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# Alternative Banking and Financial Crisis

*Edited by Olivier Butzbach and Kurt von Mettenheim*

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# ALTERNATIVE BANKING AND FINANCIAL CRISIS

EDITED BY

Olivier Butzbach and Kurt von Mettenheim

PICKERING & CHATTO
2014

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*Published by Pickering & Chatto (Publishers) Limited*
*21 Bloomsbury Way, London WC1A 2TH*

*2252 Ridge Road, Brookfield, Vermont 05036-9704, USA*

*www.pickeringchatto.com*

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BRITISH LIBRARY CATALOGUING IN PUBLICATION DATA

Alternative banking and financial crisis. – (Banking, money and international finance; 1)
1. Global Financial Crisis, 2008–2009. 2. Banks and banking – Europe – History – 21st century. 3. Banks and banking – United States – History – 21st century. 4. Bank management – Europe. 5. Bank management – United States.
I. Series II. Butzbach, Olivier editor of compilation. III. Mettenheim, Kurt von, 1957– editor of compilation.
332.1'094-dc23

ISBN-13: 9781848934474
e: 9781781440711

This publication is printed on acid-free paper that conforms to the American National Standard for the Permanence of Paper for Printed Library Materials.

*Typeset by Pickering & Chatto (Publishers) Limited*
*Printed and bound in the United Kingdom by CPI Books*

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# Alternative Banking and Financial Crisis

## *Edited by Olivier Butzbach and Kurt von Mettenheim*

The recent banking crisis has brought into question the business model used by most large banks in the United States and Europe. Post-crisis reforms have been announced, with calls for a return to 'narrow banking' methods, instead of commercial banks diversifying into areas traditionally offered by investments banks, and vice versa. In spite of wide-ranging debate on these reforms, the success of 'alternative banks' – savings banks, cooperative banks and development banks – has been largely overlooked. This success is all the more extraordinary as such banks are not expected to turn a profit. This collection of essays explores this paradox, using case studies from around the world and discussion of both the historical and theoretical context of banking practices.

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# 7 ALTERNATIVE BANKS IN A DUALISTIC ECONOMY: THE CASE OF ITALY BEFORE AND DURING THE EURO CRISIS

Luca Giordano and Antonio Lopes

## Introduction

Between the early 1990s and 2005, the Italian banking system has experienced a profound transformation. The acceleration of European economic integration, culminating in the adoption of the euro, and the birth of a highly integrated European financial market have accentuated competitive pressures: Italian banks, which had been operating for a long time in a closed and protected market, suddenly faced a much more competitive market characterized by the widespread presence of large credit institutions.

These challenges have led successive governments to devise banking regulatory reforms and to choose new models of supervision. Thus Italian banking has gone from a closed system, in which access to the market and the range of services offered were subject to stringent administrative constraints, to one in which all obstacles to banking activities were removed, keeping only prudential controls in order to ensure stability.

A legitimate question would therefore be to ask whether, before the 2007–8 global financial crisis and the eurozone sovereign debt crisis but after the radical changes mentioned above, the Italian banking system was still able to meet the needs of an economic system characterized by a profound north–south dualism and dominated by small businesses dependent, almost exclusively, on bank credit for their funding.

Furthermore, it is interesting to see whether and to what extent non-profit banks, which in the Italian context are mainly small, local cooperative banks (*banche di credito cooperativo*) and medium to large-size cooperative banking groups (*banche popolari*), have behaved differently from joint-stock banks in the context of this transformation.

In this chapter we analyse the transformation of the Italian banking system – and alternative banks in particular – and its relationship with firms, with particular attention to the dualistic nature of the Italian economy. The chapter is organized as follows. In the next section we analyse the transformation of the Italian banking system and its ownership structure, while in the following section we assess the effects of changes in the banking system on the relationship between banks and firms in southern Italy. Then we consider the changes that have occurred in the distribution of bank branches in different areas of the country before the 2008 financial crisis, after which we provide an analysis of the lending strategies followed by banks before and after the unfolding of the crisis. We then focus on the deterioration of the relationship between banks and firms as a result of the crisis in the peripheral eurozone countries during 2010–11, after which we address the effects of the crisis on Italian banks and on the bank–firm relationship in southern Italy. In the final section, we offer concluding remarks.

## Changes in the Ownership Structure of Italian Banks

From the early 1990s to 2005, the structure of the Italian banking system was profoundly transformed by a wave of mergers and acquisitions. These transactions were carried out primarily with the intention of reaping economies of scale and scope.[1] Generally, banking mergers and acquisitions were motivated by the desire to improve management efficiency and therefore profitability.[2]

To get a better idea of the scale of the phenomenon, one should consider that between 1990 and 2001 in Italy more than 552 aggregations involved banks controlling about 50 per cent total intermediated funds; the number of operating banks fell by 30 per cent, from 1,061 to 769. The intensity of the restructuring process in Italy can be highlighted through international comparisons: between 1996 and 2001 the share of bank mergers on the total number of operations was highest in Italy, where it reached 13.2 per cent, compared to 12.7 per cent in the United States, 10.3 per cent in Japan, 7.5 per cent in Germany, 6.2 in the UK and 6.1 per cent in France. In the following decade, the structure of the Italian banking system continued to show a clear trend towards consolidation that, although to a lesser extent, affected the entire European banking market; between 2001 and 2006 the number of banks in Italy dropped in a similar way to Spain, but much less than the European average and what was recorded in Germany, France and Great Britain.

Changes in the population of bank branches in Europe show a somewhat different picture: the increase in the number of branches registered in Italy during the years 2001–6 is second only to what occurred in Spain, but much higher than the European average and the French case, and in contrast with what



occurred in Germany and Great Britain, where there was a significant reduction in branch numbers. As a result, Italian banks have now (in 2013) the highest number of branches after Spanish banks.

The rapid increase in the number of branches has further elevated the level of banking in relation to population density (55 branches per 100,000 inhabitants) that approximates now the European average (57 branches per 100,000 inhabitants) and is second among the major European markets, after Spain with almost twice the European average (99 branches per 100,000 inhabitants) in 2006. The relationship between gross domestic product (GDP) and the number of branches shows substantial convergence towards the European average, with 45.6 million euros against 46.4 for all EU countries.

However, the ratio between bank employees and total population is much smaller in Italy and Spain than in Germany and Great Britain. This raises the question of evaluating the economic dimension of Italian banks; in fact, at the end of 2006, the average size of Italian banks measured in terms of assets, although in line with the German banks, was still far from that of banks in Spain and France and, of course, Great Britain. In addition, during the period 2001–6 the relative size of Italian banks declined with respect to the European average. This implies that the productivity of Italian branches in terms of intermediated funds (total assets plus total loans) is on average lower than their European competitors, with the exception of Spain.

On the other hand, Spanish and Italian branches are 'lighter' in terms of employees per branch and in terms of loans per employee. In other words, the smaller average size of Italian banks reflects, beyond structural fragmentation, a more limited national banking market.

## Banking System Consolidation and Regional Disparities

These transformations of the Italian banking system did not occur evenly from a territorial point of view but, on the contrary, have had serious repercussions especially on the ownership structure of southern Italian banks.

During the 1990s, in fact, the southern banking system, following a significant deterioration of the macroeconomic framework in that area, suffered a drastic decline. The number of banks operating in southern Italy dropped between 1990 and 2001 by 46 per cent, compared to a 20 per cent decrease in the centre-north. Consolidation has taken the form of a penetration of banks headquartered in the centre-north into southern markets.

Data reported by Bongini and Ferri[3] show that, at the end of 2004, out of thirty-seven banks (*banche popolari*, BPs, and joint-stock banks, JSBs) operating in the south, twenty-one belonged to banking groups with headquarters in the

centre-north; as a result, the share of branches belonging to independent southern banks declined from 66 per cent in 1990 to 33 per cent in 2006.

As for the opening of new branches, we observe that the geographical distribution of branches has not changed substantially between 2001 and 2006: in essence, a growing share of bank branches are now located in the north-east and central Italy, at the expense of a corresponding drop in the north-west and the south.

Banking density is still uneven among the Italian regions. The branches:inhabitants ratio remains lower in the south compared to the rest of the country. This is due, in part, to the different economic weight of the regions.

This picture becomes more complex if we measure the loans:branch ratio and the deposits:branch ratio. Branches operating in Lombardy and Lazio intermediated a stock of loans and deposits well above the Italian average, while the southern regions show lower values.

In general, the greater spread of bank branches in the area can be interpreted as a symptom of a high customer focus and value of proximity. On the other hand, this may be partly offset by a parallel reduction of branch staff for reasons of cost containment. It is possible that the increase of the contact points with customers and the reduction in the number of employees may result in a worsening of service quality (in the sense of less customization) and be more functional to the sale of standardized financial products.

Therefore it is necessary to verify whether the growth in the number of branches and simultaneous average contraction in the number of employees have resulted in reducing staff either in branch offices or at headquarters. A first indication is provided by the change in the percentage of employees working at the counter out of total employees. The average figure for the banking system differs depending on the spatial extent of credit institutions.

The weight of employees working at the counter in Italian banks decreased in 2006 compared to 2001 in banks operating in larger markets, and increased in banks operating in smaller and local markets. This fact, in order to be properly interpreted, should be related to the development of the branch network in different types of banks. Comparing the number of employees working at the counter to the number of branches leads to a similar conclusion. Also in this case, banks operating in larger markets showed the most significant reduction, followed by regional banks. Only provincial and local banks, and cooperative banks (*banche di credito cooperativo*, BCCs), maintain a constant value for this ratio.[4]

In summary, the branch spatial distribution still reflects the country's dualistic economic and territorial structure in terms of wealth concentration, the presence of small local firms and population density. However, it seems that the north-east area has gained most new bank branches, while the southern regions still retain a relatively moderate degree of banking level. Empirical studies[5] show that that the



impact of mergers and acquisitions on the degree of competition in the Italian banking system has been partly positive. Banks born out of mergers, while gaining market share, have not dramatically increased their market power, but have been following competitive strategies similar to those of other credit institutions.

However, this consolidation process is not immune from criticism. The above process in fact only partially led to an improvement of efficiency, both in terms of cost-efficiency – namely the ability to contain production costs and profit-efficiency – and in the ability to sell profitably one's output on the market.[6] Moreover, efficiency gains seem to have been distributed unevenly across bank sizes and across bank categories as well.

## The Notable Performance of Cooperative Banks

Indeed, as Tables 7.1 and 7.2 indicate, BCCs show, on average, a positive cost-efficiency differential compared to JSBs and BPs. This gap between BCCs and JSBs, after a decrease between 1998 and 2000, remains pretty constant up to 2004 and then falls to some extent in the next two years, returning to growth over 2007 and 2008. The differential in favour of the BPs remains fairly stable until 2004, then declines over the next two years and then grows again in the years 2007–8.

**Table 7.1: Cost-efficiency across Italian bank categories.**

| Year | All banks | Joint-stock banks (JSBs) | Popular banks (BPs) | Cooperative banks (BCCs) |
|---|---|---|---|---|
| 1998 | 0.8238 | 0.6720 | 0.7235 | 0.8764 |
| 1999 | 0.8317 | 0.7283 | 0.7983 | 0.8643 |
| 2000 | 0.8511 | 0.7581 | 0.8287 | 0.8804 |
| 2001 | 0.8717 | 0.7564 | 0.8474 | 0.9083 |
| 2002 | 0.8802 | 0.7795 | 0.8504 | 0.9130 |
| 2003 | 0.8748 | 0.7674 | 0.8308 | 0.9112 |
| 2004 | 0.8813 | 0.7795 | 0.8455 | 0.9156 |
| 2005 | 0.8957 | 0.8164 | 0.8614 | 0.9213 |
| 2006 | 0.8880 | 0.8477 | 0.8558 | 0.9027 |
| 2007 | 0.9106 | 0.8587 | 0.8904 | 0.9286 |
| 2008 | 0.9110 | 0.8453 | 0.8954 | 0.9323 |

Source: L. Giordano and A. Lopes, 'Analysis of the Italian Banking System Efficiency: A Stochastic Frontier Approach', in A. G. S. Ventre, A. Maturo, S. Hoskova-Mayerova and J. Kacprzyk (eds), *Multicriteria and Multiagent Decision Making with Applications to Economic and Social Sciences* (Berlin and Heidelberg: Springer-Verlag, 2012), pp. 20–45.

Regarding profit-efficiency score dynamics as shown in Table 7.2, the differential in favour of BCCs has a tendency to rise continuously until 2007 and then declines in 2008; the gap in favour of the PBs, although fluctuating, has remained fairly stable until 2006, growing in 2007 and declining the following year.

**Table 7.2: Profit-efficiency across Italian bank categories.**

| Year | All banks | Joint-stock banks (JSBs) | Popular banks (BPs) | Cooperative banks (BCCs) |
|---|---|---|---|---|
| 1998 | 0.9053 | 0.8988 | 0.9359 | 0.9042 |
| 1999 | 0.9279 | 0.9079 | 0.9409 | 0.9326 |
| 2000 | 0.9216 | 0.9021 | 0.9325 | 0.9263 |
| 2001 | 0.9128 | 0.8916 | 0.9203 | 0.9185 |
| 2002 | 0.9107 | 0.8972 | 0.9225 | 0.9138 |
| 2003 | 0.9196 | 0.8916 | 0.9258 | 0.9278 |
| 2004 | 0.9226 | 0.8944 | 0.9245 | 0.9312 |
| 2005 | 0.9129 | 0.8768 | 0.8932 | 0.9249 |
| 2006 | 0.9024 | 0.8637 | 0.8859 | 0.9156 |
| 2007 | 0.8694 | 0.8175 | 0.8791 | 0.8854 |
| 2008 | 0.8271 | 0.8007 | 0.8346 | 0.8348 |

Source: Giordano and Lopes, 'Analysis of the Italian Banking System Efficiency'.

These results confirm that the Italian banking system is still characterized by a significant presence of cooperative banks whose performance stands out positively with respect to other bank types. In other words, the empirical evidence does not support the view that higher efficiency is associated with the joint-stock for-profit organization model, which was such a powerful assumption driving the consolidation of the Italian banking system.

Further empirical support for this hypothesis can be collected from other studies[7] in which traditional profitability ratios are calculated relative to the number of bank branches (see Table 7.3).

The total volume of net interest income divided by the total number of branches during the period 2001–5 has remained roughly constant in nominal terms (+0.9 per cent), which implies a decrease in real terms. The change in operating income is rather negative, even at current prices.

**Table 7.3: Changes in Italian bank branch profitability and costs (in per cent), 2001–6.**

| | Net interest income | Operating income | Gross operating income | Total costs per branch | Net profits before tax | Borrowers per branch | Loans per branch |
|---|---|---|---|---|---|---|---|
| All banks | 0.9 | –3.9 | –11.9 | 2.8 | 34.0 | 6.3 | 14.4 |
| BCCs | 5.5 | 7.0 | 4.8 | 8.2 | 61.1 | –0.1 | 47.8 |
| Other banks | 0.7 | –4.1 | –12.2 | 2.8 | 32.7 | 7.1 | 13.2 |

Source: Data from S. Grimaldi, C. Guagliano and J. S. Lopez, 'L'evoluzione della struttura distributiva delle banche italiane dal 2001 al 2006', *Cooperazione di credito*, 195: 6 (2007), pp. 7–69.



Again, BCCs exhibit better performance compared to other bank types, with an average growth of net interest income of 5.5 per cent and operating income of 7 per cent. On the other hand, the overall costs broken down by bank window have remained very low in the system as a whole (+2.8 per cent from 2001 to 2005), especially because of the decrease in personnel costs (instead, operating costs, net of bank staff, grew by 6.4 per cent). Similarly, while borrowers per bank branch and loans per branch have grown in general, by 6.3 per cent and 14.4 per cent respectively, this increase in 'branch productivity' is particularly evident for BCC banks. As with profits, productivity has grown by 34 per cent for the entire system, with a much more significant growth of 61 per cent for BCCs.

This leads to an important observation: the growth in the number of bank branches in Italy, while having a moderate impact on costs, brought significant benefits for BCCs alone.

Two factors may explain this trend. One has to do with the time lag between corporate restructuring and its impact in terms of efficiency. Another is related to the different competitive strategies put in place: while big banks have mainly acquired already existing bank branches – following a strategy of market saturation – to prevent the entry of new competitors, BCCs adopted a different strategy, gaining position in the markets vacated by other lenders.

These results can be interpreted in light of the theoretical literature that highlights the comparative advantages of cooperative banks in an economic environment characterized by the widespread presence of small and medium-sized enterprises. In addition, it should be noted that the cooperative form tends to give stability to senior management, also because it limits exposure to the risks of takeover. The stability of top management can be good or bad: it is bad to the extent that it attenuates the market sanctions with respect to management inefficiencies; and it is good when, without prejudice to management efficiency, it helps articulate business strategies around long-term goals, thus promoting the accumulation of soft information about customers and, therefore, strengthening credit to small businesses.[8]

These results confirm that the Italian banking system, while having gone through radical transformation in the past two decades, remains characterized by the persistent presence of small, cooperative banks that stand out positively compared to the rest of the banking system.[9]

If we take into account the location of bank headquarters, Table 7.4 shows a widening gap in terms of cost-efficiency unfavourable to southern banks during 1998–9; then this trend stops and the gap decreases until 2002, but it widens again until 2006. In 2007 there is a reduction in the gap, which widens again in 2008. The gap in terms of cost-efficiency between southern banks and banks headquartered in central Italy fluctuates around zero until 2004 and then becomes increasingly unfavourable to the southern ones until 2006; in 2007 there is a gap reduction, which increases again in 2008. Overall, cost-efficiency score dynamics show a clear and permanent inferiority of the southern banks compared to those with headquarters in the rest of Italy.

**Table 7.4: Cost-efficiency of Italian banks by headquarter location.**

| Year | All banks | North | Centre | South |
|---|---|---|---|---|
| 1998 | 0.8238 | 0.8300 | 0.8043 | 0.8260 |
| 1999 | 0.8317 | 0.8442 | 0.8046 | 0.8230 |
| 2000 | 0.8511 | 0.8614 | 0.8325 | 0.8410 |
| 2001 | 0.8717 | 0.8761 | 0.8589 | 0.8721 |
| 2002 | 0.8802 | 0.8809 | 0.8758 | 0.8824 |
| 2003 | 0.8748 | 0.8790 | 0.8622 | 0.8756 |
| 2004 | 0.8813 | 0.8881 | 0.8697 | 0.8742 |
| 2005 | 0.8957 | 0.9031 | 0.8861 | 0.8842 |
| 2006 | 0.8880 | 0.9062 | 0.8699 | 0.8558 |
| 2007 | 0.9106 | 0.9191 | 0.8949 | 0.9028 |
| 2008 | 0.9110 | 0.9218 | 0.8933 | 0.8986 |

Source: Giordano and Lopes, 'Analysis of the Italian Banking System Efficiency'.

Regarding profit-efficiency scores also reported in Table 7.4, the unfavourable gap between southern and northern banks gradually decreases until 2000, then it tends to worsen until 2003; the gap decreases again in the following three years, and increases again in 2007, followed by a new reduction in 2008. What clearly appears is that the convergence between the performance of northern and southern banks was reached by means of a deterioration of the performance results of the former rather than an improvement of the latter.

The comparison between banks based in the south and those based in the centre is favourable to the former, although the gap has been characterized by large fluctuations; it was favourable until 2006, significantly deteriorated in 2007, and improved again in 2008.

We may conclude that the changes in ownership that have taken place after the late 1990s, which 'stabilized' and 'consolidated' southern banks, have obtained only a partial gap reduction in terms of cost-efficiency; in addition, we found a progressive alignment and convergent performance in terms of profit-efficiency even though this process was achieved at lower levels.

This empirical evidence allows us to state that the smaller banks organized as cooperatives may also play a significant role in the southern regions; but in these regions, this segment of the banking system has a limited relevance in terms of branches, on the one hand, and on the other, is largely controlled by banking groups headquartered in the north, which do not necessarily consider the southern credit market as a priority.

In other words, the disappearance of an autonomous southern banking system significantly impairs the prospects for development of production systems located in the weakest areas of the country.[10]



## Bank Branch Network Transformations before the Crisis

Understanding the transformation of branch networks on the eve of the crisis is crucial for the definition of business development strategies of banks, especially the large ones.

At the end of 2001 there were seven banking groups in Italy with more than 1,000 branches, and fifteen with more than 500; five years later these groups had become, respectively, nine and sixteen. Banking concentration at branch level has changed little in five years: the top three banking groups have maintained in this period a 35 per cent share of all branches, while the top ten banking groups rose from 56.8 per cent in 2001 to 57.9 per cent at the end of 2006.

Practically almost all banking groups and banks have increased the number of branches, with the exception of Banca Intesa and Banca Antoniana Veneta among the big banks, and only eight small banks (with less than twenty branches). One may ask whether there is a relationship between the size of the network at the beginning of the period and subsequent changes; in other words, we can ask whether the initial size of the intermediaries has influenced their strategy of branch expansion.

In 2001 banks with more than 700 branches were those who reported a lower net increase in branches: the median growth in fact amounted to 3.9 per cent, versus 24 per cent of banks with branches between 100 and 700, and 27.6 per cent of banks with less than 100 branches.[11]

The dimensional change of a bank's branch network is the balance of dynamic processes that combine new openings, acquisitions, divestitures and closures of branches. It is therefore important to understand how banks have made use of these different options. In particular, the share of closures and disposals was more relevant for large banks. Large groups (with more than 700 branches) either expanded through acquisitions (rather than new openings) or achieved a moderate expansion through a combination of purchases and sales.

Medium-sized banks (between 100 and 700 branches) instead adopted two different approaches: some developed a growth strategy by resorting to acquisitions (BPI, Popolare di Vicenza, Cr Firenze, Carige Popolare di Milano); others preferred new openings (Banca Popolare di Sondrio, Banca Sella, CR Valtellina).

Another important aspect of bank strategies relative to the growth of their branch network is the choice between expanding into new territories or deepening their presence in areas already served. Large banks opted for the former, with, between 2001 and 2006, a very limited increase in the municipalities already served by each bank (5 per cent); for medium and small banks, by contrast, the increase was 31 per cent and 24 per cent, respectively. However, the branches:municipalities ratio shows a higher degree of territorial concentration for large banks (1.8 branches per municipality against 1.6 and 1.4 for medium and small banks).[12]

Table 7.5 shows that the share of large bank branches has grown in the north-west and in the south at the expense of branches of medium-sized banks. Small banks have increased their share in Sardinia and in Sicily and in the centre and the north-east, while BCCs have increased their share in northern and central Italy.

**Table 7.5: Italian bank branch distribution, 2001–6.**

| Banks | 2001 | | | | | 2006 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | South | Islands | North-west | North-east | Centre | South | Islands | North-west | North-east | Centre |
| Large | 58.6 | 70.9 | 58.9 | 59.1 | 55.6 | 66.2 | 66.2 | 61.6 | 56.7 | 53.8 |
| Medium | 21.2 | 18.9 | 24.9 | 11.1 | 25.2 | 11.8 | 19.6 | 21.5 | 10.6 | 23.6 |
| Small | 11.8 | 4.4 | 8.1 | 11.7 | 9.9 | 12.7 | 76.0 | 7.5 | 13.4 | 11.9 |
| BCCs | 8.4 | 5.8 | 7.4 | 17.8 | 9.0 | 9.2 | 65.0 | 8.5 | 19.2 | 10.3 |
| Foreign banks | 0.0 | 0.0 | 0.7 | 0.2 | 0.4 | 0.1 | 0.0 | 0.8 | 0.2 | 0.4 |
| All banks | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Data from Grimaldi, Guagliano and Lopez, 'L'evoluzione della struttura distributiva delle banche italiane dal 2001 al 2006'.

Taking into consideration the evolution of the presence of banking groups according the municipalities size in the period 2001–6 (see Table 7.6), large banks have increased their presence in the smaller municipalities (with less than 10,000 inhabitants) at the expense of medium and small ones, while they decreased in larger municipalities, where the smaller banks have increased their weight. BCCs have increased their presence in all municipalities, but in a more limited way than the larger ones. It would be interesting to investigate whether small banks have opened new branches especially where large banks did not open (or where they closed) them. These trends seem to indicate that small banks (in particular cooperative ones) have filled the spaces left by the larger banks, at least in several areas of the country.

**Table 7.6: Italian bank window distribution by bank and municipality size (thousands of inhabitants).**

| | Branch distribution (%) by bank size and municipality size (thousands of inhabitants) | | | | | | Percentage change 2001–6 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Banks | <10 | 10–25 | 25–50 | 50–100 | 100–250 | Over 250 | <10 | 10–25 | 25–50 | 50–100 | 100–250 | Over 250 |
| Large | 51.6 | 57.9 | 61.7 | 59.4 | 65.7 | 70.2 | 3.1 | 1.2 | –1.2 | 0.1 | –3.0 | –2.6 |
| Medium | 18.8 | 21.4 | 21.7 | 23.5 | 16.9 | 20.7 | –3.3 | –3.7 | –3.2 | –2.3 | –1.8 | –1.7 |
| Small | 10.6 | 9.6 | 9.5 | 11.3 | 11.9 | 5.6 | –0.1 | 0.6 | 2.7 | 1.3 | 3.4 | 3.5 |
| BCCs | 18.9 | 11.0 | 7.0 | 5.6 | 5.2 | 1.7 | 1.6 | 1.8 | 1.7 | 1.1 | 1.6 | 0.5 |
| Foreign banks | 0.0 | 0.0 | 0.0 | 0.2 | 0.3 | 1.8 | 0.0 | 0.0 | 0.0 | –0.1 | –0.1 | 0.3 |

Source: Data from Grimaldi, Guagliano and Lopez, 'L'evoluzione della struttura distributiva delle banche italiane dal 2001 al 2006'.



## Bank Lending Strategies and Small Firms before the Crisis

Ownership changes and transformations of the branch network have influenced the lending strategies of Italian banks, particularly with regard to the degree of decision-making autonomy of bank subsidiaries. A study conducted in 2006 by the Bank of Italy on a sample of banks shows interesting findings in this regard,[13] especially in light of the assumption that small banks should be better able to establish intense relationships with local firms.

The Bank of Italy analysis shows an expansion of the territory by small banks between 2000 and 2006; the distance between local branches and headquarters, in particular, has increased.

Moreover, the survey also shows that the complexity of banks' internal organization (and especially local, cooperative banks) has increased between 2003 and 2006; in particular, the degree of decision-making decentralization (i.e. the autonomy of the branch manager in the small businesses financing decisions) has increased – especially so in banks operating in north-eastern and central Italy, but less in southern banks (Table 7.7). A greater degree of decision-making decentralization increases the incentives for the branch manager to gather information on customers and reduces transmission costs, but it also increases the risk of opportunism. Possible tools for mitigating this risk could be the mobility of the managers in the area and a flexible remuneration linked to performance. In the three-year period there was, in fact, an increase in the branch managers' mobility (see column 4 of Table 7.7).

**Table 7.7: Organizational variables of small and minor banks by geographical area.**

| Territorial areas | Distance centre/ periphery* 2000 | 2006 | Decentralized decision-making (%) | Stay branch manager (%) | Average length of stay of the branch manager (months) | Delegating index (%)† | Incentives for managers of subsidiaries‡ |
|---|---|---|---|---|---|---|---|
| Small banks | 28 | 34 | 47.1 | 25.0 | 47 | 16.0 | 7.8 |
| Southern Italy | 47 | 61 | 39.4 | 16.6 | 42 | 18.2 | 6.2 |
| North-west | 34 | 40 | 46.5 | 25.9 | 40 | 16.6 | 9.9 |
| North-east | 19 | 25 | 48.3 | 28.0 | 57 | 12.3 | 6.9 |
| Centre | 21 | 23 | 50.0 | 24.0 | 45 | 18.7 | 5.9 |
| Sample | 42 | 47 | 49.5 | 25.0 | 45 | 14.7 | 8.8 |

* Average distance between branches and head office (km).

† Balance between the responses which indicated an increase of decentralized decision-making in the three years 2003–6 and those which indicated a decrease in relation to the total number of banks in the sample (%).

‡ Average impact (%) of incentives on the annual salary of a branch manager.

Source: Banca d'Italia, *L'Economia delle Regioni Italiane* (Rome: Banca d'Italia, 2007).

Additional data from the same source provides information about the degree of decision-making autonomy of branch managers concerning lending to small businesses. It shows that such autonomy is lower in southern bank branches.

Overall, these empirical findings suggest that the reorganization of the Italian banking system in recent years has given rise to very rigid and hierarchical banking organizations. The increasing reliance on standardized information-processing techniques (hard information) has widened the distance between bank decision-making centres and firms. At the same time, these new organizations are less well equipped to gather intangible (soft) information, which arises out of more intense relationships with customers and in less vertically integrated organizational structures. This reorganization of banks, moreover, has taken place in an economy characterized by the widespread presence of small and medium-sized enterprises, inherently opaque, which tend to produce more heterogeneous and intangible information than larger firms.

Therefore the changes in organization and structure in Italian banking are rightly perceived to exacerbate the issue of access to credit for small businesses, further undermining the prospects of growth of the production system in the weakest areas of the country, which are characterized by more vulnerable and opaque firms.[14]

## Banks' Lending Strategies and Small Firms after the Crisis

The international financial crisis, which began with the bankruptcy of the US investment bank Lehman Brothers on 15 September 2008, had a major impact on the stability of the major US and European financial institutions and led to a sharp fall in the growth rates of world's leading economies.

It is now, however, five years later, that the impact of the crisis on the Italian financial system, hitherto quite limited, has become visible: concerns about the soundness of the intermediaries are now acute, leading to a sharp rise in risk premiums on inter-bank rates, already growing for over a year. The market capitalization of the major Italian banks collapsed in a few weeks during 2012 as a result of deep uncertainty about the quality of bank assets; major stock indices dropped, which made the issuance of securities more difficult and costly; finally, the supply of credit contracted sharply.

An event of this magnitude strongly influences bank behaviour concerning the definition of the criteria, terms and conditions for granting loans to businesses. How, then, have Italian banks behaved, especially given the fundamental changes in organization and structure that took place in the previous fifteen years, as documented above? Useful indications are provided by the findings of the quarterly survey conducted by the Bank of Italy on eight banking groups representing more than two-thirds of the Italian loan market.[15]



The first issue concerns the definition of the criteria for granting credit to businesses. These, in other words, are the criteria, not necessarily codified in writing, or other practices related to policies, which define the types of loan considered desirable or not, the priority in the granting of loans, and the guarantees considered acceptable or not. It is interesting to note a gradual tightening of credit standards applied by banks for lending, especially in the long term, which reached its maximum at the beginning of 2009.[16] According to the survey, the main factors behind that tightening were expectations regarding overall economic activity, and perceived risks on collateral, particularly for small firms with five or less employees.[17]

Turning to the terms and conditions applied to loan approval and the opening of new lines of credit, we observe that since January 2008 there has been a significant increase in the interest rates charged to riskier loans. Another aspect that characterizes the tightening of conditions applied by banks to businesses is the shrinking of the overall amount of disbursed loans.

The survey also analyses changes in the demand for loans: in this case we observe a significant drop in demand, especially from smaller firms, in the 2008–9 period. This contraction owes, essentially, to a reduction in investment in fixed capital, inventories and working capital; at the same time, short-term loans were partially replaced with long-term loans through debt-restructuring operations. In fact, borrowers have chosen to modify terms and conditions of loans to avoid insolvency, or to make debt more sustainable by postponing repayment deadlines or reducing its burden.

## Bank–Firm Relationship Deterioration during the Eurozone Financial Crisis

In 2010, while the world economy was trying to recover from the real and financial consequences of the global crisis, a new outbreak occurred in the euro area. Troubles in Greece triggered a new escalation of risk perception by international investors, who now turned their critical attention to sovereign debt. Unable to place their securities on the market in May 2010, Greece had to resort to the European Union and International Monetary Fund for assistance. Over the following months, Ireland (November 2010) and Portugal (April 2011) required the same kind of help. The three countries faced different problems: competitiveness in Portugal, public finances and also competitiveness and external imbalance in Greece, a banking crisis in Ireland.

To avoid the possibility that tensions in sovereign debt markets, through their impact on the money markets and on bank lending, could jeopardize the smooth transmission of monetary policy, the European Central Bank (ECB) decided to refinance European banks with fixed-rate tenders satisfying fully the

demand for credit; in addition, the ECB adopted a programme of purchases of government securities (securities markets programme, or SMP), although, given statutory constraints, that programme was limited.

These public interventions were not evaluated by financial operators as decisive because the very meaning and the internal coherence of the eurozone's construction were being challenged. The nature of this second phase of the crisis is different from the first one: at the root of the US and then global financial crisis in 2007–8 were excesses of monetary creation of uncontrolled financial innovation and an irrational faith in the self-regulating capacity of financial markets. At the root of the problems facing Europe today, there are serious institutional weaknesses: lack of fiscal coordination, constraints on the ECB, inadequate regulation and supervision of European financial markets, all of which weakens the eurozone.

Since the summer of 2011, signs of a slowdown in global growth, fears of repercussions on public finances and on the soundness of the banking sector, and uncertainties concerning the involvement of the private sector in the resolution of the debt crisis in Greece have increased tensions, which are now involving Italy and Spain as well.

Under the combined effect of rising public deficits due to bank bailouts and measures to support domestic demand and the deteriorating economic situation, public debt has soared in eurozone countries, creating doubts about the solvency of so-called peripheral countries. Public perception of a greater risk for government bonds issued by these countries was then compounded by the inadequacies of European institutions, mainly because of a lack of common fiscal policy and the inability of the ECB to guarantee the value of government bonds of countries in difficulty.

In early August 2012, the EBC Board of Directors finally announced the introduction of 'outright monetary transactions' (OMT), a plan to purchase government bond purchases on the secondary market without any quantitative restrictions. However, such interventions would be implemented by the ECB only at the request of countries in difficulty and subject to adoption by the latter of a 'memorandum' of measures of fiscal consolidation. Yet the announcement yielded immediate benefits: medium and long-term interest rates on bonds issued by peripheral countries sharply decreased. However, tensions remain due to the unwillingness of 'core' countries to adopt expansionary fiscal policies.

The inability of Europe to handle problems in the 'peripheral' countries has undermined market confidence, especially in Spain and Italy. The drop in value of sovereign bonds has had a negative impact on banks' capitalization given the latter's heavy exposure to the former. Thus governments have had to finance the recapitalization of their banking systems with additional burdens on public finances and a higher risk premium on government bonds. The sovereign debt



crisis in the periphery is thus linked to the banking crisis in the whole euro area – a significant source of instability for the next few years.

Faced with this situation, European institutions have subordinated the financial assistance aimed at refinancing the public debt of the peripheral countries to the implementation of supply-side policies (i.e. market liberalization and privatizations) and restrictive fiscal policies (i.e. drastic cuts in public spending and tightening of the tax burden). The assumption behind those 'austerity' policies was that in this way peripheral countries could improve their competitiveness on international markets, increasing exports more than imports, thereby reducing current account imbalances, restoring their reliability on international financial markets, thereby reducing yields on government bonds and finally restarting economic growth. However, what has been happening in the eurozone in the past two years goes exactly in the opposite direction: austerity measures, causing a fall in domestic demand, tended to have a depressive effect on economic activity, resulting in a significant contraction of GDP.[18]

Not surprisingly, the peripheral countries have fallen into a vicious circle in which the worsening of the debt:GDP and deficit:GDP ratios imposes additional restrictive fiscal measures that determine even more substantial reductions in production and a further deterioration of those indicators. It is obvious that the simultaneous adoption of recessionary policies from countries that have a high degree of integration tends to amplify the depression.

It is at this stage that the international financial crisis, interacting with the banking system, reverberated negatively on businesses. Concerns about the soundness of banking systems are acute, leading to a sudden increase in risk premiums on inter-bank rates; market capitalization of the major Italian banks collapses as a result of deep uncertainty about the quality of bank assets in which government bonds of the peripheral countries are now included; in addition, the flow of credit to the economy shrinks and credit requirements become more stringent.

In the last few years we can observe an increased heterogeneity of monetary conditions in the euro area: the intensification of capital outflows from the countries most affected by the crisis and a clearer segmentation of bank deposits along national borders increase the risk of a crisis in banks' funding, giving rise to a strong restriction of credit to firms in peripheral countries, with serious consequences to their macroeconomic performance.

The case of Italy, from the point of view of bank corporate lending, confirms the existence of a strong dualism within the euro area: while Northern European countries (Austria, Belgium, Germany, Finland, France and the Netherlands) show a pretty stable trend in bank loans, peripheral countries (Portugal, Ireland, Greece and Spain) show a strongly negative trend.

ECB data[19] show that only 48 per cent of Italian firms, especially small and medium-sized enterprises, who made a request for a bank loan in the latter six months of 2012 saw their demand accepted – much worse than in France and Germany, where loan requests were granted in 80 per cent of cases. Among the major euro area countries, only Spanish SMEs are in a worse situation.

The deterioration in the macroeconomic environment negatively affects a firm's financial situation, leading to a progressive deterioration in the quality of bank credit. Banks respond, on the one hand, with ever more stringent non-performing loans (NPL) provisioning policies, at the request of the supervisory bodies, and, on the other, with tighter credit. Solvent but illiquid firms are thus taken into a vicious cycle that eventually increases NPL.

Figure 7.1 shows that Italy experienced a gradual contraction of business loans compared to the overall performance of the eurozone countries and, above all, Germany. Moreover, lending conditions diverge as well: Figure 7.2 shows the difference between the average interest rate on loans in Italy and Germany.

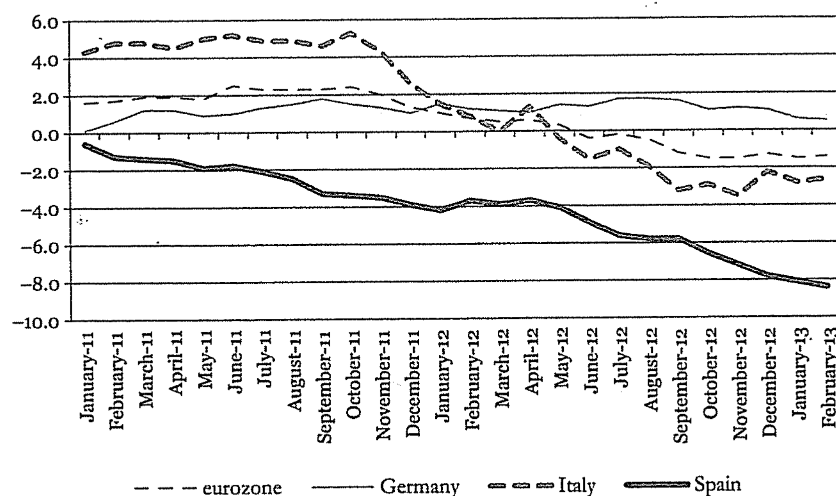


**Figure 7.1: Annual growth rates of loans to firms in the eurozone.**

Source: Data from ECB, *Survey on the Access to Finance of Small and Medium-Sized Enterprises (SAFE)* (Frankfurt: ECB, 2012).



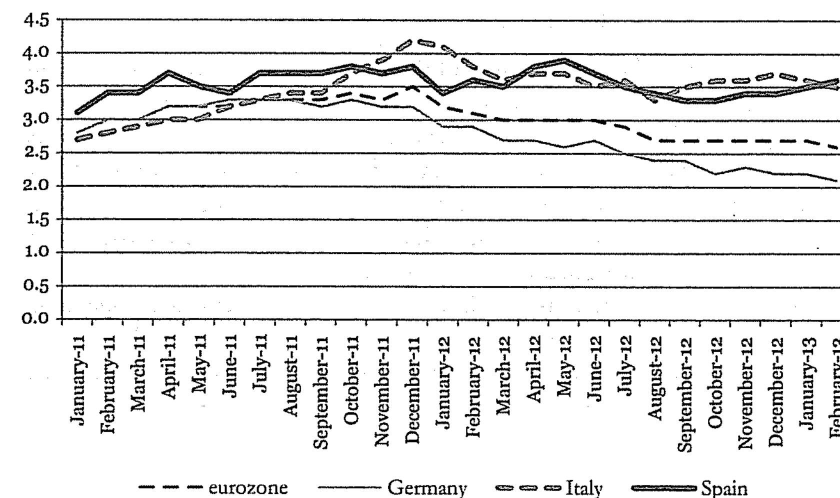


**Figure 7.2: Interest rates on loans in the eurozone.**

Source: Data from ECB, *SAFE.*

More information on the comparative behaviour of European banks can be obtained from a reordering of the ECB Bank Lending Survey. The data shows a moderate tightening of credit standards in 2010 in Italy, which remained stable in Germany and Europe, and a very sharp tightening of the criteria in the former during the second half of 2011. This tightening reflected the rise, in the same period, of the spread between the rate of return on Italian BTPs and German Bunds, from 301 basis points in July to 552 basis points in November. In the second half of 2012 we observe in Italy a relaxation of criteria for credit granting, while in Germany they remain unchanged. The beginning of 2013 sees the alignment of the Italian data to European ones, while in Germany we note a further slight easing of credit standards for approving loans to companies.

By analysing banks' assessment of the demand for loans, according to the ECB Survey, in contrast to the overall trend in the eurozone (and especially Germany), Italian banks have faced a significant decline in demand for credit from the beginning of 2012 onwards. This decline in loan applications is attributed by Italian bankers to the substantial halt of fixed capital accumulation by Italian firms. Finally, Italian firms were more likely than elsewhere to use credit with a view to restructure outstanding debts and reduce the probability of insolvency.

## Italian Banks and the Crisis

In the aftermath of the global crisis and the midst of the eurozone one, Italian banks have experienced a decrease in net interest income, this being partly due to the rising costs of funding from customers because of tensions on both deposits and bond markets. In addition, interest earned on loans is more sensitive to low market rates (Euribor) than the interest paid on bank deposits. Finally, Italian banks were adversely affected by the reduction of interest-bearing assets with respect to interest-bearing liabilities, due to loan reduction.

This phenomenon contrasts with a significant improvement in operating income on financial instruments (securities, financial liabilities and derivatives) over the previous year. This positive result owes to gains realized through the repurchase/exchange of securities issued in recent years, made possible by the low prices of securities and the recovery of values for many financial assets in portfolios (bonds, shares, etc.).

Operating costs continued their downward trend due to the implementation of programmes to limit personnel (staff reductions, unions agreements) and administrative costs (organizational rationalization), with a consequent improvement in the cost:income ratio from 68.5 per cent to 63 per cent in the last year. However, NPL increase negatively affected gross operating profits.[20]

A worrying fact is the continuing reduction in credits to the corporate sector, especially for smaller firms. In this respect, Bank of Italy data show that the percentage of rationed firms is growing. Access to credit remains difficult for smaller companies, for which resorting to alternative sources of finance is also harder.[21] Restrictive credit policies also reflect bank financial conditions: in 2012 the growth of lending to businesses was positive for banks with best capital ratios and funding.

Regarding lending quality, Bank of Italy data also show that the new bad loans:total loans ratio was stable for family loans, whereas the ratio worsened for business loans, especially for firms in the construction sector. At the end of 2012, NPL accounted for 7.2 per cent of gross loans, while total deteriorated loans (NPL, doubtful, restructured or past due) represented 13.4 per cent.

In line with what was observed previously, smaller banks, especially small cooperative banks, show a lower incidence of deteriorated loans and a lower coverage rate, which indicates a greater propensity to finance small business compared to larger banks (see Table 7.8); in addition, smaller banks have a higher share of loans fully secured by real or personal collateral (50 per cent, compared to 33 per cent for the total system).[22]



**Table 7.8: Italian bank lending according to quality and coverage ratios as of December 2012 (in per cent and in € million).**

| | Loans | Deteriorated loans | NPL |
|---|---|---|---|
| **Top five banking groups** | | | |
| % composition | 100.0 | 14.0 | 7.7 |
| Coverage ratio | 6.3 | 41.1 | 56.1 |
| **Large banks** | | | |
| % composition | 100.0 | 11.5 | 6.1 |
| Coverage ratio | 4.7 | 36.7 | 52.2 |
| **Small banks** | | | |
| % composition | 100.0 | 14.4 | 7.4 |
| Coverage ratio | 5.9 | 37.8 | 56.0 |
| **Minor banks** | | | |
| % composition | 100.0 | 13.8 | 6.1 |
| Coverage ratio | 4.1 | 27.2 | 46.1 |
| **All banks** | | | |
| % composition | 100.0 | 13.4 | 7.2 |
| Coverage ratio | 5.7 | 38.8 | 54.6 |

Source: Banca d'Italia, *Rapporto sulla Stabilità Finanziaria* (Rome: Banca d'Italia, 2013).

With regard to funding, the latter has grown on average by 4.6 per cent in 2012, mainly thanks to ECB refinancing operations and, to a lesser extent, the good performance of domestic deposits. The increase of these components offsets the decline in bonds and deposits from non-residents; the average cost of raised funds collection has decreased, reaching 1.3 per cent, thanks both to the easing of tensions in sovereign debt markets and to the greater resort to refinancing by the ECB.

However, despite the expansion of assets readily convertible into cash and the solidity demonstrated so far by retail funding, the short-term liquidity position of Italian banks still remains quite vulnerable to a possible worsening of the sovereign debt crisis, and a consequent downgrading of government bonds and banks.

In relation to these issues and at the request of supervisory authorities,[23] in 2012 the largest listed banking groups have continued to improve their capital position, while the adequacy of the balance sheet was confirmed for small local banks, who have benefited from a more limited exposure to financial risks. The strengthening in capital adequacy ratios is mainly due to a decrease in risk-weighted assets. The reduction of risk-weighted assets has helped portfolios shift towards activities with a lower capital absorption: this has obvious negative consequences for credit to small businesses located in the weakest areas of the country.

At the end of 2012, the core tier 1 ratio of the first fourteen listed groups had reached, on average, 10.5 per cent versus 7.5 per cent in 2010. The core tier 1 ratio of banks has increased over the same period from 7.3 per cent to 9.3 per cent, while the tier 1 ratio of cooperative banks is now at 14.1 per cent. The capital of the latter cat-

egory of banks remains large, although low profitability reduces their self-financing capacity. The data also confirms a higher level of capitalization for southern banks compared to centre-northern banks: 12.6 per cent versus 9 per cent.

At the same time, the slow alignment of Italian banks with the new capital requirements imposed by Basel 3 has continued; according to estimates by the Bank of Italy, the overall need for quality capital for banks would amount to €8.8 billion in 2012. This implies that compliance with the new capital requirements, especially for larger banks, can be achieved only by further reducing risk-weighted assets or otherwise rearranging the portfolio towards those activities with lower capital absorption; in any case, this would result in a further decrease of credit supply.

## Bank–Firm Relationship Deterioration in Southern Italy

The critical issues in bank lending identified above are even more apparent in southern Italy. Over the past eleven years (2001–12), the south has suffered a 3.8 per cent decline in GDP, very far from the centre-north (+3.3 per cent), reflecting the continuing development gap between the two areas. The performance is still more dramatic if we observe only the crisis years: from 2008 to 2012 the south lost more than 10 per cent of its GDP, almost twice that of the centre-north (–5.8 per cent).[24] The worsening of the southern economy is more intense because of greater reliance on domestic demand, which was reduced significantly by the restrictive policies implemented to stabilize public finances in recent years.

This negative performance has also affected, to some extent, the demand for credit:[25] the reduction of loan applications to the largest banks was much more pronounced in the south than in the centre-north. At the same time, deposits collected in the south by large banks have grown much more than in the rest of the country – respectively, 27.7 per cent and 10.5 per cent. This data confirms the trend by which larger banks increase their deposit:loan ratio in the south.

A different picture emerges for smaller banks; if we consider the period 2008–11, the demand for credit has grown more in southern Italy than the rest of the country. As already noted, it is clear that small local banks pay more attention to businesses rooted in the south compared to larger banks.

It is interesting to note that both the expansion and the decline of loans occur in a more pronounced way in central and northern Italy than in the south. The less intense loan contraction observed in the southern regions is due to the presence of persistent and more selective criteria for assessing creditworthiness there. This allows banks operating in the south to reduce loans to a lesser extent to companies already selected, and much less frequently, than is the case in other areas of the country (however, the opportunity to expand credit in the south is much more limited than elsewhere).



When we consider firm size, a perhaps surprising finding is that companies who have suffered a more severe credit restriction between 2009 and 2011 were firms with at least twenty employees in northern and central Italy. In the south, the firms with fewer than twenty employees have recorded the greatest credit contraction; it is reasonable to conclude that the expansion of loans recorded in the south over the past two years is explained mainly by the larger firms, while small businesses still experience increasing difficulty in accessing credit.[26]

Another issue that is important to consider is the cost of credit: Svimez has calculated the interest rate gap by dividing the difference between the interest rate earned on short-term loans in the south and in the centre-north by the national level.[27] At the end of 2008 it was around 10 per cent, doubled at the first quarter of 2009, and reached a peak of 27 per cent at the end of 2010; afterwards the differential continued to average more than 20 per cent, before rising strongly in 2012 to almost 35 per cent.

These data confirm the increased risk associated with a more uncertain macroeconomic environment in southern Italy; it is also evident that the more permissive monetary policy practised by the ECB during these months has not translated into a reduction in interest rates charged by banks to businesses, since the latter have increasing risk coefficients that have, in fact, more than offset these reductions, especially in the weakest areas of the country.

The NPL quarterly growth rate provides a further indication of deterioration in the quality of bank portfolios. Svimez data provide a comparison of new NPL between the centre-north and the south: the smaller deterioration in the quality of loans to the south than in the rest of Italy could be due, at least in part, to the fact that southern firms have already been experiencing, for a long time, a more acute restriction in access to credit and higher bad loan levels by virtue of an exogenous environmental risk. Finally, between the end of 2010 and 2011, NPLs for smaller amounts have increased by less than what happened to those of a greater entity. Again it should be noted that the adoption of tighter criteria for smaller loans occurred over time with the adoption of more standardized procedures that clearly act more decisively on these size classes. A wider margin of discretion could still apply to larger loans; evidently the escalation of the crisis has increased the deterioration of loans belonging also to larger-size classes.[28]

## Conclusion

At the beginning of the 1990s, the Italian banking system was characterized by predominantly public ownership, low concentration, little internationalization, capital inadequacy and modest income capacity. The last fifteen years have seen a significant restructuring process relative to all these aspects, which gradually improved many structural limitations. Nevertheless, the process towards a modernized system is still far from complete and is plagued by problematic elements that need further examination.

On the one hand, this process has not reduced the comparative superiority of cooperative and small banks in terms of cost- and profit-efficiency. Despite the fact that these banks hold a marginal share of the overall lending market (7 per cent), they have prospects for profitable expansion in the future. This is consistent with the hypothesis of an underlying demand for credit that does not meet with supply by larger banks but can be adequately met by smaller banks with decentralized structures (or rather, in the Italian case, by cooperative banks). The empirical results are in line with a substantial amount of evidence based on other credit systems (the United States and Germany), as seen in other chapters of this volume. In addition, Italian cooperative banks appear to invest more in intangible information (soft information), develop more intense customer relationships, and adopt a less vertical structure, characteristics that help us understand their comparative advantage, as argued in Chapter 4 of this book.

On the other hand, the process of consolidation of the Italian banking industry has encouraged the growth of medium-sized intermediaries and the adoption of rigid hierarchical models not favourable to credit access by small and medium-sized firms. In addition, economic and territorial dualism has been reinforced by the transformations of the Italian banking systems: the massive ownership changes following southern banks' acquisition by other financial intermediaries at the end of the 1990s have not achieved the expected outcome. Moreover, southern banks' poor asset quality (due to their external environment) adversely affects their cost- and profit-efficiency.

On top of these structural issues, the financial crisis in the eurozone, caused by doubts about the sustainability of sovereign debt in peripheral countries and aggravated by the weakness of the main European institutions, has motivated the adoption of austerity policies that have compromised the prospects for growth in Europe. In the absence of expansionary and coordinated policies at the European level, the likely situation of gradual disintegration of the euro area, with the deepening of the differences between 'central' and 'peripheral' countries, is envisaged.

Divergence tendencies within Europe also concern the banking system. The empirical evidence discussed here indicates a progressive separation between the Northern European core and the Mediterranean periphery in terms of the availability of credit to businesses, interest rates, the tightening of criteria for the assessment of creditworthiness, and the perception of economic risk by banks.

This scenario captures what is happening within the Italian economy: the fall in activity levels has led businesses to curb demand for loans (which is mainly limited to the restructuring of existing debt with the banking system); symmetrically, the worsening of their financial situation has caused a significant deterioration in credit quality. On the supply side, credit tightening has been uneven in the banking system because the reduction of loans granted by the top five banking groups was partially offset by the expansion of loans granted by small banks, but, unfortunately, in 2012 this second component has also undergone a significant slowdown. Therefore, one should insist on the significant role of small and cooperative banks in supporting the activities of smaller companies that continue to be a key pillar for the Italian economy. However, the reaction of the banking system is consistent with the application of ever more demanding criteria of capital adequacy, and with the increasingly more automatic setting of customers ratings that tend to penalize smaller companies and cast doubt on future economic growth.



These endemic problems of the Italian economy, then, tend to worsen in times of crisis such as now, resulting in deepening the problems of access to credit for smaller companies. Financial constraints become more stringent, especially for companies operating in territorial and institutional contexts that are more fragile and therefore exposed to greater systemic risks, such as in the case of southern Italy.

There is now ample evidence that within this scenario, the south, more than other areas of the Italy, has suffered the repercussions of the crisis on the productive system. The problems faced by southern firms in terms of access to credit are inevitably influenced by the role played by banking supervision in balancing the need of stability of the banking system with that of financing the economy. In a dualistic context like the Italian one, the pursuit of general goals (like banking system stability) translates into deeper asymmetries. From the banks' point of view, for a given capital, the deterioration of the rating necessarily determines a significant reduction in loans to customers in order to maintain adequate capital ratios. It follows that the deterioration in ratings, even in the presence of expansionary monetary policies such as those conducted by the ECB in the last two years that were perhaps intended to curb significantly the level of interest rates, can make substantially non-operational the 'credit channel' through the constraint posed by the 'balance sheet channel' of the banks.

Basel 2 criteria are particularly exposed to these eventualities because they only prescribe adequate provisions to cover expected losses. As a consequence, during phases of economic expansion (when a rise in lending lays the ground for the growth of bad loans once the economy changes course), expected losses are systematically underestimated compared to actual future results; in the absence of adequate provisions to cover this event, a bank's capital is highly susceptible to being inadequate.

Capital inadequacy becomes visible when the economy goes into recession; it follows that the associated depressive and restrictive effects of today's austerity policies are amplified exponentially by the persistence of a negative cycle, turning into stagnation and outright recession. Therefore current banking regulation, which sets progressive and increasingly stringent controls on capitalization, certainly does not help the real economy in a period of prolonged recession such as the one that the eurozone in general, and its peripheral countries in particular, are experiencing.

In conclusion, several warnings emerge concerning trends in the Italian banking system, and we must ask whether the significant structural changes that have taken place are sufficient to increase efficiency, or rather if the future scenario, which has become more critical after the global financial crisis, will not raise again, in a more dramatic way, the problem of availability of credit – or the problem, more generally, of the absence of a virtuous model of a bank–firm relationship able to operate as a factor for development in the Italian economy.

# 8 ALTERNATIVE BANKS ON THE MARGIN: THE CASE OF BUILDING SOCIETIES IN THE UNITED KINGDOM

Olivier Butzbach

## Origins and Development of an Alternative Banking Model

### *The Origins*

Although the purpose of the present chapter is to show how British building societies might constitute a viable alternative to the failed business model that was exposed in British banking post-2007, it would be a mistake to consider that this was always the case. Originally, building societies were not banks. They were financial institutions of another, specialized kind. They were a mix between a savings bank and a cooperative mortgage lender. It is only belatedly (in the third quarter of the twentieth century) that they were allowed to expand beyond mortgage lending and become more bank-like.

The history of building societies is not unknown to the economic historian.[1] As pointed out by Bellman, the history of building societies is longer than that of joint-stock banks – with the exception of the Bank of England.[2] The first building societies saw the light in the 1770s in Birmingham, a city of rapid economic development and accumulation of wealth. The first building society was founded in 1775 by the owner of an inn, Richard Ketley, and was aptly named the Ketley Building Society. It was founded on a very simple principle, which has stood at the core of building society business models ever since: every member would pay a monthly subscription to the society; the funds so collected would then be used to pay advances (loans) to members wishing to acquire property; the property would be used as collateral to the loans.

Housing was then, as it is perhaps now, a hotly debated social and political issue. Those who advocated the funding of housing by building societies did so on social and moral grounds. Their first concern was to ensure that working classes may have access to descent housing, especially in rapidly growing cities