

## SUMMARY OF THE REPORT

The report is divided into six chapters: the first five cover the performance of the functions entrusted to the Bank of Italy as part of the European System of Central Banks and by Italian law; the sixth describes the Bank's activity in the fields of economic research, international cooperation and statistics.

In view of the novelty of the document, particular attention is paid to how the Bank exercises its powers, although the focus is on the results of the action taken in 2005 and the early months of this year.

The appendix contains information on the organizational arrangements of the Bank. Considerable attention is paid to the reform of the bylaws, which was approved by the Board of Directors in its meeting on 27 July 2006 and incorporates the innovations introduced by Law 262/2005.

The Bank of Italy contributes to monetary policy decisions through the Governor's participation in the Governing Council of the European Central Bank. Representatives of the Bank contribute to the activity of the committees of the European System of Central Banks in which the experience and knowledge spread through the System are distilled to be submitted to the Governing Council for it to assess and decide on. As regards the implementation of monetary policy, the Bank of Italy carries out open-market transactions with the banks present in Italy and ensures compliance with the rules on compulsory reserves. In the first six months of 2006 the Bank took part in the action launched by the Eurosystem aimed at gradually absorbing liquidity.

The Bank of Italy manages the central infrastructure of the payment system, such as BI-Rel, devoted to the settlement of large transactions, and BI-COMP, devoted to the clearing of retail payments. The Eurosystem has entrusted the Bank of Italy, together with the central banks of France and Germany, with the construction of the TARGET2 unified European payment system, which is scheduled to come into operation in November 2007. In 2005 the volumes handled by BI-Rel and BI-COMP exceeded €43,300 billion, an increase of 17.7 per cent on 2004.

As regards monetary circulation, the Bank has been assigned the production of 1,182.4 million euro banknotes, compared with 574.7 million in 2005. Last year also saw the Bank put 2.1 billion banknotes into circulation and withdraw 1.9 billion. The growth in the counterfeiting of banknotes has been matched by an increase in countermeasures, especially through training courses for the police and governmental workers.

The central bank manages payment services and accounting for the Treasury. In 2005 the Treasury received €2,480,844 million of inpayments and made €2,482,210 million of outpayments; at 31 December the balance on the account earning interest at market rates held by the Treasury with the Bank of Italy amounted to €14,405 million, compared with €15,771 million twelve months earlier. The minimum end-month balance allowed on the account has been reduced to €10 billion with effect from 2006. Improvements have been made in the quality of services provided to users

and in the promptness of financial reporting to governmental bodies thanks to changes in the law and the shift to electronic transactions with the implementation of the computer-based general government payment system.

At the beginning of 2006 the General Government Transactions Information System (Siope) came into operation. The aim of the system is to provide the Ministry for the Economy and Finance with detailed and homogeneous information on the receipts and outlays of general government bodies. Lastly, a project has been launched in collaboration with the Ministry for the Economy and Finance to improve the predictability and reduce the variability of the Treasury's liquidity account.

The Bank of Italy carries out the placement and buyback of public securities and acts as agent bank for loans denominated in foreign currency issued on international markets. In the first six months of 2006 placements of domestic securities amounted to €247.1 billion, compared with €236.7 billion in the first half of 2005; net issues amounted to €66.4 billion.

In managing the country's official reserves, both directly and through the Italian Foreign Exchange Office (UIC), the Bank of Italy aims to maintain high levels of liquidity and security and, as a subordinate goal, to maximize the expected return. At the end of June 2006 the total value of the official reserves was €61.2 billion.

The management of the Bank of Italy's financial portfolio, comprising investments of both own funds and the staff severance pay and pension provisions, is directed towards covering the Bank's costs and safeguarding the solidity of its balance sheet. The market value of the financial portfolio at the end of June 2006 was €81.5 billion; 90 per cent was invested in Italian and other euro-area government securities; the remainder was invested in shares, other than banking shares, and money market instruments.

The solidity of the Bank's balance sheet enhances its ability to undertake the tasks connected with the occurrence of financial crises. In order to assess the soundness of the Italian financial system, stress test exercises have been carried out in collaboration with the IMF; the results have confirmed the ability of the system to withstand even very unfavourable changes in the macroeconomic framework.

In order to pursue the objective of ensuring intermediaries' sound and prudent management, the supervision of banking and financial intermediaries uses structures at the Bank's Head Office and at its branches. Subject intermediaries' situations are assessed by analyzing data and documents and inspection reports. Ad hoc measures are taken when critical problems are found. The intermediaries subject to supervision are banks, investment firms, asset management companies and non-bank credit intermediaries, many of which are brought together in 85 credit groups, to which specific forms of consolidated supervision apply.

The activity of banking and financial regulation is carried out both by participating in international committees that contribute to the preparation of EU legislation and the convergence of supervisory practices and by drawing up supervisory instructions for intermediaries. Two of the most important Bank of Italy initiatives in 2005 were the coordination of banking legislation with the new company law and the reform of the rules on collective asset management. In order to simplify the law and with a view to promoting regulatory convergence in Europe, constraints on intermediaries' activities not based on Community provisions or international agreements have recently been eliminated.

The activities connected with the new rules on bank capital promoted by the Basel Committee are under way both in Italy and at international level. On the basis of the recent EU directives, the entry into force will be in 2007 and 2008 depending on the methods chosen by each intermediary for calculating capital requirements and validated by the supervisory authority. The Bank of Italy is preparing the necessary instructions and verifying banks' internal systems for the determination of their requirements.

With a view to the application of the new international accounting standards to banks' annual accounts, between the end of 2005 and April 2006, the Bank of Italy issued the new administrative rules on financial statements, which supplement Community law in this field. It also published the formats for the financial statements of non-bank intermediaries subject to supervision and altered the instructions for the compilation of the reports on regulatory capital and prudential ratios.

Analysis of the financial situation of banks and other intermediaries shows a pronounced improvement: the banks that received unfavourable assessments in 2005 accounted for 9 per cent of the system's total volume of business, compared with 21 per cent in 1995.

Inspections are either comprehensive or focused on particular aspects of intermediaries' organization and operations. In 2005 there were 159 comprehensive inspections on banks and 10 on investment firms and asset management companies; they confirmed that the cause of difficulties lay principally in growth strategies that were inconsistent with intermediaries' organizational arrangements or their internal control systems and in shortcomings in the activity of the governing bodies in situations marked by an excessive concentration of power.

Supervisory action was taken against intermediaries in 2005 and in the first quarter of 2006. Last year exchanges of letters and summonses involved 372 banks. A total of 477 meetings were held with corporate officers, of which half at Bank of Italy branches. A total of 513 measures were adopted against other intermediaries. They were in relation to the intermediaries' policies and procedures for assuming, measuring and managing risks; in a significant number of reprimands stress was placed on the need for intermediaries to define their strategies more clearly and prepare reorganization plans.

Various initiatives were undertaken for the coordination of the controls on banking groups operating in several countries on the basis of guidelines issued by the Basel Committee and the Committee of European Banking Supervisors; notable in this respect are the initiatives undertaken on the occasion of Unicredito italiano's acquisition of the German bank HVB.

The Report describes several transactions involving banks' capital and a detailed account of those that saw leading European banks take control of Banca Antoniana Popolare Veneta and Banca Nazionale del Lavoro.

The Bank of Italy verifies compliance with the law on the transparency of banking business and imposes sanctions when violations are found. It also checks the characteristics of bond issues and collaborates with the judicial authorities and governmental bodies.

The Report gives an account of the activity in 2005 of the Bank of Italy as the competition authority in the credit sector, pursuant to Law 287/1990. These functions were subsequently transferred to the Antitrust Authority by Law 262/2005. In addition to describing the investigations undertaken during the year, the Report contains the preliminary results of the fact-finding enquiry launched in December 2004 into the costs and procedures for terminating the main banking and financial services. It was found that the cost of closing a current account was €34 on average, that

75 per cent of the time it was less than or equal to €50 and that 30 per cent of the time there was no charge.

The Report also describes the results obtained by the policy aimed at increasing competition in the markets for bank loans and deposits and the criteria upon which the Bank of Italy based its decisions in the performance of its antitrust functions.

In order to prevent systemic risks and ensure the proper working of the payment system, the Bank of Italy performs market supervision and payment system surveillance. In these activities it collaborates with other Italian authorities and foreign authorities and is present in the various fora devoted to international cooperation in this field.

The aim of market supervision is to verify the efficiency and orderly operation of: the wholesale government securities market; the market for interbank deposits; the clearing, settlement and guarantee systems for securities; and central securities depositories. In 2006 guidelines were issued in collaboration with Consob on the outsourcing of major components of such infrastructure. Examinations were also made of amendments to the operating rules of post-trading systems and to the bylaws of MTS, in order to send an opinion to the Ministry for the Economy and Finance. In addition, business expansion plans were examined to verify their consistency with organizational arrangements and risk management systems. Lastly, steps were taken to prevent the repetition of episodes of malfunctioning of operational procedures. The process of upgrading operational continuity plans and the disaster recovery tests the companies made, partly in response to the indications received from the International Monetary Fund, were satisfactory. Attention was paid to the measures imposed on the companies by the law on the recycling of the proceeds of illegal transactions. There were 22 supervisory interventions in 2005 in connection with anomalies found and 14 in the first half of this year.

In order to promote the reliability and efficiency of payment systems, in the first place the Bank of Italy carries out surveillance on the systems it runs directly and verifies their reliability using criteria defined by the ECB. The examination conducted in 2005 showed that the system had handled the growing volume of transactions adequately and smoothly; problem episodes were rare and did not have major consequences. In part through action to coordinate domestic operators and the issue of new rules for Italy, the Bank is working on the launch of the plan for the creation of a single area for retail euro payments (SEPA).

Various initiatives have been undertaken to promote the use of more innovative means of payment. Among the projects at European level it is worth mentioning: the introduction of rules for credit transfers that are consistent with those being formulated in Europe for cross-border transactions of this type; the evaluation of the efficiency and reliability of the circuit for the transfer of electronic money; and the implementation of a payment card anti-fraud scheme, which refers to work coordinated by the Ministry of the Economy's means-of-payment Central Anti-Fraud Office.

Lastly, the Bank of Italy is actively engaged in economic research and the compilation of statistics and collaborates closely on scientific matters with international organisms and foreign authorities.

The economic updates and research produced by the Economic Research Department serve to improve the effectiveness of the Bank's performance of its functions, first and foremost those connected with the formulation and implementation of the Eurosystem's single monetary policy.

The Report lists the issues that were the subject of the analyses carried out in 2005 and launched this year. More specifically, it highlights the initiatives aimed at developing methodological instruments of cyclical analysis and evaluating the causes of the Italian economy's slow growth.

Analyses are also conducted into legal and historical subjects of economic interest that contribute to improving our understanding of the links between the structure of the economy, the factors rooted in the legal order, and the conduct of economic operators. In 2005 special attention was paid to issues bearing on corporate governance and the slowness of bankruptcy proceedings.

The activity of collecting, processing and disseminating statistics provides support for the performance of the Bank's functions and those of the ESCB; it allows financial operators and scholars to improve their knowledge of the economy and the financial system. Various improvements were made in 2005 and the early months of 2006 to supervisory reports and to the surveys carried out by the Central Credit Register; the system for collecting data on cross-border transactions was also revised. In addition, the Bank of Italy participated in Eurosystem statistical initiatives.

Lastly, the Bank collaborates with various international financial organizations and has projects under way promoted by European institutions. Many initiatives concern assistance in the fields of supervision, collection of statistics and the payment system; special attention is devoted to the training of employees of central banks and supervisory authorities of emerging and transition countries. The 64 initiatives undertaken in 2005 concerned 40 countries; cooperation projects were carried out with the central banks of the Russian Federation, Romania, Bulgaria and Egypt.

The appendix contains a description of the Bank's organization, the criteria and procedures used in the planning, acquisition and employment of its resources, the accounting system and the main movements in the profit and loss account in recent years.

It also contains the proposed reform of the Bank's bylaws approved by the Board of Directors on 27 July 2006.

The revision of the bylaws incorporates the innovations introduced into the Bank's legal framework by Law 262/2005. It is the most far-reaching reform since that of 1936, the basic structure of which remained unchanged despite the various interventions that were made between 1948 and 1998.

The new text is awaiting the opinion of the European Central Bank. It will then be submitted to the extraordinary shareholders' meeting for approval and then transmitted to the Government for ultimate approval in a Presidential Decree pursuant to Article 10.2 of Legislative Decree 43/1998.

Among the main innovations introduced, it is worth noting the introduction of the principle of collegial decision-making with the assignment to the Directorate of authority to adopt measures of external significance regarding the Bank's institutional activities. In line with the collegial nature of the Directorate, the number of Deputy Directors General has been raised from two to three, in order to raise the total number of members to five.

Again as required by Law 262/2005, the Board of Directors is expressly charged with general administration, management supervision and internal control of the Bank, in part through the provision made for information flows.

Other important changes concern the implementation of the principle of the independence of the Bank and the members of its governing bodies, the introduction of a term of office for all the

members of the Directorate, and the revision of the rules on the procedure for the appointment and removal of the Governor.

The detailed provisions on the Bank's territorial organization have been eliminated and its regulation entrusted entirely to the Board of Directors. Limits have also been set for the duration in office of the members of the Board of Directors (three terms for a total of fifteen years) and the members of the Board of Auditors (four terms for a total of twelve years).

A transitional provision has been added to regulate the ending of the term of office of the members of the Directorate, other than the Governor, who were in office when Law 262/2005 entered into force.