Recent Developments in the Italian Banking System

I. Introduction

If we examine the history of finance in Italy in the last one or two decades, we cannot but be astounded at the singular contrast between the relative stability of the institutional structure of financial intermediaries on the one hand and the far-reaching changes in the instruments of monetary policy and even in the composition of credit flows, on the other. Indeed, this is an area in which structural and cyclical problems have been more closely interwoven than elsewhere, and one moreover in which changes have taken place very rapidly. It is therefore worth taking a look at some of the salient aspects of financial mediation as practised in Italy.

The layman may find it somewhat difficult to grasp the relation between credit transformation and the principle of credit specialization which underlies present banking legislation. By credit *transformation* we mean the activity by which financial intermediaries (especially banks), by bringing together financial surplus and deficit sectors, modify one or more of the features of the financial assets (e.g. maturity, risk, liquidity and so on) purchased by them so as to be in a position to offer operators requiring credit substantially different kinds of financial assets.

Credit *specialization*, on the other hand, is the principle that there should be the minimum differences between the type of financial assets purchased and those sold by each kind of intermediary in order to reduce the risks inherent in a situation in which there is a difference of kind between the assets and liabilities in the institution's balance sheet.

A certain degree of credit transformation is inevitable in an economic system in which borrowers' and lenders' needs and pref-

erences do not completely coincide. As against this, credit specialization by financial intermediaries has long been regarded — especially in Italy — as a fundamental principle of sound financial management, so much so that it has been incorporated in the banking legislation of a number of countries, including Italy.

It is not our purpose here to go into this problem, despite its importance. What we propose to do is simply to examine certain aspects of the recent activities of financial intermediaries in Italy and to take stock of the present situation. We shall conclude by offering a few observations on the problems arising from the current situation.

II. The Increasing Need for Credit Transformation

In line with the recently ascertained statistical trend, which seems to be valid for both industrialized and developing countries, the growth of the Italian economy has been accompanied by an even more rapid increase in the activity of financial intermediaries in their twofold operations of pure financial mediation and of credit transformation. This may be regarded as to some extent a reflection of the growing dissociation between saving and investment which is typical of the more advanced economic systems and which assumed special prominence in Italy at the beginning of the 'sixties.

One of the peculiar features of the Italian case, however, is the fact that the increasing importance of the financial intermediaries did not take the form of an increase in the ratio of the economy's financial assets to GNP or to the gross private product (see Table 1). Rather, it led to a marked change in the composition of the financial assets held by the economy. It is difficult to single out statistics which will give a complete picture of such a complex phenomenon, but a few data may be presented to illustrate the point. If we look at Table 2 we find that the ratio of liquid assets to domestic ones grew from 43 per cent in 1959 to 70 per cent in 1974, whereas the ratio of bonds to the total shows only a negligible increase, and the shares, as a percentage of the total, show a dramatic decrease — from 42 per cent in 1959 to some 9 per cent in 1974. These figures clearly prove the marked increase in the propensity of the Italian economy to hold liquid financial assets.

Conversely, if we now look at the evolution over the same period on the supply side, we note that, although short-term financing

increased from 23 per cent to almost 40 per cent between 1959 and 1974, long-term financing has increased even more — from 19 to 43 per cent. But, again, there has been a sharp drop in the relative importance of shares which in the period in question fell from 58 to 17 per cent (Table 3).

The task of reconciling demand and supply in such circumstances could only be discharged by the financial intermediaries who have done so by transformation operations under the pressure of the demand for long-term credit to finance investment. In Italy, during the last decade or so, this demand has come mainly from *firms*, whose leverage has increased from 37 per cent (in 1962) to 48 per cent (in 1974), and the *public sector*, whose increasing financial needs have obliged it to have more and more recourse to the capital market.

It is not our purpose at this point to spell out the causes of this increasing need for financial transformation or to establish whether the deficit sectors' growing proportion of long-term liabilities to total liabilities was matched by a sufficient growth of the economy. On the other hand, the growing ratio of short-term assets to total assets of the surplus sectors might be regarded either as the necessary consequence of Italy's increasing urbanization and industrialization or as a sign of the declining efficiency of the financial markets, or, lastly, as the result of institutional distortions (taxation, etc.). Abstracting from these considerations, we would point out that the increasing degree of financial transformation effected by the financial system as a whole could have taken the form either of "direct" transformation, i.e. carried out by a single type of financial institution, or of "indirect transformation", i.e. through the joint intervention of different types of intermediary. The relative importance of these two forms depends not only on the market forces but also on institutional constraints embodied in the existing legislation.

III. Institutional Constraints

The data set out above illustrate the salient features of a country which, from the financial point of view, has undergone a radical transformation in under fifteen years. This development was not accompanied by any change whatsoever in banking legislation which is still based on the 1936 law. And the keystone of the Italian credit structure is still, at least formally speaking, the rigid separation

between the short-term and the long-term credit sectors. This distinction is never explicitly made in the banking law, but it is clearly implied in the sharp separation between the provisions concerning credit institutions which rely on deposits and those concerning special credit institutions which derive their funds mainly from bonds.

Despite certain current preconceptions, no short-term credit sector can be really separated from the long-term one unless the needs and preferences of the savers coincide exactly with those of the investors. The few data given above show that a link between the two sectors exists, and is in fact becoming closer. The forms assumed by this interrelation are examined below.

To that end, we shall first look at the evolution of *direct* transformation, that is, an operation carried out by a single type of financial intermediary and not involving double or multiple mediation. We shall then deal with indirect transformation, i.e. the type which involves credit relations between banks and special credit institutions. As we shall see, the crucial role in this analysis is played by the banking system.

IV. Direct Transformation

To analyze direct credit transformation by *banks*, it is sufficient, as a first approximation, to examine the assets side of the banks' balance sheets. For, on the liabilities side, there have been no radical changes. The collection of deposits has been almost the only source from which banks have drawn their funds. Moreover, the shift in the composition of liabilities from savings to demand deposits, if anything, reinforces the conclusions emerging from the analysis of the breakdown of the assets.

In any study of the assets side of banks' balance sheets, it is essential to bear in mind that, though Italian banking legislation is based on the principle of the specialization of financial intermediaries, it allows some institutions a certain degree of flexibility and the possibility of modifying their regulations. In particular:

(a) Savings banks may, within certain limits, grant loans with maturities exceeding short-term periods (18 months in the case of Italy), and

(b) Ordinary banks and People's Banks were allowed, in 1972, to grant medium-term credits (60 months) up to a ceiling of 8-10 per cent of their deposits. This permission, however, was not such an innovation as might appear, but rather a formal recognition on the part of the authorities of the fact that these categories of banks were already operating in the medium-term sector, although on the basis of a case-by-case authorization by the Bank of Italy of each individual operation.

In the light of these considerations, one way of assessing the evolution of the banks' direct transformation of maturities is to measure medium- and long-term credits granted to non-financial institutions as a percentage of total assets. This latter sector is regarded as including not only the Government but also the Government-controlled financial institutions which issue securities by which to raise funds on behalf of the Treasury.

Table 4 gives some of the relevant data for the same period of 15 years as the other tables. The main point emerging from Table 4 is the decreasing importance of short-term credits, which fell from 73.5 per cent in 1959 to 59 per cent in 1974. Medium- and long-term loans, as column (2) shows, did not expand as fast as might have been supposed. The figures show only a very sluggish increase up to 1971, and in 1974 a sudden drop — almost back to the 1959 level. But that is only part of the story, for, from the bank's point of view, it often makes little difference whether the credit is granted as a direct bank loan or by buying securities issued by the borrowers. Thus, the small increase in medium- and long-term credit may have been balanced by a larger increase in securities issued by non-financial institutions and held by banks, and therefore in overall direct credit transformation. Lumping together these two categories of credits, as has been done in column (5) of Table 4, we realize that the latter guess is correct, but only up to a point. For the two categories, taken together, show a moderately upward trend up to 1971, and then, in 1974, fall back to a level well below the starting point (in 1959). This drop may be ignored as a consequence of the cyclical factors in 1974, and the conclusion reached that, in the period in question (through 1971), direct credit transformation increased only to a moderate extent.

The analysis of direct transformation by special credit institutions is much less important in the present context, and we shall not

attempt to undertake it here. As already noted, what we are concentrating on is the credit transformation stemming from the need to link short-term savings with long-term investments. Since special institutions are unable to collect short-term funds, they are not capable of effecting such a transformation.

V. Indirect Transformation

We shall now turn to an analysis of indirect credit transformation, i.e. the kind which involves credit relationships among financial institutions of different kinds. For this purpose, we shall examine the links between financial intermediaries, which operate in the main in the short-term credit sector and the special credit institutions operating in the long-term one. We shall pay particular attention to the most important of the channels connecting the two types of institution — the one flowing from the assets side of the banks' balance sheets to the liabilities side of the balance sheets of special credit institutions.

Table 4 should again be consulted to clarify the discussion. Column (6), giving the values of bonds issued by financial intermediaries and owned by credit institutions, shows that this type of asset has undergone a remarkable increase. The ratio of this category to bank credits has risen from some 5 per cent in 1959 to some 19 per cent in 1974 — a development which might have been deduced from the fall in the relative importance of short-term loans and the practically constant share of bonds issued by non-financial intermediaries and held by the banks.

Thus, contrary to the position as regards direct credit transformation, in the case of *indirect* transformation, there have been important changes in the Italian banking system in recent years. In particular, the links between the two different types of financial intermediaries, and hence between the short-term credit sector and the medium- and long-term ones, have been steadily strengthened in the last fifteen years, to the extent that the importance in the banks' balance sheets of bonds issued by financial institutions can be regarded as an indication of the extent of these links.

These conclusions, however, have to be accepted as a tentative, and are subject to confirmation in the light of a study of the

liabilities side of the balance-sheets of the special credit institutions. To this end, we may now turn to Tables 5 and 6.

Table 5 gives an analysis of the liabilities of special credit institutions by type of source. From these data it will be immediately obvious that the overwhelming majority of the funds collected by this kind of financial intermediary stems from the issue of bonds which accounted for some 52 per cent of total liabilities in 1959 and for 72 per cent in 1974. Besides issuing bonds, these institutions collect deposits directly in the form of savings accounts, but these constitute only a small fraction of the funds collected by special credit institutions. The same consideration applies to another potentially important source of funds for these institutions — the current account deposits with banks — and their role is extremely modest.

We may therefore take as demonstrated that the main source of funds administered by the special credit institutions is the bonds issued by them. What is now needed is an analysis of the liabilities of the special credit institutions of the kind set out in Table 6 if we are to interpret correctly the increasing flow of subscriptions to bond issues by the banks, and therefore to assess the role of these subscriptions as a channel of communication between the short-term and the long-term credit sectors.

The data cover the usual fifteen-year period. They reveal a substantial increase in the relative importance of the banks as a source of funds to the special credit institutions. Whereas in 1959 the banks accounted for some 24.4 per cent of the funds collected by the special institutions, the figure had risen by 1974 to some 42 per cent. And, if we lump together the contributions of banks and of the Bank of Italy and the *Ufficio Italiano Cambi* (Italian Foreign Exchange Office), we find that they constituted 31 per cent in 1959 and almost 54 per cent in 1974. The contribution of the public and of firms (column 1) has been somewhat irregular and has not shown a definite trend. However, it can be said that their contribution oscillated round the mean value of one third. Attention is also drawn to the declining trend in the contribution of funds by the public sector which, in recent years, have slumped.

There can be little doubt that the links between the two broad classes of Italian financial intermediaries have substantially increased during the last fifteen years or so. The growing participation by the banks in bonds issued by the special credit institutions, in line with the economy's demand for long-term funds reflecting the increasing

size of the Italian financial market, may be taken as evidence that the banks, in a way, act as collecting agencies of the special credit institutions which, in their turn, must rely on the banks for a large and increasing proportion of their funds.

VI. Other Links Between Financial Intermediaries

Having thus briefly analyzed the extent to which financial flows between different intermediaries have contributed to the increase in credit transformation in Italy, we may now try to ascertain whether such flows form the only link between banks and special credit institutions. Without dealing with the matter exhaustively, we would merely mention two other factors which reinforce the links between banks and these institutions. One is ownership and the other organization.

From the point of view of "ownership relations" with banks, and confining ourselves to credit to industry, we will divide special credit institutions into three categories — those which are *directly* controlled by banks, those which are *indirectly* controlled by them and those which are *not controlled* by them. The first group comprises the special credit sections which belong to some of the largest commercial banks (mostly chartered banks — *Istituti di credito di diritto pubblico*) and four medium- and long-term credit institutions whose share capital is held by one or more commercial banks. The "sections" act as special credit institutions but their lending activity is usually confined to specific sectors of the economy. The "indirectly controlled" sector is formed of those special credit institutions where a substantial proportion of the capital is provided by the Treasury, and a small part by commercial banks. The other special credit institutions are not controlled by banks. They are owned by the Government or other public bodies. It should be emphasized that, while the three institutions in the last group were founded long before the war, most of the others were set up in the post-war period. They were either founded by commercial banks with the aim of extending to their own clients, though indirectly, the range of financial services offered to business enterprises, or they were designed to provide support, largely through subsidized credit, to the development of regions and industries which would otherwise have found it difficult to have access to credit.

The shares of the market of these three groups of institutions provide further evidence of the increasing links between short-term and long-term institutions. Indeed, in the ten years running from 1964 to 1973, the share of directly controlled institutions (in total loans) rose from 18.2 to 24.7 per cent, while that of the uncontrolled institutions fell from 63.8 to 56.6 per cent. That of the indirectly controlled group remained stable.

While there are no readily available data to prove whether these trends are related to a preference by the banks for securities issued by controlled institutions, there is another factor which may be relevant. This is the practice of special credit institutions of using the organization of the bank itself (i.e. its branches) for their operations. If this relationship has permitted a rapid increase in the operations of long-term credit institutions, it may also have reinforced their dependence on the banking system as regards fund-raising, and in addition, it may have had a non-neutral effect on those special credit institutions which have an "ownership link" with a commercial bank.

Conclusions

The analysis in the previous pages has illustrated some of the distinctive features of the Italian financial system. What conclusions can be drawn from the data?

It was suggested at the outset that the disequilibria to be observed in the structure of the Italian capital market and credit institutions may simply reflect disequilibria in the non-financial institutions. It may be asked whether this is a phenomenon peculiar to Italy, or whether it is a feature of industrial countries in general. We feel that the question can be divided into two parts.

As regards the "deterioration" of the financial structure of *industrial firms*. Italy is no exception among the major European countries. The increasing dissociation between saving and investment in the Italian economy is to be found in the rest of Europe. It should be recalled that Dr. Carli, the former Governor of the Bank of Italy, in giving evidence before the Parliamentary Commission on restraints on competition, suggested that the progressive reduction in the self-financing capacity of industrial firms would have to be offset by an increasing volume of financial intermediation by specialized operators if investment were to be sustained at its previous pace. This is exactly

what happened in the succeeding years. It is not surprising, therefore, that the problems have arisen of "transforming private financial investment into risk capital, problems whose solution has not been made any the easier by the habits of European institutions".

If, however, we look at the financial disequilibria of the *public sector*, we are confronted with a situation for which there is no parallel elsewhere. The deficit in that sector was 6.3 per cent of GDP in 1971 and had risen to 14 per cent in 1975. These figures show the increasing role of the public sector in financial markets as well as the increasing operational difficulties encountered by financial institutions and the monetary authorities.

It can thus be understood why a recent proposal to effect institutional changes in the Italian financial structure has sought to split into two independent systems the financial institutions which supply funds to the public sector and those which finance the private one.

From the summary analysis of the preceding pages, two facts emerge. First, there is the increasing need for the transformation of maturities by the financial system owing to an increasing divergence in maturities between the financial assets and liabilities of ultimate lenders and ultimate borrowers. Second, this need has in essence been met by an increasing amount of "indirect" transformation, i.e., by a broadening of the relationships between different financial institutions in the form of larger holdings of securities by the banking system.

The controversy between those who favour a system of "specialized banks" and those who advocate a system of "universal banks" on the German pattern is a regular topic of discussion in Italy in connection with the type of financial structure created by the 1936 legislation. It should be recalled that, before that year, the latter type of banking was permitted in Italy. The same financial institution could supply both short- and long-term funds, and hence no indirect transformation was needed.

Without attempting an overall evaluation of this problem, we would point out two aspects of this problem.

First, we think that it would be too restrictive to approach the problem only from the point of view of *how* the transformation of financial instruments occurs. The *quantum* of transformation, and not just the means, is also likely to be a variable. It is true that preferences as regards assets on the part of final operators impose a minimum on the amount of transformation services required by the economy from the financial system. But it is also true that some aspects of the financial structure may in fact set the actual level above that minimum. It is not only financial operators who have to be considered, but financial instruments as well. The limited range of such instruments in the Italian financial market may have increased the need for transformation by financial intermediaries. In the same way, competition between financial institutions of the same type or of different types may affect the choices of final operators and hence the quantum of transformation.

Second, we would emphasise that, when we consider *how* assets transformation could best be accomplished, the proper balance has to be maintained between the different points of view from which a financial system may be defined as optimal. Resource allocation, stability, and monetary policy transmission seem to have particular relevance in this respect.

From the point of view of efficient resource allocation, we should weigh the advantages of having a complete view of the problems and prospects of the firm against those deriving from the economies of scale that may come from specializing in one end of the market. It can be argued that, since the information needed to assess the creditworthiness of a firm is largely independent of the type of credit required, credit specialization either involves a certain duplication of analysis, or it encourages a merely "partial" enquiry into the situation of the firm. Both consequences would make for inefficiency. On the other hand, however, it has to be considered that ineffiiciencies are also associated with lack of control by market mechanisms and that a system of decentralized decisions necessarily requires some degree of specialization. A satisfactory answer to the question of resource allocation thus implies some idea of the optimal size of credit institutions relatively to that of firms, and some idea of the desirable degree of competition in the financial system.

This leads to another aspect of the problem, that of the equilibrium and stability of financial institutions. The experience of Savings and Loans Associations in the United States in the late sixties, and the more recent Italian experience with the mortgage bond market, have once again brought out the risks and rigidities associated with a lack of correlation in the maturity structures of assets and liabilities. A distinction, however, must be made between homogeneity *across* the two sides of the balance-sheet and homoge-

neity *within* each side of it. Portfolio theory suggests that the latter does not necessarily contribute to the solidity of the institution itself.

Coming to the final aspect, we suggest that the financial system performs its role efficiently in the transmission mechanism when, first, all types of financial institutions are subject to an equivalent amount of control by the monetary authorities, and, second, they are flexible enough to be able do adapt to changing interest rates levels and liquidity conditions without becoming involved in major problems of internal stability.

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Table 1

ASSETS AND LIABILITIES OF THE ECONOMY: RATIOS TO GNP AND GROSS PRIVATE PRODUCT

Year	Ratios of domestic financial assets to:		Ratios of total financing to:	
	GNP	Gross private product	GNP	Gross private product
1959	1.49	1.69	1.12	1.27
1962	1.55	1.76	1.22	1.38
1965	1.38	1.59	1.06	1.22
1968	1.46	1.68	1.07	1.23
1971	1.48	1.70	1.06	1.22
1974	1.45	1.69	1.11	1.30

Table 2

STRUCTURE OF DOMESTIC ASSETS OF THE ECONOMY

Year	Total domestic assets (in billion lire)				Ratios to total domestic assets		
		Liquid assets	Bonds	Shares	Liquid assets	Bonds	Shares
	(1)	(2)	(3)	(4)	(2):(1)	(3):(1)	(4):(1)
1959	30,048	12,928	2,900	12,576	43.0	9.7	41.9
1962	42,302	19,963	4,374	15,479	47.2	10.3	36.6
1965	50,890	28,079	5,857	13,187	55.2	11.5	25.9
1968	69,112	40,356	9,827	13,032	58.4	12.2	18.9
1971	93,355	59,594	13,553	11,612	63.8	14.5	12.4
1974	140,567	98,868	15,478	13,070	70.3	11.0	9,3

TABLE 3

STRUCTURE OF DOMESTIC FINANCING OF THE ECONOMY

Year	Domestic financing				Ratios to total domestic financing		
	Total (1)	Short term (2)	Long term (3)	Shares (4)	Short term (2):(1)	Long term (3):(1)	Shares (4):(1)
1959	22,610	5,228	4,363	13,019	23.1	19.3	57.6
1962	33,260	9,411	7,657	16,192	28.3	23.0	48.7
1965	38,951	12,213	12,561	14,177	31.4	32.2	36.4
1968	50,644	17,401	18,650	14,593	34.4	36.8	28.8
1971	66,718	24,344	28,311	14,063	36.5	42.4	21.1
1974	98,795	39,299	42,837	17,259	39.8	42.8	17.4

TABLE 4

BANKS' CREDITS

Year	Short-term loans (1)	Medium- and long-term loans (2)	Total loans (3)	Securities issued by non-financial intermediaries (4)	Total 2 + 4 (5)	Securities issued by financial intermediaries (6)	Credit 3 + 4 + 6 (7)
	(billions of lire)						
1959	5,361	613	5,974	960	1,573	361	7,295
1962	9,636	986	10,622	1,270	2,256	1,040	12,932
1965	12,400	1,755	14,155	2,357	4,112	1,820	18,332
1968	18,042	2,652	20,694	4,916	7,568	3,144	28,754
1971	25,707	4,878	30,585	7,133	12,011	5,210	42,928
1974	45,378	6,668	52,046	10,664	17,332	14,673	77,383
	(percentage ratios to credits)						
1959	73.5	8.4	81.9	13.2	21.6	4.9	100
1962	74.5	7.6	82.1	9.8	17.4	8.1	100
1965	67.6	9.6	77.2	12.9	22.5	9.9	100
1968	62.8	9.2	72.0	17.1	26.3	10.9	100
1971	59.9	11.4	71.3	16.6	28.0	12.1	100
1974	58.7	8.6	67.3	13.8	22.4	18.9	100

TABLE 5

LIABILITIES OF THE SPECIAL CREDIT INSTITUTIONS
(percentage breakdown)

Year	Bonds		Deposits and interest-bearing certificates	Discount	Current accounts with banks	Funds from the Treasury	Foreign loans	Other liabilities	Total
	On behalf of the Treasury	Ordinary							
1959	6.58	45.90	5.76	5.90	8.55	14.06	4.00	9.25	100
1962	9.36	52.63	6.10	4.21	7.74	8.06	3.44	8.46	100
1965	13.66	54.28	6.29	2.59	6.40	5.74	4.15	6.89	100
1968	19.26	50.50	7.32	1.91	6.20	5.35	2.40	7.06	100
1971	22.29	49.19	7.18	1.40	4.89	4.40	3.92	6.73	100
1974	22.24	49.87	5.95	0.89	2.58	3.05	9.11	6.31	100

TABLE 6

FUND-RAISING SOURCES OF THE SPECIAL CREDIT INSTITUTIONS
(percentage breakdown)

Year	Public and companies	Banca d'Italia and UIC	Banks	Other credit institutions (1)	Public sector	Foreign sector	Total
1959	34.3	6.6	24.4	5.9	22.2	3.9	100
1962	35.9	6.6	29.4	5.9	18.8	3.4	100
1965	35.0	5.8	30.6	5.5	18.8	4.3	100
1968	40.6	3.5	34.5	5.4	13.5	2.5	100
1971	38.3	8.1	34.5	5.2	9.8	4.1	100
1974	24.7	12.7	41.7	6.0	5.6	9.3	100

(1) Special credit institutions and insurance institutions.