FROM THE BANKING CRISIS TO ACTION FOR ITS RESOLUTION. SOME CONSIDERATIONS ON THE QUESTION OF BANK BALANCE SHEET AND CAPITAL REQUIREMENT WITH A FOCUS ON THE ITALIAN SYSTEM

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Abstract

We will now look at some considerations relating to national regulation and inter-banking agreements, with particular reference to the regulation of banking balance sheet and capital capital requirements. We will consider the actual capacity of such regulation to guarantee, on the one hand, and for a period of time, a full picture of the actual accounting situation of a single bank and of the risks that each of them have taken on, and on the other hand, the stability of the market through an adequate capitalization of banking operators.

Keywords: Crisis, Bank Balance Sheet, Capital Requirements, Regulation

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1 Introduction. Some criticism regarding some practices of the banking industry

Our economic system includes among its main participants those managing the banking system. The importance of financial intermediaries and of banks in particular is, of course, not a new thing: from one perspective the banks are institutions who manage the flow of money, and from another they are a mere payment instrument dealing in commodity exchange, both at the point when they collect savings (and so, in a certain sense, they acquire money) and at the point in which they grant credit (and so, in a certain sense, they transfer money to others).

The key role of the banking system in relation to maintaining financial flow is clear. This may be at a private level with respect to any relevant commercial transaction where help may be sought from the banking system which is in a position to provide or guarantee the funds required. Equally, it may be at a public level for purposes of a more general and economic character.

The overriding emphasis given to the second characteristic of banking activity clearly explains why within our legal system , banks were originally seen as public institutions whose key role was aimed at providing a service and consequently benefitting the general interest, and certainly not at making a profit, motivated by an entrepreneurial profit motive[12].

EU regulation along with our country's move towards economic models of an Anglo-Saxon nature have led to the transformation into the actual system, where banking activity has taken on an entrepreneurial character linked to the generation of income for the benefit of the bank itself, its shareholders and its managers.This putting at the centre of banking operations, whether it be on the part of shareholders who invest in share capital or on the part of the management who control it, the opportunity to derive financial benefit has also been accompanied by reforms. In clarifying and recognizing the profit motive of banks, these reforms continue to impose, however, that the practice of banking activity should be under the control and authorization of Bank of Italy and grant to the Bank of Italy[13] the power to check that all rules are appropriately applied and meet legal requirements in order for a bank to be allowed to continue and practise its business.

Given that the main aim of banking has become more aligned with other entrepreneurial activity and that this is an economic sector governed by a particular set of supervisory regulations, one needs to consider the key characteristics of banking activity. It should be noted that one of the two activities in which banks are involved, that of collecting savings, renders

[12] R.D.L. 12 March 1936 n. 375 (superseded by Law 7 March 1938 No: 141) opens with the significant statement that " the collection of savings from the public in whatever form and the provision of credit have a public interest function , regulated by the provisions of the current law".

[13] The supervision of financial intermediaries is divided between Bank of Italy and Consob, according to the activity in which the entity supervised is involved

that institution's activity intrinsically different from that of any other.

Through this activity the bank gains access to sums of money from third parties which may be used by the bank itself for other activities permitted by law and by its Articles of Association. In accordance with the well-known mechanism of the deposit, the bank acquires the sum deposited with it as well as the obligation to return it to the client who made the deposit. These deposits are regulated by provisions – normally contained in general contract provisions not easily understood by the client – which link the client to the bank. These provisions vary from an obligation to hand back the sum deposited at the simple request of the client to an agreement where the return of the deposit is determined by a period of time and / or a particular set of conditions.

Access to the funds deposited with the bank, makes the bank the holder of a financial sum which may be used for its own purposes, that is, traditionally in the granting of credit[14].

In this, the activity of the bank, as already noted, is that of financial intermediary who provides a safe place for the money deposits of anyone who does not have immediate need of them. In addition, from the resources placed at their disposition by clients, they acquire the necessary funds for the provision of credit to clients requiring the financial means to develop businesses or to satisfy their own personal needs.

The positive differential that the bank manages to obtain between the interest paid to savers on the money deposited and the interest obtained from financial institutions or individuals on money left, minus any costs, represents the profit margin earned by the bank from this 'traditional' business activity.

To the extent that that the activity carried on by the bank is manifested in this dual function - the function of intermediary responding to collective needs – supports the case that the proceeds from the money deposited should remain within the bank itself. It should be remembered that this dual function was particular and exclusive to banks at a time when they were considered and regulated as institutions providing a public service.

This circumstance makes the bank responsible for the correct use of the resources placed with it by savers, and means that they may not be used on something where the risk has not been adequately assessed. There is also the requirement that the resources placed with the bank should be committed in favour of the development of the system, done in such a way that the economic benefit ensuing from the commitment of savings does not remain completely within the bank, but is also in practice gained by those depositing money and those benefitting from access to credit, and that any margin held back by the banks is nothing other than payment for services rendered to both parties.

The same holds true as far as investments of money in assets are concerned. These investments constitute the bank's assets, guaranteed by those depositing with the bank and by the solidity of the banking institute itself. The bank in its turn as part of the inter-banking system may require to borrow money according to its actual need for liquidity. This aspect of banking activity, as is true for its investments, seems to lead us back to the need for a proper and correct exercise of banking activity in the light of those characteristics specific to the banking system.

Once, however, on the basis of market logic, banks are given the option to operate as investors, to put aside considerations of net worth and to move beyond acting simply as suppliers of credit, it then becomes possible for the banking system to adopt an approach towards the commitment of available resources, including those derived from savings deposits, largely protected from risk, but now destined for the realization of profit and gain.

The return on current account deposits does not offer a very high reward. They remain a marginal phenomenon which offer a remuneration on current account deposits which at best cancel out losses on the value of money as a result of an increase in prices.

A significant remuneration, involving a certain amount of risk, is promised only in the case in which the money deposited is dealt with in administration or management and with the specific provision that the sum involved will be allocated to an investment where the risk is shared by the client.

In concrete terms, however, no form of remuneration connected to profit on investments made is envisaged for the case in which the sum deposited is not bound by contract (time bound), although the banking institution in question is free to use the sum in question to carry out similar operations to those carried out with the money of third parties bound by time. The fact that the risk of losing the sum in question rests solely with the bank, placing upon it an obligation of unconditional repayment, has the effect of making the original source of the sum in question from savers legally irrelevant and justifies the bank's right to generate its own income from investments made.

[14] In addition to the provision of credit, our jurisdiction has recently accepted the model of a universal bank, and in this way, has given approval to many other types of financial activities within the limits set out in law and in supervisory guidelines. The establishment of a single European market in the banking sector , is expressed through the second E.U directive (no: 89/646) transposed in Italy through d.lgs. n 481: 14 December 1992,. The so-called Testo Unico Bancario came into effect through Legge Amato (218/1990). The Assimilation Decree 481/92 introduced the so-called universal bank in Italy. As an alternative way of credit brokering, the universal bank moves closer to the multifunction group introduced in the so-called Legge Amato (218/1990).

In this context and in the light of the ample room for manoeuvre accorded to the banks, it begs the question, from a legal point of view, as to what are the limits set out by legislation to prevent the freedom granted from causing damage to the banks themselves and to those who have placed their trust in them.

Such a consideration is motivated, in the writer's opinion, by the events which arose from 2007 onwards and which have thrown the subsequent five years (to date) into a hitherto unprecedented financial crisis.

As has been noted, such a crisis starts as a financial crisis, understood primarily as a crisis of financial intermediaries, who find themselves involved in an explosion, a chain, a series of speculative bubbles originating in the US real estate market.

These circumstances saw western governments intervene (above all the American)[15] in order to prop up the banks who lacked the necessary liquidity to meet their obligations. At the same time there was the widespread phenomenon of the top management of banks receiving extremely high salaries, obviously tailored to certain elements which disregarded the fact that they were in the middle of what has widely been considered as a period of crisis.

Following these interventions, we have witnessed some less than edifying events occur (or rather it might be more accurate to say 'perpetrated'). These include examples of financial speculation, which have seen institutions substantially weakened by the crisis; added to this, there are countries who have become greatly indebted as a result of the aid they were obliged to give to banks in difficulty, as well as the banks who were in receipt of the aid provided by these countries. They are under attack from institutions who adopt speculative strategies, or put more simply, at least by a part of the financial community which requested help from the countries involved in order to meet the bank's liquidity requirements and who have shown themselves to be responsible for the manipulation of market mechanisms for their own advantage and to the detriment of the wider community[16].

It is true that any simplification lays itself open to criticism. However, the impression one is left with having observed the events of the last few years is that in those systems which are experiencing low growth (that is, mature economies,) where the profit margin related to the development of the real economy appears to have reached its limit, a certain part of the financial community has chosen to divert resources from support for the real economy through entrepreneurial finance initiatives to investments in differentials which are found on the financial markets (financial indicators, currencies, debts). They then gain profits from the highs and lows of market indicators, while ignoring the fact that this movement corresponds to an effective increase (or decrease) in value and through operations that influence the market by signaling a worsening of the situation. This occurs every time operators in the financial community, 'back' a downgrade or a default of a certain individual, meaning that in the end, they are contributing to the outcome of the event on which they are betting.

In relation to this, the data recently reported in the financial press is of great significance. According to this data the top ten hedge funds in the world make more profit than that made by the world's top six banks[17]. With the difference, however, that hedge funds employ just a few hundred staff as compared to the million of staff employed by the top six banks. This says a lot about the prevailing values and of the social and economic fallout of the activity carried on by these individual bodies. An activity which, moreover, could not be carried on without a market created by savings, resources which can be siphoned off through hedge fund activities. Such a hypothesis seems in a certain way in line with predictions made on the evolution of the market in a seminar held at a very different historic moment[18], at a point when the

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[15] The action taken by the administrative authorities ranges from provision of loans to action on capital reserves. The effort made to support the economy was witnessed in the need to generate liquidity by means of printing money, the so-called quantitative easing whose effect, above all on the rise in the price of raw materials , is not yet completely understood.

[16] Most recently on the matter of the manipulation of Libor by Barclays, L. Maisano, M. Longo, Libor fraud: Barclays managers accuse ex Group Chief Executive: endless questions from MPs who struggled to understand how the Libor fraud escaped the notice of a banker who had received 40 million dollars bank performance related bonuses. It is estimated that a market of a s much as 350 billion dollars is regulated by Libor- though this may be only the tip of the iceberg with regard to the city<<it would be surprising if there were not to be further cases of market abuse>> confessed Lord Turner, president of the FSA – Il Sole 24 Ore – read on http://24o.it/rESBp

[17] J. MACKINTOSH, Investing stars lead bumper year for hedge funds, Financial Times, March 1 2011.

[18] See the views expressed in the Seminar "Redditività, patrimonio e mutamenti organizzativi nelle banche italiane , E. PAOLILLO, Livello e composizione del patrimonio delle banche Italiane, (The level and composition of capital structure in Italian Banks) in "La gestione del patrimonio delle banche", (The management of bank capital) Quaderno nr.199 : Associazione per lo sviluppo degli studi di banca e borsa, p.3 (the Association for the development of Bank and Stock Exchange Research) which refers to an analysis of 91 banking groups from 17 European countries, selected on the basis of having a balance of over 10 billion euros in which it reveals that, on one hand, at that time' the Greek banking groups were the most profitable (on average, ROE pretax = 30%) and on the other hand, that the cost – in terms of capitalization as determined by Basel 2 on the issue

crisis which would shake the foundations of the financial markets had not been foreseen.

At present, as long as such activity is carried on by financial operators using their own money it is viewed as acceptable practice (although this is debatable given the instability generated by such activity) and appears to represent an investment choice – one of risk –using one's own resources. But this is, in fact, a profit making project achieved through investments which do not have any economic rationale based on production values, but which are decided solely on the basis that the investor guesses when to enter and leave the market to the cost of less astute or less opportune investors, but investors who are at least using their own resources. A different judgment must be done if a similar activity carried on by operators using money from third parties, in which the individuals who control these investments (and therefore, above all the funds of these speculations in accordance with law 24 may 1998 number .58, subsequently modified) do so using finances at their disposal which are made up of resources made available by third parties , on the basis of irregular deposits.

In this situation, the activity carried on by the institutions which profit from variations in the market comes about as the result of means made available by third parties, third parties who however gain neither positive benefit nor are made aware of the activities which financial investors have set up.

In my opinion, this topic, that is to say that activity carried on by operators in the financial system, and in particular the banks and the use on the part of the banks of resources put at their disposal by savers, ultimately also involves the granting of credit as it has been practised in recent years, particularly in relation to banking activity.

of provision of credit had pushed many banks in the direction of diversification to alternative activities of a 'low capital intensity' such as asset management.
Another participant at the seminar, similarly revealed that in order to challenge the contraction of profit margins , banks were tending to focus their own business on products linked to asset management for reasons of cost in terms of capital. cf C. COSTAMAGNA, Il mercato dei titoli emessi dalle banche(The market in bonds issued by banks), in La gestione del patrimonio delle banche (The management of bank capital), Quaderno nr.199 de Associazione per lo sviluppo degli studi di banca e borsa 3 (the Association for the development of Bank and Stock Exchange Research), p.27. He notes that the impact of Basel 2 besides encouraging banks to focus on business with a low capital impact should be to encourage a greater diversification in loan portfolios. prestiti S. Theodore, Capitale e rating di banche: una correlazione non forte (Capital and bank ratings: unconvincing correlations) , in La gestione del patrimonio delle banche (The management of bank capital), Quaderno nr.199 de Associazione per lo sviluppo degli studi di banca e borsa, p.51.

Just as with investments made by the bank, the granting of credit also represents the commitment of monetary resources by the bank which come, in part, from savers, in the same way that resources used for investments do.

The development of the provision of credit is traditionally conceived of as a support for the economy on the part of the banking system. On one hand, the presence of the bank should allow for the development of activity capable of generating wealth and value by financing entrepreneurs who are not in possession of the necessary resources of their own to guarantee growth. On the other hand, the presence of the bank should allow for the satisfying of needs related to consumption, making up for a lack of immediate availability of money, opening up the possibility to conclude transactions that would otherwise have to be put off to a later date.

Within the banking system there is the option to grant credit in order to support the requirements of entrepreneurs and consumers, and which is at the same time compatible with a sound economic framework, given that it is inspired by values attaching importance to acting with prudence. It is, however, also possible to see the granting of credit organized for purposes of the phenomenon of speculation. The most obvious historic example is represented by the granting of sub-prime mortgages – an indication of a non-rational approach to traditional banking activity which appears to be based on an increase in the volume of banking activity as well as an attempt to generate profits in as short a period as possible and which produce windfall profits, offering a greater financial reward for both managers and administration. And all this without any consideration for the medium or long term effects of such activity.

The creation of volumes of debt in a situation in which that debt can only be repaid on the supposition of an economy in permanent and constant expansion, indicates a defect in its design.

And indeed it is an unrealistic working hypothesis that supposes a future development of market conditions which will automatically be in a state of growth. Contemporary economic theory is relevant here, starting with a historic study, viewing the economic reality as a cyclical system alternating between periods of expansion and periods of recession[19].

However, in recent years there has been a common belief in the approach of management bodies as well as of banking institutions and on the part of economic doctrine, that is, the vision of an economic system as an entity benefitting from the efficiency of the market, which was capable of positive progress towards a 'pereto otimality' (no-one can become better-off while causing others to become worse-off), understood as a dynamic maximum use of resources,

[19] See P.A.SAMUELSON W.D.NORDHAUS, C.A. Bollino, Economia, McGraw-Hill, 2009

or of changes in the market or in production factors which would guarantee a systematic growth in the economy[20].

Moreover, even today , in a world hit by crisis, it is very rare to find economic predictions which envisage the possibility of the spread of the crisis or of a worsening of the situation. Even in the worst moments, even when economic contraction was at its most serious, it was argued that, within a few months the situation would pass and indeed on the basis of this supposition, the maintenance and conservation of the value of the balance of assets was permitted, which in the light of market conditions more properly should have argued for them to be downgraded (IAS 39)[21].

This second type of behaviour, relating not to investment of resources, but to the giving of credit, highlights a financial and banking activity intended to generate profits in as short a period as possible, while in the medium to long term they turn out to be the cause of losses which are capable of bringing about instability in the whole system.

This second type of behaviour, that linked to the giving of credit should not constitute a problem in an efficient market system, well able to punish excesses and capable of self-regulation: anyone who grants credit too lightly should disappear from the market given the losses that such casual behaviour brings about.

Recent history on the contrary shows that the market is not capable of this, that the market is not able to manage the consequences of mistakes committed by the financial community. Only through public intervention in the economic system it was possible to prevent the damage created by that sector of the system previously seen as the driving force of the economy, capable of guaranteeing economic expansion, but who have ended up destroying the whole system.

The considerations previously mentioned constitute in great measure a censure of both investment activities carried out by the financial community, and in particular the banks for speculative purposes, as well as the granting of credit with a disregard to principles of prudence and on the basis of unreasonable expectations.

This consideration, by merit of the need to behave in a responsible and not prejudicial way on the part of the financial community, has in my opinion at its economic foundation the belief that the financial system draws resources from the real economy, and especially from savings, using as its engine, the money of other people, which comes together through the banking system and intermediaries in order to create that body of capital which allows the financial markets to exist.

If in examining the current context as regards financial markets we take as our point of reference the beginning of the 1970s, one observes the push of the Italian legislature at that time towards the establishing of a belief in directing private savings towards the market of transferable securities, seen as more rewarding instruments than savings and support for the industrial economy, the reason being that they were more remunerative.

The partial realization of this plan has produced a system in which the flow of savings does not appear to have created an optimal allocation of resources, either for savers or for entrepreneurs. Instead now, backed by a substantial sum of money, it conducts operations which have drained a part of the resources of savers in favour of anyone who has better ‘guessed’ market movements while disregarding the production of any real value behind these movements.

This situation brings into question whether the market, as a result of self-regulation, is the ideal place for the proper allocation of savings, and leads one to hypothesize on the need for a tighter control on the part of those agencies appointed to supervise the

[20] The champion of this vision of an eternally productive system of wealth, that is, one continually in growth, is of course Milton Friedman and more generally, the so-called Chicago School.

[21] See the audit of IAS No: 39 carried out in 2008. In countries with mature economies, the prospect of continual economic growth is, clearly, unrealistic, but it is the only one that can generate an expectation of an increase in profits without making future prospects as unattractive as they would otherwise be; in other words, that the creation of new wealth in countries with low or zero growth , or the reconnection to an anti-cyclical trend of the sector to which the individual who managed to create the wealth belonged (also linked to the fact that this individual exports to foreign markets of countries in growth) or otherwise to bring about the fruit of a redistribution of earnings, all this will lead to a subtraction of resources to the advantage of some and to the detriment of others. From a general economic point of view, economic development is placed at the centre of numerous theories (the so-called Theories of Economic Growth) aimed at identifying elements capable of encouraging economic growth. The contribution of the ‘technological revolution’, the thing which has speeded up production, led people to speak of ‘a new era and attracted a strange enthusiast – Alan Greenspan, then President of the Federal Reserve, to speak of a radical change in the system beyond a simple cyclical phenomenon. (cf .A. Samuelson W.D.Nordhaus, C.A. Bollino, Economia, McGraw-Hill, 2009, p.616) On the matter of the reaction of the same Greenspan to the episodes of the manipulation of markets and misappropriation on the part of financial intermediaries, see, as reported by L. Zignales in his own commentary on the ‘discovery’ that Barclays worked to manipulate Libor to its own advantage, Break-up the big bad banks in http://24o.it/rDBxA “As former Fed chairman Alan Greenspan put it in 2008: «Those of us who have looked to the self-interest of lending institutions to protect shareholder's equity-myself especially-are in a state of shocked disbelief» Luigi Zingales with an article by Vincenzo Rutigliano http://www.ilsole24ore.com//

market and those trading within it. This would be done in order to:

a) prevent behavior on the part of market operators which brings about market instability;

b) prevent the existence of the type of environment which favours the behavior of opportunistic traders who pay no attention to safeguards or the remuneration of savings (the very thing which forms the engine of the economy and considered necessary for the creation of market capital) but instead direct their attention solely towards extracting personal benefits for the individuals and the organizations through which the market operates.

In short, the arguments of those who extolled the virtues of the free market and argued for the maximum possible use of financial control, maintaining that the financial market and the banking system represented strong pillars which guaranteed the solidity of the economic system, as well as providing an effective allocation of resources and maximum growth, all this has now been shown to be fragile and destabilizing factors for the system.

.The situation that a growing part of financial and economic resources have regularly been directed towards agencies of a financial character has thereby ended up transforming banks and other players in the financial community into instruments of destabilization for the economic system. [22]

The criticisms highlighted above have not gone unobserved by public opinion, who identified in the financial world and its traders the cause of a period of recession which has hit the€ economy. It is symbolic that The Times chose to dedicate their cover of 'Man of the Year 2011' to a protester from the Occupy Wall Street movement.

Parallel to the reaction of public opinion, a reaction has also grown up among those authorities possessed of the powers in various countries to regulate the banking sector. This reaction is moving in the direction of introducing in various ways and under various guises, regulations directed at avoiding the crises and difficulties encountered in the period 2007 -2012, difficulties that on one hand, led to an unforeseen breakdown in the banking industry, and on the other hand, has led to widespread losses for savers who had directly invested in regulated markets.

A part of the reason which has led legislators to consider greater guarantees and controls on the financial system is linked to the fact that on one hand, credit activity by its very nature focuses the risk of insolvency of financial individuals within banking operators, and on the other hand to the intrinsic volatility of financial markets and to the fact that the markets themselves follow these trends. All these elements render the 'financial sector' a strong reflection of the characteristics of the economic cycle of the moment, and hence of the effects produced by the crisis.

From this point of view, the criticism of the banking system and the financial market are elements which are physiological, structural and non-eliminable.

On the other hand, changes in the regulation of the banking system have been addressed and indeed, prior to the current crisis. These changes have, however, ended up equating such an individual or institution with any commercial entrepreneur, rendering it free of direct intervention in every economic sector and making it possible for a banking group to provide every type of financial service (following the model of the Universal Multi-Service Bank).

Following the crisis, the attention of legislators and the regulatory authorities in the banking sector seems to be drawn towards guaranteeing the contrary, by increasing the regulation of the sector and thereby reducing the freedom of trading banks, bringing into question the comparability of the banking sector to other business activity.

However, the introduction of new rules in the system, has interestingly included no direct intervention in those very aspects which produced the above-mentioned critical situation.

Compared to the variety of intervention and regulation which have, to a certain extent, been considered or demanded by social parties, the banking system has witnessed an intervention , above all, in areas of the capital requirements of the banking industry. This results from the implementation of the inter-banking agreements of Basel 2 and the provisions of the agreement in Basel 3. Of course, the inter-banking agreements of Basel 2 and 3 represent a change of perspective, as compared to the prior perspective of a focus on the effective allocation of resources in order to maximize possible profits which appeared to be key in the period preceding the economic crisis. It is clear that these agreements are aimed at and give central importance to the stability of the banking system in order to safeguard the interests of those who passively participate in the system / market, that is, savers who entrust their resources to institutions and individuals that the system judges to be trustworthy.

However, it is important to remember that the Basel 2 agreement originated in a historic moment (the signing of the agreement in its first draft dates from 2001 and came into effect in Italy in early January 2007) prior to the start of the crisis and not as a consequence of the crisis itself. The Basel 3 agreement, on the other hand, represents a true and proper reaction to the fundamental crisis (and in a certain way represents an extreme simplification) rendering the capital requirements laid down by Basel 2 much more stringent. That agreement already imposed on banks the need to hold a higher sum of

[22] L.NADOTTI C.PORZIO D.PREVIATI, Economia degli intermediari finanziari, (The Economy of Financial Intermediaries) McGraw-Hill, 2010, p.11.

fixed capital in relation to the inherent risk involved in granting credit and is designed to create more stable structures within the market. In the light of these changes to the regulatory framework, and also in the light of events of recent years, we need to be certain that the requirements laid down with regard to capital requirements for banks are both adequate and appropriate in order to prevent a repetition of the critical situation outlined above, while also taking account of the criticism levied at such agreements, criticism which maintains that this intervention has brought about restrictions in the provision of credit and thereby a worsening in the economic recession.

From this point of view, it is vital to take into account the regulation of banking balance sheet as the principal instrument communicating to the market information regarding banking activity and the actual situation of the bank.

It is worth pointing out that what is very surprising with respect to the onset of the crisis we are currently experiencing was the complete and general absence of any indication of such a crisis. The annual balance sheet of none of the banks showed any weakness indicating a serious sign of fragility. And this refers not to cases in which it was discovered that the balances were false, but rather to the issue of whether the bank balances correctly given were really able to say anything meaningful about the actual situation of the bank.

With regard to the situation outlined above, we will now look at some considerations relating to national regulation and inter-banking agreements, with particular reference to the regulation of banking balance sheet and capital capital requirements. We will consider the actual capacity of such regulation to guarantee, on the one hand, and for a period of time, a full picture of the actual accounting situation of a single bank and of the risks that each of them have taken on, and on the other hand, the stability of the market through an adequate capitalization of banking operators.

2 The Regulation of Banking annual Reports in relation to the critical situation indicate above. Some observations

Even the simple description of the issue outlined above is not at all simple.

To begin with, it is not easy to coordinate all the regulatory sources that mark out in their totality the key regulation in a specific case.

The regulation under consideration is in fact manifold. On one side, it regulates the annual balance sheet of companies which form part of the banking system; from another side the regulation deals with the composition and evaluation of capital capital requirements; from yet another point they apply to rules governing the granting of credit and the assessment of credit worthiness, connected to the procedures and the limits on the granting of credit. The regulation of bank balances takes place on a variety of levels. Internally the regulation is set out in law 27 January 1992 nr.87, which outlines the rules applicable to the auditing of bank annual and consolidated accounts.

The Bank of Italy in implementing art. 5 of the procedure, has arranged for the issue of a guidelines circular detailing the technical procedures to be followed when auditing bank balances dating from 30 July 2002.

In connection to this standard framework, there has also been law 28 february 2005 nr.38 which has made it obligatory for all banks to produce the balance sheet in accordance with the international accounting principles of regualation CE 1606 :2002.

Following this intervention, the Bank of Italy intervened again, replacing the preceding procedures with circular nr.262: 22 December 2005, which takes into account the new legislative framework, seeing international accounting principles as provisions of greater importance and of a later date.

The content of the financial accounts and of the informational documents which must be presented by banks and then integrated into the instructions issued by Bank of Italy on the question of prudential supervision is addressed in circular nr.262:2005 with particular regard to the obligations set out in the fourth part of the said document.

The regulation of bank balances does not fully lend itself to independent considerations, with regard to the regulation of individual institutions bound by international accounting principles, in other words of commercial companies involved in a different kind of activity from that of the banks.

Certainly, what emerges from an examination of the regulation of banking annual reports is the need to highlight sections and items that take on particular significance in the light of activities carried on by the banking system or whose ‘concepts’ appear to be specifically imposed on traders in the banking system by other regulatory provisions.

We must finally consider that the ‘third’ pillar of the Basel 2 agreement foresees the communication to the market of information on levels of capitalization, on levels of risk and on procedures for prudential checks on management through a series of requirements which has witnessed over the years a range of interventions inspired by the declared desire to make the content of financial reports much more transparent and comprehensible to readers.

On this point, see the latest regulation of Part 4 Chapter 1 of the instructions of Bank of Italy in circular 263/2006[23].

[23] “In order to strengthen market regulation, a duty to publish information on the adequacy of capital reserves, the extent of exposure to risk and the general characteristics of the system has been introduced, aimed at the identification, evaluation and management of such risks.

In this regard, there can be seen an interaction between the regulation set out in the inter-banking agreements and the regulation of banking annual reports, both unanimously underlining the importance of transparency and completeness of information as the first thing that the bank must aim for.

Overall, the rules mentioned above put transparency, clarity and the true and fair representation of the situation of the banking institution at the heart of the regulation of banking annual reports. This applies as well to any activity carried on by the bank and to any results provided. Moreover, these factors are also common to any company which is not involved in banking activity. It assumes a particular significance for banks, given that banking activity holds a central role in the economic system, in view of the trust placed in it by savers and from the point of view of commercial transparency and correctness of information for clients in terms of the activity carried on by the banking institution.

Nevertheless, it should be pointed out that banking annual reports have a layout and composition which, unlike those annual reports of commercial companies, make them not readily intelligible, not allowing readers to easily understand – what is the actual capital revenue and financial situation of the company, how is the banking activity distributed with regard to the multiple opportunities open to banking institutions, to what extent is the granting of credit given priority over other activities and how much capital is committed to the granting of credit and how much to other activities, what are the sources and the reasons behind the profits and the losses generated by the banking entrepreneurs, how is it allocated territorily' All this is information which can be extracted from an annual report only with great difficulty.

The complexity, the technical language of such a document, the fact that the terms used to describe the content of the various items mean that it is not easy to get an accurate picture of everything contained therein, the fact that the 'symbols' used do not transmit a clear 'meaning' which is transparent enough for the users of the financial report. It is difficult to interpret, as well as vague and so means the document has no real informational value – even for the employees who are required to produce the financial report. This, therefore means that it is particularly difficult even for an astute reader to get an overall idea of a single bank's activities .

.In my opinion, this problem of lack of intelligibility and an informative content explains why the factors which caused the crisis affecting the financial sector and in particular credit agencies from 2008 onwards arrived like a bolt out of the blue. The crisis arrived without warning and without any indication of the level of risk of many of the accounts that the banks had taken on well before 2008. Thus, there was no trace or sign of warning prior to the devaluation which affected the 2011 bank balances of the two main banking groups in Italy by over 10 billion euros.

What seems clear is that banking annual reports, like those of all other companies, are presented to give a representation of the 'final balance', that is, they refer to what has already happened through earlier activities. It is, therefore, natural that the financial report represents only events which have already happened and not those which are yet to come.

What seems anomalous, however, is that should the events and activities which determine a loss originate in the course of the financial year preceding the one to which the report refers, there is no indication in the financial statement of the extent of the danger or risk assumed by the credit agency, or it is only when that risk turns into a loss that the credit agencies will decide to reveal this in the financial report[24]. This informational deficiency of the financial

In the case of the use of internal systems for the calculation of capital reserves in the face of credit and operative risks and the technical reduction of risk, compliance with obligations relating to public information also represents an appropriate context for the recognition for prudential ends of the so-called methods and techniques.

Banks need to formalize the strategies and procedures aimed at guaranteeing compliance with informational requirements, assessing the adequacy also in terms of the mode and frequency of information-sharing. It is the responsibility of banks to ensure the completeness, the true and fair representation of information published.

Apart from this, banks must have policies capable of assessing if the information provided to market participants gives a fully comprehensive picture of the level of risk involved,. In the absence of this, banks should communicate the required information beyond that foreseen in attachment A. However, they are obliged to publish only information which seems significant and which in not considered privileged or confidential in compliance with par. 3The Bank of Italy also checks the existence of appropriate organizational procedures in order to guarantee the trustworthiness of the process of production, compiling and sharing of information. Information is published via the bank's internet. As a result of this method of information sharing, it is difficult and burdensome for banks to publish the information on the websites of relevant organizations or in the press". (……..) banks do explain (Noto to the accunt: Part E) the means used to obtain the information published. The information is published at least once a year, in accordance with the conditions laid down for the publication of annual reports".

[24] On the issue of the inadequacy of the current model of disclosure of securities in banking annual reports, in so far as it is based on the so-called incurred loss model (which is based on the concept of losses which have already occurred), and on the need to adopt, on the contrary, a system of disclosure of losses which also evaluate expected losses (expected loss model) cf G. EBHARDT, Z.

report is notable in the application of IAS 39 which is in the course of revision and which has led to the setting up of FCAG[25].

The inability of banking annual reports to take into account the risks presented through their various activities does not appear to be an intrinsic or necessary feature of such a document. Rather it seems related to the fact that the indicators present in the items which make up the key parts of the assets and liabilities in the institution, that is 'financial activity and passivity', are expressed and sub-divided in so many ways that it is not easy to understand the content of the conditions they represent.

To this should also be added a certain level of discretion which is essential in the production of annual reports.

This holds true also for reasons of the particular make-up of their capital, for reasons of the specific application of IAS 39 and for the principle of fair value as set out in the version emended in 2008 which allows banks to reveal (or not) losses related to the market value of financial instruments earmarked for negotiation or sale[26]. This greater discretion was particularly crucial with regard to the evaluation by administrators of credit portfolios and in the widening of that discretion in the case of its application to activities deriving from securitizations[27].

It is still possible for the more important assets in the financial report, especially financial and credit activity to be inserted in the report (at the decision of the institution) in different sections of the report, and in this way to allow banking entrepreneurs a wide margin of discretion in the compiling of the financial statement[28]. Within these combined categories there may be widely different assets also with respect to the classification adopted in accordance with the indications issued by the Bank of Italy[29]. As a result of a deliberate choice, a synthesis of the net value of the assets of credit agencies is lacking, given that these assets are spread over a series of specific sections[30].

NOVOTNY-FARKAS, Mandatory IFRS Adoption and Accounting quality of European Banks, in Journal of Business Finance and Accounting, due for publication shortly; R.MONACHINO, Il nuovo modello di Expected Loss: un'opportunità da non perdere, (The new model of expected Loss: an opportunity we must not miss) in Il bilancio della banca cit., (Banking Annual Reports), p212.

[25] On the issue of the role of FCAG (Financial Crisis Advisory Group) see the report produced by FCAG in July 2009 which can be found on the site www.ifrs.org.

[26] On the issue of the modifications to IAS 39 which has increased the option not to record losses linked to the assessment of fair value of financial instruments, specifically in relation to the annual report of financial intermediaries see S.ZORZOLI, Banche, ecco perché non funziona la trasparenza a corrente alternata, (Banks and why the current level of transparency does not work) in http://www.viasarfatti25.unibocconi.it/notizia.php?idArt =4673. On the same topic cf. A.AMEL-ZADEH E G. MEEKS Bank failure, market-to-market and the financial crisis, Working paper November 2011 in SSRN id1494452, according to which "The accounting regulators have during the crisis twice introduced relaxation in the fair value regime. First we consider the amendment of IAS 39 in 2008– allowing banks to re-classify certain financial instruments from the trading category (which requires continuous marking to market) to the loan category (which is measured at cost). We reason that, even though it does not affect their underlying solvency or viability, this partial suspension of fair value accounting may for some banks have reduced the probability of regulatory failure with all its attendant costs; and such a benefit would show in share prices"

[27] On this point see R.MONACHINO, Il nuovo modello di Expected Loss: un'opportunità da non perdere, (The new model of expected Loss: an opportunity we must not miss) in Il bilancio della banca cit., (Banking Annual Reports)Sul punto cfr. R.MONACHINO, Il nuovo modello di Expected Loss: un'opportunità da non perdere, in Il bilancio della banca cit., p. 214

[28] On this issue it is sufficient to look at the content of items 20, 30, 40 and 50 of capital assets. On the basis of the fact that the same assets (in particular financial assets and liabilities) can be recorded in different sections of capital assets. see F.TUTINO, Il bilancio delle banche, introduzione alla lettura, Bancaria editrice, 2010, p,18.(Bank Annual Reports, an introduction to interpreting these reports) " which means that securities / bonds with identical features may simultaneously be recorded in differing sections, and that classification may change over time only in limited cases and according to the terms allowed by the rules". On the issue of the option to insert credits in items 20, 30, 40, 50, 60, 70, 140 of the assets see L.TRIBAN, I crediti, in I bilanci delle società cit.p.188. (Credits in Company Annual Reports p 188).

[29] "The aggregates included in the assets are the following: available liquidity, including ……… re- financeable securities / bonds with central banks; it should be specified that in the EU approach, re- financeable securities / bonds should represent a component of the liquid reserves of the bank, even though in practice they can be included in frozen securities; as a result, questions must be asked as to how reliable the aggregates in question are in providing true indicators regarding the level of liquidity of the bank" G. Cerani and B. Frazza, Il bilancio bancario. Evoluzione e rivoluzione nell'informativa, (Bank Annual Reports. Evolution and revolution in information provision) M.RUTIGLIANO (Edited by), Il bilancio della banca . Schemi principi contabili analisi dei rischi,(Bank Annual Reports. Accounting Principle frameworks and the analysis of risk) Milano, 2011

[30] In addition, Circular 262 of the Bank of Italy, foresees the creation of a table of net capital variations to be inserted in the integrative notes. On the question of the composition of "Banking Institution capital" as bank net capital is defined see V.Antonini, K. Tomasini e S. Zattarin, Il patrimonio netto e il patrimonio di vigilanza (Net capital and capital

These points also hold true as far as the income statement is concerned. From the moment the items of the income statement are revealed as items no: 10, 40, 80, 100 110, 130 190, 280 of the income statement, the same differentiation between the margins of interest and the margins of intermediation appear unclear in the content, and above all in informing the market with an effective evaluation of how much of the activity of the bank is related to granting of credit and how much to other activities[31].

The reason for the informational discrepancies between the annual reports of commercial companies and those of banking institutions (as highlighted in the literature on this issue) leads back to the judicial decision to use the financial reports of banking institutions as an instrument through which the Bank of Italy can carry out its regulatory responsibilities.

That choice by the Bank of Italy was taken on the basis of regulatory requirements and has resulted in a content of the annual report which is designed to provide information necessary for supervisory purposes.

This situation means that the financial reports of banking institutions are of such technical complexity that it cannot fulfil its own informational purpose.

The necessary action with regard to the re-design of this document, unfortunately seems incompatible with the current regulatory framework and with the general clauses of international accounting principles of a 'true and fair view' as well as article . 2423 of the Italian civil code It is a financial report characterized by opaqueness and lack of intelligibility with a conflict between supervisory demands and the informative function such a document should perform. This situation should lead the regulatory authorities to accompany the annual report with another document specifically for regulatory purposes, while restoring to the annual report its original informative purpose[32].

supervision) , in Il bilancio delle banche cit., 252. , (Annual Bank Reports).

[31] Margins of interest should indentify the balance of the active and passive interests, thereby simplifying the balance between the activity of the granting of credit as compared to the interest obtained by savers, while the margins of intermediation should include, in addition, the balance of investment activity and negotiation activity. Sul punto cfr. L.TRIBAN, I crediti, in Il bilancio delle banche cit., p.189

[32] On the issue of the generally recognized opaqueness of Bank Annual Reports cf M. TONVERONACHI, Economia dei sistemi finanziari, Materiali per il corso(the Economy of Financial systems, Course Material), in Unisi.it; G. MAROTTA, L'instabilità bancaria recenti sviluppi teorici ed empirici (Banking Instability: recent theoretical and empirical developments), in Unimore.it; R. Masera and R.MAINO, Recenti tendenze e prospettive nella patrimonializzazione delle banche Italiane (Recent tendencies and prospects in the capitalization of Italian Banks) , intervento tenuto nell'ambito del seminario su

The need to provide clear and accurate financial information in order to guarantee to external users an adequate level of transparency for reasons related to strategic choices is, however, evident in a related document of Bank of Italy, Consob and Isvap : 6 February 2009. The 'exceptional nature' of the document, is not that it requires any extra information than that already foreseen, but rather that the information provided should be easily comprehensible. This undoubtedly refers back to the need to guarantee intelligible information to communicate to the market on matters of financial data22.

It should also be noted that that the over-lapping of the aim of regulation and that of transmitting clear information occurred at a time in which the model of banks existing then was not that of the universal bank. The characteristics of the financial market and the instruments affecting the former model of bank were much less than those affecting the universal bank. Therefore the need for clarity and transparency was not so great, by reason of the fact that the activities involved only the collection of savings and the granting of credit.

Given the changes in the regulatory framework, which now views banking operations as a very wide-ranging sphere of activities, the format of the annual report struggles to provide information on those aspects of banking activity which have taken on such complexity that it is almost impossible to make this accessible and intelligible in the annual report as it now stands.

The result of this new regulatory framework is that fully comprehensible information explaining trends in banking activity, revenues gained and losses suffered, can be understood much more clearly by reading the management report rather than the annual report in its strictest sense. This essentially means that the results of the decisions taken by the administrative body and capable of providing concrete and intelligible detail to the market is destined to remain hidden between the folds of the accounting document, only to emerge when the banking institution decides to, or is forced to publish it.

In view of this, the substantial level of doubt regarding the annual reports of the principal banking institutions, both Italian and foreign, is striking, a belief that these reports do not present in a clear manner, a true and fair picture of their actual situation, despite the plethora of checks to which these individual bodies are subject.

In short, the fact that banking annual reports represent supervisory instruments on the part of Bank of Italy is in part adopted as a justification for the lack of intelligibility of these documents. In these

"Redditività e patrimonio e mutamenti organizzativi nella banche italiane"(presentation given during a seminar on" "Profits, Capital and Organiztional Changes in Italian Banks) S. Marco Perugia, 16 marzo 2002.

circumstances, it is as if regulation and clarity are seen as incompatible Equally this situation does nothing to ensure the credibility of banking annual reports.

The final outcome of this, (also dictated by the specific application of these regulations to the evaluation of banking annual reports) means that we end up with such an opaque document that it is totally incapable of allowing those studying it to understand with any degree of reliability, the actual content of the accounts and the risks associated with them.

3 The Regulation of Capital Requirements: some observations

The regulation of capital requirements also operates at a multiplicity of levels: national, within the European Union, as well as on the basis of intergovernmental agreements on a negotiated basis. From the point of view of internal regulation, the fundamental control is represented by artt. 51 law 1 september 1993 nr.395.

In particular, art. 53 law 1 september 1993 nr.395 requires the Bank of Italy to issue, in compliance with the rulings of CICR, regulations of a general character to check the adequacy of capital held, the extent of risk and its diverse configurations, shares held, the administrative and accounting organization, as well as the internal checks of each banking intermediary. To implement the above-mentioned regulation the Bank of Italy has recently addressed this through circular nr. 263: 27 December 2006, containing 'the new rules of prudential supervision for banks.

Accompanying this internal check, there are also the regulations issued by the commission of Basel, a body representing the central banks of the G10[33] countries and to which have been added 100 other countries: the binding nature of this regulation is – in part – sanctioned at European Union level.

There have since been at least two subsequent agreements.

The first is the Basel agreement of 1998 – the Agreement on Minimum Capital Requirements of banks. The aim of this agreement is the identification of minimum capital requirements, minimum capital requirements determined by linking each loan operation to a quota of capital to be held for precautionary purposes.

.On the basis of this assumption, the obligatory capital requirement for each credit agency is determined by comparing the framework of the supervisory capital requirements with the amount of banking activity dedicated to the granting of loans and weighing up the risks of the loan (that is, default or late payment on the part of the borrower).

[33] Belgium, Canada, France, Germany, Japan; Italy, Luxemburg, Netherlands, United Kingdom, United States, Spain, Sweden, Switzerland

The system of evaluation is based exclusively on five co-efficients: 0% for activities with central governments, central banks and the European Union; 20% for activities with public entities, banks and investment companies; 50% for activities with mortgage creditors and leasing operations on property; 100% for activities with the private sector; 200% for shares in non-financial companies with a negative balance in the last two financial years[34]. Therefore, the assessment of credit worthiness is judged on the basis of the following elements: the nature of the debt, the existence or non-existence of guarantees, countries presenting risks, the type of activity in which the debtor is involved.

The obligation of this agreement in the case of banks operating in one of the member states of the European Union, also derives from their recognition by the EU legislature in directive 647/1989, later repealed in art.67 of directive 12/2000.

The evolution of the features of banking activity led to a re-examination of the terms of the Basel I agreement by means of a new Agreement known as Basel II, produced by the same Basel commission and ratified in 2004.

The final version was published in 2006. The Basel Agreement came into effect 1 January 2007.

Turning to the content of that agreement and with a desire to simplify, in basic terms Basel II is founded on three pillars: the prescription of minimum capital requirements for each banking institution; prudential checks on the adequacy of capital held; the transparency of information. As far as the prudential checks on the adequacy of capital held is concerned, this was represented through a more accurate assessment of the credit worthiness of individuals which should prove beneficial and, moreover, take into consideration both market and operating risks[35].

According to the provisions of the Basel II Agreement, the co-efficient consideration is no longer fixed, but must be considered on a case by case basis in terms of the so-called credit worthiness, that is, on the ability of a single company to repay any loan taken. To calculate the co-efficient consideration, banks must refer to the rating assigned[36]: the better the rating the lower the co-efficient consideration: the consequence will be a minor absorption of capital,

[34] E. FACILE e A. GIACOMETTI (editors), La guida del sole 24 ore a Basilea 2. Il nuovo processo del credito alle imprese, Il sole 24 ore(Sole 24's guide to Basel 2. The new procedure for the granting of credit to companies, Il Sole 24 ore) Milano 2008, p.7 ss.

[35] One of the limits of Basel 1 was its inability to distinguish the level of risk within the same category (companies, public entities etc.) since it did not take into consideration the specific risk which characterized the individual company as well as the nature and duration of the loan.

[36] In other words, a concise indication of the company's credit worthiness arrived at using various methods (standard method, IRB foundation or IRB advanced).

that will imply minor costs for the bank, and so, in theory, for credit costs.

As far as the second pillar is concerned, the diversity of the level of risk that affects each banking institution as a consequence of the strategy adopted by each bank on the basis of the assumption of risk, means that the Basel agreement complements the first pillar through a greater level of discretion by the central bank in assessing the adequacy of capital requirements of banks, since this is set by each of them by reason of the need for each bank to have a higher cover than the minimum requirements set out in the agreement[37].

Finally, the third pillar, as already mentioned, imposes a greater degree of disclosure in the transmission of data related to banking activity.

This agreement was subsequently superseded by Basel 2.5, superseding the Basel II agreement agreed in July 2009, by improving the assessment of risk related to secured transactions and to the exposure related to negotiation portfolios[38]. Their implementation was programmed to occur by December 2011[39].

In December 2010 the commission published Basel 3, which raised the levels of capital co-efficients and introduced a new international liquidity scheme.

The members of the commission agreed to implement Basel 3 from January 2013 onwards, following a progressive timetable supplemented with temporary regulations[40] for the transition period.

Through the Basel 3 Agreement there has been an attempt to correct gaps which became evident in the previous agreements. In particular, the Basel 1 and 2 agreements are focused on the assessment of credit worthiness and of credit risk, through requirement provisions of a capital nature.

The Basel 3 agreement, through a combination of reform provisions, tends to focus on the controls, regulation and management of risk in the banking sector, through provisions aiming to

• improve the ability of the bank to absorb shocks deriving from economic and financial pressures, regardless of their origin.

• improve risk management and governance.

• strengthen the transparency and informative function of banks.

In particular, the Basel 3 agreement, on the one hand, imposes on banks an increase in Core Tier 1 for a greater quota percentual, and on the other hand, requires the bank to conform to a series of indicators and parameters linked to liquidity in the short and /or long term, in this way enabling institutions to confront stress situations[41].

Special attention is placed not only on the issue of liquidity and leverage, but also on the issue of securitization as well as on the negotiation of derivatives in which banks are involved. This approach implies the need to set aside considerable reserves along with giving greater attention to assessment on site.

In addition, following discussions with regard to the ‘too big to fail’ intermediaries, those institutions which involve systematic concerns are required to show a greater ability to absorb losses.

On the same issue, the regulations issued by the Bank of Italy with regard to the adequacy of capital requirements (circular no:263 27 December 2006, recently updated January 2012) tend to set limits on the abstract risk assumed by a bank according to the quantity of capital held and dependent on its make-up.

Given the high frequency of inspections carried out on institutions on the question of supervision of capital, it seems appropriate to look at the provisions contained in that regulation in their essential features, referring to the regulations themselves for the detail.

According to the Bank of Italy’s guidelines ‘ the regulatory capital is calculated as an equation of positive and negative elements, minus eventual charges of a fiscal nature, which can be worked out with or without limits dependent on the level of capital of each one.

What characterizes the positive elements that form a part of the regulatory capital (and henceforth also RC) is that it deals with elements which can be used without restriction or delay to cover risks or company losses at the time when such losses appear.

The RC of banks is subdivided by the guidelines into three subsets which indicate factors which , through a descending order of consistency and trustworthiness can offer a guarantee on risks and company losses.

The first of these subsets is the Tier I Capital, which is made up of the sum of the following elements. a1) deposited capital a2) reserves including stock surcharges a3) innovative and non-innovative capital instruments a4) earnings from the period a5)

[37] From this point of view, the agreement sets the role of supervisory bodies as that of monitoring the adequacy of the level of capitalization with respect to risks assumed and of assessing the consistency of banks’ management policy in respecting the established indices in the guidelines.

[38] Enhancements to the Basel II framework, Revisions to the Basel II market risk framework e Guidelines for computing capital for incremental risk in the trading book, July, 2009

[39] “ The Commission’s parcel of reforms (…) confirms (…) higher capital requirements for trading, derivatives and securities to be introduced at the end of 2011” , press release by the Group of Governors and Supervisory Heads, 12 September 2010

[40] See Basel Commission on bank supervision, Report on progress made in the implementation of Basel 3

[41] The distinction between upper and lower tier 2 and tier 3 is also done away with. On this point see R.BOTTIGLIA, Patrimonio bancario e requisiti prudenziali secondo le regole di Basilea 3, in Il bilancio delle banche cit., p.292 (Bank capital and Prudential requirements in as established by the provisions of Basel 3), in Bank Annual Reports p 292.

the positive prudential filters of the base capital. From these elements the following negative components are deducted: b1) the shares owned by the bank b2) goodwill b3) intangible assets b4) adjustments to the valuation on credit b5) the losses shown in the preceding financial year and those currently occurring b6) adjustments in on activity assessed as 'fair value' b7) the other negative factors b8) the negative prudential filters of the base capital.

The difference between the sum of the elements from a1) to a5) and the sum of those from b1) to b8) forms the 'base capital'. The Bank of Italy may also require the deduction of other elements, which can, by their nature, lead to a 'watering down' of the base capital.

This element (the base capital as outlined above) is taken into consideration in the supervision of capital with no restrictions applied.

The second subset which makes up the supervision of capital is set out in Tier 2 Capital).Supplementary Tier 2 capital is made up of the following elements, within the calculability of which as indicated in par. 4:

a1) valuation reserves a2) innovative and non-innovative capital instruments not calculable in the capital base a3) hybrid capital instruments and subordinate liabilities a4) net capital gains on shareholdings a5) eventual surpluses on general valuation adjustments with regard to expected losses a6) other positive elements a7) positive prudential filters of additional capital.

From these elements the following negative factors are deducted: b1) net capital loss on shareholdings b2) other negative factors b3) negative prudential filters on additional capital.

The difference between the sum of the elements from a1) to a7) and the sum of those of b1) to b3) forms the ' Tier 2 capital).

The third aggregate which forms part of the supervision of capital (Tier 3) is made up of debts on short term conditions whose aim is to ensure a minimum protection against market risk.

Given that it does not have the same level of confidence as Tier 1 and Tier 2, Tier 3 is viewed as a weak form of capital, for which, however, there is a recognition of the need to improve capital requirements in order to reduce the level of market risk on core capital[42].

The guidelines on capital supervision also integrate guidelines emerging at an international level in order to take into account the resulting impact of international accounting principles (IAS / IFRS) on the calculation of capital reserves. In particular, the introduction of some 'prudential filters' has been agreed, which are to be applied to annual report data, in order to safeguard the quality of capital supervision and to reduce the potential volatility induced by the application of new accounting principles. In general terms, the recommended approach in international locations foresees for any activities which differ from those of negotiation, the total deduction of base capital from the evaluation of capital losses at fair value and the partial calculation of the evaluation of capital gains at fair value in supplementary capital. (asymmetric approach).

The Bank of Italy guidelines as regards capital supervision , therefore, contain a series of indictors with an end to linking capital supervision above all to credit risk (which could be the aim of an internal assessment by a single bank or an assessment by external credit agencies), along with the risks involving adverse parties[43], market risks[44], operative risks[45], liquidity risks[46].

The guidelines[47] also lay down specific rules on the possibility on the part of banks to invest in shares and real estate[48].

[42] V. ANTONINI, K. TOMASINI E S.ZATTARIN, Il patrimonio netto e il patrimonio di vigilanza(Net capital and capital supervision) , in Il bilanci delle banche (Bank Annual Reports) cit., p.278.

[43] The risk of counter party and the risk of default by the other party on a transaction of a specific financial instrument prior to the settlement of that same transaction.

[44] Subdivided into risk of condition and concentration, as regards trading portfolios for supervision purposes, exchange risks, regulation on commodity terms, with reference to the entire report. Regarding this set of risks, aggregated within the notion of 'market risk', banks may adopt a standard method which allows for the calculation of an aggregated capital reserve.

[45] To determine capital reserves in relation to operational risks banks may use the Base Method (Basis IndicatorApproach, BIA), which foresees that that reserve be calculated by applying a regulatory co-efficient (15 per cent) related to an indicator of the volume of company activity, identified in the intermediation margins. (cf. Titolo II, Chapter 5, Second Part, Section I).

[46] Titolo V chapter II of the guidelines, inserted in 2010.

[47] Titolo V chapter IV, First section, inserted on 12th September 2011.

[48] Shareholdings cannot be bought over and above the available margins for investment in shares and property.

The available margin for investment in shareholdings and property consists of the difference between

capital reserves and the total of the shareholdings and property held.

If, as the result of a specific event, a reduction in capital reserves of the said entity is noted, the organ responsible for management must propose to the strategic supervisory organ a programme which sets affairs back in line in as short a time as possible.

Investments made through intermediary bodies, independent of the bank, are not included in shareholdings, provided that the said investments meet the criteria of evidence of diversity in the portfolio; for the purposes of the current regulation, a shareholding investment portfolio may be considered adequately diversified if none of the investments of which it is made up rise above five per cent of that portfolio (1) and that there is no economic or legal

The assessment of the reliability of capital requirement supervision is carried out in two distinct phases: on one hand, capital planning procedures which are done on an annual basis, on the other hand, a process of capital management, aimed at monitoring and checking the adequacy of capital reserves and the effective use of capital risk[49]. The new prudential supervision regulations for banks : Circular no: 263 27 December 2006 -8° update 18 November 2011 (par.12.1) advises that ' capital requirement supervision should be measured on a quarterly basis'.

The set of regulations with regard to capital supervision involves a long journey, the result of a desire to strengthen banks by strengthening their capital structure and their own resources.

That journey, originating at the end of the 1980s, in a period of full economic expansion, is now witnessing a first legislative intervention which is attempting to limit the danger presented by an excessive exposure of banks to creditors. The natural tendency of financial intermediaries towards an excessive use of leverage, based on its particular reliability, as well as the presence of financial channels and access to ready liquidity has motivated the legislature to impose a certain balance between activities carried on and a bank's capital and own resources. By activity they essentially mean the activity of granting credit[50].

The respect on the part of the banks for the provisions contained in Basel 1, cannot, however, hide the fact that the banks manifest an unexpected and systemic weakness.

On this, the provisions of the agreement show, in other words, that it is not enough to reach the goal which was set, and thereby to prevent a crisis in banking institutions.

One sees, therefore, a sort of a resort by the legislature to the evidence that the dangers of instability in the financial system come from unexpected quarters, something in part made possible by the changes occurring in the characteristic activities that banks can become involved in.

The adoption of the model of the universal bank, open to activity profoundly different from that of the granting of credit, as well as the development of the very activity of the granting of credit in ways very different from traditional practice, has led to the expansion of banking activity into sectors and environments for which the Basel agreement did not foresee any guarantee.

The liquidity crisis that first engulfed the system, leading Lehman Brothers to insolvency and thereafter plunging the whole financial system, originated from factors which had nothing to do with credit provision activity as practiced in the traditional sense. Nor does it appear to be linked to a failure to respect the requirements of a capital nature in Basel 1[51].

The crisis spread through all financial channels and highlights the limitations of the dependability of the ratings awarded by credit rating agencies – the crisis passed from the collapse of fair value of negotiated securities, to include financial intermediaries who acquired complex instruments of which the risk involved was not adequately assessed, and saw the explosion of the leverage effect linked to the leverage mechanism built into derivatives.

As a consequence of the emergence of this crisis, the system of guarantees in Basel has evolved into including within its parameters the aim of examining the adequacy of capital reserves, the weighing up of operative and market risks, as well as risks associated with fluctuations in the assessment of fair value 42[52] and securitization.

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connection between the companies which are the subject of the investment (2) that there is sufficient liquidity, in that, there are no significant constraints on the bank's ability to quickly turn its investments into liquid capital and it is capable of assessing those investments in a reliable way. If the requirement for diversification of investments is not met, the investment is calculated in quantitative terms using the above mentioned method sub a), b), c) e d).

[49] On this point see V,ANOTNINI, K TOMASINI S. ZATTARIN, il patrimonio netto e il patrimonio di vigilanza (Net capital and capital reserves) cit. p.282

[50] Contained within both Basel 1 and Basel 2 agreements.

[51] A. AMEL-ZADEH, G.MEEKS, Bank Failure, Mark-to-Market and the Financial Crisis, Working paper, Electronic copy available at: http://ssrn.com/abstract=1494452 "First, we analyse the financial statements of the two most notorious bank failures of the crisis, Northern Rock and Lehman Brothers. And we conclude that the failure of these banks cannot be attributed to fair value accounting. When measured at fair value, and without any of the relaxations of fair value rules that were subsequently introduced, neither bank was balance sheet insolvent – usually the primary legal criterion for failure in the relevant jurisdictions; and nor did they break the regulators' capital adequacy rules in relation to their balance sheets. Their demise is instead attributable to cash flow insolvency, a condition which is of little consequence in normal times when markets are deep and liquid.

We turn then to other evidence which might reveal a pernicious role for fair values in the crisis.

We attempt formally to test whether mark-to-market risk increased the bankruptcy risk of financial institutions during the financial crisis. More specifically, in time series regressions we test whether daily changes in the ABX.HE index increased the perceived risk of bankruptcy reflected in spreads on credit default swaps. We do not find evidence suggesting this in our tests. Instead we find some explanatory power in the spread between LIBOR and Overnight Index Swaps (OIS), which measures counterparty risk for borrowings with very short maturities, confirming our theoretical argument that cash flow insolvency becomes the binding failure condition during financial crises."

[52] "The current regulations also take into consideration the emerging guidelines at international level in order to reflect the resulting impact of the application of international accounting principles (IAS/IFRS) on the calculation of

As far as the Italian framework is concerned, most of these interventions have taken place through the integration and / or changes to the guidelines of the Bank of Italy in circular 263/ 2006 on the question of capital supervision carried out in the years 2010 – 2011, while other courses of action will become applicable when Basel 3 comes into effect.

Also on the issue of determining capital reserves the legislature is intervening by setting maximum limits on the opportunity to acquire shareholdings and property, basically by establishing parameters on the total amount of capital reserves.

At this point it is appropriate to make some observations with regard to the legislative framework and capital requirements.

The legal system has seen an intervent to restrict and to direct the activities carried on by banks, banks which

a) are substantially restricted in the practice of their credit activity by the level of capital requirements;

b) are encouraged to make loans to individuals carrying a lower risk, as soon as this becomes a binding part of capital requirements;

c) are further restricted in their opportunities to make investments by the required assessment of capital supervision risks linked to negotiated activity and other risk factors (operative, other party, and market) indicated above;

d) are restricted in the option of a complete committing of resources by the requirement to maintain a certain liquidity buffer.

This combination of indicators which flow from the regulatory system, represent a framework in which the highest margin of freedom in operating terms for the banking system is assigned to the area of operational activity in assets, assets which have a secure market and which can be monetized for purposes of rapid conversion into money.

The maintenance of financial resources in liquidity or quasi-liquidity as opposed to the freezing of resources in credit activity or investment in shareholdings and / or property does not burn up capital reserves.

.The acquisition of financial products and property values with a high credit rating is, therefore an activity which does not produce, at least in the initial stages, any need for reserves on the part of the bank involved in the purchase[53].

Investment activity in property and shares is still apparently free, at least within the level of capital reserves. While it is true that the amount of investment in shares and property cannot go beyond sums higher than capital reserves, it is also true that capital reserves will not be blocked as a result of having made such investments.

In the same way, deals involving the financing and granting of credit which are incorporated into secured transactions and which respect the requirements of IAS 39 may not absorb capital reserves. This is because it is possible to proceed to their derecognition, that is to say to their cancellation from the accounts.

This assumption explains the choice by banking institutions to proceed to the securitization of assets in order to convert the single position assumed against the banking institution into financial resources, values, property which can then be converted into money through their transfer by documentary or electronic means[54].

capital reserves. In particular, the introduction of several "prudential filters" has been agreed; these are to be applied to the data in annual reports, in order to safeguard the quality of capital regulation and to reduce potential volatility brought about by the application of new accounting principles. Broadly speaking, the recommended approach in international offices foresees , for any activity other than trading, the integral deduction of net capital from capital losses at fair value rating and the partial calculation of capital gains at fair value rating in supplementary / additional capital. (the so-called asymmetric approach)." New Supervisory Prudential Guidelines for banks: Titolo I – Chapter 2

[53] As already mentioned, failure to adopt a mechanism for evaluating expected loss, does not allow for taking into account the potential danger of financial instruments.

[54] It is clear that for the holder, the negotiability of securities transforms the risk connected to the correct administration of the transaction to the risk of a loss of value of the security, which becomes evident only when the market perceives that there are toxic elements present within the financial instrument.

From this point of view, any guarantee for the system can only be realized if the system requires "an assessment in a reliable way of the underlying position", so that the holder of an instrument does not discover late in the day that these instruments do not have the corresponding market value.

In terms of the system and as a matter of principle, it is noticeable that the further the terms embodied in the security in circulation are removed from the reality (also geographically, not to mention from a supervisory point of view), the greater the chance that the assessment is inaccurate.

Once the terms of the security have been recorded in the system, the point of reference will henceforth be incidentally determined by the previously set price; it may never have been evaluated in its actual content, but rather in general notions of securities and incorporated earnings.

In Conclusion, the possible effect of this set of circumstances is the risk that the value of securities which are bought and traded, may be valued in a seriously erroneous way by placing faith in the "evaluation" made by a credit rating agency. Ratings, upon whose actual reliability, doubts are beginning to be cast from all sides, doubts also expressed by those who firmly believed in the market and in its mechanisms of self- regulation and control. As we confront times in which this faith has not been justified, one wonders just exactly what is changing in regulatory terms.

4 Conclusion

With regard to the crisis which has engulfed the financial system, the guiding line in the inter-banking agreements and capital regulation has been predominantly to intervene in relation to the capital structure of the banks themselves, requiring them to re-capitalize and imposing on banks and dictating that the banks establish parameters on all activity involving the granting of credit, as well as for certain aspects, including negotiation activity on the capital endowment of the banks themselves.

In answer to an exogenous crisis, which initially affected our banking institutions and then transferred to the real economy, the response of the banking system (formalized in the Basel inter-governmental agreements and regulatory guidelines on capital supervision) has been to require banks, on one hand, to place greater emphasis on capitalization with an aim to creating a bigger capital, and on the other hand, to require a greater prudence in the granting of credit and to the evaluation of possible risks as well as other factors- other party, market, operative risks.

The application of these guidelines has produced as a side-effect, a resulting contraction of credit, and the draining away, on the part of the banks of resources, this being done in order to meet capital reserve requirements.

Viewed in a positive light, the effect of the specified measures is to render the process of granting credit greatly more selective and to render the capital structure, of capital, of banks, more able to withstand an eventual crisis of liquidity.

Given that an adequate supply of means is an indicator of solidity and undoubtedly an element which offers a stronger guarantee of repayment to the banks, the response of the banking system as embodied in the supervision guidelines deserves a closer look.

The crisis which hit financial intermediaries did not originate from lack of financial resources. Financial resources began to run short as a result of an excessive use of financial leverage, of the underwriting of investments carrying too high a risk, and a lack of transparency which has hidden the risks and the liability that each bank institution had assumed.

The findings of the Financial Crisis Inquiry Report[55], support the argument that the point of origin of the crisis is located in the United States as a result, firstly, of sub-prime mortgages, that is, the provision of loans by American banks without checking that these loans could be paid back. The second factor which has played a part in bringing about the crisis is connected to derivatives and other financial products, often resulting from secured transactions which are incorporated into the debt conditions and which have contributed the spreading and multiplying of the negative effects contained in these debt arrangements.

The widespread use and circulation of derivatives and financial products (including the secured debt arrangements contained therein) without accurately identifying the risk assumed and the real value acquired, in turn, represents the inability of credit rating agencies to correctly assess the risks implicit in securities that contained sub-prime mortgages.

The recognition of the causes of the financial crisis therefore highlights, at least as far as Italian banks are concerned, that the origin of the problems of financial institutions is not located in a lack of capital, and nor is it the result of erroneous risk assessment on the part of the credit agencies granting credit.

From this point of view, the crisis which hit the banking system was caused by factors linked principally to the exposure of the banking system to risks and losses in operations of a financial nature, as well as to risks connected to the international context, making it more difficult for banking institutions to obtain access to inter-banking liquidity. As far as Italian banks are concerned, the close of the financial year in 2011 in particular, has shown losses of billions of euros on the part of the leading Italian banking institutions, linked to the devaluation of the goodwill on shareholdings purchased[56].

In short, if we compare the causes of the financial crisis with the regulatory action taken by the legislature to deal with the causes, it becomes clear that the action taken by the legislature have only touched a few of the factors which were involved in bringing about the crisis.

The path taken by banking institutions in their transition from a bank which used the proceeds from savings to grant credit to a bank involved in the activities of a universal bank has exposed financial institutions to risks which have turned out to be much more serious than previously thought. This has put at risk not only the capital resources of shareholders, but also those resources collected by the bank from third parties, resources which make up the major part of the capital managed by the bank.

[55] The financial crisis inquiry report, Final report of the national commission on the causes of the financial and economic crisis in the United States, Submitted by The financial crisis inquiry commission, Pursuant to public law 111-21 January 2011.

[56] Banks have had to consistently lower the value of acquisitions made in the boom years of the shopping bank. The so- called impairment has in this way undermined accounts. The total devaluation amounts to over 30 billion proportionally spread over the six main banks. For Unicredit and Intesa Sanpaolo the adjustments for goodwill have exceeded 10 billion for each. Over 4.5 billion euros for BMPS, a figure of around 2.2 billion for IBI banca and Banco Popolare. BMP shows an impairment of 438 million while it is only 107 million for Bper.

The risk of involving bank clients in the losses linked to banking activity is particularly significant within the Italian framework, given the very high level of private savings, which are thereby frozen or entrusted to be managed within the internal banking system.

Italy represents an economic system characterized by a high level of private savings, and therefore, financial resources which should assume an important position within the banking system. The banks should function as a channel for the transfer of those resources to entrepreneurial activity and to support of the economy, all done through balanced support to consumers and investments. The financial crisis then arrived in Italy under a double profile: on one hand as a public debt crisis and on the other hand, as a result of the contagion suffered by our system as a result of the spread of the financial crisis, which has destabilized banks by burning up the resources invested in property values which have experienced a depreciation in the market. All this leaves us with the suspicion that a part of the property values and financial instruments circulating on the market and which form part of the internal capital of financial investors has ended up placing this capital in a negative position. However, this negative position is not immediately reflected in the annual report of a bank, bringing into question the fate of family savings, which in Italy represent a solid base for the financial system.

As the President of the Bank of Italy revealed in the last report to an assembly of shareholders held on 31st May 2012, even at the end of the 1990s the percentage of loans made to families and companies, financed using ‘deposits and bonds from families’ was over 90% and also in the course of 2012, according to information presented in March, is equal to 85%. In the report cited, it is not clear how much the deposits and bonds from families in less stable conditions or from individuals other than families (that is, companies, organizations and others) amounts to and therefore, how much of the residual 15% of credit granted to the business sector and to families is covered by the resources of third parties which the banks use in their own activities[57].

What is certainly clear, however, is that the financing of activity and support for the economic system through the provision of credit is even today largely supported (85%) by Italian families.

All this makes one question that if nearly all the money for the provision of credit comes from families, then the ‘liquidity crisis’ which has affected the banks can only stem from a different type of investment of the resources obtained from stockholder capital and the enormous amount of liquidity which was provided by the Central European Bank in support of individual banking institutions, including subsequently Italian banks during the same crisis[58].

In the second place, in my opinion, it is evident that the express acknowledgement on the part of the Governor of the Bank of Italy that the funds invested in financial activity come from family deposits should include at least, a partial acknowledgement of the large profits generated by these resources, and that it is, therefore, not economically justifiable that the capital stockholders and internal management retain almost all of the proceeds from financial activity. They do not seem to see the need to offer to those who provide the resources an adequate economic recognition and in the light of this, the relationship of one to three of taxes on deposits and those on investments cannot be justified on the basis of

[57] In March 2012 bank loans to clients resident in Italy amounted to approximately 1,950 billion euros, 125% of GDP.Deposits and bonds from families, the most stable form of collection,permitted the financing of 85% of loans; in the first half of the last decade that quota exceeded 90%. The difficulty in collection and the increase in bonuses on risks in the retail market - European inter-banking and international financing – requires banks to gradually work towards a necessary re-balancing of the relationship between investments and the stable source of savings.” Banca D’Italia, Considerazioni finali Assemblea Ordinaria dei Partecipanti 11 (Final Remarks: General Shareholders Meeting), Roma, 31 May 2012, p.11

[58] The Council Directive from the European Central Bank has reacted by extending from summer onwards the purchase of bonds in the area of Securities Markets Programme, twice reducing official taxes, halving the co-efficient of the obligatory reserve in December, In December and at the end of February, it decided to carry out two re-financing operations with exceptionally long term rates (three years) with integral adjudication on the requested amounts; in addition, it has widened the range of eligible activities in order to guarantee financing. The liquidity put into the system through these two three-year operations has exceeded something in the region of 1,000 billion, 500 net of the time period. 112 banks have been operating in our country, to which has been given liquidity to a value of 255 billion gross, 140 net to be paid back. Gross savings are less and have been replaced by the Euro-system re-financing; part of the funds were invested in state bonds.
In the aggregate, given macroeconomic trends, the overall demand for liquid funds on the part of the banks in the Euro area has not increased. The liquidity created through the two three-year financing systems could only but translate into an equal amount of funds being held by banks within the deposit facility of the Euro-system. This explains why this liquidity remains unused: it was re-deposited by various intermediaries who had received this liquidity, after having circulated around banks and countries in the euro area, taking the place of private capital flow where this had been cut off.

'structural costs, the need to remunerate capital and for the risk assumed by the bank'[59].

In short, as already indicated, it does not appear that this crisis stems from the management of credit, and nor does it appear that a lack of liquidity is the consequence of the inappropriate granting of credit.

The legislature, of course which intervened in order to regulate banking institution capital, does not seem to have applied any regulation to the activity that that institution may deal in. And this, despite the fact that the crisis stems from risks assumed as a consequence of the activities pursued by the banks.

The underwriting or the creation of derivatives which are not covered by banking institutions is not forbidden; nor does it show any signs of diminishing. Nor is the sale of derivatives by banks forbidden or restricted, and so banks still function as a distribution channel for financial risks, all with a profit motive, which include the creation of securities and the identification of buyers for these products[60].

Securitization, an instrument for distributing risk still appears to be a convenient way for the banks to transfer to the system the risks assumed through the activity of granting credit and the covering of risk assumed by the buyer is entrusted to the awarding of a rating, a rating awarded by individuals whose reliability on this point (and also that of the institutions themselves) has been brought into question.

The structural base of the granting of credit, witnessed the continuing tendency of the relationship of debt / credit in the hands of an individual who had assessed the debtor as an aspect which guaranteed the correctness of the assessment procedure, but who is not in any way rewarded as compared to the distinct activity of securitization.

Ultimately, no preferential treatment is assigned to the direct granting of credit carried on by banking institutions as compared to that assigned to the activity of the negotiation of financial instruments.

On the contrary, while the granting of credit, and the maintaining of the debt relationship, often to its natural term, is a costly activity which implies the assessment of credit by the institution and which 'eats up' capital reserves, the securitization of credit, on the other hand, is done through a regime of derecognition which does not encroach on the freedom of movements of the banking institution. The acquisition of financial instruments which are characterized by a high level of liquidity, includes at least the percentual of the required calculation of market risk assessment, while the acquisition of assets and shareholdings faces only the limit that it must be within the parameters of the capital reserves[61].

In other words , in a context in which the crisis is not the by-product of the granting of credit, but of the 'financialization' of banking activity, the regulators firstly intervened with regard to activity linked to the giving of credit, making it more selective, and acted only partially on financial activity and activity linked to negotiation in particular, by requiring the assessment of (at least a part of) risks linked to that activity.

This requirement is still a by-product of a market viewed as a global opportunity and as a subject capable of assessing in a reliable way the products which are located within it.

From the perspective of economic expansion and an ample supply of economic resources, where the market and globalization represent a growth opportunity, such an approach would not create problems and would seem favourable for banking institutions. Neither would it create problems and inconveniences for anyone who should benefit from banking services, as long as there are resources available for everyone (as can be seen from the wide use of financial leverage prior to 2007).

The situation is very different in a context of a market in recession in which the economic system finds itself difficulty and in which resources are scarce.

In such an environment the same real economy which has accumulated resources becomes instead a subject which has need of those resources to be able to survive and also needs to prevent a situation where banks are led to assume other risks which will weigh on and be passed on to the real economy.

The main point is that in a moment of recession, the investment of resources in the activity of granting credit cannot be justified solely on the basis of the maximization of profits, at least in the short term, but to all purposes, should be dedicated to a fulfilling of the need for credit and the safeguarding of the social fabric. Just as that investment produces wealth in times of expansion, equally it absorbs part of that generated wealth in moments in which the economy is in recession and needs to be supported.

From a short term perspective, and given those things which inform the dynamic and the decisions that banking managers should take, the choice of banks to invest the resources entrusted to them by the community in a determined area in order to support it, does not justify a vision based purely on the market.

Furthermore, it should be pointed out that the safeguarding of those who have entrusted their savings to the banking system demands a selection of

[59] So G. MUSSARI, Presidente ABI, Interview with Corriere della Sera published 4th March 2012

[60] V.UCKMAR, Banche, imprese e derivati (Banks, companies and derivatives): 13 01 2012, in Uckmar.net.

[61] From the moment when the system of disclosure of losses uses a incurred loss model, to the moment of the purchase of financial instruments or shares, whatever the model may be – for shares – the impairment test does not highlight the need for any reserves.

activities as much as possible based on the certainty of the investment made.

The subject is apparently unfathomable. Following the market seemed to be the solution in order to obtain a system which is efficient and capable of producing wealth.

Departing from the rules of the market carries with it the suspicion of a return to an inefficient system. But what has emerged during the course of the crisis in the last few years is the inability of the market to react to its own excesses. The market has a tendency towards a certain dynamism which is heralded in a positive way, tending more towards a condition of movement than the ability to sustain itself: one of the few certainties that does not seem to have disappeared in the latest crisis is the tendency of the market to follow the trend, destined to lead to a market stage – the much hoped for growth of the positive phase. This attitude tends to persist beyond the limits of what is justified, producing an excess destined to destabilize the system.

Basically, what is required in the system, is the need not for efficiency but for stability: in order to prevent the market producing excesses to the detriment of the system, what is needed is not a system of a welfare nature but a system capable of assessing companies and economic operators who require aid or who need to overcome a temporary and reversible moment of difficulty.

I would argue that the existing link with the country and the relationship that is created between the bank and the donors of deposits represent elements which should be valued exactly at the moment in which the country needs them.

Support for the country is a more balanced and mature way for banking institutions to safeguard the sources of their own supplementary reserves and renders such institutions anomalous in relation to the market: the fact that banks operate in the market using the money of other cannot be forgotten or dismissed as an irrelevant fact.

In short, it cannot be argued that market rules hold true only in one direction.

What appears to be behaviour not in accordance with market rules is using financial means, which savers think are deposited securely, in investment activities in which the profits are held back by the banks, thereby failing to comply with the market in order to support the individuals from whom the money comes.

If we want to speak of the market, and if the law of the market is to offer a sale price for an asset and a value that it receives, I believe that in exchange for the economic power and the opportunity to earn that is accorded the banks by the fact of managing, administering and retaining profit from others' money, banks are in exchange honour-bound to provide loans. And such loans represent a reasonable level of support for anyone who can reasonably benefit from them - individuals who can benefit from them not from a perspective of maximization of profits, but from a perspective of preserving the system that such wealth produces. This also reduces the amount of secured transactions, which breaks the links between the bank and the country it operates in. This needs to be linked to a fuller transparency regarding the operations carried on by individual financial intermediaries and to making comprehension of these operations more possible on the part of those who make their resources available to single financial intermediaries, in other words, a fuller transparency on the investments of these very people.

This need for transparency, is a principle largely supported by the national banking system, a system which in its most concrete sense involves a combination of individuals who can interact with the individual banking institution in their capacity as shareholders and stakeholders. For them, there is a need to be able to understand how each banking institution has acted in its business activities, a need to transform banking annual reports from documents which are barely comprehensible to bank employees to ones which clearly and in line with the principle of a 'true and fair' representation describe the banking activity of each individual bank, revealing where this business activity took place and what risks it presented to the capital reserves of the individual bank.

The need for progress on the level of transparency of informational documents produced by banking institutions is, not by chance, commented on in the same Bank of Italy guidelines. The subject in itself does not appear to be exclusively linked to rules on annual reports, but to the regulation of the behaviour of financial intermediaries. The type and content of those instruments which make up banking activity are of a complexity so great as to make comprehension of what is contained therein very difficult, and even more the effective comprehension of the risks assumed on the part of those individuals who have acquired them.

Another issue which merits discussion is that of the presence of the financial instrument ofderivatives in bank annual reports. The presence of and the separation in the annual report of derivatives, produces a negative impact on capital reserves. This is the consequence of the fact that these instruments reduce the amount of capital available for the provision of credit.

In my opinion, this poses the question not about the assessment of the risk presented by these instruments, nor on their accurate presentation in the annual report, but rather as to whether it is appropriate that a banking institution uses the resources at its disposal (and of course, this includes those resources obtained from third parties) to speculate on products on the market which have been shown to have a destabilizing effect on the system.

The combination of these problematic aspects seems, however, to highlight a sort of opposition

between the 'representatives' of financial intermediaries on one hand, and families and companies on the other. The 'representatives' of financial intermediaries defend the maximization of profits for the shareholders of financial institutions, along with an adequate financial reward for internal management, while families and companies are critical of the behavior of banks given the type of activity in which they are involved (or not involved in, in the case of provision of credit).

In order to make progress[62] towards the creation of a balanced financial system, a system which nevertheless is capable of effectively operating within market rules and therefore, not exploiting proceeds which come from the management of or use of money from the coffers of the banks ; and in order to allow financial intermediaries to operate freely on the market, I believe we should seriously consider a return to the separation of activity related to the collection of savings and to that of the provision of credit (the separation of Retail and Investment Banking) which in practice balance each other and on which any intervention by management should reveal a circumspect and prudent management style. Involvement in other financial activity which does not involve the use of resources made available by families and companies, and given that the activity is carried on using their own resources, would mean that the shareholders could legitimately claim complete right to any profit made[63].

Such a separation (and therefore the need to adopt a so-called multifunctional group model to replace that of the Universal Bank) for the carrying on of business activity not related to the provision of credit or the collection of savings, does not in any way prevent an individual financial intermediary becoming involved in activities[64] which are already in practice, but it demands only that they do so through an organizational group structure which keeps diverse activities strictly separate, locating them within distinct legal sectors.

Such a separation – which is being proposed by more and more parties[65] - would , moreover, have a series of not insignificant knock-on effects.

In the first place, the provision of finance by the ECB in favour of financial intermediaries could be done with the certainty that the investment of these funds would be dedicated in part to the provision of credit and in part to other types of financial activity.

In the second place, the separation of financial activities into two distinct legal entities, would bring with it the advantage (admittedly as an indirect effect) of transforming annual reports and informational documents on banking activity, from documents which are barely comprehensible (as a result of the extreme complexity of the situation they represent) into documents which in their description of the activity concerned, can be understood as easily as the annual report of a company involved in any other type of business activity.

[62] This is not the first time that a proposal on the need to limit the type of activity that can be carried on by banking institutions has been put forward. The banking failures which were witnessed following the First World War (one prime example is the bankruptcy of Banca Italiana di Sconto in 1921) made the adoption of specific legal provisions absolutely essential, which guaranteed banking stability, through both regulation and a reduction in the areas which bank institutes could become involved. This came into being through the first general law on banking activity: the R.D.L. 7th September 1926 n. 1511.

[63] The need to take forward a plan which foresees the separation of the more traditional activities practiced by banks and those more innovative activities, is highlighted in the final UK report of the Independent Commission on Banking. This emphasizes the need for a structural separation between a bank's retail and investment sectors.
The Commission makes it clear that it is "not proposing that the Wholesale Bank and investment activity should meet the high capitalization standards required by international bodies for SIFI (Systematically Important Financial Institution), the high standards of international intermediaries, since such banks can fail without presenting risks to savers or depositors.

[64] In my opinion, the perfect structure would be one single holding under joint control, operating as sister companies, one, a company which carries on the banking business of collecting savings and granting credit, and the other, a company involved in trading activity.

[65] Besides the conclusions of the Independent Commission on Banking, I quote, without any claim to exhaustiveness, the research "Separare le attività bancarie per sostenere la crescita" (Separating banking Activity in order to sustain growth), carried out in the Club Ambrosetti , chaired and co-ordinated by P. Savona in his role as advisor and by F. Peschiera, on this point see M.CELLINO, Più liquidità senza modello universal (Greater liquidity without a universal model), in Il sole 24 ore, March 2012.