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The restructuring of the banking system in the last ten years
Problems and prospects

Testimony of the Governor of the Bank of Italy
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1. The reorganization of the Italian banking system

During the 1990s the Italian banking system underwent a far-reaching transformation. The international integration of markets, the liberalization of banking, and technological and financial innovation contributed to increased competition among intermediaries.

Public ownership of banks shrank rapidly. Since 1992, the proportion of the banking system's assets held by intermediaries more than half-owned by public entities and foundations has fallen from 68 to 10 per cent.

Privatization has strengthened the monitoring of banks' operations by the financial markets. At the end of last year listed banks accounted for some 80 per cent of banks total assets on a consolidated basis.

The 1993 Banking Law eliminated the segmentation of intermediaries' operations, further increasing the scope for competition in the different market sectors.

The 1998 Consolidated Law on Financial Intermediation allowed intermediaries to offer a wider range of asset management products, while leaving them ample discretion in their organizational choices.

Competition intensified as more banks entered the same markets and the presence of foreign intermediaries increased; since the beginning of the 1990s the spread between bank lending and deposit rates has narrowed from 6 to 4 percentage points.

The average rate on short-term bank loans has come down by 7 percentage points since the mid-1990s; it is now below 6 per cent, in line with the euro-area average.

The search for adequate structures to face the increase in competition has produced extensive consolidation. Since 1990 there have been 566 mergers and acquisitions, involving banks with assets equal to nearly half those at the beginning of the period.

Although more than 200 new banks were established between 1990 and August of this year, the number of banks has fallen by a quarter, from 1,100 to 829. The system has been recast mainly in the form of banking groups; more than four fifths of all bank branches belong to the 75 banking groups operating today.

Compared with ten years ago, the number of Italian banks' subsidiaries abroad has increased from 47 to 82. The proportion of assets consisting of claims on non-residents has risen from 17.6 to 20 per cent on a consolidated basis.

Non-bank intermediation has grown more diversified. It consists of 165 securities firms, 144 asset management companies and 286 financial companies, including those operating in leasing, factoring and consumer credit.

The growth in the relative importance of large banking groups has not meant that less credit is available for smaller firms. Credit to households has expanded at a particularly rapid pace since the second half of the 1990s but is still less developed than in the other leading countries.

In the second half of the 1990s bank lending rose more rapidly than nominal GDP; at the end last year it was equal to 81 per cent of GDP, compared with 68 per cent in 1996.

Mergers and acquisitions have permitted and spurred organizational changes aimed at more efficient utilization of information in evaluating

creditworthiness and setting the rates on loans; they have fostered the development of innovative techniques for the measurement and management of risk. These advances, together with the improvement in firms' finances, have been reflected in the decrease in the annual flow of new bad debts, which fell from values on the order of 3 per cent of loans in the four years between 1993 and 1996 to 0.9 per cent in 2001.

Profitability has recovered markedly with the supply of a wider range of services and action to reduce operating costs.

In the mid-1990s staff costs were equal to 45 per cent of gross income, significantly higher than the figure for banks in the other main countries; the measures to curb costs taken by banks, at the prompting of the Bank of Italy, brought the ratio down to 36 per cent in 2000.

Banks' return on equity, which had fluctuated around 2 per cent in the mid-1990s, rose to an average of 13 per cent in 2000, approaching the levels recorded in the banking systems of the other main countries.

In 2001 the economic results of intermediaries were affected by the negative performance of the financial markets, which also hurt savers. Banks' profits declined owing to the contraction in asset management fees and the substantial provisioning that was made necessary by the financial difficulties of some countries and large foreign corporations. The average return on equity fell to 9 per cent.

In the first half of this year the uncertainties of the financial markets contributed to a further fall in banks' profitability. Based on the half-yearly reports of the six largest banking groups, gross income was 3 per cent less than in the first half of 2001; with operating costs broadly unchanged, the operating result was down by 8 per cent.

Between 1998 and 2000 banks' overall capital and reserves rose by an average of 5 per cent per year; however, the rapid growth in assets caused the solvency ratio to fall from 11.4 to 10.2 per cent. The Bank of Italy took steps aimed at strengthening the capital bases of the leading banking groups, in line with the decision adopted at the international level to require banks to maintain own funds significantly in excess of the required 8 per cent minimum.

In 2001 banks' own funds grew by 8.9 per cent; the solvency ratio rose to 10.6 per cent.

Italian banks' international activity supports the initiatives of Italian enterprises in foreign markets. The increasing tendency of banks to operate in the international financial markets, organizing syndicated loans and bond issues, has improved Italian firms' access to a host of potential providers of finance.

In June of this year the Italian banking system had about €38.5 billion worth of outstanding loans and guarantee commitments to non-OECD developing and transition countries.

Italian banks account for a small proportion of total lending to those countries. Given the modest market share, in the current difficult economic situation the losses have been limited compared with those of banks of other countries.

According to the data published by the Bank for International Settlements, which refer only to loans outstanding as of March 2002, the Italian exposure was equal to 3.9 per cent of total bank lending to the non-OECD developing and transition countries. This compares with 17.2 per cent for the United States, 13.9 per cent for Germany, 12.3 per cent for the United Kingdom, 8.8 per cent for Spain, 8.4 per cent for France, 7.4 per cent for Japan and 6.2 per cent for the Netherlands.

The exposure towards the non-OECD Central and Eastern Europe countries amounts to €10.5 billion, of which the bulk is to Croatia and Russia. Italy accounts for 9.1 per cent of outstanding bank loans to the area; it comes after Germany, whose share is four times larger.

Loans and guarantee commitments to Poland, Slovakia, Hungary, Turkey and the Czech Republic — Central and Eastern European countries belonging to the OECD — amount to €25.3 billion.

In recent years, in view of the prospective enlargement of the European Union, Italian banks have acquired control of intermediaries operating in Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. In four of these countries their market share exceeds 10 per cent.

The Italian banking system's claims on the non-OECD countries of Latin America amount to €21.6 billion and consist almost entirely of claims on Brazil, Argentina and Peru. Its outstanding loans represent 6.9 per cent of international lending to the region. Spain accounts for 24.8 per cent of the total exposure, the United States for 23 per cent, Germany for 9.3 per cent and the United Kingdom for 8.1 per cent.

The quality of claims on Argentina has deteriorated rapidly in the wake of the crisis that erupted in the last few months of 2001. That economy's troubles stem principally from the loss of competitiveness caused by the national currency having been anchored to the dollar and the prolonged appreciation of the latter. Introduced in 1991, the currency board initially helped to restore conditions of monetary stability conducive to growth; it was abandoned last January, when the financial crisis had become exceptionally severe.

The Argentine government placed a considerable burden on the banks. To restore utilization of the national currency and reduce the risks of corporate bankruptcies, it ordered bank loans denominated in dollars to be reconverted into

pesos at the previous ratio of one to one, while deposits in US dollars were converted at the rate of 1.4 pesos to the dollar. The issue by the Argentine government of dollar-denominated securities to be assigned to the banks for the losses they incurred has yet to be finalized.

The repercussions on the other countries of South America were initially limited, but at the end of last March the financial markets began to demand increasing risk premiums. The phase of turbulence that ensued mainly involved Uruguay and, subsequently, Brazil, because of the risks of a deterioration in that country's debt situation and political uncertainty.

The spread between Brazilian government securities and US Treasury securities widened from 7 percentage points in March to nearly 25 points at the end of July. At the beginning of September the International Monetary Fund approved loans to Brazil totaling \$30 billion. By mid-September the risk premium had narrowed to around 16 percentage points; recently it has widened again to approach its July level.

The value in euros of Italian banks' exposure to the countries of Latin America fell by a third in the first half of 2002, reflecting the depreciation of the local currencies. Claims on Argentina fell from €8.2 billion to €3.2 billion as the Argentine peso lost around three quarters of its value against the euro. The exposure to Brazil fell by 33 per cent to €9.8 billion and that to Uruguay by a similar amount. By contrast, there was only a limited decline in the exposure to Peru, which amounted to €5.4 billion in June.

Argentina's financial difficulties also affected Italian savers, who, attracted by the high yields, had purchased securities issued by the federal government and local authorities. At the initiative of the Italian Bankers' Association, a good number of banks have agreed to represent their customers and protect their interests in the negotiations with the Argentine authorities on debt restructuring.

The International Monetary Fund is examining the ways to resolve the crisis and the treatment of creditors with the Argentine government.

Under the prudential rules on country risk, in calculating their supervisory capital, banks are required to make standard value adjustments to unsecured assets commensurate with the riskiness of each non-OECD country. This is assessed on the basis of indicators of the country's economic situation, its regularity in debt-servicing and the assessments of the international financial markets.

The Italian banks most heavily exposed to Argentina, Intesa-BCI and Banca Nazionale del Lavoro, have prudently written off their controlling interests in subsidiaries and made further writedowns and provisions against their credit positions. These charges amount to around €1,350 million for Banca Nazionale del Lavoro and €450 million for Intesa-BCI. The latter has also taken an additional charge of €70 million for its Peruvian subsidiaries.

The necessity of having shareholdings in banks in Latin America in order to provide financial assistance to Italian firms engaged in the region needs to be carefully evaluated.

2. The equity markets and asset management

In the second half of the 1990s abundant liquidity in the international markets, the decline in real and nominal interest rates and the rapid growth of the American economy contributed substantially to the exceptional rise in equity prices.

Share prices began to rise in the United States in 1995 and then accelerated in the European markets as well from 1997 onwards. Between 1997 and 1999 they rose by an annual average of 26 per cent in the United States and 35 per cent in the euro area. The increase was greatest for technology, media and telecommunication companies, whose market values rose by an annual average of 52 per cent in the United States and 53 per cent in Europe.

At the beginning of 2000 the price-earnings ratio in both the United States and Europe had risen from values not out of line with the long-term average to historically very high levels. These would have been justifiable only on the basis of improbably high corporate profitability and extremely small risk premiums compared with the levels of the preceding years.

In Italy, the stock market index rose by an annual average of 40 per cent between 1997 and 1999; a contributory factor was the shift in the composition of households' financial wealth.

In the spring of 2000, the slowdown of the world economy and the downward revision of the forecasts of corporate earnings made it quite clear that share prices had reached excessive heights in all the main markets. The correction involved technology, media and telecommunication stocks first and foremost; the sectoral index of such stocks fell by 74 per cent in the United States and 76 per cent in Europe between March 2000 and August of this year. The slide continued in September, with the indexes falling by 15 and 18 per cent, respectively.

The decline in equities since the spring of 2000 has also involved the shares of companies in the traditional sectors, which up to last August had fallen by 39 per cent in the United States and 47 per cent in the euro area. In September they lost an additional 11 and 18 per cent, respectively.

Uncertainty about the strength of the economic recovery and the ability of many large companies to cope with the large debt burdens they had accumulated

has weighed on the performance of the stock markets. Severe cases of corporate distress and irregularities in the preparation of annual accounts have fueled an increase in the equity risk premium. The irregularities initially emerged in a large US energy group, then in other international conglomerates. Conflicts of interest arising from the performance of both asset management advisory services and research on issuers have involved leading institutions operating in the global market.

In the past few weeks the financial markets have been adversely affected by fears of international armed conflict. Yesterday, signs of a possible easing of tensions led to a rebound in the US market.

Up to 1999 the performance of bank shares did not diverge significantly from that of the general indexes.

In Italy, bank shares benefited from positive expectations about the effects of internal reorganizations, the improvement in loan quality and the recovery in profitability connected with the supply of a wider range of services. Italian bank shares rose by 49 per cent per year between 1997 and 1999, which was more than the sector's annual gain of 15 per cent in the United States and 31 per cent in Europe as a whole.

The upward trend continued in 2000, in contrast with that abroad, thanks to the marked improvement in the banking sector's profitability.

Between the beginning of 2001 and September 2002, bank shares fell by 51 per cent in Italy. In the United States they declined by 18 per cent, in Europe as a whole by 40 per cent.

The fluctuations in share prices were particularly large in the case of intermediaries specializing in asset management services. In Italy it is possible to identify a group of five banks, including Bipop-Carire, that accounted for only 2 per cent of the banking system's total assets but for fully 19 per cent of the sector's market capitalization in mid-2000.

The rapid rise in their shares beginning in 1999 brought the price-earnings ratio of these banks to around 70 in mid-2000, compared with 19 for major banks and 17 for the banking sector as a whole.

The market value of these specialized intermediaries contracted very substantially after June 2000. In September 2002 their price-earnings ratio had fallen to 13, while the ratio for the entire sector was 10.

Asset management business has grown more rapidly in Italy than in the other European countries, starting from a lower base. Between the end of 1995 and 2000 the assets managed by investment funds increased sevenfold; according to consolidated data, earnings from asset management services rose from 3 to 30 per cent as a proportion of banks' gross income.

In 2001 the negative performance of the financial markets caused earnings from asset management services to fall to 26 per cent of gross income. The tendency has continued in 2002; in the first eight months of the year, investment funds established by Italian intermediaries recorded net redemptions amounting to €4.4 billion.

The protection of depositors has been constantly ensured in our country by the supervisory action of the Bank of Italy. As in other countries, the value of savings entrusted to the banks is guaranteed by compulsory insurance systems.

In the asset management sector the defence of savers is pursued by means of disclosure requirements, laid down by the supervisory authorities, that aim to make customers fully aware of the risks associated with financial assets exposed to the economic fortunes of issuers and the fluctuations of the market. Intermediaries are required to perform the mandate they receive from customers “to the best of their ability”; the initial value of the sums entrusted to them is not guaranteed.

The supply of investment products that guarantee to protect the capital invested or even to provide a minimum yield is not only subject to specific transparency requirements vis-à-vis customers but also requires adequate systems for managing the risks connected with such transactions and suitable capital cover against adverse market movements. The related risk items must be stated in the accounts and thereby disclosed to the market and investors.

With regard to these forms of investment, investor protection demands that the commitment undertaken by the intermediary appear explicitly in formal contracts. In addition, both the expenses incurred by the investor for the protection of the capital invested or the guarantee of a minimum yield and the criteria by which they are determined must be clearly indicated.

In recent years the regulatory framework of the financial sector has been strengthened so as to promote and guarantee transparency and proper conduct towards savers on the part of intermediaries.

In the case of the issue and placement of bank securities, the Bank of Italy has regulated the content of the detailed information documents that banks are required to draw up under the provisions governing transparency of the terms and conditions of issue. The content is equivalent in scope to those of the prospectuses

that non-banks submit to Consob for listed securities and for the solicitation of investors.

The regulations call for complete information to be provided for issues of so-called structured securities, which combine a derivative contract with a traditional type of debt instrument. In particular, the net yield of the bond component and the value of the derivative component must be indicated.

3. The Bipop-Carire case

a) Growth and specialization

The stock markets' performance and its consequences on the activity of intermediaries specializing in asset management were of decisive importance in the unfolding of the Bipop-Carire affair, which was aggravated by the financial difficulties of several important shareholders and by irregularities in the management of the bank.

The original Banca Popolare di Brescia had launched a policy of rapid growth and diversification of its channels of distribution at the end of 1996, when it purchased 50 branches from Banco di Napoli and acquired the Azimut asset management group. By establishing its first network of financial salesmen and concluding shareholding and marketing agreements with foreign institutional investors, Banca Popolare di Brescia expanded rapidly in asset management services. At the end of 1998 the assets under its management totaled €15.5 billion, three times the value of its deposits and other borrowed funds.

In 1999 the merger of Banca Popolare di Brescia with Cassa di Risparmio di Reggio Emilia S.p.A. and its transformation from a cooperative into a company limited by shares as a preliminary to listing on the main stock exchange constituted the second stage of growth for the Brescia-based group, which was renamed Bipop-Carire. The further expansion of the branch network from 150 to 250 branches was also accompanied by a leap in the scale of traditional operations: deposits and other borrowed funds rose from €5.7 billion to €8.3 billion and customer loans from €6.2 billion to €8.8 billion. The activity of the subsidiary Banca Fineco, which had been focused on personal loans, was strengthened in the field of online trading and other innovative financial services.

The growth of Bipop-Carire was accompanied by a plan for strengthening the bank's capital base. Banca Popolare di Brescia's own funds of €258 million had risen to €1,084 million following the merger with Cassa di Risparmio di Reggio Emilia.

In the two subsequent years the bank's strongly competitive position in the fast-growing markets for asset management, internet banking and online trading services was reflected in a sharp increase in its earnings and share price.

Net profit rose from €147.7 million in 1998 to €257.7 million in 1999 and €336.2 million in 2000.

During 1999 and the first few months of 2000 Bipop-Carire's shares outperformed not only the shares of banks geared to traditional activity but also those of other banks specializing in asset management. During that period the ratio of Bipop-Carire's price to book value rose from 3 to 16, while the average ratio of the other specialized banks rose from 3 to 12; for traditional banks, this indicator remained slightly below 2.

The rise in Bipop-Carire's share price was also encouraged by the particular configuration of the bank's ownership structure: the absence of a core of controlling shareholders made control fully contestable, attracting investors interested in making speculative gains on the stock market.

The principal shareholders held less than one third of the capital. In addition to a foundation and an insurance company, they included some private investors, primarily businessmen. Some of these had used the Bipop-Carire shares they owned as collateral for loans they received from the banking system.

Bipop-Carire also sought to implement strategies to expand its asset management, online trading and consumer banking activities abroad by acquiring banks and financial intermediaries. In June 2001 the group had assets under management amounting to €31 billion, deposits and bond issues totaling €17 billion and loans of €5.5 billion.

The expansion abroad focused primarily on countries in the euro area: France, with the acquisition of control of Harwanne, a small private bank; Germany, with the acquisition of Entrium Direct Bankers AG by means of an exchange of shares; and Spain, with the takeover of the Safei financial group, acquired by reinvesting part of the profits made by Bipop-Carire in 2000.

Given Bipop-Carire's marked operational specialization, its earnings were in fact correlated with the performance of the financial markets. The large fall in equity prices and the concomitant crisis in the asset management and online trading sectors led to a sharp contraction from the first quarter of 2001 onwards in both trading volumes and the contribution of fees to income for the year.

The deterioration in earnings was accentuated by the writing down of the loans made in 2001 to several leading shareholders, who were already indebted to other banks, and by the extraordinary expense arising from yield guarantees on portfolio management accounts that the managing director, acting on his own

initiative, had offered to a small group of customers. The losses in the 2001 financial year amounted to around €500 million; about half of the effects of this loss on the balance sheet were offset by the capital gain on the sale of the Azimut group to a foreign financial company.

The decline in equities, and particularly in technology stocks, also affected the price of Bipop-Carire shares, which fell from a peak of €12.5 in March 2000 to €4.5 in mid-2001. The losses for the year, the emergence of management irregularities and the resulting damage to the bank's reputation then helped to push the share price down further, to around €2 at the start of 2002.

b) The supervisory action of the Bank of Italy

From the very first phase of the Brescia group's growth the Bank of Italy requested an upgrading of its organizational system and internal controls, calling on the parent company's board of directors and board of auditors to make a greater effort in these respects.

We did not authorize territorial expansion plans and the acquisition of shareholdings in markets outside the euro area, particularly in the countries of Eastern Europe, in view of the need to strengthen internal controls and the greater operating risks that the plans entailed.

Bipop-Carire's governing bodies were requested to eliminate the deficiencies that had been found in several operating sectors and to prepare suitable measures to deal effectively with the risks arising from the expansion of the finance area. In the last five years numerous formal steps were taken and meetings held with directors and managers. There were 7 such interventions in 2000 and 15 in 2001. They regarded both the parent company Bipop-Carire and the other banking and financial components of the group.

The company made commitments and initiated projects aimed at organizational improvement. Its actions subsequently turned out to be unsystematic, tardy and often not in accordance with the rules and with the directives it had received.

It was necessary to begin on-site inspections, giving priority to Banca Fineco in view of the operational and legal risks arising from the radical conversion of its organizational model towards innovative activities. At the start of 2001 Banca Fineco had overtaken the leading domestic and foreign banks in terms of the volume and number of transactions carried out over the Internet. The on-site inspections began in May and terminated in August 2001.

In the second quarter of 2001, the further slide in Bipop-Carire' share price, in the context of the general crisis of the equity market, caused the financial position of some of its leading shareholders to deteriorate. The Bank of Italy requested the governing bodies and institutional shareholders to identify solutions likely to give stability to the bank's ownership and corporate governance structures. The directors launched a search for interested investors, in order to facilitate the exit of those intending to sell their shares.

In September 2001 another bank declared that it was willing to join a core group of shareholders, together with the foundation and the insurance company, upon acquiring a share of the capital and entering into a stringent agreement that would give stability and a strategic vision to the governance of the bank. The offer was not accepted by Bipop-Carire's shareholders.

The disagreements among the shareholders, the fruitless protraction of the search for new investors and the decline in the share price, which accelerated in October 2001 when irregularities were found in portfolio management activity, made it necessary to begin an inspection that same month at the parent company Bipop-Carire. In October the directors, the members of the board of auditors and the top managers of the Brescia bank came under judicial investigation.

The inspection was concluded in April 2002 with a sharply negative assessment of the bank's operations motivated by the unsatisfactory situation with regard to: shortcomings in organization and controls; anomalies in the functioning of the governing bodies, which led to conduct inconsistent with criteria of sound and prudent management; and irregularities in the asset management sector such as to provoke losses and to harm the reputation of the Brescia group. On the basis of these findings, sanction procedures were instituted against the members of the governing bodies and top management. The inspection documentation was acquired by the judicial authorities for the matters within their competence.

Despite the losses it suffered in 2001, the bank's capital and reserves were above the regulatory minimum. The difficulties had not had consequences for depositors and the financing of economic activity. It was not necessary for the Interbank Deposit Protection Fund to intervene or for public money to be used in favour of the banks that stepped in.

The inadequacy of the ownership and governance structure and the technical and operational problems that the inspection found were of a severity that ruled out plans to relaunch the bank based on acquisitions of minority stakes. The situation called for the takeover of the Brescia group by a bank that offered guarantees of its ability to devise and realize a corporate reorganization and rationalization plan.

Three banking groups submitted plans for consolidation with Bipop-Carire and financial restructuring aimed at resolving the problems posed by the debt of some leading shareholders.

The governing bodies of Bipop-Carire selected Banca di Roma, which obtained the votes attaching to the shares that the leading private shareholders had deposited as collateral with the banks that had granted credit. The operation received the blessing of the board of directors and the shareholders' meeting, which approved the takeover plan.

The two other groups that had submitted competing offers were of roughly the same size as Bipop-Carire. This would have made the operation more complex and lengthened the time frame for the bank's reorganization. Moreover, they had recently carried out mergers, for which the necessary rationalization of operational structures and internal controls was still under way.

The manner in which the concentration plan is to be executed can increase the synergies between the different organizational units and raise efficiency. The plan has the potential to enhance the value of the function of support for small and medium-sized firms in combination with the propensity for innovative business of the group acquired, as a result of the latter's integration into a major banking group active in all market segments and with a geographical coverage complementary to that of Bipop-Carire.

As regards the antitrust aspect, the investigations conducted by the Bank of Italy and the Antitrust Authority have found that the effects of the concentration are not restrictive of competition.

4. Banking structures in the South

On previous occasions I have dwelt on the reorganization of the southern banking system. The changes that have taken place over the last ten years are very far-reaching, in view of the initially public nature of the ownership of most of the intermediaries, their notable operating inefficiency and the serious cyclical difficulties that have affected the South.

In the recession of 1992-93, the reduction in domestic demand and the interest rate hike that was needed in order to face the currency crisis seriously eroded the profitability of firms. In the South the difficulties were compounded by

the sudden cessation of extraordinary southern development support. They proved overwhelming for an economic fabric made up of small, highly indebted companies operating mainly in construction and catering to domestic markets, which did not benefit from the effects of the devaluation.

The impact of the cyclical difficulties on southern banks was accentuated by inadequacies in their loan selection criteria and by their limited capital bases. We had already formally reprimanded banks' governing bodies for these matters and brought them to the attention of the shareholders.

The widespread difficulties of the southern banking system required an unusually wide-ranging initiative on the part of the Bank of Italy. Supervisory action was aimed at the fundamental requirements of protecting depositors and maintaining financial support for businesses in the South.

In the first half of the 1990s almost the entire southern banking system was subjected to on-site controls. Around 60 per cent of the banks inspected received a very negative evaluation, compared with 15 per cent of the banks inspected in the Centre and North.

Compulsory administrative liquidation involved southern banks to a much greater extent than in the past: 80 per cent of the liquidation procedures begun between 1991 and 1997 were for southern banks, compared with 60 per cent in the period between 1970 and 1990. The ratio of procedures to the number of banks existing at the beginning of the period was six times higher in the South than in the rest of Italy.

The need to maintain the functionality of the banking structures serving customers and to prevent the spread of financial instability made it necessary to utilize public funds.

Since 1990 the measures in support of individual banks decided by the authorities in the form of recapitalization, transfers of shareholdings or advances under the Ministerial Decree of 27 September 1974 have involved public outlays amounting to 0.6 per cent of one year's GDP at current value. This is much less than in the other industrial countries that experienced severe banking crises.

The rehabilitation of the southern banks was also achieved with the contribution of the banking system through the Interbank Deposit Protection Fund and with the intervention of banking groups based in other parts of Italy.

In seeking to remedy situations where stability was precarious, banks were urged to identify potential investors capable of contributing capital and to replace the directors responsible for inefficient operations. The interventions were conditional on the achievement of specific results in reducing labour costs and relating to staff redundancies.

The preventive action and the interventions carried out contained the repercussions of the crisis of southern banks on the national financial system, safeguarding its credibility in the foreign markets.

The control structures of banks accounting for two thirds of the assets of those based in the South were modified. The entry of operators from other parts of Italy helped to reorganize banking networks in the South and to make specialized financing and services available to households and firms. Management criteria and financial techniques adequate to the growing competitiveness of the banking markets were introduced.

The functionality of the structure of banking in the South was preserved and financial support for the region's economy restored. In the period from 1999 to 2001 lending grew at an average annual rate of 7 per cent, double that of the preceding three years; the rate was higher than average for the banks belonging to groups based in the Centre and North.

More careful evaluation of customers' economic characteristics and of the profitability of investment projects led to a better allocation of the flows of credit. The amount of loans granted each year to customers who subsequently became insolvent decreased steadily in relation to the total stock of loans, from values on the order of 6 per cent in the mid-1990s to 1.8 per cent in 2001.

The gap between short-term lending rates in the South and those in the Centre and North has narrowed from 2 percentage points at the end of 1998 to 1.6 points. It is correlated with the greater financial weakness of borrowers and the inefficiency of credit recovery procedures.

a. Banca Carime

Even before the recession of 1992-93 a start had been made on the rehabilitation of Cassa di Risparmio di Calabria e Lucania, which was suffering from poor loan quality, high operating costs and inadequate internal controls. In the early 1990s similar technical and organizational problems caused difficulties at Cassa di Risparmio di Puglia and later at Cassa di Risparmio Salernitana.

Cassa di Risparmio delle Provincie Lombarde had already taken part in a plan to recapitalize Cassa di Risparmio di Calabria e Lucania; subsequently, it acquired control of the three savings banks in difficulty. Once they had entered the Cassa di Risparmio delle Provincie Lombarde group, it became possible to carry out a thorough cleansing of their loan portfolios, with special reference to loan classification and valuation, and reduce their staff costs considerably.

In order to facilitate the rehabilitation project, the three banks were brought together in Banca Carime following the transfer of their bad debts to a group company specialized in the management of substandard loans. The new southern bank was thus born with 325 branches and 8.8 per cent of the total assets of the banks based in the South.

Steps were then taken to reorganize the company's managerial, technical and marketing structures with the aim of achieving profitability and strengthening the bank's ties with its traditional area of operations.

The improvement in Banca Carime's technical situation allowed the Intesa group, of which Cassa di Risparmio delle Provincie Lombarde had become part in the meantime, to put it up for sale; in the first half of 2001 it was acquired by Banca Popolare Commercio e Industria.

b. Banco di Sicilia and Sicilcassa

The serious difficulties that emerged at Banco di Sicilia in 1993 were tackled by replacing the governing bodies, adopting rigorous criteria for operations and drawing up balanced strategies for the reorganization and development of the bank with a view to increasing its efficiency.

The crisis at Sicilcassa, which in 1996 had led to its being placed under special administration, required, instead, compulsory administrative liquidation and the intervention of the Interbank Deposit Guarantee Fund, supplemented, on the basis of a resolution adopted by the Credit Committee on 5 September 1997, by the measures provided for in the Ministerial Decree of 27 September 1974.

In 1997 Banco di Sicilia, whose rehabilitation was under way, acquired most of the assets and liabilities of Sicilcassa; the liquidation of the remaining items is pending. This operation was made possible by an increase in Banco di Sicilia's capital that was taken up entirely by Mediocredito Centrale. At the same time a plan was prepared for the continuation of the work aimed at building the business and raising the efficiency of the new entity.

At the end of 1999, as a consequence of Banca di Roma's acquisition of the entire share capital of Mediocredito Centrale, Banco di Sicilia became part of the group headed by the Roman bank, which began to integrate the subsidiary's

organizational and marketing structures with those of the group. The action to restore the bank's profitability by significantly reducing staff costs and curbing other operating costs was continued. Banco di Sicilia's credit business was also reorganized, especially as regards loan classification and valuation and the effectiveness of loan recovery activities.

Recently, the holding company absorbed Banco di Sicilia and then spun it off to act as a commercial bank, as part of an overall reorganization of the group. Renewed in this way, Banco di Sicilia enjoys full operational autonomy and maintains its original name. It is well placed to exploit its local knowledge and consolidate the results achieved, to the advantage of the regional economy.

c. Banco di Napoli and Isveimer

The integration of Banco di Napoli into the Sanpaolo IMI group was judged by the supervisory authority as potentially capable of bringing efficiency gains and promote objectives for the rationalization of the entire banking system, especially in view of the complementarity of the two banks' branch networks.

In June 2000 Sanpaolo IMI obtained control of Banco di Napoli by acquiring its entire ordinary share capital. The Turin-based bank's purchase came at the end of the rehabilitation of the Neapolitan bank.

Banco di Napoli had taken part in the financing of major Italian industrial groups, which were severely affected by the recession. In addition, as the leading bank in the South of Italy, it had naturally acted to provide support for the southern economy, which was hit especially hard by the economic downturn.

The bank, which had acquired the legal form of a company limited by shares at the end of 1991 under the law on the reform of public-sector banks, had been slow in adapting its operational procedures to the demands of an increasingly competitive market.

The need to prevent a serious impact on the South's economy, avoid systemic risks, preserve the economic value consisting of the large volume of deposits and the extensive branch network required special legislation to be approved for the rescue of Banco di Napoli. This was carried out under Law 588 of 19 November 1996, which provided for the Treasury to supply the funds for its recapitalization.

For the first time public intervention was made subject to the bank's governing bodies adopting a restructuring plan that was to be approved by the Bank of Italy and had to provide for a reduction in staff costs. The law stated that recourse was to be made to the measures envisaged in the Ministerial Decree of 27 September 1974 for the losses deriving from the disposal of the bank's substandard loans to a newly-constituted collection company called Società per la gestione di attività (SGA) and for the steps taken in favour of group companies placed in liquidation.

Banco di Napoli's structures have been renewed, the directors have been replaced, ownership has been transferred, the decision-makers involved in the crisis have been punished. The factors that gave rise to the crisis — the poor quality of the bank's loan portfolio, its high costs and the low efficiency of its operations — can be considered as having been corrected. Banco di Napoli's unit labour costs are now in line with the national average for the banking sector.

The rescue plan for Banco di Napoli included the liquidation of Isveimer, which was approved by the bank's shareholders in April 1996 in view of the company's structural crisis and the fact that it did not have any economic or market prospects.

The liquidation can be considered as basically completed. The company's assets have been realized, its liabilities have been settled, and the many legal disputes are on their way to being settled.

Within the group it now belongs to, Banco di Napoli is still committed to supporting the southern economy. The wealth of information it built up over the years will need to be put to good use. In parallel with the necessary restructuring of the group's organization, the range of products and services available to customers will have to be broadened to meet the needs of households and firms.

The banks local roots and longstanding relationships with a vast array of customers are resources that can have positive effects on its profitability.

The contribution of Sanpaolo IMI is decisive, especially in view of its considerable experience in fields of asset management and innovative financial services, which are less developed in the South than in the rest of the country.

The holding company is responsible for defining the organizational models and rationalization measures serving to improve Banco di Napoli's efficiency and make good use of its corporate resources.

Recent experience has shown that organizational solutions exist that can combine the advantages of operational integration within banking groups with policies for developing, in part by maintaining subsidiaries' original names, a propulsive role in local economies.

In view of the size and importance of the Neapolitan bank in Italy's southern regions, the organizational choices made will have an influence on the whole economy of the South.

5. Conclusions

Over the last ten years the Italian banking system has achieved a major transformation, on a scale comparable with that of the 1930s. Our banks have

become larger and more profitable, and built up strong capital bases. Competition has intensified; the contestability of control has increased.

Concentrations have created banks that can compete with their main European counterparts; six Italian banks are among the top thirty in the euro area in terms of market value. Medium-sized groups have emerged that broaden the supply of financial products in the domestic market; smaller banks with strong local roots have increased the support given to productive activities.

International opening, the development of asset management services, and new channels of customer communications provide banks with opportunities for growth. At the same time they make their management more complicated, especially when financial markets are affected by instability. Banks must develop techniques and procedures that will permit the effective management of the new types of risks, devote more care to the quality of customer relations, and increase their ability to analyze the performance of productive sectors and securities markets.

The systematic supervision of individual banks has made it possible to identify critical situations and make an early start on overcoming them. In the management of the crises of the southern banks, the spread of instability to other parts of the banking system was prevented, the rights of depositors were protected and the orderly functioning of markets and the payment system was preserved. The conditions were created for the revival of financial support for the South's economy.

In the Bipop-Carire case, at a time of financial market turbulence, separating the destiny of the bank from that of its owners avoided the dispersion of the bank's resources. The solution chosen by the shareholders helped to make for stable governance of the company and to lay the foundations for the recovery of its operations. Depositors did not suffer any losses.

Supervisory authorities must be close to the banks they control, so as to acquire detailed knowledge not only of the latter's operating methods and organizational arrangements but also of the economic features of the areas in which they do business.

Technological and financial innovation and the globalization of markets can hinder the identification of crises, accelerate the spread of their effects to other intermediaries and make their management more difficult.

The direct, timely and detailed information that is obtained by operating on securities and foreign exchange markets and exercising surveillance over the payment system increase the effectiveness of supervisory controls.

In the present context the supervision of individual intermediaries and of the financial system as a whole plays a more important role than in the past. It is increasingly based on the complementarity between the evaluation of individual banks' soundness and the analysis of the factors of vulnerability inherent in developments at the macroeconomic level and in financial markets.

The confidence of investors in the financial system must be safeguarded, especially in periods of market turbulence. It is essential that the behaviour of banks, whose role in the financial system depends above all on their reputations, be based on correct and transparent dealings with their clients.

The effects of the fall in share prices on Italian banks' balance sheets are alleviated by prudential rules that limit their acquisitions of shareholdings and the concentration of risks. Banks' combined holdings of property and equity interests may not exceed their own funds; the equity interest owned in a single non-financial company may not exceed 15 per cent of the investee company's share capital. Other restrictions apply to banks' total shareholdings in relation to their own funds.

These supervisory rules, together with the prohibition on industrial and commercial firms from holding large interests in banks' capital, complete the regulatory framework serving to ensure the separation between banking and industry.

A sound and efficient banking system is essential in order to attenuate the repercussions of the instability of financial markets on economic activity, encourage saving and the financing of investment, and foster the growth of the economy in line with its potential.