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The Italian Financial System: trends and perspectives

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Globalization: The Role of Institution Building in the Financial Sector

Summary

1. Introduction

During the last 25 years, legislation, taxation, supervision and the promotion of competition—public, economic and institutional policy—have combined with domestic economic developments and international trends to determine far-reaching changes in the Italian financial system. Apart from the underdevelopment of pension funds, which is a serious deficiency, the structure of the Italian system is currently similar to those prevailing on the international stage.

The Italian financial industry has modernized its operations and its performance. It has become more "market-oriented" and somewhat less reliant on "relationship-based" forms of financial intermediation and institutions. It has advanced in terms of the quantity, productivity and prices of banking services and the diversification, depth and efficiency of markets. Financial integration has opened up domestic intermediaries to foreign competition. A sound legal, regulatory and monitoring infrastructure has gradually been built, properly maintained and adapted to the evolution and needs of the market process and participants. Such changes depend only in part upon the forces that have contributed to the shaping of the changes in European finance: the process of worldwide financial integration with the concomitant spreading of financial innovation; monetary policy unification in the euro-area.

The weakness of the Italian financial industry still lies in relatively high per capita labor costs, even though the gap with our main partners has been significantly reduced in recent years; also, the distribution, quality and scope of some services leave room for improvement. However such improvement cannot be entirely de-coupled from the propensity of Italian companies and households to demand increasingly more sophisticated financial products and services. Habit formation and the catching-up along the (admittedly challenging) learning curve of financial innovation may stand in the way of taking full advantage of its potential and new opportunities. The phase of technological innovation we are currently living in, its pace and magnitude, requires increasingly complex financial solutions, which often include essential components of "arm's length" type of fund-raising and products intermediated by financial markets. However, small and medium-sized enterprises, which make the bulk of the Italian private sector, still may find these instruments, entailing stock market listing (or equivalent intensive information disclosure and compliance), too costly and disproportionate to their needs.

The financial sector can contribute to the Italian economy’s return to growth. However, its contribution will depend not so much on further public policy measures, but rather on the behavior of relevant market players. On the one hand, the actions of bankers and financiers will be of utmost importance in lowering labor costs and upgrading the quality of services in what has become a competitive environment. On the other hand, the result will also depend on the willingness of households and firms to make full use both of the instruments that the financial system now offers—which they have failed to do so far—and of those the system will supply in the future, in line with the trends in international and European finance.

The present paper is organized as follows. In section 2, the main changes in Italian finance during the last two decades of the century are examined. Section 3 illustrates in detail more recent developments, focussing on the structure and the various segment of the Italian financial industry and infrastructure. Section 4 analyses competition and market structure using indicators and cross-country references to academic and central bank research relevant for gauging the progress of competition in the financial sector. Section 5 puts into perspective the changes by assessing the forces that have driven the transformation of Italy's financial landscape. Section 6 review some of the issues outstanding and near-term prospects for the Italian financial system.

2. Main changes in the Italian financial system during the last two decades

Two issues lie at the center of the analysis of a financial system. The first concerns the determinants of the overall size of the system or, to put it differently, the conditions that facilitate the provision of external finance to the economy. Empirical research has shown that institutional factors, such as the design of the legal framework and the degree of investor protection, the amount of competition, and the soundness of banks and other intermediaries play a significant role in this respect. The second regards the relative importance of intermediaries and markets in the financial system and how the latter evolves from one configuration to another.

As noted earlier, during the last 30 years major changes have occurred as regards the overall size of the financial system and its efficiency, the mix of intermediaries and the relevance of the markets[1]. In this section these changes will be briefly recalled, and the main driving forces behind them will be highlighted.

At the beginning of the 1980s the Italian financial system was not quantitatively underdeveloped in comparison with other advanced countries.[2] The volume of gross financial assets has since grown from 1,300 to 11,400 trillion lire at current prices and to 3,300 trillion at 1980 consumer prices. The ratio of total outstanding amounts of financial assets to GDP increased from less than four times in 1980 to seven in 2000. The financial interrelation ratio has also risen, to stand at 1.2 in 1996. As in other countries, this reflects increases in the prices of existing securities as well as issues of new liabilities; in the 1990s such issues have fallen as a ratio to GDP, more sharply in Italy than elsewhere. In the quantitative growth of finance Italy has basically kept pace with Germany and Japan. The three countries as a group have seen the gap widen with France (where the financial interrelationship ratio is 1.9), the United States (2.1) and above all the United Kingdom (2.9). However, the British and American financial systems are increasingly oriented to satisfying international demand; their financial centers serve the world in addition to their domestic economy.

Competition in the banking markets was fostered by the liberalization and deregulation measures introduced in the 1980s and 1990s. Among these measures the most important are: in the 1980s, open-ended investment funds were introduced and credit ceilings on banks were removed. Geographical and maturity restrictions on banking operations were also abolished at the end of the decade. Financial flows with the rest of the world were liberalized between 1987 and 1990 (see Passacantando, 1996). In the 1990s, the de-specialization of the banking sector was completed with the 1993 Banking Law, which allowed the model of the universal bank to be adopted in Italy.[3] This resulted in the statutory despecialization of banks, thereby eliminating the distinction between banks and special credit institutions and the different categories of institutions. An important consequence was the increase in competition among former short-term banks and former special credit institutions. Participation in the capital of banks continued to be regulated in accordance with the principle of separation between banking and commerce.

Though concentration of banks' market shares increased at the national level, the number of banks operating in each Italian province (which can be thought of as local markets) increased strongly and the spread between lending and deposit rates narrowed significantly (Ciocca, 1998).

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[1] For a full description and discussion, see Ciocca (2000); for more details on Italian credit structures in the 1970s and 1980s, see Banca d'Italia (1984).

[2] The ratio of gross financial assets (liquid assets, loans and securities) to real wealth (plant, machinery, stocks, buildings and land)—Raymond Goldsmith's financial interrelation ratio, or FIR—is estimated to have been 0.9 in 1980. This value can be considered high, albeit below the peaks recorded in the 1970s, which were anomalous in several respects. It was not lower than those recorded in the more advanced economies of West Germany, France and Japan.

[3] The universal bank can operate without maturity constraints and can carry on all the financial activities that are not restricted by law—see the Appendix for more details.

Deregulation progressed further with the privatization of the banking sector. The process of consolidation in the banking industry accelerated, with the number of banks falling by a third. A new law on financial intermediation set out the conditions for a more efficient provision of financial services. Furthermore, new corporate governance rules ensuring better protection of minority shareholders were introduced[4]. These changes affected the structure of the financial system.

The important role that intermediaries have historically played in Italy, both on the asset and the liability side, permitted researchers to classify the Italian financial system as being intermediation oriented[5]. Up to the 1970s, banks dominated the allocation of financing, as testified by the high value of the ratio of banks' financial activities to total financial activities. Household assets were largely invested in deposits. On the liability side of the non-financial sectors, bank loans were the main source of finance. As a result of exchange rate controls and tight regulation of financial investment abroad, assets held with the rest of the world were very limited. A first wave of disintermediation in the banking sector took place in the 1980s with the development of a growing market in government securities. On the asset side, financial accounts show the decline in the importance of deposits in investors' portfolios, paralleled by an increase in the amount of public sector securities directly held by households. Still, high inflation limited investment to short-term maturities.

In the 1990s, the reduction in inflation rates and in government deficits, coupled with the effects of the liberalization measures implemented at the end of the 1980s, further contributed to fostering the reallocation of financial wealth towards market instruments. This process was also accelerated by the European Monetary Union perspective, which contributed to the decrease in inflation as well as in nominal and real interest rates. The adjustment of public finances implied a reduction in the supply of government securities relative to GDP and prompted the redirection of household wealth towards shares and mutual funds. The rise in the proportion of shares in household portfolios was further accelerated by the privatization of formerly public firms.

The composition of financial instruments and the relative importance of the various issuers have changed significantly in the last 20 years. At the beginning of the 1980s, deposits and short-term securities represented more than 40 per cent of total financial assets, whereas by 2000 their share had decreased to less than 20 per cent. Over the same period, long-term securities, shares, insurance technical reserves and mutual fund shares almost doubled as a proportion of total financial assets (from 30 per cent to 60 per cent). As regards the issuers, the declining importance of banks was met by a marked increase in the weight of other financial intermediaries and non-resident issuers. Among non-banks, the major issuers are currently the Government (though its importance has declined in the last ten years) and non-financial corporations.

However, the importance of banks in the financial landscape has not decreased dramatically. Banks still play a central role in the Italian financial industry, though their intermediation model has evolved. Through their group structure they control a large share of mutual funds, and through the universal banking model they are engaged in the provision of services to firms and in the financing of longer-term investments.

Moreover, the new rules for corporate governance introduced forms of direct protection of minority shareholders inasmuch as they made it easier for shareholders to be heard. In addition, the

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[4] In 1998, the Single Act on Financial Intermediation was enacted. With this law, a new institution was created: the asset management company, which made it possible to overcome the segmentation of activities and allowed banking and financial groups to centralize management functions and separate them from distribution (see Banca d'Italia, Economic Bulletin, No. 26).

[5] Although with some important qualifications, such as the importance of multiple banking relationships, which reduced the strength of bank-customer relationships (see Garella *et al.*, 2000).

new regulation on takeover bids aimed to balance the need for the protection of minority shareholders with the efficiency of the market for corporate control.

On the basis of these preliminaries, we can consider the principal changes—reduced here to seven—in the structure of Italian finance over a period of twenty years which we conventionally date from “1980”. The structure coincides with the economic and legal forms of finance, its diversification in terms of intermediaries and markets, and its basic organizational arrangements.

2.1 From intermediaries to markets

Up to the 1970s the Italian financial system was oriented towards “credit intermediaries” more than “markets” to an even greater extent than in other countries, particularly in continental Europe. Leaving aside its complex and debatable qualitative implications, this simple formula reflected the high or increasing quantitative importance of banks and the traditional intermediation they performed directly, as measured by their share of the financial intermediation ratio, i.e. the ratio of the financial assets held by credit institutions (divided into banks and special credit institutions at the time in Italy) to total financial assets.[6]

Over the past two decades “primary” securities—issued directly by individual spending sectors not engaged in a prevalently financial activity (households, firms and public bodies)—placed directly with final lenders or their agents (“direct securities”) have grown much faster than “indirect securities”, i.e., those supplied to final lenders by credit intermediaries drawing on their own purchases of primary securities. The growth of the securities markets has been correspondingly rapid. The development of the markets has reflected above all the expansion of the public debt (from 58 per cent of GDP in 1980 to a peak of 124 per cent in 1995) and the ability of the private sector to absorb both massive new gross issues of public debt (amounting to 50 per cent of GDP a year) and the disposals of government securities by the banking system. The latter, including the central bank, reduced its holdings from 60 per cent of the stock outstanding in 1980 to less than 20 per cent in the 1990s. Foreign investors, who had been virtually absent from this market, today hold more than a third of Italy’s public debt. A decisive factor was the creation in 1988 of an efficient screen-based market in government securities (MTS) by the main domestic participants at the behest of the Treasury and the Bank of Italy—see BOX 1 in section 3.

The growth of the private capital market has been less vigorous, although not inconsiderable. As a ratio to GDP, the capitalization of the Milan stock exchange is currently comparable to that of the Frankfurt exchange (68 per cent), but remains lower than the figures for the Paris, New York and London exchanges (respectively 99, 178 and 191 per cent).[7]

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[6] Calculated on stocks, the financial intermediation ratio reached a peak of 0.5 in the mid-1970s. Subsequently, the excessive growth of double intermediation, with the banks financing the special credit institutions, was rapidly reabsorbed. In 1980-81 the ratio had already fallen back to levels comparable to those of France and Germany (0.4), though well above those of the United Kingdom (0.3) and the United States (0.2). Credit intermediaries’ share of financial assets declined continuously, albeit less rapidly, in the two following decades, and by 1997 it had fallen below 0.3, lower than the ratio in Germany (which had remained around 0.4), similar to those in France and the United Kingdom and higher than that in the United States (which had decreased to 0.15).

[7] In the 1980s the growth of the market was due both to the increase in the number of listed companies, from 134 to 223, and to their issues of new shares. In the 1990s it stemmed from the rise in share prices and the privatization and listing of major public-sector companies. The number of listed firms has changed little, standing at 247 at the end of 1999. Their value added is equal to 8 per cent of GDP. Privatized companies account for more than half the growth in the stock exchange since the last quarter of 1993, when the privatization program began in earnest. New share issues by listed companies declined from 8 per cent of total stock market capitalization in the 1980s to 5 per cent in the 1990s. Nearly three quarters of all listed companies are controlled de jure or de facto by a single shareholder. Non-residents hold just over 10 per cent of the total value of listed shares.

The institutional and organizational turning point for the Italian stock exchange is of recent date but the changes have been radical. Ownership of all the markets for the trading of corporate and government securities was privatized between 1996 and 1999, after nearly half a century during which the markets were instituted, managed and supervised within the framework of public law. Companies limited by shares have been charged with managing the markets' structures and endowed with self-regulatory powers concerning the admission, exclusion and suspension of financial instruments and market participants, trading rules and the dissemination of information on trading. The procedures for exercising these powers are laid down in rules adopted by the market management companies and approved by the authorities.

Italy also has a large and efficient money market today for trading in both short-term government securities and inter-bank funds (E-MID). It is an integral part of the euro market, indeed one of its most advanced components, and enables Italian banks to vie in their treasury management with other European banks. Monetary policy was strengthened with the introduction of repos (1979) and changes in the classical refinancing instruments, including the revision of the penalty rates on fixed-term advances (1991) and the introduction of a commission on overdraft facilities (1985). The transition from administrative instruments and direct control—ceilings on the increase in bank lending and securities investment requirements for banks—to market based, indirect instruments in the conduct of monetary policy was completed in 1988. The mobilization of compulsory reserves was introduced in 1990. The creation of the screen-based inter-bank deposit market (MID) in the same year combined new rules and advanced technology. The undertaking by MID participants to concentrate their trades in the market and the binding nature of quotations contributed to the market's growth, transparency and efficiency.

Innovations in the payment system helped to reduce the use of correspondent current accounts. There was a positive interaction between monetary policy and the markets. Monetary policy conducted through the markets gained in effectiveness and signaling efficacy as the markets developed, while monetary policy measures and its information content enhanced the efficiency of the markets. Strengthened in this way, the Bank of Italy's monetary policy was able to manage expectations and subdue inflation between 1994 and 1998, thereby creating the essential condition for Italy's political decision to join the single currency to be implemented. At the same time the proportion of potentially "listable" financial instruments actually listed in organized and continuously operating markets rose from no more than 28 per cent to over 50 per cent today.

The decline in the financial intermediation ratio, the improvement in efficiency of the markets and their growth have a clear meaning as a whole: the Italian financial system is no longer predominantly bank-oriented (**Tab. 1**). However, the decline in the relative importance of traditional bank instruments has not coincided with a decline in the role of the banks, which remains pivotal. A stock of private capital for the financial industry offering an effective alternative to that built up over time by the banking system has yet to emerge. While deposits and loans were declining in importance, banks developed their securities trading and administration activities. They accommodated customers' demand for portfolio diversification (**Tab. 2**). Taking account not only of deposits but also of the securities intermediation performed by banks directly or through their securities market subsidiaries and affiliates, the share of financial savings managed by the banking system has not decreased. It stands well above 90 per cent, the level it had risen to in the 1980s from the already very high level of 80 per cent recorded in the late 1970s.

2.2 Market participants, instruments, and organizational arrangements

As activity in the markets came to prevail with respect to intermediation by credit institutions, the range of instruments, intermediaries and segments that constitute the financial system changed and in some respects was enriched. The composition of financial assets shifted radically. The fall in inflation and nominal interest rates from the early 1980s, together with high real yields and rising rates of profit, was a contributory factor.[8] These developments were sanctioned by the 1993 Banking Law and the 1998 Single Act on Financial Intermediation, which provide for an extended taxonomy of financial services that can be further expanded by contractual autonomy, in accordance with Article 1322 of the Civil Code (see the Appendix).

The universe of financial undertakings has been simplified with de-specialization in the banking industry, which now counts 875 banks with 27,000 branches, and enriched in both number and types of non-banks. On the organizational plane, the intermediate solution of the multifunction group is available to cover the range of situations in which "all-purpose" intermediaries would be unmanageable but which are beyond the reach of intermediaries with a specialized mission. The division of the banking industry into distinct legal and institutional categories has been overcome with the ending of maturity specialization. Alongside the former "banks" and "special credit institutions", the number of non-banks operating in the credit sector has increased (to around 1,400) and their market share has grown. These "other credit intermediaries" supply leasing, factoring, consumer credit and venture capital services. Their loan portfolio is now equal to about 10 per cent of that of the banks. Life insurance has expanded. Premium income from the life sector has surpassed that from the casualty, in part because the life insurance policies sold through the banking channel now account for about half the total. Among security market participants, the range of "other financial institutions" has expanded with the introduction and growth of securities firms, SICAVs, investment funds, asset management companies, and pension funds, and greater synergy between insurance and financial intermediation. In addition, more than a hundred companies established under foreign law are authorized to do business in the Italian market; they operate investment funds with an 8 per cent share of the total resources under management by the sector.

In 1990 "other credit intermediaries" together with "other financial institutions" accounted for 5 per cent of gross financial assets in Italy. In 1998 the figure exceeded 13 per cent, thanks especially to the gain of seven percentage points in the share attributable to "other financial institutions". The latter had been less developed in Italy than in the other countries of continental Europe. In 1996 their assets were equal to 35 per cent of GDP in Italy, 42 per cent in Germany and 80 per cent in France. Three years later the ratio in Italy has risen above 75 per cent (**Tab. 3**).

Pension funds have recently been created but their assets are still negligible. The coverage and generosity of the pay-as-you-go pension plans, and the consequent modest importance of funded schemes, remain the principal cause of the delay on this front. So far, the tax benefits provided have done little to accelerate the take-off of these intermediaries.

2.3 Ownership and contestability: from public to private.

In 1980 and even a decade later the activity of public-sector banks accounted for nearly 70 per cent of the total volume of business, one of the highest ratios in Europe. The figure is 15 per cent today, one of the lowest in Europe, and will decline further with the residual disposals to be carried out by the bank foundations. The privatization of the public-sector banks was concentrated in the space of a few years, but its institutional gestation was long and complex. The reform passed through three phases: the alignment of the rules applying to banks in the public sector with those governing banks in the private sector, the transformation of public-sector banks into companies

[8] Money and the most liquid monetary instruments (currency, deposits and Treasury bills) fell from 44 per cent of total financial assets in 1980 to 33 per cent in 1990 and 20 per cent in 1998. Loans, especially short-term lending by intermediaries issuing liquid liabilities, also declined, from 25 per cent in 1980 to the present level of 20 per cent. Bonds (notably longer-term government securities), equities, insurance technical reserves and investment funds recorded a corresponding increase in their share, which rose to more than half: it was 31 per cent twenty years ago and is nearly 60 per cent today. Issues of corporate bonds and commercial paper still remain fairly limited, albeit growing in the wake of the introduction of the euro.

limited by shares and the elimination of the restrictions on the ownership of the capital of the former public-sector banks.

On the basis of holdings in excess of 5 per cent of the capital reported to the Bank of Italy in 1998, 27 per cent of the capital of Italian banks is owned by other Italian banks, 4 per cent by foreign banks, 18 per cent by public and non-profit institutions and 5 per cent by insurance companies and financial undertakings (holdings of less than 5 per cent account for the rest). In terms of their shares in total bank intermediation, banks are 63 per cent controlled by other Italian banks, 15 per cent by foundations and public bodies, 5 per cent by insurance, industrial and financial undertakings, and 2.5 per cent by foreign banks. The problems of ownership structure in the banking system—hard cores, shareholders' agreements, and cross-shareholdings—must also be evaluated in the light of the huge scale of the privatization process and the short time in which it was carried out.

2.4. Opening the financial system.

Progress in the international integration of the Italian economy and financial system is reflected in the volume of transactions connected with capital flows recorded by the balance of payments (the sum of the changes in gross assets and liabilities). In the 1990s they have increased ten-fold and sixteen-fold respectively for Italian and foreign non-bank capital movements. Total transactions in the foreign exchange market have tripled to reach $30 billion a day.

The Italian banking system has never been closed to international relationships since the Second World War, not even when capital exports by residents were discouraged or prohibited and even subject to penal sanctions such as those laid down by Law 159/1976. In the 1980s and even more in the 1990s, with the removal of exchange controls, Italian banks' international activity grew in every respect indicating an effective ability to be a competitive player in financial globalization.[9]

As suggested in the academic literature[10], entry by foreign banks makes domestic banking systems more efficient by reducing their margins. Moreover, Barth *et al.* (2001) and (2002) analyze various regulatory restrictions in place in 1999 (or around that time) on commercial banks, including various entry and exit restrictions and practices. They find that tighter entry requirements are negatively linked with bank efficiency, leading to higher interest rate margins and overhead expenditures, while restricting foreign bank participation tends to increase bank fragility. These results are consistent with the view that tighter entry restrictions tend to limit competition and emphasize that it is not the actual level of foreign presence or bank concentration, but the contestability of a market that is positively linked with bank efficiency and stability.

The Italian banking system's exposure to the emerging countries is on the order of $30 billion, equal to 25 per cent of its capital and reserves; the amount is not inconsiderable, but the ratio to capital is the lowest among the OECD countries with advanced financial systems.

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[9] The assets of banks operating in Italy vis-à-vis non-residents grew from $25 billion at the beginning of the 1980s to $94 billion in 1990 and $186 billion in 1998. Between 1990 and 1997, including Italian banks' branches abroad, residents' foreign currency deposits plus non-residents' lira and foreign currency deposits rose from 8.2 to 10.9 per cent of total deposits, while lira and foreign currency loans to non-residents increased from 5.8 to 6.7 per cent of total lending. The number of Italian banks' branches abroad rose from 43 in 1980 to around one hundred in 1990, and then remained at that level over the last ten years. That of foreign banks' branches in Italy has increased uninterruptedly, from 24 in 1980 to 37 in 1990 to 58 at the end of 2000. The foreign banking and financial subsidiaries of Italian banking groups numbered 140 in 1992 and 182 in 1998. In 1990 there were seven subsidiaries of foreign banks in Italy, today there are eleven. Italian subsidiaries of foreign groups numbered 13, of which ten belonged to EU groups. The presence of Italian banks abroad was extended, thanks notably to the acquisition of foreign banks. At the end of 2000, 26 Italian banking groups were operating abroad; there were 73 foreign subsidiaries and 94 foreign branches. Branches and subsidiaries located in non-EU countries numbered 44 and 49 respectively.

[10] See, for example, Claessens *et al.* (2001)

In 2000, the ratio of banks' total assets to GDP was 153 per cent in Italy, against an euro area average of 255 per cent. In particular, there are four balance sheet components that are relatively underdeveloped for Italian banks compared with banks in the other euro area countries: inter-bank activities, securities portfolio, foreign assets and loans to households[11]. Inter-bank activities (loans to MFIs resident in the euro area) represented 14 per cent of total assets, compared with 21 per cent for the euro area. The difference basically reflects the existence in Italy from the beginning of the 1990s of an efficient screen-based market for inter-bank deposits (*Mercato Interbancario dei Depositi*, MID), which led to a reduction in the number of bilateral current accounts between banks.

The ratio between the overall amount of securities and shares with counterparts in the euro area and total assets was one percentage point lower in Italy than the euro-area average (16 per cent and 17 per cent, respectively).[12] The foreign assets to total assets ratio was 5 per cent, seven percentage points lower than the euro-area average. Loans to households represented slightly more than 13 per cent of total assets, against an euro-area average of 18 per cent. Loans to the non-financial sector represented slightly more than 50 per cent of total assets and were equal to 81 per cent of GDP in Italy (26 percentage points less than in the euro area). This difference can be largely ascribe to loans to households, which are equal to 20 per cent of GDP, against 46 per cent in the euro area.

Regarding the maturity structure, the share of medium and long-term loans of Italian banks is lower than in the other euro-area countries. Short-term loans to non-financial corporations represent 52 per cent of banks' total assets. The proportion also remains high if loans with an original maturity of less than five years are considered (73 per cent in Italy, against 52 per cent in the euro area). The high share of short-term loans in assets of Italian banks is mainly the result of past high inflation rates. A high proportion of short-term loans may also constitute a monitoring device on borrowers in the presence of inefficiencies in the liquidation of projects in financial difficulty.[13] In 2000, variable interest rate loans represented 63 per cent of the total amount of loans to the non-financial sectors.

On the liability side, Italian banks also have a larger share of short-term instruments. Overnight deposits represented around 67 per cent of total deposits, against 31 per cent in the euro area. Virtually all deposits (98 per cent) have a short-term maturity (overnight, deposits redeemable at notice up to three months, deposits with agreed maturity up to two years). The share of bonds in total domestic funding (96 per cent) is similar to the euro-area average.

2.5 The payment system

Since the mid-1980s the payment system in Italy has achieved a quantum leap: in the efficiency and security of cash and securities settlements, in technical infrastructure and in the payment services offered to customers. Settlement in monetary base of inter-bank positions has been encouraged, giving certainty and finality to these transactions and contributing to the growth of the screen-based inter-bank deposit market. The volume of transactions settled in central bank money

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[11] See Gambacorta, Gobbi and Panetta, (2001) for more details.

[12] The difference would be 20 percentage points if the ratio were worked out relative to GDP, which reflects the more limited depth of the Italian financial system. It is not attributable to different investment strategies by Italian banks since, as illustrated above, the proportion of securities and shares in total assets is similar to that recorded for the euro area.

[13] According to the last survey conducted by the Banca d'Italia on loan recovery procedures by banks (on a sample representing 90.5 per cent of total lending to Italian residents), the time for recovery ranged, for the reference month of December 1999, from a maximum of six or seven years for bankruptcy proceedings or composition agreements between creditors and debtors, to around two years for private settlements, the most frequent recovery procedure. The average recovery rate is estimated to be around 38 per cent of the amounts owed, with a substantial dispersion depending on terms and conditions of loans, such as the presence of collateral (Banca d'Italia, Economic Bulletin, No. 34).

grew from 6 times GDP in 1988 to 41 times in 1998, in line with the EU average of 43. In conjunction with this, the balances on correspondent current accounts declined from 34 per cent of total inter-bank liabilities at the end of the 1980s to 14 per cent in 1998.

The changeover from clearing to gross settlement (the BI-REL system) for large-value payments strengthened the security of payments, substantially reducing systemic risk at a time when transaction volume was growing. Following the launch of the European Monetary Union, the Italian gross settlement system has been one of the main components of the Target, the European payment system.[14]

The creation of central depositories allowed ownership of securities to be transferred from one trader to another by book entry on the accounts at these depositories. The dematerialization of securities was completed with the measures issued for the introduction of the euro. The use of automatic trade checking systems in the securities markets made it possible to automate trading and settlement. The system has coped with the rise in volume generated by growing financial markets. In the period 1988-1998 the value at constant prices of the transactions handled by the securities settlement procedures has increased by a factor of 48. In 1998, at 26 times GDP, it was higher than the EU average. In the stock market, the change from securities settlement on predetermined account days to rolling settlement has reduced the interval between trading and settlement from between 15 and 45 days to 3, in line with European standards. The use of the BI-REL system for the cash side of the settlement of securities transactions has helped to increase settlements on a gross basis to 92 per cent of the total volume of settlements in monetary base in 1999.

In retail payments, the gap with other countries has narrowed in terms of the infrastructure employed and the efficiency of the services offered. In the last ten years the number of POS terminals per million inhabitants has risen from 98 to 5,970, that of ATMs from 137 to 482. The continuation of this trend will close the small remaining gap between Italy and the other principal European countries in this field.

The introduction of specialized inter-bank procedures has shortened the time for executing cashless payments. New channels of customer contact have been created as an alternative to the branch network (remote banking) and innovative products developed for corporate customers (inter-bank corporate banking). Customer payments ordered by means of automated procedures have more than tripled since 1990. The time required to execute payments has declined: at the end of the 1980s the average execution time for payment orders was six days; in 1998 it was four days for payments of less than 500 million lire and one day for “urgent” and large-value payments. The range of services has been widened with the creation of new instruments (electronic money) and the promotion of instruments that had been little used (debit and credit cards).

Households and firms so far have made only limited use of the services made available by the technical and organizational advances of the payment system. Although the number of cashless transactions has risen in recent years, it remains substantially lower than the European average (43 payments per capita in Italy, against 121 in the EU). The fact that current accounts are less widespread (0.5 accounts per inhabitant in Italy, against 1.4 in the main European countries), the fragmentation of the distribution network and slower acceptance and use of payment cards explain only part of the gap. It is also due to the lower propensity of businesses to use innovative payment instruments. At the end of 1998 only 250,000 firms, or just 7 per cent, used electronic systems in dealing with their own bank.

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[14] The relevance of Target is confirmed by the system’s operating volume: in its first year of activity it handled an average of more than 163,000 payments totaling 925 billion euro a day. Cross-border transactions increased by 58 per cent in number and 6 per cent in value between January and December 1999. The share of transactions originated by Italian intermediaries is high in terms of number (25 per cent), lower in terms of value (10 per cent).

2.6 Managed savings

The share of Italian households' financial assets entrusted to third parties for management was negligible at the beginning of the 1980s. Asset management and institutional investors have grown appreciably since then, contributing significantly to strengthening the money and securities markets. In Italy, as elsewhere, they have satisfied a need on the part of savers arising from the growth of financial wealth and its spread to employee households, the possibility of investment diversification for even modest portfolios and the resulting volume of transactions, in a setting of volatile and technically complex markets.

The birth of investment funds and the spread of individual portfolio management services in the early 1980s imparted decisive impetus. Financial wealth under management (investment fund units, individual portfolio management accounts, insurance policies and pension funds) rose from 10 per cent of households' financial assets at the beginning of the 1990s to 33 per cent at the end of 2002. However, this share remains lower than the average of some 38 per cent for the Group of Seven countries. This part of the remaining gap is also largely attributable to the social safety net provided by the public sector in Italy, and hence to the scant role still played by pension funds.

Italy holds an intermediate position among the main euro-area countries in terms of managed savings as a percentage of GDP: over 90 per cent at the end of 2001, compared with 80 per cent in Germany and Spain and just over 130 per cent in France[15]. A chasm remains with respect to the United Kingdom and the United States, where professionally managed savings are close to 200 per cent of GDP. In both these countries the combined contribution of insurance companies and pension funds is preponderant, amounting to some 130 per cent of GDP in the UK and almost 100 per cent in the US, compared with just over 30 per cent in Italy. In France and Germany the market share of insurance companies (but not that of pension funds) is large, accounting for more than half of managed savings.

2.7 Derivatives

Among the most important of the financial instruments recently been introduced or used more widely in Italy are “derivatives”, which have surpassed the traditional techniques of risk management and risk allocation both in convenience and in cost.

The Italian Futures Market (MIF), the first organized Italian market in financial derivatives, was created in 1991. It is a screen-based market for financial futures and options contracts on Italian government securities and futures contracts on short-term interest rates. With the privatization of the financial markets in 1998, MIF was purchased by Borsa Italiana. An Italian market in futures contracts on shares (Italian Derivatives Market, IDEM) was constituted at the end of 1994 as an integral part of the Stock Exchange. The creation of an options market sharply reduced the business in traditional options ("*mercato dei premi*"), which had been traded on the public stock exchanges since their institution in 1913. Negligible in Italy at the end of the 1980s, use of these instruments expanded rapidly thereafter. Unstable macroeconomic conditions, floating exchange rates following the crisis of the EMS in 1992 and uncertainty over interest rate convergence within the EMU hastened the learning process.

In 1998 the average daily turnover in lira denominated derivatives in organized markets was more than 60 trillion lire ($35 billion); two thirds of this business was in the money and bond markets. The latter component - nine tenths of the trading is done in London - contributed significantly to the formation of the euro area's derivatives market[16]; it accounts for 15 per cent of

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[15] See Banca d'Italia, Annual Report, 2002.

[16] See Violi (2003) for details.

all the area's transactions in interest rate and bond derivatives. The size of the European market is now significant, on a par with that of the United States (**Tab. 4**).

In 1998 trading in stock index derivatives on the Italian exchange accounted for 15 per cent of all such trading in European markets, a larger share than those of London and Paris and exceeded only by that of the German-Swiss Eurex exchange. Unlike that on organized markets, the information on OTC trading is fragmentary. Data are gathered only from the leading players. Italy's share of the European-wide market, though significant, is smaller than its share of trading in organized markets.[17] Like the foreign exchange market, the derivatives market is dominated by inter-bank transactions and transactions with non-residents (92 and 75 per cent of the total, respectively); euro-denominated transactions outweigh those in other currencies, accounting for some 90 per cent of the total.

3. Recent developments in the Italian financial system

Tab. 5 shows the composition of financial assets and liabilities[18]. On the asset side, at end-2000, the intermediated assets of the resident non-financial sectors represented 38 per cent of total intermediated and non-intermediated financial assets and were equal to 109 per cent of GDP, compared with 42 per cent and 94 per cent respectively in 1997[19]. Most intermediated assets were held in household portfolios (96 per cent of GDP in 2000, against 82 per cent in 1997)[20]. Within intermediated assets, a major shift has taken place from bank deposits to mutual fund shares, the proportion of which has risen significantly. The banks in particular facilitated this spread of mutual fund shares.

Guiso and Jappelli (2002), using the Survey of Household Income and Wealth, find that in the second half of the 1990s participation of households in the equity market increased. Moreover, they observe a sharp increase in the share of stocks in households' portfolios (held both directly or through mutual funds) and a decline in less risky assets. Micro data confirm the increase in the degree of diversification of households' portfolios.

In 2000, most of the assets of the resident non-financial sectors were non-intermediated (i.e. 62 per cent of the total or 181 per cent of GDP). Households held 60 per cent of non-intermediated assets of resident non-financial sectors (108 per cent of GDP in 2000, against 90 per cent in 1997). A substantial share of non-intermediated instruments was held by non-financial corporations and nonresidents (62 per cent and 60 per cent of GDP, respectively). As a proportion of total assets, non-intermediated instruments represented 53 per cent of the total household portfolio and around 80 per cent for the other resident non-financial sectors and the rest of the world.

On the liability side, intermediated financial liabilities of the resident non-financial sectors are also much less significant than non-intermediated ones (about 84 per cent of GDP compared with

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[17] Turnover in Italy in forward foreign exchange contracts and derivatives amounted to $33 billion a day in 1998, nearly 50 per cent more than in 1995. Forward foreign exchange transactions rose from just under $16 billion in 1995 to just over $22 billion in 1998, essentially owing to the steep increase of 127 per cent in foreign exchange swaps, whose share of the total rose from 33 to 52 per cent. The share of total trading accounted for by non-resident counterparts remained basically unchanged at about 75 per cent. Daily turnover in exchange rate derivatives fell from $1 billion to $700 million, owing to decreased use of currency swaps and domestic currency swaps; turnover in options increased.

[18] For illustration purposes, the instruments have been split into those that can be considered as mostly issued by intermediaries (labeled as " intermediated") and those that are mostly directly issued on the market (labeled as " non-intermediated").

[19] In 2001, the share of intermediated financial assets in total intermediated and non-intermediated financial assets remained stable around the values recorded in 2000.

[20] It has to be considered that, among the intermediated assets, severance payments and casualty insurance technical reserves equaled 13 per cent of GDP in 2000.

206 per cent). The share of intermediated liabilities in the sum of the two categories was around 30 per cent in 2000. Non-intermediated instruments represented 66 per cent of total intermediated and nonintermediated liabilities of non-financial corporations. By contrast, household financial debt is exclusively composed of intermediated liabilities. Nonintermediated instruments mostly represent the liabilities of the rest of the world with resident counterparts.

The growth in non-intermediated instruments, both on the asset and the liability sides, observed when looking at outstanding amounts was partly due to the increase in the valuation of shares. Despite the decline in stock prices during 2000 onwards, the ratio of intermediated assets of the resident non-financial sectors to the sum of intermediated and non-intermediated assets increased to 44 per cent. On the liability side, the growth in the share of intermediated instruments was less pronounced, with a rise to 32 per cent.

According to consolidated financial accounts data, the share of non-intermediated instruments for non-financial corporations as a proportion of GDP is much lower owing to the large cross-shareholdings of Italian firms.[21]

3.1 Flows of funds composition and dynamics in the 1990s

In Italy the household sector is a net provider of funds, whereas the corporate sector and government are net absorbers. In the 1990s, the economic downturn in the first half and the improvement in the financial situation of the public sector were associated with a decrease in households' propensity to save. The need to reduce the budget deficit implied a large increase in the tax burden, which led to a deceleration of growth in disposable income. Correspondingly, the net financial surplus shrank (from 9.9 per cent of GDP in 1995 to 7.8 per cent in 2000). Notwithstanding the decrease in savings, Italian households' net financial position is larger than in the euro area (202 per cent of GDP in 2000, compared with 156 per cent for the euro area).

In the 1990's the financial position of firms weakened as the recession loomed in the wake of the 1992 ERM crisis. After the 1992-93 recession, the financial position of firms progressively strengthened. The increase in profits and in retained earnings led to a reduction in firms' net financial indebtedness. As a share of GDP, the net incurrence of liabilities progressively fell during the second half of the 1990s (averaging 2.4 per cent in 1995-97). Subsequently, the increase in both gross fixed investment and M&A activity led to a rise in net financial indebtedness, which averaged 2.5 per cent of GDP in 1998-2000. This rise was particularly sharp in 2000, when the flow of net liabilities was equal to 5.2 per cent of GDP. Looking at amounts outstanding, net financial liabilities of Italian non-financial corporations were equivalent to 87 per cent of GDP in 2000, against a euro-area figure of 110 per cent.

In the 1990s, major budgetary adjustment brought government net financial indebtedness closer to balance. While it averaged 6 per cent of GDP in 1995-97, it decreased to 1.9 per cent in the subsequent three years (and to less than 1 per cent in 2000). Government indebtedness is higher in Italy than in the euro area.

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[21] In Italy the ratio of non-intermediated assets of the resident non-financial sectors to GDP (181 per cent in 2000) was relatively close to the euro-area figure (169 per cent). The corresponding ratio for intermediated assets was, however, much lower (109 per cent against 162 per cent for the euro area), largely reflecting the limited development of private pension funds. The ratio of intermediated liabilities to GDP is lower in Italy than in the euro area, mainly owing to the much lower indebtedness of the household sector (considering intermediated liabilities, it is 23 per cent of GDP in Italy against a euro area average of 51 per cent). The ratio of non-intermediated liabilities of the resident non-financial sectors to GDP is not very different to the euro-area figure (206 per cent against 218 per cent), but the sectoral composition differs, with a lower recourse to non-intermediated liabilities for the Italian non-financial corporations and a higher one for the general government.

The 1990s also featured a major adjustment in the country's external position and the current account of the balance of payments. The rest of the world was a net creditor in the first half of the 1990s, but became a net debtor in the second half. Net financial indebtedness of the rest of the world as a percentage of GDP was substantial in the years 1995-97 (1.6 per cent on average, reflecting a similar figure for the current account deficit), but it then decreased in the subsequent three years (0.7 per cent on average).

3.2 Channeling of funds through intermediaries

Most of the instruments intermediated in Italy are issued by monetary financial institutions, more specifically banks. In 2000, considering the total economy, deposits and money market fund shares were equivalent to 87 per cent of GDP. The central government also intermediates a substantial amount of funds through the deposits collected by the post-office system.

In the second half of the 1990s financial assets issued by investment funds increased dramatically, reaching 38 per cent of GDP (less than 5 per cent in 1990). The decreases in nominal and real interest rates, as well as in inflation, were accompanied by a shift in the composition of financial assets, with investors looking for higher returns. This shift did not imply a reduction of the importance of the banking sector. In fact, the vast majority of these financial intermediaries are controlled by the banking sector either directly or through banking groups (see Section 2). Moreover, banks' presence in the issuance of non-intermediated instruments increased considerably: the amounts outstanding of bank bonds were equivalent to 17 per cent of GDP in 2000, against 5 per cent in 1990.

Holdings vis-à-vis the insurance sector equaled 19 per cent of GDP in 2000 (10 per cent in 1990) and were mostly in household portfolios. Private pension funds have played a very limited role in Italy so far (1.5 per cent of GDP), the reason being the predominance of public pay-as-you-go pension schemes and generous, government-funded welfare and social insurance schemes. This feature has been mentioned as one of the reasons for the Italian financial intermediation ratio being lower than in the other major industrialized countries.

3.3 Bank intermediation

The legislative and structural changes affecting the banking system in the 1990s broadened the range of options available to banks when defining their corporate strategies (see section 2 for more details). Therefore, no single model characterizes the Italian banking system. Liberalization of the banking sector has prompted some specialized banks to form groups. Other credit institutions have followed the universal bank model.

The rationalization of the structure of the Italian banking system and the more intense competition that followed have seen a steady decline in the number of credit institutions in recent years (from 921 to 841 between 1998 and 2000). Most of the decrease has been accounted for by mutual banks (*banche di credito cooperativo*), the number of which fell from 563 to 499 (at the end of 2000, their market share in terms of loans was around 5 per cent, compared to 82 per cent for limited company banks).

In the 1990s, heightened competition in the loan and deposit markets led to a narrowing of margins (Angelini and Cetorelli, 2002; Cetorelli and Violi, 2003). The Italian banking system thus experienced a sharp drop in net interest income, a feature common to many European countries. However, the economic slowdown and the subsequent increase in loan loss provisions accentuated the decrease in profitability in the second half of the 1990s. Since the end of the 1990s, the increase in income from fees and services, greater cost-efficiency and better economic prospects have resulted in a general growth in profitability: in 2000, Italian banks' return on equity averaged 12.9 per cent, the highest value since the mid-1980s (6.4 per cent in 2002; **Tab. 6**). As in other countries, Italian banks sought to increase the scope of their activities and to provide new services to customers in order to offset the decline in income from the more traditional activities.

The wave of mergers was spurred by the need to achieve a scale of activity consistent with the widened range of banking products and services, such as asset management and corporate services (see Focarelli *et al.*, 2002). The process of consolidation was particularly intense between 1996 and 2000 (see Group of Ten, 2001). Bank mergers accounted for 39 per cent of the total value of M&A operations targeted on Italian enterprises, a value higher than that recorded in the euro area in the same period (22 per cent). Since 1990, consolidation in the banking industry has affected banks with total assets representing around 50 per cent of the sector[22].

As regards market concentration, at the end of 2000 the five biggest banks accounted for 23 per cent of total assets. In 2001, the share of the five biggest banks increased to 29 per cent of total assets. When considering the first five banking groups, the degree of concentration (54 per cent of total assets in 2000) was more similar to the other main euro-area countries.

The role of government in the Italian banking market steadily declined in the 1990s. The share of total assets held by banks and banking groups controlled by the State fell from 68 per cent in 1992 to 12 per cent in 2000, one of the lowest levels in Europe. The privatization of the banking sector and the transformation of banking structures led to an increase in the number of banks listed on the stock exchange, which doubled over the decade. On a consolidated basis, at the end of 2000 the 40 banks whose shares were traded on the main stock exchange accounted for 80 per cent of the banking system’s total assets.

With regard to the participation of banks in the financial industry, cross-shareholdings between banks and insurance companies have increased in recent years, although the sort of integrated bancassurance conglomerates found in other European countries, in which banking and insurance business are equally important, were not formed. At the end of 2000, 68 Italian asset management companies out of a total of 101 were bank-controlled. As in most other European countries, banks in Italy have a large stake in the investment fund industry. At the end of 2000, the market share of asset management companies controlled by Italian banks was equal to 94 per cent of total assets, a value not dissimilar to those observed in other major euro-area countries. Foreign banks accounted for 13 per cent of the investment fund market in Italy.

With regard to the use of collateral in banks' lending, 50 per cent of banks' loans are backed by real guarantees (i.e. there are material assets that back the loan) or by personal ones (respectively 29 per cent and 21 per cent of the total value of loans). The share of secured loans shows a high variability across sectors and geographical areas (cf. Pozzolo, 2000). Secured loans range from 12 per cent of total loans for general government to 71 per cent for households, and from 44 per cent in the northwest to 61 per cent in the south. Furthermore, 67 per cent of medium and long-term loans (with a maturity of more than 18 months) are backed by collateral (13 per cent and 54 per cent, respectively, with personal and real guarantees). The percentage of secured short-term loans is 33 per cent (28 per cent being backed by personal guarantees).

3.4 Investment funds, insurance companies and pension funds

As a result of rapid growth in the second half of the 1990s, at the end of 2000 the investment fund industry in Italy amounted to €448.9 billion, the equivalent of 38.5 per cent of GDP. It was almost twice as large as the insurance industry and much larger than pension funds. While the number of mutual funds has steadily increased since their introduction in 1984, the average size is still quite large by international standards. The degree of concentration in the asset management

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[22] Bonaccorsi di Patti and Gobbi (2001) analyze the consequences of bank consolidation on small business lending; Focarelli and Pozzolo (2001) examine the determinants of cross-border bank mergers and acquisitions.

industry diminished substantially throughout the 1990s. At the end of 2001, the market share of the five largest asset management companies was 46.0 per cent. According to data collected by Lipper (the global mutual funds research subsidiary of Reuters), this value was lower than in most euro area countries.

In Italy, investment funds are mainly open-ended, publicly offered funds investing in transferable securities (UCITS). In the period 2000-01, asset management companies launched funds of funds, funds reserved for qualified investors and hedge funds. Closed-end funds (specialized either in securities or real estate) still only play a minor role.

By international standards, the Italian mutual fund industry is still characterized by a high proportion of bond funds. At the end of 2000, these represented 34.6 per cent of the total, about eight percentage points more than the euro-area average and three times the proportion in the United States. The net assets of equity funds amounted to 34.6 per cent of the total. In the equity segment, the proportion of net assets managed by funds specializing in domestic stock markets was 17.4 per cent, one of the lowest levels in the euro area.

At the end of 2000, securities other than shares constituted 51.7 per cent of the total portfolio of Italian investment funds, compared with 68.3 per cent in 1998. This substantial reduction was mainly attributable to a large fall in these funds' holdings of Italian government securities. Italian shares made up 9.9 per cent of the total portfolio, almost unchanged from 1998. By contrast, the proportion of foreign shares rose considerably in 1999-2000, from 12.5 per cent to 29.9 per cent.

At the end of 2000, 200 national insurance corporations were operating in Italy. Of these, 78 were in the life sector, 98 in the casualty sector, 20 in both sectors and 4 in the reinsurance business. In addition, 46 offices of foreign insurance companies were open for business in Italy. Technical reserves of Italian insurance corporations amounted to €216.5 billion, which equaled 7.0 per cent of households' total financial assets, less than in other major euro-area countries.

In the second half of the 1990s, total assets managed by Italian insurance corporations grew rapidly. The expansion was almost entirely attributable to the life sector, which at the end of 2000 accounted for more than three-quarters of the total. Policies offering index-linked or unit-linked benefits grew at faster rates than more traditional products. At the end of 2000, such policies represented 29.2 per cent of the life assurance sector's total technical reserves. Life assurance products are mostly sold through banks, which in 2000 collected more than 50 per cent of the total premium income of the life sector. Bancassurance has become prominent only in the past decade; partnerships and joint-ventures between banks and insurance companies have been successful especially in life insurance. At the end of 2002 Italian banks held equity investments in 74 insurance companies (35 in the life sector) and in 34 Italian insurance brokers; in 19 life insurance companies they held controlling interests. Italian banks also held investments in 24 foreign insurance companies and foreign brokers. Insurance groups had significant holdings in 32 Italian banks, including controlling interests in 7 small banks. In 2002 the premium income of new life insurance business accounted for by bancasssurance joint ventures and partnerships has reached 80 percent (33.3 billion of euro, according to a Banca d'Italia survey); such share has tripled since 1995.

Insurance corporations' total assets were equivalent to 21.5 per cent of GDP in 2000. Their securities holdings rose to €194 billion in 2000 (77.7 per cent of total assets), with shares accounting for 17.6 per cent of total assets. In the period 1999-2000, insurance corporations' investment behavior was marked by a sharp reduction in the proportion of government securities held, accompanied by increases in the shares of euro-denominated equities, eurobonds issued by non-residents and investment fund units.

After reforms in 1992, 1995 and 1998, the Italian social security system now consists of a predominant government controlled pay-as-you-go scheme, two types of private pension funds (closed and open) and insurance plans. Closed pension funds are occupational pension funds that are set up by an agreement between unions and employers (see Forni and Giordano, 2001). Workers not entitled to participate in a closed pension fund have the opportunity to join an open pension fund, which can be managed by an asset management company, an insurance corporation or a bank. Both occupational pension funds and open pension funds are funded and, at least for employees, have to be defined contribution schemes.

There are tax incentives for contributions. Moreover, workers joining an occupational pension fund are required to convert provisions to severance payments schemes into contributions to the fund. In addition to public pension schemes and pension funds, workers can subscribe an insurance policy for pension purposes. Also in this case tax incentives are provided. So far, the enrolment rate in pension funds has been quite low, in particular among young workers. The slow development of supplementary pension schemes can mainly be ascribed to the high level of compulsory contributions to the public pension system and to the firmly entrenched tradition of severance pay. At the end of 2000, pension funds held a substantial proportion of their assets in the form of securities other than shares (almost 53.0 per cent). The percentages of shares and deposits were equal to 8.5 per cent and 5.1 per cent, respectively. Real estate continues to be a large item in pension funds' assets (14.3 per cent of the total).

3.5 Market-based financial instruments

In terms of outstanding amounts, most non-intermediated instruments are issued by residents, although the role of those issued by non-residents is rapidly increasing. In 2000, these represented 21 per cent of the total (**Tab. 5**), against 13 per cent in 1997. Moreover, in the period 1998-2000 the instruments issued by non-residents represented 57 per cent of the total flow of non-intermediated instruments. These instruments were in large part held by corporations, accounting for 38 per cent of financial corporations' portfolios and 22 per cent of non-financial corporations' portfolios. Their share in households' portfolios was smaller, although by no means negligible (at 15 per cent).

The deceleration of the issuance of securities by residents is mostly due to the improvement in the financial balance of the Government. At the same time, the increase in issuance by resident non-financial corporations was rather limited. On the whole, the average flow decreased from €76.1 billion per year in 1995-97 to €54.7 billion per year in 1998- 2000. The issuance of securities by non-residents accelerated, however, and partially compensated for the deceleration of the resident component.

The amount of shares issued by the resident sectors has increased over time. On average in the period 1998-2000, this flow was €33.6 billion per year (3 per cent of GDP), compared with an average of €16.5 billion per year in the preceding three years. In terms of amounts outstanding, it increased from 84 per cent of GDP to 149 per cent, the rise being partly due to higher share valuations. The issuance of shares by non-residents also increased in the second half of the 1990s.

Looking at recent market flows, during the period 1998-2000, households actually reduced their holdings of securities and shares issued by residents, whereas they invested more in foreign shares and other securities. Non-residents increased substantially their net acquisition of securities issued by residents.[23]

Over the past decade, all Italian markets have developed further, particularly with the creation of new market segments, the privatization of the stock exchange, and the creation and consolidation of

[23] In the 1980s and the first part of the 1990s, the government sector accounted for the lion's share of the issuance of non-intermediated instruments. The large amount of bonds in circulation led to the creation of large, liquid and efficient secondary markets for the trading in government securities.

markets for futures and other derivatives. Furthermore, the privatization of state-controlled corporations contributed to the increase in stock market capitalization.

3.5.1 The bond market

3.5.1.1 The primary market: issuance

Since the first half of the 1990s, the techniques for allotting government securities have met the most stringent standards. The base price at auctions was abolished for all Treasury securities between 1988 and 1992. The introduction in 1994 of a category of intermediary called " specialist in government securities" has substantially improved the liquidity of the primary market. The reopening of auctions has enabled an increase in the size of each single issue. The Italian Treasury has also increasingly resorted to new financial instruments, such as global bonds, interest rate swaps and currency swaps.

At the end of 2000, the value of outstanding bonds issued by Italian residents (public sector, banks and firms) amounted to some €1,150 billion, or 127 per cent of GDP. Of this amount, 77 per cent had been issued by the public sector, 17.4 per cent by banks and 5.7 per cent by firms. The percentage of medium and long-term bonds was equal to 92 per cent. The average life of government securities, which stood below 36 months at the beginning of the 1990s, rapidly increased to approximately 70 months at the end of the decade. New bonds from banks and firms accounted for a large share of the total amount of new issues and were mainly placed on the international markets.

3.5.1.2 The secondary market: organization and integration

Since 1988, Italy has had an electronic wholesale market for trading government securities called MTS. This market has rapidly expanded from an initial average daily trading volume of €150 million to a peak of nearly €21 billion in 1997, stabilizing at around €7.9 billion in 2000. The impressive growth in turnover in the middle of the 1990s reflected the exceptionally strong demand for Italian government securities, fuelled by expectations of a rapid convergence of medium and long-term interest rates on lira-denominated assets to the levels prevailing in Germany and France (**Chart 1**). In 1994, the introduction of the specialists in government securities, which are typically market-makers on MTS, favored a sharp narrowing of the bid-ask spread, which fell from 36 basis points in 1993 to less than 4 basis points in 1999. In 1997, a segment for repo contracts was also introduced on MTS. At the end of 2000, trading on MTS accounted for almost half of the overall turnover in the secondary market for Italian government securities (for both outright transactions and repo contracts).

BOX 1 – Bond markets: MTS platforms

MTS is an inter-dealer quote-driven electronic market, reserved to professional operators. Since the end of 1998, MTS has established its market model and technology throughout Europe and the rest of the world. It is an Electronic platform which centralizes onto an interactive screen 2-way bid-ask proposals in terms of price and quantity from big professional players committed to deal securities for large-size volumes, in competition with each other to attract other big traders interests. It was created in 1988 and has represented the first important informatic realization of financial markets in Italy. At the very beginning there were only two categories of operators: primary dealers (which should have guaranteed liquidity to the market) and dealers (which should have had access to trade at the price proposed by the primary dealers). During the early nineties there were problems related to extreme concentration of trades on a few benchmarks and a considerable share of trades took place with foreign operators over the counter. In 1994 the firs reform of the market introduced two main innovations: 1) foreign operators were allowed to access the market as dealers 2) a new type of operator was introduced: the specialist, a sort of market maker obliged more than the others to guarantee liquidity subject to quantitative and qualitative requirements. Entering the Euro Markets represents a great opportunity and a big challenge: the competition between sovereign issuers is increased (reduced home bias effect) but if the issuance policy is well structured the pull of investors gets significantly wider and country spread are reduced. Market liquidity becomes crucial to attract investors. The presence of an efficient primary dealer system committed to guaranteeing market efficiency plays a key role. An equilibrium between primary dealer competition and cost sustainability is necessary. Primary dealer evaluation criteria must take into account several parameters in order to avoid manipulation.

Market regulation

The consolidated law on financial intermediation confirms the innovation introduced by legislative decree 415/96 about the organization and the functioning of financial markets. In particular financial markets must now be managed by private companies giving in that way an impulse to competition among producers of financial services. The law extends the privatization principles to the area of clearing and settlement too. Financial services production is no more managed by public Authorities and is not considered a public service any longer. Public Authorities still play a considerable role on financial markets, they still keep the responsibility to verify that market management companies activity is consistent with the aims of integrity of the market, protection of investors and financial stability. Market management companies are self regulated companies: in particular the organization and management of regulated financial markets shall be governed by rules approved by the ordinary general meeting of the management company. MTS, the wholesale market for government bonds, has been privatized in September 1997, with the transformation of a public entity (*Comitato di gestione*) in a joint stock company according to legislative decree 415/96, and was appointed with the status of regulated market. Now the shareholder are specialist and primary dealers the major domestic and international Market Makers in the Italian Government securities market; the chart of the company provide each partnership individual or belonging to the same group cannot be more than 5 per cent.

Microstructure

The microstructure of the market is one of the key factor of MTS limited impact of trades on price (liquidity). Primary Dealers (PD) are committed to carry out firm quoting of instruments assigned by Market Company (20% of all listed securities by type of security, maturity and liquidity) for a minimum quoting time (5 hours) and complying with bid-ask spread limits (depending on maturity). Each primary dealers' dealing station serves three main functions: i) listing of pre and post trade information, including the five best bid and ask quotes for each security, ii) trade execution at key press, iii) automatic clearing and settlement onto centralized system for bank reserves and government bonds managed by central bank and central depositories. Proposals are displayed exclusively by PD in anonymous form and an Auto-Matching mechanism clears them automatically if they match on opposite side (bid/ask). Remaining quantities are handled as an outstanding proposal and shown according to the best price on the "best" pages, favoring discovery process and best execution. The structure and Organization of the MTS platform has evolved in order to create an efficient marketplace. High technical connectivity among markets and segments lead to the introduction of EuroMTS as the platform for euro-zone benchmark issues, which was followed by other domestic MTS markets in EMU countries. Trading platform interoperability with any settlement system make feasible to implement any settlement model (BIS DvP1, 2, 3, etc) and to interface any existing European settlement provider (Euroclear, Clearstream, etc). An electronic trading system is more transparent than OTC markets. Collection of pre-trade and post-trade data is more timely and automated, price information delivery is accelerated and asymmetry reduced. Reduced information and transaction costs shrink liquidity risk: dealers can better assess market depth, price comparison for market participants is easier and less costly. Deals are executed at best price available. The extensive distribution network provides economies of scale and an increased number of market participants can transact directly with each other within one reference market where analysis of market movements and information collection easier. Price formation occurs centrally through multilateral order flows and prices published for the most liquid securities may be used to provide quotes for other bonds: market makers have the possibility to price easily and efficiently many different products (spread quotes). Increased liquidity makes the market more appealing for investors. Wider participation makes the market more liquid with consequent risk reduction, tighter bid ask spread, reduced liquidity premiums. Such a virtuous circle reduce issuer costs: market liquidity makes quoted instruments more valuable (liquidity premium shrinks significantly). Possibility to pass straight to the middle and back office by linking the execution, confirmation, clearing and settlement, reduce back office costs, minimize risk of errors in trade reporting and record keeping increasing operational efficiency.

Borsa Italiana, the company managing the Milan-based Italian Stock Exchange, also operates a screen-based retail market (MOT) for domestic fixed income instruments, and another screen-based market (EuroMOT) for eurobonds, foreign bonds and asset-backed securities.

The need to provide market agents with appropriate risk-hedging tools gave rise in 1992 to a market for government bond futures (MIF) and options (MTO). Despite a fast start, both of these segments were outpaced by other European markets, especially LIFFE (for short-term instruments) and, more recently, Eurex (for long-term instruments).

3.5.2 The stock market

Since the beginning of the 1990s, the pace of innovation on the Italian Stock Exchange has increased substantially (**Tab. 7**). In 1991, a screen-based continuous auction trading system was introduced, together with a market for block trades. The futures and options markets were launched in 1994 and 1995 respectively, while the changeover to rolling settlement was completed in 1996. Liquidity, transparency and speed of execution were further enhanced by the abolition of the stockbrokers' monopoly, the liberalization of commissions and the requirement to trade on the official market. The laws on take-over bids and insider trading enacted in 1992 and reinforced in 1998 by the Single Act on Financial Intermediation increased the contestability of control of listed companies and the protection afforded to minority shareholders. The Nuovo Mercato, established to facilitate the listing of innovative companies with high growth potential, began to operate in June 1999. New screen-based segments for covered warrants and after-hours trading were launched in February and May 2000, respectively. More recently the STAR segment was created, aimed at medium capitalization enterprises which meet higher requirements in terms of liquidity, information provided to customers and corporate governance.

Despite the organizational improvements, the size of the Italian stock market relative to GDP is smaller than in other major countries. Pagano *et al.* (1998) analyze the reasons behind the reluctance of Italian firms to go public. Company's size is a very significant determinant of listing, suggesting that fixed costs of listing may be an important explanatory factor to the decision to going public. Such costs are likely to be important if one goes beyond the mere out-of-pocket expenses incurred in obtaining and maintaining the listing, but extends them to the broader implications of complying with much more demanding information disclosure (including the likely substantial curbing of tax avoidance opportunities) resulting from stock market scrutiny and appraisal. As a matter of fact, many young start-up companies do not use the stock market to finance their expansion, resorting to other source of external finance, typically bank loans, which might be reckoned as more efficient if the costs of transparency were to be properly factored in.

Since the second half of the 1990s foreign participation, though limited, has been increasing. In 2000 it reached 9.9 per cent (against 4.3 per cent in 1998). Market liquidity has moved into line with that of the other major European stock exchanges. In terms of average capitalization, turnover increased from 46 per cent in 1995 to 116 per cent in 2000. On the Nuovo Mercato, the average daily turnover at the end of 2000 stood at €116.1 million.

On the derivatives markets, the notional value of futures contracts on the MIB30 index (the index of the 30 blue chips of the Italian Stock Exchange) totaled €985 billion in 2000, while that of options contracts amounted to €323 billion. In the run-up to its peak, in the period 1998-2000, the MIB index (the index of all shares listed on the Italian Stock Exchange) gained more than 81 per cent, compared with the 52.6 per cent rise in the Dow Jones Euro STOXX index (**Chart 2**). The higher return on Italian shares over the period is mainly attributable to the shares of banks (which benefited from the restructuring and consolidation of the banking sector in the second half of the 1990s) and to those of telecomm companies.

BOX 2 – Securities Clearing and Settlement

The clearing and settlement of securities transactions on regulated markets are carried out by means of a nation-wide system owned and managed by the Banca d'Italia (*Liquidazione dei Titoli*, LDT). In the past, the main regulations concerning LDT were contained in a decree of the Ministry of the Treasury, issued on December 1991 on proposal of the Banca d'Italia in agreement with the Consob. The Legislative decree 415 of 1996 gave Banca d'Italia, in agreement with the Consob the competence to regulate LDT; the Banca d'Italia issued those regulation on 9 April 1997. Operational features on the LDT are fixed in a model agreement which participants have to subscribe. The subsequent Consolidated Law on finance entered into force on July 1998 confirmed (while strengthening) Banca d'Italia regulatory powers in the field of securities settlement.

Applications for participating in LDT are handled by Banca d'Italia: it is compulsory for participants in the clearing system to maintain securities account with the Monte Titoli, the Central depository. Since April 1997 "indirect" participation has been introduced in the Italian settlement system. Direct market participants may decide to settle their transactions on their own account or through another operator that directly participates in the settlement securities system. Membership of the system allows intermediaries to carry out all types of operation, from notification to settlement; settlement in cash however takes place through BIREL, the Italian Real Time Gross Settlement System. Every kind of transaction can be settled through the LDT procedure: outright purchase and sale, repurchase agreement, free-of-payment deliveries, securities lending. The clearing system works on a daily basis since every kind of securities is traded on a rolling settlement basis, currently with different maturity depending on the type of securities. The system works following the so-called Target calendar.

The duties of the clearing system being with the notification of bilateral net position in cash and securities of participants. Bilateral balances, however, are determined outside the clearing system: they are prepared by the electronic centers which handle the trading system. These balances are automatically sent to the LDT procedure according to its cut-off hours, without any further intervention of individual participants. On receipt of these notification the clearing system computes the participants multilateral positions in securities and cash through netting. The determination of multilateral balances does not involve the novation of underlying obligation. The balances in securities resulting from multilateral clearing are automatically sent to the Central securities depository Monte Titoli and settled by way of book entries in the accounts opened at LDT participants. Cash balances are settled through book-entries at the cash accounts which participants have at Banca d'Italia: Participants not having a cash account at Banca d'Italia have to entrust a bank to pay and receive these balances on their behalf. Monte Titoli Spa, the company which manage the Italian central depository, was created in 1978 by initiative of the Banca d'Italia along with some major banks. Monte Titoli has been now privatize and has, so far, developed linkages with main European central securities depositories which enable Italian intermediaries to trade and settle through book-entries at Monte Titoli. The settlement procedures eliminates the principal risk through the automatic and strict application of the principles of delivery-versus-payments: clearing houses cannot settle credit balances in cash and securities until they have finalized the collection of all debit balances. On settlement day the debit balances in securities are conveyed electronically to the central depository institution and debited to the participants accounts. As above mentioned the cash leg of securities transactions is settled on Banca d'Italia accounts. The final stage of the process is represented by the delivery of securities to the members with credit positions, by directly crediting their accounts with the central depository institutions.

In addition to the application of DVP principle in the settlement of final net balances to the adoption of the "rolling settlement" balances, the Italian system relies on different risk control measures. First, membership requirements: the categories allowed to participate are all subject to individual supervision aimed at verifying either their financial soundness or the not undertaking of market risk. Then participants are notified of their final balances in the afternoon of the day before the settlement day, in order to let them the time to borrow on the market the cash and the securities they need to cover their debt position. Finally, with specific regard to transactions on listed equities and warrants, there are two guarantee funds, both managed by the Clearing and Guarantee House: one aimed at ensuring the timely settlement of transactions; the other is aimed at ensuring the right performance of trades in case of the default before the settlement date. As far as the first fund is concerned, in the event of a participant's default the Clearing House intervene within the settlement procedure replacing its position, i.e. by settling the defaulter's debit balances and receiving his credit balances. To do this the Clearing House resort to the resources of the Guarantee Fund, which is fed by intermediaries participating in LDT proportionally to their respective volume of business. The other fund, aimed as just mentioned at ensuring the right performance of "pending" transactions in case of default of an intermediary, is fed by intermediaries admitted to trade on the stock exchange circuit; Thanks to the mechanism of "indirect" participation an intermediary could only act on the market, and thus participate in this Fund, without participant in the settlement procedure. The two funds are legally segregated; the Clearing House is just the operator of the guarantee system, without any property-responsibility; should the final losses coming from a participant default exceed its contribution, the remaining losses are shared among all participants in the two funds, in proportion to their volumes of business, without affecting the CH net worth.

3.6 Financing

3.6.1 Non-financial companies

The increase in firms' profitability in the second half of the 1990s was associated with a decrease in firms' indebtedness. The improvement in profitability increased firms' internal sources of finance and also allowed a greater recourse to the markets. From 1996 to 1999, the drop in interest rates made a substantial contribution to reducing interest costs, thereby reinforcing the growth in self-financing. The ratio of external to internal financing (defined as gross savings plus capital transfers) of the sector was around 0.51 in 1998-2000, compared with a figure of 1.34 for the euro area. Financial debt (loans and bonds) as a percentage of GDP progressively decreased in the 1990s, reaching a low of 50.6 per cent in 1998, against 58.4 per cent in 1993.

The improved economic prospects, as well as the development of the stock exchange, prompted financing through the issuance of equity. The ratio of financial debt to the sum of financial debt and equity – a measure of leverage – decreased to 36 per cent in 2000 (from 46 per cent in 1997), partly as a result of the increase in the market value of shares. After 1998, the ratio of financial debt to GDP started to rise again, mostly in connection with the increase in investment spending and M&A activity, reaching 58.1 per cent in 2000. However, leverage remained low by historical standards.

In 2000, loans accounted for about one-third of outstanding liabilities. Shares and other equity accounted for 55 per cent. The majority of loans were granted by resident banks and were short-term. Liabilities vis-à-vis the rest of the world represented 13 per cent of total liabilities, while loans from the rest of the world accounted for 14 per cent of total loans. A feature of the financial structure of Italian firms is that trade credit and advances account for a significant proportion of firms' liabilities (11 per cent).

Empirical evidence shows that firms make greater use of trade credit during economic downturns or when monetary policy tightens. Moreover, firms with more limited access to external finance or with less internal funds tend to use this type of liability more frequently.

Bonds issued by firms represent a relatively limited share of their total liabilities. While shares are the most important liability among securities, it must be stressed that a large amount of them (around 50 per cent) are unlisted shares and other equity issued by small and medium-sized firms and not traded on the market.

Considering the average annual flows over 1998-2000, loans represented a higher share of external financing, accounting for 55 per cent of the total increase in liabilities over this period. Unlike the stock analysis, which highlighted the shorter-term nature of loans, the flow analysis highlights the dominance of the long-term component, pointing to a progressive lengthening of the maturity of firms' debt in Italy.

In contrast, securities issuance represents a rather limited source of finance. Large firms have mainly used this source of financing up to now. More recently, euro-denominated issues by Italian firms have increased rapidly. This phenomenon was spurred by the introduction of the euro and the associated deepening of the market after the elimination of exchange rate risk. Italian issuers are mainly large in size, even if in the last three years 25 medium-sized firms, which are generally unrated, have issued bonds on the euro-market. The placement of smaller firms' issues was facilitated by the presence of Italian banks in the placement syndicates.

Another recent development in Italian firms' financing is the marked growth of the syndicated loan market. In 2000, syndicated loans accounted for 10 per cent of outstanding bank loans to the corporate sector. Compared with bond issues, syndicated loans (in which one or more lead banks specify the amount, form and terms of a loan to a borrower and invite other intermediaries to provide a share of the funds under the same contractual conditions) allow borrowers to obtain large amounts of funds more quickly. They also allow greater flexibility in the interest rates, terms of use and repayment arrangements. Moreover, intermediaries benefit from a greater diversification of risk.

Historically, intermediaries other than banks have played a limited role in the financing of firms. However, the recent rise in the number of firms going public was met by an increase in the amount of finance supplied by venture capitalists to small and medium-sized firms. While growth in venture capital is significant, the outstanding amounts (equivalent to 0.2 per cent of GDP in 2000) remain limited by international standards (**Tab. 8**).

Micro data suggest a high degree of heterogeneity in the financial structure of firms. The financial structure mirrors the peculiar features of Italian industry, notably the strong presence of small firms. The share of employment accounted for by firms with less than 100 employees is estimated to be around 70 per cent. Smaller firms tend to provide less information to their creditors, while also possessing less collateral assets. This is reflected in the high share of short-term debt on the liability side of firms' balance sheets. Small firms also tend to use less internal financing and have a higher interest burden owing to higher external debt.

3.6.2 General government, household and the external sector

During the 1990s, the primary deficit of the general government progressively contracted, turning into a surplus. In the second half of the decade, the net financial indebtedness of general government further improved as a result of the reduction in interest expenditure and the decrease in debt owing to accruals from the privatization of state-owned enterprises. The maturity structure of general government debt, previously mostly short-term, lengthened. Overall, in the period 1998-2000 external financing through short-term bonds decreased by €17.5 billion, whereas financing from long-term issues increased by €35.6 billion. The process of privatization of public enterprises is reflected on the asset side in the reduction in shares.

Italian household financial indebtedness is low, if compared with other large industrial countries. The outstanding amount of financial liabilities was 31 per cent of GDP in 2000. The ratio between external and internal funds (net savings) was also low at 0.16 in 2000 (0.41 in the euro area). However, the ratio of household financial indebtedness to GDP increased rapidly in the second half of the 1990s. A large part of the rise was accounted for by long-term debt (mainly mortgages). In 2000, this form of debt represented 59 per cent of total liabilities of the household sector. Loans with an original maturity over 5 years granted by resident banks represented 38 per cent of total liabilities. Of the total amount of liabilities the largest share is loans from the banking sector (69 per cent in 2000).

Consumer credit is not historically widespread in Italy, although it is on the rise. In 2000, it accounted for 14 per cent of total financial debt of the household sector and was equal to 3 per cent of GDP. More than 75 per cent of this consumer credit had a maturity of up to 5 years. Uncollateralized loans represent a small part of the total. The level of collateralization probably reflects the perceived riskiness of this form of debt, and also the length and costs of recovery procedures for loans.

Considering the amounts outstanding, financial liabilities of non-residents held by residents increased from 72 per cent to 112 per cent of GDP between 1997 and 2000 and from 12 per cent to 16 per cent of total financial liabilities of all sectors. In the period 1998-2000, the rest of the world was a net debtor. The liabilities of non-residents held by residents were mainly in the form of shares and other equities, a large proportion of which were issued by financial institutions. Securities other than shares accounted for 25 per cent of total liabilities of the sector and were mostly long-term in nature. Total assets of non-residents represented 14 per cent of total gross financial assets in 2000 (compared with 12 per cent in 1997). On the asset side, securities other than shares accounted for 42 per cent of the total. They were mostly Italian government securities held by non-residents. Direct investment from non-residents was equivalent to 0.7 per cent of GDP in the period 1998-2000, whereas direct investment made abroad by Italian residents averaged 1.0 per cent.

4. Competition in the Italian financial sector

Competition in the financial sector matters for a number of reasons. As in other industries, the degree of competition in the financial sector can matter for the efficiency of the production of financial services. And, again as in other industries, it can matter for the quality of financial products and the degree of innovation in the sector.

A reason specific to the financial sector why competition matters is the link between competition and stability, long recognized in theoretical and empirical research and most importantly in the actual conduct of prudential policy towards banks. It has also been shown, theoretically as well empirically, that the degree of competition in the financial sector can matter for the access of firms and households to financial services and external financing, in turn affecting overall economic growth, although not all relationships are well known. The degree of competition in and stability of the banking system will in turn depend on entry barriers, including on foreign ownership, and the severity of activity restrictions, but also on the importance of other type financial institutions (finance companies, merchant banks, insurance companies, capital markets).

The long-existing theory of industrial organization has shown that the competitiveness of an industry cannot be measured by market structure indicators alone (such as number of institutions, Herfindahl or other concentration indexes). Rather, testing for the degree of effective competition needs a structural, contestability approach. As suggested in section 1.4 lack entry restrictions in the banking sector and foreign bank presence can make for more competitive banking systems; also, activity restrictions on commercial banks can reduce competition. Being open to new entry is one of the most important competitive pressures and banking system concentration need not be negatively associated with competitiveness. At the opposite, there is some evidence that more concentrated banking systems are more competitive. Since market structure matters along with other dimensions of market rivalry, competition policy in the financial sector is more complicated than perhaps usually thought. Changes in the production and distribution of financial services, altering industrial structures and large deregulations, including the removal of barriers between markets and products, may have made for new industrial structures that require a different competition policy paradigm, that takes into account, among other things, the increased importance of networks and network externalities in financial services industries (cf. Claessens *et al*., 2001).

Empirical research on competition in the financial sector has also not yet reflected recent analysis comparing financial systems' functioning. This analysis of financial systems' functioning and performance has made clear that characterizing financial systems by the prevalence of certain type of institutions or importance of markets can be misleading. Although countries vary greatly in their financial structures, e.g., the mix between banks and markets or the concentration of their banking systems, these may not be the most important characteristics for their functioning, including competition. Research indeed has shown that what matters in the end for financial sector efficiency, access, growth and financial stability are the functions that the financial sector provides which may or may not vary by financial structure (Demirgüç-Kunt and Levine, 2001). This importance of functions rather than institutions or structures may also apply to the issue of competition, suggesting that tests focusing on how the structure of institutions may affect competition are not complete.

Italy's financial services industry has been undergoing rapid changes, in part triggered by deregulation and technological advances. These changes have led to many changes, including dis-intermediation, removal of barriers between financial products, consolidation, increased cross-border capital flows, greater commercial presence, and more financial integration, as well as some risks and short-run costs. They have made the definition of a financial market and any particular financial service more complex. They also have increased the network properties of financial services, making competition more complex, even when a pro-competitive entry/exit regime in terms of institutions or markets for various types of financial services is in place. And it is making empirical analyses of the competitive nature of financial systems more complicated.

These considerations suggest some advantages of using a more structural approach to assessing the degree of competition in the financial sector. While one cannot expect to address all issues, a more formal test of the degree of competition will allow one to overcome some of these concerns. It will also allow a comparison of results to other approaches to measuring competition, such as using concentration ratios or the number of banks in a market.

Cetorelli and Violi (2003), using bank-level data and applying an adapted version of the generalized Cournot-Bertrand competition model—extending Neven and Roller (1999) model—estimate the degree of competition for the euro-area countries' banking systems. They find strong evidence that Bertrand-type of competition is prevalent in the main countries among commercial banks—e.g., price competition is fairly strong—and the level of competition does not differ substantially across country in the second half of the 1990s. Banking system concentration, as such, do not seem to matter. Our findings confirm that contestability determines effective competition. Our results partly differ from Shaffer (2001), one of the very few studies with very large sample of countries, 15, in North America, Europe, and Asia during 1979-91. He finds significant market power in five markets and excess capacity in one market. Estimates were consistent with either contestability or Cournot type oligopoly in most of these countries, while five countries were significant more competitive than Cournot. Since the data refer to the period before the European single banking license was adopted (1993), the result may, however, not be reflective of the current situation.

Angelini and Cetorelli (2002) analyze the evolution of competitive conditions in the Italian banking industry using firm-level balance sheet data for the period 1983-1997. Regulatory reform, large-scale consolidation, and competitive pressure from other European countries have changed substantially the Italian banking environment. They find some evidence of a substantial increase in competitive conditions in the banking market after the introduction of the European Single Banking License, with a decrease in mark-ups**.**

The results of Cetorelli and Violi (2003) also differ, in part, from those of De Bandt and Davis (2000), who reject both perfect collusion as well as perfect competition and find mostly evidence of monopolistic competition for the period 1992-96[24]. However, the Panzar and Rosse (1987) model used by these authors cannot properly rank the degree of competition, when monopoly or perfect competition does not hold.

5. Competition, stability and the forces shaping the changes in the Italian Financial Sector

The foregoing account reveals the radical, albeit gradual, transformation of the Italian financial system. Until one or two decades ago, the comparative radiology of financial systems—conducted using statistical and institutional parameters à-la Goldsmith—showed the Italian system to suffer from hypertrophy in some segments and to be absent or underdeveloped in other, innovative ones. Today, such an analysis reveals morphologically similar structures.

Change has taken the same directions as in international finance, which in Europe have also been reflected in Community directives. In some sectors and in some respects, this has resulted in Italy's having achieved practically full convergence, as in the predominance of securities, the financial markets and intermediaries specializing in securities business, and the private ownership of credit institutions.

In other fields convergence is clearly proceeding and will certainly be completed, not only in derivatives and investment funds but also in the use of the new payment system and international openness. In other areas, while Italy is moving in the same direction as other countries, it is moving more slowly so the gap has widened; the main surviving anomaly of the Italian financial system is the backwardness of private pension funds, which is tied to the country's present retirement provisions. The transformation of the Italian financial system has been guided and sustained by a succession of changes in the legal framework, which the 1993 Banking Law and the 1998 Single Act on Financial Intermediation have shaped into a consistent whole. Supervisory action—by the Bank of Italy, joined over the years by a series of other independent authorities (Consob for the Stock Exchange in 1974, Isvap for the insurance industry in 1983, the Competition Authority in 1990, and Covip for pension funds in 1993)—provided enforcement of the new rules, without which the elements of change that they introduced would not have been embodied in the behavior of market participants. Fiscal and administrative requirements (such as constraints on banks' securities portfolios, lending and deposit-taking), which were still notably burdensome in the 1980s, were removed or eased over the decade that followed. In this way, among others, the development of finance was fostered, the distortions affecting the choices of both users and producers of financial services were diminished, and "neutrality" was approached. The engine of change, however, along the guidelines traced by public policy and reflecting the impetus imparted by the international markets and economic developments, was the progressive emergence of competition in banking from an initial situation that was far removed from what could be described as competitive markets.

[24] Also Bikker and Groeneveld (2000) find monopolistic competition in all of the 15 EU-countries they study.

At the end of the 1970s, interpreting the Italian economic crisis as the irreversible decline of the “mixed economy,” the Bank of Italy began to act to move beyond the forms of market oligopoly that then prevailed among banks and throughout the financial system. Bank chartering powers, which the law had assigned to the Bank of Italy as supervisory authority in the twenties, came to be exercised according to principles of competition. Even such a structural supervisory instrument as authorization to open branches was now directed not to limiting competition but to intensifying it. In his concluding remarks to the general meeting of shareholders in May 1977, Governor Paolo Baffi was explicit on this point: “...the supervisory authority has developed criteria which emphasize the need to increase the productivity of the system and, where necessary, to raise the degree of competition to a more uniform level”. Thus long before it was given formal antitrust duties for the banking industry, the Bank of Italy made competition the fulcrum of its drive to enhance the efficiency and soundness of the banking and financial system. It acted accordingly in the years that followed. With Law 287/1990, which entrusted the Bank with the task of safeguarding competition in banking, Parliament recognized the existing state of affairs and built upon it.

The precondition for the change in the Bank’s approach was abandonment of the idea—which had won many adherents, not only in Italy and not just among central bankers, in the wake of the crisis of the thirties—that competition, or at least “excessive” competition, was a cause of banking instability, antinomic to stability. Yet, especially in view of the international opening that characterizes the Italian economy in normal times, an inefficient banking system such as Italy’s in the 1970s, while profitable because oligopolistic, was liable to show systemic instability. A powerful spur to improving profitability and hence achieving a sound capital base through efficiency, was specifically identified in heightened competition in the domestic banking and financial markets. Without competition, in the long run there cannot be efficiency; without efficiency, in the long run there cannot be stability in the banking and financial industry. A further conviction, based on the economic theory on which antitrust legislation ultimately rests, is that competition is not the same as laissez-faire; that the latter can negate the former, especially in an industry offering economies of scale; that deregulation itself is ineffective unless it is part of an economic and institutional policy framework designed to foster competition and, in the final analysis, to impose it upon producers who may not like it and who tend to reject it in practice if not in their public statements.

A higher degree of competition became the crucial intermediate objective, the fulcrum of the Bank of Italy’s monetary, exchange rate and supervisory policy. Thus the assignment of antitrust responsibilities to the Bank did not constitute a break with the past, an anomaly to be corrected but the natural, institutional recognition of the state of affairs that had lasted for a decade. Above all, it enshrined a principle that needs to be consolidated and extended: prudential supervision and safeguarding competition are not contradictory but complementary activities.

Between the 1980s and the 1990s there was not a break, but rather an acceleration, in the growth of competition in banking and hence, given the importance of banks in Italy, in the financial system. Labor productivity in Italian banking (total assets per employee at constant prices) has risen almost without interruption since 1981, by a total of 68 per cent. Per capita staff costs (in real terms), which are structurally very high in Italy, also rose until 1992, after which they remained unchanged. In 1998 they were 18 per cent higher than in 1981. Yet the profit rate has declined: from 12 per cent in the first half of the 1980s to barely positive values between 1993 and 1997. This is the simple, incontrovertible portrait of a banking industry that has emerged from an initial position of inefficiency but high profitability, possible solely because of the lack of competition. The industry then, even as it reduced its inefficiency, saw its profits eroded by sharpening competition both internally and externally. In particular, profits were low in the mid-1990s, when even faster productivity growth was accompanied by stable labor costs. During those years the privatization and stock market listing of banks (listed institutions came to account for about 70 per cent of total bank assets) extended competition from the product and service markets to that of ownership and control, which became highly “contestable”.

Innovation in the stock market began in 1991 with the launch of screen-based continuous auction trading together with a market for block trades. It proceeded with the guarantee fund for monthly settlement (1992), the creation of the futures market (1994) and the options market (1995), and the changeover to rolling settlement (completed in 1996).

The laws on takeover bids and insider trading enacted in 1992 and reinforced by the Single Act on Financial Intermediation, together with that Law’s revision of the regulation of proxies and shareholders’ agreements, increased the contestability of control of listed companies and the protection accorded to minority shareholders. Liquidity, transparency and speed of execution were enhanced by the abrogation of stockbrokers’ monopoly, the liberalization of commissions and the requirement to trade on the official market. Since the reorganization, transaction costs—the differential between the best buy and sell limit orders in the continuous auction—have not been out of line with those in other European financial centers and have been lower than the bid-ask spread on Italian securities on SEAQ International in London.

In the asset management industry the degree of concentration has diminished almost uninterruptedly and is now comparable to that found in the United States. In 1997 the Herfindahl index was 0.04. The trend has halted only recently, in connection with mergers between large banks. The competition from foreign intermediaries is now fierce. It is estimated that about half of the industry’s products are offered by foreign institutions. Owing in part to the effects of economies of scale and scope, investment funds’ operating costs have declined in relation to their assets since the end of the 1980s, falling from 0.6 to 0.13 per cent. Thanks to widespread competition, a large part of this saving has been passed on to final investors, mainly in the form of lower entry fees, which have fallen from 4 per cent of gross fund-raising in 1988 to 0.3 per cent, while management fees have remained basically stable (slightly over 1 per cent of investment funds’ assets).

In the government securities market, the introduction of a category of intermediary called “specialist in government securities” in 1994 led to a bid-ask spread of just 8 basis points in 1998, and less than 5 for the most active issues. Over the same period, volume nearly quadrupled and the degree of concentration in the market was significantly reduced. The number of market makers rose from the initial 7 to 35, and the share of total volume accounted for by the top 5 plunged from 85 to 15 per cent; the Herfindahl index for the securities traded fell from 0.25 to 0.04. Fiercer competition and intermediaries’ greater “internal” efficiency went hand in hand with an increase in the “external” or “informational” efficiency of the Italian financial markets. The ability of current prices to incorporate the information contained in past prices—efficiency in a weak form—was already present in the stock market of the 1970s. In the 1980s and even more so in the 1990s (with the screen-based market in government securities, stock exchange reforms, the development of asset management, the introduction of derivatives and international integration), the stock market evolved, like the government securities market, towards efficiency in semi-strong and strong forms, denoting the ability of prices to incorporate information held by the public and, though less clearly, also that available privately.

6. Concluding remarks: issues and prospects

The Italian financial system has experienced a profound structural change in the last two decades. The financial system that Alberto Beneduce and Donato Menichella had to conjure up in 1933 out of the ruins of the previous one remained unchanged, basically unquestioned, until the wage and oil-induced stagflation of the 1970s. Today that system no longer exists.

The intermediate objective pursued by the Bank of Italy for more than twenty years has been largely achieved: more competition in banking, together with a sizeable number of mergers and a start on reorganization projects that have achieved gains in efficiency and presage further advancements in the near future. Competition has produced its effects on the prices of intermediation; it has leveled them and kept them down. The degree of competition within Italy's financial industry is now comparable to that of other advanced economies. Nonetheless, it can be increased further. The underlying factors are still present: the Italian banking and financial system is still relatively fragmented and marked by a low level of concentration; technological innovation and advances in telecommunications have only recently begun to produce their effects; the privatization of banks and markets and the reduced scope for obtaining public support are stimulating more efficient structures; banks and markets are two alternative channels of finance, a fundamental choice for economic agents. While the Bank of Italy seeks to foster efficiency by promoting competition and through its day-to-day supervisory action, it cannot guarantee its achievement beyond the limits imposed by the ability of producers (and investors) to respond to market forces and administrative solicitations.

Increasing competition has ultimately contributed to the strengthening of the capital base of Italian banks. The average capital ratio of Italian banks stands at over 11 per cent (the amount in excess of the minimum requirement of 8 per cent at € 40 billion). The capital adequacy ratios of the largest Italian banks, that were low by comparison with those of the other Group of Ten countries for some time, have improved significantly in recent years.

It is necessary to recognize the degree of inertia that had to be overcome in a process of change whose complexity was due to its being of a cultural even more than a legal, institutional and market nature. The low level of competition prevailing at the start of the 1980s, an inheritance from the past, acted as a brake on change and the reduction in banking labor costs and lengthened the time needed to achieve results. Had there been a higher level of competition at the start in "1980", had it not been necessary for competition to be included among the intermediate objectives of public policy, this would have probably produced results much earlier because the financial structure would have responded more promptly to the stimuli it created.

The Bank of Italy intends to continue along the path it has followed so far, not only because the rules of the single market impose the duty to act "in accordance with the principle of an open market economy with free competition" and the 1993 Banking Law explicitly establishes the stability, efficiency and competitiveness of the financial system as complementary objectives, but also in the belief that this path is the right one, a necessary condition for Italy's financial industry (and the Italian economy) to make further progress.

The build-up of competition played a fundamental role by contributing to the changes that occurred in the structure of the financial system since 1980. On the supply side the pressure that only a competitive market can exert on producers led banking and financial intermediaries to strive to meet the needs of their customers. This pressure was also in line with the policies that were being given expression in new laws and tax rules and in the action of the supervisory authorities. Far from constituting an obstacle to these policies, the increase in competition facilitated their implementation. In the last twenty years the Italian economy has followed a checkered course, marked by a high degree of instability and notably different from that of most of the other European economies. The dark and bright periods resulted in decelerations and accelerations on various fronts. All in all they did not prevent Italy's financial system from participating in the international tendencies that globalization has so powerfully reinforced.

The factors that caused the peculiarities still to be found in Italy's financial system included not only the strengths and the weaknesses of the players in the market but also the propensity of Italian households and firms to exploit its potential. This propensity remained underdeveloped, and not only with regard to the payment system. In the 1990s Italian firms' investment declined in relation to GDP, while their profits rose. As a consequence their reliance on external financing declined in comparison with self-financing. At end of 2002 only 275 companies are listed on the stock exchange. Although substantial, issues of new shares have frequently been made off market. Issues of commercial paper and corporate bonds remained negligible until 1998, albeit growing in the wake of the introduction of the euro, and are still not widely used in the private (non-financial) sector. Small and medium-sized enterprises still find these instruments too costly and disproportionate to their needs. More than 90 per cent of Italian firms have fewer than ten employees; together they account for more than half of total employment. The vast majority of small firms remain small. The greater variety of services other than credit intermediation that banks can now supply is also important, as is the much wider range of contracts and technical forms that the classic instruments of loans, bonds and shares can now assume compared with the past. However, there is little sign of growth in the number of firms demanding advanced financial services, not only from Italian merchant banks and venture capital companies but also from their more experienced foreign counterparts. Between 1992 and 1998 takeover bids for listed companies averaged less than 20 a year in Italy, with the value of acceptances averaging around 1.9 billion euro. In 1999, under the new rules, the number of takeover bids rose to 24 and the value of acceptances soared to around 55 billion euro in connection with the takeover of Telecom Italia.

The scope for Italian households to make more use of the financial system is also considerable. The abolition of operating restrictions and geographical barriers has increased the opportunities for competition at retail level. Today there is one bank branch for every 1,900 inhabitants, compared with one for every 3,400 at the beginning of the 1990s. It has become easier to compare the conditions and products offered. However, households' demand for some services is less than the system could satisfy. This is true for the creation of pension funds and for recourse to credit, especially in order to cover the cost of enhancing “human capital” accumulation and quality. In Italian society such expenditure does not appear to lie in the top part of the “Engel curve”, where the distinction between consumption and investment becomes blurred[25]. Further increases in the quantity and above all the quality and efficiency of the Italian financial system will depend as much on the ability of households and firms to express a demand for financial services as on that of banks and other intermediaries to supply them.

[25] The proportion of household expenditure accounted for by education, foreign travel and books and newspapers is equal to around 3 per cent of GDP and has only grown slightly in the last twenty years. Italy ranks only ninth among the 15 European Union countries in spending on education and culture.

Tables and charts

Table 1

THE STRUCTURE OF THE ITALIAN FINANCIAL SYSTEM

	31 December 2000			31 December 2001		
	Interme-diaries	No. of branches		Interme-diaries	No. of branches	
		Italy	Abroad		Italy	Abroad
Banks	841	28,177	94	830	29,270	91
of which: limited company banks (1)	*240*	*20,338*	*84*	*252*	*21,081*	*81*
cooperative banks (banche popolari)	*44*	*4,789*	*10*	*44*	*5,036*	*10*
mutual banks (banche di credito cooperativo)	*499*	*2,951*	–	*474*	*3,044*	–
branches of foreign banks	*58*	*99*	–	*60*	*109*	–
Securities firms	171	–	–	162	–	–
Asset management companies and Sicavs	101	–	–	132	–	–
Financial companies entered in the register referred to in Art. 106 of the Banking Law	1,357	–	–	1,376	–	–
of which: entered in the special register referred to in Art. 107	*211*	–	–	*263*	–	–

(1) Includes central credit and refinancing institutions.

Table 2

ASSET MANAGEMENT COMPANIES AND SICAVS

	31 December 2000		31 December 2001	
	Total	*of which: bank-controlled* (1)	Total	*of which: bank-controlled* (1)
Asset management companies (2)	101	68	132	86
of which, instituting and managing:				
harmonized open-end funds	*62*	*35*	*60*	*36*
harmonized and non-harmonized open-end funds	*11*	*11*	*21*	*16*
closed-end securities funds	*11*	*10*	*18*	*13*
closed-end real estate funds	*6*	*5*	*7*	*5*
open-end and closed-end funds	*9*	*7*	*10*	*7*
hedge funds	*2*	–	*16*	*9*
Memorandum items:				
Companies with individual portfolio management services	*48*	*36*	*65*	*48*
Companies managing funds instituted by others	*14*	*8*	*16*	*10*
Companies instituting open pension funds	*20*	*15*	*19*	*15*
Foreign Sicavs and management companies (3)	173		219	
of which: Sicavs	*122*		*152*	

(1) Companies in which banks hold more than 50 per cent of the equity. – (2) The data include Italian Sicavs. – (3) Companies that market units to the general public in Italy pursuant to Legislative Decree 58/1998, Article 42.

Table 3

COLLECTIVE INVESTMENT UNDERTAKINGS

	31 December 2000	31 December 2001
Italian collective investment undertakings: total (1)	**1,200**	**1,485**
of which:		
Harmonized open-end funds and Sicavs	**1,116**	**1,234**
of which: equity	*465*	*523*
mixed	*65*	*73*
bond	*316*	*337*
money market	*120*	*108*
global	*16*	*23*
not operational	*134*	*170*
Non-harmonized open-end investment funds	**58**	**183**
of which: non-reserved funds of funds	*39*	*152*
funds of funds reserved to qualified investors	*0*	*8*
other non-reserved funds	*0*	*1*
other reserved funds	*19*	*22*
Closed-end investment funds	**26**	**47**
of which: non-reserved securities funds	*16*	*18*
securities funds reserved to qualified investors	*0*	*11*
non-reserved real estate funds	*10*	*17*
real estate funds reserved to qualified investors	*0*	*1*
Hedge funds	**0**	**21**
Foreign funds and sub-funds marketed in Italy	**1,844**	**2,613**
of which: equity	*1,009*	*1,527*
mixed	*145*	*196*
bond	*525*	*719*
money market	*116*	*121*
global	*49*	*50*

(1) Sectors are considered individually.

Table 4

10-year euro-area bond futures trading in selected markets

Monthly average, EUR millions

	1996	1997	1998	1999	2000	2001 (a)
German bonds	596,390	827,981	1,211,089	1,402,122	1,323,842	1,639,148
EUREX (b)	172,424	341,019	1,055,158	1,402,122	1,323,842	1,639,148
LIFFE	423,967	486,962	155,931	0	0	0
French bonds (EURONEXT (c))	224,366	214,397	145,910	51,092	360,975	301,000
Spanish bonds (MEFF)	93,337	104,848	78,386	29,810	9,121	3,772
Italian bonds	130,507	150,527	74,506	11,404	123	0
LIFFE	106,191	125,097	63,379	9,835	109	0
MIF	24,315	25,430	11,127	1,569	14	0
TOTAL	1,044,599	1,297,754	1,509,891	1,494,427	1,694,061	1,943,921

Sources: FIBV, Banca d'Italia, LIFFE, EUREX, MEFF, EURONEXT

(a) Up to June.

(b) Formerly DTB

(c) Formerly MATIF

Table 5

Table 1: Distribution of financial assets and liabilities of the resident non-financial sectors and non-residents between intermediated and non-intermediated instruments

(as a % of GDP; end-2000)

Amounts outstanding	Financial assets		Liabilities	
Sectors	**Intermediated** (Deposits, technical reserves, money market funds and mutual fund shares)	**Non-intermediated** (Shares and securities other than shares)	**Intermediated** (Loans)	**Non-intermediated** (Shares and securities other than shares)
Residents non-financial sectors (1)	109.2	180.6	83.9	206.2
Households	95.7	108.0	22.9	-
Non-financial corporations	11.0	61.7	54.8	105.3
General government	2.5	10.9	6.3	100.9
Non-residents (2)	17.5	59.9	11.3	76.1
Total (1+2)	126.7	240.5	95.2	282.3
Total economy	163.8	356.9	118.1	356.9
excluding central bank	160.9	348.8	116.8	356.9

Source: Banca d'Italia, national financial accounts statistics.

Table 6

RESULTS OF THE MAIN ITALIAN BANKING GROUPS AND OF THE BANKING SYSTEM (1)

(end-of-period amounts; millions of euros)

	Main banking groups		Banking system	
	2000	2001	2000	2001
Gross operating profit	15,706	15,574	27,150	26,934
Charges for loan losses	4,436	6,028	6,818	8,817
ROE	17.1	12.5	12.9	9.1
Allocations to supervisory capital	3,758	3,182	7,189	5,991
Capital increases (2)	774	675	4,661	4,428
Supervisory capital	61,051	66,787	118,625	129,205
Solvency ratio	8.7	9.5	10.2	10.6
Capital excesses	5,188	11,231	26,109	33,499
Capital shortfalls	–	–	9	522

(1) Consolidated reports for banking groups and individual reports for banks not belonging to groups, Excludes the Italian branches of foreign banks. – (2) Capital increases net of redemptions.

Table 7: Italian Stock Market Indicators

Description	1998	2000
Number of public companies listed [1]	243/86	297/94
Market capitalisation of listed shares (EUR millions) [2]	485,187	818,384
Market capitalisation of listed shares (as a % of GDP) [2]	45.2	70.3
Gross amount of capital raised by domestic companies through listed shares (EUR millions) [3]	20,960	16,796
Gross amount of capital raised by domestic companies through listed shares (as a % of GDP) [3]	1.9	1.4
Number of stocks belonging to EURO STOXX 50 and EURO STOXX	5/43	6/87
Concentration index (top-ten companies share of total market capitalisation) (%)	56.2	52.3
Number of foreign companies listed	4	6
Number of stock exchanges and other organised exchanges [4]	1	1
Number of participants in these markets [5]	138	152
Share of non-domestic participants [6]	4.3	9.9
Number of transactions of traded shares [7]	99,721	232,512
Total turnover of traded shares [8]	1,680.6/107.5	3,421.8/115.5

Source: Borsa Italiana, STOXX Limited.

1) The first figure refers to the total number of listed enterprises; the second refers to those operating in the financial sector.
2) Capitalisation of domestic firms.
3) Includes IPOs and seasoned equity offerings.
4) In 1995 regional stock exchanges were merged into the Italian Stock Exchange in Milan. Stock trading in Milan is divided into three main segments, although within a single market.
5) Includes SIMs, banks and stockbrokers. The number of stockbrokers has been constantly declining since 1991 because, according to the new leglislation, no new positions will be available for this role.
6) Share of intermediaries operating through a remote system, i.e. from their country of residence.
7) Screen-based market, Nuovo Mercato (since 1999) and Mercato Ristretto; daily average number of transactions.
8) The first figure is the daily turnover in EUR millions; the second is the turnover velocity as a % of market capitalisation.

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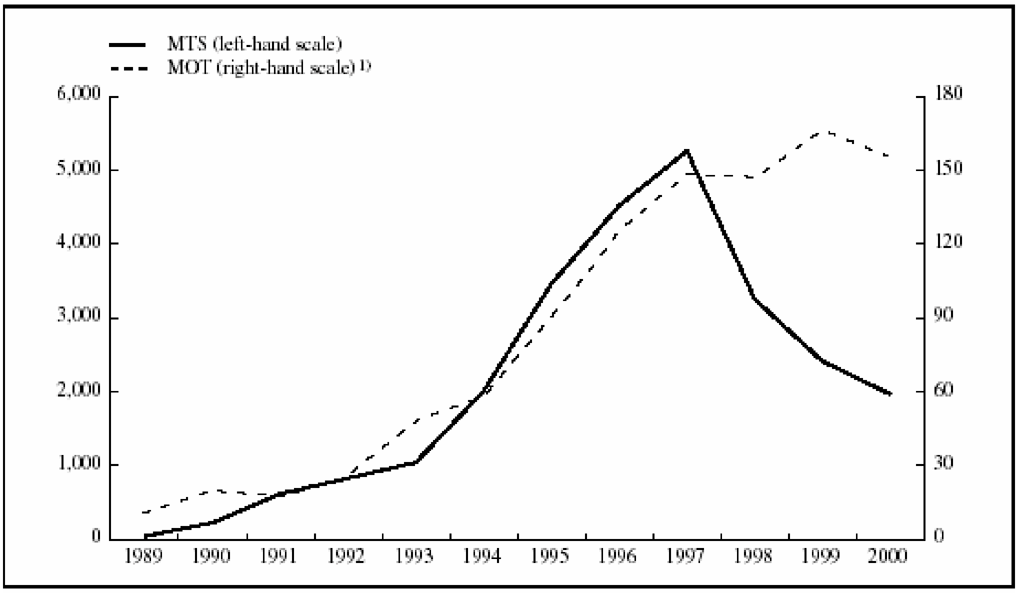
Table 8
Financing and financial balance of non-financial corporations
(as a per cent of GDP)

Liabilities	Average financial transactions, 1998-2000	Amounts outstanding, end-2000
External financing		
Shares and other equity	2.6	103.3
Securities other than shares incl. financial derivatives	-0.1	2.0
of which short-term bonds (<1y)	0.0	0.2
of which long-term bonds (>1y)	0.0	1.5
Loans	4.6	56.3
from resident MFIs	3.0	41.6
of which short-term (<1y)	1.2	24.1
of which long-term (>1y)	1.8	17.5
from resident OFIs	0.6	5.2
from other residents	0.0	1.6
from non-residents	1.0	7.9
Trade credits and advances	0.6	20.4
Other liabilities	0.6	7.6
Total liabilities	8.4	189.7
Internal financing		
Gross savings	14.3	-
Net savings	0.1	-
Net capital transfers	2.1	-
Memo: Ratio external/internal financing	0.51	-
Financial assets	5.8	102.5
Deposits	0.6	9.3
Shares	3.5	57.9
of which mutual fund shares	0.2	1.3
Securities other than shares	0.2	5.1
Other financial assets	1.5	30.2

Source: Banca d'Italia, national financial accounts statistics.

Chart 1: Yearly turnover (EUR billions)



Source: National statistics.
1) From 1999 MOT and EuroMOT.

Chart 2: Italian stock index development relative to EURO STOXX

Source: National statistics, STOXX Limited.

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Appendix: The legal framework for banking and finance in Italy

This appendix depicts Italy's legal framework for banking and finance. The first section briefly describes the main steps in the evolution of the legislation in this field, while the second outlines the main aspects of the legislation currently in force. The third and fourth sections are devoted to the measures that have recently been adopted or which are being contemplated, with those of a national nature and those deriving from the modernization of Community law examined separately.

A.1 The evolution of the Italian legal framework

The far-reaching transformation of the Italian financial system is reflected in the evolution of the legislation governing financial intermediaries, markets and issuers. The legislation governing banking and finance remained largely unchanged from the 1930s—marked by the economic events that accompanied the Great Depression and led to the approval of the 1936 Banking Law—until the early 1980s.[26] In the 1980s a start was made on the modernization of the legal framework that culminated in the adoption of a new Banking Act in 1993 (Legislative Decree 356/1993) and the Financial Services and Markets Act in 1998 (Legislative Decree 58/1998 hereinafter referred to as Financial Services Act). As a result of this gradual but continuous process, the legal framework for banks, financial intermediaries, markets and issuers of financial instruments was adapted to the structural characteristics of Italy's financial system, brought into line with the highest international standards and made consistent with the probable evolution of Community law.

A.1.1 The legal framework for banking

Starting from the transposition of the First Banking Directive in 1985, a series of statutory and regulatory measures were adopted that created a completely new legal framework for banking.

In 1985 legal force was given to the concept of banking as an entrepreneurial activity under private law. Much of the public-sector component of the banking system was privatized through a series of statutory measures (1990, 1991, 1993 and 1994). The share of banks' capital in Government ownership fell considerably, the legal form and governance of banks were made subject to company law, the management of banks became profit-oriented and therefore required the search for the best conditions of efficiency, according to a typically market rationale. An antitrust law was passed in 1990.

The forms and instruments of supervision evolved, with the gradual abandonment of administrative controls in favor of prudential rules; the neutrality of supervision with respect to banks' operating and organizational choices was embraced as a guiding principle.

The segmentation of the banking market deriving from the principle of specialization was gradually overcome through a series of statutory measures adopted in the early 1990s. Moreover, in 1990 the first legislation of banking groups was adopted and provided safeguards in the form of prudential supervision of banks engaging in financial activities through subsidiaries. With the transposition of the Second Banking Directive in 1992 the distinction introduced by the 1936 Banking Law between banks operating primarily in the short term and special credit institutions operating in the medium and long term was definitively abolished. A single model of bank was introduced, according to which banks i) could raise funds in any form and grant credit without any

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[26] The legal framework provided by that law was based on: principles of strict sectoral, maturity and geographical specialization for banks; a major presence of the State as the direct or indirect owner of the majority of Italian banks, as the arbiter of the structure of the market and banks' operations, as the creator and organizer of the regulated markets; and the concept of banking as a public service and not an entrepreneurial activity. It did not provide a specific legal framework for securities market intermediaries or issuers or for the defense of competition.

restrictions on the type of borrower, the form or the maturity; and ii) could also engage in other financial activities, except for the provision of insurance and the management of mutual funds (reserved by law to other intermediaries). The freedom granted to banks as regards their choice of operations is matched by the autonomy they enjoy as regards their choice of organizational structure: universal bank, specialist bank, group are options open to the banking entrepreneur.

With the adoption of the 1993 Banking Act, the whole regulation of banking was rationalized and an organic body of rules established; remaining segmentations in the special credit field were eliminated; and specific rules were introduced to foster transparency in the supply of banking products and services. One cardinal principle has remained in place from the 1936 Banking Law until today: the separation between banking and commerce. Non-financial companies cannot acquire control of a bank (or an equity interest of more than 15 per cent); conversely, except in some marginal cases, a bank cannot acquire control of a non-financial company. This strict rule is intended both to ensure the stability of banks, by limiting the risk of contagion as a consequence of crises originating in the industrial sector, and to preserve banks' autonomy in the delicate and valuable task of allocating credit.

A.1.2 Securities market intermediaries

At the beginning of the 1980s the legal framework for securities intermediaries was still little developed. Rules for institutional investors were completely lacking, as was comprehensive legislation on securities intermediation. The far-reaching change in the Italian financial landscape, from a totally bank-oriented system to a more market-oriented system, made it necessary to enact an equally far-reaching legal reform (or was stimulated by its enactment).

In the 1980s and the early 1990s a series of laws were passed to regulate new intermediaries and products: the first rules on open-end funds were introduced in 1983, on investment companies (*Sicav*) in 1992, on closed-end funds in 1993 and 1994, and on pension funds in 1993. In 1991 comprehensive legislation on securities intermediation was introduced that provided the legal framework for *società di intermediazione mobiliare* (SIMs), which were granted a reserve for investment services. However, the various statutory measures treated financial intermediaries in a fragmented way: the operations that such intermediaries could engage in were separated under a system of reserves that gave each category the exclusive right to engage in just some activities; organizational autonomy was limited; each type of intermediary was subject to a specific regulatory regime; and the instruments for the control of these intermediaries varied from one category to another. The fact that banks were prohibited from trading on the stock exchange—together with the requirement that trading in listed securities be concentrated on regulated markets—made it necessary for subsidiary SIMs to be set up to perform that service, with a consequent increase in costs for the system as a whole.

These arrangements were gradually dismantled in the 1990s. Restrictions on banks' operations were removed in 1996. With the 1998 Financial Services Act, the reserves granted to SIMs were diminished; the segmentation of asset management was eliminated; greater organizational autonomy was allowed and uniform rules drawn up for all securities investment firms. The rules of conduct and disclosure requirements vis-à-vis clients were rationalized and their bite increased. A further step forward in the evolution of the legislative framework was taken in 1999 with the adoption of the law on securitizations.

A.1.3 The markets

The legislation governing financial markets, which had remained largely unchanged from the beginning of the last century, was extensively modified from the 1980s onwards. The creation of new infrastructure, the introduction of modern methods of trading, and measures to reduce credit, market and liquidity risks were the directions in which the reform of the law moved. More recently, in 1996 and 1998, there was a shift from an approach to markets and the related supporting infrastructure as public goods to one in which they are seen as private-sector entities with scope for competition. The creation, organization and regulation of markets cease to be entrusted to public bodies; the role of the competent authorities is restricted to supervision. Both the Stock Exchange and the electronic secondary market for government securities turn themselves into public limited companies, *società per azioni*. Recognition of the entrepreneurial nature of markets extends beyond their management to include post-trading services. The Financial Services Act provides for the termination of the monopoly of Monte Titoli S.p.A. (central securities depository) and of that of Cassa di compensazione e garanzia S.p.A. (clearinghouse). A different solution has been adopted for settlement since the service, although privatized (except for the cash leg), is not provided under competitive conditions and continues to be regulated by the supervisory authorities in view of the systemic risk involved.

A.1.4 Issuers and public offerings

Plans for a separate body of legislation for issuers saw the light in the early 1970s, in parallel with the establishment of an authority charged with supervising the markets (Consob). The evolution of the law in this field followed three strands: i) disclosure of information; ii) the market for corporate control; and iii) the governance of listed companies.

As regards the first aspect, the few rules introduced in 1974 with regard to preventive information (prospectuses) and subsequent information (annual and interim reports) were later added to (in 1983 and 1985, respectively). Further measures strengthened the protection of the provision of information: the rules on insider trading and those requiring the disclosure of price-sensitive information to the market and to the supervisory authority (1991). The Financial Services Act rationalized and extended the earlier disclosure requirements (1998).

The first legislation on voluntary and mandatory tender offers was introduced in 1992. The shortcomings of these provisions, both complex and with gaps, were removed in 1998 with the Financial Services Act, which introduced rules aimed at fostering the efficiency of the market for corporate control and adequately protecting minority shareholders.

The rules pertaining to the governance of listed companies, previously little different from those applicable to other companies, were beefed up significantly in 1998 with the Financial Services Act. Minorities' "voice" instruments were made more powerful.[27] New rules on proxy voting make it easier for minorities to participate in shareholders' meetings. The effectiveness of both internal and external controls was enhanced. Additional action to improve the efficiency and transparency of the corporate governance of listed companies has been taken on the self-regulatory front with the listing rules of Borsa Italiana S.p.A. and the code of corporate governance for listed companies.

A.1.5 International opening

The modernization of the Italian legal framework for banking and finance was carried out in compliance with the Community law and its development. Numerous technical directives (on own funds, solvency ratios, market risks, supervision on a consolidated basis, large exposures, deposit guarantee schemes and investor-compensation schemes) were incorporated into the Italian law during the 1980s and 1990s. These directives were flanked by those aimed at giving a single “European passport” to banks, investment firms, investment funds and their management companies, and at allowing intermediaries to trade on foreign markets. To date, the Community

[27] In particular, the thresholds for calling shareholders’ meetings were lowered, together with those for reporting matters to boards of auditors and the courts. Provision was made for minorities to bring derivative actions against directors and to appoint one or two members of the board of auditors. New majorities for the approval of resolutions in extraordinary shareholders’ meetings increase the importance of active minorities.

rules on issuers have only dealt with matters concerning transparency. The various directives adopted are all reflected in the Italian law.

The convergence of the Italian legislation on banking and finance towards internationally uniform or equivalent standards is nonetheless the fruit of a process involving a multiplicity of sources: European directives and recommendations; principles established by international bodies, such as the BIS, the Financial Stability Forum, IOSCO; codes of conduct and the standardization of contracts.

A.2 The basic features of current law

The Banking Act and the Financial Services Act offer a modern legislative framework that capitalizes on the complementary characteristics of the credit and securities markets, prevents from turning intermediaries' activities into a sort of public function, and takes for granted the irreversible integration of the Italian with the European and international financial market. The two laws are based on shared principles: i) banking and finance as entrepreneurial activities; ii) competition; iii) supervision focusing on efficiency and stability as well as proper conduct, disclosure and investor protection; iv) flexibility of rules; and v) international openness. The outcome is a regulated competitive market, which is key to growth for enterprises capable of earning profits by providing high quality services while minimizing costs.

Credit and securities intermediaries are run according to standards of entrepreneurship, hence of efficiency, profitability and competition. Attainment of these objectives is fostered by a series of characteristics: the possibility of increasing economies of scale and scope, the development of new distribution channels and the possibility for different types of intermediaries to offer the same financial products and services (all induced by sweeping despecialization of lines of business and the equally broad range of organizational options); the generalized adoption of the joint stock company legal form (with positive fallout in terms of the internal and external governance of intermediaries); the rules on market access, which is no longer discretional but subject to controls solely in order to prevent the entry of incapable or dishonest entrepreneurs; and the overall regulatory framework, which avoids disparities of treatment between intermediaries that offer the same services and provides for rules that apply regardless of type of institution. Specific instruments to guarantee competition, in the three spheres of concentrations, agreements and abuse of dominant position, are available to safeguard the working of the market.

Many of the choices inherent in the present regulations of the financial markets are guided by the objectives of efficiency and competitiveness. Competition between financial marketplaces, accentuated by financial globalization and European integration, has heightened the need for greater entrepreneurship and competitiveness in the provision of the trading and post-trading services underlying privatization. The removal of internal segmentations within the asset management industry institutes a more modern and efficient regulatory framework for Italian institutional investors. The new rules on corporate governance of listed companies help to improve the direct and indirect protection of shareholders. In this way they provide incentives for investment. They broaden the market. They stimulate competition and the contestability of corporate control. They lower the cost of capital.

The primary purpose of regulation is to guarantee the overall stability of the financial system. Powers of regulation and control over intermediaries consist, in brief, in: i) setting prudential rules and standards of reliability for the management of intermediaries; ii) powers of authorization for key events (constitution, change in ownership, mergers, acquisitions and significant shareholdings); iii) monitoring of the quality of the management of banks and other financial institutions through access to and analysis of data; iv) intervention, graduated in severity according to the seriousness of the anomalies detected; v) crisis management. The oversight of markets, clearing and settlement systems serves among other things to guarantee financial stability. Surveillance of payment systems is specifically called for in the Banking Act, and is intended to ensure their efficiency and reliability.

Transparency and correct conduct are principles that cut across all the sectors of financial regulation. They protect the market and help to foster correct competitive dynamics. Objectives of clarity, completeness and timeliness of information lie at the basis of the rules governing the annual and other periodic financial statements of intermediaries and securities issuers, the relations of intermediaries (banks and non-banks alike) with customers, the disclosure requirements for issuers (price-sensitive information, prospectuses), information on transactions. Specific rules of conduct designed to ensure correctness are placed upon intermediaries, issuers, and all persons soliciting public saving.

International openness is promoted and protected. The Banking Act and the Financial Services Act transpose into Italian legislation the Community rules on freedom of establishment and the cross-border provision of services. Access, including remote access, to trading on foreign markets is allowed. As to issuers, the rules of governance introduced respond to the need for rules that are in line with those in place in international financial markets in serving the needs of foreign institutional investors. The prudential regulation of intermediaries and the tools for oversight of markets and payment systems are consistent with international standards. The competition rules are in line with Community principles. At the same time the integration between markets in different countries requires effective international supervisory cooperation. This is the need addressed by rules governing information exchange and division of tasks between the supervisory authorities of different countries.

The need for an effective legal framework—one that can respond promptly to the continual new demands of the market—is reflected in the sources of Italian financial law. The supervisory authorities are given broad regulatory powers to be exercised in the framework of the principles laid down by primary legislation. Adequate room is left for self-regulation.

A.3 Recent actions and the outlook for Italian legislation

Adequate and consistent rules governing business activity are essential to the growth and competitiveness of an economy. This conviction, which guided the revision of banking and financial legislation, also underlay the recent reform of company law. At the same time it signals the need to revise other areas of economic law as well.

The 2003 reform of company law (which goes into effect in January 2004) completely rewrites the rules on joint stock companies and private limited companies. The guiding principles are: fostering entrepreneurial activity of companies; simplification of rules; greater scope for “private ordering”; more effective direct and indirect protection of investors; strengthening the role and responsibilities of directors; greater resort to the market for finance.

The effects on the financial sector would appear to be twofold. First, application of the new rules to banks and other intermediaries will improve corporate governance. It will enhance the efficiency of management. It will have positive feedback on supervisory activity. For it is clear that the stability of the financial system and the sound and prudent management of intermediaries will be better ensured when the latter’s objective functions factor in the correct perception and management of the risks involved in their business. Second, the innovations design a relationship between firms and finance that is consistent with the increasingly market-oriented stance of the Italian financial system. Direct access to capital markets is encouraged by the improved quality of corporate governance and greater diversification of the financial instruments that can be issued (equity, debt, and “hybrid”). The substantial modulation of the rights assigned to shareholders or inherent in the instruments issued helps to strengthen the tools at the disposal of banks and other institutions for the monitoring of borrower firms. New rules on participation in shareholder meetings should encourage the activism of institutional investors.

Other areas of economic law—bankruptcy law, collateral, civil trials—remain critical, as the inefficiencies have direct consequences for the financial system. The rules governing company crises tend more to liquidation than to the preservation of the firm's value, they impose excessive sanctions on the entrepreneur, they involve costly procedural obligations, they are too slow, and in the end they recover only a modest portion of credit claims. The necessary modernization of Italian bankruptcy law has been under consideration for some time now, and a draft reform was recently presented. The rules on collateral are rigid—in terms of eligible assets, forms, and the type of protection accorded creditors—and require revision for more efficient allocation of rights and risks between the parties. Civil trials are uncertain in outcome, and their duration is much longer than the European average, which undermines effective enforcement of the rules.

A.4 From the standpoint of European law

In perspective, further changes will derive from developments in European banking, financial and company law. The implementation of the broad set of measures called for in the Action Plan on financial services will require changes in national legislation. Some involve just fine-tuning, others more important modifications of substance. The latter, apart from the revised Basel Capital Accords (Basel 2) and the consequent changes to EU legislation, include:

i) the *Financial Conglomerate Directive*; its enactment will require a stronger and active cooperation both between and within national supervisory Authorities in order to ensure effective oversight of financial groups engaged in multiple types of financial activities;

ii) revision of the *Investment Services Directive*; the definitive abrogation of the rule requiring trading to be conducted on national regulated markets and the recognition of other trading venues will entail full competition between different types of trading venue, which may significantly increase the level of competition both within and between national financial marketplaces;

iii) the regulation adopting *international accounting standards* (IAS); the adoption of fair value accounting marks a significant turning point in accounting rules and transparency for financial intermediaries and for companies more generally;

iv) the *Directive on prospectuses*; the full harmonization approach adopted in the new rules, together with the extension of the prospectus requirement to banks' fund-raising instruments, will require significant revision of national legislation;

v) the proposed *takeover bid Directive*; a uniform legal framework on takeover bids will help foster the growth of European enterprises and spur further integration of financial markets if the Directive ensures the proper functioning of the market for corporate control and if a sufficient and equivalent degree of contestability of control of European corporations is guaranteed. Uniform rules could also provide further stimulus to banking and financial concentration on a European scale;

vi) the *Directive on collateral in cross-border transactions*; the provisions of this measure suggest and in some cases necessitate a general reconsideration of national legislation on collateral and its treatment in the event of default.

The recent Action Plan on company law opens the way to greater uniformity in the rules on corporate governance in Europe, as it envisages a core set of harmonized principles and calls for enhancing the role of the market in promoting convergence on more efficient governance structures. The measures proposed are largely consistent with Italian law and could foster the efficient development of the European financial market.