STRUCTURAL CHANGES IN THE ITALIAN BANKING SYSTEM

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Introduction

The level of competition in the Italian banking system has intensified as monetary and financial flows have become more international in nature. The increased integration of countries into the EU dramatically changed the competitive landscape for banks and financial institutions across the continent, resulting in dynamic changes for the Italian banking system. In the past ten years, legislation intended to redefine bank ownership and operation transformed this historically regulated and protected system. With their newfound "freedom," Italian banks are in a position to catch up to the financial institutions of the most advanced European financial centers. Italian banks also have been strengthened by a series of structural changes such as consolidation through mergers and acquisitions, improvements in managerial methods and enhanced operational processes. However, in order to become competitive, the industry must deal with issues of ownership, performance and product offerings. Conventional wisdom suggests that European banks will face a period of consolidation, eventually leaving only five to ten mega-banks on the continent. This article considers whether or not Italian banks are up to the challenge of European and international competition. The fundamental question I investigate is: Do Italian banks have the highly specialized expertise needed to compete successfully in global financial markets? I describe and discuss the historical ownership structure of the industry with special reference to issues of deregulation, privatization and consolidation. I then evaluate the industry's current position and provide comment on its future.

Historical Ownership Structure

The Banking Law of 1936 and policies pursued by the Bank of Italy (Italy's central bank) created a set of regulations to protect the banking system from instability and market failure. The industry was subject to strong government intervention, with close to 70% of bank assets under public control. ("Italy's Banking System") Public ownership helped banks fund public

interests, such as supporting the growth of specific sectors or regions and providing credit to small firms that otherwise would be rationed by profit maximizing entities. Additionally, the strict regulations included total control of entry and exit as well as control over branching decisions, with few banks allowed to operate at the regional or national level. The end result of these regulations was a proliferation of small local banks, with few concerns over profitability or performance issues. Given limited competition, individual banks could be profitable without being particularly efficient and without having to pursue aggressive market strategies. Despite high costs, banks were able to achieve high profit levels due to the unusually wide spread between lending and borrowing rates. In short, limited competition allowed banks to offload their high costs onto prices borne by consumers.

Deregulation and Privatization

Although the Italian government began deregulation of the financial system significantly later than others in Europe, the industry has quickly adapted to the new environment. The passing of the Amato Law in 1990 reduced the political influence of the state by encouraging government-owned public sector banks to change their corporate status from trusts, foundations and associations to joint-stock corporations. Public entities that owned the joint-stock corporations were encouraged to place as much as 49% of their equity with private shareholders. ("Banks & Other Financial Institutions") Since the Amato Law, there has been a switch from a banking industry dominated by banks under public control to a banking industry where the major role is played by private legal entities.

Furthermore, the Bank of Italy deregulated branching by relaxing the guidelines for new branches. As a result, 8,000 new branches began operation between 1989 and 1995. This increased the size of the branching network for more than 70% of Italian banks. (Cerasi et al) The Banking Law of 1993 (Teso Unico Bancario) allowed for further geographic and sectional deregulation, lowered entry barriers and branching constraints, increased private ownership and set the tone for a series of consolidation efforts. The main objective of the law was to increase competition in the banking sector and integration in the European banking industry.

A renaissance of the Italian banking industry began as massive privatizations occurred during the past decade. The share of total assets held by banks controlled by the state or other public institutions decreased from 68% in 1992 to 12% in 2000. ("OECD Economic Surveys") However, an oddity of the current structure is that many Italian banks are not owned by institutional investors under pressure to produce returns, rather by charitable foundations. The origins of bank foundations lie in the public-sector banks that historically dominated Italian banking. When banks were required by the Amato Law to spin off their banking activities into joint-stock corporations, ownership of the shares went to newly established charitable foundations. The law required income from bank operations to be allocated for education, culture, health care, conservation, scientific research or aid to the disadvantaged. But new guidelines have been established in recent years to encourage foundations to give up control. A reform introduced in 2002 set guidelines for the fiscal and civil status of bank foundations and the fiscal treatment of bank restructuring operations. In the past, foundation divestiture often was completed through a merger with a larger private bank, reducing the foundation's holdings to minority status in the merged entity. The 2002 law calls for a compete withdrawal of foundations from the banking business, leaving the management of their investment portfolios to independent trusts. Under this new ownership structure, foundations give up their ability to exercise control over the operations of banks. This must be accomplished by June 2006 if foundations wish to maintain the status of a private nonprofit institution and maintain the fiscal benefits associated with taking on the legal status of a non-mercantile institution. ("OECD Economic Surveys") Privatization is not complete, as the nonprofit foundations continue to directly or indirectly control 20 banks, including Banca Monte dei Paschi di Siena (MPS), one of Italy's largest. Partial privatization causes issues in the industry's competitive

position. Because the foundations are not subject to market forces, there is concern over their ability to contribute to effective capital allocation in the banking system. The purpose of excluding foundations from the sector is to enable banks to compete more successfully in the European and international financial arenas.

Consolidation

Another contributing factor to the changing structure of the Italian banking system is the consolidation efforts through mergers and acquisitions. Between 1990 and 2001, the number of banks decreased steadily (Table 1). Reasons for consolidation include the need to cut costs, manage risk, broaden product offerings, gain access to information and proprietary technologies, increase market power and extend geographic coverage. In some cases, acquiring another bank to increase size also may be a defensive strategy if it helps reduce the likelihood of becoming victim to a hostile takeover. However, the most widely cited motive for bank mergers in recent years is the desire to gain improved performance through achieving cost synergies. (Goddard et al) The largest banking groups all have been formed through consolidation and currently are in the process of internal reorganization; they include IntesaBCI, UniCredito Italiano, San Paolo IMI, MPS and Banca di Roma. According to the Bank of Italy, the domestic market share of the five largest Italian banks accounted for 29% of total assets in 1995 and rose to 54% by the end of 2001. Although the degree of concentration has risen significantly, the banking system remains fragmented with a multitude of smaller institutions sharing the rest of the market. This allows room for further consolidation within the industry. Mergers and acquisitions are not limited to top-tier banks. Many of them have been in the form of link-ups among regional banks, creating super-regional players.

Once restricted to local and regional expansion, Italian banks now are able to consolidate along the north-south axis, with a large number of northern banks spreading to the south to acquire locally based banks. The rationale behind this strategy is finding new market shares as an alternative to the over-branched north, leveraging on the acquired banks' large base of deposits and containing costs of acquisitions. More than 80% of deposits in the south are intermediated directly or through southern subsidiaries from banks based in the central-north regions. ("Bank Industry Risk Analysis")

To respect local sensitivities, many of the mergers have been implemented using a "federal" model. The new groups are formed by a holding company and various bank subsidiaries, which maintain their own name and distribution channels. This structure allows the local bank to retain its identity and operations while being a subsidiary within a larger bank. However, some groups that have adopted the federal structure have recently turned to a straight merger solution in order to remove inefficiencies and optimize synergies.

Regulation

The Interministerial Committee for Credit and Savings (CICR), the Ministry of Treasury and the Bank of Italy regulate the Italian banking system. The primary objectives of these organizations are to maintain sound bank management; ensure overall stability, efficiency and competitiveness of the financial system; and comply with banking legislation. The Bank of Italy's role has evolved into one of a central bank. Its functions include note issuance, banking and financial supervision, market oversight, safeguarding competition in the credit market and, jointly with the European Central Bank (ECB), oversight of payment systems. Another main responsibility of the Bank of Italy is to adopt regulations and implement policies formulated by the CICR and the ECB. Since 1998, Italy also has incorporated all EU banking directives into its legislation.

According to the Bank of International Settlements, the Basel Committee on Banking

[1]The Basel Committee on Banking Supervision is a committee of banking supervisory authorities, established by the central bank governors of the G-10 countries in 1975. It consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Sweden, Switzerland, the United Kingdom and the United States.

Supervision[1] currently is working on proposals for major reforms to the 1988 Basel Capital Accord. The original Basel Accord was an agreement among the G-10 central banks to apply common minimum capital standards to their banking industries by year-end 1992. If implemented, the new Basel Capital Accord's (Basel II's) proposals represent a major advance in the current supervisory approach to capital and will be an improved alignment of risk and regulatory capital requirements. Bank managers are trying to accomplish three objectives with Basel II: bring capital charges closer to the banks' own measures of risk; establish a continuous review of banks' management, and especially of their risk management, as a factor in adjusting the capital charge; and create incentives for greater public disclosure of a bank's risk exposures. These standards, which focus on addressing credit risk (the main risk incurred by banks), will help Italian banks allocate credit more effectively. This is especially important because overall credit risk is expected to rise in 2003 as midsized and family-owned enterprises that form the backbone of the Italian economy begin to weaken as a result of global economic pressures. ("Bank Industry Risk Analysis") However, banks have a substantial amount of work to do in order to have their internal rating systems ready in time. They also will face significant challenges in meeting the operational risk standards because the quality of many credit rating systems will need to be significantly upgraded. These rules allow for significant national discretion, which runs the risk of regulators introducing or reinforcing competitive inequalities as a result of differences in implementation and supervision. In addition, these rules will likely burden banks with extra costs. There is a fear that smaller Italian banks may not be equipped to rate the companies to which they lend, causing them to be disadvantaged against the national and international players.

Current Financial Position

Through structural changes such as privatization and consolidation, banks within Italy are becoming more competitive. The current banking system is characterized by:

1) A highly intermediated market where banks still enjoy a leading role in the economy
2) A retail banking business where the majority of clients are individuals and small businesses
3) Mainly domestic activity with little business generated from abroad and low penetration of foreign banks
4) Strong presence of regional banks with solid customer relationships

Overall data suggest that Italian banks are economically sound. With structural reforms, enhanced managerial techniques and increased efficiencies, Italian banks have proved their resilience to turmoil in global financial markets. Because capital markets continue to be poorly developed in Italy, the banking system enjoys a leading role in the economy due to its high level of intermediation carried out on behalf of the large number of small and midsized companies.[2] However, the increasing squeeze on interest margins in recent years caused lower interest rates and has led to a series of measures intended to diversify income sources. Italian banks have dedicated significant resources to developing other product offerings such as fee-generating activities in fund management, life insurance, securities negotiation and consultancy. The decrease in net interest income from 1990 to 2001 and the concurrent increase in non-interest income are detailed in Table 1.

The moderate domestic economic slowdown is not expected to significantly deteriorate asset quality, especially with the improvement in credit-risk management and with banks better equipped to evaluate risk throughout all phases of credit life. The fundamental retail and domestic nature of Italian banks has made them less susceptible to international fluctuations. Less than 17% of consolidated total assets are generated abroad. (Testoni) Even for large banks, the majority of banking business is generated by local customers,

[2] The market capitalization of the Milan stock exchange remains at a lower level than that of stock exchanges in other major European countries.

Table 1
Financial Performance of Italian Banks

	1990	1995	1998	1999	2000	2001
Net interest income (as % of total assets)	3.40	2.78	2.15	1.95	1.94	1.93
Non-interest income (as % of total assets)	1.02	0.86	1.40	1.60	1.77	1.76
Operating expenses (as % of total assets)	2.72	2.45	2.16	2.15	2.07	2.03
of which: banking staff costs	1.77	1.55	1.30	1.26	1.17	1.11
Net profit as % of capital and reserves (ROE)	10.2	1.6	7.4	9.6	11.6	8.9
Total assets (% of GDP)	120.7	142.0	146.6	147.4	153.3	155.1
Total number of employees (thousands)	337	359	346	344	343	345
Banking staff costs per employee (thousand euros, constant prices)	54.3	57.0	54.4	53.6	53.6	52.8
Non-performing loans (as % of total loans)	5.0	9.2	8.7	7.4	5.7	4.7
Number of banks	1,156	970	921	876	861	844

Source: Bank of Italy 2001 Annual Report.

reflecting deep roots in the banks' strongholds, loyal customers and an insignificant presence abroad.

Italians remain underleveraged, with financial liabilities representing only 30% of GDP at year-end 2001, versus more than 70% in Germany, Japan, the U.S. and the U.K. ("Bank Industry Risk Analysis") The increase in the lending rate over the past few years not only reflects the low level of interest rates but also the dynamism of the nation's economy and an environment of improving confidence. This important aspect of growth reduces banks' vulnerabilities to economic slowdown or financial market volatility.

Above-average labor costs and low productivity mean that Italian banking charges are high. "There is a serious problem of overstaffing, and it is estimated that thirty to fifty thousand jobs need to be cut in order for efficiency and profitability of the industry to improve." ("Banks & Other Financial Institutions," p. 3) An agreement between the Italian Banking Association (ABI) and trade unions in 1998 addressed this issue, laying the foundation for reducing labor costs, the creation of a redundancy fund, the reform of pay scales and the bargaining system and the introduction of greater flexibility in employment relations. ("Agreement Signed...") Table 1 shows a steady decline in banking staff costs, enhancing the system's competitive position.

Another factor favoring the competitiveness of Italian banks is improved management expertise. With privatization, there has been a heightened sensitivity towards profitability issues. A new breed of managers more internationally educated and oriented to market needs is able to further the competitive nature of their banks. Finally, privatization and less political interference give banks easier access to capital. All these factors should lead to a stronger Italian banking system.

Barriers to International Competition

Despite globalization and Europeanization intensifying in recent years, convergence of the banking sector has not occurred to a large extent in Italy. EU directives require Italy to lift many of its transnational banking barriers in order to increase competition among banks, so it can no longer be argued that the low level of foreign involvement is the result of government interference. It is, however, due to the few short-term gains achieved by European cross-border mergers. Cross-border merger and acquisition activity is expensive and bank executives are limited by shareholders who are focused on quarterly performance. ("Displacement Activity") Many shareholders are impatient and demand immediate return on

equity after approving expansion. In cross-border mergers and acquisitions, the strategy is to achieve a better competitive position in the international arena leading to long-term gains rather than profits within a quarter or even a few years.

In addition, Italy is less attractive to foreign banks looking for cross-border expansion opportunities because of the country's strict labor laws and high tax rate. There are fewer opportunities to cut overlapping branches and employees. Strict labor laws make it difficult to terminate employees, and with 95% of staff salaries remaining fixed, it is difficult to use monetary incentives to move staff towards cost-efficient working practices. Italy's high tax rate also reduces potential profitability for foreign owners.[3] Finally, many of the banks are national champions harboring stubborn pride and disdainful of merger opportunities with other European banks. ("Scent of a Banker")

With that said, the Italian banking industry is not completely averse to combinations with foreign financial firms. French, German, Spanish and Dutch institutions have taken positions in the Italian market via mergers and international branching. Between 1990 and 2001, the number of foreign banks in Italy rose from 37 to 74, approximately 9% of the Italian banking system. (Bank of Italy) At the same time, some precocious Italian banks have started to take majority or even minority stakes in banks located in Central Europe. Known as strategic investors, Italian banks are building a network of subsidiary banks in Hungary, Croatia, Slovakia and other Central European countries. This region is attractive to many second-tier banks because the major institutions, including the emerging market specialists, are not involved in the region. The strategy of these established multinational banks may be to wait a few years and then acquire an Italian bank that has already developed a strong presence in the Central European region. ("Rogue Trader, Rogue Parent")

Although the presence of foreign banks in Italy remains limited in retail banking, they are active in the investment-banking arena. This is an area where Italian banks historically have been weak (with the exception of Mediobanca). In the past decade, foreign banks have established a key position in the country's investment banking operations.

Outlook

Because the presence of foreign retail banks in Italy is limited, domestic banks have a window of opportunity to become more competitive without the threat of fierce international competition. It is imperative for this industry to take the opportunity to strengthen internally through further privatizations, consolidations and improvement in management techniques. In the future, top-tier Italian banks no doubt will face intense international competition if they expand abroad or if international banks encroach into the Italian market. The rapid shift to online banking, pressure to enhance market value and customers' increasing preference for securities as investments may place stress on Italian banks. Competition in financial services will be tough. According to Goddard et al,

> In all major industrial countries, the distinction between traditional banking activities, such as supplying deposits and making loans, and other capital market activities, has become eroded. An ever increasing array of negotiable assets, fed by a sustained innovation process, has combined with the use of new technologies to support the emergence and rapid growth of money and financial markets.

There is good news, however, for the Italian banking industry. Foreign banks compete primarily in the investment banking, asset management and wholesale subsidiaries market engaged in Eurocurrency business. They play a marginal role in domestic retail and corporate banking and generally account for less than 10% of total banking sector assets. (Goddard et al) In addition, a report by McKinsey & Company concludes, "Customers prefer domestic providers, value established brands, still make most use of the stationary branch net-

[3]According to KPMG's Corporate Tax Rate Survey, the average 2002 rate for EU countries is 32.54%, whereas Italy's tax rate is 40.25%. The 40.25% is composed of a 36% corporate income tax rate (IRPEG) and a basic 4.25% regional tax (IRAP).

work, and wish for personal advisory services." (Leichtfub, p. 1) To be successful, Italian banks must focus on enhancing their core competency of domestic retail banking before looking towards international activities.

Global Trends

Deregulation, Europeanization and globalization have had a major impact on the banking sector. Easy profits based on lending are disappearing, and banks are forced to participate in more aggressive, high-risk, high-stake activities. According to Hughes and MacDonald, "The danger lies in being left behind, which in turn carries with it the risk of declining market share, reduced profitability and ultimately being bought out as part of an ongoing wave of consolidation." (p. 417) The traditional business of providing loans has become less attractive, especially with set European-wide interest rates. The introduction of the Euro reduces inefficiencies in the market and arbitrage opportunities, once an easy source of profits. With a more efficient and transparent market, banks are earning lower margins on traditional activities.

Financial deregulation and technologic advances worldwide lead to some banks losing their competitive edge. There has been an ongoing shift to universal banking, where a range of financial services (e.g., commercial banking, securities issuance and trading and selling insurance products) is offered within the same institution. Customers also can turn to international capital markets, the Internet and other non-bank financial institutions for their financing needs. In addition to what has been done in the past decade, strategic options for Italian banks include new revenue sources, investment banking and riskier lending. These strategies may help Italian banks gain competitiveness with higher profit margins, but can also substantially increase risk within the industry due to uncertain revenue streams.

Italian banks must consolidate, streamline and attract sophisticated management expertise in order to pursue fee-income business more rigorously and address competition and disintermediation. This is evident in the revenue decline from net interest between 1996 and 2002. Still relatively high at the beginning of the 1990s (on the order of 3%), income started to dissipate from the effects of intensifying competition, financial deregulation and the implementation of the anti-usury law. Revenues consisting of non-interest income steadily rise, but profitability as measured by return on equity is inconsistent, as shown in Table 1.

Conclusion

The Italian banking industry has benefited from a series of structural changes begun in the 1990s. Privatization, consolidation and advancement of management techniques all contribute to the positive process of regeneration. Because of the system's retail and domestic nature, Italian banks will remain resilient to global financial shifts. The system's competitive advantage lies in its regional and local presence. ("Bank Industry Risk Analysis") There is a strong relationship between banks and customers, with the personal touch an important attribute. Italian banks will maintain control of the majority of domestic retail banking activity in the coming years, especially because they remain protected from cross-border mergers and acquisitions. However, in order to gain a competitive international position, top Italian banks must strive to achieve the expertise necessary to compete in universal banking arenas. The ability to offer a full range of financial services will determine if the Italian banking system can maintain its domestic position as well as expand beyond its national borders to become a force in European banking. Banking is no longer a safe, conservative business. Aggressive growth and profitability strategies must be established and pursued by top Italian banks if they wish to differentiate themselves in the high-risk global financial market.

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