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Regulators and Innovators Play Tag: The Italian Historical Experience*

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Abstract

Between the 1880s and the 1930s, three "regulatory cycles" can be identified in Italy. In the underlying model, each financial crisis gives rise to a regulatory change, which is circumvented in due time by financial innovation, that can then contribute to the outbreak of a new financial crisis. In Italy, overtrading of the banks of issue in the 1880s contributed to the 1888-1894 financial crisis, which yielded regulation concerning only these banks and restricting their activity. The German-type universal banks, created at the turn of the century and unconstrained in their undertakings, were at the core of the 1907 and the 1921-1923 crises. These led to a banking law in 1926 which, however, was born obsolete, in that it was not aimed at regulating universal banking as it had developed until then, but it contained general provisions regarding the whole range of deposit-taking institutions. Finally, the evolutionary adaptation of the universal banks into holding companies, not taken into account by the preceding law, contributed to the 1931-1934 banking crisis, followed by the 1936 bank legislation.

Keywords: Financial crisis, prudential regulation, banks

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1. Introduction

In his forthcoming book about the origins of market institutions in Victorian England, Paul Johnson writes: "Each set of 19th century market regulations produced new constraints but also an array of opportunities for businessmen and financiers to develop innovative ways. With unerring inevitability, innovation prompted regulation, and new ways of doing business promoted further rounds of boom and bust" (Johnson 2009, forthcoming).

Johnson's observation lends itself to a fairly universal application, at least as financial markets and regulation are concerned. In its wake, each financial crisis gives rise to a regulatory change in order to supplant the obsolete legislation and to prevent the occurrence of similar events in the future. In due time, financial innovation which sidesteps the restrictions and requirements imposed by the institutional setting emerges to exploit new profit opportunities and/or adapt to a new business environment, fuelling in turn a further financial crisis. We find that this "regulatory cycle", possibly with one exception, fits Italy's experience in the 1880s-1930s period.[1]

Between the Peninsula's political unification in 1861 and the Great Depression of the early 1930s, Italy's financial system proved to be highly unsettled, punctuated as it was by numerous episodes of financial instability of varying severity. Most crises provided the intellectual and political impetus for a new regulatory wave, which was then followed by unregulated financial innovation. Only the post-1945 adaptation of the Banking Law of 1936 seemed to produce (or accompany) a long period of financial stability, which persisted on the whole until 2008.

As Italy's financial market was, until recently and possibly even nowadays, largely bank-oriented, financial crises mainly coincided with banking crises, which are thus the subject of our narrative. The term "financial innovation" is therefore taken in a broad, and perhaps loose, sense to include new processes or business practices that banks employed to carry out their intermediation activity, untrammelled and unheeded.

Three types of financial innovations are identified in the period under study. Overtrading of the banks of issue in the 1880s contributed to the 1888-1894 financial crisis, which yielded regulation concerning only these banks and restricting their activity. The German-type universal banks, created at the turn of the century and unconstrained in their undertakings, were at the core of

[1] The idea of a regulatory cycle can be traced back to Kane (1986), who adopts the expression "regulatory dialectic", and to Miller (1986), who aptly recognizes taxes and regulation as impulses to innovation.

the 1907 and the 1921-1923 crises. These led to a banking law in 1926 which, however, was born obsolete, in that it was not aimed at regulating universal banking as it had developed until then, but it contained general provisions regarding the whole range of deposit-taking institutions. Finally, the evolutionary adaptation of the universal banks into holding companies, not taken into account by the preceding law, contributed to the 1931-1934 banking crisis, followed by the 1936 bank legislation.

The paper is structured in the following way. A brief overview of the main financial crises in Italy since unification is followed by four sections devoted to as many episodes of financial instability and to the subsequent regulatory legislation. A final section sums up the main findings and briefly accounts for post-war financial regulation. A first appendix lists the main banking reforms in Italy from the XIXth century onwards. A second appendix describes in detail the contents of the three main crisis-prevention regulatory laws. A third and last appendix concerns the crisis-management institutions created in Italy in the period under study.

2. Italy's financial instability

For the scope of the paper, it must be noted that Italy's financial sector was (i) underdeveloped at least until 1914, (ii) bank-oriented, (iii) highly unstable until 1931, stable thereafter.

Underdevelopment can be roughly measured by Goldsmith's Financial Intermediation Ratio (FIR), which was 0.2 in 1861, 0.3 in 1881 and 0.4 in 1914, below that of countries of comparable per caput GDP levels. Thereafter, Italy's FIR reached the level roughly to be expected in relation to its per caput GDP: 0.6 in 1930 and 0.4 in 1951. The FIR attained its peak in 1973 (170%). It was approximately 150% at the beginning of the century (Goldsmith and Zecchini 1999, Carriero, Ciocca and Marcucci 2002).

At the time of the Restoration, the Italian financial system was made up of a handful of traditional public credit institutions[2], of a few joint-stock banks (*società anonime*),[3] and private bankers. No stock exchange worth mentioning existed at the time. In the following decades, other

[2] Banco delle due Sicilie, Banco di Santo Spirito, Monte dei Paschi, la Compagnia di San Paolo.
[3] They were mainly discount banks, in Florence, Livorno and Rome.

institutions came to life: mutual savings banks (*casse di risparmio*)[4] from 1822, other public limited-liability banking companies from 1856, cooperative banks (*banche popolari*) from 1865, and small rural banks (*casse rurali*) from 1883. The Cassa Depositi and Prestiti (similar to the French *Caisse des Depots et Consignations*), founded in 1863 to fund public works and invest in Treasury bonds, soon (1875) became the main depository of postal savings. Pivotal to the system were the numerous banks of issue, which operated as commercial banks.[5] Onado (2002) describes the Italian financial system at the time of unification as underdeveloped, based mainly on its banks of issue and on a few financial circuits directed towards specific sectors of the economy. Subsequent development was slow and, as we shall see, punctuated by banking crises.

Besides being underdeveloped, Italy's financial system was bank-oriented. Almost all the XIXth century was characterized by the existence of numerous local stock exchanges, most of which were all but irrelevant. Financial market unification, measured by price convergence, was not achieved until the 1880s (Toniolo, Conte and Vecchi 2002). The price-maker for Italy's government bonds was the Bourse de Paris. After 1900, the Milan Stock Exchange gradually grew to concentrate most of the country's bond and equity deals; it remained however relatively small, thin and expensive, while banks retained a considerable market power. Between 1900 and 1906, both the number of listed companies and equity transactions increased in a most promising way. The crisis of 1907 dealt a blow to Italy's equity market from which it did not fully recover until at least the 1980s. It was, therefore, the banking system that provided the majority of financial services.

Until the early 1890s, the system was dominated by six banks of issue and by a couple of large commercial banks, one of which, created by the Perèire brothers, had survived the fall of the French parent company. From the 1890s onwards, the system was led by a handful of German-type universal banks while the Bank of Italy (resulting from the merger of three banks of issue and the takeover of a fourth) gradually assumed the standard functions of a central bank. In the interwar years, a number of State-owned or State-promoted long-term credit institutions flanked commercial banks by providing long-term credit via a large use of State-guaranteed bond issuance. One of the reasons for this development can be ascribed to the gradual transformation of the large banks which by the mid-1920s looked more like holding companies than traditional universal banks, each providing credit first and foremost to the joint-stock companies in which they had invested.

[4] The *casse di risparmio* were initially charity institutions, created to collect the lower classes' savings, but, over time, they turned into proper credit institutions.

[5] Banca Nazionale, Banca Nazionale Toscana, Banca Toscana di Credito and Banco di Roma (added in 1870) were already banks of issue and inherited as such by the new State, whilst Banco di Napoli and Banco di Sicilia became banks of issue in the modern sense only in 1866, after Italy's unification.

Finally, Italy's financial system proved to be unstable until 1931-36 (the period of time covered by the paper), while it showed a remarkable stability in the following years, possibly up until the current crisis.

Given the above-mentioned features of the system, Italy's financial crises were all essentially banking crises. Most of them were preceded or accompanied by stock market crashes and one of them by a currency crisis, while Italy never experienced episodes of sovereign default on external or domestic debt.

The paper deals with four financial crises, those of the early 1890s, of 1907, of 1921-23, and of 1931-1934. We do not deal with the first post-unification crisis of 1873, when Italy shared in the first significant international crisis (Kindleberger 1989: 146).[6] This was, in fact, mainly a stock market crisis, which did not affect the six Italian banks of issue (accounting for over half of financial intermediation), it posed no systemic threat, and it was not followed by any regulatory action.[7]

The four financial crises, here reviewed for their impact on subsequent financial regulation, occurred alongside corresponding international crises, but at the same time presented marked idiosyncratic features. The co-movement of the financial and real economy variables was negligible in 1907, but was quite considerable in the other three cases, all marked by falling output and employment. The crises of the early 1890s and early 1920s interacted with and possibly reinforced a situation of deep social distress with serious political repercussions. Most crises were either triggered or accompanied by stock market crashes and the crisis of 1888-94 was a typical "twin" bank and currency crisis.[8]

After the Second World War, the Italian economy enjoyed a long period of lower real economy volatility and of financial stability. Some bank failures did occur, however posing no systemic threat. In the 1970s price, income and employment volatility increased and financial stability was threatened by the little known and under-researched solvency crisis of a few long-term

[6] The crisis began in Vienna, it then spread to other European (Dutch, Italian, Belgium) and to the US stock markets.

[7] The crisis involved savings banks and cooperative banks (together accounting for about 20 per cent of the credit market)l, but it was private bankers and joint-stock companies (which accounted for 25% of the market) that suffered the most. The crisis resulted in a downsizing of the banking sector , with a capital loss equivalent to about 2-4% of 1873 GDP (Carriero, Ciocca and Marcucci 2002).

[8] The nominal exchange rate of the lira with respect to the US dollar dropped from 103.5 in 1889 to 94.8 in 1894, whilst the real exchange rate dropped from 104.8 to 95.4, implying a devaluation of nearly 10% (Ciocca and Ulizzi 1990).

credit institutions (*Istituti di credito speciale)* which were bailed out and eventually restructured by the State. For the following three decades, Italy again enjoyed a remarkable financial stability.

3. 1888-1896

This section is devoted to the first regulatory cycle, focusing on the nature and ratio of the banking act of 1893. The act of 1893 – which gave origin to the Bank of Italy – is the most important and consequence-ridden piece of the first phase of regulation.

The Italian story parallels in many respects that of Great Britain some fifty years earlier. Initially, regulation of the banks of issue was due to their nature of joint stock banks rather than to their note issuing activity.[9] When, in 1866, the convertibility of the lira was suspended[10], the Italian financial debate partially shadowed the British one, with bullionists set against anti-bullionists and with the adherents to the currency school against those of the banking school. In Italy, however, the setting was complicated by the fact that the fragility of new-born State did not allow the central Government to defy the powerful regional groups, each supporting the persistence and expansion of the banks of issue which had been active in the former States. The controversy concerning discretion vs. rules in banking, which had been crucial in the British debate, was partially effaced by the more sensitive political issue concerning plurality vs. unification of note issue. The focus of this dispute was not on the merits of free-banking, but rather on those of monopoly vs. oligopoly of note issue (Cardarelli 2006). A rather extensive body of regulation regarding the banks of issue (which had reached the number of six) was put in place, but it was not uniform across banks and it was difficult to enforce, due both to its cumbersome nature and to the political backing which any violation could muster.

In 1881 a law was passed to reintroduce the gold standard by 1883. A widespread belief among the disciples of the currency school was that monetary stability and financial stability were intimately tied under the gold standard regime.[11] Convertibility to gold constituted a constraint on credit expansion and therefore a deterrent to financial imprudence. Some contemporary journals[12]

[9] We refer here mainly to the case of Banca di Genova, founded in Genoa (Kingdom of Sardinia) in 1844.
[10] Due to the preparation of the war with Austria-Hungary, with the subsequent difficulties in the international financial markets.
[11] See Issing (2003), Borio (2004) and Borio and Toniolo (2006), among other publications on the subject.
[12] See for example the "Giornale degli Economisti", directed by De Viti De Marco, Mazzola, Pantaleoni and Zorli, in which Pareto had a monthly column.

argued that the convertibility of banknotes into gold was the pivot of an orderly functioning of the money and credit market. Once convertibility was guaranteed, no other form of regulation was deemed necessary. Banking school supporters, on the other hand, argued that financial crises could develop even under a regime of convertibility (Messedaglia 1876), but never got far enough as to propose regulation on non-issuing banks.

The resumption of convertibility in 1883 was backed by a gold-denominated international loan which increased bank reserves and allowed for credit expansion. Overheating of the economy, largely brought about by investment in building construction, resulted in a *de facto* suspension of convertibility in 1887. In that year, the real estate bubble began to deflate and a number of banks which had extended generous credit to the building sector ran into serious difficulties. Some of them (Banca Tiberina and Banco di Sconto e Sete) failed, after an ill-conceived and unsuccessful bail-out attempt by the largest bank of issue, Banca Nazionale nel Regno d'Italia.

Meanwhile, the public debate concerning the banks of issue became intense. It was inflamed by the awareness that the banks of issue had not remained aloof from the real estate bubble. The quality of their assets was uncertain, especially since some of these banks, either because of business relations or in response to government pressures, had largely financed the construction firms or the banks involved in the bubble, even after real estate prices had started to decline. The concern about the soundness of the banks of issue turned into scandal at the end of 1892, when two MPs of the low Chamber read excerpts of a report, written by State examiners, concerning the Banca Romana, one of the six banks of issue. The document, which had been kept secret by the government, revealed not only huge bank losses, but also the illegal measures Banca Romana had undertaken to remain afloat. The scandal prompted a new examination of all six banks of issue and speeded up the legislative process towards a new law.

In barely six months the law was passed and it was enacted on 10th August 1893. Basically, the regulatory response consisted in the following. The number of the banks of issue was halved from six to three. Currency circulation was tightly regulated by imposing a limit to its outstanding amount, a 40% reserve requirement and norms on capital adequacy.[13] Convertibility was reaffirmed in principle, but the decree which should have set the legal framework for its application was never brought about. The three banks of issue were placed under tight Government control: the discount rate could not be changed without the assent of the Government and was to be

[13] See Appendix 2 for the details.

the same for all three banks. Furthermore, the operations they were allowed to undertake were stated one-by-one in the law (rather than in the individual bank charters); the chief officials had to be approved by the government; and finally, the control apparatus was reinforced and obtained the necessary political backing. Even note-printing was tightly controlled, to the point that the printing of each banknote could not be completed without the application of a stamp by a State official.

Needless to say, the 1893 law was harshly criticized by free market economists, particularly by those writing for the "Giornale degli Economisti", who condemned the suspension of the public's right to conversion of banknotes. Pareto also belittled the effectiveness of government supervision, which was considered inevitably inferior to market discipline (or "public supervision" as he puts it), that is by the public exercising its right to conversion.[14]

In the wake of the crisis fuelled by overlending, two issues had come to the forefront. A macro issue – an excess of money circulation – and a micro one with systemic implications – the soundness of the individual banks of issue. The reduced number of banks was probably intended to be a response to both matters: the emergence of a clear leader (Bank of Italy) was seen as a decisive step towards the unification of note issue and the control of money supply. The macro issue, including the stability of exchange rate, was addressed by imposing limits to circulation and metallic reserve requirements, but not by re-introducing convertibility since this move was feared to be too costly (e.g. in deflationary terms) for the economy as a whole. The remaining regulation was designed to tackle the micro issue. Once asset quality had been taken care of (in principle) by limitations on the kind of permissible assets, one had to worry about imperfect application of the law: hence, the capital ratio. Guaranteeing the stability of the individual banks of issue was also a motivation for prescribing a liquidity ratio, although its main justification was in the macro domain (Negri 1989: 207). Next came the Government's veto right on the nomination of top managers and the prohibition of MPs to serve in the banks' governing bodies. These provisions were a clear response to pro-bank lobbying, which had been pervasive in the preceding years. Finally, the strengthening of supervision. The scandal of Banca Romana had severely shocked the public opinion, and a clear message had to be sent out : abundance of controls, severity of penalties.

A crucial point of the story is that the banks of issue had gained a bad reputation: their managers were perceived to be at odds with the public interest and were not trusted by the political leaders who were trying to raise Italy out of its financial mess. Shortly after the enactment of the

[14] In particular, see his columns in "Giornale degli Economisti", April 1893, p. 313-319 and May 1983, p. 398-404.

law (February-March 1894), a decisive battle against the private interests operating within the Bank of Italy was engaged by the Finance Minister Sydney Sonnino on a relatively unimportant issue. As a result, the director general Grillo and the president of the board of directors Parodi had to leave. This also stressed the new will of the Government to end old practices of elusion and evasion of the law (Bonelli and Cerrito 2003).

But while the financial crisis was waning and the system was beginning to function under the newly-introduced rules, the international financial turmoil set in motion three years earlier by the Baring crisis struck Italy with a massive flight of foreign capital (October 1893 to March 1894). Consequently, the two main commercial banks failed, victims to runs, and tens of local banks followed suit. Losses were of the same magnitude of those of the preceding decade and have been estimated to be approximately 2.5% of GDP (Carriero, Ciocca and Marcucci 2003: 504). Either the banking law did not change market expectations about the country risk or it arrived too late (it came into force only on 1st January 1894) to shelter the country from domestic and international shocks. This sudden and deep after-shock in the crisis did not elicit new significant regulatory action. Some adjustments were made to the banking law of 1893, which, we recall, regulated only the banks of issue, but no lesson was drawn from the insolvency of the two largest commercial banks. Pantaleoni (1895) noted that the general public was hostile towards those who had made runs on the banks, by withdrawing their deposits. These agents were named *ribassisti* (short sellers) and enemies of the people, while the Government and the police, who deprived the depositors of their right to be reimbursed, were seen as saviours. As for the idea of bank legislation, the famous economist confined himself to reporting a witty note taken from Sumner: “There ought to be no laws to guarantee property against the folly of its possessors” (Pantaleoni 1895: 160).

A Government Committee was set up to study reforms of the existing corporate law. Its recommendations included the proposal of setting aside three tenths of the capital of joint stock banks as a guarantee for deposits (Vivante 1895). These were not, however, translated into law. Inaction was possibly due to the fact that political energies had been exhausted (new priorities emerged immediately after the crisis) and to the lack of an economic or legal theory sound enough to provide a rationale for regulation beyond the realm of note issuance: as we have seen, it was widely believed that currency and financial stability were the two sides of the same token. Hence, the only rule specifically aimed at banks in the Italian legislation remained the Article 177 of the Code of Commerce, which required banks to transmit their balance sheets every month to the Trade

Court (*Tribunale di commercio)*. Their actual publication, owing to organisational difficulties, was lagged, however, by over one year.

Once the tsunami passed, a period of rapid GDP growth in a stable monetary, financial and exchange rate environment got under way. Abundant remittances by Italian workers abroad, contributed to the creation of large gold reserves which, as we shall see, would make the difference in the 1907 crisis. While convertibility was never formally declared, by 1902 the exchange rate had reached its par and the interest rate applied to the government debt steadily declined. Also, the stock market staged a considerable upswing; the number of listed companies rapidly increased.

4. 1907

The main financial innovation of the pre-war period of sustained growth was the expansion and evolution of the so-called universal bank. For the first time since Italy's unification, banks – in particular the three largest ones created during and after the crisis of 1894 - came to play a leading role in corporate finance. They forged close ties with their client companies, both large and medium-size. "Fiduciaries" of the banks, as they were then called, routinely sat on the boards of the companies or were appointed as consultants. Banks advised and assisted IPOs, frequently underwriting large amounts of shares to be gradually placed thereafter on the market. As a result of this innovative practice by unregulated intermediaries, banks acquired relevant market-maker positions in the three main stock exchanges (Milan, Turin and Genoa), whilst often holding in their portfolios consistent amounts of shares either from IPOs or as collateral for loans. The main banks were therefore partly responsible for the rapid increase of equity prices, which suited them well by swelling the value of their assets; this, in turn, made it easier for the banks to float new capital on the market. Increased capitalization attracted new depositors, thus contributing to a rapid expansion of bank lending and equity underwriting.

Particularly impressive was the growth of Società Bancaria Italiana (SBI, established in 1898), the junior member of the large universal bank league (the other two being Banca Commerciale Italiana, est. 1894, and Credito Italiano, est. 1895).[15] The new issues were mostly made in connection to M&A operations by which the bank acquired a number of smaller credit institutions and expanded its operations to become the "third credit pillar" of the rapidly

[15] The initial 1898 SBI's capital of 4 million lire was progressively increased to reach 50 millions 8 years later (Bonelli 1971: 30-31).

industrializing North Western regions (Bonelli 1971: 32). Similarly to the two larger universal banks, SBI engaged in extensive industrial lending, promoted IPOs and new capital issues, advised and financed restructuring operations. Having started operations on a large scale only in 1900, when its competitors had already conquered the largest, most solid and profitable industrial clients, and being less firmly established as a universal bank than its rivals, SBI had to base its business on riskier clients that had often been discarded both by the other big banks and by the larger savings banks. Huge if perilous business came to the bank also through the acquisition of the previously mentioned Banca di Sconto e Sete under liquidation (Bonelli 1971: 34). Moreover, by 1907 SBI was controlled by a group of Genoese business people which "included some of less scrupulous representatives of the stock exchange speculation" (Bonelli 1971: 32).

In 1906, aggregate demand – both for consumer and investment goods – was buoyant. Wages and profits increased, as did the already excessive demand for credit. In the second half of the year, interest rates progressively rose; international markets signalled the onset of the liquidity crunch that would characterize the following year. Italian banks sharply reduced credit to stock market traders. In October a liquidity injection by the Bank of Italy avoided the transmission of difficulties in Genoa to the other Stock Exchanges. To a farsighted observer, these developments should have highlighted the fragility of a system characterized by overstretched credit institutions, an over-indebted industrial sector and bank-dominated, oligopolistic, rather thin and illiquid equity markets. But very few people, in Italy or abroad, understood the dangers of increasing tension in the international liquidity markets.

News coming from the United States advised banks to further limit credit to stock exchange operations, thus accelerating the fall in equity prices. Yet, the Bank of Italy saw no reason for concern about the stability of the main banks. Banca Commerciale and Credito Italiano discontinued their attempts at containing the decline in equity prices, whilst SBI alone persevered in attempting to raise the price of its own shares and that of its main debtors. The insolvency of one of its important client companies (Ramifera) highlighted the vulnerability of SBI and of the whole banking sector. The Bank of Italy stepped in to finance a consortium of bankers and stock market brokers aimed at avoiding the liquidation of Ramifera with its likely implications for SBI. This move by the Bank of Italy signalled the possibility of further lending of last resort interventions, and revived earlier proposals for amendments of the existing regulation of the banks of issue in order to allow for additional liquidity creation (i.e. expansion of circulation).

In September the stock market nose-dived again. Bank of Italy branch managers reported widespread evidence of a credit crunch. Hence, a considerable amount of liquidity was fuelled into the system out of concern for both the real economy and the position of smaller banks deriving from the drying-up of inter-bank credit (Bonelli 1971: 88). Pressed for liquidity, corporate clients of the large banks drew on their deposits, as did members of the general public. It became clear that SBI, the weaker ring of the chain, was in urgent need of a greater liquidity injection. The Bank of Italy persuaded SBI's two main competitors to join a consortium which lent 50 million lire to the ailing bank, warning of contagion should the public lose confidence in the third largest bank in the country.[16] It is perhaps interesting to note that in order to close the deal, SBI had to accept the creation of a supervisory committee and subject itself to inspection. This financial relief measure kept SBI going for a few weeks but it did not restore confidence. The Bank of Italy again persuaded the two main SBI's competitors to participate in a lending consortium. This time, however, financial assistance was made conditional on SBI being put under control of the lenders, who would then dispose of its assets. The unintended consequence for the Bank of Italy of its first large-scale lending of last resort operation was that it became involved in the management of a commercial bank. The Bank of Italy decreed that SBI was to survive. Thus, capital was reconstituted with fresh subscribers and Stringher, the head of the Bank of Italy, put one of his closest aids at the helm of SBI. By late Spring 1908, the crisis was overcome.

What "lessons", if any, were learned from the crisis of 1907? The main ones were about crisis management rather than prevention through adequate regulation. Both the Government and the Bank of Italy brought home the "domino effect" argument of avoiding big bank failures. To prepare for the management of future similar crises, the Bank of Italy came to believe that more ammunition had to be added to its arsenal, in particular more flexibility was required of its liquidity management. In 1907, the Bank could act without endangering macroeconomic equilbria as it was sitting on a much larger metal reserve than required by law, but circumstances could not be expected to be as favourable all the time in the future. This led to the loosening of limits on circulation with a sequence of laws in 1907, 1912 and 1914.[17]

[16] Polsi (2001) emphasizes the fact that, for the first time and in a virtually unique case of the history of Italian finance, the Bank of Italy managed to bail out an important bank without requiring an upfront disbursement of taxpayers' money.

[17] These laws were the corner-stone of a policy of deregulation of the banks of issue, started soon after le 1893 law, which included: a) Interest rates: the possibility of applying a rate lower than the official one to prime customers was introduced in 1895; b) Permissible operations: a larger part of reserves could be kept in foreign bills; the holding of consols was allowed in 1928; longer time was conceded to sell non permitted assets; d) Capital requirements: they were dropped altogether; e) Taxation: a shift took place, from a note circulation tax regime (which left the burden of non performing loans entirely on the bank) to a profit tax regime.

The 1907 crisis also highlighted for the first time the pro-cyclical nature of the universal bank, the financial innovation of the time. Furthermore, it enshrined the Bank of Italy as the agent responsible for the stability of the banking sector. Moral hazard also came to the forefront. In 1907 the largest banks had been reluctant to cooperate with the Bank of Italy and only too glad to pass on to the latter the task of bolstering credit to the economy (in particular to the large manufacturing companies). Moral hazard issues would characterize the following decades with requests and political pressures for last resort lending, not only to banks but also to large industrial companies in distress.

It would take another crisis for the "lessons" of 1907 to be translated into regulatory action. Nevertheless, the general idea that the credit sector should be made more responsible in order to better 'safeguard depositors'[18] began to take hold. In 1908 a member of the Cabinet – Cocco Ortu – initiated legislation aimed at protecting small depositors of commercial and cooperative banks, which was however torpedoed by the prime minister (Bonelli 1991: 39)[19]. Stringher, general manager of the Bank of Italy, indicated that rather than legislation what was needed was self-regulation of the banking sector.[20] In 1913, Nitti, Minister of Agriculture, Industry and Commerce, again proposed legislation for the regulation and supervision of deposit-taking institutions. Provisions for the introduction of liquidity and reserve ratios and supervision were envisaged. If nothing came of these proposals, they nevertheless indicate a shift in the paradigm of bank regulation, hitherto synonymous with bank of issue regulation.

5. 1921-26

If, as we have seen, a first proposal for bank regulation stemmed from the events of 1907, Italy's first organic piece of regulatory and supervisory legislation[21] originated from the banking crisis of 1921-23.

Wartime expansion of industrial output by heavy industries such as steelmaking, shipbuilding, automotive, arms and ammunitions was financed by credit lines generously opened by

[18] This expression became the catch-word of bank regulators for forty years until it was actually introduced in the 1948 Constitution of the Republic as "savings' safeguard".
[19] Banks were required to create two autonomous, fire-walled, sections for the separate management of 'fiduciary' (or 'saving') deposits and 'commercial' deposits; the former - enjoying privileges in case of liquidation – could not be used for long term lending (Bonelli 1991, Doc 34 : 279).
[20] Bank of Italy Report of 30th March 1912 (cited in Bonelli, 1991: 39-40).
[21] Royal Decree 7 September 1926 n. 1511 and Royal Decree 6 November 1926 n. 1830.

the largest universal banks. One such bank, the Banca Italiana di Sconto, was actually created shortly before the outbreak of the hostilities by a group of industrialists who had large stakes in the Ansaldo heavy industry conglomerate (see e.g. Falchero 1990). It acquired the previously mentioned SBI.

As long as the war lasted, a discount window of the central bank ensured that bank liquidity never became an issue. To prepare for worst-scenario situations, the Bank of Italy acquired a panoply of new instruments to guarantee the stability of the system. When Italy was still neutral, in the Autumn of 1914, a general moratorium (or rather strict regulation) on bank-deposit withdrawal pre-emptied runs on the weakest banks and the spread of contagion (Toniolo 1989: 18-25). The Bank also sponsored the creation (December 1914) of a special institution (the CSVI, Consorzio per Sovvenzioni su Valori Industriali) authorized to discount paper not eligible for direct discount at the banks of issue.[22] The original motivation for CSVI was to avoid the dumping of industrial equity on the market by banks or industrial companies in need of liquidity (Guarino and Toniolo 1993: 197-98). As we have mentioned, since at least 1907, the Bank of Italy had understood its duty in guaranteeing the stability of the financial system; the war provided an excellent acid test for its effectiveness in the job. But action was taken on an *ad hoc* basis and with *ad hoc* instruments either already at the Bank's disposal (foremost among these, the exercise of moral suasion) or through legislation initiated by the Bank itself. The post-war banking crisis showed that case-by-case (and often *ex post*) action did not secure financial stability and entailed costly lending of last resort operations, thus paving the way for a crisis-prevention rationale for regulation.

After a brief post-war boom, all European countries bar Germany experienced quite severe, if relatively, short depressions. They were accompanied by financial turmoil and bank failures in Italy, Spain, Portugal, the Netherlands, and Scandinavia (Feinstein H., Temin P., Toniolo G., 2008: 42-45), countries in which corporate finance largely depended on bank lending. Hyperinflation spared Germany (the inventor of bank-centred industrial finance) from a banking crisis (Holtfrerich 1986). In Italy the banking crisis coincided with the crucial months of social and political instability that led Mussolini to power. It was also marked by a fierce struggle among capitalist groups for the control of the largest banks and industrial conglomerates. Both circumstances made emergency lending by the Bank of Italy not only subject to huge pressures, but also liable to accusations of partisanship from all directions.

[22] See Appendix 3 for more details.

At the heart of the banking crisis was the interlocking shareholding between the Ansaldo conglomerate and the Banca Italiana di Sconto (from now on Sconto). As a slow post-war restructuring process threatened Ansaldo's solvency, Sconto commissioned as many as ten ships to the sister company. In little over a year's time, the bank, which could not discontinue lending to Ansaldo, became virtually illiquid. As in 1907, the Bank of Italy turned to the two largest banks in order to create a consortium to supply liquidity to Sconto. This time, however, the two banks (in particular Banca Commerciale who had been the target of a hostile takeover by the main shareholders of Sconto) were even more sluggish to act than they had been in 1907. The consortium did not materialize until the end of 1921, too late to stem the withdrawal of foreign deposits from Sconto as well as from other banks in a classic scenario of bank contagion. The Government briefly toyed with the idea of a moratorium, but soon liquidation emerged as the only solution. A partial guarantee of deposits was given by the Bank of Italy through a new entity, a "Special Section" of the afore-mentioned CSVI. Ansaldo was *de facto* taken over by the Government, thus becoming the first State-owned large conglomerate in the history of the Italian Kingdom. Almost at the same time (end of 1921 – spring 1922) another large bank, Banco di Roma, suffered huge deposit losses and became virtually illiquid. It was however provided with enough liquidity from the Special Section, with the guarantee of the newly-formed Mussolini Government, to outlive the crisis, even if as a crisis-prone lame-duck.

How did this episode shape the regulatory attitude of the authorities? The crisis brought home the lesson that regulation concerning banks of issue was not sufficient to attain the stability of the whole banking system. Time had come to regulate commercial banks. A first draft of a new Banking Act was prepared in the fall of 1923 (Guarino and Toniolo 1993: 403-15). It took three more years for the law to overcome intense bank lobbying and to land in Parliament, where it was passed in the Autumn 1926 (shortly after another law had granted the bank of Italy monopoly of note issue). Free bankers and the lobbying association of limited liability companies strongly argued against the desirability of "protecting depositors by law" and the creation of a supervisory authority with inspection powers. A brief act was passed in September, to which a more articulate one followed in November.

The new regulatory regime applied to all banks. A key provision of the act was that an authorization was required for the creation of a new bank or branch, as well as for mergers and acquisitions. This created a power to control over-banking, which was considered one of the main

problems of the time. On the other hand, the ability to get a hold on the actual management of the banks rested on two other provisions: the first was minimum capital and reserve requirements; the second was a limit to credit to any individual client, which could not exceed one fifth of the bank's equity. The regulating entity was entrusted with supervisory powers, via information disclosure and on-site inspections. One major problem of this legislation was that different categories of banks were subject to different supervisory authorities.

The bank legislation of 1926 was largely obsolete before even being enacted. It regulated banks as they existed before the war. In fact, its drafters made explicit reference to the 1908 and 1911 proposals. But the war had already changed the banking industry as observed, in 1920, by the Minister of Industry and Commerce who – speaking before the Parliament – had to say: "Our credit institutions have changed their nature from deposit-based commercial bank into investment banks". He argued that the very nature of the credit system was thus changed for two reasons: on the one hand the balance sheet of the banks was linked to the ups and downs of equity prices of the industrial companies they invested in and, on the other hand, "banks aim at taking control of industrial companies and the latter of being the masters of the banks" (Santoro 1927: 44-45).

6. 1931-1938

By 1931, when State intervention quelled the liquidity crisis of the two largest Italian banks and shaped the financial and industrial set-up that would then prevail for the following four decades, the main universal banks[23] had undergone a transformation into quasi-holding companies. During and immediately after the war, the bank-industry link, hitherto limited to long term lending and investment bank operations such as IPOs, M&A and advising, had become much tighter due to the acquisition by banks of permanent stakes in manufacturing and utility firms. At the same time industrialists sought, with varying degrees of success, to gain control of the banks.

During the brief, if buoyant, cyclical expansion of 1922-25, a stock market boom, partially fuelled by the banks themselves, allowed the latter to easily extend credit to industrial companies on the security of the firms' equity. When the stock market weakened in 1925, the banks stepped in in order to stem the falling value of equities. Unable to reverse the bear market on their own, the main banks resorted to the Bank of Italy which provided them with a billion lire facility

[23] Banca commerciale italiana, Credito Italiano and Banco di Roma.

for equity purchases on the market. Since this attempt too failed and most equity prices remained lower than they had been in 1925 for the rest of the decade, the banks had no alternative but to hold on to their equity portfolios. These portfolios were actually swollen in the following years as the intertwined fortunes of banks and industrial companies made it impossible for the former to refuse credit to the latter, again taking equity as collateral (Toniolo 1978). By the end of the decade, as it will dramatically appear in 1931, Banca Commerciale and Credito Italiano actually controlled over 50% of the equity listed on the Milan stock exchange

Overall, the 1920s were characterized by endemic bank instability. The group of the so called "catholic banks", undercapitalized and poorly managed, was partially bailed out by the state on the eve of the Concordat between Church and State.[24] Another significant, yet isolated, episode of bank hardship was that of the Banca Agricola Italiana, linked by mutual equity holdings to the industrial conglomerate Snia-Viscosa, producer of rayon, which was strongly affected by the drop in exports due to the revaluation of the lira in 1927, which preceded the declaration of convertibility. The Bank of Italy financed an orderly wind-down of the bank.

Like other countries, Italy too was strongly affected by the Great Depression. Industrial output contracted by 25.1% between 1929 and 1932.[25] The real slump had an immediate impact on the banking sector. Confronted with deflation and falling demand, industrial firms could hardly rely on financing out of retained profits, while at the same time they saw the real value of their debts increase. They could thus only turn to banks for further loans to attempt to defend the integrity of their previous loans and the value of their equity assets. The withdrawal of foreign deposits made this strategy ever more dependent on credit from the Bank of Italy. As a last resort, the two largest banks made an attempt at self-regulation by trying to solve the maturity mismatch between their short term liabilities (deposits) and their long-term assets (stakes and credits to the industry) through the creation of *ad hoc* holding companies to which they shed their industrial stakes.[26] This was a first timid (and voluntary) attempt to create a fire-wall between ordinary short-term lending and industrial long-term credit.[27]

[24] Guarino and Toniolo (1993).
[25] See Toniolo (1980) on the matter.
[26] Therefore, Banca commerciale increased its already existing financial firm Cisalpina's capital and changed its name to Sofindit, whilst Credito italiano created Banca nazionale di credito.
[27] The attempt failed in that the universal banks had control over their financial firms and could not interrupt credit flows to the industrial sector. The financial firms were, in fact, a clear example of captive finance with respect to the banks that created them (Battilossi, 2000: 332).

When all the above-mentioned measures failed to solve the liquidity problem of the banks, these had no alternative but to turn to the Government which, on 31st December 1930, issued a secret decree mandating the Istituto di Liquidazioni (the heir of the Special Section: see Appendix 3) to offer loans and advances to a whole list of financial institutions, including Credito Italiano. This then led to a secret deal (*Convenzione*) of 20th February 1931 between the Bank of Italy, the Ministry of Finances and Credito Italiano. The latter accepted a restriction of its activities to "ordinary" (i.e. short term) commercial bank operations in exchange for a large liquidity injection. Credito Italiano's industrial stakes were passed on to a financial firm (Sfi) at balance sheet value. This deal is particularly relevant as it represents the first significant step towards the subsequent regulatory legislation, based on the separation between commercial and industrial banking. In fact, Credito italiano was banned from underwriting shares in industrial or real estate firms and was forbidden speculative trading in securities and real estate.

Next, it was the reluctant Banca Commerciale's turn to unveil its financial difficulties. In July 1931, it turned for help to the Bank of Italy, after the withdrawal of deposits, mainly by Americans, preoccupied by the rampant banking crises in Central Europe. In October 1931, another deal (*Convenzione*) between Banca Commerciale and the Government provided for the acquisition of the totality of the bank's industrial stakes by the financial firm Sofindit, which obtained an *ad hoc* loan from the Istituto di Liquidazioni (i.e. ultimately from the central bank). From then on, Banca commerciale too was allowed only commercial banking activities.

This huge, secret and complex bail-out operation spared Italy the consequences of a banking crisis similar to the Austrian and German ones (Toniolo 1995). The rescue and transformation of the main Italian banks was completed in 1933-34. In 1933, the holding companies were permanently separated from the parent banks; their assets were taken over by the newly-created Istituto di Ricostruzione Industriale (IRI), which also absorbed the Istituto di Liquidazioni. Originally designed as a temporary solution to Italy's industrial problems, it was supposed to restructure and recapitalise the main companies that came under its wing before being newly privatized. When privatization proved to be difficult, IRI became a permanent State holding of utility and manufacturing firms in1937. To finance its activities, IRI issued bonds, guaranteed by the State.

In 1930-1931, the banks had been saved by turning their short term debt into *de facto* long term exposure toward the Bank of Italy. The matter was finally settled in March 1934 by three deals

(*Convenzioni*) between the State and each of the main universal banks[28]. The idea was to free the three banks both from their excessive debt burden towards the Bank of Italy and from their excessive credit exposure towards firms. All the industrial assets of the banks were transferred to IRI, which also took over the control of the banks. The banks, on their side, were banned from acquiring stakes in industrial or commercial firms, directly or indirectly, and from financing firms that later purchased majority stakes in the banks themselves. A clear-cut separation between bank and industry, in both directions, was thus definitively attained in 1934.

The *Convenzioni* of 1934 were a significant milestone in the new re-regulation wave, in that they not only re-organized the banking and financial sector as it had emerged from the crisis, but also contained regulatory prescriptions which inspired the 1936 banking legislation and which were, under this new guise, extended to all deposit-taking institutions, in an explicit intent to prevent further crises. The banking crisis of 1931-1933 brought home to legislators the inadequacy of the 1926 law in guaranteeing financial stability, for two reasons: a) it turned out to be incomplete, not biting and incapable of handling new entities, such as the universal banks turned into holding companies; b) it was not sufficiently enforced, especially due to lax supervision of the major financial institutions, thus resulting in a partially ineffective regulation.[29] On the contrary, the crisis management and crisis resolution measures implemented in the 1930s were effective, due to two main features: a) the secrecy with which the rescues were conducted and the pressure set on depositors not to withdraw their savings, which fended off runs; b) a learning-by-doing process, which proved that something had been learned from the previous banking crisis of the 1920s, if not in crisis prevention terms, at least in crisis management and resolution ones.

"Permanent" and "intelligent" were the two adjectives used by IRI to describe the needed regulation.[30] The rules and sanctions prescribed were to be more detailed than those of 1926: the idea was that of more regulation, not only of better regulation. So whilst the 1926 legislation was made up of only 19 articles[31], the definitive 1936 law included 105 articles.[32] If we consider the

[28] Banco di Roma, which had already been re-financed in 1922, had been less affected by the crisis than the other two in the 1930s. However, already in 1930 it had been asking the Bank of Italy for help in its reorganization to catch up with the "big two". See the memorandum of Banco di Roma for the government and for the Bank of Italy of 19th December 1930 on the matter.

[29] Inspections, in fact, mainly targeted small local banks. The reluctance to interfere with the big banks was palpable. Between 1926 and 1932, 2,532 on-site examinations were conducted: 4 in national banks, 72 in interregional ones, 94 in regional banks, 270 in provincial ones and 2,092 in local ones. No inspection took place in the "Big Three". Another example of ineffectiveness of the 1926 law is represented by the number of excess *fidi* granted.

[30] IRI statement to the Government on 5th December, 1933.

[31] We here refer to the *regolamento* of 6th November 1926.

contribution of the numerous *Convenzioni*, then the regulatory reform took seven years (from 1931 to 1938) to be devised and refined.

The first novelty of the 1936 law was the huge discretionary power attributed to the regulating entity, which could dictate instructions and decide on many regulatory issues case-by-case. The flexibility of the law thus coincided with great power, on the regulator's behalf. Another factor was its composition of two parts: one concerning prudential regulation and supervision (crisis prevention), the other concerning crisis management, not at all treated in the 1926 law.

The 1936 law incorporated the idea of one sole regulatory and supervisory authority, thus overcoming the 1926 division of regulatory powers. It hence created a supervisory authority (*Ispettorato per la difesa del risparmio e per l'esercizio del credito*), subordinated to a Committee of Ministers, led by the Prime Minister. Governmental authorities were thus empowered to regulate and to marshall the credit flows in the economy. "The State is not willing to pay for other bank rescues and the control of deposits cannot be left to anonymous shareholders, but must go to the State, which represents the people".[33] The 1930s regulation had a clear allocative aim, as well as a stability purpose: by controlling credit, the Government could direct investment flows. Head of the Inspectorate was, however, the Governor of the Bank of Italy and, *de facto*, the Inspectorate never operated separately from the bank of issue, which therefore built up its supervision experience and know-how. Separation was formally reversed in 1947 when supervisory responsibilities were again assigned directly to the Bank of Italy.[34]

The law also marked the final transition of the Bank of Italy from a bank of issue to a modern central bank, with three functions: control of money supply, last resort lending and bank supervision.[35] Its commercial banking activity was discontinued.

The new perimeter of regulation included two broad categories of institutions, distinguished according to the maturity of their liabilities (short-term vs medium/long-term). A different, and less stringent regulation, was designed for the second category of institutions, thus

[32] What is commonly defined as the banking law of 1936 is however actually made up of the law 7th March 1938, with amendments made by the successive 7th April 1938 law. These two laws were the result of the conversion of two legislative decrees respectively of 1936 and of 1937.
[33] Free translation from the IRI statement of 27th March 1935.
[34] In 1944 the Inspectorate was abolished and its faculties and powers were transferred to the Treasury. Banking supervision was, however, delegated *ex lege* to the Bank of Italy, even though the Treasury could organize its own inspections when deeming them necessary. In 1947, the ex-Inspectorate's functions were transferred directly to the Bank of Italy.
[35] Statement of the Confederazione Fascista dei Lavoratori delle Aziende del credito e dell'assicurazione, 1935.

creating a segmented banking system, in which financial entities were clearly defined by their functions.

The tight inter-relations between banks and industry were pinpointed as the main cause of the 1930s banking crisis, as the “root of all evil”[36]. The 1936 legislation confirmed the separation between the two sectors, if in a rather subtle manner, allowing some flexibility. It stated that the purchase by commercial banks of certain types of assets required the Inspectorate’s authorization. The norms on assets were introduced to avoid excessive risk-taking and risk-concentration, but also to ensure the mentioned separation. In the following years, the Inspectorate denied authorization to almost any investment in the industrial sector by any regulated entity. Universal banks, whose extreme evolution had led to the financial innovation at the core of the 1930s crisis, were thus banned from the Italian financial system, as was the relapse into maturity mismatching. On this point, whilst distinguishing financial institutions according to the maturity of their liabilities, the 1936 legislation did not, however, explicitly regulate deposit and credit maturity. Except for the three ex universal banks (bound by the *Convenzioni*), in theory, other short-term liability institutions could lend long term. However, in order to avoid maturity mismatches between assets and liabilities, which had played a major role in the 1930s bank crisis, *de facto* the temporal specialization was imposed by the Inspectorate’s instructions, which, in general, blocked long-term investments by institutions with short term funding. Finally, director interlocking between banks and firms was also forbidden.[37]

Oddly, the issue of bank ownership was not explicitly treated in the 1936 legislation. One reason was that by that time most banks were under public control, making the issue almost irrelevant. In fact, the share of private banks in the credit market dropped from 55.6% of total credits in 1927 to only 16.96% in 1936 (Ferri and Garofalo 1994: 138). In order to avoid the purchase of bank shares by non-financial firms, moral suasion was used by the regulating entity.

The limitation of competition is another predominant feature of the new regulation. Free competition was, in fact, considered as the major source of banking instability. This belief, already present in 1926, was taken to rather extreme levels in 1936. The Bank of Italy itself believed that

[36] Statement of IRI’s board of directors dated 31st December 1936.
[37] The analogy with the US Glass-Steagall Act immediately comes to mind. However, the two acts had different rationales and focused on partially different matters. In the US, commercial banks were accused of having contributed to the stock market crash via questionable securities dealings and were thus banned from underwriting and dealing in securities for their own account while, on the other hand, investment banks were denied the possibility of collecting deposits of any kind. In Italy, the (under-developed) financial market was not an issue: given the nature of the crisis, the main priorities were a complete separation between bank and industry and maturity alignment.

cut-throat competition between banks, defined as "bank rivalry" (*rivalità bancaria*), had been responsible for high interest rates on bank deposits, in a struggle to attract depositors in a low-liquidity market.[38] The regulators were concerned that price competition in the market for deposits would induce banks to take eccessive risk in their investments or to engage in activities outside of their core banking business (with negative effects on the stability of the banking sector)[39]. In 1933 a blanket bank cartel (*Cartello Bancario*) was created by the Government fixing mandatory interest rates on deposits. The 1936 legislation not only imposed price caps, killing interest rate competition, but denied banks other competitive tools such as free branching. Compulsory mergers and liquidations were part of further "structural regulation", aimed at defining and modelling the banking sector, leading to the emergence of "an administrated oligarchy" (Costi 2007: 59) of banks. The emphasis set on other regulatory instruments, such as on capital adequacy, was thus decidedly inferior to the one attributed to the anti-competition measures.

Finally, information disclosure, on-site examinations and enforcement were made more effective. As well as disclosure to the authorities, some form of disclosure to the public was also required. In all forms of communication and publicity, in fact, the intermediaries had to list the capital and reserves held, according to the latest balance sheet. The Bank of Italy, on its behalf, was still attempting to educate the public to become more "responsible": "Notwithstanding regulation, depositors must check the solidity of the banks they entrust their savings with."[40] However, transparency in the 1936 legislation was basically intended as transparency towards the supervisory authorities, rather than towards the market. In commenting the 1934 *Convenzioni*, the IRI management stated: "(…) another myth had fallen: the myth of bank secrecy, that secrecy that had cost the State millions and millions and which had allowed the bank directors to prevent the State from looking into banking issues",[41] confirming that transparency was intended toward the State. A shift in this attitude would have to wait at least another 40 years to be translated into a law.

[38] Bank of Italy note of 1932.
[39] See also IRI note of February 1937 on the "Proposal to allow ordinary credit institutions to extend medium-term credit", which states that the increase in bank profits, consequent to limits on branching and price regulation, limits the need for risk-taking and thus contributes to the stability of the system.
[40] Free translation from Bank of Italy Annual Report, 1931. This statement recalls a previous one made by the Governor Stringher to the general assembly of the Bank of Italy on 31st May 1928, in which he states that depositors must only turn to trustworthy institutions with a prudent and cautious management.
[41] Free translation from IRI statement of 27th March 1935.

7. Conclusions

To sum up: loosely regulated banks of issue engaged in overtrading and risky loans to the construction industry were perceived to be responsible of the early 1890s crisis. They were therefore merged, downsized in their commercial business and tightly regulated by the Banking Law of 1893, with the belief that financial stability would follow sound circulation and macroeconomic equilibrium. While the latter was remarkably attained in the years up to 1914, financial instability re-emerged in 1907, since part of the credit market previously covered by the banks of issue was now conquered by pro-cyclical intermediaries such as the German-type universal banks. However, it took another crisis in the wake of the war for a new banking law to regulate commercial banks in 1926. This new regulatory wave did not *per se* induce the birth of new financial instruments; by then, in fact, the war and the stock market boom and bust of 1922-25 had largely transformed the universal banks into holding companies with extensive permanent stakes in the manufacturing and utility industry. It was this new type of banks which became illiquid in 1929-30 threatening the stability of both the financial system and the real economy. The ensuing regulatory wave originated from the need to prevent the recurrence of episodes of bank illiquidity which spread to the real economy due to the close interlock between banks and industry. It then went beyond bank-industry relations in regulating the system and providing regulators with wide, largely discretional, powers.

The regulation that emerged in the wake of the crisis of the early 1930s was long-lasting. It contributed to nearly half a century of financial stability and held steady until 1993. Stability, however, was bought at a price. In guaranteeing financial stability, the bank law of 1936 sacrificed competition, thus leading to inefficiency, compounded by the extensive public ownership of the banks, with negative spillovers on consumers. The straight-jacket imposed on the banking system probably contributed to the underdevelopment of the Italian financial system, by stifling financial innovation.

Given the previous pattern of regulation leading to financial innovation, the obvious question is: why did it take so long, after the Second World War, for new unregulated financial instruments to develop in the Italian context? Answering this question goes beyond the limited aims of the present paper. A plausible hypothesis however is that post-war financial repression was made possible by three concurring causes: tight regulation, state ownership of the main financial intermediaries and limited international capital mobility. Moreover, the unprecedented high rate of

growth of the real economy coupled with extraordinary macroeconomic stability hid the costs of "financial repression". It was only in the 1970s with the collapse of the Bretton Woods system, the spreading of the eurodollar and the reappearance of episodes of bank failures that the soundness of the 1936 arrangements began to be questioned. It took another decade for financial innovation/liberalization to emerge: this new phase led to bank privatizations and to a new banking law.

Appendix 1: The main banking regulatory reforms in Italy

Year	Regulating entities	Regulated entities	Main regulatory instruments*
Post-1861 (year of Italy's unification)	Commercial banks were subject to the Code of Commerce, similarly to industrial firms; there was, however, a fragmentary plethora of laws concerning specific financial institutions. Issuing banks were regulated according to their statutes.		
Law N. 1920 of 30th April **1874** (Minghetti Law)	Ministry of Finance	The six banks of issue	Limits on competition; limits on note issuance; restrictions on activities and asset holdings; information disclosure to Ministry of Finance
Law N. 449 of 10th August **1893**	Ministry of Agriculture, Industry and Commerce, together with the Treasury Ministry	The banks of issue (Bank of Italy, Banco di Napoli, Banco di Sicilia), reduced in number from six to three	Upper limit on issuance; list of permissible activities; reserve requirements; regulation on corporate governance; on-site examinations; disclosure to Parliament; suspension or annulment of issuing right in case of violation of law
Royal decree N. 442 of 12th October **1894**	Treasury Ministry	Unvaried	Unvaried
Law N. 804 of 31st December **1907**	Unvaried	The three banks of issue	Less stringent limits on circulation
Royal decree N. 812 of 6th May **1926**	Unification of note issuance, attributed solely to the Bank of Italy		
Royal decrees N. 1511 of 7th September **1926** and N. 1830 of 6th November **1926**	Ministry of Finance, Ministry of the National Economy and Bank of Italy, both in subordinated positions	Deposit-taking credit institutions, defined as *aziende di credito* (except for the two ex-issuing banks, Banco di Napoli and Banco di Sicilia, subject to a specific regulation)	Restrictions on entry and mergers; information disclosure to the Bank of Italy; capital and reserve requirements; restrictions on assets; fines and repeal of bank charters in case of violation of law
Royal decrees N. 375 of 12th March **1936** and N.1400 of 17th July 1937	Inspectorate (*Ispettorato per la difesa del risparmio e per l'esercizio del credito*), under a Committee of Ministers; head of the Inspectorate is the Governor of the Bank of Italy; *de facto*, the Inspectorate never operated separately from the Bank of Italy	Two obligatory categories according to the maturity (short term and long term) of their liabilities; the long-term liability institutions had a less stringent regulation.	Restrictions on entry and on dimensions; form of banks; caps on interest rates; capital and liability requirements; regulation on corporate governance; obligation for directors to lodge deposits to be used in case of losses caused to the institutions; disclosure to authorities and on-site examinations; some form of disclosure to public; replacement of directors with state officials and repeal of the bank charter

			in case of violation of the law
Legislative decree N. 691 of 17th July **1947**	Bank of Italy (the Inspectorate was eliminated in 1944 with a temporary transition of powers to the Treasury Ministry)	Unvaried	Unvaried
Law N.287 of 10th October **1990**	Anti-trust authority over banks assigned to the Bank of Italy.		
Legislative decree N.385 of 1st September **1993** (Banking Consolidated Act)	Bank of Italy, in harmony with the European Union	Banks, banking groups and financial intermediaries (defined by the law and which abandons the previous categorization)	Controls on entry and on dimensions; regulation on bond issuance and on subordinated debt; regulation on bank stakes; capital requirements; regulation on corporate governance; information disclosure to Bank of Italy and on-site examinations ; information disclosure to the public; enforcement procedures
Law N. 262 of 28th December **2005**	Bank of Italy, whose Governor's appointment is limited to six years (renewable), except for anti-trust matters handed over to Anti-trust Authority	Unvaried	Greater transparency of banking contracts; restrictions on ownership; regulation on corporate governance; greater information disclosure to public

* The categorization used refers to Giordano (2008).

Appendix 2: A focus on the three regulatory laws (1893, 1926, 1936)

The contents of the three regulatory responses to the financial crises described are here briefly recalled, by breaking up each law into the different crisis-prevention tools it prescribed.

A. Law 10th August 1893, n. 449:

1. Regulating entity

The regulatory and supervisory authority was the Ministry of Agriculture, Industry and Commerce, together with the Treasury Ministry.

2. Perimeter of regulation

Only the three banks of issue were regulated. The Bank of Italy, a joint stock company like its predecessors, was founded as the result of the merger of Banca Nazionale nel Regno d'Italia, Banca Nazionale Toscana and Banca Toscana di credito. It also absorbed the assets and liabilities of Banca Romana. The other two banks of issue, Banco di Napoli and Banco di Sicilia, continued operating.

3. Restrictions on undertakings

Each bank of issue was allotted an upper limit to its banknote issuance (800 million lire for the Bank of Italy, 242 million for Banco di Napoli and 55 million for Banco di Sicilia, for a total of 1.097 million, about 10 per cent of 1893 GNP), which could be exceeded only if the banknotes in excess were backed up by an equal amount of gold/silver in the bank's possession. The upper bound was not binding also in the case of ordinary and extraordinary advances to the Treasury. However, these advances were restricted (by a previous law of 1891) to 172 million for the three banks put together.

The range of activities permitted to banks of issue was listed: discounting of bills, Treasury bills, warrants not earlier than 4 months from expiration; advances on government bonds and other safe assets[42]; purchase or sale in currency of foreign drafts and cheques with an expiration date no later than three months. The banks of issue could also retain deposits on demand. However, if the deposits exceeded specified amounts, the bank involved had to reduce the circulation by three

[42] Bonds guaranteed by the State, certificates issued by land credit institutions (*istituti di credito fondiario*), bonds payable in gold, issued or guaranteed by foreign States, gold and silver currency and gold, raw and processed silk and silver, certificates of credit, certificates of deposit of spirits and cognac, not earlier than six months from expiration.

quarters of the exceeding amount. Any other operation was forbidden and if the banks were found to be engaging in forbidden activities, they were forced to pay a sanction which was three times the discount rate applied to the amount of the illegal pursuits.

4. Price regulation

The discount rate could not be changed without the assent of the Government and was the same for all banks.

5. Capital and liability requirements

The reserve in gold, silver and foreign bills was brought to a minimum of 40% of the banks' paper circulation. The composition of such a reserve was also regulated (silver and foreign bills had to be a very minor part of the total). Other liabilities, such as promissory notes, also had to be counterbalanced by a 40% reserve. Any circulation in excess was taxed at twice the discount rate. The paid-up capital of the banks ought to be no less than 25% of paper circulation.

6. Regulation on corporate governance

The law prescribed by: a. collegiality of the executive board; b. approval of the director general and two vices by the government; c. prohibition of MPs to work, even without remuneration, in the banks of issue.

7. Disclosure to authorities and on-site examinations

Every two years an on-site examination had to be organized by the two supervisory authorities, after which the subsequent reports had to be presented in Parliament within three months from the inspection.

8. Enforcement of the regulation

Enforcement of the regulation was induced by the fact that any bank of issue which did not conform to the banking law or to its statute would see the suspension or annulment of its issuing right. Any employee of the bank who deliberately deceived the inspectors could be punished with imprisonment. An even longer prison sentence was set for inspectors who covered up for the banks of issue.

B. Royal decrees 7th September 1926, n. 1511 and 6th November 1926, n. 1830:

1. Regulating entity

The regulators were the Ministry of Finance, the Ministry of the National Economy and the Bank of Italy, the last two of which were in a subordinated position. Specific categories of banks were under the direct supervision of the Ministry of the National Economy.

2. Perimeter of regulation

This included all banks and credit institutions which collected deposits, defined as *Aziende di credito*. Exempt from regulation were industrial and commercial firms which retained deposits, as a secondary activity, of their directors or employees. The 1926 law also referred to savings banks, *Monti di Pietà* and rural credit institutions.

3. Restrictions on entry and dimensions

The institutions could not start up their activity nor open up offices or branches without the two previously mentioned Ministries' authorization, once the bank of issue has been heard. Mergers too had to be authorized by the Ministry of Finance.

4. Restrictions on asset holdings

Loans extended by a bank to the same borrower could not exceed one fifth of the bank's equity. Derogations from the law could be authorized.

5. Capital and liability requirements

Minimum start-up capital requirements were stated; they varied according to the type of credit institutions. The regulated entities had to use at least one tenth of annual profits to build up an ordinary reserve, until this became 40% of capital. Total equity could not be lower than one twentieth of the deposits collected. Any excess deposits had to be invested in government bonds or be deposited at the Bank of Italy.

6. Disclosure to authorities and on-site examinations

Annual balance sheets were to be sent to the Bank of Italy, as well as two-monthly financial situations. Occasionally on-site inspections were organised and banks were asked to present all documents requested

7. Enforcement of the regulation

In case of violation of the norms, pecuniary sanctions were applied. In the case of severe violations, bank charters could be revoked.

C. Royal decrees of 12th March 1936, n. 375 and 17th July 1937, n.1400 :

1. Regulating entity

The *Ispettorato per la difesa del risparmio e per l'esercizio del credito* was created as the regulatory and supervisory authority. The Inspectorate was subordinated to a Committee of Ministers, led by the Prime Minister (and since 1947 by the Minister of Treasury). The Prime Minister could also adopt urgent measures by decree. Head of the Inspectorate was the Governor of the Bank of Italy. The problem of the Bank of Italy's ownership was also sorted: shareholders of the bank of issue could only be savings banks, public institutions and banks of national interest[43], social security institutions and insurance companies and it was hence defined a public institution (*Istituto di diritto pubblico*). The Bank of Italy was also vetoed direct discounting operations to firms and private individuals.[44]

2. Perimeter of regulation

The new perimeter of regulation included two broad categories of institutions, distinguished according to the maturity of their liabilities. The short-term liability institutions included: a) public institutions (*istituti di credito di diritto pubblico*)[45] and banks of national interest (*banche di interesse nazionale*), that is joint-stock companies of national tenure, recognized as such by royal decree, with branches in at least 30 Italian provinces[46]; b) banks and institutions which held demand or short-term deposits; c) branches in Italy of foreign banks; d) savings banks (*Casse di risparmio*) and e) other minor banks.[47] A different, and less stringent regulation, was designed for the institutions which collected medium or long-term funds,[48] thus creating a dichotomy in bank regulation. With respect to the second category of institutions, the 1936 law mainly referred to the specific legislation previously introduced for each type.[49]

3. Restrictions on entry and dimensions

[43] Banks of national interest are defined in point 2.
[44] Until 16th March 1939, the Bank of Italy could still exceptionally be authorized to discount private agents' notes in order to satisfy urgent and exceptional needs of certain sectors of production.
[45] These were: Banco di Napoli, Banco di Sicilia, Banca Nazionale del Lavoro and Istituto di San Paolo a Torino, plus the newly created Monte dei Paschi di Siena.
[46] These were defined in the first decree as *banche di diritto pubblico,* causing great lexical confusion with the former banks, and included the three ex-universal banks.
[47] These included State pawnshops (*Monti di credito su pegno*) and rural and artisan banks (*Casse rurali e artigianali*).
[48] The definition of short, medium and long-term was left to the credit authorities. Only in a deliberation of 28th January 1963, the CICR stated that short-term meant less than 18 months, medium-term was between 18 and 60 months and long-term greater than 60 months.
[49] Land credit, building credit, agricultural credit, naval credit, Imi, Icipu, Crediop, etc.

Controls on entry and restrictions on branching and mergers by the regulatory authority, introduced by the previous legislation, were confirmed. All possible types of branches were enumerated, in order to subject them all to authorization. The Inspectorate could also order the closure of banks and branches.

4. Regulation on ownership and control

The form of the private regulated entities had to be that of public limited companies (*società per azioni*) or limited partnerships with share capital (*società in accomandita per azioni*). Their shares had to be registered. The issue of bank ownership was not explicitly treated in the 1936 legislation.

5. Restrictions on undertakings and asset holdings

Certain types of assets (e.g. long-term credits, industrial stakes) required the Inspectorate's authorization to be purchased. The regulatory authority also decided on the proportions of different investments that intermediaries could undertake, considering liquidity issues and the different branches of economic activity the investments referred to. Finally, the Inspectorate could also decide upon the procedures to eliminate or reduce any residual long-term investment in the short-term liability banks' portfolios.

The Inspectorate could also dictate instructions on the prudential measures to be undertaken to avoid excessive risk-taking due to an accumulation of *fidi*, on the maximum limit of allowable *fidi*[50], on the procedures to reduce any excess, on the information borrowers had to reveal to be able to demand credit.

6. Price regulation

Regulated entities had to comply to instructions on interest rates both on loans and on deposits and on the costs of other banking services, dictated by the Inspectorate.

7. Capital and liability requirements

The Inspectorate decided on the minimum amount of capital necessary to open a new financial institution, the minimum percentage of profits to be allocated to reserves, the ratio between equity and liabilities.

8. Regulation on compensations and insurance schemes

[50] The fixed proportion of one fifth introduced by the 1926 law was, thus, abandoned.

The 1936 legislation did not regulate directors' remunerations. Instead, insurance schemes were contemplated. Directors of the banks and of their branches had to contribute up to 3% of their compensations to a special deposit which could be liquidated only after one year from the termination of the directors' working contract. This deposit could be employed by the bank in case of losses incurred, due to activities undertaken which exceeded their assignments. This provision was later abolished (Associazione Bancaria Italiana 1972: 325).

9. Regulation on corporate governance

State officials were forbidden to work for the regulated entities. On the other hand, banks' directors could not cover similar roles in other firms, if not otherwise authorized. Directors and auditors could not freely contract obligations nor sign purchase or sale contracts with the intermediaries they managed or oversaw. The Inspectorate could also order the convocation of shareholders' and of Board of Directors' meetings or convene the meetings directly if the competent authorities did not act promptly.

With respect to the afore-mentioned *fidi,* financial institutions had to keep a book of credits, in which all the authorized lines of credit were to be written down. The names of the officials that had offered the lines of credit were also registered. Incentives to avoid excessive risk-taking by banks were also accompanied by norms aimed at attaining correct information disclosure by the borrowers, also concerning *fidi* obtained by other banks. In fact, any erroneous or misleading information given was to be punished with a fine or by imprisonment.[51]

10. Disclosure to authorities and on-site examinations

The regulated entities had to periodically transmit their balance sheets and any other information required to the Inspectorate. The contents and the form of the balance sheets were decided by the Inspectorate, as was their means of publication. Furthermore, the minutes of the shareholders' meetings had to be submitted to the Inspectorate, together with any proposals, assessments or objections made by the auditors.

Periodic and unannounced on-site examinations were also undertaken by officials who could ask for any type of document or act deemed useful.

11. Disclosure to the public

[51] In 1962 the Bank of Italy created the *Centrale dei rischi bancari*, a centralized centre of risk monitoring, following the example of other countries, to better oversee the concession of lines of credit.

As well as disclosure to the authorities, some form of disclosure to the public was also required. In all forms of communication and publicity, in fact, the intermediaries had to list the capital and reserves held, according to the latest balance sheet.

12. Enforcement of the regulation

To enforce the regulation, the Inspectorate could turn to the Prime Minister, who could break up the Board of Directors in the case of serious irregularities or violations of the law. Situations of extreme urgency could lead to bank directors being replaced by an official of the Inspectorate, but for no more than 2 months. The liquidation procedures were also regulated. Finally, in the case of extreme irregularities or law violations, the bank authorization could be revoked.

Appendix 3: Institutions involved in crisis management and resolution in Italy

Prudential regulation is a tool used for crisis prevention, in order to make the financial system robust to crises. However, in the case of the actual occurrence of a financial crisis, crisis management and resolution becomes the relevant issue. In this appendix, we have recalled the *ad hoc* institutions that were founded in Italy in the period under analysis in order to resolve financial crises.

Consorzio per Sovvenzioni su Valori Industriali. Founded in 1914, it became active in 1915, just before Italy's entrance in the First World War. It was designed as a temporary institution in order to avoid fire sales of troubled industrial firms' assets. The Consorzio, in fact, extended credit to the industrial sector, accepting the firms' shares as collateral, an activity which was forbidden by law to the Bank of Italy. The Consorzio was financed by the banks of issue and the Bank of Italy guided its management. The Consorzio's "Special Section" was created in 1922 to guarantee a safety net for banks: it aided the liquidation of the Banca Italiana di Sconto and it was used to rescue the Banco di Roma.

Istituto di Liquidazioni. It was created in November 1926 to wind down the Special Section's undertakings, when the latter was closed down. In particular, it was to sell the previous institution's assets on the market, in order to deflate the economy, in view of the return to the gold standard. However, due to the outbreak of the new crisis starting in 1930, it was involved in new rescue operations. The Istituto was financed, in part, by the Bank of Italy, in part by the State and was guided by a committee nominated by the Ministry of Finance.

Istituto per la Ricostruzione Industriale (IRI). It was created with the legislative decree 23rd January 1933, n. 5, as a temporary institution to rescue the banks and firms by them controlled. It then became a State-owned holding company. In particular, it was made up of two sections: *Sezione smobilizzi*, which substituted the previous Istituto delle Liquidazioni, and *Sezione finanziamenti* for the financing of the industrial sector, with up to 20-year loans, since the universal banks had been abolished. The latter section was soon closed down and its functions were transferred to Istituto Mobiliare Italiano (IMI), an institution created in 1931, which made medium-term (maximum ten-year) loans to industrial firms, and financed itself by issuing securities, not being allowed to collect deposits. The *Sezione Smobilizzi* acquired all the industrial stakes in the universal banks' portfolio and the banks themselves. Its funding was not provided via the issuance

of money by the Bank of Italy, but it was financed by the market and by the State. In 1933 IRI controlled[52]:

- 100% of the iron and steel war industry, of the artillery industry and of the coal-extraction industry
- 90% of the naval industry
- 80% of naval companies and of the locomotive industry
- 40% of the iron and steel industry
- 30% of the electricity industry
- 20% of the rayon industry
- 13% of the cotton industry

It also controlled the mechanical and armaments' industries, telephone services and the three biggest banks. In all, IRI owned over 40% of the Italian shareholders' capital, hence resulting the greatest holding company of the country. In 1937, the institution became permanent.

[52] See Toniolo 1980: 250.

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