

The Evolution of Financial Regulation in Europe and Italy

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1. Introduction

The growing globalisation of financial systems and European integration make it very difficult to isolate for each country the topics of this conference (factors of crisis, stability and growth), which are fundamental to the general theme of the theory and practice of financial regulation.

A country analysis may therefore be written from at least two points of view. The first is to look at the particular facts of each country and then to build the whole picture (a sort of bottom-up approach). The alternative is to sort out the impulses common to all countries originating from globalisation and European integration and then to analyse the position of each country (a sort of top-down approach).

In this paper I have chosen the second approach for at least two reasons. First, because when considering regulation – i.e. a topic which has changed so much in recent times, both in theory and in practice, it is necessary to start from general problems, such as the final objectives and instruments of the regulatory system. This means starting from the very top. The second reason is that Italy is a country where the swings of the pendulum between the extreme positions of the trade-off - stability vs. competition; stability vs. disclosure - have been particularly evident and to a great extent (but not

completely) determined by international competition and the European Directives¹.

The paper is organised as follows. Section 2 briefly reviews the rationale for financial regulation, its final objectives and instruments. In particular, it will show that, while stability is one final objective of financial regulation (from a historical point of view, the very first), economic growth mentioned in the title of this conference, is not a final objective *per se* of regulatory action. As a matter of fact, economic growth is a result of (or is a co-determinant with) the efficiency of the financial system, which is strictly correlated with competition, which is a final objective. As competition must be seen in the broadest sense (including, e.g., the market for corporate control) the concept of growth relates, generally speaking, to the presence and intensity of market forces in the financial system.

Section 3 analyses the long-term evolution of regulation in Europe, with particular reference to the progressive swings of regulatory trade-offs from the objective of stability to other objectives: disclosure and competition. It will be shown that this movement is less visible in the architecture of financial regulation, i.e. in the division of labour among regulatory agencies.

Section 4 looks at the main reforms in the Italian financial system from the view-point of interest to this conference: stability and growth, i.e. stability, competition, efficiency.

2. The objectives and instruments of financial regulation

The *raison d'être* of financial regulation, as in any form of economic activity, is to correct market failures. Both economic theory and historical experience show that financial intermediation is particularly prone to market failures, due to information asymmetries that dominate the relationship between borrowers and lenders. These asymmetries can destroy the fiduciary relationship

¹ Onado 1998.

that lies at the heart of both using money and lending. In other words, the question whether financial intermediation needs to be regulated is equivalent to the question of why financial intermediaries exist (Onado 1992).

Both from a practical and a theoretical point of view, the debate on financial regulation started from banks. Bank liabilities (sight deposits) are generally accepted as a means of payment, while bank assets consist of risky loans whose maturity is longer than the liabilities. This entails a liquidation value of bank assets lower than the face value of liabilities, which brings a risk of runs, the spread of panic and eventually produces systemic consequences.

This is sufficient to explain why we need public intervention to:

- i) control the money supply and, via price stability, the fiduciary nature of bank-created money (hence monetary policy and the macroeconomic function of central banks);
- ii) control the liquidity and solvency of banks to protect depositors (hence, supervisory powers).

Lending of last resort granted by central banks is the link between the two functions. As to solvency regulation, some scholars focus on the problem of protection, particularly of small depositors who do not have either the incentive or the competence to collect information to control bank management (Dewatripont-Tirole 1996). Another school of thought points to the strict link between the monetary policy function and the supervisory function and stresses that, historically, the latter led to the former and not viceversa (Goodhart 1985). The two approaches lead – as we shall see below – to different regulatory solutions.

Although the stability of banks (and, generally speaking, of financial intermediaries) has been historically the first economic need that regulation was meant to satisfy, there are other motives for regulating financial activity. All financial contracts are dominated by information asymmetries and need to protect investors against insufficient information, fraud, negligence, conflicts of interest, mismanagement, unfairness of the mechanisms that translates information into prices. These asymmetries can undermine the

operations of the markets, by making it impossible for investors to assess the 'real' quality of securities. Other objectives of regulation are therefore to assure comparable, transparent and reliable information, as well as the correctness of behaviour of financial agents towards their clients².

An important component of this branch of regulation refers to the functioning of markets. The correct translation of information into prices depends also on the design and functioning of the "black-box", i.e. on the microstructure of the exchanges or other trading platforms. Assuring the efficiency and the orderly condition of the money and financial markets is therefore an important component of the task assigned to the regulator.

A specific aspect of this form of regulation bears on the control function (i.e. the function of distributing residual claims on the firm's assets) and the market for corporate control. Regulation must set out the general framework of duties and rights of the shareholders involved, managers, and lenders.

Finally, there is another reason why economic activity, and financial markets in particular, need to be regulated, i.e. to remove obstacles to competition which is essential to productive and allocative efficiency. Financial markets may be unable to attain autonomously competitive conditions due to the specific nature of typical services (in the payment system there are natural monopolies such as information networks) or to information asymmetries that make retail banking markets contestable only to a limited extent. It is important to stress that the objective of competition refers to all the components of the financial system: intermediaries, instruments, markets. In particular, present technology now allows for full contestability of services offered by exchanges and other trading systems.

The evolution of the theory and practice of financial regulation

² "Conduct of business regulation and supervision focuses upon how financial firms conduct business with their customers. It focuses upon mandatory information disclosure, the honesty and integrity of firms and their employees, the level of competence of firms supplying financial firms and products, fair business practices, the way financial products are marketed etc. [...] Overall, conduct of business regulation establishes guidelines about appropriate behaviour and business practices in dealing with customers" (Llewellyn 1999 p.11)

led to the identification, for each objective, of a type of intervention, specific instruments and objects (intermediaries or markets).

Table 1 shows the complete picture. We leave aside for the moment the question of which authority is responsible for the achievement of the final objectives. For instance, table 1 says that price stability is achieved through monetary policy, whose present tools are open-market operations and various types of refinancing, and it is transmitted through intermediaries and markets.

TABLE 1. Financial Regulation: A Taxonomy			
Final Objectives	Broad areas	Instruments	Object (transmission mechanism)
Price Stability (macro)	Monetary Policy	Open-market operations Refinancing	Markets Intermediaries
Financial Intermediaries Stability (micro)	Lending of last resort	Secured credit Emergency credit	Intermediaries Markets
	Refunding of losses	Deposit Insurance Compensation Schemes	Intermediaries
	Prudential supervision	* Structural controls (bank chartering and controls to entry); * Restrictions on asset holdings and activities; * Separation of the banking and other financial industries, such as securities, insurance, real estate; capital requirements; * Special reporting to the supervisory authorities; * On-site inspections.	Intermediaries
Disclosure and Fairness • Issuers • Intermediaries • Markets	Disclosure	* Financial information * Prospectus * Price-sensitive information (insider trading and market abuse)	Markets Intermediaries
	Company and Shareholders rights	* Company Law * Bankruptcy law	
	Corporate governance rules	* Company Law * Self-regulation	
	Rules of conduct	* Specific regulation (brokers; mutual funds..)	Intermediaries
	Orderly and efficient functioning of the markets	Regulation of exchanges	Markets
Competition	Rules to prevent • Cartels • Abuses of dominant positions	* Approval of mergers * Measures against restrictive business practices	Intermediaries (markets)

The scheme is sufficiently self-explanatory. It is worth stressing that competitive conditions are determined *ex post* by specific rules and regulators (antitrust authorities). *Ex ante*, they are determined to a large extent by entry conditions (broadly defined) i.e. by the structural controls activated by bank supervisors.

The third objective of financial regulation stems from the typical situation of every financial contract, in which one party has much less accurate information than the other party. Hence the risk of moral hazard and adverse selection and the typical areas of intervention: disclosure, rules of conduct and interventions to assure the orderly and efficient functioning of the markets

Credit markets, particularly for retail products such as loans and deposits, often fail to reach autonomously a sufficient degree of competition, mainly as a consequence of the fiduciary nature of the relationship between the bank and the customer and/or because of asymmetries in the distribution of information. This leads to the application to the credit markets of the general regulations provided by specific regulations and particularly of antitrust laws. As a matter of fact, until recently, credit markets were considered to be an exception to this general regulation, but – as has been said – “the days in which banking was off-limits for competition policy are gone and should not return”. (Cepr 99 p.xx).

We have thus identified four fundamental objectives for bank and financial regulation: price-stability, bank (and other intermediaries) stability; disclosure (to use a single word); competition³. The pendulum of actual regulation swings between these four positions, according to the evolution of historical conditions and the political motives which drive the regulatory action. To conclude with a semantic warning: the objective of microstability refers to every kind of financial intermediary, as no single financial agent can produce

³ In the classification suggested by Lewellyn (1999) special emphasis is given only to the second and third objectives and of our Table 1. According to Llewellyn (p.10): “two generic types of regulation and supervision are identified: i) prudential regulation which focuses on the solvency and safety and soundness of financial institutions and ii) conduct of business regulation which focuses on how financial firms conduct business with their customers”.

systemic consequences. As the banks entail the highest possible risk, due to the monetary nature of their liabilities, it is common to refer to this objective as bank stability or bank supervision. These names must be seen as shorthand (literally as *synecdoches* - a part for the whole) for "financial intermediary stability" or "microstability". Throughout this paper, the three expressions will be used as equivalents. By the same token, the objectives of "disclosure" are often referred to as "securities regulation". Even these two terms will be used as equivalents.

3. The evolution of European financial regulation

3.a The situation at the dawn of the EEC. When the Treaty of Rome was signed, the financial regulation of the six founding countries involved – as their underlying economic conditions – were very different. In those times, regulation was the reaction to the nightmare of the Great Depression, which had prompted in all countries major reforms of banks and (at least in the US) financial markets. For the first time in economic history different countries were trying to work out a solution to the biggest "market failure" that had ever occurred. Although stemming from the same problem, financial reforms were still national in scope, mirroring the deep differences in the underlying economic and institutional conditions and the low degree of interdependence.

The only common characteristic was the heavy (and to some extent new) weight given to the objective of bank stability and to the function of monetary policy as a macro-economic tool. This meant that lesser emphasis was given to the other two objectives of financial regulation: disclosure and competition. The hypotheses underlying the emphasis given to bank stability can be summarised as follows:

- i) banks are more prone to liquidity and solvency crises;
- ii) a bank crisis is likely to assume a systemic dimension;
- iii) bank depositors deserve more protection than other investors.

In particular, to those who invest in securities, the *caveat emptor* principle should apply, i.e. the protection should come from ordinary civil-law property rights rather than from special legislation;

iv) in the banking markets competition can increase the propensity to risk and increase financial fragility.

While the first two hypotheses are still part of the received wisdom in banking theory, the other two are fundamentally a mirror of the specific conditions of those times, namely the fear of (and lack of specific instruments against) bank instability on the one hand and the overwhelming importance of banks in the financial system on the other.

As a matter of fact, the Great Depression was the last of a long chain of bank crises, dating back to the creation of commercial banks in their present form. Both practitioners and economists soon discovered the high probability of bank crises and found the underlying causes in three characteristics of the new-born institutions. The liabilities were redeemable at sight and circulated as a means of payment; the cash reserves were a fraction of the deposits; the interest-bearing assets had a longer duration than deposits and were to a great extent represented by risky loans, subject to those which would be later called information asymmetries.

Although many authors (Thornton, Bagehot) developed a thorough theoretical analysis of the problems involved, the instruments used were mainly confined to lending of last resort and the "art" of central banking. On the eve of the bank crises of the '30s, the situation had hardly changed. After the terrible shock of those years, regulators were particularly concerned about stability but they also knew that the instruments they should rely on were still those of Bagehot's times. This is the main reason why they decided to sacrifice on the altar of stability both disclosure and competition.

The concept of the 'unconscious saver' was the key for putting the problem of disclosure (and protection of investors) well below stability. The typical buyer of a security was considered to be a "conscious" investor fully able to assess the risks involved and therefore entitled to receive available information. So deep was this belief that most countries did not find it necessary to issue special legislation on this point. Only in the United States were the Banking and Securities Acts issued simultaneously.

Moreover, in the climate of opinion prevailing in the '30s, particularly in European countries, regulators looked on competition with a suspicious eye. Hence, the fourth hypothesis. Although it is true that many banking crises were characterised by overbanking and cut-throat competition, it is also true that in those times there was no specific instrument to monitor bank risks.

In many respects, the regulators of the '30s were inclined, and to some extent forced, to think that restraining competition would help to keep bank rates to levels favourable to bank profitability. If oligopolistic conditions followed, it seemed a fair price to pay for soundness and stability in the banking system as a whole.

This is why bank regulation was characterised by heavy structural controls, barriers to entry, restraints on assets and liabilities. The whole fabric of financial regulation was designed to ensure that institutions remained profitable most of the time. The "uniqueness" of banks from a theoretical point of view was the justification for the special regulation and the extent of structural controls.

In most European countries, there was a further motive: the myths of economic planning and public ownership of banks went hand in hand in those times, giving strength to the idea that banking was a very special sector, where the principles of market freedom had somehow to bow to "superior" interests of controlling the economy and the private sector.

The net result was a drastic diminution of competitive impulses both in the market for financial services and in the market for corporate control. The suspicion against competition and the *penchant* for the control of credit by the state, explain why in most European countries, bank legislation empowered authorities (central banks *and* the Ministry of Finance) to impose structural controls.

At the same time, the growing role of monetary policy as an anti-inflation and counter-cyclical weapon, gave new life to the role of central banks, giving them a key role in the making of economic policy as a whole. Although always important, central banks became policy makers only after the reforms following the Great Depression. Price stability and bank stability became the two cornerstones of financial

regulation, both from the political point of view (witness the growing importance of central banks) and the theoretical point of view. Objectives, instruments and the *modus operandi* of monetary policy soon became one of the main themes of research and discussion.

The importance given to these two objectives led many countries to separate the responsibilities. Bank stability was often assigned to new-born agencies (typically in the Continental European countries) separated from the central bank. Italy and the UK were the most notable exceptions, although it is interesting to remember that the 1936 Italian Banking Act had originally chosen the “separation” solution. The US adopted a sort of compromise between the two solutions.

This is one of the reasons why, in most European countries, the authority in charge of bank stability was an independent commission separated from the central bank. The six founding fathers of the Treaty of Rome adopted the *separation* solution; Italy was the exception (Padoa-Schioppa 1999).

To sum up, the regulatory framework after the Second World War and at the moment of the signing of the Treaty of Rome was:

- Discovering monetary policy as an anti-inflation weapon and central banks as policy makers;
- Primarily oriented to the objective of micro-stability. Lacking specific instruments, this objective was pursued mainly with discretionary, structural controls.
 - Focused on banks;
 - Lacking a specific regulation to protect investors in securities (the United States being the only country to innovate in this field);
 - Stressing stability at the expense of competition.
 - Exercised by a bank authority, often separated from the central bank responsible for monetary policy.

3.b From the Treaty of Rome to the European Monetary Union. Four driving forces common to all industrialised countries can be found behind the evolution of financial regulation in all countries and specifically in Europe during the last decades, particularly after the dividing line of the '70s which ended the post-war era of recovery and stability.

- the gradual shift of households' portfolios towards securities (particularly, risky securities) issued by the private sector;
- internationalisation (European integration being a component of a general trend);
- mounting political pressure to increase the efficiency of the banking sector;
- dismal results of the public ownership of banks and administrative controls on credit.

The growing importance of securities markets coupled with a few significant cases of heavy damages for investors led gradually to the creation of specific regulation to protect investors. France (1967) and Italy (1974) gave the lead; other countries followed suit. Disclosure and rules of conduct were given an outstanding position as regulatory objectives. *Ad hoc* regulators, more or less modelled on the American SEC were established.

The objective of bank stability was pursued more and more by way of specific instruments instead of through restricting competition and - *ceteris paribus* - raising bank profits. Structural controls were gradually phased out in favour of prudential, non-discretionary measures. Gradually, since the late '60s, competition in banking was seen more and more as an independent objective, as it became clear that the excess weight given to stability came at the expense of the efficiency and benefits to consumers which are the typical outcomes of competitive conditions. Albeit gradually (and in some countries very slowly) public-policy objectives were achieved by relying upon competition and market forces rather than upon structural controls (OECD, 1998).

Particularly important has been the gradual shift from structural controls to prudential controls as a means to achieve financial stability. The real watershed has been the international agreement on minimum capital requirements (Basle Agreement). Since then, the objective of micro-stability has been able to rely on instruments aimed at ensuring a cushion of capital in proportion to the risks taken by each institution. For the first time regulators were in the position of using specific instruments of prudential, *ex ante* supervision to control the riskiness

of portfolios. From this point of view, the achievement marks the end of the Bagehot's era.

At the same time (but also as a consequence of the adoption of measures to ensure the adequacy capital provision) this change enhanced the role of market forces in achieving bank efficiency. The adoption of capital ratios strengthened the relationship between profitability, growth and equity. Banks had to adopt the same behaviour as other firms and had to compete in the market for products and financial resources. Competition and stability were no more seen (at least officially) as mutually exclusive (Ciocca 2000).

In EEC/EU countries the process of regulatory change was also driven by European Directives. It is important to remember that the Directives had their basis in the Treaty of Rome (art. 85 and 86) although their full application has been questioned at least until 1981, when a Court of Justice decision explicitly stated that those articles could be applied also to banks. This means that the idea of the "uniqueness" of banks was well-rooted in the European regulators' minds. Both in the Commission and in most countries this was a major cause of tiresome discussion on whether and how to design and implement banking directives. This is the main reason why it took twenty years to issue the First Banking Directives and another twelve years to implement it in the country (Italy) which chose the longest possible period of implementation.

The EC legislative framework for financial markets is grounded in a concept known as 'competition within rules' which takes the reality of separate and distinct national legal and regulatory systems as given, but states that member states must recognise the validity of each other's laws, regulations, and standards. This mutual recognition was meant to facilitate free trade in goods and services without the need for prior harmonisation.

Directly derived from this principle is the Second Banking Directive provision for a *single passport*, under which credit institutions incorporated in any member state are permitted to carry out a full range of 'passported services' detailed in the Directive's annex, throughout the Community. Similar guidelines are laid down

for the provision of investment services in the Investment Services Directive.

Mutual recognition was built on two pillars: harmonisation of minimum standards of supervision and home-country control. The former was meant to provide a common denominator of prudential controls: in other words to restrain the scope for competition among rules above this bottom line. Home-country control seemed from the practical point of view the only criterion compatible with the internationalisation of financial activity and the need for supervision on a consolidated basis.

The European convergence made it easier to remove restrictions on financial activities and therefore to adopt the universal banking model. A major obstacle to competition *within* national markets and *between* national markets was therefore removed. Those principles were applied to all financial activities (although insurance companies succeeded in remaining partially unaffected) so the net result was – at least theoretically – competition *à tout azimuth*: among intermediaries, among markets, among financial systems. It is worth remembering that the idea of mutual recognition and the European passport was worked out when the monetary union was still a long-term objective for most Europeans (scholars, practitioners, authorities), something that still inhabited the realm of Utopia. In other words, this philosophy was prior to (and independent from) monetary union and the consequences that this can create *per se* for the achievement of a single market.

Therefore, during this period every effort of harmonisation in the field of financial regulation was confined to the objective of working out the necessary conditions for mutual recognition, i.e. the necessary and sufficient conditions of prudential supervision for each country to host banks safely from other EU members, supervised by other authorities.

It was generally taken for granted that financial systems and markets were essentially national in scope, had to use different currencies (somehow linked together in a “narrow” band of fluctuation) and therefore should be regulated by national authorities.

The objective of this period was to remove the obstacles to the free circulation of financial services among EU members, and, in particular, to lift any barrier to the free provision of services both with a physical presence or on a cross-border basis.

The second stage of harmonisation was built on the triangle: directives-mutual recognition-home country control. Its main achievements are the Second Banking Directive and the Investment Services Directive. The former led to a series of directives which set the regulatory conditions for the acceptance of mutual recognition. The most important set the capital requirements for credit and market risks, following the principles established by the Basle Committee on Banking Supervision.

The European directives made a major contribution to the harmonisation of the regulatory framework in all member states. Thanks to the common identification of the services admitted to mutual recognition, the general model of the intermediary embodied in each national legislation is now the same. This model allows each institution to move freely along the whole gamut of banking and financial services. This objective was - however - an intermediate objective to the final target of realising the single market for financial services.

The third stage began with the achievement of monetary union. From the point of view of the architecture of financial regulations it meant the transfer of the objective of monetary stability from national central banks to the European System of Central Banks (ESCB), i.e. the European Central Bank (ECB) plus eleven (now twelve) national central banks. For the first time, the responsibility for price stability was assigned to a "federal" system made up of a supranational body directed by two boards, one where national central banks are in the majority and one, the executive board, made up of members directly appointed by the European Council.

To sum up, the history of the convergence of European financial regulation:

- begins twenty years after the Treaty of Rome (First Banking Directive);

- is based on a continuous flow of directives aiming at harmonizing conditions across member countries in the main fields of financial regulation;
- gradually increased the importance of competition as an objective *per se* of financial regulation;
- following the Second Banking Directive is based on the three pillars of mutual recognition, home country control; harmonization of prudential supervision.
- Has been realised in a scenario where the monetary union was far away and seemed to many to be impossible.

3.c The architecture of financial regulation. An important characteristic of financial regulation is the design of regulatory authorities, in terms of independence, responsibilities, powers, division of labour. The balance between the final objectives of regulation and particularly between the topics of our conference is crucially dependent on the solutions obtaining in each country. As we have seen, for many years, all European countries had only one supervisory authority, in charge of bank supervision, then the only intermediary which was deemed worth specific regulation.

Neither economic theory nor central banking history give us a solid argument for preferring this kind of separation, On the contrary, both should lead to the opposite conclusion. The fundamental reason is to be found in the debate on the independence of central banks as a necessary condition for successfully achieving price stability. The debate has been particularly important in Europe, because it has been the *leit-motiv* of the process of monetary union and the establishment of the ECB.

The "ideal" central bank had to pursue monetary stability as a fundamental (unique?) goal and had to be independent of the government. In many countries, France and Germany being the most important examples, the government is deeply involved in supervision: either it has specific functions or it is directly represented on the top Board.

Most Continental Europe countries (Germany, Austria and France being the leading examples) chose to separate supervisory powers

from the central bank. The main reason for this separation has to be found in the desire of the government to keep a grip on the banking system: in all the mentioned countries, the government either had specific functions or was directly represented on the executive Board of the authority. It is worth remembering that Italy, which had chosen the separation of responsibilities in the 1936 Banking Act, reversed this option in 1947 and decided to assign supervisory responsibilities to the Bank of Italy.

In the first two or three decades following the Second World War, financial regulation in Europe was essentially aimed at two objectives (price stability and financial stability) and was based on two regulators or just one regulator: the central bank.

Major changes were realized in the following years; new authorities were established; new enforcing powers were given to them. The underlying philosophy still seemed to be mainly orientated towards stability. The dividing lines of rules and regulators were designed according to the type of intermediary involved: banks, securities intermediaries, insurance. The idea was that each player had a right to its turf and no intrusion from other segments of intermediation was admitted. At the beginning, the division of labour among regulators was therefore organised "vertically" i.e. according to the subject involved: banks, market intermediaries, insurance companies. Competition was seldom allowed the honour of a specific regulator.

Structural controls and the vertical division of labour between authorities were strictly linked together. In a sense, the former were a condition of success for the latter. Regulating entry, either *de novo* or through new branches, preventing specific classes of assets, setting interest rates or "speed limits" to bank loans, all worked in favour of a reciprocal relationship between a specific intermediary and its regulator.

The triangle – 'maximisation of stability-structural controls-vertical organisation of regulators' – was broken by the gradual blurring of the dividing lines between the various segments of intermediation: banks vs non-banks; market issues vs bank loans; international vs domestic credit. This market force was strengthened by a growing

awareness of the link between competition and the efficiency of the financial system and, in Europe, of the implementation, albeit very slowly, of the First Banking Directive.

The strongest request coming from the financial system was to "level off the playing field". Needless to say, it came from those who were eager to enter the field or were confined to the outskirts, not from those playing where the grass was green and soft.

The net result was a gradual phasing out of structural controls, particularly since the mid-80s, when international authorities reached the historic agreement to base prudential supervision on capital requirements. Since then, barriers to entry as well as limits to specific classes of activity were gradually removed. First in Europe, then in the United States, the universal banking model was adopted.

The new scenario of enhanced competition prompted new changes in the regulatory architecture. When, as in many European countries, new authorities were established, the first solution was often to follow the American division of labour: a bank regulator (more often than not separated from the central bank) and a securities regulator (the French Cob, the Italian Consob, the Spanish CBV, the belated German BaWe).

European countries, therefore, adopted a second "separation" in building their regulatory framework: i.e. a division of responsibilities between banks (and/or financial intermediaries) and securities markets. What were the reasons behind this choice? The answer is mainly to be found not in economic theory, but in the constitutional problem of balancing powers within the state. It was the legislator that in most cases decided that banks' and securities' regulation should not "remain domiciled in the hands of the same supervisory body" (Wymeersch 1998). A second reason (albeit less explicit) was the idea that stability and disclosure can be conflicting objectives and therefore had to be assigned to two different authorities. A third reason was the idea that only banking can entail problems of systemic stability (Mayer-Neven 1990).

Only in one case (Belgium) was the bank regulator (separated

from the central bank) given responsibility for the securities market. It is important to stress that the separation, already adopted in the US, was not justified by the characteristics of financial intermediation in Europe. As a matter of fact, in no European country were commercial banks and securities markets as separated as in the United States. With the exception of Belgium, European countries adopted a solution which was consistent with a separation between commercial banking and investment banking which they never adopted in the American form. It therefore meant subjecting each intermediary (bank) to two different authorities for two areas of activity which were becoming more and more integrated.

A third separation divides micro-stability regulation of insurance companies from other intermediaries. In practically all European countries, this field of supervision was organised on a strict "by subject" basis.

At the same time, the first "separation" (between monetary policy and price stability) was not only unquestioned, but somehow reinforced. What are the reasons behind the European preference for the 'separation' approach?

The separation approach was judged at the European level to guarantee both the ECB and the national central banks of the Eurosystem the necessary independence. This is why in countries such as Italy, where the central bank was sufficiently independent, no major reform has been suggested.

One ingenious solution is to be found in the Italian Securities Act passed in the early '90s. It established the principle of "regulation by objectives", giving the Bank of Italy responsibility for stability (both of banks and investment firms) while the responsibility for disclosure and transparency (both of banks and financial intermediaries) was assigned to the Consob.

The "horizontal" solution was devised as a way to organize regulation "horizontally" i.e. according to the final objectives of regulation. The solution is certainly consistent with theoretical research, which confirms that only these functions form the permanent side of financial intermediation while competition and financial innovation

continuously blur the dividing lines between instruments, activities, intermediaries (Crane et al.1995).

At the same time, this solution had apparently the advantage of submitting any economic agent to the same kind of regulation and supervision. As the Cob's chairman put it: "The information disclosed to the public and the integrity of markets are of equal importance whosoever the intermediary concerned (bank, investment firm, insurance company) and for any financial product whatsoever (loan, security, insurance contract)"⁴.

Nevertheless, the "horizontal solution" has seldom been applied to its full extent. Practically speaking, in all countries a new regulation based on a "horizontal" criterion was superimposed on the old "vertical" criterion. In most countries, insurance firms were still regulated by a specific authority; in no country disclosure responsibilities cover both banks and financial markets. In one country (Italy) the authority responsible for both micro-and macro-stability has been entrusted with the role of an anti-trust authority. In all countries, the resolution of possible conflicts between objectives is confined to informal arrangements between authorities, or even to the *interna corporis* of a single authority.

The principle of "regulation by objectives", often affirmed even in legislative texts, has never been applied in a complete and coherent way. In other words, one can say that there is a large gap between the pace of change in the regulation of financial services on the one hand and the architecture of regulatory powers on the other. Which is why the major innovation introduced in one European country opted for a new solution, the single regulator.

Other European countries went beyond this solution and devised a reform based on a single financial services regulator. First came the Scandinavian countries, then the UK (Briault 1999).

The British reform, announced just after Labour's election victory in 1997, stems both from the dissatisfaction with the existing system and

⁴ Prada, 1997. He was echoed by the Rapport de la Martinière: p.12 "Le moment paraît venu de relâcher le contrôle des produits pour reporter l'attention de l'autorité publique sur le contrôle des acteurs".

the desire to increase the competitiveness of the London market. The regulatory structure is based on two pillars: a clear definition of tasks and responsibilities of supervision and a unification of overall supervision in a single authority. The reform stresses the need to avoid any duplication of responsibilities to reduce the costs of regulation (for a given level of overall efficiency) and enhance the competitiveness of the UK financial community. The Bank of England will have the responsibility for macro-economic stability while the new FSA will be responsible for both the objectives of stability and disclosure and in particular for what we have called prudential regulation and conduct of business regulation.

The FSA will therefore incorporate the responsibilities of the previous supervisory body, the self-regulatory organisations for the various financial industry sectors (9 bodies) and the micro-stability functions of the Bank of England. Although the reform is still under way, there is a growing consensus in the UK that the single regulator solution is better than a structure based primarily upon the objectives of regulation (Briault 1999).

It is worth remembering that the single regulator is not alone (financial stability must be pursued in cooperation between the Bank of England and the FSA, while the powers of the antitrust authority in the financial field remain unchallenged). Thus UK ends up with three regulators at least.

The making of the Monetary Union has, of course, meant assigning the objectives of price stability to a single authority: the ESCB and the ECB. It has also meant a fourth separation between central banking and banking supervision: not only a geographical but also a functional one (Padoa Schioppa 1999 p.6). "This is the case because for the euro area as a whole banking supervision is now entrusted to institutions that have no independent monetary policy function. The separation approach that was chosen for EMU has effectively been applied not only to the euro area as a whole, but to its components as well. Indeed, even in countries where the competent authority for banking supervision is the central bank, by definition this authority is, functionally speaking, no longer a central bank, as it lacks the key central bank task of autonomously controlling monetary creation".

4. The stylised regulatory changes in the Italian financial system

The cornerstones of regulatory changes in Italy can be summarised thus:

- 1974** Establishment of the Consob and first reform (albeit minor) of Company Law
- 1983** Introduction and regulation of mutual funds
- 1982-1987** Gradual phasing out of structural controls and implementation of the free-entry principle (First Banking Directive)
- 1989-1992** Separation between public bodies (foundations) and banks (joint stocks). Implementation of the Second Banking Directive
- 1990** Antitrust Law. The Bank of Italy is given the main responsibility in the banking field
- 1991** First comprehensive Securities Act
- 1991-1992** Implementation of Directives in the securities field: public bids; insider trading etc.
- 1993** Banking Act
- 1996-1998** Implementation of the Investment Services Directive and new Company Law

As can be easily seen, the reform has experienced acceleration in the last twenty years and did not originate only from European integration. It has been demonstrated (Ciocca 2000) that other factors explain the progressive reform of the Italian financial system. In particular, one has to remember the crisis of the political and economic mechanism based on public ownership (both in banking and industry) and administrative controls which have supported Italian economic development at least since the end of the Second World War. This explains the acceleration of the last two decades or, alternatively stated, the unreserved adhesion of Italy to the principles of international competition and European integration.

This deep-seated and continuous innovation has favoured an important restructuring of the Italian financial system which cannot

be analysed here. Its main components are a significant expansion of the Italian stock exchange, the explosion of new agents such as mutual funds (mostly controlled by banks), important mergers among the top banks, a dramatic decrease in the number of banks and a higher concentration ratio, albeit lower than in other countries (Fazio 1999; Ciocca 2000). Notwithstanding these structural changes, the profitability of Italian banks still compares very well with other European countries (Landi-Lusignani-Onado 2000).

In this process, Italy has been faced with significant bank crises: unlikely other European countries, these episodes have been concentrated in a specific region: the Mezzogiorno. At the end of the '80s, research from the Bank of Italy (Banca d'Italia 1990) had demonstrated that Southern banks were less capitalised, less efficient, and had more bad loans than their Northern competitors. This explosive combination was ignited by the economic slowdown of the early '90s: year after year, one after another, all major banks came to the brink of bankruptcy and had to be bailed out by other banks. As in the Agatha Christie's novel, "and then there were none".

Thus Italy, as any other European country, has paid its price for the "tough" period of the early '90s which ended with the devaluation of the lira and suspension from the exchange-rate agreements. Unlike other European countries, the burden to the taxpayer has been quite small (particularly if one spreads the cost over the entire credit cycle) because failing banks were bailed out by other more capitalised and efficient banks. In other words, higher bank profits (the endowment of the period when competition was not given priority as a regulatory objective) became the internal shock absorber for the wave of instability of the '90s.

This leaves us with the relevant question: how can we rate the Italian financial system from the point of view of competition and efficiency and hence its capacity to foster economic growth? In the current debate on this controversial topic, three points can be sorted out to demonstrate that market forces are certainly stronger now.

First. Competition in retail markets has greatly increased as is shown by all evidence on interest rates in both the loan and deposit

banking markets (Ciocca 2000). One has to remember that retail banking markets are not the ideal habitat for competition, due to the importance of proximity, the personal relationship between the banks and their clients and the information asymmetries involved. Even in countries where official regulatory action has been, at least officially, more orientated towards competition, the effective benefits to the customers have been seriously questioned.

Second. The Italian market came of age in the '90s and now compares quite satisfactorily with other European countries in terms of size, liquidity and efficiency. This has been a real breakthrough in the race for efficiency and competition, not only because it has opened up new alternatives for external financing, but also because it has prompted important changes in the general regulatory environment and particularly because it has increased – at least in principle – the importance of the objectives of disclosure and competition.

Third. Most Italian banks and all top financial groups are now listed. They must therefore comply both with regulation aiming at stability and regulation aiming at disclosure. This has favoured the gradual shift in the relationship between stability and disclosure (and between stability and competition) from one of alternatives ('you must choose one of them') to a complementary one ('you can have both'). This attitude has been reinforced, once again, by an international driving force, i.e. the new Basle agreement on capital requirements which has affirmed the principle that an efficient prudential regulation must rest on "three pillars": capital requirements; internal controls; market discipline.

So what can be our final judgement on the present situation? Let us review the three themes of our title: growth, factors creating crises and stability.

Growth. One point that strikes non-Italian observers is the huge gap between the intensity of regulatory changes, at least in the last 20 years, and the dismal results in terms of maximising growth and minimising internal duality conditions. On the one hand, the Italian growth rate is systematically lower than the European average and

on the other hand, the gap between the North and South regions is the widest among European countries and is still widening.

Does that mean that the Italian financial system is less efficient than others? A recent interpretation (Ciocca 2000) reverses the argument: the new financial framework is, in fact, the only success in a landscape of unsatisfactory or aborted reforms of economic institutions and legal frameworks. Italy has simply failed to adapt its institutions to the economic needs of the last decades of the twentieth century. As a consequence, it has seen its competitiveness fading away and the rate of growth slowing down. There is therefore no direct link (or a very tenuous link) between the performance of the Italian economy and the efficiency of the Italian financial system. Alternatively stated, a hostile environment (the rigidity of the labour markets; the inefficiency of the general legal system; the diffusion of the "black economy") had a negative effect on economic performance which more than offset the positive impulses coming from financial reform.

Factors of crisis. In the last decade, Italy, like any other developed country, has met a major financial crisis. For many years, Italian banks have been sheltered from instability by three factors: regulation, public ownership and the huge public deficit. Structural controls have kept competition at low levels at least until the mid '80s, while a restrictive monetary policy, based on credit ceilings, lowered the level of competition in the loan market. At the same time, the public ownership of most banks dwarfed the contestability of the market for corporate control, at least until the beginning of the '90s. The new Banking Act, the so-called "Amato law" (allowing for the separation of the public institution from the banks as a firm) and finally straightforward privatisations, changed the landscape in a few years.

Not surprisingly, the collapse of so many protective devices meant that inefficiency could be sustained no longer. Given the structural weaknesses of the Italian economy, the crisis immediately hit the Southern banks. In a few years, practically all of them experienced a dramatic increase of bad loans which has wiped out their already thin capital base. In all cases, other banks from Northern regions stepped

in – under the auspices of the Bank of Italy – and acquired the majority or even complete control of the ailing bank. Only in one case (Banco di Napoli) did the bailing out involve a cost to the taxpayer. The interventions of the deposit insurance scheme were limited to a few marginal cases. The net result has been a major change in the ownership of the Italian banking system and in its concentration ratio.

It must, however, be stressed that the system has proved to be very resilient: such a serious crisis has been met internally, i.e. using resources coming from within the banking system, while all indicators of profitability and capitalisation continued to rank fairly high in international comparisons (Landi-Lusignani-Onado 2000).

It has been argued (CEPR 2000) that such a preference for national regulators is one symptom of Italian dislike for cross-border mergers which could bring more benefits to European competition. While the problem is still open to debate, it is unquestionable in the Italian case that the severest banking crisis of the second half of the century has been faced without any particular trauma for the banking system as a whole.

Stability. The capacity to absorb such a crisis raises at least one doubt: has the objective of stability been pursued in Italy with such intensity as to dampen the other (final or intermediate) objectives of regulatory actions, such as disclosure, competition and efficiency?

The question refers first to the problem of the architecture of financial regulation and the division of labour between regulators. From this point of view, the peculiar characteristics of the Italian framework is to give the Bank of Italy the responsibility for both stability and competition in the banking field. This is an exception to the rule adopted in other countries (in US, where the Federal Reserve has the first decision, the appeals go to “natural” jurisdiction). This solution has been justified on the grounds of the complementary relationship between concentration and competition (Ciocca 2000) and the superior information that supervisors have (Fazio 1999).

It must, however, be pointed out that the authority in charge of competition has only “ex post” powers, as it intervenes only when

there is a threat to competition coming from specific evidence (an agreement among producers; any other practice against other producers) or from a planned merger. There is also an "ex ante" component of competitive forces which, in all circumstances, is under the control of the bank supervisors. One needs only to mention structural controls, controls for entry, authorisations for acquiring significant or controlling stakes in other firms (financial or not); authorisation to acquire even a minority participation in a bank.

The problem is, therefore, whether regulation aiming at stability has been used, or could be used, to the detriment of competition, disclosure and efficiency. We have seen that this happened in the Italian case, at least until the early '80s. The through reform which was completed by the turn of the century was meant precisely to achieve a better trade-off.

Are there any "left overs" from the old world? Three points could be pointed out, which, even if applicable to many other countries, could be particularly relevant to this conference discussion.

First, notwithstanding the phasing out of structural controls, a great deal of discretionary power still remains in the hands of national authorities. This determines differences across countries which could prove to be a major obstacle to cross-border competition (Cepr 1999). In Italy, the broad interpretation of the "fit and proper test" dictated by the European directive could be a channel through which discretion could return (Minervini-Onado 2000) to give an advantage to stability vs competition and disclosure. Discretion is intrinsically built into any form of supervision, but in the present situation it must be kept to a minimum level and must not undermine the "third pillar" of stability, i.e. market discipline.

In a world where most financial intermediaries are listed, market discipline can be pursued only through complete disclosure, which means shrinking the area of privileged information that supervisors traditionally enjoy. As has been said (Spaventa 1999) the new Italian legislation is clearly based on the idea that disclosure of banks' conditions does not endanger their stability.

A second critical point in the present situation refers to the

architecture of financial regulation, i.e. the division of labour among regulators. To manage in an efficient (and transparent) way the relationship between stability, competition and disclosure, the ideal solution is to organise supervision "functionally", i.e. according to the final objective. As we have seen, with the exception of a few countries (the UK being the leading example) disclosure and stability rest on the shoulders of two different regulators. This principle has been set in Italian regulation at least since the 1991 Securities Act, which has assigned stability to the Bank of Italy and disclosure to the Consob. The principle has also been reinforced by the 1998 Securities Act, but its actual implementation leaves many loopholes (Consob 1998) which could move the balance away from competition and disclosure. Paradoxically, this is one of the main points in favour of the "single regulator approach" followed by the UK. If the trade-off cannot be clearly dealt with by two regulators, let us "internalise" it within the same institution. In other words, the problem of a clear-cut and efficient division of responsibilities turns out to be a more general problem of the ideal architecture of regulation, which will surely be one of the most important points of debate in the foreseeable future in all European countries.

A third point refers to the regulatory exception allowed for insurance. This is the only financial intermediary which is still supervised on a strict "by subject" basis, both for stability and disclosure. In a world where major intermediaries are organised as financial conglomerates, always including an insurance company (sometimes integrally mixed up with the bank), this situation is not efficient from the point of view of overall stability. Moreover, it risks creating an unfair advantage at the expense of other categories of institution. At the same time, both theory and practice point to an accelerating convergence of techniques of risk management in the two fields, which blurs the borders between the two types of business. This could therefore prove to be a major challenge for the years to come for the present regulatory architecture.

To sum up. In Italy, as in other European countries, the financial system has had a positive effect on stability and growth; the causes

of structural weaknesses (e.g. in Italy slower rate of economic growth) are to be traced to the general factors of rigidity (the labour market; the administrative and legal framework; the "black" economy) more than to specific financial inefficiencies.

In the process of reform of financial regulation a few contradictions are left, but their solution must now be found in the present European debate. Since the objective of price stability has been moved from the national level to the European level, the objective of micro-stability (along with disclosure and competition) has a relevant European dimension. Individual solutions risk widening the gaps in regulation and slowing the process of convergence and integration. In the future, Europe only a uniform European regulatory framework can sustain both stability and growth, hence, competition and efficiency.

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