

SUMMARY

The Bank of Italy's Report to Parliament and the Government describes the activity it performed in carrying out its functions and administrative duties.

The Bank of Italy contributes to decisions taken by the Eurosystem 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 participates in the implementation of monetary policy in the euro area by carrying out open market operations with banks present in Italy. From August 2007 onwards the money market has been affected by an acute crisis that has increased banks' need for funding. The Bank of Italy has contributed in the relevant Eurosystem fora to the examination of markets' situation and the planning of interventions. There were increases in both the number and the types of transactions decided by the ECB and carried out by the Bank of Italy and the other NCBs to regulate the liquidity of the banking system: in 2007 there were 92 open market operations, as against 75 in 2006. As of 2007, on the basis of decisions taken by the Eurosystem, the Bank of Italy also accepts bank loans as collateral for its refinancing operations. At the end of the year Italian counterparts had used 1,073 loans as collateral for a total of €16.3 billion.

The Bank of Italy manages the basic infrastructure of the payment system. November 2007 saw the start in the wholesale payment segment of the new Trans-European Automated Real-Time Gross Settlement Express Transfer System (TARGET2). The system, based on a single shared platform (SSP), was built and is run jointly by the Bank of France, the Deutsche Bundesbank and the Bank of Italy on behalf of the Eurosystem. Compared with the original TARGET system, TARGET2 guarantees greater efficiency, complete equality among the users from the various European banking communities, innovative ways of managing liquidity and a high level of business continuity. The migration to TARGET2 by the individual national communities took

place gradually in three stages. On 19 May 2008 the migration of the last group of countries, including Italy, was completed successfully. During 2007 the BI-Comp system was brought into line with the requirements established for retail infrastructure in the single euro payment area (SEPA). During the year the number of transactions handled by the system increased by 2.3 per cent to 1,992 million.

As regards monetary circulation, the Bank of Italy participates, within the Eurosystem, in the preparations for the second euro series, scheduled to be issued in the coming years, and contributes to the formulation of common guidelines to ensure the quality of the circulation and fight counterfeiting in collaboration with the police. In 2007 the Bank of Italy produced a total of 1,047 million €20, €50 and €100 banknotes.

The Bank of Italy runs the state and provincial payment and accounting services for the Treasury. In 2007 further progress was made in automating the services and strengthening the General Government Payments Information System (SIOPE). The creation of the electronic Treasury service is already at an advanced stage: in 2007 electronic payments of taxes and social security contributions amounted to €465 billion and more than 50 million payment orders were issued, corresponding to about 13 per cent of the national total. Public payments thus play a key role in the migration to SEPA.

On behalf of the Ministry for the Economy and Finance the Bank of Italy carries out the transactions for the placement and redemption of government securities, as well as those for the servicing of the debt. In 2007 the Bank placed government securities amounting to €415 billion (€393.3 billion in 2006), of which €410 billion were domestic instruments. The Bank also cooperates with the Ministry by providing assistance in defining the policy for the issue of securities to cover the borrowing requirement. In April 2007 the Bank began to carry out transactions on the money market on behalf of the Ministry for the Economy and Finance. The aim of the transactions was to optimize the management of the Treasury's liquidity and to make it easier to forecast the daily balances of the Treasury payments account.

The Italian legal system gives the Bank of Italy ownership of the country's official reserves. As of 3 December 2007 the part of the foreign reserves entrusted to the Italian Foreign Exchange Office (UIC) was joined with that managed by the Bank of Italy, in preparation for the Bank's absorption of the UIC as of 1 January 2008. At 31 December

2007 the official reserves managed by the Bank of Italy amounted to €68.4 billion, an increase of 9 per cent on the end of 2006. The strategic choices with regard to the market, credit and liquidity risks associated with the national foreign reserves are incorporated in benchmark portfolios that represent the reference point for investment activity. The Bank also manages a part of the foreign reserves of the ECB.

The financial portfolio consists of the investments of the Bank's own funds and those of the staff severance pay and pension provisions. The Bank is also responsible for the investment of the supplementary pension fund for staff hired since 28 April 1993. At 31 December 2007 the financial portfolio amounted to €91 billion. Some 90 per cent of the listed portfolio – which amounted to about €88.5 billion – is invested in bonds (above all Italian government securities and securities issued by other euro-area countries) and the remainder in equity instruments, excluding bank shares.

The Bank of Italy performs supervisory tasks established by law on an extensive range of intermediaries. In the investment services and asset management sector the powers of control are divided between the Bank of Italy and Consob. The Bank is responsible for supervising intermediaries' risk containment, capital adequacy and sound and prudent management; Consob is entrusted with ensuring the transparency and correctness of their conduct.

The Bank also promotes the correctness of intermediaries' conduct, both by supervising the application of the rules on the transparency of contractual conditions for deposits, loans and payment instruments and by answering complaints received from users of banking and financial services and by combining their examination with its ordinary supervisory activity aimed at safeguarding intermediaries' sound and prudent management.

At the end of 2007 the entities subject to Bank of Italy supervision comprised: 806 banks, 107 investment firms, 214 asset management companies and SICAVs, 480 financial companies entered in the special register referred to in Article 107 of the Consolidated Law on Banking, 3 electronic money institutions (EMIs) entered in the register referred to in Article 114-*bis* of the Consolidated Law on Banking, the Bancoposta division of Poste Italiane S.p.A. and Cassa Depositi e Prestiti S.p.A.

As regards regulatory activity, at international level there has been a pursuit of greater uniformity in the rules governing intermediaries and more pronounced convergence of supervisory practices, in part through forms of closer coordination and cooperation among authorities. In 2007 and the first part of 2008 the Bank of Italy continued to participate in the international cooperation committees intended to maintain financial stability and develop the convergence of supervisory rules and practices (the Financial Stability Forum and the Basel Committee). The Financial Stability Forum, currently chaired by the Governor of the Bank of Italy, has tackled the issues inherent in the turbulence of the financial markets and in April 2008 published a report on the factors underlying the phenomenon and the policies to follow in order to enhance the resilience of markets and intermediaries. The report was approved by the G7 Finance Ministers and Central Bank Governors, who indicated the schedule for its implementation. In view of the financial crisis, in 2007 the Basel Committee on Banking Supervision launched new regulatory initiatives aimed at strengthening the prudential rules on banks' capital and attributing special attention to the correct representation of certain on and off-balance-sheet items.

Following the adoption of Legislative Decree 164/2007, which introduced the amendments to the Consolidated Law on Finance required to transpose the Markets in Financial Instruments Directive (MiFID) and the related implementing measures as regards organizational requirements and operating conditions for intermediaries, the Bank adopted the measures for which it was responsible and thus completed the framework of the implementing provisions of the directive. In March of this year the Bank of Italy also issued supervisory regulations aimed at strengthening banks' organizational and governance arrangements. The rules concern the most important aspects of corporate governance, such as the tasks and powers of the governing bodies, and their composition, remuneration mechanisms and information systems. Intermediaries are required to identify the solutions most consistent with their characteristics and give the reasons for their choices in a corporate governance report.

As part of its supervision on banks and banking groups, in 2007 the Bank of Italy issued 14 authorizations to engage in banking activity and examined 28 plans for changes in ownership structure. In addition the Bank almost completed its Supervisory Review and Evaluation Process (SREP), the aim of which is to provide a judgment on intermediaries' present and prospective situations and trigger the consequent supervisory

action. In September 2007, in relation to the crisis of the US subprime mortgage market, the Bank of Italy called the attention of banks and asset management companies active in the hedge fund sector to the question of exposure to assets linked to loans of that type and called for a complete self-assessment of the risks associated with asset-backed securities (ABSs), collateralized debt obligations (CDOs) and exposures to vehicles and hedge funds. At the same time the control on banks' liquidity was enhanced.

In 2007 a total of 141 inspections were carried out at banks, compared with 165 in 2006; on average they lasted 49 days. In the first quarter of 2008 another 52 inspections were started. The reduction in the total number of inspections was offset by the increase in the number carried out at intermediaries that were either larger or riskier. During the year a total of 843 supervisory interventions were made, in the form of warning letters and meetings with corporate officers, involving 452 banks or 56 per cent of the supervised intermediaries. The measures mainly concerned the management of the various types of risk to which intermediaries are exposed, organizational arrangements and internal control.

Turning to the supervision of asset management companies and investment firms, the procedures concerned with access to the market of intermediaries and products numbered 475, compared with 567 in 2006. In more detail, the Bank examined 371 applications for the approval of investment funds' management rules, compared with 374 in 2006; in 177 cases the applications referred to the establishment and in 194 cases to the amendment of the rules of harmonized funds and non-harmonized funds (mostly real-estate and hedge funds). There was a substantial increase in applications involving real-estate funds, to more than 50 per cent of the total. The number of inspections rose from 10 in 2006 to 17 in 2007, of which 6 at investment firms and 11 at asset management companies.

As for financial companies entered in the special register, in 2007 the Bank of Italy carried out 141 supervisory interventions, involving 89 intermediaries. Of the total, 71 interventions consisted of meetings with corporate officers. The Bank also inspected 15 financial companies entered in the special register referred to in Article 17 of the Consolidated Law on Banking, compared with 13 in 2006. The interventions involved intermediaries of various sizes operating mainly in the consumer credit and factoring sectors.

In 2007 one extraordinary administration procedure was initiated and two were closed. No compulsory administrative liquidations were initiated.

During the year the Committee for the Examination of Irregularities, the technical body of the Bank of Italy responsible for the last fact-finding stage of sanction procedures, examined 92 procedures involving officers of banking and financial intermediaries and submitted 66 proposals for the application of fines to the Bank's Directorate. The Directorate imposed fines in 71 cases, of which 10 were in relation to procedures concluded in 2006. Most of the measures concerned violations of the supervisory provisions laid down under the Consolidated Law on Banking to protect intermediaries' sound and prudent management.

Attention to relations between intermediaries and customers has become one of the main strands of the Bank of Italy's model of supervision. Efforts are currently being focused on the revision of the legislation governing the transparency of contractual conditions, in order to simplify the rules, enhance the comparability of offers, ensure the characteristics of services can be fully known, and make better use of self-regulation. The monitoring of transparency has been conducted through checks carried out by the branches of the Bank of Italy at intermediaries' branch networks, checks carried out during ordinary inspections, and the examination, as part of prudential supervision, of the information sheets of 136 financial intermediaries entered in the special register. In 2007 users of banking and financial services sent 4,821 complaints to the Bank of Italy. In view of their greater complexity, in October new procedures were introduced requiring the Bank to provide a personalized response to complainants, indicating, where possible, references of a legislative or technical nature to facilitate comprehension. The Bank also invited intermediaries to provide adequate and prompt responses to their customers and to inform the Bank of Italy accordingly.

The Bank of Italy carries out supervision on the financial markets and oversees the payment system, to which ends it cooperates with other Italian and foreign authorities and participates in international fora.

The transposition into Italian law of the Markets in Financial Instruments Directive brought far-reaching changes to the regulation of the markets. The amendments to the Consolidated Law on Finance are intended to foster greater competition in the sector. At

the same time the aims of Bank of Italy and Consob supervision on central depository and clearing, guarantee and settlement systems have been clarified and the supervisory powers with respect to their management companies have been enhanced. The Bank's control over the wholesale government securities and interbank deposit markets and post-trading services has been marked by a high level of analysis and intervention, owing in part to the turmoil affecting money and financial markets. In 2007 special attention was paid to organizational aspects of the Borsa Italiana Group companies subject to supervision that are involved in the ongoing integration with the London Stock Exchange.

In 2007 the Bank of Italy's oversight of the payment system continued in the three main directions shared with the Eurosystem: *a)* completion of monetary integration; *b)* maintenance of financial stability and *c)* promotion of innovation. Various initiatives were undertaken. The Bank promoted the Single Euro Payments Area (SEPA) project, participating in the specification of the Eurosystem's approach, and played a coordinating role among the various interested categories in the consultation fora set up in Italy. In view of their importance as the most direct substitute for paper instruments, a reference framework has been defined within the Eurosystem for the oversight of the models adopted for payment cards. Although declining, use of bank and postal cheques remains at a high level in Italy; specific initiatives are under way to improve the interbank cheque circuit, in order to reduce the time before amounts transferred become available. Renewed attention has been paid to systemic operational risks, whose effects on the Italian financial scene are being tackled by a special entity headed by the Bank of Italy and Consob.

During the year further progress was made in the analysis and assessment of the most important companies providing services for the improvement of payments, with the aim of ensuring their reliability and efficiency. The Bank of Italy participates in cooperative oversight, at European and international level, on infrastructures and payment systems of systemic importance that operate in more than one jurisdiction, with special reference to SWIFT and the Continuous Linked Settlement system. In the area of large-value payments, oversight continued of the BI-REL gross settlement system, which showed a high level of reliability and security, even during the period of market turbulence. When TARGET2 was launched, the Bank of Italy contributed within the Eurosystem to the assessment of the technical and functional design of the new system, to verify its conformity with the requirements of efficiency, reliability and security.

The research and analysis carried out by the Bank of Italy contribute to the formulation of euro-area monetary policy and to other institutional functions that the Bank performs. This activity comprises the preparation of documentary information for the public, the dissemination of research and the production of statistics. No less intensive are the Bank's relations with foreign and international bodies and entities, to fuel the debate on the leading economic and financial problems in the world today and increase the comparability of data and statistics referring to Italy and other countries.

In 2007 the economic research and international relations functions were the subject of a radical organizational restructuring. They are now divided into four main fields of activity: the contribution to the formulation of euro-area monetary policy, with analyses of important monetary and financial phenomena, the analysis of cyclical developments and forecasts; the study of the problems of the Italian economy, including from a comparative and historical prospective, in terms of their different structural, real and financial aspects and as regards their implications for the public finances, public policies and regulatory arrangements; the study of the evolution of the global economy and of the interactions between its main areas and cooperation with international institutions in the Bank's fields of interest; and the improvement of statistical and economic methodologies and the dissemination of economic and financial statistics.

In support of the Bank's policy, the Economic Research and International Relations Area produces forecasts and descriptions of the various real and financial aspects of the current performance of the national economy, the euro area and the international economy, together with studies on specific questions concerning economic policy and the functioning of the economic system. These studies also serve as the basis for the drafting of official documents such as the *Annual Report* and the *Economic Bulletin*. The research work mainly focused on: the implications of bank loan securitizations for the supply of credit and the manner of communicating monetary policy decisions; the economic and financial structure, with special reference to the changes in the Italian productive structure, the gap between the Centre and North of the country and the South and Islands, and the liberalization of local public services; the international economy, with analyses of the various aspects of globalization; and economic history and statistical analysis. Work of a methodological nature is also worth noting, such as the creation of the €coin indicator, which provides a monthly estimate of the cyclical position of the euro-area economy and the development of dynamic general equilibrium models at the frontier of

econometric research in this field. The activity of the Economic Research and International Relations Area also ties in with the analysis of the regional economies carried out by the regional economic research nuclei; a specific project in this field concerned local credit markets. The main series for the dissemination of Bank of Italy research is that known as *Temi di discussione (Working papers)*, which has been supplemented since 2006 by that known as *Questioni di economia e finanza (Occasional papers)*. The Bank also publishes a series known as *Quaderni di storia economica (formerly Quaderni dell'Ufficio ricerche storiche)*.

In order to give greater strategic importance to the Bank's statistical function, the management of this activity has been enhanced by providing for the Chairman of the Statistics Committee to be a member of the Directorate. Outside the Bank new statistical commitments have arisen from the issue of a guideline and a regulation by the European Central Bank and by the start of the new provisions governing the prudential supervision of banks, banking groups, non-bank financial companies and investment firms. Some developments in the reference framework encouraged the Bank to undertake a comprehensive reform of banks' statistical supervisory reports, aimed at curbing the reporting costs incurred by intermediaries. As for the service provided by the Central Credit Register, a start has been made on a project to increase the information concerning smaller loans and Consob has been granted access to the register. The survey data obtained on household wealth in 2006 were published in *Supplements to the Statistical Bulletin: Household Surveys*, no. 7, 28 January 2008. In 2007 and the early months of 2008 work continued on the revision of the system for collecting data on Italy's balance of payments and external financial position; maximum attention was paid to the need to keep the costs incurred by reporting firms to a minimum and to avoid the duplication of information.

The Bank of Italy participates in the work of the international community on economic and financial issues, contributing in the various fora and at the various levels in which international cooperation is organized. In 2007 the Bank's foreign network, made up of delegations and financial attachés, continued to follow the development of real and financial conditions in their respective geographical areas, including by means of studies on specific subjects; the network also maintained relations with national and international entities and authorities, monetary institutions, banks and financial institutions, and provided assistance and technical advice.

Progress continued in the reform of the Bank's organization, which is involving all of its structural components —the Head Office, branches and representative offices abroad.

Far-reaching measures have been carried out at the Head Office. The profound changes in the banking and financial markets, in the legislative and regulatory framework and in the operational approaches adopted in supervisory activity have led to the reorganization of the Supervision Function, which will become operational on 1 August 2008. The reorganization is aimed at improving supervision's ability to watch over the system in the face of new risks, ensuring more effective ways to protect savings in connection among other things with the growing complexity of financial products, enhancing the effectiveness of controls while reducing the burden on intermediaries, strengthening cross-border cooperation and the coordination of supervisory action, and rationalizing internal management. In May of this year the reorganization of the Central Banking and Markets Area and the Payment System and Treasury Services Area was approved, resulting in the creation of a single functional area in view of the close integration of the functions in question and the growing need for internal and international coordination. The reform is intended to concentrate all financial investment operations in a single functional area, enable integrated management of financial risks from a position independent with respect to the units involved in operational activities, place monetary policy and special financing activities within a single department, and integrate the activities of payment system oversight and money and financial market supervision. Other measures concerned the reorganization of the Property Function, according to a model designed above all to safeguard the interdependence of the different phases of technical management and improve the coordination of interventions, and the rationalization of the State treasury service carried out in Rome, to improve the quality of the services provided to users.

As a consequence of the incorporation of the Italian Foreign Exchange Office (UIC) into the Bank of Italy at the end of 2007 pursuant to Legislative Decree 231/2007, the Bank acquired the competences and powers of the UIC, with the related human, technical and financial resources. This has affected several areas of activity. The decree also envisaged the creation of the Financial Intelligence Unit (FIU) for Italy at the Bank, with duties of preventing and combating money laundering and the financing of international terrorism, and provided for its autonomy and independence. The Bank has

adopted an internal regulation governing the organization and functioning of the FIU and entrusted its management to a manager appointed by the Bank's Directorate acting on a proposal from the Governor. Decree 231/2007 also strengthened the Bank's anti-money-laundering role by giving it regulatory duties and powers of control and sanction in respect of persons subject to supervision. The Bank also assumed management of the registers and lists of financial intermediaries entered in the general register, financial agents, loan brokers and gold dealers. The powers involved in carrying out controls on these persons are less extensive than those envisaged for banks and financial intermediaries referred to in Article 107 of the Consolidated Law on Banking, being largely circumscribed to verification that the requirements for access to the market are met. In full continuity, the Bank also took over the statistical tasks previously carried out by the UIC. These concern the gathering of the data and the compilation of the statistics on Italy's balance of payments and international investment position and the performance of the activities, instrumental to the production of those statistics, of National Numbering Agency for financial instruments and manager of the database of foreign financial instruments dealt in by resident intermediaries. Lastly, the UIC's budget balances were consolidated into the Bank's accounts as of 1 January 2008.

In September 2007 the Bank's General Council approved the new organizational architecture of the branch network. The new model, which was the subject of ample and prolonged discussion with the trade unions, prefigures a different presence of the Bank on the territory. It envisages a reduction in the number of branches and differentiates the functions and roles of those that remain open according to the characteristics of the geographical area and the demand of institutional and private users for services. The model envisages: 20 branches located in the regional capitals, which will perform the full range of tasks assigned to the network; 6 branches with a wide range of operations, which will handle all tasks except those of economic analysis and statistical survey; 6 branches specialized in handling cash; 25 branches specialized in providing services to users; one branch specialized in the State treasury service; and the closure of 39 branches (in 6 provinces there will remain units specialized in supervision, under the branches located in the respective regional capitals). In January the plan for implementing the project was prepared. The programme of branch closures will be concluded by the end of 2009 in three stages. A wide-ranging revision of the Bank's presence abroad is also under way, with the closure of some representative offices and the secondment of Bank staff to a number of embassies and consular offices as financial attachés.

At 31 December 2007 the Bank's staff numbered 7,400, down by 148 compared with a year earlier. Implementation of the reorganization plan will modify the number and distribution of personnel. When fully phased in, it is expected to result in a further reduction in staff and a redistribution of personnel to the benefit of the functions having institutional importance. In a context marked by increased specialization in the various fields of activity, a major effort went to supporting the professional development of personnel.

The Internal Auditing Function has worked to improve the quality of performance and risk management on the part of the various components of the Bank, including through discussions with its counterparts in the other Eurosystem central banks. The increasing attention paid to environmental issues has spurred the Bank to strengthen the measures aimed at reducing its environmental footprint.

In the course of 2007 the Bank completed numerous projects involving software applications, services for internal users, computers and telecommunication networks, data storage and exploitation of the data in the Bank's possession, and security safeguards. The Bank coordinated the infrastructural aspects of the TARGET2 shared platform. Since the start of 2007 the electronic procedure enabling Italian banks to deliver bank loans as collateral for loans disbursed with monetary policy operations has come on-stream and the accounting procedure has been brought into line with the criteria of the economic approach, which prescribes daily entry of accrued income and expense in respect of financial instruments denominated in foreign currency. Regarding the Public Key Infrastructure, the procedure was completed for the Bank's accreditation as a certification authority with the National Centre for IT in General Government.

The organizational reform of the Head Office and reconfiguration of the branch network involve significant property management measures. In addition, steps continued to be taken to streamline the procurement of goods and services, including by means of the electronic market, with benefits in terms of efficiency and speed.

The Bank of Italy's accounting system consists of structures located at the Head Office and in the branch network. The accounting procedure is integrated with the procedures that manage the various segments of the Bank's operations. Accounting activities are completed at the end of the day so as to satisfy the obligation to transmit a daily statement of accounts to the ECB by 8 a.m. of the following day. Accounting

control is assigned to the Board of Auditors; the accounts of the Bank of Italy are checked by external auditors in accordance with Article 27 of the Statute of the ESCB. In drawing up its annual accounts the Bank is required to comply with special rules and, for matters not governed by these, with the Civil Code provisions. The special rules consist mainly in the harmonized Eurosystem rules approved by the Governing Council of the ECB and published in specific guidelines.

The Bank has a cost accounting system that permits costs to be accounted for both by individual organizational units and by functions and activities performed. The system, which adopts the principles and criteria defined in the Eurosystem harmonized methodology of cost analysis, will satisfy manifold informational demands and is used as the basis of reference for pricing the services that the Bank provides for a fee.

For legal services and legal research, the Bank uses its own lawyers, entered in the special list attached to the professional roll. The tasks assigned to them include the handling of legal disputes under civil and administrative law. In the field of advisory activity, opinions are provided to the different departments of the Bank or in ad hoc working groups on problems of a general nature or on the adoption of acts, including normative acts, or measures. Assistance is provided to the competent departments in identifying cases constituting administrative violations, for the bringing of sanction procedures falling within the scope of the Bank's authority, and grounds for the presumption of crimes, for subsequent reports to the judicial authorities. The Bank's legal research focuses on matters most directly connected with its institutional activities. Especially important was the activity performed following the suppression of the UIC and the Bank's succession to the UIC's functions and positions in legal disputes, and on the occasion of the setting up of the FIU at the Bank.