The Italian banking sector: an overview

Research Department

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1 Sector structure

Institutional framework

The Italian banking sector comprises 792 banks (figures as at March 2004), of which 243, or 30%, are joint stock companies (SpA) and account for 80% of the domestic banking market. The sector also features two types of entity operating under a cooperative structure, namely 38 cooperative banks ("banche popolari") and a large number (444) of small mutual banks ("Banche di credito cooperativo – BCC").

### Institutional bank categories
(figures as at March 2004)

<table>
<thead>
<tr>
<th>Category</th>
<th>N° of banks</th>
<th>% of total</th>
<th>N° of branches</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks established as SpA</td>
<td>243</td>
<td>30.7%</td>
<td>23,599</td>
<td>77.2%</td>
</tr>
<tr>
<td>Cooperative banks</td>
<td>38</td>
<td>4.8%</td>
<td>3,475</td>
<td>11.4%</td>
</tr>
<tr>
<td>Mutual banks</td>
<td>444</td>
<td>56.1%</td>
<td>3,353</td>
<td>11.0%</td>
</tr>
<tr>
<td>Branches of foreign banks</td>
<td>62</td>
<td>7.8%</td>
<td>96</td>
<td>0.3%</td>
</tr>
<tr>
<td>Central Institutes</td>
<td>5</td>
<td>0.6%</td>
<td>30</td>
<td>0.1%</td>
</tr>
<tr>
<td><strong>Total Banks</strong></td>
<td><strong>792</strong></td>
<td><strong>100.0%</strong></td>
<td><strong>30,553</strong></td>
<td><strong>100.0%</strong></td>
</tr>
</tbody>
</table>

Source: Bank of Italy, Statistical Bulletin; Banca Intesa calculations.

With the exception of BCCs, which are subject to specific regulations and have mutual ends, all the other sector players undertake their activity as private entities pursuing profitability. Even the cooperative banks, though still characterised by the one-person-one-vote principle, operate on the market exactly like their SpA counterparts, and some of them are listed on the stock market; a few of them are leading players in the Italian banking sector. By contrast, BCCs are very small in size, with an average of eight branches each. They are organised around regional federations providing centralised services to the individual members; similarly, specialist products are created through consortium-structured initiatives. The category has its own specific deposits insurance fund. Traditional customers of BCCs are artisans, farmers, retailers, small businesses in general and households. Their retail mission is borne out by market share in savings deposits (8.3% at December 2003) in excess of the share in loans (6.2%).

### Market share by bank category
(figures as at December 2003)

- **Loans to domestic customers**
  - Banks established as SpA: 79.3%
  - Cooperative banks (Banche popolari): 9.3%
  - Mutual banks (BCC): 6.2%
  - Branches of foreign banks: 5.2%

- **Customers deposits**
  - Banks established as SpA: 80.4%
  - Cooperative banks (Banche popolari): 10.2%
  - Mutual banks (BCC): 8.3%
  - Branches of foreign banks: 1.1%

Source: Bank of Italy, 2003 Annual Report; Banca Intesa calculations.
With regard to the size of sector players, Bank of Italy statistics provide a breakdown into five categories. As shown in the table and the following charts, 11 major banks possess one-third of branches and generate 36% of the loans furnished by the Italian banking industry to domestic customers. The same number of large banks generates combined volumes corresponding to one-third of that produced by their largest rivals. A good 20% of business is undertaken by 31 medium banks and around the same amount by 130 small banks. Note that both the medium and small banks are stronger in lending than in customer deposits. The vast number of minor banks (609) accounts for the remaining 11-12% of business.

### Bank categories by size
(figures as at March 2004)

<table>
<thead>
<tr>
<th>N° of banks</th>
<th>% of total</th>
<th>N° of branches</th>
<th>% of total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Major banks</td>
<td>11</td>
<td>1.4%</td>
<td>10,135</td>
</tr>
<tr>
<td>Large banks</td>
<td>11</td>
<td>1.4%</td>
<td>3,584</td>
</tr>
<tr>
<td>Medium banks</td>
<td>31</td>
<td>3.9%</td>
<td>6,235</td>
</tr>
<tr>
<td>Small banks</td>
<td>130</td>
<td>16.4%</td>
<td>5,993</td>
</tr>
<tr>
<td>Minor banks</td>
<td>609</td>
<td>76.9%</td>
<td>4,606</td>
</tr>
<tr>
<td>Banks</td>
<td>792</td>
<td>100.0%</td>
<td>30,553</td>
</tr>
</tbody>
</table>

*Source: Bank of Italy, Statistical Bulletin; Banca Intesa calculations.*

Basically, 70% of traditional banking activity is undertaken by around 50 medium/large banks, while the remaining 30% is handled by around 740 small and minor banks. Given that, of these, there are 444 banks belonging to the mutual circuit of BCCs, there remain around 300 small banks handling 20% of banking activity. It is clear that there is considerable fragmentation at the smaller size level of the Italian banking industry and it is reasonable to expect sector consolidation to continue through deals primarily involving medium and small banks.

### Market share by bank size category
(figures as at December 2003)

**Loans to domestic customers**

- Major banks: 36.0%
- Large banks: 10.8%
- Medium banks: 22.4%
- Small banks: 20.3%
- Minor banks: 10.5%

**Customers deposits**

- Major banks: 36.9%
- Large banks: 13.0%
- Medium banks: 20.6%
- Small banks: 17.6%
- Minor banks: 11.9%

*Source: Bank of Italy, 2003 Annual Report; Banca Intesa calculations.*

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1 The banks are grouped into five classes: major banks (with average total assets of over €45bn), large banks (total assets between €20bn and €45bn), medium banks (assets between €7bn and €20bn), small banks (assets between €1bn and €7bn) and minor banks (assets below €1bn).
To better understand the geography of the sector, account should also be taken of the importance of the organisation of Italian banks into multi-functional groups, rather than into universal banks, which frequently comprises a number of banks specialising in different local areas or in specific customer segments. At end-2003 there were 82 bank groups, comprising 1,063 companies, of which 225 Italian banks and 80 foreign banks. Taking 100 as the total lending activity of banking groups, a hefty 88% is undertaken by Italian banks, while the remainder is split between domestic financial companies (7%) and foreign subsidiaries (5%).

Ownership

The Italian banking sector is now totally private. Following the intense privatisation process of the 1990s, the state’s share in Italian banks is virtually zero, at below 1%. At the start of the 1990s, by contrast, the state and local public authorities owned 68% of total banking assets. This result was achieved both by the sale of the stakes held directly by the state, and through regulatory intervention to encourage the conversion of public banks – mainly savings banks (“Casse di Risparmio”) – into SpAs, with the concurrent creation of Foundations and the separation of the banking side from the foundation via conferral in exchange for shares of the new banking companies.

Currently, after a series of regulatory changes, the bank foundations are private no-profit legal entities with statutory and operating independence, whose aims are social good and the promotion of economic growth. Accordingly, the regulations required the Foundations to proceed over time with the gradual disposal of their stakes in the banks. A legislative change introduced in 2003 exempted banking foundations whose own funds were under €200m and those operating in special-statute regions from the previous requirement to cede controlling interests in banks. The deadline for compliance by the other Foundations was postponed to 31 December 2005. However, even now the presence of banking foundations in the share capital of banks is much diminished. In 2003 the number of banks and groups over 50% of whose capital was held by foundations fell to 19 (from 25 in 2002); they account for 9% of total assets. According to the ACRI (Association of Casse di Risparmio SpA and Foundations), all the foundations which had over 50% of the share capital of banks complied with the rule, since they have under €200m in own funds. In the case of the other foundations with stakes in the share capital of banks, the amounts vary widely. Specifically, according to Bank of Italy figures for 2003, 14 foundations are present in the share capital of the top five Italian banking groups; in nine cases the stake is over 5%.

Another peculiar feature of the Italian banking sector is the corporate governance system of cooperative banks (“banche popolari”) which, by virtue of their cooperative nature, give one vote to each shareholder irrespective of the number of shares owned. Alongside this, the by-laws of the cooperative banks also set an upper limit on the maximum number of shares owned. The European Union has initiated infringement procedures against Italy since the voting system at the cooperative banks is alleged to be an obstacle to the free circulation of capital and competition, since it actually erects a barrier against takeover. Proposals to reform the category have been submitted to the Italian parliament, but no real developments have materialised to date. According to the prevailing stance, any intervention should first focus on listed cooperative banks. Indeed, there is a widely held view that the cooperative banks system must be defended since it is seen as an asset for the local economy and the SMEs, artisans and small businesses which form the traditional customer.

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base of cooperative banks, as well as BCCs. Note too that thus far these specific attributes of the cooperative banks have not prevented major mergers between banks in the same category, or the acquisition of cooperative banks by SpA banks, post-conversion.

Since aggregate figures on the ownership structure of the Italian banking sector are not available, some rough indications on the weight of each category of investor can be extracted from an examination of the shareholder structure of the six largest Italian banks, all listed. The aggregate ownership structure, obtained by weighting the stakes held by the individual shareholders in the ordinary share capital\(^3\) by the consolidated capital of each bank, shows that the free float accounts for almost 60%. The stake of the banking foundations is almost 19%, but would fall to 15% excluding from the sample MPS, the only major Italian bank to still have a significant Foundation presence, with 49% of the ordinary share capital. Foreign investors, including investment and pension funds, account for over 15%.

![Ownership structure of top six Italian bank groups](image)

Source: Consob; Company data; Banca Intesa calculations.

In conclusion, the Italian banking sector is now virtually completely private and largely characterised by SpA banks (except for cooperative banks and BCCs). The shareholder base of the banks is also quite widespread, considering that a large proportion of the capital of listed banks is free float and that there is a large body of cooperative and mutual bank members. Alongside this, the foundations are stable shareholders, whose aim is constant profitability over time and medium/long-term investment, which does not clash with the attainment of high earnings performance by the banks themselves.

**Concentration**

After a period of extensive consolidation in the 1990s and subsequent stabilisation, recent developments in the structure of the Italian banking sector show the reduction, albeit modest, in the degree of sector concentration. This trend coincides with a period of stability in the structure of the sector, with the major groups engaged in integration and rationalisation projects, following an intense period of growth in size.

\(^3\) The figures are taken from Consob releases, which show ownership stakes in excess of 2%.
In 2003, as in the previous two years, we note a reduction in the intensity of M&A activity among Italian banks, both in terms of the number of deals, which fell to their lowest level in the last ten years (26), and their size (measured on the basis of the transaction volumes of the banks involved, see below). This is consistent with the general trend in merger and acquisition activity recorded in the last three years both at the global and European level: the number and value of M&A transactions falls, as does the average size of transactions. In Italy, however, according to Antitrust figures, the monetary and financial intermediation sector (which also includes insurance companies) again in 2003 proved to be one of the sectors most heavily engaged in concentration deals, as well as reporting high volume transactions.

Despite the slowdown in M&A activity, in 2003 the number of banks continued to fall (-3.2% vs. 2002). Note that, following the ongoing reduction, almost one-third of the banks in operation in 1990 no longer exist. This consolidation in the number of players appears to be slightly more pronounced among smaller banks: the number of small and minor banks fell 3.8% vs. end-2002, while mutual banks ("banche di credito cooperativo") fell by 3.5%, taking their decline vs. 1990 to 38%.

Following the slowdown in M&A activity among banks, the average size of the top five Italian bank groups works out to €190bn in total assets, a figure broadly unchanged since 2000, when it was more than double the value at the start of the 1990s. This stabilising trend is due to integration and rationalisation processes under way at leading Italian bank groups, following a phase of rapid growth.

Consequently, the growing degree of concentration in the banking industry has come to a halt for the time being. Through to 2000 this phenomenon was provoked by a series of M&A deals involving medium-large size banks with substantial market share. Thereafter, notably in 2001 and 2003, M&A transactions involved banks with more modest market share (in 2003, 1.7% of total assets, vs. 5% in 2002 and a high of almost 15% in 1999), indicating that the domestic concentration process had peaked and major new transactions were encountering problems.

In 2003, the degree of sector concentration fell slightly: the proportion of total system assets controlled by the top five Italian bank groups fell to 51%, from the previous level of 55%. At the same time, the smaller banks grew in importance. This is a particularly interesting development and, according to the

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Bank of Italy, is due to branch openings by small banks in areas where they were not represented. Another possible explanation could lie in the focus of the major banks on their own integration and rationalisation projects, causing them temporarily to lose commercial effectiveness, or in portfolio policies designed to reduce concentration on customers at the local level. A more aggressive approach by the minor banks and their strong local presence enabled them to snap up business opportunities stemming from local customer demand.

There are numerous indicators of the growing importance of minor banks. If we take lending activity, for example, in 2003, in the context of system average customer loans growth of 5.8%, the small and minor banks grouping grew by no less than 16.0%, vs. 1.8% for the major, large and medium-sized banks; the mutual banks category in particular, was even more dynamic, reporting loans growth of +17.6%. Although this phenomenon had also been seen in the two previous years. As shown in the chart above, the share of the customer loans market held by small and minor banks has grown steadily over the last three years (+5.5 points to 30.8%), after a period of stability.

**Trend in distribution networks**

Another structural area that has been the focus of particular attention and extensive re-organisation is the distribution network. Exceeding even the most optimistic forecasts and contradicting those who predicted a decline to the advantage of virtual channels, **bank branches have not stopped multiplying, albeit at a slower rate than previously**. In 2003, the number of branches grew by 1.9% vs. end-2002 to over 30,000 (30,502 as at 31 December 2003). Thus, for the second straight year the growth rate is half that of the previous six years, when it fluctuated around 4%. Of the c.580 new bank branches opened in 2003 (net balance of openings and closures), most of them were small branches (no more than five staff), which now constitute the majority of bank branches in Italy (55% of total branches).

In the context of this slowdown in new openings, **branch network rationalisation and internal reorganisation by the individual groups has been intense**: in 2003 350 branches were closed, vs. 105 in 2002 and 57 in 2001, and 178 were sold, vs. just 46 in 2002; in addition, around 2,200 branches were involved in infra-group transfers (over 4,800 in 2002). Accordingly, the large groups have reorganised their networks through internal transfers, closures and disposals, without losing sight of their expansion targets, while the small banks have pursued a policy of endogenous growth. Specifically, in recent years **mutual banks, faced with a sizeable decline in their number due to M&A operations**
within this category, have grown in importance in terms of distribution networks. In 2003, the c.130 net branch openings made by mutual banks accounted for 23% of system openings, twice the weight of their branches within total bank branches in Italy (10.9% at end-2003). Moreover, this weighting has steadily grown in recent years, notably in 2002-2003 (+0.5 points, which compares with +0.7% vs. start-1996).

In 2003, the distribution structure reorganisation and rationalisation process also extended to financial salesmen networks. In this specific segment, the strategies of the individual groups were very different, ranging from strengthening existing networks through acquisitions to the integration of various adviser networks resulting from previous M&A transactions, and to the decision to quit the business by selling the network. The result is sector consolidation and a stabilising in the number of financial salesmen in the last two-three years, following a period of robust growth, in the wake of asset management and financial market growth. According to Consob figures, which show the number of registered advisers, in 2003 turnover was slightly negative, for the first time since 1995. This is consistent with the figures produced by the Bank of Italy, which show a fall of 6% in the number of advisers used by banks (to around 34,000), and with the association of financial product placement companies (Assoreti) which for the first time in 2003 reported a downturn in the number of active financial salesmen among its members (-3.3% in December y/y).

(Elisa Coletti)
2 Profitability and soundness

Profitability

In recent years Italian banks have demonstrated their ability to cope with adverse economic and financial conditions and to weather the rapid sequence of shocks that have affected the sector as a whole, both domestically and internationally. Following a process of radical transformation in the 1990s, the Italian banking system is now more solid, efficient and profitable, as shown by the trend in the profitability indicators over the long term (see next chart).

Trend in ROE of Italian banks

(aggregate individual data)

In most recent years too, despite the tough operating conditions, Italian banks have improved their economic performance. In 2003, aggregate net income recovered, growing by 10.7% y/y (figure relating to individual income statements), and the profitability of equity (ROE) grew to 7.2%, from 6.2% in 2002. This 2003 figure, though below the high recorded in 2000 (11.5%), is well above the low levels seen a decade ago.

The aggregate figure does however mask broad differences within it: looking at the bank groupings by size we see improvements particularly at the two extremes of major and minor banks. The major Italian banking groups reported ROE growth of over 3 percentage points in 2003, to 9.2% (from 6.0% in 2002; consolidated figures), largely through the containment of operating costs and an increase in profits from financial operations. On the other hand, even the small and minor banks showed an improvement in profitability, with ROE rising to 6.5% from 5.3% in 2002, largely on account of the robust trend in the interest margin. Thanks to the lively trend in loans to residents, the interest margin of small and minor banks grew by 4.8%, vs. the broad stability shown by the major, large and medium banks combined.

1H04 saw a further improvement in profitability: the aggregate figures for a sample of major Italian banking groups (the top ten listed) show net income growth of 27% vs. 1H03, due mainly to the reduction in costs and value adjustments and loan provisioning. For more details, see “Recent trends” below.
Credit quality

The long-term trend in the credit quality indicators denotes a marked improvement, due largely to the securitisation of NPL in past years and to the upgrading of the banks’ credit management and evaluation capabilities. As the next chart shows, the ratio of gross problem loans (NPL and substandard loans) to total loans fell from 11% in June 1999 to a broadly stable value of around 6.5% in the last few years. The sharp fall in the index coincides with the large NPL securitisation operations conducted following the introduction of the law in 1999 which regulates them. The termination of the tax breaks connected with these operations caused a gradual decline in NPL securitisation, which went from a total of almost €24bn in 1999-2001 (c.€8bn per annum) to just €2.5bn in the last two years.

In 2003, despite the tough economic conditions and the deterioration in several major loans to companies in crisis, including Parmalat, the trend in the credit quality of Italian banks did not cause particular concern. On average, the amount of NPL and substandard loans relative to total loans grew to 6.60% from 6.45% at end-2003. Moreover, although the decline in asset quality was less pronounced than in previous economic downturns, loan adjustments and provisioning by banks grew sharply in 2003 (+20% on 2002), partly on account of the write-downs made on exposure to Parmalat. Loan adjustments and provisioning thus had a growing impact on income statements, absorbing 33% of gross operating income vs. 28% in 2002; the impact is even greater for major, large and medium banks (from 29% in 2002 to 35%) and smaller for small and minor banks (from 24% to 29%), both in terms of weighting and increase.

This behaviour is consistent with the trend in the weight of problem loans, which shows some differences according to bank size category. Specifically, while the most recent evidence on major and large banks shows slight growth in the ratio of problem loans to total loans (see next chart), small and minor banks report a continued fall in the ratio, aided by the robust growth in the denominator (loans). For this category of banks, however, problem loans grew by just +4% in 2003 vs.
end-2002, compared with 16% for medium banks and 9% for major and large banks.

In 1H04, based on the indications arriving from the top ten listed banks, value adjustments and loan provisioning booked in the income statement were down on 1H03 (see “Recent trends” below), while the weight of doubtful loans stabilised. However, banks continue to take a cautious stance in loan assessment, given the weakness of the economic environment.

In conclusion, in spite of the challenging environment, the Italian banking sector as a whole remains robust. Losses deriving from corporate scandals were absorbed without too many difficulties, whereas a few years ago we would probably have a banking crisis. Italian banks have proved to be resilient and solid, on the back of the restructuring and financial strengthening undertaken in recent years.
Trend in capital adequacy

In the last seven years the trend in the degree of capitalisation of Italian banks, measured as the ratio of shareholders’ equity to total assets, seems to show three distinct phases: 1) a first phase of strengthening, around the end of the 1990s; 2) a period of stabilisation with signs of a reversal (2000–2001); 3) a recent, rapid recovery in the strengthening trend for larger banks.

Considering capitalisation in terms of regulatory requirements, the capital adequacy ratio reached its period low in 2000 (10.1% in December), as compared with values fluctuating around 11.5% in 1997-1998. The reduction in 2000 vs. two years before, corresponding to over one percentage point, was due to the robust growth in risk-weighted assets (+22%), virtually double the large increase in regulatory capital (+11%). In turn, the expansion of risk-weighted assets was due to the vigorous growth recorded in those years in customer loans.

As a result of this, in 2001 the Regulatory Authority expressed concern at a declining capital adequacy ratio among Italian banks, “lower than the average for international banks in the other leading countries”.\(^6\) Moreover, with reference to newly formed groups, it indicated the need for capital bases to be “commensurate with the risks implicit in complex organisational structures”.\(^7\) More specifically, the Bank of Italy required the top 14 Italian banking groups to formulate plans to achieve a level of capitalisation above the regulatory minimum. In particular, target values were given of 6% for the ratio of primary capital to risk-weighted assets and 10% for the overall capital adequacy ratio.

The degree of capital adequacy started to improve in 2001 and the measurement made in 2002 showed the banking sector capital adequacy ratio rising to 11.2%. Compared with end-2001, the improvement was substantial (+0.8 points) and was due to the combined effect of an increase in supervisory capital

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\(^7\) A. Fazio, 3 July 2001.
and a reduction in risk-weighted assets, largely on account of the decline in foreign exposure and securitisation operations.

In 2003 the capital adequacy ratio showed a further slightly increase to 11.4%, on the back of the growth in capital (+4% vs. end-2002) which, in turn, was due to self-financing, share capital increases, subordinated debt issues.

The increase in the capital adequacy ratio is particularly marked in the case of the large banking groups, rising from an average of 9.3% at end-2001 to 10.6% at end-2002 (+1.3 percentage points) and 10.8% at end-2003. Compared with December 2000, the improvement in the capital adequacy of Italy's top bank groups stands at +2.1%, vs. +1.3% for the sector as a whole.
Comparing the individual figures of the main European banking groups and the top six Italian banks, we can identify several common trends and the specific issues that still persist at the domestic level:

- **In the last two years, the increase in capitalisation was common to almost all six Italian banking groups**, both in terms of Tier 1 ratio and Total capital ratio;

- most European groups also increased their capital adequacy ratios;

- some Italian groups, despite the improvements, continue to show capitalisation ratios below those of their main European competitors. However, the quality of Tier 1 is generally superior to that of other European groups, since the use of innovative capital instruments – such as preference shares – is still limited.

In conclusion, the Italian banking system substantially strengthened its level of capital adequacy in the last two years, despite the adverse operating conditions and their negative impact on earnings. The European banking sector too, as a whole, showed good resilience in capitalisation levels.

*(Elisa Coletti)*
3 Recent trends

State of the Italian Banking Activity

Loans: business demand downshifts

Current trends. The pace of expansion in business loans has shown signs of a gradual slowdown in the first seven months of the year, though in the past two months growth seems to have picked up. On an annual basis, average volume for the period increased 5.4%, showing more than proportional growth to nominal GDP. The pace of bank lending in Italy is mostly in line with the eurozone average, also in terms of loan maturity.

The main drivers behind the sharp expansion in the medium/long-term component continue to be the low level of interest rates, the persistent rise in real estate prices, and, a more structural factor, the growing propensity of households to take on debt and of businesses to lengthen loan maturity. In contrast, the downturn in short-term loans continues. There are two factors behind this trend: first banks and businesses have been turning these loans into more collateralized long-term ones; second, sluggish economic growth continues to make banks still cautious when it comes to issuing loans to mid-size and big corporates.

Focusing on the loans analysis by economic sector, demand from retail customers is still growing at a faster pace than that from non-financial companies. The biggest laggard in business lending has been the manufacturing sector, accounting for 40% of total loans to businesses, with growth returning to just above zero in June after several consecutive months of contraction.

Returning now to the overall picture, in July the total lending growth rate was 5.6%, unchanged from the previous month. The trend in lending volume by maturity remained consistent, with loans beyond 18 months expanding 13.5% y/y and short-term loans contracting 4.0%. Early indications for August (Bank of Italy press release) point to a slowdown in lending growth to 5.0%, due to another sharp contraction in the short-term component.

Loans dynamic by economic sector. Both households and businesses are contributing to lending growth: loans to households increased 13.9% y/y in July, while business loans grew 6.1%. The remaining sectors, which account for around 18% of the stock of credit, continued to show a very modest trend: loans to financial
companies actually decreased 8.4% y/y, while the negative trend in the government sector seems to have been reversed, with a small 1.2% increase.

### Loans (including NPL and repos) by economic sector – July 2004

<table>
<thead>
<tr>
<th>Economic Sector</th>
<th>% chg. y/y</th>
<th>Contribution to growth (1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Businesses</td>
<td>6.1%</td>
<td>3.6%</td>
</tr>
<tr>
<td>Households</td>
<td>13.9%</td>
<td>3.0%</td>
</tr>
<tr>
<td>Non-FMI financial companies</td>
<td>-8.4%</td>
<td>-1.2%</td>
</tr>
<tr>
<td>General government</td>
<td>1.2%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Total sectors</td>
<td>5.4%</td>
<td>5.4%</td>
</tr>
</tbody>
</table>

(1) Contribution in terms of annual percentage change. Column figures may not add up to totals due to rounding off.

The increasing contributing of households to total lending growth once again reflects the sharp expansion in mortgages and consumer credit, the former up 22.8% y/y in July and the latter 15.9%. It is not yet clear whether households are rushing to take on debt because of difficulties in making ends meet, as some maintain, or, on the contrary, because of a structural change in their consumption behaviour. This latter view is supported by the y/y growth in household financial balances in the first quarter of the year. In any case, the indebtedness ratio of Italian households (financial liabilities to disposable income) increased from 33.6% in 2000 to 37.7% in 2003, though even at this level it is still much lower than the European average (71% in 2002). According to the results of a recent survey commissioned by Il Sole 24 Ore, 43% of the Italian population between the ages of 35 and 54 have at least one outstanding loan, mainly in the form of a home mortgage. Households are also increasingly taking out consumer credit loans from banks or, to a greater extent, from specialised lending companies: in the first six months of 2004, this segment grew 15.3% in value terms and 24.1% as number of loans (source: Assofin). This trend reflects increasing offers of instalment payments for an increasingly wider range of goods and services and the marketing campaign by specialised companies and banks to push revolving credit cards.

In contrast to household lending, **business loan growth slowed slightly** in July m/m, though remaining just above the 8% level. Growth in demand for bank
lending was more intense among businesses with less than five employees (up 6.7% y/y) than among larger companies (6.0%), though the gap between the two segments has recently begun to narrow.

In detail, the main drivers of business loan growth were once again non-commerce service providers (up 12.0% y/y in June) and the construction sector (up 10.5%) where the business cycle is still at peak levels after the pause in late 2003. Partially offsetting these positive performances, the manufacturing sector is still stagnating (it managed to return to modest positive growth in 2Q04, up 0.6% y/y), reflecting the sharp deterioration in business confidence in the sector, as indicated also in the more recent ISAE economic survey.

Credit quality. The growth rate of non-performing loans (NPLs) in the Italian banking system continued to accelerate into the second quarter of the year, reaching 11.7% y/y in June. The increase in unpaid business loans, accounting for more than 75% of all NPLs, reached 14.9% y/y, accelerating slightly from an average 13.8% in the first five months of the year. It should also be noted that non-performing loans are largely concentrated in manufacturing, which in the last three quarters has recorded growth rates of more than 30%.

The situation is decidedly more moderate in the other sectors, especially among households where the annual percentage increase remained around 2% in the second quarter. In general, the banks seem to have the situation under control: the NPL/total loans ratio stood at 4.8% in June, practically unchanged since the beginning of the year.
Interest rates. Harmonised lending rates progressively stabilised during the first half 2004: the downward trend petered out in the first quarter, followed by consolidation, with slight variations around the new levels reached. The consolidation process seems to have continued into July, though yields on business and household loans differed. As for new lending, the cost of a home mortgage came down 2 bp m/m to 3.67%, while consumer loan rates decreased by 10 bp, to 8.63%. In contrast, the cost of borrowing among non-financial companies increased to 3.47% on average, up from 3.34% previously.

Outlook. By year-end, average growth in bank lending will be more moderate than in 2003, due to the weak demand for short-term loans. At any rate, 2004 growth should approach or exceed 6% (and remain at that level for all of 2005), reflecting consolidation in the pace of economic growth and an improvement in business confidence. The main drivers of credit demand will continue to be represented, apart from the low cost of long-term borrowing, by the growing propensity of households to take on debt and the tendency among businesses to consolidate their liabilities by switching to long-term bank loans. Over the next months, the interest rates applied on loans should remain at a low level, though they are likely to pick up somewhat, reflecting the pricing policy among banks aimed at improving lending margins and containing risk. As a result, the spread can widen gradually, but not to the extent that net interest income industry-wide will increase significantly.
Funding: growth in sight deposits continues to slow

Current trends. After the July peak, the trend in funding (harmonised defined) returned to a more "normal" pace, estimated at 5.6% y/y in August, mostly in line with the 1H04 growth rate. In detail, the expansion in sight deposits decelerated to 5.3% y/y, down from the previous 7.7% and keeping on the slowdown trend shown in the first half of the year. In parallel, bank bonds (including subordinate) continued to grow at an 11.0% y/y clip (unchanged from 10.9% previously), reflecting on the one hand the strong investor interest in this instrument as a valid alternative to government bonds, and on the other hand the banks’ stance in favour of new issuance in view of the current low level of borrowing costs against expectations of an upcoming tightening of monetary policy.

The slowdown in funding growth does not seem to favour expansion in indirect deposits which in the most recently available figures for June showed stagnant growth, indicative of risk-aversion among investors towards sophisticated investments. This is reflected in the fact that among securities in custody at banks, growth was recorded in BOTs, BTPs, and bank bonds only. We also point to the decrease in AUM in the second quarter, down by 5.9% in June.

Interest rates. The total cost of funding remain unchanged in July (estimated at 1.73%), reflecting offsetting trends in short-term rates (on the decline) and bond rates (on the rise). In detail, harmonised deposit rates (including repos) paid to households and businesses decreased from 0.68% previously to 0.66%, while the average rate paid on bonds edged up from 3.18% to 3.19%.
The flat deposit rate curve has helped the spread to begin to widen, reaching 3.14% in July, bouncing off the low of 3.09% reached in June.

**Outlook.** The trends under way in funding seem consistent with a gradual shift in the portfolio mix in favour of longer-term, preferably low-risk, financial assets. As a result, in the coming months we expect growth in the sight accounts component to slow, also because of the reduced propensity to save for precautionary reasons among households, on the back of the expected improvement in economic and financial market conditions.

*(Stefano Corona)*
1H04 results

In 1H04 Italy’s leading banking groups generally showed strong earnings growth vs. 1H03, confirming the first quarter trends. The aggregate income statement of the top ten Italian listed banks shows net income growth of 27% vs. 1H03, largely due to a reduced cost and value adjustments weighting. Income on ordinary operations was up sharply (+17.2%), despite stagnant revenues (total income +0.3%), which weakened on average after the tentative recovery in 2003, which came mainly from profits on financial operations. The growth in income on ordinary operations thus benefited crucially from cost containment (-1.3%) and the downturn in provisioning and net value adjustments (-14.6%), following the massive amounts booked in the income statement last year.

Income statement results as at 30 June 2004.

Aggregate figures of top ten listed Italian bank groups

<table>
<thead>
<tr>
<th></th>
<th>% change 1H04/1H03</th>
<th>Relative to total income</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net interest margin</td>
<td>-3.0</td>
<td>49.9/51.5 -1.7</td>
</tr>
<tr>
<td>Dividends and income from investments carried at equity</td>
<td>8.8</td>
<td>3.0/2.8 0.2</td>
</tr>
<tr>
<td>Net interest income</td>
<td>-2.4</td>
<td>52.9/54.3 -1.4</td>
</tr>
<tr>
<td>Net commissions</td>
<td>6.6</td>
<td>32.5/30.6 1.9</td>
</tr>
<tr>
<td>Profits (losses) on financial transactions</td>
<td>-15.0</td>
<td>7.3/8.6 -1.3</td>
</tr>
<tr>
<td>Other operating income, net</td>
<td>12.9</td>
<td>7.3/6.5 0.8</td>
</tr>
<tr>
<td>Total income</td>
<td>0.3</td>
<td>100.0/100.0 0.0</td>
</tr>
<tr>
<td>Administrative costs</td>
<td>-0.8</td>
<td>55.2/55.8 -0.6</td>
</tr>
<tr>
<td>- personnel costs</td>
<td>-0.9</td>
<td>34.5/34.9 -0.4</td>
</tr>
<tr>
<td>- other administrative expenses</td>
<td>-0.6</td>
<td>20.7/20.9 -0.2</td>
</tr>
<tr>
<td>Adjustments to tangible and intangible fixed assets</td>
<td>-6.2</td>
<td>5.5/5.9 -0.4</td>
</tr>
<tr>
<td>Operating costs</td>
<td>-1.3</td>
<td>60.7/61.6 -0.9</td>
</tr>
<tr>
<td>Gross operating income</td>
<td>2.8</td>
<td>38.3/38.4 1.0</td>
</tr>
<tr>
<td>Provisions and net adjustments to loans, financial fixed assets</td>
<td>-14.6</td>
<td>14.8/17.4 -2.6</td>
</tr>
<tr>
<td>Pre-tax income on ordinary operations</td>
<td>17.2</td>
<td>24.5/21.0 3.5</td>
</tr>
<tr>
<td>Pre-tax income</td>
<td>22.3</td>
<td>25.7/21.1 4.6</td>
</tr>
<tr>
<td>Net income</td>
<td>27.3</td>
<td>14.8/11.6 3.1</td>
</tr>
</tbody>
</table>

Source: company data, Banca Intesa calculations.

Revenues were generally weak, following the decline in net interest income and profits from financial operations, offset by growth in commissions. In detail:

- **net interest income confirmed its weakness** (-3.0% y/y), due both to low interest rates and to an **unsatisfactory trend in volumes**. Lending demand among businesses remains limp, while household mortgages and consumer credit continues to expand vigorously. On average, in the sample examined, customer loans were little changed vs. end-2003 (+0.9%). In some cases, the trend in loans also reflects the scaling back of dealings with large accounts and overseas exposure, accompanied by a gradual change in the loans portfolio towards higher contribution positions;

- **profits from financial operations continue to shrink** (-15.0% y/y on average for the panel), especially following the decline in sales of hedging derivatives for firms, in contrast to the boom the previous year. With a few exceptions, most banks show a sharp downturn;

- **ongoing growth in net commissions**, which on average are up 6.6% vs. 1H03. Commissions made a positive contribution to the trend in revenues for almost all the groups examined (nine out of ten). The dynamic relates to the robust trend in AuM and Life assurance, as well as traditional banking services.

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8 The analysis is based on the consolidated results of the top ten Italian banking groups listed on the stock market. Averages are calculated using the sum of the ten groups.
With regard to costs, 1H04 fully confirmed the 1Q04 figures, which in turn were in line with 2003: on average operating costs fell 1.3% y/y, thanks to the downtrend in all components. Personnel expenses, in particular, fell by 0.9%.

Sluggish revenues and a generalised downtrend in costs led to a modest increase in gross operating income (panel average +2.8%). This average trend is due to different individual performances, as the next chart shows. However, in most cases the operating results grew, with four groups recording double-digit increases.

The improvement in operating efficiency thus shows no signs of slowing: the panel average cost / income ratio was 60.7%, 1 point less than 1H03. Most of the groups made efficiency gains and, in general, the results achieved on the efficiency front were satisfactory: of the ten top Italian listed banks, only four have a cost / income ratio of over 60%.
Following the massive value adjustments booked in 2003, the impact of write-downs is far less marked in 1H04. Total net value adjustments on loans and financial fixed assets, including prudent provisioning and goodwill amortisation, is down almost 15% y/y for the panel average. Their weight within the income statement has thus diminished, as reflected in c.15% absorption of total income, 2.6 percentage points less than 1H03. However, a very cautious stance persists in the loan assessment process. Indeed, narrowing the field to loan adjustments alone (net value adjustments on loans and loan risk provisioning) we find a smaller average fall (-10.7%), though still significant, and four groups show double-digit increases.

The cost of risk\(^9\) falls on average to 64bp, vs. 72bp in 1H03 (annualised figures). This trend is however affected by the sharp fall in the indicator in respect of one group which in 2003 effected an exceptional asset clean-up. If we exclude this group, the average cost of risk of the top Italian banks is basically unchanged at 62.7bp vs. 62.6bp in 1H03, confirming a shared, prudent stance in loan assessment, given the weakness of the economic environment.

The 1H04 reports confirm the caution on the credit quality front, but some signs of improvement can be glimpsed. On average, in June 2004 the major banking groups reported a slight growth in doubtful loans over end-2003 (+1%), due to the stabilisation of substandard loans (-0.1% YTD) vs. a small increase in NPL (+1% YTD). At the same time, adequate provisioning against lending risks and balance sheet strengthening continue. These are reassuring signs in terms of the solidity of the Italian banks. Following the increase in 2003 (+0.08% vs. end-2002 for the top ten groups), the net NPLs weighting stabilized at 2.61%. The same happened to the total doubtful loans ratio, which remained at 4.86%, as the ratio of net substandard loans to total loans was down slightly to 1.74%.

On the capital adequacy front, the June figures generally provided further reassurances regarding the solidity of the major Italian banks. With the exception of two groups, there was a further substantial, across-the-board improvement in the equity ratios.

![Trend in capital ratio](image)

*Source: Company data, Banca Intesa calculations (Elisa Coletti)*

\(^9\) (Net loan value adjustments + loan risk provisioning) / net loans at end of period. Annualised figures.