FESSUD
Financialisation, economy, society and sustainable development

WP2 Comparative Perspectives on Financial Systems in the EU

D2.02 Reports on financial system

Report on the Italian Financial System

Work in progress report, June 2012
2. The Growth in Finance and its Role in the Decades of Financialisation

2.1. Indicators of financialization. The analysis of the financial sector and its role for the Italian economic system can be measured in different ways. In terms of stocks, the Italian financial sector was not significantly different from the German and the Japanese cases. The financial interrelations ratio (FIR), determined as the fraction between gross financial assets and real wealth, in 1980 was 0.87%, while in Japan 0.80%, in Germany 0.81%. The same ratio in the UK was 1.35%, while in France and the US was 1.05%. At the end of the Nineties, the values were 1.34 in Italy, 1.31 in Japan, 1.39 in Germany, 2.09 in the US and 2.86 per cent in the UK. During the last decade, FIR slightly decreased for the diminished capitalization of financial assets recorded during the dot.com crash from 2000 to 2002 and after the beginning of the subprime crisis in 2007. In 2009 the Italian FIR was 1.21. The output generated by the monetary and services sector to the Italian GDP ratio (fig. 1) increased from 5.15% (1980) to 8.96% (2009). The ratio decreased only from 1993 to 1995, because of the devaluation of the Italian lira within the European Monetary System. When we compare (1980-2010) the value added (VA) generated by the financial sector, we observe a different behaviour. Until 2004, the financial VA to the total VA ratio averaged 4.47%. In 2010, albeit the experience of more than 3 years of financial crisis, the contribution of the financial sector raised to 5.75% (fig. 1). The Italian job market from 1980 to 2010 has experienced events directly and indirectly linked with the financialization process (fig. 2): the services sector, in which the financial sector is included, has faced a huge growth of 41%. A switch from labor intensive to technology intensive and technology driven processes with the introduction of remote banking solutions was observed. Part of the workforce moved from the financial divisions of banks to outsourcing and off-shoring companies. The highest ratio of employees was reached in 1994 (2.78%) and decreased to 2.57% in 2010 (fig. 3). The recent slight increase of the ratio (from 2006 to 2010) can be explained with the reduction of employees in the industrial and commercial sectors essentially due to the real impact of the financial crisis. The productivity exhibited a different dynamic behaviour over the last 30 years. From 1980 to 2010, the output per employees (fig. 3) increased by 108.5%, while the value added per employee increased by 63.3%.

Research question: Is there a different pattern in the Italian financialization process and its impact on real growth, income, inequality?

2.2. Banking activity. Although the volume of loans and deposits increased rapidly during the period 1995 – 2010 (fig. 4), in the same years we observe the continuous increase of capital and reserves in absolute terms while the capitalization ratio raises only after 2007 (fig. 5). This behaviour influenced the capability of Italian banks to sustain the market and the credit risk of their balance sheets. Only after the beginning of the crisis the Deposit to Loan (DTL) ratio increased, both for the credit crunch and for the increase of capital for most of the large banks driven by regulators.

Research question: Does the credit policy of Italian banks influence the income distribution and was also managed to reduce the income distribution disproportion?

2.3. Stock market capitalization. The Italian stock market capitalization to GDP ratio increased from the early nineties to the end of the 2000 (fig. 6): from 10.19% in 1992 to 70.02% in 2000. After this year it started decreasing until when, in 2007, the crisis has dramatically reduced it bringing it back to the values of the late eighties. The market is fairly closed to small caps, both in terms of capital and in terms of organizational features
required to be listed. The number of companies in 15 years has increased only slightly: they were 266 (their market capitalization was 14% of GDP) in 1990; they are around 300 (15% of GDP) at the end of 2010. After the crisis the number of IPOs has collapsed. The financial intermediaries sector (banks and insurances) is the most important sector, both by number of listed companies and by capitalization.

**Research question: Which is the role played by the stock and bond market in the creation and distribution of private wealth?**

**2.4. Private and public debt.** At the end of 2010, the total financial liabilities of Italian households amounted to €887 billion (2010 prices). Financial liabilities include loans, consumer credit, home mortgage loans. In 1995, this figure stood at €365 billion, indicating a 143% increase. Loans and residential mortgages account for larger shares of the total household liabilities, but consumer credit grew 1332% between 1995 and 2010. A rapid increase in public sector debt took place in the 1980s. Between 1980 and 1990, government debt as a percentage of GDP grew from just above 52% to 92%. OECD data indicates that government debt as a percentage of GDP in the period 1995-2010 reached its peak in 1996, about 114% of the country’s gross domestic product. This debt then declined and reached its minimum in 2007, just before the financial crisis. Since then, a steep increase has been observed.

**Research question: Which is the role played by the financial system in the financial and fiscal process managed by the public and the private sectors to redistribute wealth?**

**3. The Structure of the Italian Financial System**

**3.1. The structure of the financial system.** The core Italian financial system is strongly linked with the banking activity. Not only in terms of assets and capitalization, but also in terms of functions and services provided. Few intermediaries (less than 16% at 2010) are independent from banks or banking groups. Leasing, factoring and investment services are essentially managed by banks or companies owned by banks. Most of the largest banks operate as universal banks since January 2004, while business line strategically chosen is retail and commercial banking. During the last years a concentration process has affected most of the financial institutions. On balance, the number of financial intermediaries reduced (1997 – 2011) from 2641 to 2005 (table 1).

**Research question: Was the structure of the Italian financial system modeled by country forces or by international drivers?**

**3.2. Corporate governance.** The Italian financial system has been characterized by a high level of public dominance. In 1993 the largest privatization process has been implemented. The most important public banks and insurances have been sold through IPOs. Actually, most of them are controlled by banking foundations, with a public nature. At the beginning of the 1990s neither banks nor institutional investors played a significant role in Italian companies’ ownership. Whereas banks still show a limited presence in non financial companies capital, ownership by institutional investors significantly increased over the years between 1990 and 2010. Relevant differences emerge distinguishing between banks and non financial companies: whereas institutional investors are present approximately in the same percentage of banks over the whole period, in 2010 they own stakes in twice the number of non financial companies than in 1990.

**Research question: Was the privatization of banks aimed at increasing public or private wealth and which was the channel: assets or liabilities?**
3.3. **Intensity of intermediation.** Non financial companies are significantly oriented to manage their financial liabilities through banking relations. The indicator we estimated is 
\[
\text{Liabilities of firms to banks) / (Total financial liabilities of firms)}
\]
This average ratio is 70.4% (min 67.5%; max 74.8%). The trend is only slightly declining (fig. 8). On the other side, the increasing need to support the public debt has transformed the propensity of households to invest in assets issued by banks. The indicator we estimated is 
\[
\text{Assets of Households to Banks) / (Total Financial Assets of Households)}
\]
which ranges from 22.2% to 34.5% (average 29.9%) during the period 1997-2011.

**Research questions:** Did the Italian system changed its orientation to intermediaries to sustain the public debt? The GDP was negatively affected by this choice?

3.4. **Financial innovation.** The accurate disclosure of derivative usage of financial and non financial firms is not easily available. The Bank of Italy and the Global Financial System (CGFS) of the BIS provides country level information for a sample of Italian banks from 2000. Data show a dramatic increase of the notional amount of financial derivatives (forex, IR, equity and commodity) from 1,400 billion USD at the end of 2000 to 11,000 billion of USD at the end of 2011.

**Research question:** Financial innovation did create or destroy value for non financial firms and households?

4. **The Nature and Degree of Competition**

4.1. **The concentration process.** The process of banking concentration has experienced 9 operations from 1984 to 1986, 20 M&A from 1987 to 1989, 45 operations on average each year from 1990 to 1994. After 1997 the concentration activity was accelerated: between 1990 and 1995 the assets of the first 5 largest banks was around 30%. In 1999 this ratio was 48% (compared with the European average of 57%). During the Nineties the banking M&A have been 514, affecting 50% of total assets of the Italian banking system. At the same time, the number of branches increased from 1996 to 2008 of about 40% (718 branches). During the crisis 532 branches, on balance, have been closed. This trend is expected to accelerate (fig. 9).

**Research question:** Is there an Italian model to bank mergers or it was affected by large foreign institutions?

4.2. **Cooperation among banks and other financial institutions.** The Bank of Italy and the Italian Banking Associations (ABI) strongly orientated the banking system to cooperate both within the payment system and the money market. The payment system reform experienced three different important steps: in 1988 with a White Book, the Bank of Italy underlined the inefficiencies and the guidelines for a reform aimed at increasing the efficiency for wholesale and retail payments and their settlement. In 1998, the real time gross settlement system (BI-ReL) was introduced in order to optimize the settlement of large payments in euros. This reform was managed within the Trans-European Automated Real-time Gross Settlement Express Transfer (TARGET) system. In 2008, the Single Euro Payment Area (SEPA) Directive introduce homogeneous pricing and structural changes for all the EU countries. Banks also cooperate to define standards of many info structures, such as the interbank market (MID), the interbank deposit insurance system, the transparency agreement for banking fees. The most important role
is played by ABI, which operates with other associations of intermediaries as a lobby in the legislative debates affecting the financial activities.

Research question: Which is the role played by financial firms in the economic and political debate and policy making process?

4.3. Area of competitiveness. Most of the banking and financial services and markets are technically designed with the purpose to increase the efficiency, which is one of the goals of regulation (art. 5 of the banking Act, 1993). Nevertheless, many reforms should be done in order to optimize the degree of competitiveness, since there are high worries that a more intense competition could affect the stability and push banks to behave less safe and sound. The Herfindhal index for deposits and loans remains relatively high (respectively 18.07 and 15.18, in 2010. In 1983 they were respectively 20.87 and 17.94) and the only slight change can be explained with the pressure introduced by foreign banks. Figures 10 and 11 show the concentration of loans and deposits in large banks’ portfolios. This evidence is even stronger in business lines, such as trading, asset management, investment banking, were only few Italian players operate.

Research question: Where competitiveness and openness support the economic and income sustainability of production firms and households?

5. Profitability of the Financial Sector

5.1. Banking profitability. In Italy, banks structurally dominate the domestic financial system (80% of financial assets in 2010), and their quasi monopoly position was even strengthened after the severe crisis that swept the asset management industry in 2003. Although income statements of Italian banks in the last twenty years show an increase in net income of 70%, in the period 2001-2011 they show a decrease of more than 20%. Between 2007 and 2010, the aggregate net income of Italian banks fell by more than half; profits levelled off in 2009 and 2010, but then banks ran up considerable losses in 2011. Net interest income accounts for more than 50% of gross income, illustrating not only the extent to which Italian banks are almost exclusively geared towards retail activities, but also the high level of margins through 2010. All profitability ratios follow, in general, a similar trend. The erosion of profits in recent years has strained both the return on assets (ROA) and the return on equity (ROE).

Research question: How banks can solve the “equation” to increase their capitalization with a lower profitability and the need to support their credit activity?

5.2. Banking strategic model. Banks show a decreasing orientation to contribute to net income with the net interest income (from 0.35 in 1995 to 0.10 in 2011) which represents the traditional European continental model. On the other side the financial services contribution increased from 1.31 to 1.89. This is a demonstration that the Italian strategy tends to the services model, imported from the US and UK systems.

Research questions: Is the Italian banking business model changed affecting the support to the real sector? Is the real sector expected to increase its capability to raise funds in financial markets?

6. Regulatory Framework: Financial Market Regulation in Italy

6.1. Financial Regulation Organization. The structure of financial regulation is based on the specialization. The Bank of Italy is asked to supervise the activity of monetary and credit institutions; CONSOB is expected to regulate markets and control actors’ behaviour in order to protect investors; ISVAP is the insurance regulator.
Research question: Is the empirical evidence showing that this regulatory model helps to manage supervisory goals and to minimize the risk of financial crises?

6.2. The key changes in banking regulation (since 1980). In 1981 The Bank of Italy and the Italian Government agree to reform the bid system of government bonds (“divorce between Bank of Italy and Italian Treasury) and allowed the central bank to buy bonds only in the secondary markets. In 1985 the first Bank Directive (77/780) aimed at increasing the competitiveness and the openness of the banking activity. For Italy this was a fundamental reform, since until then the control of stability was managed through a structure-conduct-performance model, that is imposing an oligopolistic structure, where banks and branches could not be settled without the agreement of the regulatory body. The relationship banking orientation pushes banks to increase the number of branches and reduce the average distance between customers and distribution units (fig. 9). The first directive was the first step towards a prudential regulation which was confirmed with the introduction of the Basel I principles (1988), based on a minimum capital requirement defined in standardized way for the credit risk. In the same year the Bank of Italy publishes the Second White Book on the banking system where regulators suggest to transform banks, until then non profit companies, into corporations. The Italian legislator in 1990 reformed the system, allowing banks to issue bonds, to invest in non financial stocks and to remove all the constraints between short and long term operations. In 1992 the second Directive was introduced in the Italian system. This reform is about the freedom to establish all over Europe (home country control). After few months a new Banking Law has been approved (Testo Unico Bancario, TUB). This is the final step towards the liberalization of the financial system. In 2004 the Basel 2 principles have been approved. Internal models can be introduced with the validation of the regulators. Italian way to validate appears to be generally more severe than other banking systems.

Research question: The implementation of a prudential regulation after a long structural approach was differently designed and generated potential regulatory arbitrages?

6.3. Market regulation. In 1998 the New Financial Markets Act was approved. It was about the rules for intermediaries, financial markets, and companies issuing bonds and stocks. The five principles of the regulation are: (i) maintenance of trust in the financial system; (ii) investors protection; (iii) stability and well functioning of the financial system; (iv) financial system competitiveness; (v) compliance of financial rules. More recently financial markets have been affected by the introduction of the Markets in Financial Instruments Directive (MIFID) aimed at increasing the retail investors protection and the transparency of pricing processes.

Research questions: Which is the specificity of the third level of market regulations and are Italian investors differently protected by the domestic regulation?

6.4. Changes in regulation in response to crisis. The main purpose of the bank capital reform (Basel III and CRD IV) is to raise the quality and quantity of capital, achieving a more comprehensive coverage of the risks, and introducing stronger supervision, risk management and disclosure standards. Large banking groups recognize the importance of specialization, often applying divisional business models in order to optimize the ability to meet the needs of a variety of customer segments, offering personalized services.

Research question: International standards to face the financial crisis and the banking fragility can be implemented without any kind of customization to be effective in the Italian financial system?
Annex. Figures and Tables

Figure 1. Output of monetary and financial services to GDP ratio (1980 – 2009, dotted line) and Added Value of monetary and financial services to Added Value (1980-2010, continuous line)

Source: Istat and our elaboration

Figure 2. Employment dynamic by sector (agriculture, industry, services; 1980 - 2010)

Source: Istat
Figure 3. Employees in monetary and financial services to total economy ratio and output per employee (1980 – 2010)

Source: ISTAT

Figure 4. Bank Loans and Deposits (1995 – 2011; 1995 = 100)

Source: Banca d’Italia
Figure 5. (Capital and reserves) / Total assets of Italian banks (1995 – 2010)

Source: Banca d’Italia

Figure 6. Market capitalization of listed companies (% of GDP) in Italy (1988 – 2010)

Source: Borsa Italiana and ISTAT, our elaboration
Figure 7. Private credit (left) and GDP (right) (1995 – 2010)

Source: Banca d’Italia

Figure 8. Liabilities of firms to banks / Total financial liabilities of firms and Assets of Households to Banks / Total Financial Assets of Households (percentage values; 1997 – 2011)

Source: Banca d’Italia
Figure 9. Banks and branches (1995 – 2011)

Source: Banca d’Italia

Figure 10. Share of loans by size of banks (1995 – 2011)

Source: Banca d’Italia
Figure 11. Share of deposits by size of banks (1995 – 2011)

Source: Banca d’Italia
Table 1. Financial firms and Banks in Italy (1997 – 2011)

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Source: Banca d’Italia