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THE CROSSING-OVER BETWEEN CREDIT INSTITUTIONS AND FIRMS

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THE CROSSING-OVER (1) BETWEEN CREDIT INSTITUTIONS AND FIRMS

The wall between banks and companies is being destroyed?

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(1) A crossing over is a part of a complicated process which can occur during cell division: two chromosomes of a homologous pair may change segments, producing genetic variations in germ cells.

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A bank is a «*financial intermediary which participates in the payment system and finances entities in financial deficit using the funds of entities in financial surplus*»That's sounds a little bit inadequate doesn't it?

Banks have a crucial importance in the economy for two main reasons: they are the only source of finance for a large number of borrowers and they manage the payment system. Their financial disruption is likely to be more serious than it would be with other sectors of financial system.

A failure (or a perceived threat of failure) would be very dangerous: the interconnectedness of banks is much greater than that in the most other industries so the failure of one bank can directly cause immediate losses to the interconnected banks.

Faced with deregulation and financial disintermediation banks in the industrial countries are reacting to prevent further deterioration of their financial performance and to improve their competitive position. In order to achieve these goals, we see different strategies: for example, their transformation into universal banks, diversification toward non-bank and non-financial activities, internationalization for activities and the new organizational forms to respond sooner and better to industry changes.

The reason for this variety of strategic options is related not only to each bank's starting position and resources but also to the structure of its governance.

And yet, as we develop responses to these challenges, we also need to step back and consider how we have arrived at where we are.

Originally the large Italian banks were established to operate as a mixed banks: there was no difference between short term from the various types of medium and long term banking business.

Banks had huge amount of firms' share: buying a share gives its holder part of the ownership of a company, as a result, they had a chair in the board of directors, they vote at a company's annual general meeting, they receive a proportion of distributed profits in the form of dividend – or to receive a part of the company's residual value if it goes into liquidation.

This system showed soon its weakness, during the crisis of 1930s to let a certain number of commercial banks and among them the big mixed one, go bankrupt would have been to pose a serious threat not only to the survival of entire industrial sectors but also to the central bank itself, which, by 1932 had given advances to the three major mixed banks.

Formally, these were short term advances but they had been continuously renewed in order to keep these banks at the satisfactory level of liquidity. Moreover the Central Authority was exposed with huge credits to the commercial banking sector and secondary industry, which was practically cut off from the banks for its medium and large term credits needs was searching desperately for a solution.

The decisive breakthrough only comes in 1933 with the establishment of a state owned holding company, IRI to which all industrial securities originally owned by the mixed banks were transferred.

Following the crisis it was decide to separate short term from the various type of medium and long term banking business and this was implemented under the terms of the Banking Act of 1936, a statute which reserved each kind of business specifically for a separate type of organization. Futher, any relationships between banks and industrial groups weren't allowed anymore.

Until 1970 the discussion about banks' industries shares didn't come out: in fact, the role of the state on banks' governance was too heavy and the Act of 1936 caused a really "divorce" between our protagonists.

Only a CICR (*Comitato interministeriale per il credito ed il risparmio*) decree of 27th November 1970 allowed to some credit institutions to buy shares in firms only for "public" or "social" reasons. At the end of 1970s a directive (77/80/EEC) opened the banking system to competition.

In the 1980s, another CICR decree (28th January 1981) and a Banca d'Italia decree (19th June 1981) introduced a new concept of share and the difference between financial firms and industry firms. These decrees indicated the limits to the banks' firms shares and the mission that the banks had to follow: the enforcing of the credit system and the efficiency of banking itself.

During the 1990s the rules about banks' shares have been revised.

With the Amato Act (n.218/1990) Italy started the privatization state owned firms including banks: the result would be a dismantling of Italy's public sector, constituting about one fourth of the national economy. Amato's plan was designed to free the economy from that stultifying embrace and to boost competition by opening the Italian market to more players, including foreign investitors. In fact this Act overturned the bank regime of the previous 60 years and it showed the path to a private banking system.

The Ministry of Treasury decree of 22nd June, 1993 n. 242632 and the "Istruzioni di vigilanza" from Banca d'Italia of 1993, updated in 1998, fix fundamental principles.

First of all, they convert into an institution the despecialization of banking: all the banks can do both short term and long term activity and the banks' governance became a strategic choice of the single bank.

Nevertheless there are some limits for banks yet. For banks' shares in holding company, insurance company and instrumental company (that means companies which provides other services, ITC, for example) there are two kinds of limits.

Banks can't buy shares that exceed their regulatory capital.

The authorization of Banca d'Italia is due when shares exceed the 10% of the capital subsidiary company. When shares reach or exceed the 10% of the capital's subsidiary company the bank (proposed acquirer) must first notify in writing to the competent authority the size of its share, moreover a financial plan, the statute and the last two account of the target firm and the share effect for the bank shareholder (financial situation, for instance).

For firms' shares there are three types of limits: the "concentration limit", the share must not exceed the 3% of the regulatory capital of the bank shareholder to avoid risk connected to the financial and economic trend of the subsidiary company.

The "maximum limit" tends to avoid the capital risk linked to the size of the share. For listed company must not exceed the 15% of regulatory capital, for the others the 7,5% of regulatory capital.

At least the "separation limit" : the share must not reach or exceed the 15% of the capital of the subsidiary company.

On the 29th July 2008 a new chapter about the relationships between banks and firms has been written: actually CICR has decided to reduce the limits for credit institutions to buy firm's shares.

The new rules contents only thresholds of 15% of regulatory capital for the banks' stakeholders and a global limit of 60%.

The prudential assessment is inclusive of affiliated company where bank can condition broadly the management's choices: this is crucial to prevent conflict of interest and every transaction which could influence management caused by the great exposure towards affiliated companies.

In order to quantify the size of a bank's share the authorities must consider both the direct and the indirect influence. Despite, the increasing possibility to buy industry's share for credit institutions is balanced by new rules to control the respect of capital requirements.

Conclusion

The separation between bank and industry is revolving around a fundamental principle: the merciless logic of the market (supported by firms) and the logic of credit (supported by banks).

Credit institutions think about purely financial terms, investment yield, whereas firms think about purely economic terms, competition, production, that's because these two entities have always been separate, to avoid dangerous cross-contaminations.

Moreover, the 80% of italian firms run into debt and their survival skills are guaranteed by the impossibility for banks to regain of their holding in hard times.

Making a valuation of somebody creditworthiness banks could play the double role of estimator/shareholder: how could this is balanced? The shareholder role would corrupt the estimator role?

Nevertheless the wide entry of banks in capital's firms could enforced the relationship lending; its theory is based on the idea that close ties between borrowers and banks may be economically beneficial because of the banks capital growth, lower credit costs and better quality services.

This is correct correct, but we don't have to forget that credit system is a public interest as provided the section 47 of the Italian Constitution law.

The intermediation system is the most interesting under the viewpoint of coexistence of public politics of regulation (to maintain financial stability) and, on the other hand, the public politics that improve market competition.

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Moreover, regarding the nature and heterogeneity of banking services these problems may involve financial intermediary and insurance broker.

In the end, the fundamental task for authorities should be a reconsideration of the principle of separation between banks and firms: we don't have to step back at 1930s, but we must think about problems that this contagion may cause.

It is important to begin creating a legal environment in which internal risk analysis, management and control systems will be able to work with public regulation.

Consequently, policymakers could reduce potential distortions by structuring policies to be more "incentive-compatible" in order to support the profit maximizing goals of investitors and firms managers and, at the same time, "transparency- compatible" to protect savings, ad most of all the confidence of people.

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