

# The Italian Financial System in the Perspective of 1992

## 1. Introduction

Within the broad topic "Target 1992", I will devote my remarks to the Italian financial system, which, in the perspective of the completion of the Single European Market, must catch up with the more developed markets.

The creation of the single market is by far the greatest opportunity for economic progress in Europe for many years, comparable only to the creation of the Common Market 25 years ago and of the EMS in 1979. This new momentum in Community action is the combined result of market pressures and of institutional changes such as the majority decision-making procedures and the greater reliance on mutual recognition of national regulations. However, I would like to stress that the tasks to be achieved are truly formidable and many questions are still open. The great vision of the 1992 project requires — and deserves — a great deal of work if it is to be realized, especially in the financial field.

Some of this work will have to be done at the Community level and some at the national level; some specific steps will be required in the banking and financial field, while broader intervention will be needed in the field of economic policy-making; some changes are the responsibility of public authorities, others will have to be made in the private sector. Varied as it is, this list is not exhaustive and it would not be wise to try to cover all the possible issues in a short presentation. However, before tackling the questions raised for the Italian financial system, I would like to mention a few problems that require a Community solution.

## 2. The problems of regulation and supervision of financial activities at the European level

At the Community level the creation of the single financial market is entrusted to two policy instruments: first, the full liberalization of capital movements and second, the freedom of establishment and cross-border provision of services in the banking sector.

The two instruments are designed to work together. The former will act mainly on the demand side by giving savers and borrowers greater freedom of action. The latter will work on the supply side by granting each country's intermediaries access to all the other national markets. Both will increase competition and exercise a restraining influence on the price of banking products and financial services. In practice, however, their *modi operandi* are less similar than this symmetry suggests. The liberalization of capital movements will remove restrictions on cross-border financial flows but will not prevent national authorities from regulating financial markets and activities, provided this does not discriminate between residents and non-residents. A degree of administrative segmentation of markets will thus remain. By contrast, the freedom of establishment and to provide services on the basis of mutual recognition of home country prudential rules implies that banks incorporated in different countries will be operating side by side in the same markets but under different regulatory frameworks; the jurisdiction of supervisory authorities will be based on institutions rather than countries.

These innovations require far-reaching changes in monetary policy and in supervision. Without close monetary policy coordination, in an integrated European market and with an exchange rate system such as the EMS, there is a danger that countries might resort to restrictive adjustment measures, the costs of which would be exported to their partners. The danger of aggravating exchange rate fluctuations is also present and a strengthening of the EMS is therefore necessary. Similarly, in the field of banking supervision, Community-wide interstate banking will require a higher degree of convergence and integration of rules and practices than exists today.

At present European banking legislation comprises only three Directives and two Recommendations.<sup>1</sup> The "minimum harmonization"

<sup>1</sup> The First Banking Coordination Directive gives the criteria for authorizing the setting up of credit institutions, the other two Directives regard consolidated supervision and bank accounts. The two Recommendations cover, instead, large exposures and deposit protection arrangements.

programme envisages three additional Directives: the first to lay down the minimum requirements for banks to be allowed to operate across borders under the "mutual recognition" rules, the second to define capital for prudential purposes, and the third to set a minimum adequacy requirement in relation to risk assets. Even with these additions, we would clearly not have a full set of prudential rules by 1992, while there are a few basic issues on which a common stand should be taken before the completion of the single market, lest their solution be jeopardized.

Firstly, as regards the question of cross-border takeovers by Community banks, we obviously need to reach an agreed and fully reciprocal position. Secondly, as regards the separation of banking and commerce, it should not be impossible to achieve an adequate degree of convergence, since the difference lies more in what has actually been legislated than in appreciation of the importance of keeping some degree of separation. Finally, I would mention the question of a common position *vis-à-vis* non-Community banking systems, where we need to avoid the two opposite dangers of protectionism and a bilateral approach that would undermine the effort towards harmonization.

## 3. The development of the Italian financial system

On the question of what is needed in Italy if we are to be ready for 1992, it is, I think, important to recognize that the problem is not so much one of moving from one static equilibrium to another as of adding a new target, or a new direction, to a process of change that is already under way. Indeed, since the changes stemming from European integration will supplement those already set in motion domestically, we will probably experience a faster transformation than most other countries.

The rate of development of the Italian financial system in recent years can be gauged by comparing its present structure with its rudimentary form in the mid-seventies. At that time, bank deposits were virtually the only savings instrument, while bank loans were the dominant source of corporate finance. Correspondingly, the direct control of banks was the main instrument of monetary policy.

Today, investors can choose between a wide variety of assets. Bank liabilities have declined in relative importance but, with certificates of deposit gaining momentum, they cater better to customers' transactions and investment needs. A large and diversified market for government securities offering competitive yields has fostered a new willingness on the part of investors to purchase financial assets. The creation of unit trusts, increased corporate profitability and clearer regulation assisted the strong growth of the stock market in 1985 and 1986. Despite the difficulties that followed the boom, the qualitative improvement of the market has not been lost. This was reinforced by the reorganization of the clearing and settlement system for securities. Foreign exchange liberalization has ensured, for its part, complete freedom to invest abroad except in so-called monetary instruments. Even these will be freely available to Italian investors by 1990. When the relevant EEC Directive takes effect, it will create a situation of complete freedom, that has few precedents in the history of Italy since its unification.

Foreign operators are increasingly active on the Italian market and can now find fertile ground on which to practise their skills, enhancing both their business opportunities and the functioning of the financial system.

The broadening of the range of financial assets available to households has been matched by an increase in the external sources of corporate finance: the stock market has provided a significant amount of new capital; the growth of leasing and factoring has met new needs of firms; and a fledgling commercial paper market is adding new flexibility to the management of short-term assets and liabilities.

Despite the growing pressure of the budget deficit, this progress has enabled the monetary authorities to rely increasingly on indirect methods of monetary control. Monetary policy is now essentially conducted by regulating the rate of interest at the very short end of the market via open market operations. The overnight rate and bank liquidity transmit the impulses, thanks in part to the increased flexibility of the three-month Treasury bill rate, to those segments of the market whose conditions influence private agents' behaviour. This transmission, however, is neither smooth or fast enough, and this is a field in which much work is being done.

The reform of the secondary market for Government securities has eliminated an awkward situation: transactions in these securities on the official market represented a tiny proportion of total trading, yet they were the only ones for which an organizational framework was available.

Now, with a screen-based system of dealers for wholesale transactions paralleling the stock exchange, the transparency of the market and its liquidity and breadth have been significantly enhanced.

The payments system is also undergoing substantial change. The scope of the whole exercise is often summarized by noting that the settlement of a cheque issued in a town different from the one where the deposit is held can, in some unfavourable cases, take up to a month in Italy, against 3-4 days in most other European countries. This is indeed an important problem in itself as well as an effective summary indicator of the inefficiencies of the system. These are much more pervasive, however, and consequently require far-reaching solutions. One of the systemic advantages the reform will bring about is a substantial improvement in the interbank market. This currently comprises, on the one hand, a small overnight segment, which is very — indeed often too — reactive to changes in liquidity conditions and, on the other, a large segment made up of bilateral accounts, which is cumbersome and marked by sticky prices. In between, there is little room for a market to spread signals concerning the stance of monetary policy and, at the same time, to absorb erratic liquidity changes. By relieving the market of the burden of the large bilateral accounts, the reform of the payments system should bring a remedy for this situation.

The stability of the overnight rate, increasingly regarded as the hinge of the whole structure of interest rates, will also be enhanced by the planned reform of the reserve requirement system. At present, banks have to keep the amount prescribed by the coefficient in special accounts with the Bank of Italy on a day-to-day basis. Under the new system they will have to comply with the constraint on a monthly average basis and will thus be able to withdraw, within given limits, funds on some days provided they deposit more on others in the same month. This will stabilize the very short end of the market since banks will, of course, be encouraged to withdraw funds when rates are high and deposit them when they are low.

The structure of the banking system has also been considerably modified since the late seventies. The segmentation by legal category, location and type of activity has been gradually dismantled as regulations were standardized for all banks, statutes of incorporation were revised and successive plans for the opening of new branches brought more competition to local markets. Recently, banks have been allowed to expand their medium-term lending and fund raising and to move,

through subsidiaries, into new lines of business such as mutual funds and merchant banking.

In practice, Italian banks, which have always had the power to underwrite securities, will be able to operate, through specialized subsidiaries, to supply any of the wide variety of services covered by the Second Banking Coordination Directive, including the trading of financial instruments on their own account and on behalf of customers, money broking, and portfolio management and advice. We think that the solution of banking groups with specialized subsidiaries allows all the activities of a universal bank to be performed within a unified entrepreneurial strategy, while providing both organizational and supervisory advantages and making it possible to draw on the valuable experience of the existing specialized credit institutions.

Through the substantial liberalization of branch opening procedures, which will shortly be completed, and by reinforcing competition our new regulatory framework has set the stage for greater efficiency in the banking system. There has already been a reshuffling of market shares and plans for mergers and reorganizations are becoming more frequent by the day. It is likely that the shape of the Italian banking system will change considerably in the near future, and that the larger banks will not be exempt.

Italy has a relatively unconcentrated banking system and its major banks are smaller than their counterparts in other industrial countries. It is certainly questionable whether they are large enough for the kind of business to which they aspire, difficult though it is to pinpoint economies of scale.

The growth of the major banks' international activity has been hampered by the exchange controls which were imposed after the first oil shock and gradually lifted in the eighties. They now have to plan carefully whether, when and how to enter into new fields of activity where competition is fierce and earnings thin, even for the best players. In many cases they could find ways to provide their customers with a full range of the more sophisticated products without actually being physically present in every segment of the market. What is certain is that the primary focus of their planning must be their domestic customer base. Nonetheless, the liberalization of capital movements will create new opportunities that will benefit the larger, internationally-oriented banks more than others.

As for the regional and local banks, they will be the most affected by the removal of domestic market segmentation, which may signifi-

cantly alter the conditions on which their economic equilibrium is presently based. A two-pronged strategy will be required if they are to thrive in the new environment. On the one hand, they will have to reinforce their links with local customers. On the other, they will have to be able to provide a wider range of financial services without incurring excessive setting-up and running costs. To this end, alliances with larger national or foreign banks could prove necessary.

Factors of strength for banks able to exploit them include the high rate of saving of Italian households, the vitality of industrial firms, the scope for developing consumer finance, the potential of new payments systems and the high value of information on local markets in a very diversified country.

#### 4. The need for further structural changes

Most of what needs to be achieved by 1992 can be accomplished with existing legislation and market structures, yet some important institutional innovations still need to be implemented.

As regards financial intermediaries, there are two areas in which new legislation could pave the way for significant improvements.

The first concerns the harmonization of the institutional set-up of public-law and savings banks, which account for nearly half of Italy's banking system, with that of other banking firms. A first step in this direction has already been taken by allowing savings banks and public-law banks to issue shares to the public. A bolder step, now under way, is the introduction of legislation to separate the public entity from the banking firm, with the former owning the latter, which would become a limited company. This would not alter ownership patterns, but it would separate ownership from management and place all banks on the same legal and organizational footing.

The second field of action is the regulation of non-bank financial intermediaries. The desirability of competitive equality with banks, the contagious nature of instability in financial intermediation and comparison with other financial systems, including that of the UK, would be sufficient reasons to warrant such action. But there is a more fundamental reason involved when savings are entrusted for investment to an intermediary under the terms of a fiduciary contract: some form of

public control to discipline conflicts of interest and prevent abuse should strengthen the credibility of the industry, reduce information costs and ultimately enhance the efficiency of the savings-investment process. Within this broad regulatory framework, the financial system would substantially benefit from the creation of new intermediaries and specialized operators such as pension funds and closed-end investment funds.

With regard to financial markets, here again there are two areas in which improvement is needed.

The first is the stock exchange, for which the CONSOB (the Italian Companies and Stock Exchange Commission) has presented a blueprint. A first bill covering one of the basic points of that programme has been presented to Parliament. Its main purpose is to redefine the operators allowed to conduct business on the stock exchange and to introduce a new trading mechanism based more on computer screens than on a physically unified market. In the same field, the adequate regulation of take-over bids — which are the subject of another bill before Parliament — and insider trading would reassure investors and increase transparency. The latter would also be enhanced if information concerning companies' results were supplied more frequently to shareholders and if the concept of a group of companies were strictly defined in order to support, *inter alia*, the production of consolidated balance sheets.

The second area is the development of options and futures markets, which are at present limited in both size and depth. The development of these markets can be envisaged along similar lines to those already adopted for the market in government securities and planned for shares.

## 5. Conclusion

The agenda is full of demanding problems, some I have treated at some length, others I have only touched upon, and yet others I have not even mentioned. It is my firm belief, however, that a solution can and eventually will be found for all of them. For Italy, the top priority is to find a solution to the problem that most seriously threatens our economic development: the stubbornly high budget deficit. This is the

fundamental weakness of the Italian economy and must be rapidly removed. Failure to do so could spike the opportunities offered by the unified market, the growing sophistication of Italy's financial system and the drive of Italian industry.

For many years the Bank of Italy has been stressing the need to eliminate the budget deficit net of interest payments, as a first step. The Government has now adopted this as its objective, to be achieved by 1992. We must now proceed with determination along this road, fully aware that the stakes are too high to permit failure.

*Roma*

LAMBERTO DINI