Notes on Firms, Banks and Company Law

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Corporate governance, a combination of law and economics, is in fashion. The combination is useful in view of the synergy it can create between the two subjects, not because it is based on a new or in some way better company law or theory of the firm.[1]

From the methodological point of view the literature on corporate governance is confirmation that law and economics are tending to draw closer once more. A tendency, it is worth stressing, that is positive and potentially fruitful. For Italian scholars it represents a return to the interdisciplinarity of which they had carried the baton, before giving it up to others in a late imitation of extreme specialization that needs to be reversed today.

As regards the substance of the matter:

a) the modern firm (in which control is separate from ownership) is seen as having two fundamental values, both of which deserve to be protected: autonomy (A) of the control exercised by directors (entrepreneurs) and scrutiny (S) of the exercise of that control by, or at any rate in the interests of, owners and creditors (financers);

b) the existing institutions of company law, and numerous other conceivable ones, are analyzed and catalogued according to whether they protect one or other of the two values, enterprise or financing, A or S;

c) no general criteria are found by means of which to establish whether A or S is more valuable in any given case, and in par-

□ Banca d'Italia, Rome (Italy).

[1] For a helpful examination of the literature, see: A. Shleifer and R.W. Sishny, "A survey of corporate governance", Harvard University, September 1995, mimeo; F. Barca, "Le politiche del governo societario", in A. Ninni and F. Silva a cura di, *Le politiche industriali*, Laterza, Roma-Bari, 1996; and Associazione D. Preite, "Rapporto sulla società aperta. La proposta di una società aperta per la riforma del governo societario in Italia", 1996, mimeo.

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ticular whether they are incompatible. Economic theory, for instance, is unable to say whether more A and less S makes an economy more growth- and stability-oriented and *vice versa*;

d) reliance is therefore placed on empirical case-by-case analysis or on the value judgements of the individual lawmaker when deciding which of the two values is more deserving of protection in a given context (economic system/legal order).

1. Economic aspects

This last decision cannot be avoided even where both interests are actually protected in a sub-optimal manner under the existing legal order. There is thus necessarily a conflict: a legal institution cannot simultaneously protect two conflicting interests, except by giving greater legal certainty to the holders of *both* interests. There are no short cuts, not even a 'weighted average' (with what weights, besides?) of the various legal institutions reflecting the preference each accords to one or the other value.

It would therefore be dangerous to copy the solutions adopted elsewhere. They are the expression of the economic and legal histories of countries that are very different, with none of which Italy can be compared except by carrying out the very assessment, making the very decision, that imitating the solutions of others was intended to avoid.

Nor is there a general, universally valid, answer based on economic theory to the question whether one or the other value is more deserving of protection. Walras, starting from the assumption of maximizing agents, would probably not have admitted the question. Schumpeter would have defended his entrepreneur who, as such, "is never the risk bearer",[2] but who must be able to decide freely in order to innovate. Keynes would probably also have defended the autonomy of his entrepreneur, condemned to operate in conditions of insuperable, non-Bernouillian, uncertainty, driven by "animal spirits", the source of "unconscious mental action".

[2] J.A. Schumpeter, *The Theory of Capitalist Development*, Oxford University Press, Oxford, 1961, p. 137.

The problem therefore has to be set in a given real context. Its nature is that of an empirical-inductive, or historical, problem. However, even when tackled in this way, it is difficult to solve except by making conscious and explicit value judgements.

Deciding whether, at a specific moment in time, an economy has a greater need for A or S faces two difficulties:

– attributing the weaknesses of the economy to A or to S and believing that they can be remedied with A or S;

– overcoming, even in the specific case, the problem of the trade-off between giving preference to A and giving preference to S.

If the investment of firms is low, it is hard to establish how much this is due to a lack of A. If investment in firms is low, it is hard to establish how much this is due to a lack of S. If both problems are present, it is hard to tell which should be solved first, taking account of the probability of succeeding and the time needed to do so, by acting on A or S.

Nor can recourse be made to highly synthetic judgements based on history, economic or otherwise. It is probably true that in recent decades the Italian economy has shown lively entrepreneurship coupled with a reluctance to accept controls. On the other hand, it is also probably true that despite the progress made this entrepreneurship has had to operate in an environment marked by "rejection of the market as an institution able to orient productive activity".[3] While the first of these features suggests a need for more S, the second points to a need for more A.

I shall therefore attempt to draw a first empirical picture of the Italian economy. Considered over the long term and compared with those of more advanced countries, the Italian economy is marked by high operating margins in relation to value added and a rapid rise in labour productivity, especially in manufacturing industry. But those are gross margins and need to be related above all to the investment effected, while the rise in productivity probably reflects the closing of the gap that existed owing to the late development of modern industry. In reality, ROI, ROE and the real return on shares are relatively low and point to the difficulty encountered by Italian firms

[3] G. Carli, *Cinquant'anni di vita italiana*, Laterza, Roma-Bari, 1993, p. 14.

in matching the profitability of foreign firms.[4] Above all, this difficulty is confirmed by the *variability* of these indicators (which, besides, are less exposed to doubts as to their statistical comparability than the corresponding levels). Self-financing (not gross operating margin), ROI, ROE, the real return on shares, the rise in productivity and in all probability the mark-up on normal unit costs show wider fluctuations than in other countries. ROI and ROE, moreover, are much more widely dispersed across sectors with differences on the order of 10 percentage points, with smaller enterprises generally performing better than large ones. The picture, or at any rate the impression, of a structurally volatile economy with highly variable corporate operating results tallies with the greater frequency and entity of the revisions of investment plans.

The directors of Italian firms thus appear to be more exposed to risk, especially the risk that the management of the business and their choices will be unjustly condemned by financers, by the capital market, if companies' results are assessed in terms of the low points and not of the trend or average or maximum values.

Control – the defence of control – thus becomes a reaction, a conditioned reflex: a more important objective even than growth of the firm itself. It is thus possible to explain – in terms of objective data on the economy, rather than by invoking a special propensity, almost an anthropological trait, of Italian entrepreneurs – why only 10 per cent of manufacturing firms' capital is held by persons other than the controllers (or by persons linked to them under voting agreements or by family ties), why only 20 per cent of these firms' capital is listed on the stock exchange, why the ownership of only 2 out of a 100 industrial firms with more than 50 employees changes hands per year (the bylaws of nearly 50 per cent of Italian companies have clauses restricting the transfer of control), and why there are only 7 Italian companies among the top 500 in the world.

At this point it is necessary to consider the legal system applying to firms. A recent study[5] has confirmed what was intuitively obvious: that different legal traditions lead to differences in the legal protection of investors, the quality of law enforcement and corporate governance. The comparison is between countries with legal systems

[4] A recent work on large enterprises shows that Italian firms' return on investment is significantly lower. See B.B. Yurtoglu, "Rates of return on corporate investment: an international comparison", University of Siena, 1996, mimeo.

[5] R. La Porta *et al.*, "Law and finance", Harvard University, 1996, mimeo.

based on common law and civil law and, among the latter, between those that refer respectively to the French and German civil codes and those of the Scandinavian countries. The authors classify 49 countries and in their comparison of investor protection mainly consider the provisions of company and bankruptcy law. They find major differences between the common law countries, which offer shareholders and creditors the most protection, and those – including Italy – with legal systems based on the French civil code, which offer the least. The quality of law enforcement in the latter countries is also less satisfactory, and their accounting standards have a lower rating. On the other hand, ownership is generally more concentrated in these countries.

Let us now suppose that the facts set out above are true and, as Einaudi used to say, not stupid, and that the interpretation I have proposed is correct, with the causal link running from the instability of the economy to the defence of directors' control. Supposing, furthermore, that the Italian legal system, independently of its distant origins, reflects the traits of the economy described above, sanctions and helps to perpetuate them. Under this hypothesis, it would be rationalistic, illusory, and above all dangerous, to seek to overcome or attenuate them by amending the law. The risk is not only of failing but also of producing counterproductive effects, or at the least considerable confusion.

The opposite hypothesis is that the law itself has produced these traits of the economy, with the causal link running from positive law to the behaviour of entrepreneurs marked by a low propensity to open their companies to the contributions of others, list them on the stock exchange, give priority to growth or put their control at risk. This interpretation cannot, of course, explain the instability of the real economy with which Italian firms are faced. It suggests that a legal policy oriented towards common law criteria would be considerably more effective. It would nonetheless have to overcome strong resistance by those with vested interests in the present system.

A third hypothesis is to assume that a common law approach is preferable in itself, on the basis of value judgements that ignore how it would work in the economy or the compatibility of the new legal institutions with the economy as it actually is. It could be argued, for instance, that the common law approach is, or will become, prevalent at the international level, so that adopting it would be desirable and failing to do so costly for the whole economy. The Leopardian *buon*

tuono of Italian customs would be aligned in this field, for the sake of advantage and *de iure condendo*, with that of other nations.[6]

These brief considerations prompt an invitation to proceed with caution, not to opt for conservative inaction. Prudence is especially necessary where A or S are to be modified by amending today's company law. The uncertainty does not so much concern the link between the instrument (amendments) and the intermediate objective (more or less A or S) as the actual choice of the intermediate and final objectives, which, if pursued through changes in the legal system, are alternatives; it also concerns the link between the intermediate objective and the final objective (the particular aspect of the performance or *modus operandi* of the economy to be improved).

Prudence is needed in view of the damage that ill-considered changes in the legal system could produce in such a delicate sector. It would be especially serious if the error consisted in excessively restraining the freedom of entrepreneurs and hence the spirit of enterprise: "Without development there is no profit, without profit no development. For the capitalist system it must be added further that without profit there would be no accumulation of wealth".[7]

But there is another solution: that offered by competition and the market, both in the structures of the economy and in the prevailing culture. In Italy we must, and can, go much further along this road, which appears distinctly promising, with high marginal benefits. This solution is free from the trade-off that afflicts the legal solution. Competition stimulates both A and S. Together with the market culture, it implies strengthening S without curbing A (shareholders, and especially minority shareholders, must know that when they acquire their interests they run a risk and cannot expect to manage the firm directly with the aim of limiting it). Recourse to the legal system to protect competition and the market – "for a competition law in Italy"[8] – not only does not involve any trade-off but is also necessary: what is required is *regulated* competitive markets, that is markets ensuring competition and governed by rules.

Another important point is that competition, in addition to stimulating and controlling firms from the outside, can also exert

[6] G. Leopardi, *Discorso sopra lo stato presente dei costumi degl'Italiani*, Feltrinelli, Milano, 1991.

[7] J.A. Schumpeter, *op. cit.*, p. 154.

[8] See the proceedings of the meeting organized by the Bank of Italy on this theme, published in the Bank's *Quaderni per la ricerca giuridica.*

valuable pressure from the inside if the enterprise is organized appropriately. There are two basic ways in which a company or a group can be organized. That which has generally prevailed to date is based on the principle of internal planning, coordination and hierarchical command. It is assumed – in line with traditional neoclassical economic theory – that the aim of minimizing costs permeates companies from the boardroom to the factory floor. This assumption is not borne out by the facts, however. The drive to minimize costs is variable, a function of numerous factors. Competition is the most general and powerful stimulus/constraint encouraging those within the firm to improve efficiency. Inside the firm[9] an organization based on competitive collision – with a synthesis at the highest level rather than collusion planned by top management – can promote this end. It can reconcile the operational and entrepreneurial autonomy of management with the need for scrutiny and above all the pursuit of profit that interest shareholders and creditors.

Before embarking on complex reforms or, worse, on piecemeal adjustments of today's company law, it is worth evaluating how much progress can be made, and how fast, along the road of competition and the market, of the culture and rules of the competitive market. This would also avoid the risk of creating yet another alibi for all those who fear and continue to obstruct competition: that of 'work in progress' at the very heart of commercial law, company law.

At all events, the search for better guarantees for shareholders and creditors must avoid two major risks, respect two limits. The bodies and institutions for the scrutiny of firms must be placed downstream from the directors' legitimate decision-making, the verification cannot be *ex ante.* Entrepreneurship in a firm is one and indivisible. The relationship between those who verify and those whose action is verified must be dialectic, it must not degenerate into a permanent conflict that would paralyze the firm or destabilize its decision-making.

[9] H. Leibenstein, *Inside the Firm. The Inefficiencies of Hierarchy*, Harvard University Press, Cambridge, 1987. However, see also some other penetrating but strangely neglected contributions by the same author: "Allocative efficiency vs. X-efficiency", *American Economic Review*, no. 3, 1966, pp. 392-415; *Beyond Economic Man. A New Foundation for Microeconomics*, Harvard University Press, Cambridge, 1976; *General X-Efficiency Theory and Economic Development*, Oxford University Press, Oxford, 1978.

2. Legal aspects

The Italian Parliament – evidently on the basis of value judgements – has recently expressed its intention of strengthening the legal arrangements for verifying the performance of the directors of companies that raise funds from the public. Article 21, paragraph 4, of Law 52 of 6 February 1996 (known as the Community Law for 1994) states that "when the provisions concerning intermediaries, financial and securities markets and other related matters are revised, changes may also be made in the rules on companies issuing securities in regulated markets, notably as regards the board of auditors, the rights of minorities, voting trusts and intragroup relationships, with a view to enhancing the protection of savings and minority shareholders".

Although the law states that the aim is to improve the protection of financiers (savings) and minority interests and identifies the fields in which changes are to be made, it does not specify how the new equilibria within the firm are to be achieved.

Apart from this cautionary note, it is necessary to have a clear understanding of the law in force today, in terms of the underlying approach, the institutions and the main provisions concerning A and S. The key elements are *i)* the management of companies, *ii)* shareholders' self-protection and *iii)* the protection of shareholders by third parties.

i) The management of a company is entrusted by law to the board of directors, which is given broad overall powers: "The directors who are the legal representatives of the company may adopt all the measures provided for in its instrument of incorporation" (Article 2384 of the Civil Code). Directors are also required to "fulfill the duties established by law and the instrument of incorporation with the diligence of agents" (Article 2392 of the Civil Code). The reference to the principal/agent relationship is important for the assessment of the decision-making autonomy of the board of directors in management matters. The prevailing view is that the powers of directors are of an exclusive nature, so that interference by the general meeting of shareholders is not admitted. Resolutions adopted by the general meeting are not binding on the directors. The latter are not released from their civil and penal liabilities because an operation has been approved by the general meeting. Neither the

general meeting nor individual shareholders are liable in any way. The autonomy of the board of directors with respect to the general meeting is clearly established.

The relationship between the board of directors and the bodies with delegated powers – managing directors and executive committees – is a different matter. It concerns the internal structure of the governing body, the actual exercise of directors' powers. There is little to be gained by criticizing the organization of Italian companies on the basis of specific episodes, such as cases of negligence on the part of members of the governing body, instead of analyzing structural shortcomings in the system of corporate governance.

The general meeting has the power to remove directors "at any time" (Article 2383 of the Civil Code). This power applies both to directors appointed by the general meeting and to those appointed initially in the instrument of incorporation. Directors may not be removed without good cause. Where directors are removed without good cause they may sue the company for damages. Court decisions have established that good cause exists where directors have acted against the law or the bylaws, or in a manner that undermines the relationship of trust on the basis of which the mandate was conferred. Court decisions based on this principle have ruled out good cause where the resolutions of the general meeting are of a generic nature or fail to state the reason for the removal and where a director has disagreed with specific aspects of the management of the company. By contrast, they have found good cause in cases of censurable behaviour concerning the trust relationship, such as failure to prepare the annual accounts.

ii) While the law clearly spells out and protects the autonomy and responsibility of the director-entrepreneur, it also provides instruments for the protection of shareholders. The reference here is, of course, to civil law remedies and not to cases of criminal behaviour, with respect to which Italian law is quite severe.

A company is a contract, a contract entered into with the common aim of "jointly exercising an economic activity [...] for the purpose of sharing the profits" (Article 2247 of the Civil Code). Profit is thus inherent in the notion of company adopted by the drafters of the law in 1942. Article 2247 is the linchpin of the system. From it we can deduce the socio-economic function (the cause) of the contractual agreement, the basic criterion for interpreting and applying the law.

The interest of the company – profit – and that of the shareholders – profit – necessarily coincide when reference is made to the ultimate purpose inherent in the cause of the contract. It is this purpose that must be considered when applying the provisions that govern the actions of directors in relation to a company.

Nonetheless, the fact that the corporate contract gives rise to an *ad hoc* organization has sometimes led to companies being seen in institutional rather than contractual terms. This is revealed by the notion of the "interest of the company" referred to in Articles 2373 and 2441 of the Civil Code (on conflicts of interest in votes on resolutions in the general meeting and on pre-emptive rights to newly-issued shares and convertible bonds). In the Fifties the Court of Cassation interpreted the interest of the company as that of the company itself, superior to and separate from that of the shareholders, and potentially in conflict with that of the shareholders as a body. This view was based on an extreme interpretation of the principle of legal personality conferred on companies by law. Separate and autonomous legal persons with respect to the shareholders, they appeared to be endowed with a subjective otherness, to possess a patrimony of their own and hence to have an interest of their own.

Subsequently, however, the conception rooted in the contractual nature of the instrument of incorporation came to prevail. It was argued that the notion of the interest of the company should be traced back to the voluntary communion of interests that links the individual shareholders and led to the contract establishing the company. The corporate nature of the interest pursued needs to be assessed in the same way as the cause of the corporate contract, as can be deduced from Article 2247 of the Civil Code. A recent judgment of the Court of Cassation[10] has confirmed the adoption of this approach, making it clear that the creation of a company does not involve the creation of an entity different from the physical persons in question, but only the application of a particular set of rules designed to regulate the relations between such persons. The opinion stressed the contractual nature of the instrument of incorporation drawn up by the founding members and referred to the cause of the corporate contract and the aims for which it was drawn up for the purpose of assessing the legitimacy of resolutions adopted by the general meeting, defined as "real *acts of performance*", because they are designed to achieve the best implementation of the corporate contract.

[10] Sentenza della Corte di Cassazione, 26 October 1995, no. 11151 (written by Marziale), in *Giurisprudenza commerciale*, 1996, II, p. 329.

Under this approach, the conflict between directors and shareholders cannot concern the aim pursued but only the manner in which it is pursued and the related time horizon.

Sometimes the position defended by the law is that of the single shareholder. This emerges from the provisions that grant a power of reaction, that is of control. Articles 2377-2378 of the Civil Code authorize anyone who possesses even just one share to challenge resolutions that are contrary to the law or the instrument of incorporation. Article 2395 defines the right of individual shareholders to be compensated for damage caused by the fraud or negligence of directors. Article 2422 recognizes individual shareholders' right to examine the register of shareholders and that of the meetings and resolutions of the general meeting. Article 2408 authorizes individual members to lodge a complaint concerning facts deemed to be censurable with the board of auditors, which must take account of the complaint in its report to the general meeting.

Elsewhere the law considers the interests of a group of shareholders rather than those of individual shareholders, or better, it requires remedies to be invoked by a qualified minority of shareholders. This occurs primarily in matters concerning the control of the activity of directors so as to prevent the holder of just one share from abusing the protection provided merely to cause a disturbance. Accordingly, while the first paragraph of Article 2408 simply requires the board of auditors to take account of the complaint of an individual shareholder in its report, the second paragraph lays down that the board must immediately act (and if necessary convene the general meeting) where the complaint is lodged by shareholders representing at least one twentieth of the capital. Equally, Article 2409 empowers shareholders representing one tenth of the capital to report serious irregularities to the competent tribunal. Shareholders representing at least one fifth of the capital may require the directors to convene the general meeting without delay (Article 2367). Shareholders may bring an action for liability against the directors where they fail to fulfill the duties imposed upon them by law and the instrument of incorporation (Articles 2392-2393).

iii) In addition to the controls on the activity of directors based on the self-protection of shareholders, both individually and jointly as representing a given percentage of the capital, there are those the law attributes to the board of auditors.

Companies are required to have a board of auditors, except for private limited companies *(società a responsibilità limitata)*, which must make special provision for such a board in their instrument of incorporation. The need for auditors to have appropriate professional qualifications prompted the requirement, introduced in 1992, that they be entered in the register of auditors kept by the Ministry of justice and to include removal or suspension from the register as cause for disqualification from the office of auditor.

The board of auditors must not pass judgement on the appropriateness or advantageousness of the decisions of the directors, who are solely responsible for managing the company. Its principal tasks fall into two categories:

a) administrative controls: the board of auditors "shall control the management of the company, verify compliance with the law and the instrument of incorporation" (Article 2403 of the Civil Code);

b) accounting controls: the board shall "verify the regular keeping of the company's accounts, the conformity of the annual accounts with the accounting records, and compliance with the rules laid down in Article 2426 for the valuation of the company's assets" (Article 2403 of the Civil Code).

In companies whose shares are listed on the stock exchange, the activity of the board of auditors is supplemented by that of independent auditors entered in a special register kept by Consob. Pursuant to Article 1 of Presidential Decree 136 of 31 March 1975, the independent auditors "verify the regular keeping of the company's accounts, the conformity of the annual accounts with the accounting records, and compliance with the rules laid down in Article 2426 for the valuation of the company's assets". The independent auditors certify the annual accounts of companies (as well as the consolidated accounts) with a declaration as to their regularity. Legal scholarship generally attributes independent auditors and the board of auditors with joint authority in these matters, recognizing the different functions of external and internal controls: the former are intended to ensure that the accounts provide a clear, accurate and independent picture of the company's situation at a specific moment in time; the latter to contribute to the assessment of management performance by providing a historical perspective through the diligent and continuous monitoring of the board of auditors.

It has been argued that the body of rules described above are inadequate, especially for larger firms, and that the conflict between autonomy and S is sharper within firms that issue securities in official markets or are listed on the stock exchange. According to this view, the corporate contract has degenerated in Italy, majority voting is distorted by the dichotomy between entrepreneurial shareholders and investors, and voting syndicates keep control in the hands of organized, stable minorities. The main effect of this underlying distortion, which is not found in Anglo-Saxon systems, is to debase the role of the market. It is necessary to carefully define the rights of all the parties to the corporate contract in order to restore a balance between 'controlling minorities' and 'minority majorities' and give certainty to the property rights of both by strengthening the rules disciplining the corporate contract.

The tools provided in the Civil Code for regulating corporate relations are also seen as having proved inadequate to protect shareholders, especially minority shareholders, against the power of the directors. The board of directors is the direct expression of the majority shareholder; it is the instrument of the latter's policy for the company. The controlling interest is often concentrated in only a few hands.

It is no solution, however, to allow the majority to appoint the entire board of directors in order to maximize the effectiveness of management; to separate accounting controls, entrusted exclusively to an independent auditor, from management controls and to entrust the latter to a supervisory board elected using a form of proportional representation in order to ensure the presence of directors representing minority shareholders. This would deprive the board of directors of the contribution of representatives of interests that, while different from those of the majority shareholder, are nonetheless 'company' interests, thus eliminating any form of dialogue within the board. The risk of permanent conflict would be greater owing to the strengthening of the position of minority interests on the supervisory board. The German model of a dual administrative structure composed of a management body and a supervisory body reflects the participation of employees in the management of firms. Italy differs from Germany in that the legal form of the public limited company *(società per azioni)* is often adopted by small businesses. These and other considerations have blocked the Community's proposed fifth directive based on the German model, which has remained at the draft stage.

Other proposals also appear questionable. The indiscriminate lowering of limits on the exercise of powers, such as reporting suspected irregularities to the courts pursuant to Article 2409 of the Civil Code and the attribution to minorities of the right to bring an action for liability against the directors, would bring with it the danger of interested or nuisance actions. The reversal of the burden of proof to facilitate actions of liability is plausible in cases of obvious violation of the law; in other circumstances, it would result in directors, when the proof requested became little more than a *probatio diabolica*, having a sort of objective liability for the poor performance of the business, for 'having been unlucky', with the benefit of hindsight.

A reallocation of powers within the corporate democracy delineated by the Civil Code[11] obviously risks hampering the "legal person" (which is and remains a *fictio iuris*) in the pursuit of profit, which is the purpose clearly attributed to companies by Article 2247.

Before achieving a definitive solution of one sort or another based on a careful analysis of the economic interests worthy of protection (bearing in mind the impact of Community law), it is necessary to decide whether the problems regarding Italian company law depend on the absence or inadequacy of today's rules or rather on a failure to implement them.

The average duration of a civil trial in Italy is estimated at 2,927 days (Pretura 616, Tribunale 1261, Corte d'Appello 1050).[12] And the situation is not improving. Such delays have serious effects on civil society and, in the narrower realm of company law, have prompted a flight from the courts. Justice delayed is equivalent to justice denied. The most important litigation has moved to arbitration; the protection of 'outsider' shareholders who wish to challenge company decisions is inadequate. This is clearly demonstrated by the lack of court decisions: legal journals are hard put to find company law decisions to comment or annotate.

If we add the backwardness of markets and competition in Italy to the pathological state of civil justice, any assessment of the effectiveness of today's laws in safeguarding the various interests associated with companies must wait. Not just these rules, but any rules, will be less than effective as long as courts, markets and competition are lacking.

[11] G. Minervini, "Un progetto di riforma della società per azioni", in *Società, associazioni, gruppi organizzati*, E.S.I., Napoli, 1973, p. 479.

[12] F. Zucconi Galli Fonseca, "Relazione sull'amministrazione della giustizia nell'anno 1995", in *Documenti giustizia*, 1996, Table 6, p. 230.

3. Banks and corporate governance

In a theory of how to govern the behaviour of directors with the aim of also protecting financial backers, banks play a role as *i)* shareholders, *ii)* creditors and *iii)* participants in the financial market; moreover, *iv)* in a competitive environment the directors of banks must themselves answer to vigilant owners for their results.

i) Like other shareholders, banks combine the control inherent in the option to exit the company with that exercised through their right to vote, with representation on the board of directors and through agreements with other shareholders. The larger the banks' shareholdings in firms, the greater their incentive to play this role effectively.

Italian banks' scope for participation in the capital of non-financial companies was broadened in 1993. One aim of the change was to strengthen the stock market: Bank of Italy regulations require that at least half a bank's equity investments be in listed shares. Only in exceptional cases can shareholdings be acquired through debt-equity swaps with firms in temporary difficulty.

The size of the shareholdings that can be acquired is limited by rules designed to avoid tying up banks' assets. The overall limit on shareholdings and real estate investments prevent the transformation of customer savings into equity capital. The need for banks acquiring shareholdings to be able to assess the related risks has led to the possibility of investing up to 100 per cent of own funds in industrial companies being restricted to banks with proven experience and fund-raising that is mainly medium and long term.

Under the rules in force today banks can invest up to a total of 55 trillion lire in industrial shares. This is a high level in relation to both the capitalization of the Italian stock market and the volume of trading. Banks' equity investments have increased from 2.4 to 6.6 trillion lire since 1993. They remain on a modest scale, despite the

improvement in corporate profitability and the increased recourse to capital increases.

The size of their equity investments is not, however, the only reason for banks to monitor the behaviour of directors, nor is it decisive in determining their effectiveness. In other systems, this is enhanced by banks expressing the desires of shareholders who have entrusted them with the management of their shares. In Italy, the prohibition on soliciting the conferral of proxies (Article 2372 of the Civil Code) prevents banks from performing a similar function. A bill to remove the ban was examined by the lower house of the Italian Parliament during the last legislature, and it is to be hoped that the issue will be taken up again.

ii) As creditors the banks carry out a function comparable to that of large shareholders, at least in one sense: they have the incentive to monitor the management of the company closely because they have invested considerable resources on which they wish to obtain an adequate return, taking account of the risk involved. They also have the tools needed to take effective action in their dealings with directors.

The literature now identifies banks' function as that of reducing the informational asymmetry in financing agreements. Firms have private information on key aspects of their business, such as the riskiness of the projects they want to finance, their entrepreneurial abilities and integrity. The ultimate providers of finance are well-advised to delegate the analysis of creditworthiness and the monitoring of credit relationships to specialized intermediaries charged with gathering information and selecting borrowers.

Banks perform this task effectively if the number providing credit to a single borrower is not excessive and if the credit relationship is stable. Among the firms covered by the Company Accounts Data Service, those with more than 200 billion lire of drawings on credit facilities had borrowed from an average of 29 banks in 1995; the number declines to 10 for firms with borrowings of less than 50 billion lire. The average duration of firms' credit relationship with their main bank did not exceed three and a half years.

The fragmentation of loans results increases the credit risk divided among the banks concerned; it reduces the discipline imposed on individual firms. Each bank has less of an incentive to bear the costs of selecting and monitoring borrowers, which may hinder the

detection of problems. Firms may initially be able to hide their difficulties by increasing the number of banks from which they borrow and drawing more extensively on existing lines of credit.

By using more than one bank, firms can draw on one or another credit facility according to the terms that the different banks are prepared to offer, thus minimizing the overall cost of financing by stimulating competition between banks. Although it may not be desirable for a firm to have just one bank, the excessive fragmentation of credit relationships creates problems for firms as well, especially healthy ones. They may have to pay a higher price for credit if their bank does not have an accurate picture of the outlook for their profits and the financing and other financial services offered may be inappropriate. A less intense credit relationship can increase the cost of financing.

Less fragmented banking relationships should not hamper competition in the credit market. Competition between banks should be based not on the mere granting of financial resources but rather on assessing creditworthiness, selecting firms in relation to their plans and developing appropriate financing programmes. With more highly concentrated credit relationships, competition is crucial in order to prevent the main bank from exploiting its information advantages to extract excess profits.

iii) Banks can contribute to the development of the equity and debt markets, a necessary condition for firms to be subject to the scrutiny of private shareholders and institutional investors.

The smallness of the official market is the real anomaly in Italy. The amount of equity capital in Italy is not negligible: in relation to firms' total financial liabilities, it is in an intermediate position compared with the other leading countries. However, this capital does not circulate, so that the market is prevented from assessing the efficiency of firms.

The main cause of this situation was long held to lie in the demand for shares. With the share of households' financial assets managed by institutional investors nearly doubling in the last 10 years to 20 per cent and with the introduction of a flat-rate withholding tax on dividends in 1994, the focus of research has shifted to the factors that affect firms' willingness to allow their share capital to circulate. Many Italian firms are still reluctant to expose themselves more openly to market scrutiny. Ensuring the stability of control

takes precedence over the ability of firms to grow beyond a family business, to enter new operational areas and to compete in international markets. The greatest cost of a stock exchange listing is seen to be the transparency it entails; the explicit cost appears low compared with other countries.

Banks would also benefit from the development of the capital market. Their balance sheets do not lend themselves to aggressive lending policies; the share of loans is large and the slow growth in deposits appears hard to modify. At some large banking groups, the availability of capital may hinder the expansion of lending.

iv) If banks are to make their influence felt with non-financial enterprises, it is indispensable that they also should be committed to making profits.

The Bank of Italy has sought to foster the concept of banks as enterprises since the early Eighties – by asserting the principle, removing operating restrictions, especially for public-sector banks and imposing competition on the banking system.

Law 47 of 1985, which empowered the government to transpose the First Banking Directive into Italian law, established the basic principle in "the entrepreneurial nature of banking". The 1993 Banking Law reinforced the principle, reducing the number of banking regulations that derogate from commercial law. It also sanctioned competitive equality among banks by eliminating operational specialization. The Bank of Italy was entrusted with the task of promoting the stability and efficiency of the banking system by ensuring directors' sound and prudent management of banks and safeguarding competition.

Competition is now at work in the Italian banking system. In the Eighties the concentration of banking markets was gradually reduced in every segment and geographic area, especially where it had initially been greatest. Following deregulation, the number of bank branches increased by 8,000, or 53 per cent, bringing banking services to 600 previously unserved municipalities; the average number of banks in each province increased from 21 to 28. The major shift in banks' shares of the credit market that began with the removal of ceilings on lending has continued in recent years. More dynamic market-oriented lending has also led to combinations between banks. Competition policies have also led to combinations between banks. Competition has been reflected in the prices of banking services. Lending rates have come closer to money market rates. The geographical dispersion

of both lending rates, net of borrower insolvency risk, and deposit rates has declined. The differential between the return on loans and the average cost of funds has narrowed by more than two points in the last ten years.

Despite the demands of the new competitive environment, banks have been slow to cut operating costs, especially staff costs. The average cost per employee is out of line compared with other sectors of the Italian economy. The disparity with other countries is even greater: on a purchasing power parity basis, the average cost per employee is nearly 50 per cent higher in Italy than in the United Kingdom and Germany. After falling in real terms in the second half of the Eighties, the contractual wages of Italian bank employees have risen steadily. The contract agreed this year includes further increases, which contrast sharply with the increase in bad and doubtful debts, the fall in average productivity per employee and the poor return on equity of Italian banks (2 per cent in 1993-1995, down from 10 per cent in previous years), which nevertheless agreed to the increases.

In increasingly competitive markets, both private and public-sector banks must pursue the same objective and measure themselves with the same yardstick: the ability to boost their capital by earning a profit and to offer shareholders competitive returns. The legal form of both categories of bank is now the same after the transformation of all the public-sector credit institutions into public limited companies. This eliminates any residual differences in legal treatment between banks and ordinary firms, in terms of both corporate purpose and the structure of corporate governance (apart from the special public controls needed to carry out the supervisory duties specified in Article 5 of the 1993 Banking Law). The privatization of banks under some form of public control, which still account for 60 per cent of banking activity, has begun and will continue. Apart from the debate over the relative merits of creating a broad shareholder base or retaining a hard core of institutional investors, it is crucial that bank privatizations should be carried out in such a way as to ensure that the controlling shareholders are clearly identified.

The public presence in the banking system must not be replaced by constraints of a different order, perhaps even more pernicious ones. The principle of separation between industry and finance, the cornerstone of the 1936 Banking Law, is explicit in the new legislation. The key to ensuring the efficient allocation of credit and the stability of the banking and financial system lies in avoiding both

captive banks and banks that are excessively involved in non-financial firms.[13]

Controls on the ownership of banks are regulated by the 1993 Banking Law (Articles 19-24). To ensure the separation between banks and non-financial firms Article 19, paragraph 6, forbids persons engaging in significant business activity (more than 15 per cent of their balance sheet assets) in sectors other than banking and finance from acquiring holdings exceeding 15 per cent of the voting capital of a bank or that would confer control. The direct or indirect acquisition of holdings in banks in excess of certain thresholds or that would confer control must be authorized by the Bank of Italy. The Bank assesses the quality of the major shareholders in terms of the principle of separation and the broader criterion of sound and prudent management. Pursuant to Article 19, paragraph 7, of the Banking Law the Bank of Italy refuses or revokes authorization for persons who are engaged in significant business activity in sectors other than banking and finance where there are agreements with other shareholders that would result in a significant concentration of the power to appoint or remove the directors of a bank such that its sound and prudent management is jeopardized. Any agreement governing the exercise of voting rights in a bank must be notified by the participants to the Bank of Italy within five days.

Article 53(c) of the Banking Law empowers the Bank of Italy to issue general regulations concerning permissible shareholdings, in conformity with the resolutions of the Interministerial Committee for Credit and Savings. Bank of Italy regulations regarding the acquisition of holdings in non-financial companies impose three constraints on banks and banking groups: *a)* a separation limit, equal to 15 per cent of the capital of the investee company; *b)* an individual concentration limit, equal to 3 per cent of the supervisory capital of the investor bank, for holdings in an individual firm or group; *c)* a global limit, equal to 15 per cent of supervisory capital, for all equity holdings. Large banks (with at least 2 trillion lire of capital) that meet the capital standards in force may be authorized to apply higher individual and global concentration limits, equal to 6 and 50 per cent respectively. 'Specialized' banks, with structurally stable fund-raising, may be authorized to acquire shareholdings in non-financial companies within the

[13] For more on the economic foundations of the principle of separation between industry and finance, see P. Ciocca, *Banca, Finanza, Mercato*, Einaudi, Torino, 1991, especially chapter VI.

maximum individual and global concentration limits provided for by the Second Banking Directive, equal to qualified holdings of 15 and 60 per cent respectively.

The significance, the spirit, of the rules on banks' equity interests in non-financial companies and those of non-financial companies in banks is clear: the authorities have said *no* to the subjugation of banks by firms and to the commingling of banks and firms. Beyond these limits, there cannot be an effective dialectic relationship between banks and firms, the only means of ensuring the efficient allocation of real resources. Within these limits, and only within these limits, banks – whether as shareholders or creditors – are called upon to scrutinize the choices and policies of corporate management, without being directly involved in the decision-making process. Within these limits, established by law, the professionalism and independence of bankers can link the role of banks to the variable S, place them in the position of "watchdog shareholder", active in forestalling and eliminating operational problems, and make them suitable counterparts, supplementing the market, in orienting firms' autonomy towards the satisfaction of savers' requirements.

In the light of the disappointing results achieved between 1993 and 1996, we can only suspend judgement on the prospects for the Italian banking system in the Single Market. Nevertheless, the stage has been set, the legal framework put in place: banks as enterprises, operating in full autonomy in a competitive market. It is up to the actors to interpret their parts to the satisfaction of the public and entrepreneurs.[14]

[14] "Since the late Seventies economic and institutional policy has been framed and in various points implemented with the aim of permitting the modernization of Italy's banking and financial industry. The process has steadily been stepped up – including legislative measures – since 1985, when the need arose to equip Italy's financial structures to face the competition that the European single market would unleash in 1993. Much has been done, perhaps all that could be done, at the level of economic policy and legislation, but this could still prove insufficient. The market will decide whether banks and financial firms have responded adequately in the Nineties: ultimately the fate of the sector, and its crucial contribution to the Italian economy, lies in their hands." (P. Ciocca, *op. cit.*, pp. x-xi.)