

Competition and Corporate Governance: the Case of Italian Banks *

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1. Introduction

Debate on the corporate governance of banks in Italy took off well and truly when the major legislative barriers hampering entry into the markets and restricting both the range of services and the chance for banks to have shareholdings in non-financial firms were finally cut down to size. As the scope for entrepreneurial action widened out, the limitations posed by the present ownership and control structures on the possibilities for banks to operate as efficient enterprises in a regime of competition were called into question.

Relations between competition and corporate governance in banking are not always clear. In this article we intend to highlight certain aspects. One of the first questions to tackle is the extent to which removal of the institutional barriers to entry and an active competition policy help to solve the problems deriving from inefficient governance systems and what additional efforts may be necessary to improve ownership and control structures with a view to corporate governance. The second – closely connected – question is about the positive influence improved governance structures can have on competition, and thus on the prices and quality available on the market.

After a general survey of these issues (Section 2), we shall go on to consider the various forms of corporate governance now coexisting

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* The opinions expressed here imply no commitment on the part of the institution itself.

in the Italian banking system, highlighting their major critical points (Section 3). A brief analysis of how the banks reacted to the new entrepreneurial opportunities opening up as from 1990 with the slackening of regulatory restrictions (Section 4) will be followed by a few remarks on how well geared the present ownership and control structures are to match up to competitive developments in the coming years.

2. The relation between corporate governance and competition

To start with, it is worth considering just what we mean by corporate governance and competition in this context. Corporate governance may be seen as a set of methods designed to guarantee remuneration for people investing financial resources in a firm, in view of the agency problems involved in controlling the behaviour of managers. Once the investment has been made, it is in fact to a large extent sunk, at least in the short term. Thus, unless effective mechanisms ensure that the firm will be managed in a such a way as to remunerate investment, there is no incentive to finance it.¹ Therefore, an inefficient corporate governance system hampers the growth of firms and unduly limits possible market developments.

Apart from the effects on investor incentives, inadequate corporate governance systems resulting in widespread company behaviour that is not guided by the search for profit may result in serious distortions to competition. Suffice it to recall that the 'appropriation' of resources by the managers may lead not only to inefficient company organisation or external growth policies that do not match the interests of shareholders, but also to non-market criteria for the choice of suppliers and the establishment of price and non-price conditions offered to clients. This is directly reflected in distortions to competition in the markets upstream and downstream from those in which the bank operates.

By competition we mean here not so much a static market structure as a dynamic process to allocate resources within a context of incomplete information. Like corporate governance, competition

¹ See Shleifer and Vishny (1996) and Prowse (1997).

affects the allocation of resources both within individual firms and the entire economic system. In the absence of stable monopoly positions, firms are led to operate efficiently in order to keep a footing in the market.

Let us now take a look at the connections between competition and corporate governance. In the first place, one effect of competition is to restrain the discretionary power of company managers. Even if we suppose that competition does not actually reduce the agency costs involved in manager control, when the chances of steady high extraprofits are limited, there are fewer resources for managers to appropriate at the expense of the company financiers. Nevertheless, the limits competition sets on managers' discretionary powers are not sufficient to eliminate all the above-mentioned problems of corporate governance. Once financiers have invested their capital in a firm, inadequate corporate governance does in fact leave managers the freedom of sub-optimal behaviour as far as the return on capital is concerned, even though such behaviour may result in below normal profits or even losses. Thus we once again come up against the problem of disincentives for external financing of firms.

Of course, in competitive markets the temptation for managers to behave unprofitably will ultimately be curbed by the risk of the firm exiting from the market or – a particularly relevant prospect for banks – the risk of a crisis calling for the replacement of managing staff. However, the fact that competition does not generally suffice to solve all the problems of corporate governance in terms of disincentives to external financing points to the answer to the first question: even when the institutional barriers standing in the way of market entry are removed and an active policy is implemented to guarantee competition, it still remains necessary to seek out effective systems of corporate governance in order to ensure that resources are allocated efficiently.

The other aspect of relations between corporate governance and competition, involved in the second question, is that an inefficient system of corporate governance results in disincentives to the search for competitive price and quality conditions that will satisfy customers. If the ownership and control structures are such as to prompt scant reaction to opportunities for profit, they will also represent a limit to the bank's capacity to respond to market demand for efficiency and innovation, introducing rigidities and thus slowing down the operation of the competitive process. This sort of rigidity can lead

to even more serious consequences than any static inefficiencies when it affects the firm's capacity to make strategic choices, e.g. regarding productive and geographical specialisation or personnel policies.

3. The different forms of corporate governance in Italy's banking system

In Italy as in other European countries the banks have long known a variety of ownership and control structures. In part, these manifold bank models were the result of private initiative as vacant market niches were occupied. For example, the rise of the co-operative banks (*banche popolari*) in the last century may be seen as an attempt to provide customers (mainly small entrepreneurs, labourers and craftsmen) with more favourable conditions of credit, exploiting the co-operative system and close local connections to solve the problems of information asymmetry. The rural and artisan banks arose, on a smaller scale, with a similar pattern (co-operative system, close connections with the area) but more distinctly mutual aims. Somewhat more complex is the case of the savings banks, which in some cases were established by associations of persons, in others by public authorities, with the aim of promoting and enhancing the savings of small and medium-size clients. From the outset savings banks were characterised by the non-profit motive, gains being first by the articles of association and then by law reserved to consolidate the bank's capital and otherwise channelled to charitable initiatives, enhancing the links between bank and local area.

However, the competitiveness of the various forms of bank has also been affected by public intervention, not only creating public credit corporations itself but also applying over the years dissimilar tax and monetary policy conditions, as well as unequal restrictions to the geographical expansion of branch networks, to the different categories of banks. On the subject of relations between categories of banks and competition, it is worth recalling that until the late Seventies, when applying the Banking Law of 1936-38 to decide whether or not to authorise the opening of new bank branches, the Bank of Italy took into account the criterion of not increasing the competition between banks of the same type (e.g. between co-

operative banks or savings banks) in a given geographical area, thus by and large sharing out the local markets within each category. Moreover, for a long time implementation of the Banking Law excluded the authorisation of new branches in minor centres for the nation-wide banks, the aim being to encourage the development of local banks.² Given the specialization of credit institutions imposed by the Banking Law, this policy actually meant for customers potentially negative barriers to competition in each geographical area. It also gave rise, in some cases, to highly concentrated market structures at the local level, often giving powerful positions to banks of relatively minor importance in the national context. This was the situation when it was decided to liberalise the opening of branches.

As is widely recognised, there has been a gradual but steadily growing process of homogenisation in the operations and balance sheets of Italian banks. A boost came to this process in the Seventies (partly due to the increased weight of the small- and medium-sized firms in domestic production and the adoption of more uniform monetary policy requisites for the various categories of banks), and a further boost in the following decade when constraints on operating and geographical specialisation were reduced and the institutional barriers to competition cut down. For the co-operative banks the time soon came when the constraint to operate mainly with shareholders was lifted and the non-mutual, profit-making aims were increasingly recognised, also by the courts. In the present situation, unanimity is no longer required for transformation of a co-operative bank into a limited company, but only the majority necessary to modify the deeds of association. In the case of the savings banks, the process of de-specialisation is particularly evident in the evolution of balance sheets.³

As these developments came about, the Eighties saw a vigorous debate arising over how to tackle the limitations deriving from the legal status attributed to certain types of banks, mainly the savings banks, and involving most significantly difficulties in recapitalization and efforts to merge with banks of a different legal status.⁴ With the law of 30 July 1990, no. 218 (known as the Amato Law), banks were eventually encouraged to take on the form of limited companies.

² See also Desario (1995).

³ For these aspects, the reader is referred to Onado (1988) and Padoa-Schioppa (1994).

⁴ For detailed analysis on the savings banks, see Giorgetti and Marmorato (1996).

With the new Banking Law as set down with the legislative decree of 1 September 1993, no. 385, only the operations of mutual banks (former rural and artisan banks) remain subject to special limitations concerning both the opening of new branches and the obligation to supply credit mainly to shareholders. There also remains an obligation for these banks to reserve a quota of the annual net profits for mutual purposes (mutual funds for the promotion and development of co-operation).⁵ With these constraints, on the other hand, mutual banks continue to enjoy favourable tax conditions (in that they are co-operatives with mutual objectives).

Basically, only four different models of corporate governance are now operating among the Italian banks:

- limited companies controlled by foundations constituted after the Amato Law was passed (former savings banks and first-class pledge banks, plus most of the previous public law banks);

- limited companies controlled by other subjects (and here a further distinction arises between private and public subjects);

- co-operative banks, which take on the form of co-operative limited liability joint-stock companies;

- mutual banks (former rural and artisan banks and second-class pledge banks, which in turn take on the form of co-operative limited liability joint-stock companies).

Table 1 presents a break-down of Italian banks according to legal status in 1990 and 1995 respectively.

Each of the various ownership and control structures now operating in the Italian credit system has, at least in principle, its own particular problems to tackle in the sphere of corporate governance. Let us begin by taking a look at the non-co-operative type banks established as limited companies.

One point emerging from the literature on ownership and control is that, while no perfect solution exists to the problem of the corporate governance of limited companies, the more efficient systems of governance are based on the combined presence of large shareholders accounting for significant quotas of capital and voting rights and an effective legal protection of investors, especially with

⁵ Legislative decree no. 385/93, articles 35 and 37. In the case of the mutual banks activities, operations and geographical scope of action are regulated by the by-laws, according to the criteria established by the Bank of Italy.

respect to minority shareholders. The aspect of legal protection of minority shareholders will not be dwelt upon in this paper; banks do not differ greatly from other Italian limited companies in this respect. On the other hand, it is worth looking into the connection between ownership concentration in banks (shareholders with significant quotas of capital) and the effectiveness of corporate governance structures.

TABLE 1

BANKS OPERATING IN ITALY ACCORDING TO LEGAL STATUS
(1990-1995)

1990		1995	
Savings banks ^a	82	Limited companies accepting short-term funds	163
Public law banks	6		
Banks of national interest ^b	3		
Private banks	106		
Special credit institutions	92	Limited companies accepting medium- and long-term funds	34
Co-operative banks	108	Co-operative banks	96
Rural and artisan banks ^c	717	Mutual banks	619
Branches of foreign banks	37	Branches of foreign banks	52
Central category and re-financing institutes	5	Central category and re-financing institutes	6
<i>Total</i>	<i>1156</i>	<i>Totale</i>	<i>970</i>

^a Including seven first-class pledge banks.

^b One of the former banks of national interest, the Banco di Roma, went on through concentration with the Cassa di Risparmio di Roma to be controlled by a foundation. Banca Commerciale Italiana and Credito Italiano went under private control.

^c Including two second-class pledge banks.

Source: Bank of Italy.

In principle, the advantage of having significant shareholders results from the incentives they have to seek out information and monitor the managers' actions, together with the voting power which allows them - either individually or by creating coalitions - to guide the firm in its major decisions, including the decision to replace management.⁶ The fact that control over the firm may be acquired on

⁶ Theoretically, the problem of the possible expropriation of minority shareholders by control shareholders is much like the problem of shareholder expropriation by managers, resulting from the fact that the objective function of control shareholders does not necessarily coincide with profitability for the firm (separation between ownership and control). Therefore, the presence of significant shareholders is not in itself sufficient to guarantee satisfactory corporate governance structures; if this type of problem is to be avoided there must also be legal structures protecting the rights of the other subjects financing the firm.

the market, even through hostile takeovers, is in turn seen as a dynamic factor in providing for sufficiently concentrated ownership to guarantee effective control over the managers. An ownership structure including large shareholders is seen as particularly important when the firm is going through critical periods – when starting up, for example, or subsequently reorganising or restructuring.

Another point emerging from the literature cited above is the odd case of certain large shareholders who may even hold the absolute majority of capital in a firm but make no particular efforts to ensure that the company is run in such a way as to give high returns on their investment. These so-called 'soft large shareholders' may be so on account of agency problems within them. Another case which, a concentrated ownership notwithstanding, may reveal a gap between the objectives of those in control (the representatives of majority shareholders) and profit maximization is when the majority shareholder is the state. In this case the incentives for those delegated to exercise control will not necessarily work in the direction of ensuring an adequate return on investment.

These theoretical situations can be seen in action in the Italian banking sector. Banks in the form of limited companies mostly have large shareholders, often with quotas exceeding 50% of the capital. There are few cases of more fragmented shareholding structures (e.g. the Istituto Mobiliare Italiano, Banca Commerciale Italiana, Credito Italiano). Turning to shareholder typologies, we find a large proportion of banks (including 76 former savings banks and 5 former public law banks) – accounting for about 50% of total assets – that have as control shareholder a foundation established in conformity with law no. 218/90. It is also worth noting that the features of the corresponding control structures involve not only the banks which changed their legal status in conformity with the Amato Law, but also all the other banks subsequently entering into the orbit of foundations through concentrations (e.g. Crediop, taken over by Istituto Bancario San Paolo di Torino in 1995, or Banca Nazionale dell'Agricoltura, previously a private bank, control of which was acquired by the Cassa di Risparmio di Roma Group in the same year; subsequent to privatisation, IMI itself, which was previously controlled by the Treasury, has had as major shareholders with quotas of about 10% each Cariplo, San Paolo di Torino and Monte dei Paschi di Siena, whose majority shareholders are foundations). Apart from

the foundations, the Italian banks with a state majority shareholder (in particular the Treasury) are now few in number.⁷

Given the large number of Italian banks whose control structures are now associated with foundations, it is worth considering briefly what kind of majority shareholder the latter represent in terms of corporate governance. Here there are a number of points to bear in mind: according to their corporate by-laws, foundations are non-profit organisations operating in the social sphere; they are empowered to administer their own shareholdings (and appoint managers), but are formally denied powers to manage or direct the strategies of the banks they control; therefore, these powers are entrusted to the managers of the controlled limited companies which, in cases where the foundation holds the absolute majority of the capital, remain exempt from the discipline resulting from the market for corporate control.

Considering the system of individual incentives for members of the foundations' decision-making organs and the formal limits set to their capacity to influence the operating and strategic lines of the controlled banks, foundations are clearly – to use the language of the corporate governance literature – 'soft large shareholders': they do not represent reference shareholders structurally inclined to keep up a fair degree of pressure on the bank managers in the interests of greater efficiency and – ultimately – of returns on the capital invested.

The area of the banking sector now organised in the co-operative form also has a certain significance, especially in terms of the number of banks involved (at the end of 1995 there were 96 co-operative banks and 619 mutual banks, accounting for 15.7% of total assets). From the point of view of corporate governance, a feature common to all these companies is the system of voting rights (one vote per head) in shareholders' meetings, a minimum number of 200 shareholders and a ceiling to individual shareholdings (amounting to 0.5% of capital for co-operative banks and 80 million lire for mutual banks).⁸ Mutual banks still set conditions on the provenance of shareholders (they must be resident in the municipal district where the bank has its head office). For all the banks organized in the co-operative form, the law allows for the distribution of profits to

⁷ Such is the case of Mediocredito Centrale and Banca Nazionale del Lavoro.

⁸ Exception being made for shares held by investment trusts; see legislative decree no. 385/93, articles 30 and 34.

shareholders, although mutual banks are obliged to channel a quota of the profits into mutual funds for the development of co-operation. The option remains for the co-operative banks to allocate part of the profits for charity or assistance, and for charity and mutual purposes in the case of the mutual banks.⁹

The literature on corporate governance also has some interesting things to tell us about the efficacy of ownership and control structures in the case of banks organized in co-operative form. Where the shareholders are also users of the services downstream, the co-operative structure of the company (one vote per head) can in some cases prove more efficient than a company structure controlled by an external majority shareholder interested in maximising profits. This is particularly so where shareholders as users of the services have homogeneous preferences (the preferences of the median voter coinciding with average preferences) and the bank is not exposed to competition.¹⁰ On the other hand, where significant differences arise among the preferences of shareholders-users and the firm is exposed to competition, a company structure with a well-defined control shareholder may prove more efficient than a co-operative in working towards the maximisation of total surplus (producer plus consumer surplus) on the market – a point that Maffeo Pantaleoni¹¹ had clearly grasped long ago.

One risk facing co-operative structures with widespread ownership is free-riding, with the consequence that the shareholders' meeting loses much of its effectiveness in controlling management and laying down strategic lines for the firm. For the same reason, it may also be difficult to reach the majority in the shareholders' meeting needed to implement the transformation of a co-operative bank into a limited company. At the same time, the particular system of voting rights in co-operatives prevents the – even temporary – concentration of voting rights in the hands of a single shareholder, which might otherwise take place through the acquisition of the company control on the market (unless the shareholders' meeting has already deliberated the transformation of the bank into a limited company).

Thus, in effective bank governance with the co-operative model a particularly important role is played by the uniformity of shareholders' preferences and by fiduciary relations between shareholders

⁹ Legislative decree no. 385/93, articles 32, 34 and 37.

¹⁰ Hart and Moore (1995).

¹¹ Pantaleoni (1925).

and managers (who may in turn also be chosen among the shareholders). These conditions are all the more easily satisfied where the network of interpersonal relations within a limited geographical area is sufficiently close-knit to allow for accurate *ex ante* selection of managers and afford external mechanisms to prevent managerial behaviour clashing with the interests of shareholders.

4. Competition, bank choices and performance

Having taken this overview of the range of problems arising – in theory, at least – for the various ownership and control structures existing in the Italian banking industry, one may at this point wonder how the banks reacted to the removal of regulatory limitations to their competitive scope as from the mid-Eighties. Apart from the abolition of the ceiling on loans in 1988, one of the measures most closely affecting competition was the liberalization – as from 1990 – of the opening of new bank branches throughout Italy.¹² As we have seen, the only appreciable limits remaining to the expansion of branch networks apply to the mutual banks. Again in 1990, the Amato Law not only provided for the transformation of public banks into limited companies but also introduced fiscal relief to cut the costs of merger between banks. With the implementation of the Second EC Banking Directive, the new Banking Law of 1993 and, more recently, the EC Directives on investment services,¹³ the regulatory barriers to entry into Italy's financial services markets were further reduced, both with respect to the establishment and operation of competitors from other member states of the EU and in terms of

¹² While gradually recognising the importance of encouraging efficiency and more evenly distributed competition regardless of the legal categories the various banks belonged to, the 'piani sportelli' (branch planning) of 1978, 1982 and 1985 were still based on the idea of structural regulation of supply according to the authorities' assessment of the economic requirements of the market. Liberalisation of the opening of new branches was launched by the Interministerial Committee for Credit and Savings (CICR) in 1987, with the go-ahead to transform sub-offices restricted in their range of operations into ordinary branches. In 1988 it was also made possible to transfer branches within certain geographical areas. Between March and May 1990 the removal of administrative restrictions on the opening of new branches and geographical limitations to the supply of credit within Italy was practically completed.

¹³ Legislative decree 23 July 1996, no. 415.

reversing the institutional segmentation deriving from specialisation constraints. Thus the whole framework of regulations applying to the banking markets in Italy has now taken a decidedly different shape. In this context it is also worth recalling that 1990 saw the introduction in Italy of law 10 October 1990, no. 287, for the protection of competition. This law is designed to prevent anticompetitive agreements and the abuse of a dominant position, as well as concentrations creating or enhancing dominant positions to the extent of eliminating or seriously and lastingly impairing competition in the various markets, including those in which the banks operate.

The empirical analysis of the connections between ownership and control structures on the one hand and competitive conduct on the market on the other would require a systematic study of the responses given so far by the different banks to the competitive challenges resulting from deregulation. Here we shall confine ourselves to making a few remarks, aware as we are that an adequate empirical analysis would reach far beyond the scope of this paper.

In terms of market structure on the national scale, between 1990 and 1995 the number of banks operating in Italy fell by 16% (from 1156 to 970; see Table 1). The disaggregated data show a decrease in the number of banks in all categories save the branches of foreign banks. The drop is more marked than the average for banks in the form of limited companies accepting short-term funds (17%), less pronounced in the case of mutual banks (14%) and, above all, co-operative banks (11%).¹⁴ Along with these variations in the number of banks we also see developments in market shares at the national level as measured over total assets, net loans and deposits, with net growth shown by both the co-operative banks and the mutual banks (Table 2).¹⁵ With observation limited to these variables, the banks operating in the co-operative form seem to show a relatively satisfactory competitive capacity.

¹⁴ The reduction was particularly marked in the case of the former special credit institutions, partly because of the incorporation of pre-existing special credit sections in the controlling banks. It should be borne in mind that variations in the number of banks per category result not only from the opening of new banks and concentrations, but also from direct transformation of the legal form of a bank (such as the transformation of a co-operative bank into a limited company).

¹⁵ Taking the banks in terms of size rather than legal categories, we see an increase (from 28% to 42%) in the share of loans of the ten major banks between 1990 and 1995, although the share of the smaller bank also grew. See Bank of Italy (1996).

TABLE 2
MARKET SHARES OF THE BANKS AT THE NATIONAL LEVEL, 1990-1995

	Total assets (%)		Net loans (%)		Deposits (%)	
	1990	1995	1990	1995	1990	1995
Limited companies accepting short-term funds ^a	65.4	72.0	55.5	68.7	74.8	76.7
Limited companies accepting medium- and long-term funds ^b	22.1	10.3	34.5	16.0	9.6	0.8
Co-operative banks	9.5	12.5	7.8	11.9	12.1	15
Mutual banks	2.0	3.2	1.5	2.7	3	5.7
Others	1.0	1.8	0.6	0.6	0.5	1.8

^a Including, for 1990, savings banks, public law banks, national interest banks and private banks.

^b Reference is to banks that were special credit institutions in 1990.

Sources: Bank of Italy (various years) and Salomon Brothers (1996).

However, in these data banks that retain their own legal status are considered distinct subjects, only those concentrations taking the form of actual mergers being recognised as such; the data do not reflect the drop in the number of independent banks operating on the market brought about by acquisition of control. For example, Banco di Sardegna and Banca Popolare di Sassari are seen as two distinct banks, although the former has taken over control of the latter. From the point of view that interests us here, i.e. that of the corporate governance of banks, it is useful to view the results of concentration also in terms of the control structures. To this end we must reconstruct the process of concentration itself, as shown by the falling number of economically independent banks operating on the market.

Analysing the 321 operations leading to concentration between banks from 1984 to 1995, some conclusions may be drawn about the connections between the different types of banks and the process of concentration:

– about 40% of the concentrations in this period (127 operations) were between mutual banks; the number of operations regarding these banks rose not only year by year, but also in proportion to the total number of bank concentrations (from 22% of the total in 1984-86 to 43.5% in 1995);

- nearly half the remaining operations involved co-operative banks as acquirers or acquired companies. There were a great many concentrations between medium-sized banks (mostly co-operative banks or former savings banks), particularly in certain regions of Central-Northern Italy. It is worth noting that the early Eighties had already seen a remarkable process of concentration between co-operative banks;¹⁶

- concentration often occurred between banks belonging to the same category, especially between co-operative banks and between former savings banks; however, 1995 saw a number of cases of concentration between the former savings banks and the co-operative banks;

- all seven of the large bank groups, with their various ownership and control structures (in four cases control shareholder is a foundation, in one case the Treasury, in two cases there is a private control company structure without absolute majority shares), have been particularly active in acquiring and incorporating other banks as from 1990.¹⁷

The data on concentrations give us limited help in drawing conclusions about the connections between corporate governance and entrepreneurial behaviour. On the one hand, we see widespread and fairly intensive acquisition activity that does not seem to depend on particular ownership and control structures. On the other hand, these concentrations might well be seen as a response to the new terms of competition, aiming at enhancing the banks' prospective profitability, even at the expense of a temporary decline in profits; however, acquisition policies are often cited in the literature as examples of manager behaviour not necessarily corresponding to the interests of the shareholders, made possible by inefficient corporate governance systems.¹⁸ To ascertain whether the recent bank concentrations have been dictated by profit-oriented strategies there is no choice but to

¹⁶ De Bonis, Manzone and Trento (1994).

¹⁷ Desario (1995) and Bank of Italy (various years). Confining attention to operations coming within the turnover thresholds prescribed by the Italian competition law no. 287/90, 93 bank concentrations occurring between the coming into force of Italian antitrust concentration control and the end of 1995 were analysed, and the process appears to have retained momentum in 1996. For a list of the bank concentrations examined in terms of law no. 287/90, see Autorità Garante della Concorrenza e del Mercato (1996, pp. 77-81).

¹⁸ See Prowse (1997).

take them case by case. They do, however, seem to be increasingly oriented in the direction of profits, as suggested by empirical analysis of data from 1991 to 1995, showing an increase in the correlation between the evaluation of the acquired bank and its prospective profitability and risk features.¹⁹

Further data about the operational choices made by banks with the new regulatory environment are offered by the number of branches which, once restrictions were lifted, rose by 32% between 1990 and 1995 (from 17,721 to 23,440). The increase was above average for banks in the form of limited companies accepting short-term funds (+34%), average for the mutual banks (despite the restrictions still in force for this type of bank) and below average for the co-operative banks (+22%). However, the share each category held of the total of branches remained much the same (over 70% for the limited companies, 10% for the mutual banks and 18% for the co-operative banks: see Table 3).

TABLE 3

BRANCHES PER TYPE OF BANK, 1990-1995

	Number	
	1990	1995
Limited companies accepting short-term funds	12387	16621
Limited companies accepting medium- and long-term funds	-	95
Co-operative banks	3481	4239
Mutual banks	1798	2379
Others	55	106
<i>Total</i>	<i>17721</i>	<i>23440</i>

Source: Bank of Italy.

At the aggregate level the costs involved in acquiring banks and opening new branches are clear enough, but to ascertain the strategic potential of these activities and their effects from the point of view of service users one must also examine how they affect the market structure of bank services at the local level. The combined effect of mergers and acquisitions and of the opening of new branches on the

¹⁹ Bank of Italy (1996, p. 293).

degree of concentration in local markets cuts more than one way. Internal growth (new branches) can go in the direction of reducing the concentration of supply at the local level or, on the other hand, it may increase it. External growth (mergers and acquisitions) can increase the concentration of supply at the local level or leave it unchanged, according to the overlapping of areas covered by the involved banks.

Empirically, the combined effect of changes taking place at the local level since 1990 has been a reduction in market concentration in some regions, but an increase in others. In lending, the degree of concentration as measured by the Herfindahl index fell in 61 provinces between 1990 and 1995, while rising in 34 (in 24% of the provinces in the north, 35% of the centre, 38% of the south, excluding the islands, and by a sizeable 69% of the island provinces). Particularly high degrees of concentration were obtained in certain provinces of Sardinia.²⁰

When approaching these developments from the viewpoint adopted in the present paper, i.e. considering the positions of the individual banks, it is important to bear in mind that in many parts of Italy the most significant market shares are held by the former savings banks and co-operative banks. For example, measuring market shares in terms of the number of branches we find that 17 of the 20 leaders at the regional level are controlled by foundations (in 11 cases these foundations are the holding companies of groups including former savings banks), while only 3 are limited companies controlled by other subjects. If we take the first 3 banks in each region, we find about one third controlled by foundations connected with former savings banks and over 10% accounted for by co-operative banks.²¹ At the same time, in 1995 the medium-size, small and minor banks held a greater share of the total loans than the large and major banks in nearly half the regions of Italy.²²

During the period of the so-termed *piani sportelli* or 'branch-planning' in Italy, i.e. when administrative restrictions were placed to the opening of new branches at the local level, empirical analysis showed that where the market concentration rose at the local level the rates on deposits tended to fall.²³ Studies on the relation between

²⁰ See De Bonis, Farabullini and Fornari (1994) and De Bonis and Ferrando (1996).

²¹ Corbellini (1995); 1994 data.

²² Bank of Italy (1996).

²³ Conigliani and Lanciotti (1979).

market concentration and the market power of banks at the local level show that when the way was cleared for new branches to be opened the correlation lessened but did not simply disappear. Recent empirical analysis shows that where the market structure is highly concentrated at the local level, banks still have enough market power to apply relatively unfavourable conditions to clients: in fact, local concentration is significantly related to the level of lending and borrowing rates, as well as to the spread. Even taking account of the different degree of risk of the lending activity in different geographical areas, the relation remains significant.²⁴ With regard to the effects of new branches opening on the market power of the banks, a certain lag has also been found in the adjustment of market shares in terms of deposits and loans to the changes in market shares in terms of branches: while the aggregate market share of the first 3 banks (CR3) in terms of branches fell in 15 out of 20 regions between 1989 and 1995, in terms of deposits it fell in only 13 regions (often to a negligible degree), and in terms of loans in just 9 regions.²⁵

However, neither the connection remaining between market concentration at the local level – often resulting from large market shares of former savings banks and co-operative banks – and market power, nor – for that matter – the advantage certain co-operative type banks operating in limited areas enjoy in terms of access to information (which can boost their competitive capacity) can do much to counter the effect of declining interest margins: between 1990 and 1995 the average dropped from 3.3 to 2.7%, partly as a result of structural factors (greater competition) and disintermediation. Thus, from the competitive point of view, particular importance attaches to the banks' capacity to cultivate non-interest sources of revenue by enhancing and extending the range of services they offer. In this respect the general picture is hardly encouraging: in 1995 non-interest income accounted for 25% of the total revenues of the Italian banks as compared with the European average of 35%.²⁶ Only a few isolated banks show promising developments (between 1990 and 1995 the share of non-interest income increased from 21.5 to 34.6% for Ambroveneto, and from 20.4 to 33.5% for Cariplo). Taking the banks in terms of legal categories, the non-interest income of the co-operative banks does not come below the average of the banking

²⁴ Corbellini (1995) and De Bonis and Ferrando (1996).

²⁵ De Bonis, Farabullini and Fornari (1994).

²⁶ Salomon Brothers (1996).

system,²⁷ while service diversification remains – in principle, at least – a problem for the smaller banks, and particularly for the mutual banks which do not reach a scale sufficient to individually take on schemes implying sizeable fixed costs.

Let us take a look at the cost indicators. The period from 1990 to 1995 saw a significant increase in the cost-revenue ratio at the aggregate level (from 62 to 68%), in part due to the opening of new branches and concentration; the average cost of labour is relatively high, accounting for over 60% of the operating costs, and deposits per employee are relatively low (2.8 billion lire) in comparison with other countries in Europe. Again, no general conclusions can be drawn about costs for the legal categories and different sizes of banks; the evaluation of operating efficiency requires a close analysis of each individual bank.

In terms of the profitability of the resources managed, comparative analysis for the year of 1993 shows relatively high levels for the co-operative banks (2.83%) as compared with the former savings banks and pledge banks (2.36%), the smaller and minor banks taken as a whole (2.34%) or the major, larger and medium-sized banks, again taken as a whole (1.45%). In the same year the mutual banks revealed distinctly above average performance in Central Italy (2.84%) and – confining attention to the medium-sized and large banks in this category – in the north (3.08%). Less profitable performance was shown by the small mutual banks in the north (2.71%) and, even more so, in the south of Italy and islands (2.29%). Another factor characterising the mutual banks, apart from relatively high average profitability and taking account of their geographical location together with the type and scale of the clients' business activities, is a lower ratio of non-performing loans to total loans, as well as lower drawing in excess of granted credit lines with respect to other banks.²⁸ If we confine our attention to the south, however, the picture is somewhat different. Here the ratio of non-performing loans to total loans as shown by the mutual banks is above average, which appears to bear out the theory that the efficacy of the co-operative model in local markets depends to a very large extent on the kind of environment it functions in.

²⁷ De Bonis, Farabullini and Fornari (1994).

²⁸ Cannari and Signorini (1996).

5. The corporate governance of banks in competitive markets

The empirical analysis sketched in this paper of how the banks responded to the lifting of legal restrictions to competition over the past five years reveals no clear connection between corporate governance models and operating results.²⁹ Within the various categories of banks the profitability picture is far from even. In part these differences may be attributed to the particular strategic positioning shown by the individual banks when liberalisation was launched (standing in the market, existing client relations), in part to the individual entrepreneurial ability and approaches of the various bank managements.

In fact, the various models of corporate governance are reflected in different forms of structural incentives for managers; hence all the concern about the capacity of the various ownership and control structures to guarantee that banks are run along profit-oriented lines. Of course, there is always room for those virtuous cases where 'well-intentioned' managers run their banks with a steady eye to profitability despite inadequate or distorted incentive systems.

However, the pressure of competition from within and without the Italian banking system is bound to grow, and the real problem with ownership and control structures in the present situation is the huge efforts the banks will have to be making in the coming years to reorganise and re-position themselves on the market in order to face up to it. In fact, regardless of the various positions of the individual banks, Italy's entire banking industry shows a level of profitability distinctly below that obtainable with alternative uses of capital, with returns on equity in 1995 in general not exceeding 6% even in the best cases and often touching levels below 1%. Apart from the whole question of whether the present capital accounting values need revising, it is absolutely essential for the individual banks to get their strategies clearly defined, in terms of both costs and revenues. In terms of costs, it is not simply a matter of cutting down on staff but of rethinking the bank's investment policies concerning human resources, technologies, network and acquisitions, the aim being not so much growth in size as enhancement of the firm's profit-making capacities. Similarly, in terms of revenue each bank must make its own strategic choices regarding the range of services it supplies; this

²⁹ Similar conclusions were reached by Conti and Fabbri (1996).

also means a new approach to relations with client-firms now that competition is growing in lending activity, while large and medium-sized firms are reducing the number of banks with which they have credit lines and legislation restricting bank shareholdings in non-banking firms is being relaxed. In general, banks are going to have to make greater efforts to use information on the prospective profitability of firms and enhance their own capacity to come up with new proposals for their clients.

Without the right strategies for reorganisation and the competitive re-positioning, the risk is that the present state of low profitability may in the coming years give way to truly critical situations for many banks operating in the system. With a certain – albeit imperfect – degree of competition in the financial services markets, the functioning of the market itself sets certain limits to ‘excessive’ operating inefficiency, whittling down the market shares of the less competitive firms (just as the fact that taking on excessive risks will sooner or later create unviable situations represents a restraint). However, if the ownership and control structures of individual banks were such as to ensure attentive, dynamic pursuit of the maximisation of their value, then the adjustment processes could prove not only swifter but also less costly in private and social terms.

This seems to be a problem with the foundations in the first place, given their particular incentive systems and the fact that they are attributed with no powers over the banks they control at the level of operations and general strategy; when they hold an absolute majority share in the capital, these powers are delegated to the managers of the limited companies, who remain immune to any pressure deriving from an active large shareholder or the market for corporate control. It is of course true that individual groups of managers may nevertheless turn their efforts effectively in the direction of profitability. However, if the weaknesses of the present corporate governance model in the foundation-related area of the banking sector are structural, depending on the system of constraints and incentives thus created for the choices of individuals, then no scheme of strategic restructuring of banks seems likely to work on a large scale within reasonable time limits as long as the present ownership structures remain. This is a very good reason to hope in the rapid privatisation of the banks controlled by foundations through a pre-defined sequence of stages.

The banks in co-operative form have often shown levels of profitability above the average of the system over the last few years; it has been noted that the effectiveness of the relevant corporate governance models depends on particular conditions including shareholders with homogeneous preferences and close fiduciary relations with the managers. As the banks grow in size, these conditions are less likely to survive. Thus the viable aspects of the co-operative model as compared with the limited company may change as market conditions evolve, and the possibility created by current legislation for the co-operative banks to adopt the form of limited companies takes on a certain importance. In 1995 this possibility was exploited in five cases. The mutual banks have the additional problem of the limits to growth set by the present regulations (restrictions regarding the provenance of shareholders and the geographical scope of activities). Such limits may make themselves particularly felt when it comes to developing a wider range of services, which implies fairly high fixed costs. One way of overcoming this problem is through co-operation between a number of banks to produce certain services – e.g. asset management. Should the disadvantage of such scale limits outweigh the advantages of the locally-based co-operative form, however, there is always the possibility – admitted by the regulations also for the mutual banks – to take on the form of limited companies through concentrations.

In the delicate stages of a firm’s life when restructuring and strategic re-positioning are called for, studies on corporate governance suggest that it can be very positive to have large shareholders with every incentive to promote profit-oriented lines of management. In view of the competitive challenge the coming years hold, it is increasingly imperative for the Italian foundations – by their very nature soft large shareholders – to abandon control of the banks. As for the banks in co-operative form, we can offer no general indications. Here the need is for case by case analysis in order to ascertain whether the conditions exist to make this model competitive with the limited company model.

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