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Essays on Banking in Italy

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Introduction

The work 'Essays on Banking in Italy' consists of three studies conducted at the Research Department of the Bank of Italy in the period 2005-2008. The first and the second study investigate pricing behaviour of banks on loans granted to private sector, i.e. to firms (*The Monitoring and certification effects of bankers on industrial boards)* and to households (*What's risk got to do with it ? An analysis of interest rates in the Italian consumer credit market*) while the third study (*Why is the volume of bank loans low in some countries and high in others? The role of government debt*) deals with the determinants of the size of business activity in developed countries.

The papers are not linked to each other. All of them reflect empirical analyses aimed to test some theoretical predictions taking advantage of data available at the Research Department of the Bank of Italy. In particular, in the first research, a database collecting information on board's composition of a very large number of firms (those registered at the Chamber of Commerce) was matched with other three sources of data, including the Central Credit Register, for the first time to the best of my knowledge. Such a matching allowed us to identify and study effects of bank representation on corporate board, and to discriminate between a beneficial monitoring activity as well as, alternatively, a costly conflict of interest.

In what follows, motivation and conclusions of each of the three papers are briefly summarised.

The research *'Monitoring and certification effects of bankers on industrial boards'* analyses the reasons driving the presence of bank directors on firm's boards and tries to discriminate between competing explanations. The presence of bank directors on industrial boards is a known fact in several developed countries. According to data reported by Kroszner and Strahan (2001), large firms having bankers on boards were 31 per cent in the US, 75 per cent in Germany, 53 per cent in Japan. Costs and benefits of bankers on boards are discussed by a growing strand of literature.

The study carried out an empirical analysis of the effect of bankers on boards on financial outcomes, focusing mainly on the interest rates charged to firms. Banks use to establish relationships with borrowers for mitigating problems of asymmetric information and reduce their credit risk (*information view*). Sitting on the board of a firm is an obvious way for a lender to extract private information about that firm. In addition, being on boards allow lenders to perform a

more accurate screening of clients and to observe the outcomes of financed projects. In this way, potential opportunistic behaviours are prevented. By representing a long-term investments in relationships with borrower firms, representation on boards is expected to cut fixed costs of monitoring and to be reflected in a lower cost of financing.

Secondly, bankers on boards generate externalities. Information acquired from being on board - which generates informative advantages over other lenders - is partly transmitted to the market (certified) when the company is granted credit by banks represented on board. Such a certification in turn allows other providers of financing to avoid duplications of information costs on the capability to repay loans for the same firm. In that perspective, Boot (1992) noted that contracts may have lower monitoring costs as a result of information produced through 'cross-monitoring' activities by other claimants.

The possible dark side of bank presence on the boards of borrowing firms is the conflict of interests (*conflict of interests view*). The literature (see Crockett et al, 2003) suggests that *'conflicts arise when a financial service provider, on an agent within such a service provider, has multiple interests which create incentives to act in such a way as to misuse or conceal information need for the effective functioning of financial markets*'.

As far as we are concerned, conflicts are generated as bank directors have incentives to pursue interests of both debtholders - as board's member of the banks - and firm's shareholders – as board's member of the firms, under the assumption that the pay–offs of firm's debtholders and shareholders are not aligned (Kroszner and Strahan, 2001). Conflicts may affect pricing behaviour of lenders on boards, as they may grant loans at more favourable terms relative to similar risky loans granted by creditors which are outside the boardroom.

In Italy, credit institutions are an important source of external finance for firms and are expected to play some role in their corporate governance[1]. The presence of bankers on industrial boards has indeed been shown in several paper (e.g. Bianco and Pagnoni, 1998; Ferri and Trento, 1997). Conflicts of interests are attenuated by the Italian law by mean of restrictions to lending activity among banks and companies which have bank's directors on their boards (related parties)[2].

In this paper, the information view and the conflict of interest hypothesis are discriminated by examining how bank presence on boards of industrial firms affect interest rates applied to loans granted to firms. Our database is made of 32,000 Italian companies reporting information to each of the three data sources we resorted to: 'InfoCamere' for board compositions, 'Central Credit Register'

[1] Bank of Italy has recently relaxed the limits to banks holding in equity-stakes of industrial firms which were established by the 1933 Banking Law - as the 1956 Bank Holding Company Act did in the US.
[2] Loans granted to related parties have to be lower than the 20 per cent of bank capital.

for financial data, 'Balance Sheet Register' for data on firm's financial statements. Board's compositions of banks are provided for by 'Organi Sociali delle Banche' of the Bank of Italy. To our knowledge, this is the first study to be carried out on such a topic in Italy.

Our analysis shows that interest rates loans from the bank with a director who is also a director of the borrowing firm and those charged by other banks are very similar. Therefore, we do not find evidence of a conflict of interest effect.

In contrast, we find a significant certification effect supporting the information view. A lender on a corporate board reduces costs of monitoring of the bank represented on the board and transmits good signals on the firm's creditworthiness to financiers which are outside the boardroom. Our evidence is in line with Boot (1992) who noted that contracts may have lower monitoring costs as a result of information produced through 'cross-monitoring' activities by other claimants.

In the research '*What's risk got to do with it ? An analysis of interest rates in the Italian consumer credit market'*, we investigate the determinants of the price of consumer lending in Italy. This study was stimulated by the high level of Italian interest rates in comparison with the euro area countries. In our sample period (2003-2006), interest rate on consumer loans in Italy has consistently been above the euro area, a difference hovering around two percentage points. The expansion of the market - that led the country to double its share of the euro area market between 1999 and 2006, from 4 per cent to 8 per cent - started denting the differential in interest rates but, still in the first half of 2008, the APRC on consumer credit was 9.7 per cent in Italy, and 7.6 in both France and Germany.

The consumer credit market has been regarded as characterised by three distinct features: small size of the business, rapid growth, high cost of loans (Gobbi, 2007). Media, policymakers, consumer associations repeatedly pointed out that interest rates are high and may not entirely be justified by the characteristic of borrowers. According to data collected in compliance of the usury law, the average rate on instalment and revolving loans up to 5,000 euros in the third quarter of 2006 was above 16 per cent while, in the same period, the main policy rate of the European Systems of Central banks was 2.75 per cent (3 per cent since mid -Oct 2006) and the non-performing loans ratio for consumer credit was only 1.7 per cent for banks. A peculiarity of the consumer credit market is the level of business concentration which is higher than other retail lending categories, at least according to Herfindahl or market shares measures.

In 2007, the Governor of the Bank of Italy remarked that: '*Data harmonized at European level show that Italian banks' annual percentage rate of charge on consumer credit is still about one percentage point higher than the euro area average, even though the gap has narrowed in the*

last few months. Not all of the difference is due to risk factors or to the still limited development of the consumer credit market in Italy".

Up to now, there have been a very few attempts to investigate those factors which driving the cost of loans for consumption, perhaps due to the small size of this market - until a few years ago - and to the fact that data on price availability were (and, partly, still are) scarcely available.

Bertola et al (1999) which is the most comprehensive study of pricing of consumer credit in Italy to our knowledge analyse determinants of the interest rates recorded in a proprietary database made available by a leading intermediary. According to their results, heterogeneity is mostly accounted for by time, region and type of item purchased, plus a limited number of contract characteristics.

We study the pricing behaviour of a large sample of Italian banks, which are representative of the entire population. Our results suggest that, ceteris paribus, concentration level exerted a significant influence on pricing conditions. On the contrary, a missing element in the price equation is risk. According to results from a quintile regression approach, we may track down a standard relationship between risk and prices only as for the lowest quintiles of the interest rate distribution. As well as interest rates applied by banks above the median prices are concerned, costs of lending seem to be less sensitive to risk. More recently, Magri (2008), looking at the Household Survey of the Bank of Italy (SHIW, 2008) find that the price of consumer loans is barely connected to the specific household risk of delinquency, or default, in line with our results.

In the paper '*Why is the volume of bank loans low in some countries and high in others? The role of government debt'* we look at the determinants of the size of banking markets. The analysis is stimulated by the fact that an extensive literature emphasised the importance of banking system in promoting economic growth, as it is confirmed by substantially higher credit to GDP ratios for higher-income countries. If factors limiting banking development are singled out, then political authorities may introduce reforms to foster this development.

Both developed and developing countries are heterogeneous as far as the size of their banking systems is concerned. Among the former, in 2004, the ratio of loans to GDP was around 46 per cent in the US, 77 per cent in France and 100 per cent in Germany.

We investigate factors driving those cross-country differences by exploiting a longitudinal dataset for 18 OECD countries which range over the period 1981-1997.

Several strands of literature studied how the level of banking intermediation is influenced by economic and institutional factors. The Financial Repression approach underlined the link between the financial development of countries and the array of restrictions, policies, laws, qualitative and

quantitative controls set up by government by the second half of the 60's for financial stability purposes. These restrictions introduced distortions in the allocation of resources (Battilossi, 2003) and made costly for financial intermediaries to operate at their full technological potential (McKinnon,1973; Show, 1973, Roubini and Sala - i – Martin, 1995). According to some scholars, financial repression also generated revenues for the state, interest groups or lobbies (Perotti and Von Thadden, 2005).

Other studies track down the heterogeneity in financial deepening to the their history. Path dependency theories of financial development trace back cross-country differences we observe today to the legal origins of the countries (La Porta *et al*, 1997).

The novelty of the paper is to shed a light on the negative linkages between government securities issuance and the amount of credit granted by banks to private sector. We find a crowding–out effect that we interpret as an outcome of financial repression, along the lines described above (Battilossi, 2003). As well as Italy is concerned, restrictions to financial activity operated through credit ceilings and branch restrictions which may have shrunk bank supply of financing to private sector, on the one hand, and artificially channelled bank resources to domestic assets such as the public debt[3], on the other hand.

Secondly, we find that a part of cross-country variability of banking deepening not accounted for time-varying factors is explained by the legal origin of countries. As we restrict the study to the size of banking market – and not to financial systems as defined by some more comprehensive indicators - we do not identify the Anglo-Saxon legal origin as the crucial factor for promoting credit systems. According to our evidence, the German legal origin happens to be the most effective.

[3] Until the divorce of 1981, the Bank of Italy acted as automatic buyer of last resort in primary auctions of short-term Treasury bills which was generally reserved to banks and financial intermediaries. Later on, the placement of these securities was realised with the domestic market. Further, the demand of such an asset was increased via reserve requirements of banks, as the minimum level fixed by the law was not negligible in the 80's and government bonds were allowed to meet that requirement.

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