

**SUMMARY**  
**OF THE REPORT TO PARLIAMENT AND THE GOVERNMENT**

The Report is divided into six chapters, covering the Bank of Italy's institutional functions under the Treaty on European Union and Italian law. The Report also contains a description of the activities carried out in the performance of these functions. One chapter deals with the Bank's departments, its human capital and technological resources, the accounting system, and the activity of legal counsel.

The Bank of Italy contributes to decisions on monetary policy through the Governor's participation in the Governing Council of the European Central Bank. Representatives of the Bank take part in the work of the committees of the European System of Central Banks that assist the Governing Council. The Bank contributes to the implementation of monetary policy in the euro area by carrying out open market operations with banks present in Italy. In 2006 the Bank set up IT procedures and infrastructures and adopted the necessary regulations to allow banks to use loans as collateral in refinancing operations. It also continued work on the upgrading of compulsory reserve management procedures as part of the new European platform TARGET2 that will come on stream in November.

The Bank of Italy manages the central infrastructure of the payment system, i.e. BI-Rel for the settlement of large-value payments and BI-Comp for the clearing of retail payments. In 2006, the total volumes handled by the two systems increased to almost €50 trillion, 15 per cent more than in 2005. The Eurosystem has entrusted the Bank of Italy, together with the central banks of France and Germany, with the task of developing and operating the TARGET2 unified European system for large-value payments. In addition, by 1 January 2008 BI-Comp will be adapted in view of the creation of the Single Euro Payments Area (SEPA) for non-cash transactions. Finally, the central banks of Italy, France, Germany and Spain have been charged with developing the TARGET2-Securities (T2S) project for the settlement of securities

transactions in central bank money. In March 2007 the project was approved as feasible by the Governing Council of the European Central Bank, which will issue a final decision by April 2008.

As regards monetary circulation, in 2006 the Bank's printing works produced 1,170.8 million euro banknotes in denominations of €20, €50 and €100. Preparations for the second series of euro notes continued in collaboration with the printing works of other European countries, and action to stem the counterfeiting of the single currency was strengthened with the cooperation of the police.

The Bank of Italy manages the state and provincial treasury service. In 2006 the departments concerned collected €2,579.2 billion of receipts and made €2,571.3 billion of disbursements. The Bank assisted the Ministry for Economy and Finance in drafting a new version of the Instructions for the Treasury, a compendium of general operating rules, thus creating an organic body of regulations to which operators can refer. The General Government Transactions Information System (SIOPE) became operational during the year, enabling the Ministry for Economy and Finance to monitor general and local government finances at all times.

The Bank of Italy manages placements and buy-backs of government securities on behalf of the Treasury. A total of 183 auctions were held during 2006, at which government securities with a face value of €93.3 billion were placed, compared with 181 auctions and €40.2 billion of securities placed in 2005. Placement at auction is the best means of guaranteeing a transparent and efficient primary market. It is important that the Bank should be able to notify bidders quickly about the amounts allotted and the prices in order to limit uncertainty on the financial markets. At the start of this year, trials were begun of a new placement and buy-back procedure that should bring substantial improvements in this area. The Bank of Italy also performs tasks for the Treasury connected with the financial servicing of the external debt, making collections at the time of issue and paying out principal and interest when the loans mature. During 2006, 573 operations were conducted as part of this service.

The Bank of Italy manages the country's official reserves, part of which are invested through the Italian Foreign Exchange Office (UIC), an instrumental entity of the Bank. The Bank also invests a portion of the reserves of the European Central Bank, following the guidelines set by the Governing Council. The total value of gold and foreign currency reserves at the end of 2006 was €62.7 billion, rising to €63.3 billion at the end of March of this year. The Bank of Italy aims to maintain high levels of liquidity and security and, as a subordinate goal, to maximize the expected return by determining appropriate medium to long-term risk/return ratios.

The Bank has a financial portfolio comprising investments of own funds and of the staff severance pay provision; it also manages the investments of the staff's supplementary pension fund. The market value of the portfolio on 30 March 2007 was around €94.3 billion. Further purchases were made of non-Italian euro-area government bonds, which now represent 19.5 per cent of total debt securities in the Bank's portfolio. Equity investments were made mainly outside the Italian market, replicating market indexes directly or by buying exchange-traded funds. The Bank exercised its rights in respect of shareholdings in a spirit designed to foster monitoring by minority shareholders.

The Bank of Italy supervises a broad network of intermediaries to which the public entrusts its savings and which finances the economy, a function assigned to it by law. At the end of 2006 Italy's financial system consisted of 793 banks, 106 investment firms, 199 asset management companies and SICAVs, 444 financial companies, 3 electronic money institutions, the Bancoposta division of Poste Italiane SpA, and Cassa Depositi e Prestiti. The innovations in supervisory regulations and the evolution in the system's structure require changes to be made in the way supervision is conducted. The forthcoming reorganization of the supervisory departments described below reflects these developments.

In 2006 the Bank continued to participate in international committees on cooperation set up among supervisory authorities in order to safeguard financial stability and enhance the convergence of supervisory rules and practices. Convergence

is essential in order to guarantee equal competitive conditions and limit the costs to banks.

The issue of circular order 263 of 27 December 2006 marked the completion of the transposition of the EU directives on capital adequacy (Basel II). The “New provisions on the prudential supervision of banks” set out requirements based on risk exposure and the ability of banks to develop suitable risk management and control techniques and adopt appropriate organizational solutions for their characteristics and strategies. The compliance function, on which the Bank of Italy published a consultation document in August 2006, is required to play a complementary role with respect to the risk management system required by the new prudential regulations.

The Bank of Italy is engaged in a broad review of supervisory provisions affecting banks and other intermediaries that should lead to the simplification and reduction of administrative formalities, especially those involved in authorizations. In 2006 and 2007 this process has led to changes in the rules governing the acquisition of controlling shareholdings in banks, amendments to by-laws, branch openings and securities issuance.

At the beginning of 2007 the Bank issued provisions to update supervisory regulations on business continuity, the solicitation of non-bank investors, bank and postal cheques and the outsourcing of cash handling, as well as supervisory instructions on the issuance of covered bonds.

In 2006 there was an increase in discussions with the leading banks that were already developing internal systems for calculating capital adequacy prior to the entry into force of the new regulations. In view of the international scope of some of these banking groups, the approval process will involve ad hoc consultation and collaboration between the Bank of Italy, as authorizing body, and the foreign supervisors concerned. In view of the new prudential regulations and the EU guidelines the Bank has made an individual contribution to strengthening the role of the networks of supervisors. It is responsible for the consolidated supervision of UniCredit and Intesa Sanpaolo.

The approval of banks' internal rating systems involved the Bank's supervisory departments in 4,418 man-days of work during 2006 and the first five months of 2007. The task was performed both off-site and on-site at the banks concerned.

In 2006 new methods were introduced for the analysis of individual banks to support the evaluation of large or particularly complex banking groups. During discussions with the financial intermediaries criteria were agreed for the evaluation of asset management companies operating private equity funds and special attention was paid to those specializing in hedge funds. The methods of analysis employed in the supervision of investment firms were supplemented by the addition of data on indebtedness provided by the Central Credit Register.

In 2006 a total of 165 inspections were conducted at banks, compared with 173 in 2005, lasting an average of 48 days. Overall, 521 inspections were carried out between 2004 and 2006. In the first quarter of 2007 the number was 43. Different methods of inspection were adopted according to the banks' size and sophistication. As the practice of coordinated supervisory activity spreads, more and more on-site inspections are being conducted in collaboration with other national and foreign authorities.

Inspections were also conducted on 16 financial intermediaries, including 7 asset management companies. In addition, there were 6 inspections of depositary banks to check the level of internal controls and the reliability of the service's operational and IT procedures.

Inspections of investment firms focused on those experiencing recurrent problems – none part of a banking group and all with different characteristics – and brought to light poor organizational arrangements and levels of control, entailing operational, legal and reputational risks. Two investment firms belonging to the same group were placed under special administration during the course of the inspection and a third was liquidated as a result of negative findings.

In 2006 in addition to ordinary supervisory action, 5 on-site assessments were made (8 in 2005) to verify the main banking groups' progress towards obtaining

approval of advanced credit and operational risk measurement systems, in line with the regulations on capital adequacy. The complexity of the subject has entailed a considerable investment of specialized resources, as well as close collaboration with the other supervisory authorities, and the experimentation of new criteria based on more flexible inspection teams and methods. The new methods were adopted, for the first time last year, during on-site assessments relating to the innovative issue of operational risk. During the year, inspections of parent banks in Italy led to 3 inspections of foreign establishments to verify the degree of control Italian banks exercise over their branches and subsidiaries.

Specific checks to verify compliance with the regulations on transparency and ensure correct bank-customer relations were also carried out by the branches of the Bank of Italy on 1,040 branches of 176 banks. In addition inspections were conducted on 118 branches of Poste Italiane SpA, which is subject to transparency regulations in connection with the activity of its Bancoposta division pursuant to Presidential Decree 194/2001.

In 2006 the number of supervisory interventions, either in the form of letters of warning or meetings with corporate officers, totalled 857 and involved 454 banks, equal to over 57 per cent of supervised intermediaries. These measures were taken on the basis of analytical outcomes and were predominantly of a preventive or fact-finding nature. The official warnings requested adjustments to risk management systems and called for the adoption of appropriate arrangements regarding the structure and independence of the internal control functions.

Supervisory interventions vis-à-vis financial intermediaries included 199 formal warning letters and 132 meetings with corporate officers. These steps involved 114 asset management companies and 74 investment firms, or 63 per cent of supervised intermediaries.

Very substantial human resources were allocated to the punishment of irregularities, cooperation with the judicial authorities and public sector entities, management of crisis procedures for banks and financial intermediaries, and

cooperation agreements with the Antitrust Authority, Consob, Isvap, the Finance Police and the Italian Accounting Organization.

The Bank of Italy is responsible for financial market supervision and payment system oversight. In these sectors it collaborates with other authorities, domestic and foreign, and is present in the relevant fora of international cooperation.

Supervision of trading systems, operated by MTS S.p.A. and e-MID S.p.A., aims at verifying compliance with the rules, the adequacy of organizational structures and correct risk management on the part of the operating companies. In the post-trading sector, where Monte Titoli and Cassa di Compensazione e Garanzia are active, the objectives of supervision are to limit risk and check that the efficiency of operations is consistent with international standards. In 2006 controls were carried out through on-site inspections as well as via the traditional means of off-site supervision and meetings with corporate officers. Thirty supervisory interventions were conducted.

Oversight of the payment system is designed to ensure the reliability and efficiency of payment circuits, infrastructure and services. It seeks to improve the efficacy of monetary policy and contribute to the stability of the financial system by limiting systemic risks in the functioning of payment infrastructures. For the implementation of the Single Euro Payments Area (SEPA), a national committee, chaired by the Bank of Italy and the Italian Bankers' Association and composed of representatives of consumers, firms, retailers and general government bodies, was established in 2006 to manage Italy's migration to the SEPA. Further action was taken during the year to promote the modernization of the payment instruments and services supplied to final users, partly with a view to reducing the use of cash and paper-based instruments (cheques particularly). In line with the initiatives adopted by the Eurosystem, the Bank of Italy, pursuant to Article 146 of the Consolidated Law on Banking, issued "Provisions on payment system oversight regarding the handling of cash". These implemented the "Framework for the detection of counterfeits and fitness sorting" that the European Central Bank approved on 16 December 2004.

Domestic and international initiatives to ensure business continuity of infrastructures and prevent unforeseen events from having a systemic impact were completed in 2006. The Bank of Italy monitored the progress of compliance with the guidelines drawn up in 2004 for the main domestic infrastructural service operators. The Committee for Business Continuity, chaired by the Bank of Italy and Consob, analysed the risk scenarios, defined the vital financial services to be safeguarded and investigated systems' interdependencies.

In the area of large-value payments, oversight of the BI-REL gross settlement system continued. The system's operational risks were extremely limited, with the number of technical failures down on 2006. Banks also further improved the efficiency of their liquidity management within BI-REL. The European System of Central Banks began evaluating the legal, financial, functional, technical and operational aspects of the TARGET2 project. The results of the assessment will be transmitted to the Governing Council of the ECB. As regards retail payments, the Bank of Italy continued to monitor the efficiency and risk profiles of the BI-COMP settlement system with various quantitative indicators. Since 2002 the Bank has been responsible for the interbank register of irregular cheques and payment cards, which was established to increase public confidence in the use of payment instruments.

Economic analysis and research contributes to the formulation of euro-area monetary policy and to other institutional functions that the Bank performs, including its role in providing economic and financial information and advice. This helps explain why the Bank conducts economic analysis on a wide range of subjects, including legal, historical and institutional issues, and works intensively to provide documentation for the benefit of the public, disseminating economic studies, producing statistics and making available the resources of its library and historical archive. No less intensive is the Bank's cooperation with international institutions, including for the purpose of increasing the comparability of data and statistics referring to Italy and other countries.

Noteworthy among new developments concerning the Bank's publications are the revised *Economic Bulletin*, streamlined, more focused on short-term conditions and



now appearing quarterly; the new *Occasional Papers* series, treating topical issues and featuring non-technical discussion, published alongside the traditional *Working Papers*, which undergo rigorous evaluation by anonymous referees; and an English-language electronic newsletter on economic research in the Bank of Italy. The Report lists the main issues on which research was conducted during the year and gives an account of the publishing process; the results of the studies are described in the relevant publications.

Statistical activity has mirrored developments in supranational rules in the field of accounting standards, the balance of payments and banks' capital adequacy while also taking account of the need to limit the reporting burden placed on supervised institutions. The ranks of reporting institutions were extended to electronic money institutions, Cassa Depositi e Prestiti and Bancoposta. Numerous changes were introduced in the reports for banks, asset management companies and investment funds. The Central Credit Register was improved in several respects, and activities were begun with a view to giving Consob direct access to Central Credit Register data, as provided for by Law 62/2005. The "Statistics" section of the Bank of Italy's website was reorganized and its content enriched. The *Statistical Bulletin* was supplemented with new data on interest rates. In the field of statistical production for other institutions, Consob now also receives the reports of foreign funds; the periodic flow of data to Istat has been flanked by information on interest rates, investment firms, financial companies and loan delinquencies. Use of the Internet was extended to distribution of return data flows to bank. The Italian Foreign Exchange Office (UIC) engaged in revising the data gathering system for compiling Italy's balance of payments and net international investment position. During the year the new version of the Securities Register was completed, with a structure able to satisfy the information needs of the Centralised Securities Data Base created by the European Central Bank.

The Bank of Italy participates actively in the work of the international community on economic and financial issues. It is in constant contact with the governmental authorities to formulate Italy's positions and present them in those fora. In 2006 the Bank's representative offices abroad and the financial attachés to the Italian embassies not only analysed economic conditions in the countries to which they were assigned but also studied issues bearing on financial intermediation, financial stability,

the mortgage market, hedge funds and instruments for managing bank insolvencies. Technical cooperation with other central banks intensified with respect to 2005; the total number of initiatives rose from 64 to 90, that of individuals who received training in Italy from 205 to 431 and that of beneficiary countries from 40 to 52.

In 2006 and the first few months of this year the Bank drew up a far-reaching reorganization plan for the Head Office, the branch network and the representative offices abroad. The documents on the Bank's future development and organizational reconfiguration are under discussion with the trade unions. The branch network is to consist of one branch with a full range of operations in each regional capital and in the autonomous province of Bolzano, additional branches in the regions where demand for services is greatest, and branches specialized in supervision or cash handling. A first measure at the Head Office concerns the reorganization of the Economic Research and Legal Research Areas. A new Economic Research and International Relations Area has been instituted. The functional ramification of these activities will be improved, following the four fundamental directions that already distinguish them: contribution to euro-area monetary policy making with forecasts and analysis of cyclical conditions and studies of monetary policy and transmission mechanisms; research on the Italian economy, including comparative studies, with investigation of the different real and financial aspects and their implications for the public finances, public policies and regulatory arrangements; studies of the evolution of the world economy and of interaction between its main areas and cooperation with international institutions in the Bank's fields of interest; and refinement of economic statistical methodologies and the dissemination of economic and financial statistics. The property management function is now being reorganized with a view to integration between technical phases and specialization of objectives. The drawing up of reorganization plans for the departments belonging to the Banking and Financial Supervision Area is at an advanced stage; the aim is to strengthen macroeconomic analysis of risk, deepen the analysis of regulatory impact, protect consumers, ensure close integration between off-site and on-site supervision, and enhance integration between supervision and research. Special attention is being paid to the needs of business continuity.

The Bank's staff decreased by 409 over the year to number 7,548 at 31 December 2006; the reduction is continuing in 2007. At the end of last year 49.3 per cent of the Bank's employees worked at the Head Office, 48.6 per cent at the branches and the remainder were assigned to the representative offices abroad or seconded to other institutions. Newly hired staff numbered 201 in 2006.

The internal audit function launched a plan to renovate its approach in line with international developments in the field of internal controls and risk management, taking account of the corresponding functions at other central banks. The plan calls for expanded auditing of the areas of institutional activity and an increase of targeted controls on internal operating processes and IT procedures.

For the TARGET2 European gross settlement system, the Bank of Italy undertook the design and realization of the ITC and transmission and security infrastructures. The settlement system will be managed by the Bank of Italy and the Deutsche Bundesbank.

A number of new applications were developed to assist the Bank's operations in various sectors. To cope with the growth in data processing demand, the Bank upgraded its technological infrastructure by acquiring latest-generation mainframe systems. As of February 2007 available computing power equals 8,600 million instructions per second, 22 per cent greater than in 2006. New memory systems were installed, substantially expanding data storage capacity. The technological renewal of the computers dedicated to statistical and econometric applications for economic research was completed. The strengthening of the fibre-optic network linking the Bank's building in the Rome area was begun; the technological upgrading of the Head Office's local networks is nearing completion. In May 2007 the Bank's re-styled, content-enriched website was inaugurated, with a new section devoted to financial education. The renewed website also offers more interactive features for outside users.

In 2006 renovation work was completed on some Head Office buildings that house units assigned to institutional functions and on some branch buildings. Efficiency of supply, simplification of administrative formalities and cost savings were the aims of the European tender for the supply of electricity to the Bank's Head Office buildings

and, for the first time, to the headquarters of the UIC and the branch buildings. Further disposals were made, by means of open procedures, of buildings no longer fit for their original institutional uses.

In 2006 goods and services procurement procedures were rationalized further through greater recourse to the instruments of electronic commerce. Use of e-procurement produced benefits in terms of speed of supply, advantageous prices and inventory reduction.

The Bank's accounting system is ramified in units at the Head Office and in the branch network that record transactions within their competence. The accounting procedure is linked and integrated with those that manage the different segments of operations of the Bank. The entire working process is designed with a view to completing accounting activities by the end of the day, so that the Bank is in a position to send the required statement of accounts for the previous day to the ECB by 8 a.m. In preparing the annual accounts the Bank is required to comply with special rules and, for matters not governed by these, with the Civil Code. The special provisions consist mainly of the Eurosystem's harmonized rules, approved by the Governing Council of the ECB and formalized as guidelines. On 1 January 2007 Guideline 16 of 10 November 2006 entered into force, introducing the "economic approach" accounting policy. The Bank is subject to direct and indirect taxes levied by both central government and local authorities. The Bank's Statute assigns accounting control to the Board of Auditors; the accounts are audited by independent external auditors, as required by the Statute of the European System of Central Banks.

The accounting function is responsible for the periodic calculation of the monetary income produced by the Bank; such income is pooled with that of the other national central banks for subsequent redistribution within the Eurosystem.

The Bank has a management accounting system that records for individual organizational units and according to the functions and activities performed. The system satisfies manifold information requirements and is used as a basis of reference for pricing the services that the Bank provides for a fee. During the year the management

accounting system was brought into line with the Common Eurosystem-wide Cost Methodology approved by the Governing Council of the ECB in June 2006.

For legal questions and legal research, the Bank uses its own lawyers, who are entered in the special list attached to the professional register. Among the tasks entrusted to the Legal Services Department is litigation, which has increased in the course of time both for general reasons and for reasons connected with the evolution of the Bank's functions. The former include the new rights granted to private parties, such as access to administrative documents, and the shift in opinion regarding the activity of the public administration, which is no longer viewed as immune from censure. The latter include the specification by law of the purposes of supervision, the obligation to determine the methods by which supervision will be conducted in advance and the increase in the amount of sanctions imposed, which encourages appeals. In addition to handling civil and administrative cases, the Legal Services Department represents the Bank when it intervenes as a civil party in criminal proceedings and provides advice to the Bank's various departments, helping to ensure the legitimacy of the measures and procedures they adopt.