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Rapporteurs: Barbolini and Costa
on conclusion of the fact-finding inquiry on**

"The international financial crisis and its repercussions on the Italian economy"

The extent and effects of the global financial crisis – so severe that it has weakened the until recently sound relation between politics and the market – have led Governments, regulators and operators to question the validity of the principles on which the relation between rules and market functioning is based.

It is common belief that the stability of the financial and credit system has direct and immediate consequences on the volumes and character of the wealth of social structures. In this context, therefore, the decision to use public resources to keep such stability with tools and measures considered inappropriate until a few months ago is absolutely justified. The global financial, credit and insurance industry is experiencing an unprecedented crunch. The ultimate outcome, however, may turn out to be beneficial: credit and insurance activities will hinge again upon the traditional way of working, while complex and structural financial instruments will play a certainly important but marginal role, appropriate for the ancillary purposes and good market functioning for which they have been designed.

Though this is likely to be the final result of this very serious crisis, a very preoccupied judgement needs to be passed on the responsibilities of the system, individual wrong choices, weak supervision activity and control mechanisms which have failed to contribute to reversing a trend which was clearly identifiable and verifiable.

In general, the deregulation culture – with its confidence in the self-regulatory ability of markets – which has been spreading in the United States and subsequently quickly imported into Europe, due to the strength of Anglosaxon brokers on European and global markets and the weight of the Anglosaxon countries in the negotiations to issue EU rules, is the political and legal background against which this trend has emerged and exploded.

Public extraordinary emergency measures will restore normality in financial market activities, but they need to go hand in hand with an overall intense, deep and necessarily internationally concerted and shared modification of the rules in order to minimise moral hazard cases, unfair conduct and violation of fundamental ethical principles. Undoubtedly, now the boundary between market and rules is shifting because, in one of the “sanctuaries” of the culture of a self-regulating market, the idea that legal rules are just a hindrance to or expression of forces running against everybody’s well-being has been refuted. Conversely, savings and investment protection will be the leading star of all actions. "More rules, more capital, less debt, more transparency": this very simple list of objectives of the Governor of the Bank of Italy well summarises the plan to overcome the crisis in the forthcoming months. The Committee complete this list by duly adding an explicit and pressing invitation to the whole banking and financial system to attach major importance to savings protection, in order to avoid constant erosion of confidence and credibility. At the same time, they urge supervision and control bodies to make all possible efforts to fully guarantee the trust that companies and savers have in the banking and financial system.

KEY ELEMENTS OF THE CRISIS

Structural factors

In the global financial sector, the weight of markets and non-bank brokers has dramatically increased, compared to the traditional structure based on the activity of banks. This is a basic element to explain some aspects of the crisis. Undeniably, it started on the market of securities traded by banks and other financial brokers and then circulated on the market, including the debts on risk mortgages. “Historically”, the crisis began with the progressive deterioration of the quality of subprime mortgages in the United States started in 2006. When the increase in real estate prices – then expected to be relentless – stopped, the value of securitised instruments started to decrease, with no one being able to predict since the outset the effects of that devaluation on the balance sheets of banks and other brokers.

Considering how this crisis has developed, it can be noted that it has accelerated and greatly increased since last September.

It can be maintained that, until that time, the attention of analysts and the financial world was concentrated on the assessment of the impact of the spreading of securities directly or indirectly connected to subprime mortgages. The Northern Rock Bank bankruptcy and consequent measures taken in the United Kingdom were closely connected with real estate mortgages. The rescue of US semi-public real estate mortgage agencies was linked to the US market trend. Until then, the US institutions had followed the “too big to let fail” motto, which had permeated the prevailing atmosphere, also on international financial markets, despite the fact that the process was increasingly worsening, as was apparent in the negative trend of global banks.

Subsequently and, more precisely, starting from the collapse of the US investment bank Lehman Brothers, the character and effects of the crisis have considerably changed.

This scenario was confirmed by the reports of COVIP (the Italian pension fund regulator), CONSOB (Italy's financial market regulator), the Bank of Italy and ISVAP (the regulatory body with authority over the insurance sector). COVIP had not detected any exposure of Italian pension funds in relation to sub-prime mortgage securities and had identified their involvement – albeit to a limited extent – in the Lehman Brothers adjudication of bankruptcy. However, in that case, the implementation of the investment diversification principle, consistent with economic theories, protected the system from a direct drop in the value of securities and funds.

It is general opinion that, in Italy, the traditional credit and insurance pattern has minimised direct exposure to sub-prime mortgage securities.

Over the last few months before September 2008, Italian supervisory authorities had detected the anomaly of the difficulty to enter the loss of value of a whole series of structured and complex financial products (credit default swaps, OTC stocks, derivative bonds with underlying stock exchange indices, etc.) in bank balance sheets: the anomaly was the off-balance recording of many instruments and their trade on non-regulated markets, which was the reason why, in May, the Governor of the Bank of Italy had spoken of a “shadow banking system” based on the untransparent circulation of that kind of securities. It is a notion also reiterated during the hearing which took place in the sitting of 21st October 2008. Despite the fact that the alarm had been launched, in clear terms, by such very authoritative source, and considering the bigger size of that phenomenon, no measures were taken to stop that trend. Unfortunately, international market interconnection and the foreign activities of some Italian subjects are, in this case, a weakness factor.

It must be considered that the very absence of sure, detailed and unquestionable information on the effects of the loss of value of unofficial credit certificates has progressively led credit institutions to limit the possibilities to resort to the interbank market to raise the necessary funds – this instrument normally enables banks to avoid the effects of the information discrepancy between lenders and borrowers – and that, traditionally, the interbank cost of money is steady. The unaccountable loss of value has reduced mutual confidence among operators; hence their restrictive

behaviours. The interbank interest rate has reflected such conditions, in particular as a consequence of illiquidity of the banking sector; bank stock rates had plummeted due to sales, and this situation has further reduced bank manoeuvring scope. The total lack of liquidity in the banking system led to anomalous operations on the stock market, the only market which guaranteed conditions of real liquidity during the crisis. Sales on stock markets became instruments to create “liquidity niches” and for more or less formal repayment of previously pledged guarantees. It must be noted, however, that the general illiquidity of over-the-counter financial markets and the total lack of liquidity of the banking system have not had a contagion effect on international regulated markets, including those organised and managed by Borsa italiana (Italian Stock Exchange).

Exposure to Lehman

The Committee express concern over the overall financial extent of the Lehman risk Italian operators, brokers and savers are exposed to. In general terms, the Committee acknowledge that the US investment bank bankruptcy was absolutely exceptional and unpredictable; so much so that the American group had been granted high credit rating until a few months before its default. Nevertheless, the Committee are convinced that the perception that the trend was towards default was excessively weak, belated and, basically, little effective. Though the security had not been not “toxic” or extremely risky, it became so during summer 2008, but there was no one able to prevent the effects of such evolution.

Savers’ exposure to Lehman has been diversified: direct security purchasing, managed funds (pooled funds, asset administration) including this kind of securities, underwriting of insurance policies following the trend of financial instruments connected to the group.

In conclusion, Italian issuers have declared exposure by €120,000,000 for derivatives and €13,700,000 for portfolio securities. The Lehman securities notional value has turned out to be approximately €138,000,000 in pooled assets and approximately €400,000,000 as far as individual asset administration is concerned. Overall Lehman exposure of insurance companies is €1,100,000,000. The value of insurance products (basically index-linked policies) placed with prospectus to retail investors having Lehman underlying assets is over €1,600,000,000.

According to a Bank of Italy survey on the Italian banking system (with the exception of co-operative banks), during the days following the American bank crack in late September, the value of household securities held under bank safe custody was equal to approximately €1,500,000,000; by adding administered and pooled fund assets, such amount reaches €2,000,000,000.

So total exposure amounts to approximately 4,200,000,000. These are huge amounts, belonging to different sectors, which, first and foremost, require bank and insurance intermediaries to support savers involved in the failure. The efforts of supervisory authorities to make brokers make up for this situation must therefore be appreciated; the decisions individually made by operators to indemnify their customers for losses are to be equally appreciated. Nevertheless, the Committee are convinced that savers have also been exposed to the risk of investments suggested by brokers because of management choices that favour the placement of specific securities and financial instruments. They are also concerned that, in general, many savers will be affected by the impact of the situation.

The insurance role on financial markets

Undoubtedly, one of the conditions enabling the insurance sector to hedge against individual or corporate risks is the correct functioning of financial markets. Finance is indeed one of the most important instruments insurers resort to in order to share out risk among policy holders – always guaranteeing to make up for negative events – as well as to use all technical means to find the necessary resources. Under such conditions, on a financial market subjected to wide fluctuations, insurance brokers, who are interested in long-term investments, play an offsetting role. During the

recent crisis, however, it was apparent that the combination of some accounting rules and the peculiar supervisory requirements of the insurance sector created a potentially perverted mechanism which might become dangerous and destabilise the system itself.

The measures taken

The Committee express their conviction that a distinction must be made between the measures taken facing the dangers of an international systemic crisis and the analysis of what happened before the acute stage, trying to identify the faults and the regulatory and legal deficiencies of the system.

As far as the acute stage is concerned, appreciation must be expressed for the international, and particularly European, co-ordination of the decisions made, that have certainly taken the right path to restore balance in the credit sector – given the unquestionable strategic role of this sector vis-à-vis the real economy – by also resorting to exceptional and extraordinary measures regarding technical elements, as well as elements of structural economic policy, such as the use of huge financial resources to bail out banks and provide the resources that normal financing mechanisms could no longer guarantee.

Economists have always warned Governments and regulators to allow for *ex-ante* last resort payment mechanisms, in order to avoid those moral hazard effects which induce bankers to take investment risk without assessing its level with the necessary caution. Beyond this theoretical consideration, it becomes increasingly clear, on the one hand, that it is necessary to put the Italian banking system in line with that of other European countries which have been compelled to bail out various banks; on the other hand, that it is necessary to prepare the conditions for the banking system to be able to adequately support Italian companies, should the present negative trend further deteriorate.

Conversely, there is deep concern that a whole series of factors have negatively affected the market trend:

1. lack of transparency in bank balance sheets;
2. rating agency belated awareness that economic conditions were worsening;
3. non-compliance with caution rules by banks using derivatives;
4. excessive delay of supervisory authorities in stopping said behaviours despite notices and alerts given in different circles and ways;
5. the practically unrestrained circulation of complex derivatives recorded off balance sheets which have progressively deteriorated the conditions of brokers.

In practice, no one has been able to predict the evolution of the market, to clearly identify the external factors which caused the financial shock.

Prospects

American investment banks have spread their presence on the European market by settling on the continent generally London-based companies, which have been able to market services and products all over Europe taking advantage of the opportunities offered by the single market (freedom to provide services and "European passport"), since EU legislation actually limits the scope for action of host countries. The weakness of a culture of wide-ranging liberalisations not founded on high levels of harmonisation – that is common and clear rules applied by all Member States to the same extent and with the same strictness – has become increasingly evident.

The change in the macro-economic context has tragically unveiled the dangers of the new banking model and, consequently, in particular, the weaknesses of the international regulation pattern.

Therefore, we share the remark of the Governor of the Bank of Italy whereby "it is high time the institutional structure was subjected to thorough revision internationally. The financial system is global. International market integration must be preserved because it has been and will continue to be a fundamental development factor".

Quoted company ownership

Under the present circumstances, a need for legislative action is increasingly being felt, in order to enable the supervisory authority to require from any operator shareholding information – with the possibility to disclose it to the market – on companies quoted below the 2% threshold set by law, though only for particularly important reasons and a pre-established length of time. In this context, too, the increase in transparency and information is an objective that can be improved, starting with the transposition of the EU directive on identification of shareholders (Directive 2007/36/EC of the European Parliament and of the Council of 11 July 2007).

Takeover bid

New concerns are emerging about the consequences that the market situation may have in terms of exposure of quoted companies to hostile takeover attempts. Actually, present restrictions to company protection capacity imposed by the Italian legislation – which are more stringent than those of other European countries (what is known as *passivity rule* does not allow target companies to make operations which may hamper the takeover) – are legitimate and justified in an ordinary market context different from the present one. The Committee express their opinion that the present legal framework, having a tendency to strongly privilege market dynamics, hence minority shareholders or small savers, has the quality of counterbalancing, as far as possible, the inefficiency of the control shareholding market, which has always been, historically, an instrument for non-transparency of choices and penalisation of minority shareholders. This statement also holds true against the present background. It is advisable to better analyse, in general terms, the effects of a reduced buy-out possibility, with the risk of lessening the responsibility of administrators and managers who could rely on the reduction of an essential power granted to shareholders, especially minority ones, in case of a takeover bid. On the contrary, EU legislation needs to be harmonised, going beyond the downward compromise of the EU directive, by introducing common rules for Member States abiding by the weakest saver protection principle and relinquishing the generic defence of non-economic principles (e.g. the inherent "Italian" nature of a company). Conversely, it is self-evident that, in case of strategic sectors involving general and security interests, the availability of mechanisms to protect ownership is desirable. That particularly applies to the introduction of special investors such as sovereign funds directly issued by foreign states into capital stock. In practice, the Committee deem it advisable to consider changes in the regulations regarding takeover bids which, without radically altering their principles, involve meetings more directly and timely in case of hostile takeover bids, also considering the implementation of the reciprocity clause in case of third-country players.

International Accounting Standards and Solvency II

Consequently, the Committee share the opinion that the implementation of some internationally-set accounting rules was one of the causes of the financial crisis. That is why they agree with the proposals, made at a higher political level, to modify the application of IAS recommendations to allow for greater flexibility in the application of the assessment at market prices, according to international norms of financial information. Undoubtedly, the re-rating of some financial assets traded on illiquid markets, and previously entered according to the fair value

principle, at the original cost is a first, albeit not sufficient, step to create conditions for competition equality among all insurance companies in the world.

The international initiatives to change the Solvency II regulatory requirements regarding the insurance sector follow the same direction.

Moreover, the Committee express their conviction that, by means of a specific modification in legislation, the drawing up of the budget will also have to reflect the modifications introduced at the international level.

Rating agencies

The diligence duties of investors have been insufficient and they have uncritically used the assessments of rating agencies. They have shown to have serious conflicts of interest in their double function of assessment and advice to issuers and investors.

The Committee express full endorsement of the initiatives planned by the European Commission to introduce regulations requiring full transparency and publicity of rating agencies vis-à-vis ownership and the existence of business or advice relations between them and intermediaries and issuers. Conflicts of interest can be neutralised by making them publicly known. In particular, legislation ought to be passed requiring rating agencies to draw a clear-cut separation, in organisation and management terms, between their analysis and rating activities and their advisory services to issuers and intermediaries. However, there is still an open question: the role that rating agencies play in steering the choices of brokers and financial players, over and above the conflict of interest itself. The uncritical use of information has been the result of a misinterpreted "objective" function of such agencies, the synthetic and graded evaluations of which are only to be considered indicators of failure risk, without any guarantee that the event will never occur. In the near future, financial and credit market supervision and control authorities will consequently have to re-propose solutions which reduce the "objective" and unquestionable character of those evaluations.

In addition, in order to avoid the uncritical use of assessments, the Committee urge a revision of the Basel II Accords (of the Basel Committee on Banking Supervision) and the Mifid discipline (Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004), in order not to use only external rating as a standard to determine bank capitalisation. The Committee strongly maintain that agency rating is a service provided to the market, the result of recognised professional skills, upon request of the same subjects that are to be assessed, and therefore restore its value of a merely private operation. All interferences between the evaluation expressed and the action of supervision and control authorities must be eliminated, considering assessments indicative parameters which do not necessarily guarantee financial stability. The market itself will tone down their importance.

New regulations and regulators

The 2009 G8 Italian Chairmanship is an opportunity to seize to ask our Government to act internationally to promote a re-organisation of the international economic, monetary and financial system and co-operate with the most important countries to create a new system of a Bretton Woods type, based on the principle of marginalising the excessively speculative, thus inherently destabilising, operators on financial markets and restoring the function of investment and economic development support function of the credit system. Moreover, direct and constant commitment is necessary in calling for the establishment of a new financial market regulatory structure in all international fora. This reform – which is public action *par excellence* and enables politics to resume its key and unique function of steering and regulating market forces to increase general well-being and collective wealth – will have to re-introduce the restraints ensuing from scant

resources and guarantee full respect of those principles of transparency, stability, adequacy and savings protection that are the foundations of regular financial markets functioning.

The projects to create an international body able to play the role of last instance payer at the global level and, at the European level, to create a common financial market supervisory body also fall into this framework. In particular, the need that the innovations introduced by the above-mentioned Mifid Directive – e.g. multilateral negotiation systems – are offset by supervision and control over the whole EU area is increasingly felt. A good example is the ban on short sales adopted by Consob, which can be easily bypassed because of both the limited area in which it is applied and the presence of other non-regulated negotiation subjects. Considering the at least European and continental scale of supervised subjects and protected interests, an exclusive competence of the European Central Bank on financial markets will therefore have to be added to the existing monetary one.

Banks and companies

The Committee, during the ABI (Italian Banking Association) hearing on 28 October 2008, learnt that, at that moment, there was no need for public measures to bail out Italian banks. Conversely, it is noteworthy that Italian banks have been able to face the crisis with greater effectiveness than European competitors. Government action, with the 155 Decree-Law of 9 October 2008 and the 157 Decree-Law of 13 October 2008 (subsequently merged) is a protection measure which will be more effective in terms of stability if less resorted to: no banks will go bankrupt and no savers and depositors will lose their savings. It was an urgent and necessary measure that has provided for countermeasures and clarified possible future moves in the hope that this apparatus will remain unused.

The emergency measures taken have fended off destabilising effects. Now a new and perhaps more difficult aspect that the crisis is taking up must be tackled: the strong and violent contagion of companies financing sources.

The real economy was already slowing down, also owing to the inflation upsurge due to the increase in raw material prices over the last few months. The expansion pace of the global economy and, particularly, of the Euro-zone economy is strongly decreasing. The intensely recessive stage of the global economy is assuming deeply concerning characters and intensity. The Italian situation is further aggravated by the limited manoeuvring scope for public finance. In this context, the decision of the Government to propose an increase in the range of options made available to banks for possible need of capitalisation came after the above-mentioned decree-laws had been issued, to deal with the main question of support to the real economy confronted with a strong recession stage.

In any case, they are issues intertwining with the financial crisis above described. We are out of the financial sector and action will have to be taken at different levels, among which the fiscal one, to support the economy. The purpose of the measures taken was that of reducing the impact on the stock market of a crisis having its origin and epicentre elsewhere, in the system of bank intermediation. Further measures regarding transactions on the market will have to be agreed at the international level, considering that the available data show that our country is exposed to less risk than other markets. Ironically, we can maintain that Italy has better shouldered the impact of the financial crisis but runs the risk of being greatly weakened by the consequences on the real economy, in a situation of financial need. Its points of strength are the usual ones: flexible and export-oriented production fabric, low indebtedness and high saving rates of households. For all these reasons, the Committee calls for, also through a consistent tax policy, the anti-cyclic action of the budgetary policy, with the adoption of consumer-good and investment demand support measures. Finally, mention must be made of the possible positive effects of the introduction of quotation systems for small- and medium-sized enterprises, such as those outlined by Borsa italiana with the AIM Italia market.

Conclusions

Passing judgements and expressing condemnation is not the Committee mission. Nor is responsibility identification the purpose of a fact-finding inquiry. It is worth stressing, however, the firm statement by the Governor of the Bank of Italy, whereby in Italy there is no "shadow banking system" based on off-balance circulation of toxic products. The same statement was made by Isvap. Similarly, the Committee acknowledge that Consob has not detected anomalous market conditions, nor situations of infringement of norms or rules of conduct. Nevertheless, they express concern over failure to timely detect peculiar situations and behaviours and to warn, at least, responsible political subjects against the impending risks. The Committee have also taken due notice of the authoritative and appreciationworthy opinion of the bank and insurance associations representatives who maintain that, by and large, the system has been resilient.

The Committee express deep concern on the impact of the financial crisis, in light of its ways of evolution and intensity, in terms of loss of credibility and confidence in the banking system. Similarities can be noted between some features of the financial scandals of the recent past and the passive attitude of operators in relation to financing and hedging mechanisms, which ultimately affected savers. Certainly, the Italian financial and banking system is sounder and has a greater recovery capacity. Clearly, however, the role that the banking system can play to support companies and households under the difficult conditions of the next months will be an opportunity not only to strengthen its structural role in the domestic economy, but also to re-build the confidence which has been eroded over the last few months. In particular, the banking system is required to play a fundamental role to support small- and medium-sized enterprises and advise them about the best investment choices to overcome the present difficult situation.

In addition to these considerations, the Committee explicitly underlines the responsibility that administrators and managers have to respect the moral and professional principles deriving from their role.

As far as the role and control and sanction activity of supervisory authorities are concerned, the Committee, being aware that the global dimension of the crisis demands the designing of new international regulation instruments, requires the establishment of a supervision and control body at the European Union and European continent level.

At present, in order to make up for the persistent difficulty of the inter-bank market, they suggest the European Central Bank should provide for a direct guarantee on the amounts traded on the inter-bank market, so as to increase the liquidity banks have at their disposal, thus releasing further resources to be used for the productive economy.

Finally, the Committee stress the urgency of legislation, inevitably at the EU level, regulating the activities of rating agencies, as above described.