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Sixth Standing Committee (Finance)

**Inquiry into the situation and prospects
of the banking system
with particular regard to southern Italy**

The banking system and economic activity in the South

Testimony of the Director General of the Bank of Italy
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1. Introduction

In the last two decades the financial systems of the main industrial countries have undergone major changes in regulation, market structure and the organization of intermediaries. Progress in information and communication technology and financial innovation have eroded the geographical and operational segmentations that had become established in the preceding decades. The international integration of the capital markets has increased very considerably.

The Italian banking industry has shared in these developments. At the beginning of the 1990s a series of measures redefined the legal framework of banking, the main aspects of which had remained until then basically unchanged with respect to the 1936 Banking Law.¹ The legislative innovations made it possible to reduce the public sector's presence in the ownership structures of banks and created the conditions for the extensive consolidation which began in the second half of that decade and which today is once more proceeding at a particularly rapid pace.

Between 1995 and 2006 there were mergers and acquisitions involving 476 banks that accounted for 70 per cent of the assets of the entire banking system. The total number of banks fell by 18 per cent, from 970 in 1995 to 793 in 2006.

The consolidation led to the integration of local credit markets through the formation of banking groups operating on a nationwide basis. The international opening of Italy's banking system increased with the expansion abroad of the leading domestic groups and, recently, with the acquisition of Italian banks by international intermediaries. The mergers agreed in the last twelve months have given birth to two banking groups that are among the largest in the euro area.

¹ Between 1989 and 1990 the limitations on the setting up of new banks and the opening of branches were removed. In 1990 the Amato-Carli Law laid the basis for the privatization of publicly owned banks. In 1993 the Consolidated Law on Banking brought together the legislative changes introduced with regard to banking and aligned Italian law with Community law in this field.

Far-reaching structural changes began in the banking system of southern Italy in the aftermath of the 1992-93 recession. In that period the acquisition of southern banks by banks located in the Centre and North permitted a systemic crisis to be overcome.

In order to assess the progress made and the adequacy of today's financial system with respect to the development needs of the South, it helps to recall the changes that have taken place since the beginning of the 1990s in both the national system and the southern system.

2. The transformation of the southern banking system²

2.1 The national context

At the beginning of the 1990s the Italian economy underwent a serious crisis that led to the recession of 1992-93.

The effects of the crisis were more pronounced in the South, where the economy was not export oriented and benefited to only a limited extent from the devaluation of the lira in September 1992. Between 1991 and 1996 the GDP of the southern regions grew by 2 per cent, 6 percentage points less than in the Centre and North.

In the second half of that decade the pursuit of a rigorous monetary policy and the prospect of participating in EMU made it possible to reduce interest rates considerably, with substantial benefits for firms and the public finances. GDP nonetheless recorded only modest growth, partly as a consequence of the weakness of the economic cycle in Europe.

² For more details, see *Il sistema finanziario e il Mezzogiorno* (Cacucci editore, Bari 2006), edited by Luigi Cannari and Fabio Panetta and containing the analyses made by Bank of Italy economists of the development of the South's economic and financial system in the last ten years.

In the early years of the present decade the Italian economy stagnated. From the middle of the 1990s onwards labour productivity improved less than in the other industrial countries, owing to delays in adapting firms' technological and organizational capacity and in modernizing the government apparatus. Since the middle of 2005 the Italian economy has been recovering; GDP growth gathered strength in 2006, although it nonetheless remained below the average of the euro-area countries. Recent export and productivity gains may indicate the start of a process of structural adjustment.

In the wake of the recessionary shock Italian banks' unrecoverable loans rose rapidly and in 1995 exceeded 9 per cent of their total loans. Their return on equity fell from 10 per cent in 1990 to about 2 per cent between 1993 and 1997. The annual rate of growth in loans fell to just over 1 per cent in 1994, from close to 15 per cent between 1989 and 1992. The ratio of bank credit to GDP fell by 6 percentage points between 1992 and 1996.

From the middle of the 1990s onwards the return to conditions of profitability that could ensure the stability of the system was achieved by several means. In the first place mergers and acquisitions made it possible to increase revenues by exploiting the opportunities to grow and diversify deriving from disinflation.

Faced with the fall in the yields on government securities, investors increasingly entrusted the management of their portfolios to specialized intermediaries in the hope of achieving greater profitability. The banks encouraged this development, both by offering their own portfolio management services and by marketing the products of other intermediaries, especially investment funds, and thereby significantly increasing their fee income.

As regards costs, the agreements reached in the second half of the 1990s between banks and the trade unions in the credit sector made it possible to stabilize the rate of increase in unit staff costs in real terms. In addition, banks, especially the larger ones, introduced inducements to early retirement for redundant employees. In that period the recovery in both labour and total factor productivity was sustained by banks' very substantial investments in information and communication technology.

Rigorous policies for the selection of customers and the management of claims permitted a large improvement in loan quality and a reduction in costs deriving from loan losses.

The innovations in lending policies made it possible to enhance the relationship between banks and firms, lengthen the maturity of loans, encourage the restructuring of loans of firms in temporary difficulty and facilitate the non-traumatic exit from the market of no-longer-profitable companies.

These improvements in the structure of credit intermediation, which emerged gradually over the years, helped, against a background of monetary stability in the euro area, to keep a large volume of low-cost credit available during the long period of stagnation of the Italian economy from 2001 to 2005.

2.2 The South

2.2.1 The changes in ownership structure

The changes that occurred in the 1990s in the banking system in the South were more pronounced than those in the rest of the country, reflecting the greater intensity of the recession in the early years of that decade. In the southern regions the cyclical difficulties combined with the end of extraordinary intervention policies, with lacerating effects on the productive system – already weak and heavily dependent on public support – and with a seriously adverse impact on banking business. Between 1993 and 1998 about 30 per cent of the loans granted in the South were classified as bad debts. The intermediaries on which the banking system in the South hinged suffered substantial losses. In the period 1993-97 these eroded a large part of the southern banks' capital, which in several cases in those years fell short of the minimum requirements.

The difficulties of the southern banks, which amounted for all intents and purposes to a systemic crisis, were overcome thanks to public intervention and even

more decisively to the transfer of their ownership from entities mainly of a public nature located in the South to efficient and more highly capitalized banking groups located in the Centre and North.

Between 1995 and 1999 there were 125 mergers and takeovers of southern banks, which was more than twice the number in the five preceding years and the five following years. In relation to the volume of business of the southern banks, these transactions increased steadily in importance, from 17.9 per cent in 1990-94 to 30.5 and 49.4 per cent in the two following five-year periods.

The mergers and takeovers carried out since the beginning of the 1990s have reduced the number of banks having their registered office in the South by half, to 148 (Table 1).

In 1990 there were 313 banks located in the South, of which 213 were rural and artisans' banks (classified as mutual banks in the Consolidated Law on Banking). Taken together, these banks had a 41 per cent share of the loan market in the southern regions. At the end of 2006 the number of banks having their registered office in the South had fallen to 148, comprising 110 mutual banks and 38 other banks, of which 19 were part of groups with registered office in the Centre and North. Excluding the latter, the southern banks' share of the loan market was 11 per cent.

The fall in the number of southern banks is all the more significant when considered in the light of the apparent demographic vitality of banks in the South in the period following the recession of the early 1990s. In the last 15 years 55 new banks have been established in the South, compared with 77 in the Centre and North. But a great many banks have exited the market: only four out of ten new banks have survived in the South, compared with six in the Centre and North. The fall in the number of mutual banks – which are typical representatives of banking localism – has been relatively much larger in the South than in the rest of the country. The fragility of the southern economy and the limited scope it offers to expand and diversify banking business made, and make, it difficult to develop local banks as in the rest of the country.

The capital adequacy of the southern banks is much better than in the middle of the 1990s, especially as regards independent local banks. No individual banks have capital shortfalls.

The solvency ratio – that is the ratio between banks' capital and their risk-weighted assets – for all the southern banks was 14.1 per cent at the end of 2006, compared with 18.1 per cent for local banks not belonging to groups located in the Centre and North. In 1996 the ratio was 11.5 per cent in both cases.

In the last ten years southern banks' profitability, measured as the percentage ratio of net income to capital and reserves, has also shown a considerable improvement, rising from less than 1 per cent to more than 9 per cent.

The improvement has occurred both for the independent local banks and, to a greater extent, for banks belonging to groups located in the Centre and North. In particular, in 2006 the latter recorded a ratio of 10 per cent, which was only slightly less than the national average (11.6 per cent).

The presence of non-bank intermediaries with their registered office in the South is also limited and their average size is modest.

At the end of 2006 there were 238 finance companies with registered office in the South entered in the register referred to in Article 106 of the Consolidated Law on Banking, corresponding to 14 per cent of the national total. In 1996 the number was 325 corresponding to 20 per cent of the national total.

At the end of 2006 there were only 11 financial intermediaries supervised by the Bank of Italy having their registered office in the South, corresponding to 7 per cent of the total number of such intermediaries and to 2 per cent of their total assets. At the end of 1996 these figures were respectively 10, 4.6 per cent and 2.8 per cent.

Certain types of financial intermediaries are present to a greater extent in the South. In particular, there are 18,000 financial agents entered in the register kept by the UIC and 36,000 loan brokers, corresponding respectively to 38 and 45 per cent of the national total.

2.2.2 The structure of supply

With the shift to the Centre and North of the centre of gravity of bank ownership and the consequent reorganization of the banking system improvements have taken place in the supply of banking products. The reduction in the number of banks having their registered office in the South has been accompanied by a large increase in the number of southern branches, from 3,900 in 1990 to 6,300 in 2000 and to 7,000 in 2006 (Table 2). The number of municipalities not served by banks has declined; and the average number of intermediaries present in each municipality has increased. The channels of distribution of banking services related to new information and communication technologies are expanding.

The disparities with respect to the rest of the country nonetheless remain large. In the South there are 34 branches per 100,000 inhabitants, compared with 66 in the Centre and North. Although it is expanding, use of Internet and telephone banking is less frequent in the South. To a significant extent these disparities reflect the smaller demand for financial services. The geographical dualism in terms of branch density becomes much less pronounced if it is in relation to variables that provide a better approximation than population of the volume of potential demand. In fact, in relation to GDP the number of bank branches in the South is nearly in line with the value for the rest of Italy.

One factor curbing the demand for financial services is the low rate of participation of southern households in banking markets. In the South no less than four households out of ten do not have a bank account, compared with one out of ten in the northern regions. Econometric analyses show that these differences reflect southern households' lower incomes and socio-economic conditions.

Firms' demand for sophisticated financial services remains limited; the experience of the main banking groups shows that corporate finance business is still not highly developed. Positive signs are to be found in the field of private equity, where, even though the share of business in the South is still marginal, there has been an increase in the number and size of investments. Project financing initiatives are showing

greater dynamism, especially those that involve the joint public and private-sector financing of projects.

2.2.3 *The conditions of access to credit*

In the 1990s the structural changes in the southern credit market, especially the considerable importance that intermediaries from other regions acquired in the ownership of southern banks, gave rise to fears concerning the possible effects on the availability and cost of banking services for southern households and firms. Developments over the last few years have prevailed over these fears.

The availability of financing. – The loans serving to finance local production gradually rose to about 100 per cent of the savings collected by the banks in the South in 2005. Bank of Italy analyses show that this figure is much higher after including the loans assigned by banks by means of securitizations and other transactions. These loans remain available to the borrowers, since such assignments merely transfer the ownership of claims from the banks to other institutions. The figure rises even higher when account is taken of firms with production facilities in the South but their registered office in the Centre and North, whose loans are assigned in the statistics to borrowers in the Centre and North even though they really finance the southern economy. Thus, at present the loans disbursed by banks to customers in the South exceed the funds raised in the area.

The positive gap between lending and fund-raising in the South is concentrated in the hands of the banks of the Centre and North, with their greater ability to raise funds in the international markets and diversify risks. By contrast, the ratio of lending to fund-raising in the South is lower for banks having their registered office there, which invest a larger share of their resources in public securities and interbank loans (Table 3).

Recent empirical analyses carried out at the Bank of Italy³ show that the differences between the various provinces in the ratio of lending to fund-raising do not

³ See Cannari and Panetta (2006), *op.cit.*

reflect the origin of the intermediaries operating locally but rather the characteristics of each provincial market, such as the efficiency of civil justice, the riskiness of loans, and the quality of the informal mechanisms that regulate economic relationships – so-called “social capital”. Above all, the ratio is highest where the opportunities for firms to invest are most favourable.

Analogous results to those described above are obtained for the ratio of lending to value added.

On average in the last ten years bank loans have been equal to 46 per cent of the South's GDP, compared with 94 per cent in the rest of the country. The gap has narrowed in the last few years.

The differential between the ratios of lending to value added are smaller if attention is focused on the sectors of industry, construction and private non-financial services for which the availability of credit has a direct impact on firms' production and investment decisions. The differences between the Centre and North and the South are narrowed further by taking account of the different geographical levels of banks' unrecoverable and assigned loans and of the presence in the South of production facilities of firms having their registered office in the Centre and North. Lastly, there is the effect of the greater diffusion of irregular jobs in the South, estimated by Istat to be 20 per cent of total employment, nearly twice the figure for the rest of Italy. Statistical analyses show that unregulated employment reduces the demand for credit. When only the regular economy is considered, i.e. excluding the underground economy, the ratio of lending to value added is similar in the South and in the Centre and North.

The improvement in the availability of credit in the South is confirmed by the performance of lending in the last few years. Loans to southern firms have accelerated since 2002; in the last three years their growth has systematically outpaced that of loans to firms in the Centre and North (Figure 1). This pattern is common to all the main sectors of production and the various size brackets of firms. The lending of leasing and factoring firms has also grown faster in the South than in the rest of the country.

According to Bank of Italy analyses, about half of the larger increase in lending in the South is due to the faster growth in southern firms' demand for funds, related in

turn to the slower growth in their internal sources of financing. Another contributory factor has been the fall in some types of public transfer payments: data published by the Ministry for Economic Growth show that disbursements to southern firms under national support programmes in 2004-05 were one third down on the two previous years, so that borrowers were forced to increase their recourse to bank loans.

The rate of increase in loans in the South also reflects the more favourable supply policies of the large banking groups with their registered office in the Centre and North. Loans granted to southern firms by banks belonging to groups located in the Centre and North progressively accelerated, until in 2006 their rate of growth was almost twice that of loans granted by southern banks (Figure 2).

The difference between the rates of growth in loans to southern customers granted by banks belonging to groups located in the Centre and North and by southern banks narrowed in the early months of 2007.

The quality of bank loans has shown signs of deteriorating recently. In the twelve months ending in December 2006 the ratio of new bad debts to total outstanding loans to firms rose to 2 per cent in the South, compared with 1.1 per cent in the Centre and North. The increase in unrecoverable loans in the southern regions mainly concerned firms in the construction and service sectors.

At the end of April 2007 non-performing loans – comprising loans overdue and credit overdrawn for more than 180 days, restructured loans, substandard loans and bad debts – amounted to 11.9 per cent of total loans in the South, compared with 5.2 per cent in the Centre and North.

The cost of borrowing. – The geographical disparity in the cost of borrowing for firms has tended to diminish in recent years, despite some fluctuations. In the case of medium and long-term interest rates, which are particularly important for firms' investment decisions, the spread between the South and the Centre and North narrowed

from 1.2 percentage points in 1998⁴ to about 0.9 points in 2003 and 0.3 points in March 2007; the spread on short-term rates declined from 2.3 points in 1996 to 1.6 points at the end of last March.

The geographical difference is due in part to the characteristics of banks' customers. One underlying factor is the difference in the size and sectoral composition of the productive system: in the South, firms are on average smaller and sectors such as construction and agriculture, with higher insolvency rates, have a larger weight. Bank of Italy studies indicate that, taking the difference in size and sector of borrower firms into account, in March 2007 the spread had narrowed to 0.1 percentage points for medium and long-term rates and to 1.2 points for short-term rates.

The gap reflects the greater financial vulnerability, on average, of southern customers, the external diseconomies affecting production in the South, and the slowness of debt recovery proceedings there.

Empirical analysis indicates that if one considers the characteristics of each provincial market – such as the endowment of social capital, borrowers' riskiness and firms' productivity – the spread between rates in the South and the Centre and North disappears.

2.2.4 The payment system

Progress has also been made with the payment system in the South. There is now less of a gap with the regions of the Centre and North in terms of the variety and distribution of access points and the use of non-cash payment methods, particularly debit and credit cards. However, households and firms in the South still make more frequent use of cash and bank cheques to settle transactions, to the disadvantage of more technologically advanced alternatives.

⁴ The first year in which the new data series was available.

In 2006, payment cards accounted for some 40 per cent of all non-cash payments in the South, compared with 50 per cent in the Centre and North. On the other hand, use of cheques was greater in the South: 22 per cent, against 14 per cent in the Centre and 11 per cent in the North.

Data on use of the main payment methods point to less favourable conditions in the South. Crediting cheques takes about one day longer: 5 days in the South and 4 in the Centre and North; the same is true of the time before availability for withdrawal: 8 days against 7. Commissions on fund transfers are higher: about €3 in the South against €2 in the Centre and North. This state of affairs can be ascribed both to the banks and to the habits of customers in the South, who more often choose non-automated payment methods and use them sporadically.

At the end of 2006, bounced cheques reported to the interbank database of irregular cheques and payment cards in the South represented 2.23 per mille of normally debited cheques in number and 4.30 per mille in amount; these ratios are about twice the national averages. As far as payment cards are concerned, the ratio between users entered in the database for irregularities and the total number of payment cards in circulation is 1.13 per cent in the South, which is almost double the national average of 0.66 per cent. Unpaid electronic bank receipts are also more frequent in the South.

2.2.5 Banking supervision

Since the mid-1990s the Bank of Italy has performed 1,541 interventions in the South, had 1,773 meetings with senior management and conducted 495 on-site inspections. Partly as a result of this close evaluation of the conditions of the local banking system, the number of southern banks with serious problems has gradually decreased, from 52 per cent in 1997 to 20 per cent in the latest available reports. The number of inspections resulting in a negative judgment fell from 35 in 1996, equal to over 60 per cent of the banks examined in that year, to 7 and 19 per cent in 2006.

The supervisory authorities continue to pay close attention to the South's banking system: there were 138 interventions in 2006, equal to 35 per cent of the national total; meetings were held with senior management of 129 banks, that is 28 per cent of the total; and 36 on-site inspections were performed (24 per cent of the total).

Measures taken during the 1990s to prevent unauthorized banking led to the elimination of potential risks for savers in the South. *Casse di mutualità* – cooperatives that gathered savings from members and granted them loans, thus performing operations reserved to banks – were invited to comply with the regulations on deposit-taking, if necessary transforming themselves into commercial banks or financial corporations. The phenomenon, which was fairly widespread two decades ago, with more than 150 unauthorized operators in the Centre and South, has now disappeared entirely.

The awareness campaign aimed at the financial system regarding the prevention of money laundering has elicited greater efforts on the part of intermediaries. More than 57,000 reports of suspicious transactions have been received in the past decade, almost half of them in the last three years, mainly from banks, which have been the source of nearly 90 per cent. Reports sent in by banks in southern Italy represent about 22 per cent of the total.

The reports have identified a number of sectors where more frequent use of cash may increase the risk of money laundering. The sectors in question are construction and ferrous materials; there has also been an increase in the number of reports of suspicious transactions involving usury and in those associated with waste disposal and with financing linked to government subsidies.

In recent years the Bank of Italy's ordinary supervisory activity has brought to light irregularities in compliance with customer identification and registration requirements at 15 per cent of intermediaries examined; among banks whose registered office is located in the South such irregularities have been found at 21 per cent of those inspected. As part of its supervisory role the Italian Foreign Exchange Office has conducted 430 inspections in the last ten years, the findings of which led to 117 reports

to the judicial authorities. Of this total, 71 inspections and 25 reports concerned banks having their registered office in the South.

3. Institutional and real determinants of financial disparities

Although progress has been made, the South's financial system continues to lag considerably behind those of the Centre and the North. The difficulty of accessing credit, the greater cost of borrowing and the higher bad debt ratio indicate weaknesses in the institutional framework and in the set of rules and institutions – informal as well as formal – that regulate economic and civil life and influence operators' decisions and actions. The institutional environment influences the operation of the financial system both directly and indirectly via its effect on the behaviour of citizens and firms and hence on the decisions of financial operators.

The protection of creditors' rights is the clearest example of the direct impact that the institutional context has on the financial system. Wherever these rights are not fully guaranteed, lenders are less willing to grant loans to very risky borrowers and demand higher rates of interest. In the South in particular, creditor protection is hampered by the slowness of justice – by longer civil proceedings than in other European countries and even than in the Centre and North.

The institutional environment affects the operation of the financial system by other channels too, ones more directly linked to the context in which people and firms operate. Measures to ensure that the activities of firms and of the community are performed in an orderly fashion, to prevent crime from infiltrating into the economy and the public administration, entailing costs and hindering competition, and to strengthen the trust people place in one another and in the institutions are essential in order to render credible any undertakings by the parties and to ensure honourable conduct. The absence of these underlying conditions, which is particularly evident in the South,

causes the economy to malfunction and heightens the risk of insolvency for intermediaries.

A sound economic environment capable of inducing growth and employment needs a proper endowment of factors influencing firms' productivity, as well as an institutional context conducive to growth. A crucial role is played by human capital and by infrastructure. The South lacks both. In 2005, in the economy as a whole, output per employee – i.e. productivity – was a fifth lower in the South than in the Centre and North.

In manufacturing the ratio between productivity in the two areas is about 75 per cent. This sort of gap cannot be put down to a smaller endowment of fixed capital assets per worker. Analyses using balance-sheet data of individual firms indicate that the main cause of the weakness of southern firms is their low level of total factor productivity, which is in turn due to the inefficient combination of factors of production. In southern firms the ratio of value added to employees and to the value of tangible fixed assets is less than in firms in the Centre and North, reflecting lower gross operating profit: in 2005 the ratio of gross operating profit to total assets for the 6,300 southern firms surveyed by the Company Accounts Data Service was 5.9 per cent, compared with values ranging from 6.5 to 7.6 per cent for other firms. Since debts represent a larger percentage of value added, entailing greater interest expense, southern firms generated less cash flow and profits.⁵

Low productivity makes the productive system vulnerable and may encourage firms to engage in unauthorized and non-transparent acts, which themselves impede growth. The South of Italy has a large underground economy. High-productivity output can only expand if firms grow in size and invest heavily in fixed capital assets and personnel training: these conditions are harder to achieve in a situation of widespread irregularity, in which many firms try to remain invisible, especially to the tax authorities.

According to the latest figures, there is no sign of the productivity gaps lessening. In 2006 labour productivity in industry excluding construction in the South

⁵ Geographical divergences in productivity and profitability are apparent even considering the different size and sectoral composition of the productive system in the two areas.

rose by 0.8 per cent, compared with 1.3 per cent in the Centre and North. Surveys by the Bank of Italy on a large group of firms indicate that the reorganization process that Italian industry initiated in response to technological changes and heightened competition has been less widespread in the South. Despite the risks of a possible regression in the South, there also appear to be opportunities for growth. Analyses based on figures from the Company Accounts Data Service reveal that, as in the Centre and North, in the South, too, alongside firms in difficulty others are growing apace; a category of strong medium-sized firms has asserted itself. It is essential that there should be an efficient financial system to accompany growth.

4. Conclusion and lines of action

The transformations of recent years in southern Italy's banking system and the acquisition of its leading banks by banks in the Centre and North have had important positive effects, contributing to improve principles and techniques of credit management and encouraging increased lending and a lowering of interest rates. Fears that the entry into southern markets of banks from the Centre and North might adversely affect the availability and cost of borrowing in the South – partly because of the distance between the decision-making centres and the local customer base – have proved unfounded.

The banks still based in the South are also sounder and have a stronger capital base than in the past. The proportion of southern banks with serious problems has decreased considerably. The efforts of the supervisory authorities have contributed to this result.

Macroeconomic indicators reveal no sign of tension in access to credit in the South; lending continues to expand rapidly, indeed faster than in the Centre and North. Given the slower rate of economic growth than in the rest of the country, the less evident signs of productive reorganization and the sharply rising rate of loan downgrading, the

supervisory authorities are paying close attention to credit market developments in the South.

Despite the progress made, the structure of banking supply in the South remains backward and the conditions of access to credit less favourable. To a large extent these shortcomings reflect the fragile nature of the local economic environment and less efficient institutions.

This is not to say that the financial system – and the banks in particular – cannot or should not make a greater contribution to strengthening the South's productive system and to the growth and modernization of its economy.

First, further progress is needed in order to offer firms not only the support of credit, but also know-how and services to promote greater efficiency and broaden their scope of operation. This entails assessing firms according to the quality of their investment projects, their growth prospects and the potential synergy from mergers and acquisitions, rather than on the basis of the real guarantees they can provide.

In a situation in which the demand for finance for major corporate actions has also declined, the leading banking groups are enhancing the supply of private equity and project financing services.

In the South in particular, where the civil justice system is slower, it is important to resolve disputes rapidly. The law now requires that financial intermediaries be party to arrangements for out-of-court settlements. The Bank of Italy will present a proposal to the Credit Committee for the regulation of these matters.

Relations between banks and small firms can be improved by the latter participating in loan guarantee consortia. Our estimates suggest that small firms in the

South that join these syndicates are less likely to be downgraded and obtain credit at a significantly lower cost – almost one percentage point – than those that do not.

As a result of the Bank's efforts in international fora, the European directive on banks' capital requirements, which incorporates the new Basel II Capital Accord, allows lending banks, under certain conditions, to use favourable weights for small-sized firms and to recognize guarantees granted by consortia for risk-rating purposes. A regulatory framework of this type could promote the supply of credit and reduce borrowing costs for small firms in the South, where they are particularly numerous.

In the South, the consolidation of consortia could improve the quality and quantity of services available to members. Under the 2003 reform, consortia can expand their operations and strengthen their organization and capital structure by becoming mutual banks or financial intermediaries subject to the Bank of Italy's supervision.

The backwardness of southern households' saving habits requires an exceptional effort on the part of banks to broaden the market and establish firm ties with their customers; it also offers them opportunities for growth if they win over savers through increased transparency and better quality and less expensive services. The use of new technologies, and the ability, thanks to a larger network of branches, to reach customers once less accessible, can play an important role.

Transparent conditions for the supply of products and services, fair dealing with customers and consumer protection are important for the development of Italy's banking system, especially in the South. Transparency and customer safeguards are useless, however, if savers do not have the means to make informed decisions. The Bank of Italy continues to increase its commitment to financial education, working with other institutions to spread financial culture. These activities may encourage households in the South to alter the composition of their portfolios, aiming for greater diversification and higher returns.

In retail payments the development of electronic methods in the South can benefit customers, banks and the economy as a whole. The increased use of e-payment methods allows operations to be traced, helping to cut the risk of unlawful use of means of payment and to combat small crime and undeclared transactions.

In national payment systems, greater efficiency, lower costs and increased competition will be fostered by the scheduled introduction in 2008 of the Single Euro Payments Area (SEPA), which will allow European citizens, firms and government departments to use the same system to make and collect payments in euros, regardless of their country of origin. The Bank of Italy is assisting the Italian and European banking community in the implementation of the project by participating in the evaluation performed by the Eurosystem and offering clearing and settlement services.

The use of innovative payment methods will be encouraged by forthcoming legislation. The legislative decree transposing the third directive on money laundering will tighten the existing regulations on the use of cheques and will contain measures to discourage the use of cash. A bill already passed by the Chamber of Deputies and now before the Senate⁶ makes provision for measures to foster the adoption of modern payment methods.

The Bank of Italy takes a positive view of these initiatives, which can help to improve the quality and the security of services provided to firms and the public, increase the scope for using high-tech payment methods, and reduce the frequency of small financial crimes.

The Bank continues to strengthen its commitment to combat crime. The transposition of the third European directive will create the conditions for further progress in preventing and combating money laundering. The draft legislative decree transposing the directive aims to strengthen the role of the Financial Intelligence Unit by incorporating the Italian Foreign Exchange Office within the Bank of Italy. The Bank

⁶ The bill concerns “measures for consumers and to facilitate productive and commercial activities, as well as intervention in sectors of national importance”.

has undertaken to expand the FIU's activity in terms of human and technical resources and information technology.

These initiatives, too, may bring benefits to the economy of southern Italy, which is afflicted by the presence of organized crime.

There is still some way to go before the financial disparities between the South of Italy and the Centre and North are eliminated. The financial system, the banks, and the Bank of Italy will continue to make their contribution.

What are needed, however, are measures to improve the institutional context and overcome the imbalance in the real economy. Neither the Bank of Italy nor supervisory regulation present an obstacle to the creation of banks by, in or for the South if the proposals respect the economic conditions. The attribution of inappropriate tasks to banks in conflict with the entrepreneurial nature of their business would be a dangerous return to the past.

Figures and Tables

Figure 1. Lending and GDP in the Centre and North and in the South

Figure 2. Lending to firms in the South

Figure 3. Spread between interest rates on loans to firms in the Centre and North and in the South

Figure 4. Rate of downgrading of loans in the Centre and North and in the South: levels and spread

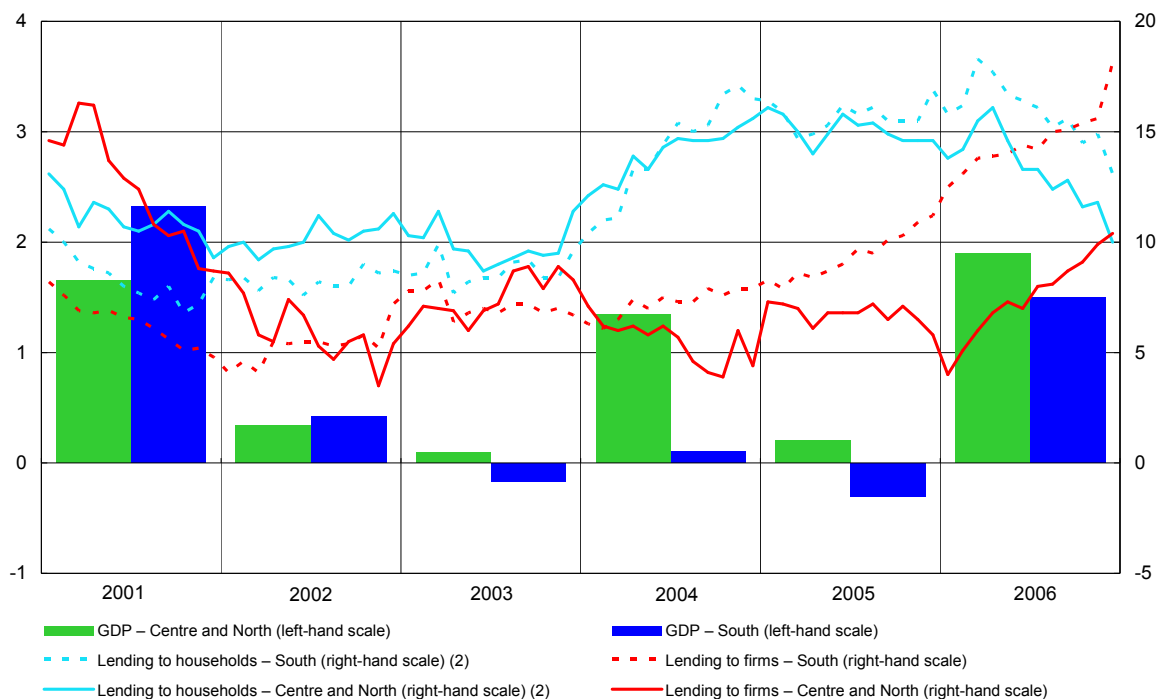
Table 1. Number of banks with registered office in the Centre and North and in the South

Table 2. Bank branches in the Centre and North and in the South

Table 3. Italian banks' assets and liabilities by location of registered office

Figure 1

LENDING AND GDP IN THE CENTRE AND NORTH AND IN THE SOUTH (1)
(percentage changes)

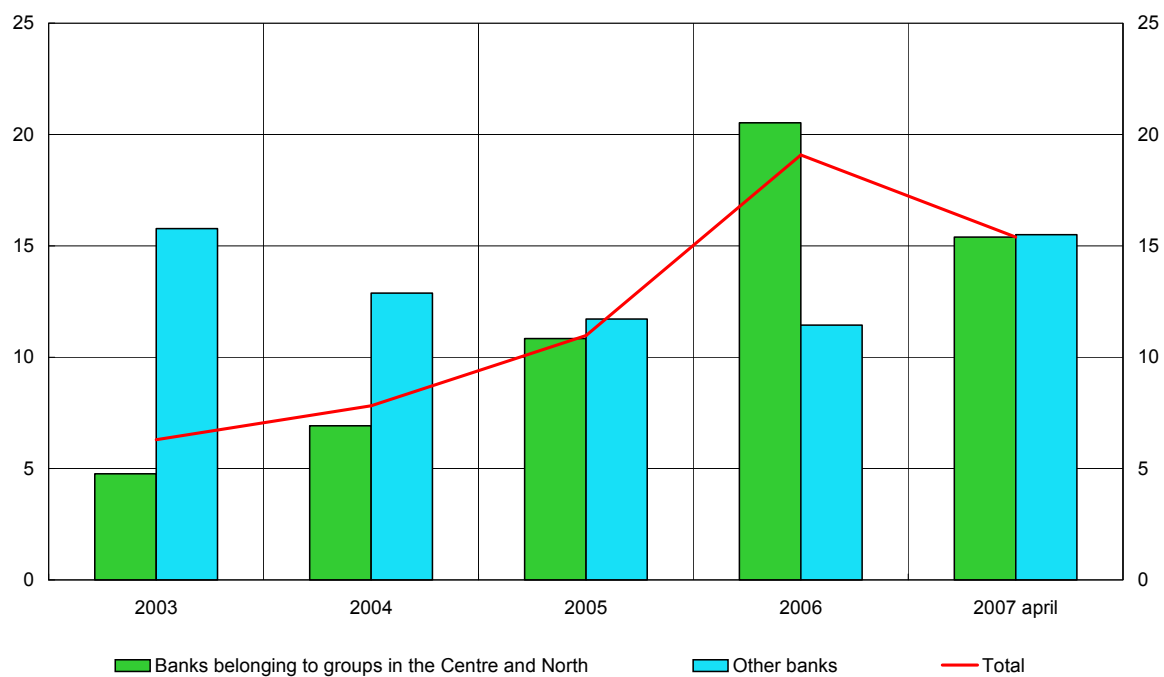


Sources: Based on Bank of Italy, Istat and Svimez data.

(1) Changes on the previous year for GDP; twelve-month changes for lending. – (2) Consumer households.

Figure 2

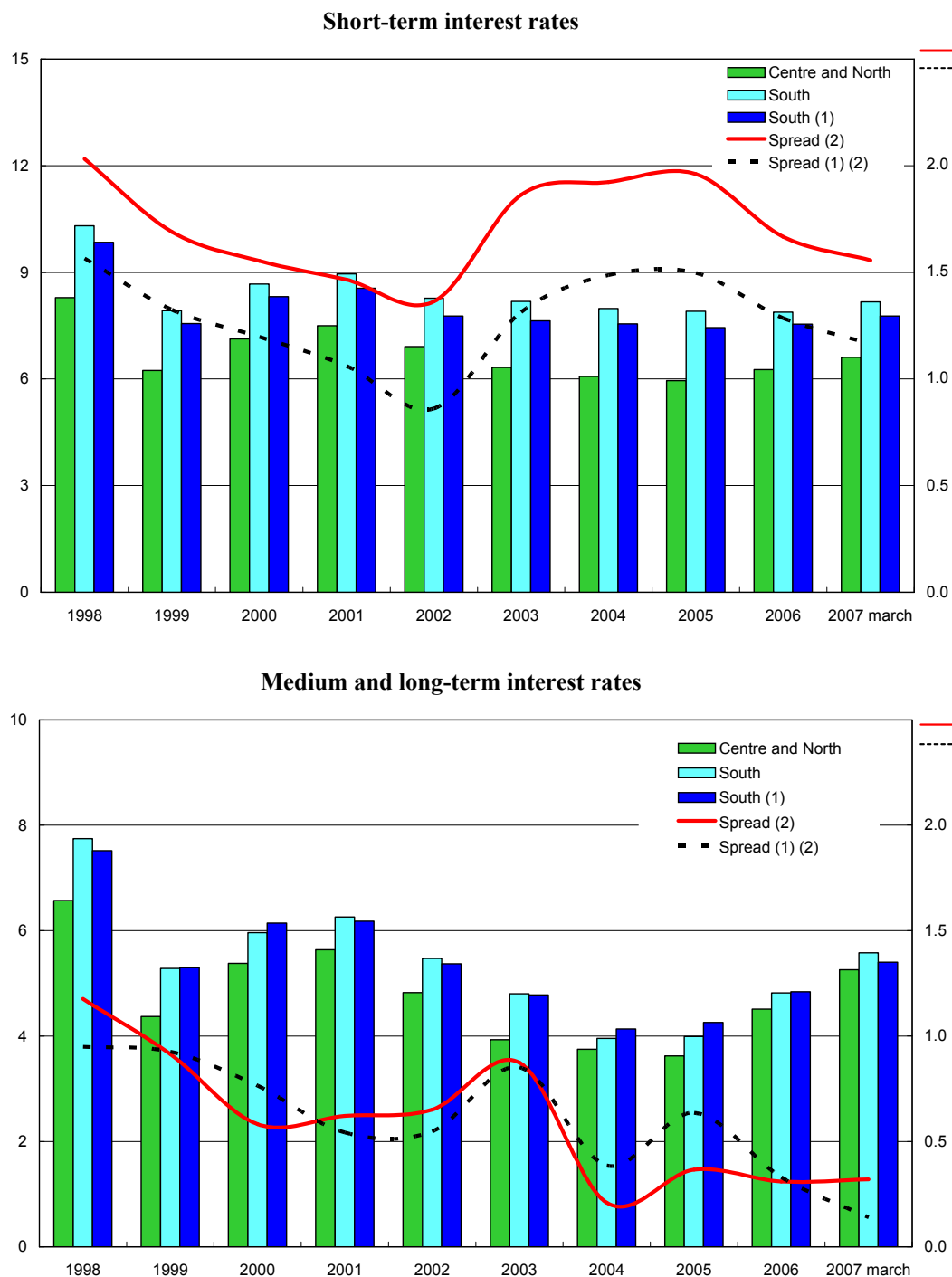
LENDING TO FIRMS IN THE SOUTH (1)
(12-month percentage changes)



Source: Based on Bank of Italy data.
(1) Excluding repurchase agreements and bad debts.

Figure 3

**SPREAD BETWEEN INTEREST RATES ON LOANS TO FIRMS
IN THE CENTRE AND NORTH AND IN THE SOUTH (1)**
(quarterly data; amounts and percentage points)



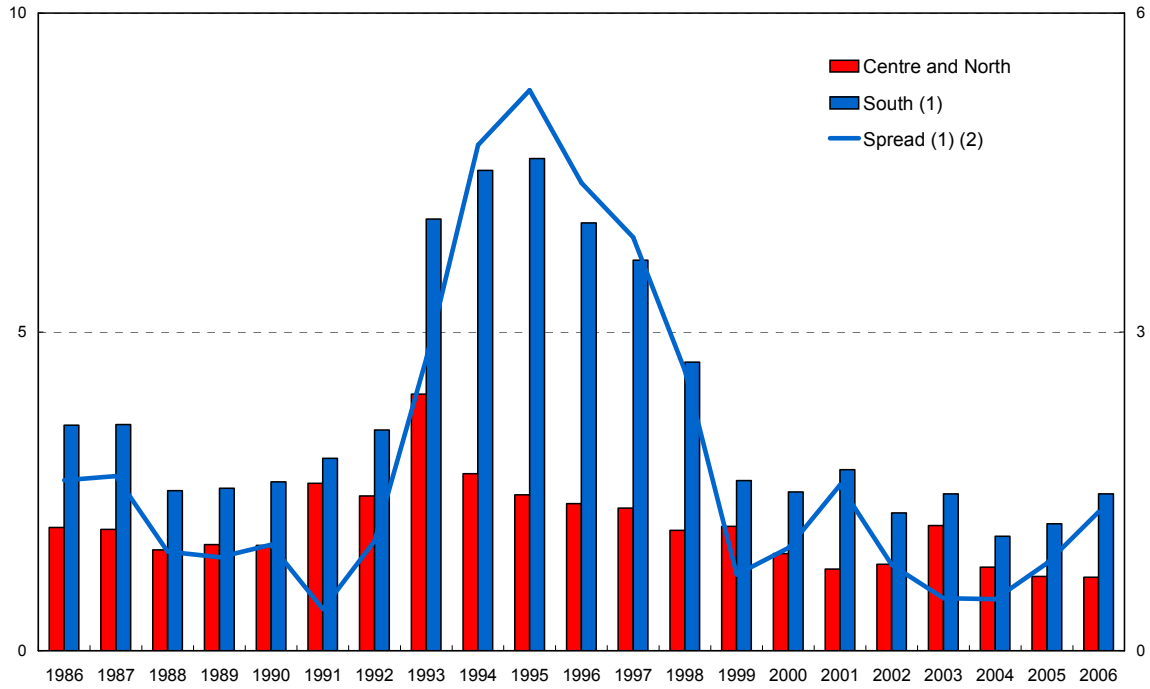
Source: Based on Bank of Italy data.

(1) Interest rates weighted according to the composition by sector and size in the Centre and North. – (2) Right-hand scale.

Figure 4

**RATE OF DOWNGRADING OF LOANS IN THE CENTRE AND NORTH
AND IN THE SOUTH: LEVELS AND SPREAD**

(ratio of new bad debts to total loans; non-financial companies and producer households)



Source: Based on Bank of Italy data.

(1) Rates weighted according to the composition by sector and size in the Centre and North. – (2) Right-hand scale.

Table 1

**NUMBER OF BANKS WITH REGISTERED OFFICE IN THE
CENTRE AND NORTH AND IN THE SOUTH (1)**

	1990	1995	2000	2006
Total	1,061	918	783	719
Centre and North	748	641	599	571
of which: mutual banks	500	425	366	326
other banks	248	216	233	245
South	313	277	184	148
of which: mutual banks	213	194	133	110
other banks	100	83	51	38
<i>of which: belonging to groups in the Centre and North</i>	..	10	25	19

Source: Based on Bank of Italy data.

(1) Does not include branches of foreign banks.

Table 2

BANK BRANCHES IN THE CENTRE AND NORTH AND IN THE SOUTH (1)

	1990	1995	2000	2006
Number of branches				
Total	16,542	23,353	28,096	32,205
<i>of which: mutual banks</i>	1,558	2,378	2,944	3,748
<i>other banks</i>	14,984	20,975	25,152	28,457
Centre and North	12,623	17,891	21,759	25,195
<i>percentage of banks from Centre and North</i>	98.2	98.4	99.0	99.1
South	3,919	5,462	6,337	7,010
<i>percentage of banks from South</i>	67.8	56.4	15.9	17.6
Branches per 100,000 inhabitants				
Total	29.2	42.3	48.6	54.7
Centre and North	35.0	51.1	59.0	66.1
South	19.1	26.7	30.4	33.8
Branches per 1,000 sq. km.				
Total	54.9	77.5	93.2	106.9
Centre and North	70.8	100.4	122.1	141.3
South	31.9	44.4	51.5	57.0
Branches per €100 million of GDP				
Total	2.6	2.7	2.6	2.5
Centre and North	2.6	2.7	2.7	2.6
South	2.4	2.6	2.4	2.3
Branches per €100 million of households' financial wealth				
Total	1.4	1.5	1.1	1.3
Centre and North	1.3	1.4	1.0	1.3
South	1.8	2.0	1.5	1.6
Branches per €100 million of deposits				
Total	..	3.2	3.4	2.9
Centre and North	..	2.8	3.3	2.7
South	..	3.2	4.2	3.7

Source: Based on Bank of Italy data.

(1) Does not include branches of foreign banks.

**ITALIAN BANKS' ASSETS AND LIABILITIES
BY LOCATION OF REGISTERED OFFICE**

(millions of euros and percentages; December 2006)

	Banks with registered office in Centre and North		Banks with registered office in South	
	million euros	percentage of total assets	million euros	percentage of total assets
Assets				
Loans in Centre and North	1,163,139	40.8	12,846	8.6
Loans in South	135,940	4.8	68,446	45.7
Securities (1)	166,945	5.9	11,596	7.7
Foreign assets (A)	277,887	9.8	2,820	1.9
Other assets (2)	1,105,738	38.8	54,039	36.1
Total (3)	2,849,650	100.0	149,747	100.0
Liabilities				
Funds raised in Centre and North	937,820	32.9	7,738	5.2
Funds raised in South	92,651	3.3	99,484	66.4
Foreign liabilities (B)	468,163	16.4	1,196	0.8
Other liabilities (4)	1,351,016	47.4	41,329	27.6
Total (3)	2,849,650	100.0	149,747	100.0
Memorandum item:				
Net foreign liabilities (B-A)	190,275		-1,624	

Source: Based on Bank of Italy data.

(1) At book value. – (2) Include interbank accounts, shares and equity, buildings and furniture, and cash. – (3) Total balance-sheet assets net of expenditures and losses and items suspended or in transit. – (4) Include interbank accounts and capital and reserves.