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ITALY: Banking foundations adjust and thrive

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EVENT: The country's banking foundations last week launched a legal challenge to recent Treasury guidelines aimed at preventing foundation directors from serving as executives in banks they control.

SIGNIFICANCE: A large part of the domestic banking system remains under the control of foundations. Their crucial role at the centre of intricate webs of cross-ownerships poses a range of problems.

ANALYSIS: In 1990, the so-called 'Amato law' required the transformation into stock companies of casse di risparmio, public credit institutions and banche del monte -- different traditional forms of publicly-controlled saving banks. In many cases, savings banks were required to split into two separate entities: a foundation and a bank. Foundations were legally defined as private non-profit organisations and were given large holdings in the banks from which they originated.

The 1990 legislation implied a formal restructuring of ownership rights, but had little practical impact on privatisation. Furthermore, some commentators have argued that foundations lack the right incentives to manage their holdings efficiently and that they aim at the mere preservation of their capital. Empirical evidence seems to confirm this hypothesis: returns on investment have generally been low and the capital allocation inefficient, with little diversification. In terms of management, the nature and structure of foundations exclude any kind of market control on their administration and guarantee little monitoring on their management. Indirectly, this could lead to distortions in the corporate governance of the many banks where they are important shareholders.

Reform attempts. During the 1990s, there were efforts to limit the influence of the foundations for three central reasons: to increase market competition in the banking sector; to encourage mergers and acquisitions (M&A); and to improve the corporate governance and internal restructuring of banks:

1. **Direttiva Dini.** In November 1994, a first attempt (the so-called 'Direttiva Dini') was made to limit the influence of foundations on the banking sector. According to the directive, foundations were required to diversify their investments. More specifically, they had to reduce their share in the banks to less than 50% within five years. An intense process of concentration and restructuring in the banking sector followed the directive. Between 1990 and 1998, approximately 300 banks took part in M&A activity and more than 100 have changed their ownership structure. Foundations have been the principal actors in the whole process.

2. **Legge Ciampi.** In May 1999, a new law (the 'Legge Ciampi') aimed at removing the presence of the foundations from banks, assigning them a new role in the non-profit sector. There are a number of central guidelines:

Foundations must renounce positions of control in banks and any other companies within a period of four years (extendable to six years). This is to be achieved by selling on the market the holdings in their possession.

Foundations are allowed to invest their capital in the market and maximise profit, albeit respecting certain prudential criteria.

Foundations are required to invest at least half of their earnings into non-profit activities of social benefit, in the fields of art, social assistance, environment, education, scientific research and health.

The state provides fiscal incentives for operations of M&A activity in the banking sector that result from the sale of stakes held by foundations.

Ambiguous status . The 1999 law has left many ambiguities in the legal status of foundations: although formally private, they are in practice run by state-elected administrators. According to the Ciampi law, foundations should represent both the interests of local government (regions, provinces and communes) and of non-profit organisations by offering them adequate representation on their board of directors. Last year, most of the 89 foundations rewrote their statutes according to the new requirements and defined the composition of their board of directors. The majority have completed this process. In most cases, local government has retained a firm control on the institutions and private non-profit organisations have received limited representation.

According to the 1999 law, foundations must give up positions of control in banks as well as in any other companies outside the field of social utility. The law defines control as the ability to elect the majority of seats in the board of directors of a company, either directly, by holding 50% plus one of the shares, or indirectly by syndicating with other shareholders. This definition of control is less strict than in the civil code; according to the latter, control exists whenever a company enjoys by any means a dominant position in another company.

The looser definition of the Ciampi law also allows foundations to retain minority stakes in banks and other enterprises. This implies that when foundations have the relative majority -- which could grant them a position of de facto control -- the ownership structure can remain unaltered. Significantly, foundations will be allowed to retain their stakes in important companies (such as Telecom Italia) and to take part in auctions for the privatisation of other public companies.

Increasing influence ? By selling their holdings, foundations have raised enough money to become major institutional investors in Italian capital markets. Almost two years after the publication of the Ciampi law, the total value of holdings owned by the foundations in the banking sector has significantly diminished. However, their influence on the economy as a whole has increased. Foundations have gradually withdrawn from the capital of larger banks and have acquired significant stakes in medium and small ones. Furthermore, they still hold important shares of SanPaolo-IMI, Banca Intesa, Unicredito Italiano, Banca di Roma, Banca Montepaschi di Siena (Italy's five largest banking groups) and Mediobanca. As a result, 80% of the major Italian banking groups are stuck in a complex net of cross-ownerships with foundations as crucial background players.

So far, the process of M&A in the banking sector has been encouraged by Central Bank Governor Antonio Fazio. However, more recently, Fazio has considered a consolidation and internal rationalisation of the newly created groups, which include Banca Intesa, SanPaolo-IMI and Unicredito Italiano -- a fourth group could involve Banca Montepaschi di Siena and BNL. Large banking groups argue that the Bank of Italy should allow them to proceed to a second round of M&A, so that two important results would be achieved: the hold of foundations over banks would decrease (as originally envisaged in the Ciampi law) and Italian banks would reach the dimension of their European counterparts. If this second round of M&A does not take place, it is likely that large foreign groups will seize the opportunity to strengthen their positions in Italian banks.

Foundation future . At the end of May, outgoing Treasury Minister Vincenzo Visco proposed new guidelines intended to prevent foundation directors from serving as executives in financial institutions they control. The guidelines have given rise to numerous protests coming from all political factions and the foundations themselves. Last week, Associazione delle Casse di Risparmio, the association representing banking foundations, asked a regional administrative court to block the Treasury initiative.

The new government under Prime Minister Silvio Berlusconi has not expressed a clear position on how it intends to restructure the banking sector. Economy Minister Giulio Tremonti in the past has talked about the need to introduce significant corrections to Ciampi's reform. However, at the same time, Luigi Grillo, the leading specialist on banking issues for Forza Italia, has shown a certain reluctance to alter the delicate equilibrium that revolves around the foundations. Like the last administration, the

Berlusconi administration seems uncomfortable about taking decisions against well-entrenched interests that dominate the banking industry.

CONCLUSION: In the near future, foundations are likely to maintain and possibly increase their influence on the domestic banking system. Although they are withdrawing, at least in part, from the banks from which they originated, they are acquiring significant weight in a number of small and medium sized banks.