at such institutions and as a prerequisite for effective market discipline.

At the end of 2000 Italian banks' capital amounted to 230 trillion lire on a consolidated basis, or 10.8 per cent more than two years earlier. Over the same period risk-weighted assets expanded by 22 per cent, so that the average solvency ratio fell from 11.3 to 10.3 per cent. This is lower than the average for international banks in the other leading countries. No significant capital shortages were found, but total holdings of capital in excess of the minimum requirement diminished from 64.2 trillion to 50.6 trillion lire.

The soundness of banks is fostered by a composition of capital in which the higher-quality elements, equity and reserves, bulk large. The need to earn good returns on equity spurs bank managements to improve efficiency and develop high value added products.

For Italian banks capital and reserves have traditionally accounted for a large share of own funds by international standards. In 1999 it was 72 per cent, compared with 65 per cent in the banking systems of the other leading countries.

In recent years, however, core elements have accounted for only a quarter of the total growth in banks' own funds. In the space of two years subordinated liabilities increased from 31.5 to 54 trillion lire.

In contrast with the United States, where subordinated debt instruments are purchased by institutional investors that are in a position to assess the relative riskiness of the issuing banks, in Italy most such debt is placed with households via bank branches. The portion listed on organized markets is small.

Subordinated debt instruments sold to individual investors, which must clearly indicate the subordination clause, should carry simple conditions, above all as concerns the formula for determining the yield. The listing of subordinated debt instruments and their placement with institutional investors would lay the basis for a market that could help discipline banks' operating choices.

The international financial community is engaged in consultations on the proposal for a new Capital Accord put forward by the Basel Committee. The new rules seek to link prudential requirements more closely to banking risk.

Banks have expressed appreciation of the flexibility of the overall scheme. A sample of international banks are conducting a simulation of the impact of the new rules. We share the concern of the banks that consider the rise in capital requirements with the increasing probability of borrower insolvency to be too sharp. A better graduation of the risk-weighting curve to reflect the characteristics of small and medium-sized enterprises is being studied, in order to encourage a large number of banks to adopt the new internal ratings-based approach.

Borrower risk should be evaluated in the long run. This will attenuate the potentially pro-cyclical impact of the new capital requirements on the supply of credit.

The Committee considers it desirable to limit the capital requirements that will be imposed in respect of operating risk.

The complexity of the exercise and the need for careful consideration of the results have suggested holding another round of consultations early next year and deferring the entry into effect of the new capital accord until 2005. At international level we are engaged in improving the proposals that have been made, for closer correspondence with the features of Italian banking and the Italian economy.

Customer relations and transparency

An efficient credit system serves economic growth. Efficient credit is essential in an economy like Italy's with its preponderance of small businesses, which depend to a greater extent on bank loans. The ratio of bank debt to value added is 130 per cent for firms with fewer than 500 employees, 60 per cent for larger firms.

The appropriate use of contractual instruments, greater transparency and better customer relations, and adequate safeguards for creditors' rights are necessary conditions for improving efficiency in the allocation of credit.

The 1993 Banking Law imposes information requirements and rules on the form and substance of contracts, mechanisms for protecting customers against unfavourable variations in terms, and periodic notifications of changes in customers' positions. These rules have been supplemented by legislation and regulation by the credit authorities. The Bank of Italy's supervisory instructions are aimed chiefly at achieving broad compliance with the rules of correct conduct and good faith in business relationships.

Specific measures taken in 1999 and 2000 bore on the procedures for the issue of structured securities, which combine the features of derivatives and those of bonds. Savers are now in a better position to make an informed judgment of the risks inherent in such investments; they must carefully sift the proposals.

Through our branches we are conducting on-site inspections at banks to verify compliance with the disclosure obligations concerning the form and substance of contracts and, on a sample basis, methods of value dating and calculating interest. This year the inspections will cover branches of 159 banks, including the largest ones.

We are taking steps to make prior information on prices and conditions more effective. The banking system has instituted forms of self-regulation, laying down standards of conduct and creating procedures for the settlement of disputes.

Better relations with customers help to capitalize on improvements in service quality. It is up to banks' top managements to promote better understanding of the needs of households and firms and full compliance with the rules of conduct, in the awareness that the trust of the public is the foundation-stone of banking.

A survey conducted by the Bank of Italy in 2000 on the recovery of bad debts showed that the procedures are very lengthy: bankruptcy proceedings last for seven years on average; out-of-court settlements are reached more quickly, in about two years. The time taken to recover claims has been lengthening in recent years; it is longer in the South.

The lengthiness of the procedures has a significant impact on their cost and the percentage of claims recovered. Taking into account the loss of interest income while proceedings are under way, the recovery rate is on the order of 40 per cent. Where loans had been fully backed by collateral, the rate is in excess of two thirds. In Italy such loans account for about 50 per cent of total lending, as in Germany, the United States and the United Kingdom.

Recovery costs are substantial; on average the annual cost is equal to about 1.2 per cent of bad debts. The incidence is higher for smaller banks and for banks in the South.

The length of judicial proceedings tends to increase the recourse made to out-of-court settlements, especially in the South, where banks also require more collateral.

The inefficiency of the procedures for recovering bad debts discourages banks from supplying medium and long-term credit. In 2000 loans to non-financial enterprises with a maturity of less than one year were 35.7 per cent of such lending in the euro area, 50.9 per cent in Italy.

The improvement in corporate profitability and some of the economic fundamentals has brought an appreciable reduction in credit risks. In 2000 new bad debts fell to 1 per cent of total lending, compared with 2.5 per cent in the mid-nineties. The Italian banking system has accommodated the recovery in the demand for credit and generally applied favourable conditions.

The acceleration in lending has also involved the South. Although higher than the national average the risk of default has diminished significantly there too. The differential between interest rates in the South and the Centre and North is 0.6 percentage points for medium and long-term loans, 1.9 points for short-term loans. The gap has narrowed compared with the mid-nineties.

Better prospects for growth in the South, improved procedures for selecting borrowers, efficiency gains in the public administration are necessary conditions for the consolidation of the progress made in enhancing the quality of credit; they can help to increase the availability of funds for households and enterprises.

This is one of the ways of combating usury.

Usury is found where there is social and economic degradation. It flourishes outside the legal credit system.

The Bank contributes to the scrupulous application of the statutory rules in this field. But I have already had occasion to recall that, although administrative limits on bank interest rates reduce their dispersion, they worsen the allocation of financial flows. Ceilings on lending rates that are the same throughout the country may have the paradoxical effect of reducing the volume of legal credit where credit risk is highest and lead to the expansion of illegal lending.

Banks must improve their procedures for granting loans, ensure that valid initiatives do not end up outside the legal credit system. It is necessary to increase the awareness of households and enterprises of the consequences of making inappropriate use of money and borrowed funds.

Competence, correctness and foresight in the performance of banking make a decisive contribution to balanced economic growth and social development.

Strong local roots permit banks to acquire more knowledge about the system of small and medium-sized enterprises. It is necessary to improve the ability to select and finance investment projects in innovative sectors, which offer better prospects of boosting the economy’s growth. It is important that venture capital activity be developed in Italy too; to date it has been performed primarily by foreign intermediaries. It requires special skills and implies closer involvement in the management of the companies invested in.

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The international economic scene still appears to be dominated by uncertainty.

The figures for production and GDP in the quarter just ended will be less good than those for the first quarter, both in Italy and in the rest of the industrial world.

The level of equity prices has fallen, especially for high-tech stocks. The fact that prices in the other sectors have held up may reflect expectations of a recovery in the world economy, at least in 2002.

With the leeway provided by the budget surplus and the solidity of the dollar in international markets, economic policy in the United States is seeking to achieve an economic upturn starting in the second half of this year.

An upturn in world economic activity will attenuate the tensions present in some emerging countries; it will also have a positive effect on the Italian economy.

The limited international openness of the Italian banking system makes it less exposed to the risks that are still present in the global financial system.

In Italy the expansion of economic activity in the first quarter was sustained only by stockbuilding. According to the most traditional of the models of the business cycle, this would inevitably have an adverse effect on production in the following months. The data available suggest that industrial production in the second quarter was sharply down compared with the first. Households’ behaviour and expectations bode well for consumption.

The average annual rate of increase in investment and consumption will be lower than in 2000.

The increase in the oil price is producing its full effects on consumer prices. Average annual inflation should be less than 3 per cent this year and then ease in 2002.

The possible and necessary upturn in economic activity in Italy in the second half of this year and 2002, together with the favourable outlook for the long term, will consolidate the structural improvements in banks' accounts; it is necessary to continue the work of reinforcement and rationalization.

Well-capitalized intermediaries, efficient in managing financial flows and allocating credit, are an indispensable auxiliary, the financial infrastructure, for an economic policy aimed at reviving growth by means of an acceleration in private-sector investment and a greater commitment to public-sector investment.

Financial stability, public finances that are in order and economic growth constitute a triad to be realized by making the necessary changes to the structure and legal framework of the economy, with the cooperation of the social partners and the financial system.