Mr. Ciocca discusses competition and mergers in the Italian financial system

Speech by Sig. Pierluigi Ciocca, a Deputy Director General of the Bank of Italy, at a conference on "La concentrazione nell'industria dei servizi finanziari:aspetti teorici ed esperienze internazionali" held at the Università Cattolica del Sacro Cuore in Milan on 12/11/98.

Introduction

In the last twenty years there has been considerable consolidation in the credit field. The process began in the United States, where there have been more than 7,000 bank mergers since 1980. The United Kingdom was the first country in Europe to see significant merger activity, but it has spread to other countries, including Italy.

The most frequently cited general cause of consolidation lies in the changes that have occurred in the external environment: advances in electronic data processing and telecommunications, provisions aimed at attenuating the institutional separation of intermediaries, and the contraction in the role of public pension systems. Among other things, these developments have fostered financial globalization, asset management services, the use of powerful IT systems, and a drastic reduction in data transmission and communication costs. The repercussions have not been restricted to international and wholesale markets but have also been felt in local and retail markets. Banks appear to have seen the larger scale of operations as offering the prospect of coping with these repercussions better.

In Italy's case, however, a key additional factor has been the increase in competition. The Italian banking system had entered the eighties with the low level of competition inherited from the past. The subsequent change was radical and the consequent narrowing of margins stimulated restructuring and consolidation. From the eighties onwards, the dictum of comparative statics "more concentration, less competition" has been replaced by the dynamic alternative "more competition, more mergers". The premise, already tested in analyses carried out by the Bank of Italy, was that the Italian banking system — traditionally marked by a low degree of concentration and banks of limited average size with multiple branches — offered not only plenty of niches for small banks but also considerable scope for economies of scale. This potential is at last being realized, in the international context I have just described, under the pressure of the "novelty", at least for Italian banking, represented by the growth in competition that the Bank of Italy has been pursuing.

In my remarks I shall touch on three aspects of these complex processes, the outcome of which is still wide open:

a) antitrust action can forestall the adverse effects of consolidation on competition and reinforce the beneficial effects;

b) the Bank of Italy, both before and after 1990, has pursued a policy aimed at fostering the efficiency of the banking system through competition;

c) more competition, consolidation and restructuring remain objectives to be pursued, even though they are only necessary, and not sufficient, conditions for increasing the competitiveness of the Italian banking system, which is still burdened by high operating costs.

Mergers and the protection of competition

A high degree of concentration and a small number of large banks that enjoy growing economies of scale represent a situation that needs to be watched carefully. It is necessary to ensure that mergers bring benefits for customers and not an increase in market power. The law recognizes the threat that concentration poses for competition. Nonetheless, the traditional attitude towards mergers has been attenuated, in view of the positive effects that they are capable of producing.

In Italy, Article 6 of Law 287/1990 defines the scope of antitrust action. The ban on mergers applies to those that would create or strengthen a dominant position that is detrimental to competition.

Antitrust law, in turn, can supplement the monitoring of mergers with a range of alternative instruments. Controlling a firm’s behaviour may prevent it from exploiting its position to discriminate against competitors. Controlling the agreements between competing firms may prevent such understandings from distorting the play of competition.

In addition, there is the action — which does not derive directly from antitrust law in the strict sense of the term and which often falls within the scope of several institutions’ authority — aimed at ensuring the contestability of markets, at making it possible for other firms to enter the market and erode the dominant firm’s profits. Freedom to enter the market must be coupled with freedom to leave the market by keeping down the sunk costs of withdrawing, allowing inefficient firms to go to the wall, and making it effectively possible for entrepreneurs to sell all or part of their businesses.

The provisions concerning the abuse of dominant positions and agreements detrimental to competition, together with control of the effective freedom to enter and leave the market, make it possible to take a fairly relaxed view of most mergers and acquisitions, bearing in mind that in particularly serious cases operations hindering competition may be prohibited at law. It should also be noted in this respect that the parties can be required to dispose of assets or to adopt other measures like to ensure sufficiently competitive conditions. This practice is widely followed in the banking sector: in the United States some recent mega-mergers have been waved through subject to the mandatory disposal of assets equivalent to between 5 and 13 per cent of the deposits acquired.

The banking industry still has several distinctive features, especially as regards the taking of deposits and the granting of loans. One important sunk cost is related to the information content of the customer relationships on which lending decisions are based, an asset that is not easily marketable. Credit relationships involve an information asymmetry between borrowers and lenders that results in their not being completely fungible. Small banks that establish particularly close relationships with their borrowers enjoy an information advantage. This explains why it is difficult for banks to enter directly into geographical markets in which they were previously absent; indirect growth by acquiring existing banks or branches is often the easiest way to overcome this barrier and enter a retail market characterized by information asymmetries.

At the same time this peculiarity is likely to act as an exit barrier, thereby reducing the incentive to enter the market and the potential competition. Sometimes the authorities themselves encourage mergers in order to remove inefficient banks from the market without their having to be put into liquidation, with all the costs the resulting termination of customer relationships entails. The scope for mergers is accordingly a condition for keeping down market entry and exit barriers and thereby reducing the probability of collusion. A market for the control and ownership of banks that works is a necessary condition for the efficiency of banking as a whole. Mergers also make the financial market’s assessment of banks more effective; larger credit

institutions are encouraged to open up their ownership structure to third parties and the stock market in order to increase their ability to raise equity capital.

On the liabilities side of banks' balance sheets, the demand for deposits and accessory services is still linked to customers' physical closeness to branches. The evaluation of mergers must therefore take into account not only imperfect contestability but also the evolution of local markets and the conditions effectively applied to customers.

Lastly, credit intermediaries are multi-product enterprises and often operate in several markets. Mergers between diversified intermediaries will have a different impact on the ability to be present in the various markets — for loans, deposits, payment instruments, securities business, asset management, leasing, factoring, consumer credit and corporate finance, etc. When assessing mergers, account therefore needs to be taken not merely of the increase in the degree of concentration in one market, but also of how competitive conditions change in the other markets.

The Bank of Italy and the promotion of competition

From the end of the seventies onwards the action taken by the Bank of Italy has been aimed at increasing competition in the banking and financial system. The powers of authorization assigned by law to the Bank as the body responsible for supervision were exercised from the twenties onwards according to the principle of competition. In the "Branch Plan" drawn up in 1978 the Bank explicitly announced the objective of fostering competition in the banking industry: the opening of branches was envisaged primarily in the areas where the concentration of loans and deposits was highest, and not infrequently monopolistic.

Thus the Bank of Italy placed competition at the centre of its policy aimed at increasing the efficiency and solidity of the banking and financial system well before it was granted formal antitrust powers in 1990.

The precondition for the change in the Bank's approach was the abandonment of the idea — widely held after the crisis of the thirties, not only in Italy and not only among central banks — that competition, or "excess" competition, caused banking instability and was antinomic with respect to stability. On the contrary, and especially in the conditions of international openness typical of the Italian economy in normal circumstances, an inefficient banking system is bound to be prone to systemic instability, even though oligopoly allows it to be profitable. A powerful stimulus to achieve profitability and hence a congruous capital base through efficiency could clearly be detected in the increase in competition in the domestic banking and financial markets. Increased competition therefore became the key intermediate objective, the fulcrum of the Bank of Italy's monetary, exchange rate and supervisory policies. 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 consideration, rooted in the economic theory upon which antitrust legislation is based, was that *laisser faire* and competition were not the same thing, that the former could override the latter (especially in an industry with economies of scale), and that deregulation was likely to be more effective if set within the framework of an economic and institutional *policy* aimed at protecting and strengthening competition and ultimately imposing it on producers who might well not like it. The attribution to the Bank of Italy of responsibility for implementing antitrust law in the banking field was thus not a break, an anomaly to be removed later. It was the natural, institutional, recognition of a state of affairs that had already existed for tens of years. Above all it sanctioned a principle that must be consolidated and applied more widely: not only are prudential supervision and the protection of competition not in conflict, but they are rigorously complementary.

The declarations of intent, the strategic decisions, the single acts with which the Bank of Italy interpreted and applied these general criteria in practice have been many and spread over twenty years. They cannot all be listed here, but I shall briefly indicate the most important in a series of summary points:

- the first, absolutely fundamental, step was taken at the beginning of the eighties with the reaffirmation of the notion of banks, both publicly and privately-owned, as enterprises. In the wake of the transposition of the EEC's First Banking Directive of 1985, the issue was finally settled in a judgement handed down by the Court of Cassation in 1989. The transformation of publicly-owned banks into companies limited by shares followed, as provided for in Law 218 of 1990;

- between 1985 and 1990, while the amendments to the law that would lead to the new Banking Law of 1993 were being enacted, administrative measures were adopted attenuating or eliminating the restrictions in fields such as branching, fund-raising and lending beyond the short term, and the creation of new banks. The growth of individual banks was increasingly related, by way of solvency and gearing ratios, to the amount of capital they were able to bring into play;

- starting in the early eighties, the quantity, the quality and the diffusion of the information disclosed by banks to customers and the market were enhanced;

- by the end of 1988 the shift from direct administrative instruments to indirect market instruments in implementing monetary policy had been completed;

- in response to the need to place growing volumes of public debt with domestic investors, steps were taken to create efficient money and bond markets. The share of bank deposits in households' financial assets fell from 53 per cent in 1979 to 34 per cent in 1990 and stands at 25 per cent today;

- the removal of exchange controls was started in 1988 and completed in 1990, with the result that, for the first time in its history, Italy had a fully convertible currency and complete freedom of both short and long-term capital movements.

All the indicators show that the degree of competition in the Italian banking system increased significantly in the eighties. Between 1979 and 1989 the average number of banks present in each province rose from 20 to 27. The concentration of the loan market fell by 15 per cent nationwide and by 20 per cent in the Centre and South. The differential between the average bank lending rate and the pre-tax yield on Treasury bills narrowed from 5 percentage points in 1980 to less than 1 point in 1989 and this happened in a period which saw the riskiness of bank credit increase slightly. The spread between lending and deposit rates also narrowed, declining initially from more than 9 percentage points in 1980 to less than 7 points in 1989. Inevitably, these developments resulted in the margins on credit business coming under pressure.

In 1990 the law establishing the Competition Authority (Law 287/1990) made the Bank of Italy responsible for the antitrust function in the banking sector. The choice was made in view of the specific technical nature of banking and the complementary nature of prudential supervision and the protection of competition. In the United States, with its century-long tradition of antitrust legislation, the situation is similar since the Federal Reserve or the Office of the Comptroller of the Currency, according to the banks involved, are responsible for evaluating the anti-competitive effects of mergers. The Department of Justice cooperates with the regulatory authorities and in extreme cases may bring a legal action against an operation. In Europe, it is

worth mentioning the case of the Netherlands, where, in establishing a Competition Authority at the beginning of this year, the law provisionally assigned the protection of competition in the banking and insurance industries to the respective supervisory authorities. Other antitrust authorities are also beginning to recognize the specificity of the banking sector and, as in Canada, have issued special instructions for the evaluation of bank mergers.

The growth in competition has continued in the decade that is drawing to a close. Following the decision taken by the Bank of Italy in 1990 to liberalize banks' branch networks by abandoning the system of "branch plans", the number of branches increased as never before, rising by 10,000, or more than 60 per cent, to 25,600 in June of this year. At the end of 1989 there were 1,173 banks in Italy, of which 83 were medium-term credit institutions or sections. By the end of June the number had fallen by more than 20 per cent to 937, of which 120 belonged to banking groups. In recent years the process of consolidation has involved large commercial banks, partly in response to the prospect of an integrated European market with a single currency. The average number of banks present in each province has risen further to 30.

During the nineties the differential between the average bank lending rate and the pre-tax yield on Treasury bills has tended to remain close to its level at the end of the eighties. But, partly owing to the rather weak performance of the economy, this decade has seen a sharp increase in the average riskiness of loans and a deterioration in the quality of banks' assets. Hence, the stability of the differential between bank lending rates and the yield on government securities is further evidence of the increasing competition within the banking industry.

The differences between the lending rates applied in the various parts of the country have also narrowed in the last four years after peaking in the second half of 1994. The difference between the rates on short-term lira loans in the North and the South is currently around 2 percentage points for non-financial companies and about 1.5 points for producer households. The gap is entirely attributable to the greater average riskiness of lending in the South and the longer time it takes to recover credits there. The ratio of bad debts to total loans disbursed to customers in the South is 22 per cent, as against 7 per cent for borrowers in the Centre and North. Analyses carried out at the Bank of Italy show that, after adjusting for the risks that materialized, the geographical differential disappeared in the early nineties. The spread between lending and deposit rates has narrowed further and now stands at 4.5 percentage points.

The growth in competition has contributed to a substantial redistribution of banks' shares of the loan market. The major changes that occurred after the ceiling on bank loans was removed were followed by further large shifts in the two years 1989-90 and from 1995 onwards. In the last three years the market shares that changed hands each year were equal to around 4 per cent of the total loan portfolio on average, excluding the amounts directly affected by mergers. The increase in competition has led to banks adopting more aggressive supply policies and growth strategies more closely attuned to demand.

Mergers and acquisitions in the Italian banking system

Between 1990 and 1997 the Bank of Italy, pursuant to the provisions of antitrust law applying to the banking sector, examined some 300 proposed mergers and acquisitions. The banks in play grew steadily larger. In the last four years the banks involved accounted for 7 per cent of the banking system's total assets on average each year. The consolidation process has had a particularly pronounced impact on the southern banking system, partly as a result of the acquisition of the control of local banks in difficulty by banks situated in the Centre and North.

In ten cases the Bank of Italy decided to examine proposed mergers in order to verify whether the operation was likely to create or strengthen a dominant position and prejudice competition. In four of these cases the go ahead was made conditional on measures aimed at protecting competition in the market in question.

Another ten examinations concerned agreements suspected of being detrimental to competition. The investigation of industry-wide standard terms and of payment instruments were especially important in this respect. In its recently published findings on the rules governing the use of the PagoBANCOMAT card, the Bank of Italy identified several circumstances that were potentially anti-competitive and made its approval of the agreement conditional on a number of changes that will help to make the market more competitive.

The Bank of Italy also investigated five alleged abuses of dominant positions. In four of these cases the banks were accused of using their exclusive right to provide tax-collection services to gain undue competitive advantages in neighbouring credit markets. In the fifth case the Bank took action to prevent the bank from exploiting its dominant position to expand its branch network abnormally with the aim of obstructing the entry or growth of competitors in the market in question.

In addition to its normal examination activity, in 1996 the Bank of Italy investigated the possibility that banks were coordinating their pricing policies, but found no evidence of such practices. In 1997, in agreement with the Competition Authority, it conducted a general fact-finding inquiry into the corporate services sector.

In the nineties the consolidation of the Italian banking system has proceeded primarily by means of mergers and amalgamations, of which there had been 265 by the end of 1997. Acquisitions of the control of banks that subsequently continued to operate as separate entities also played an important role, with a total of 91 such takeovers. Even where these operations have not yet significantly reduced operating costs, they have allowed capital to be used more efficiently and brought tax benefits, increases in fee income and improvements in the quality of the acquired bank's loan portfolio.

Mergers between banks which are not present in the same markets, or with only limited overlap, increase competition. By contrast, the "market power" effect tends to prevail over the efficiency effect where the merging banks both have a large presence in the same market. These findings confirm the continued importance of the physical closeness of customers to their banks and the need for the attention that the competition authorities pay to local markets.

Mergers inevitably impact the payment system and the stability of the banking sector. By diminishing the number of participants in the payment system, they tend to reduce the volume of transactions to be settled. The setting of operational and technological standards aimed at exploiting network economies may well be easier. On the other hand, larger banks are likely to cause more serious problems in the event of insolvency: the overall effect of mergers on the stability of the payments system will depend on how they affect the riskiness of the individual banks.

Competition, consolidation and costs

Competition, consolidation and reorganizations have helped to curb operating costs in relation to the total assets of the banking system. In the three years from 1995 to 1997 this ratio averaged 2.4 per cent, compared with 3 per cent in the second half of the eighties.

Nonetheless, partly as a result of the rigidity of the Italian labour market, the competitive gap between Italian banks and their counterparts abroad, which is attributable primarily to the greater incidence of staff costs, has not narrowed in the nineties. In 1997 bank staff costs amounted to 43 per cent of gross income in Italy, compared with an average of 38 per cent in France, Germany and Spain.

The agreements between employers and the trade unions to reduce the cost of labour, prompted by the Bank of Italy and promoted by the Government, have not yet been given effect in a new wage agreement linking earnings more closely to a bank's performance. Significant cost savings, as well as increased revenues, can be achieved by modernizing structures, reorganizing production processes and developing innovative distribution networks. Other banking systems have invested a substantial volume of resources, deriving in part from savings in staff costs, in technological innovation, thereby acquiring competitive advantages on several fronts.

The increase in competition in banking markets, further intensified by foreign intermediaries accustomed to operating on a larger scale and with smaller interest rate spreads, has sharply reduced the profitability of Italian banks' traditional activities. The fall in net interest income, which began several years ago and will be accentuated by the introduction of the euro, has not been offset by a lasting increase in revenues from innovative activities: corporate advisory services and finance, the administration and management of households' savings, and business in the international securities markets.

In the first half of the eighties Italian banks' return on equity was in excess of 14 per cent, in line with that of the other leading European banking systems. Since then it has fallen, reaching a low of around 1 per cent last year. Apart from the level of costs, the large loan losses incurred in the last few years have made a major contribution to the decline in profitability. The risk-asset ratio of the Italian banking system is 13 per cent, well above the requirement of 8 per cent established in the Basle Capital Accord. Only a very few banks are below this limit and the total shortfall is around 500 billion lire.

The decline in profitability has nonetheless reduced the flow of internally-generated resources with which to finance growth and merger operations. The larger banks have suffered especially in this respect: at the end of last year they held less than one third of the free capital of the banking system, as against 80 per cent of its total assets. The lack of free capital, not tied up in tangible and financial fixed assets and available for acquisitions, will curtail the scope for modernizing the system and pursuing efficiency.

The intermediate objective pursued over the last twenty years has been largely achieved; there is more competition, there have been numerous mergers and a start has been made on reorganization projects that promise to improve efficiency. Competition has produced its full effects on the prices of banking products and services, holding them down and making them more uniform. But other benefits have been, still are, slow in coming: lower costs, international competitiveness, profits and fresh capital generated by efficiency and the quality of services.

The picture is thus chiaroscuro. Disappointment should only be felt by those who fail to recognize that competition fosters efficiency but cannot guarantee it where producers lack the ability to respond — à la Leibenstein — to the competitive stimulus. It is necessary to appreciate how much inertia has to be overcome in a complex process that is more cultural than juridical or institutional, in short the "passage" from oligopoly to competition of an industry that is based on information asymmetries, bilateral customer relationships and the reputation of producers. This journey was bound to be laborious and slow, especially in Italy's case. The Italian banking

system arrived at the world economic crisis of the seventies after two postwar decades in which its oligopolistic nature had become deeply rooted, while the economy had enjoyed an extraordinary boom. The model formulated by Donato Menichella and Raffaele Mattioli had "worked" in a certain sense; it had met, albeit with the inefficiencies that were the inevitable corollary, the demand for credit and money of the Italian economy in that buoyant phase. The subsequent resistance to change cannot be entirely attributed to the reluctance of any industry to face the forces of competition or to the natural tendency to continue to do things in the same way.

To give way to counterfactual criticism based on hindsight — such as, the injection of competitive enzymes should have been much larger and more intense — would be not only sterile but also debatable in theory and risky in practice. It is analytically doubtful whether it would have been possible, given the context. It is sufficient to mention just one aspect referred to earlier: the uniform treatment of banks and enterprises and of banks in the public and private sectors became a part of Italian law — as a result of the judgement of 1989 — ten years after the supervisory authority had clearly stated the principle. The risk at the practical level is that at this point banking competition will be seen as a missed opportunity, and that this will lead to the idea of renouncing it in the future.

The position of the Bank of Italy is to proceed, if possible with greater determination, on the road taken twenty years ago — not only because the single market, the euro and their rules leave no option, and not only because the law in force in Italy today mandates this course, but in the belief that the progress that has already been made is in the right direction, even though competition on its own, it is worth repeating, does not guarantee an optimal financial system.

The Bank of Italy will devote more resources, a revised internal administrative structure focused on banking competition, and additional analyses serving to underpin new interventions to the task of fostering competition in the markets in which banks operate and the mergers they autonomously plan.

Two changes that are already under way will also produce their effects. Mutually reinforcing, they should, together with competition in the markets for banking products, stimulate efforts to achieve the cost reductions and quality improvements that are necessary. The first change is the privatization of the banks that are still under public control, the second concerns the exit procedures aimed at preventing moral hazard and the neglect of costs.

The transfer of the ownership of banks to the private sector is the precondition for control to be contested in the market. In the last few years the process of privatizing public banks has gathered pace, in parallel with the growth in mergers. Including the operations that are currently being organized, the share of the banking system's assets in the hands of banks of which the state, local authorities or foundations own the majority of the capital will shortly fall to 20 per cent, as against 70 per cent ten years ago. BNL is about to be privatized. The Monte dei Paschi di Siena foundation, the only one that still owns all the capital of a major bank, has recently decided to place some of its capital in the market and to seek a stock exchange listing.

The prospect of contestability opened up by bank privatizations has been strengthened by the changes to the legal framework introduced by the Consolidated Law on Financial Markets, which came into force in July of this year. The new rules serve to increase the disclosure of information, enhance the efficiency of the financial markets and the contestability of control — in the case of listed companies partly through the revision of the provisions governing takeovers. There are 25 commercial banks listed on the stock exchange; they account, directly and indirectly via listed and unlisted subsidiaries, for 50 per cent of the banking system's total assets. In addition, there

are 10 cooperative banks listed on the stock exchange, accounting for 10 per cent of total assets, and another 7 banks are listed on the *ristretto* market.

Although the Community authorities recognize the specific features of the banking sector, their application of Article 92 of the Treaty to banks tends to be rigorous. The authorization of state aid to some large European banks has been made conditional on their disposing of assets, parts of the business and equity interests. The fact that bankers will be able to count less on public support means they will have to adopt even more stringent criteria of autonomous, sound and prudent management.

The number of banks in distress that have been consolidated (by means of mergers, amalgamations and takeovers) or placed under special administration or in liquidation has increased in the nineties, in both absolute and relative terms. The ratio of the number of such banks to the total number rose from 1.5 per cent in 1990 to an average of 4.3 per cent in 1996 and 1997; the ratio of their assets to the total assets of the banking system rose from 0.2 per cent to nearly 6 per cent. The increase in the number of such interventions with respect to troubled banks has been partly due to the increased emphasis on the preventive nature of supervisory action. Since the action is taken when the troubled bank still has a net value, it is possible to look for market-based solutions and hence to reduce the burden borne by the deposit protection system or the public finances. The proportion of troubled banks subjected to restructuring that were liquidated rose from 6 to 16 per cent between 1990 and 1997. In terms of their assets, the ratio rose from just a few percentage points at the beginning of the decade to 11 per cent in 1997.

The potential for the development of the financial sector, in both quantitative and qualitative terms, that the Italian economy requires and that it can achieve is considerable, probably greater than in most other European countries. The Bank of Italy remains committed to ensure, with the instruments the law provides, that this further development takes place in a competitive environment and in conditions of greater efficiency.