Fondo Interbancario di Tutela dei Depositi

Interbank Deposit Protection Fund

Annual Report 2000

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Current Outlook

In 1999, as in 1998, the Interbank Deposit Protection Fund (FITD or Fund) did not have to carry out any interventions. This enabled the Fund to orient its activities around longer-range projects focusing, first of all, on a careful evaluation of the way deposit insurance in Italy can best function in the light of a statutory reform, and, secondly, on elaborating systems capable of increasing the banks safety and soundness through better ways of measuring and of managing the risks inherent in banking itself.

As of December 31, 1999, the number of member banks stood at 306, compared to 312 member banks on December 31, 1998. During the year 11 banks joined the Fund. Of these, two are Italian branches of banks from countries outside the European Union. In line with Article 2, paragraph 3 of the Statutes, they were required to become members of the Fund because of the lack of an equivalent system of deposit insurance in their country of origin, as specified by the Bank of Italy in Article 96, third paragraph, of the Italian Banking Law. Over the same period 16 member banks merged and one member split off its banking activities.

On February 1, 1999 the Banca Popolare Andriese, which had been placed under *special administration,* returned to normal administration after a majority control of its shares was bought by the Credito Emiliano S.p.A. . On July 5, 1999, the Banca Popolare del Ticino S.c.r.l. was placed under *special administration* as a result of serious irregularities on the part of its management together with violations of banking regulations, leading to significant losses of assets. The bank is due to be merged into the Banca Popolare di Intra to solve this situation.

Reimbursable Funds of Member Banks

As of June 30, 1999, based on the figures supplied by member banks, the decline in Reimbursable Funds (henceforth RF) which began in June, 1997, ended and reversed itself. The funds protected by the FITD, in fact, amount to more than 562,000 billion lire (or more than 290 billion Euros), a figure superior to the one reported in December 1998, and roughly the same as that reported the previous June. The total of RF available to meet the 20,000 Euro limit, which under Article 27, paragraph 8 of the Statutes, is the community's minimum amount that must be reimbursed to depositors within three months of a bank's liquidation, is now slightly above 413,000 billion lire (or a little more than 213 billion Euros).

The gain in RF (1.6% compared to December, 1998) is due to the increase in the total liabilities of the banks (+3.6%) between December '98 and June '99) and, in particular, by that part of the funds consisting of deposits and certificates of deposit due to customers (which form part of the funds protected by the FITD).

Reimbursable Funds of member banks
(in billions of lire, and of Euros)

	The limits of reimbursement			
	Up to 200 milion		Up to 20,000 Euro	
	in Lire	in Euros	in Lire	In Euros
06-30-96	748,734	386,69	544,159	281,03
12-31-96	771,252	398,32	569,056	293,89
06-30-97	647,401	334,35	482,271	249,07
12-31-97	603,718	311,79	452,185	233,53
06-30-98	561,893	290,19	413,927	213,78
12-31-98	553,798	286,01	412,198	212,88
06-30-99	562,448	290,48	413,038	213,32

Source: FITD statutory reports

Bank Balance-sheet Profiles

The figures reported through June, 1999 revealed a slightly weaker picture compared to the two preceding semesters. The number of member banks that did not have in *Order* Balance-sheet Profiles, in fact, rose to 145, corresponding to 31% of the RF. In December and June 1998 the number of banks outside the in *Order* class were respectively 127 (corresponding to 27% of RF) and 121 (corresponding to 24% of RF).

In particular, there was a notable increase in the number of banks that fell into the statutory classes *Attention* (50 banks corresponding to about 12% of RF) and *Severe Imbalance* (17 banks corresponding to almost 5% of RF).

As of June 30, 1999, on the other hand, only one bank (with RF of 188 billion lire, or 97 million Euros) had fallen into the *Expulsion* class, compared to 4 banks in December and 2 banks in June, 1998.

The one bank in the *Expulsion* class, moreover, belongs to a banking group. The holding company in this group has presented valid assurances that restructuring measures will be taken to avoid action on the part of the Fund.

The distribution of banks per statutory classes as of June 30, 1999, reveals a significant increase in the number of banks considered "not normal" with respect to the profitability indicators (**D1** – Overhead Costs / Net Operating Income, and **D2** – Loan losses, net of recovery / Net Operating Profit). This situation, however, is the result of short-term factors (in particular the unrealized capital loss on securities held by many banks), and should not therefore be regarded as a cause for concern.

Distribution of Banks according to statutory classes

	06-30-98		12-31-98		06-30-99	
	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF
Order	182	75.69	176	72.72	158	68.66
Attention	37	2.45	35	4.13	50	11.72
Watch	37	14.15	39	14.76	36	11.47
Penalty	38	7.31	41	4.94	41	3.16
Severe Imbalance	7	0.26	8	3.32	17	4.95
Expulsion	2	0.14	4	0.12	1	0.03
Total Banks	303	100	303	100	303	100

Source: FITD statutory reports

The average weighted values of the indicators of Financial Statement continue to show an improvement as of June 30, 1999. In particular, further progress emerged in the risk profile (**A1** – Total Net Doubtful Loans / Shareholders' Equity, and **A2** – Net Doubtful Loans vs. customers / Net Outstanding Loans vs. customers), while the solvency indicators remain firmly above the "minimum" statutory thresholds (**B1** – Capital for supervisory purposes / Supervisory capital requirements and **B2** – Shareholders' equity / Funds due to customers).

The indicators of profitability, instead, revealed an interruption of the positive trend that had appeared in June '98.

The overall picture that emerges from these indicators of bank balance-sheet profiles is that of a fundamentally solid banking system, which continues to strive for greater efficiency but which still has to work at becoming more profitable.

Weighted average values of Balance-sheet indicators

	06-30-98	12-31-98	06-30-99
A1 Tot. Net Doubtful Loans / Shareholders' equity	29.05	27.81	25.67
A2 Net Doubtful Loans vs. customers / Net Outstanding Loans vs. customers	4.74	4.55	4.27
B1 Capital for supervisory purposes / Supervisory capital requirements	181.08	182.04	179. 62
B2 Shareholders' equity / Funds due to customers	15.15	16.08	16.09
C Maturity transformation rules	N.C	N.C.	N.C.
D1 Overhead Costs / Net Operating Income	58.39	62.18	62.18
D2 Loan losses, net of recovery / Net Operating Profit	26.41	34.12	27.72

Source: FITD statutory reports

Analysis of Individual Profiles

Risk Profile

The average weighted values of the two indicators of Risk Profile, as of June 30, 1999, maintained the positive trend that had started in June 1998.

The **A1** indicator (Total Net Doubtful Loans / Shareholders' equity), signalled a reduction of more than 11 percentage points compared to a high reached in December 1996 (25.67% in June 1999, sharply down from the 37.17% registered in December 1996). The decline was also significant compared to the levels reported in June and December 1998, when the indicator revealed percentages of 29.05% and 27.81% respectively. A considerable reduction in Net Doubtful Loans (-2.56% compared to December '98) contributed to this positive result, as well as a continuing improvement in the capital structure of the banks (+5.48% compared to the same period). Confirming the improvement in the value of this indicator, the number of banks that were below the "normal level" declined (55 banks, equal to 18.1% of the total, compared to 58 banks in December '98), as did the corresponding percentage of RF (20% compared to 22.7% in December '98). The reports, instead, showed an increase both in the number (19) and in the percentage of RF (5.05%) of banks with a value in this indicator above 100% (category of *Violation*).

"A1" Indicator

Total Net Doubtful Loans / Shareholders' equity

	Normal ≤ 40 %		**Attention ≤ 60 %**		**Warning ≤ 100%**		**Violation > 100%**	
	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF
06-30-98	248	77.20	21	5.12	22	14.09	13	3.60
12-31-98	245	77.27	21	6.25	20	12.69	18	3.79
06-30-99	248	79.98	20	8.60	16	6.37	9	5.05

Source: FITD statutory reports

The **A2** indicator (Net Doubtful Loans vis-à-vis Customers / Net Outstanding Loans vis-à-vis Customers) also registered an improvement even though it was a more modest one. This indicator, in fact, declined from 4.55% in December '98 to 4.27% in June '99. Another positive signal was the significant increase in the number of banks, and in the corresponding percentage of RF, where the value of the indicator was below 6% (*Normal* category). A further positive result was the shift of a significant percentage of RF from the category of *Warning* (up to 12%) to that of *Attention* (up to 8%).

“A2” Indicator

Net Doubtful Loans vs. Customers / Net Outstanding Loans vs Customers

	Normal ≤ 6 %		**Attention ≤ 8 %**		**Warning ≤ 12%**		**Violation > 12%**	
	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF
06-30-1998	216	77.19	27	8.27	25	9.28	36	5.25
12-31-1998	222	78.41	19	8.02	29	8.87	34	4.70
06-30-1999	228	78.75	23	11.92	22	4.87	30	4.47

Source: FITD statutory reports

Solvency profile

The average weighted values of the two solvency indicators, **B1** (Capital for supervisory purposes / Supervisory capital requirements) and **B2** (Shareholders’ equity / Funds due to customers), remained substantially stable as of June 30, 1999, compared to the values reported in the two preceding semesters.

That level, moreover, is well above the statutory thresholds of *Normal* (superior to 120% for the **B1** and superior to 10% for the **B2**), and indicates that the Italian banking system has achieved a high level of stability.

To confirm this positive valuation, the distribution in statutory classes of the **B1** indicator**,** as of June 30, 1999, reveals that a very high number of banks (274), and a correspondingly high percentage of RF, are within the *Normal* category. This is due, above all, to the fact that the **B1** indicator represents an obligation to maintain a prudential level of capital. The Bank of Italy can apply sanctions against a bank that does not maintain that level.

“B1” Indicator

Capital for supervisory purposes / Supervisory capital requirements

	Normal > 120 %		**Attention ≤ 120 %**		**Warning ≤ 100%**		**Violation ≤ 80%**	
	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF
06-30-1998	280	88.18	18	10.08	4	1.59	2	0.15
12-31-1998	276	93.17	21	5.30	3	1.41	4	0.12
06-30-1999	273	92.76	23	5.74	6	1.46	1	0.03

Source: FITD statutory reports

Despite the large number of banks that can be found in the *Normal* class, and the corresponding percentage of RF, the distribution of the **B2** indicator by statutory classes was slightly less satisfactory as of June 30, 1999 compared to the two earlier semesters. In particular, there was a significant rise in the number of Fund members considered in the *Attention* class, with a corresponding rise in RF. From the moment that several of these banks can be found in the *Normal* category with respect to the other indicators, some perplexing questions arose as to the significance of this indicator (the question is treated in greater detail in another part of the Report).

“B2” Indicator

Shareholders’ equity / Funds due to customers

	Normal* > 10%		**Attention* ≤ 10 %**		**Warning* ≤ 8%**		**Violation* ≤ 6%**	
	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF
06-30-1998	271	84.11	21	7.43	11	8.34	1	0.12
12-31-1998	272	87.22	18	4.78	8	7.72	6	0.29
06-30-1999	264	82.25	27	10.08	7	7.05	5	0.62

*Current thresholds. Up to the reports filed on 06-30-97, the thresholds of *Attention* and *Warning* were respectively equal to **≤ 12 %** e **≤ 10 %.**

Source: FITD statutory reports

Maturity transformation profile

The maturity transformation profile consists of three rules that set up an aggregate comparison between the bank’s assets and liabilities within a structure that has an analogous maturity, thereby showing the alignment (or lack of alignment) within the structure. In particular, the function of this indicator is to measure the eventual liquidity risk that a bank can face when it finances a medium-long term asset with a short-term liability.

The distribution by statutory classes of the **C** indicator, after a slight deterioration in the June, 1998 reports, once again evidenced a great majority of banks (291), and a similarly high percentage of RF (92.23%), conforming to the three rules that cover the maturity transformation dates.

Nevertheless, 10 banks were found to be in the *Attention* class (with an RF equal to 7.43%), and 2 banks were in the *Warning* class (with an RF of 0.34%), while none was in *Violation*.

Banks are strongly motivated to respect this indicator, as is the case with **B1**, since this is one of the Bank of Italy’s supervisory indicators.

"C" Indicator

With respect to supervisory maturity transformation rules

	Normal *3 rules respected*		**Attention** *1 rule not respected*		**Warning** *2 rules not respected*		**Violation** *3 rules not respected*	
	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF
06-30-1998	284	88.54	16	11.42	4	0.03	0	0.00
12-31-1998	288	91.83	10	8.17	5	0.00	1	0.00
06-30-1999	291	92.23	10	7.43	2	0.34	0	0.00

Source: FITD statutory reports

Profitability Profile (values 1° semester 1999)

As noted in last year's Annual Report, after the statutory modification adopted in March, 1998 (which went into effect relative to the reports of December 31, 1997) regarding the reporting deadlines, the profitability indicators came into alignment with those of the Asset and Liability Statement (whereas previously there had been a six-month gap between them).

Following the strong improvement in this indicator in the reports of June 30, 1998, a year later the Profitability Profile evidenced a marked regression.

The average weighted value of the **D1** indicator (Overhead costs / Net Operating Income) rose to 62.18% compared to 58.39% in June, 1998. That level, nevertheless, is decisively inferior to the levels that were reported between June, 1996 and December, 1997 (as shown by the past figures for this indicator which are printed in the Appendix).

The increase in the average value of this indicator was caused by higher costs (+2.79%) brought about by the modernization of the banks' IT systems in view of the much-heralded Y2K problem, and by a reduction in Net Operating Income (-3.48%), due mostly to the unrealized capital loss on securities held by various members. This is a temporary situation, therefore, and one that should not cause concern.

Together with the deterioration of the average weighted value of the indicator, there was a corresponding increase in the number of banks considered "not normal" in terms of the fixed statutory thresholds (149 banks with a percentage of RF of about 29%). In particular, there was a sharp rise in the number of banks, and the percentage of RF, that fell into the categories of *Warning* and of *Violation*.

"D1" Indicator

Overhead costs / Net Operating Income

	Normal ≤ 70 %		**Attention ≤ 75 %**		**Warning ≤ 85%**		**Violation > 85%**	
	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF
06-30-1998	217	86.51	22	4.04	35	8.75	30	0.69
12-31-1998	187	76.45	48	10.10	39	12.78	30	0.67
06-30-1999	154	71.05	35	8.27	62	15.62	52	5.06

Source: FITD statutory reports

The average weighted value of the **D2** indicator (Loan losses, net of recovery / Net Operating Profit) as of June 30, 1999, remained substantially stable compared to June, 1998, while it fell compared to December, 1998.

This result reflects an improvement in the banks' asset quality. An accompanying reduction in the amount of non-performing loans meant that the volume of loan losses fell by 7.84% compared to June of the previous year. Nevertheless, there was a sizable reduction of 12.21% in the banks' Net Operating Profit between June, 1998, and June, 1999.

The distribution by statutory classes of this indicator as of June 30, 1999, shows an increase in the number of banks considered "not normal" in terms of the statutory thresholds, and in the corresponding percentage of RF. This is due in good part to the already-noted deterioration in the distribution by statutory classes of the **D1** indicator. In fact, as is well known, the denominator of the **D2** indicator (Net Operating Profit) is equal to the difference between the denominator (Net Operating Income) and the numerator (Overhead costs) in **D1**. As a consequence it is very likely that a bank with a low Net Operating Profit and a similar ratio of loan losses will slide out of the *Normal* category for this indicator. It should be noted, in fact, that for the method of determining the statutory class in the **D2**, banks with a negative Net Operating Income are automatically placed in the *Violation* class, independently of the level of loan losses.

"D2" Indicator

Loan losses, net of recovery / Net Operating Profit

	Normal ≤ 50 %		**Attention ≤ 60 %**		**Warning ≤ 80%**		**Violation > 80%**	
	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF	Number of Banks	% RF
06-30-1998	242	93.46	8	0.70	16	4.82	38	1.02
12-31-1998	226	84.61	15	5.79	12	3.86	51	5.74
06-30-1999	228	81.45	17	8.83	7	2.17	51	7.56

Source: FITD statutory reports

Banking Groups

During 1999 the officials of the Fund continued their analysis of the effect banking groups are having on risk and other aspects of financial stability, so as to introduce appropriate new measures into the statutory mechanisms of the FITD.

The first step was to determine how many banking groups have been established in Italy.

As of June 30, 1999, the Bank of Italy's register listed 84 groups. Of these, 76 represent banks that are members of the Fund, while the others belong to the world of cooperative banks (also known as credit unions in the U.S.).

Among the FITD's member banks, 203 are part of a group and represent over 65% of the total membership. Even more striking is their percentage of RF which stands at 94%.

Clearly, the phenomenon of banking groups has reached such dimensions that the Fund must take it into account.

The attention of the analysts then turned to a key question: which of the Fund's operational mechanisms were likely to be affected significantly by this phenomenon?

The following aspects were examined in great detail:

1. The responsibility of the holding company for the liabilities of its members;
2. measuring the level of risk of individual banks that are part of a group;
3. the quota of contributions that such banks pay to the Fund for operating expenses and as part of the reserves the Fund earmarks for eventual interventions.

In terms of the first aspect, the Fund's analysts first examined the existing laws and regulations (common law and special legislation) defining the powers and responsibilities of the holding company towards the other financial institutions forming part of the group. The aim was to identify the holding company's precise legal and corporate responsibilities if a bank that it controls should find itself bankrupt. An analysis of the prevalent laws and their application in this area lead to the conclusion that, in the light of the principle of the juridical and financial autonomy of the individual banks within a group, the holding company does <u>not</u> have this sort of responsibility, except in the limited case of a pathological situation caused by illicit actions on the part of the holding company towards the banks that it controls.

Nevertheless, a careful examination of the regulatory norms set forth in the Italian Banking Law and their relative operational applications (in the Bank of Italy's Supervisory Norms) reveals that the holding company has an "obligation" to exert leadership and control over the banks in its group, particularly in relation to the capital adequacy of the individual banks that are part of the group, the lack of which could trigger disciplinary sanctions by the Bank of Italy.

This being the case, one can interpret such an "obligation" on the part of the holding company to exert leadership and control also in terms of how the individual banks in the group appear when they are positioned according to the FITD's indicators of balance-sheet profiles. Thus, the analysis carried out by the FITD came to the conclusion that a letter assuming a "strong" degree of *patronage* would be the most effective instrument through which the holding company would commit itself to correcting any lack of equilibrium on the part of the individual banks in its group whenever this is manifested through the Fund's indicators of balance-sheet profiles.

As is well known, the Fund evaluates a bank's exposure to risk through a mechanism of seven indicators referred to four balance-sheet profiles.

Each bank's exposure to risk is measured individually. And yet, given the fact that banks increasingly follow a group logic in their operations, it is now quite possible that the resulting picture of a bank's riskiness may be distorted if the group as a whole is not taken into account. It could well be, in fact, that the group represents a *source of strength* for the individual banks that belong to it. The larger dimensions of the holding company's business (which is presumably also more diversified) could enable it to more easily absorb any losses incurred by some of the banks in its group.

On the other hand, however, from the moment that the entire group was made responsible for the losses suffered by one component, the result could be *systemic instability* rather than strength.

Even a few considerations like these make it clear that it is necessary to integrate the traditional emphasis on individual banks with a new emphasis on banking groups.

For this purpose the Fund's analysts elaborated a model using, on the one hand, the reports submitted by individual member banks on December 31, 1998, and, on the other, constructing a consolidated balance-sheet profile using the reports submitted in that same semester by 57 of the 80 groups containing banks that are members of the Fund.

An examination of the data at the level of individual banks reveals, in the first place, a greater riskiness (measured as the percentage of RF of the banks that fall into the statutory classes *Order* and *Attention*, conventionally termed *Low risk*) for banks belonging to a group compared to those that are not part of a group.

Distribution by statutory classes of the banks belonging to groups and those that do NOT belong to groups
On the basis of a comprehensive analysis of balance-sheet profiles
As of 12/31/98

	Banks belonging to Groups		**Banks that do NOT belong to Groups**	
	Number	% RF	Number	% RF
Order	118	73.4	58	62.12
Attention	19	3.2	16	19.91
Watch	25	15.24	13	7.22
Penalty	27	4.62	14	10.02
Severe Imbalance	7	3.49	1	0.74
Expulsion	4	0.13	0	0
Total	200	100	102	100

Source: FITD statutory reports

Nevertheless, the analysis of the balance-sheet profiles in their consolidated form (again referring to the 57 banking groups out of 80 that represent FITD member banks as of 12/31/1998), reveals a riskiness at the group level that is significantly lower than that of the banks which belong to groups when they are considered individually. In fact, the percentage of RF of the Groups in the *Low risk* classes (*Order + Attention*) is equal to about 80%, while that of the individual banks that are part of those groups is equal to 76%.

This would seem to support the thesis that the group represents a source of stability for the individual banks belonging to it, further reinforcing the hypothesis that it is necessary to proceed to a statutory integration between the analysis of the individual bank's profile with that of the group.

Distribution by statutory classes of Banking groups and of the individual banks belonging to groups
On the basis of a comprehensive analysis of balance-sheet profiles
As of 12/31/98

	Banking groups		**Banks belonging to Groups**	
	Number	% RF	Number	% RF
Normal	39	74.39	101	73.33
Attention	6	5.58	16	2.79
Watch	6	13.78	21	15.33
Penalty	3	2.67	25	4.8
Severe Imbalance	3	3.57	6	3.62
Expulsion	0	0	4	0.14
Total	57	100	173	100

Source: The elaboration of data from Bilbank and FITD statutory reports.

In order to integrate the analysis of individual banks with that of banking groups, an Aggregate Indicator was developed (known by its Italian acronym as ISA) utilizing the average weighted value of the Aggregate Indicator of individual banks together with those of banking groups (as stated in their consolidated balance-sheets), with the weight represented by the percentage of operations carried out by the individual bank vis-à-vis the total operations carried out by the group.

This index was used in two ways: to determine the statutory position of the individual banks, and in order to adjust the quotas of their contribution for interventions and to cover the Fund's operating expenses (the third aspect considered in this analysis of banking groups).

Its effect was to establish a minor level of overall risk (compared to what the individual bank's positioning had been), thereby reducing the number of banks subject to an additional levy on top of their normal quota of contribution to the Fund. Another discovery emerging from the analysis of the balance-sheet profiles of groups side by side with that of individual banks was an increase in the number of banks that bettered their quota of contribution (that is, they were able to contribute less). The analysis also revealed, finally, that no bank which did NOT belong to a group suffered an increase in its own quota of contribution to the Fund, a result, moreover, which is consistent with the statistical picture that emerged of the lower level of risk that these banks enjoy compared to banks that are part of a group.

It should be stressed, however, that this analysis was conducted applying the Fund's current Statutes to the new reality of banking groups. This means, for example, that in calculating the statutory classes the thresholds used were those currently stipulated in the Appendix to the Statutes. Moreover, the elaboration was done using the most recent data available, which goes back to December 31, 1998, and reflect the reality of banking groups only up to that date.

For this reason, and in order to obtain results that will be more significant and allow the introduction of modifications in the Fund's Statutes on the basis of a more complete picture of the reality of these groups, it was decided to continue studying banking groups for a sufficient period to be able to arrive at well-founded operational decisions.

Monitoring the system of balance sheet indicators (B2 Indicator)

Ever since the FITD's "new" system of indicators of balance-sheet profiles were introduced during the statutory reform adopted in December, 1996, these have been carefully monitored by the Fund's offices in order to evaluate their significance in measuring the risk levels of member banks.

Carrying out a mandate from the FITD Board dated July 14, 1999, therefore, Fund officials conducted a study of the "B2" indicator (Shareholders' equity + subordinated debts / Funds due to customers) in the Solvency Profile.

This study produced:

1. a description of the indicator;
2. an examination of its behavior and its distribution in relation to several relevant variables;
3. a number of simulations carried out to measure the effect of eventual modifications to the structure of the indicator on the distribution by classes and by statutory positions.

Looking at the first point, the FITD's analysts pointed out that the "B2" indicator, which should express the degree of protection that the assets of the bank offer to its creditors, has, for some time now, been substituted in the area of prudential supervision by indicators that compare the bank's capital to the level of risk inherent in its profitability, such as, for example, the "B1" indicator (Capital for supervisory purposes / Supervisory capital requirements, also referred to as the solvency ratio), with which it also shares a high degree of correlation (equal to 0.88 as of June 30, 1999).

The argument for keeping "B2" in the system of indicators of the Fund's balance-sheet profiles is that a high degree of *leverage* could be indicative of a notably risky strategy that would not be exposed by the solvency ratio. In other words, the justification for an indicator of financial leverage could lie in its capacity to anticipate an eventual deterioration of the bank's assets.

Because of the high degree of capitalization by Italian banks, the examination of the behavior of this indicator revealed a growing tendency for this very relationship to exist. The analysts also found that "B2" is not one of the indexes that contribute more than other indexes do in bringing to light problematic situations in the Fund's member banks, even, in several cases (though in fact they are quite rare), penalizing banks that are classed as "Normal" in the other indicators of balance-sheet profiles.

With their simulations (point 3), the analysts attempted to evaluate the effect of several modifications in the structure of the indicator on the distribution by classes in the “B2” and on the overall positioning of banks by statutory classes.

In particular, the following modifications were considered:

- a reduction of one percentage point in the indicator’s statutory thresholds for banks that belong to a group, conforming with what occurs at the level of prudential supervision with the coefficient of the individual bank’s solvency (indicator “B1”);
- the elimination of the Reverse REPOs from the denominator of the indicator (Funds due to customers);
- elimination of the indicator from the Fund’s system of indicators of bank balance-sheet profiles.

In synthesis, these simulations resulted in an improvement in the distribution of the banks by statutory classes in the “B2” and in their overall statutory positioning. On the whole, however, these “adjustments,” even though quite significant, were not of such an order that they rendered the system of indicators of bank balance-sheet profiles excessively “lax”, while they did correct several situations that for some banks could be penalizing.

As a result the analysts proposed that the work of monitoring the system of bank balance-sheet profiles should continue.

Moreover, to correct a possible distortion in the measurement of risk in the case of banks that have undergone a transformation in their ownership structure (such as a merger or an incorporation), the Fund’s officials proposed that article 5 of the Appendix to the Statutes be modified with the addition of the following paragraph:

paragraph 6. – *Modifying what was specified in paragraph 2, banks that were affected by a merger or any other change in ownership can be exempt from applying the thresholds of Warning and Violation in the B2 indicator for a maximum of two years from the date of the transformation. In these cases a coefficient equal to one will be used in determining the aggregate indicator. The exemption will only be granted when the member bank, or the holding company of the group to which the bank in question belongs, presents evidence justifying its application.*

Due to the statutory modification specified above, the Fund’s officials also proposed the following modification to article 14 concerning the FITD Board’s functions:

paragraph 1, letter k). - *....with the modification regarding article 5, paragraph 6, of the Appendix to the Statutes*.

Reimbursable Funds of the branches of Italian banks in non-EU countries

As specified in article 3 paragraph 2 of the Statutes, the Fund can insure depositors at the branches of Italian banks in non-EU countries that have a guarantee system, wherever that system does not cover the branches in question.

No indication, instead, has been provided for depositors at branches of Italian banks located in non-EU countries that do not have a guarantee system.

Legislative Decree n° 659/96, introducing article 96-bis paragraph two in the Italian Banking Law, has specified that guarantee systems *"…can also extend their coverage to the depositors at the branches of Italian banks in non-EU countries…"*.

Taking into account this more ample and generic legislative formulation in the Decree, as well as the current absence of such language in the Statutes, the Fund's officers felt it was opportune to draw up a normative measure in that respect.

Therefore, the Fund's Board decided to propose extending to the branches of member banks in the above-mentioned non-EU countries the Fund's guarantee.

The Board proposed the following modification to article 3 paragraph 2 of the Statutes:

paragraph 2. – *The Fund can also insure depositors of Italian member banks that have branches situated in countries outside the European Union, if such countries have deposit insurance schemes that do not cover those branches,* ***or if they do not have a scheme at all****. In either case, the guarantee offered by the Fund will match the level of coverage in those countries where a deposit insurance scheme exists, and will in any case not exceed the limit set forth in these Statutes*

Due to the statutory modification noted just above, the Board also proposed the following modification to article 14 concerning its functions:

paragraph 1, letter c). - *....on the extension of the guarantee to depositors at the branches of Italian banks located in countries outside the EU.*

Working group on credit risk

In December, 1998, the Interbank Deposit Protection Fund established a Working Group on Credit Risk. Its objective has been to promote the study of the role and the management of credit risk within the Italian banking system.

In the course of the five meetings that have been held, the 50 or so participants, comprising representatives of the seven biggest Italian banks, the universities, the Bank of Italy (as observers) and the Italian Banking Association (ABI), have discussed the role of internal systems of credit ratings (such as the process of determining the credit worthiness of borrowers), and the models of credit risk (such as the process of determining the economic capital connected to the loan portfolio), their output and relative applications, and the supervisory implications relative to credit risk in general.

The group's work has stimulated the interest of everyone involved, and in particular it has:

- **offered** the banks an opportunity to exchange opinions, methodologies, and results based on their own experiences of doing business;
- **contributed** to clarifying several common needs of the banks participating in these meetings in terms of the availability of data and of information to be found in the official data bases (e.g. the *Centrale dei Rischi*);
- **promoted** the transparency and the sharing of information relative to the systems, models, and alternative methodologies for measuring and managing credit risk, through the organization of a conference held at the Luigi Bocconi University of Milan on December 14, 1999, where the working group announced its results which will also be available in the volume "La Gestione del Rischio di Credito nelle Grandi Banche Italiane" (The Management of Credit Risk in the Great Italian Banks) to be published shortly by Bancaria Editrice.

In the wake of the results achieved by the Working Group on Credit Risk, on December 15, 1999 the Fund's Board approved the creation of a Permanent Observatory on the Banking Risks Management that will dedicate itself to a further and more detailed analysis of the themes associated with the management of banking risks (those of the market, of credit, and the operational ones). The Observatory will organize periodic meetings (probably every three months) that will bring together representatives of the Italian academic and banking world and international representatives, very much along the lines of the preceding encounters organized by the Working Group on Credit Risk.

The Observatory intends to furnish, principally, three products: a) to communicate initiatives at the scientific level to all of the Fund's member banks and to the financial community in general; b) to bring about exchanges of opinions and experiences between executives of the banking community, scholars and qualified observers; c) to make techniques available to medium and small Italian banks by preparing a manual by the end of the year 2000 (accompanied by a floppy disk with numerical examples that can be repeated in some form by the banks using it) for the creation of a simplified internal system for managing credit risk.

Reform of the deposit insurance system

Since 1997, following certain events that occurred that year, a process has been underway of re-thinking the Fund's own methods in what it does.

This process continued during 1999 as well.

In particular, the Fund's officers continued to examine and discuss – in the institutional venues that had been proposed for this purpose (the Italian Banking Association and the Bank of Italy) – those aspects of its activities that seemed most useful to study in depth, in order to eventually agree on their revision, and these are:

- the level and the extension of protection;
- the system of levying resources for interventions;
- the fiscal deductibility of the eventual reserves accumulated by banks to be able to cover the risk of an intervention on the part of the Fund;
- the mechanisms for measuring and controlling risk and the powers for carrying out a preventive intervention.

An examination also continued of the situation of deposit insurance in other countries, so as to be able to evaluate the differences between those systems and the Italian one (and on this point the reader should please see the sections of this Annual Report dealing with the Working Group on Deposit Insurance and the schemes of guarantee existing in the EU, as well as the summarized table found in the Appendix).

FITD officials are working, in collaboration with those of the Italian Banking Association, on a more detailed analysis of the questions listed above with the aim of finalizing a proposal for a project of reform.

Working-group on deposit insurance and guarantee systems in the European Union

As already noted in last year's Annual Report, in the wake of the international conference on deposit insurance held in September, 1998, the system of deposit insurance in the United States, the *Federal Deposit Insurance Corporation* (FDIC), promoted the establishment of an informal working group at the international level with the aim of making an in-depth study of the problems related to deposit insurance and of increasing the cooperation and the exchange of information between the individual systems of deposit insurance.

To this end three executives of the FDIC flew to Rome in November, 1999 for meetings in the Fund's offices in order to discuss the ways in which such a working group could be established. In this context, and also in the light of the wide-ranging experience already acquired in the field of deposit insurance, the proposal was made that the Fund should undertake a role of coordinating the activities of the working group with regard to Europe.

The meetings with the executives from the FDIC also represented a chance to review the state of deposit insurance in Europe. Making further progress in this direction, the Fund organized a two-day Workshop attended by representatives from six European guarantee systems (Austria, Denmark, Greece, Portugal, Spain, and Sweden). The Workshop clearly brought out the differences that still exist between the model of deposit insurance used in the United States and the European ones, as well as the differences between individual guarantee systems within the European Union.

In the light of these discussions, there was a consensus that a primary objective should be to develop a more intense level of cooperation and exchange of information between the individual guarantee systems.

Towards this end, the Fund's Board in its meeting on December 15, 1999, decided that the FITD could best contribute in these specific ways:

- by intensifying its relationships with the guarantee systems in the European Union;
- by collaborating with the FDIC;
- by participating in the international working group promoted by the FDIC and by the Canadian deposit insurance system (CDIC).

Activities carried out by the Fund's offices

As already noted, the fact that during 1999 no intervention was necessary meant that the activities of the Fund's offices could be oriented towards longer-range projects.

Beyond those that have already been described in other sections of the Annual Report (the working group on credit risk, reform of deposit insurance, analysis of banking groups, the monitoring of the system of the indicators of balance-sheet profiles, and the working group on deposit insurance), other initiatives were undertaken as well.

In particular, work was completed on the creation of a new software (named INDI2000) for the reports that the member banks are required to send to the FITD.

In this same context, with the reports of December 31, 1999 (with a reporting deadline of April 30, 2000), a new method will go into effect for relaying the statutory reports utilizing the National Interbank Network, a project that was interrupted by technical problems.

Another facilitated reporting method is in the late stages of development, and that is the use of the Bank of Italy's Data Dictionary (*Dizionario Dati*) to transmit the aggregates of the statutory reports to the Fund. This will further simplify the production of the flow of data that the member banks are required to send periodically to the FITD.

The Fund's technical staff is also studying, in collaboration with the Supervisory authority, a project that would allow member banks to send their statutory reports through the Bank of Italy. The plan is to use the June, 2000 reports to test this project, which would relieve the Fund's member banks of the work needed to produce a separate set of statutory reports for the FITD, at the same time improving the quality of the data being transmitted.

In December, 1999, the Fund published the first three issues of a series of "Working Papers." The aim of these publications is to actively take part in the spread of knowledge on the techniques of measuring and managing banking and financial risks, deposit insurance and banking crises, aspects of the regulation of banking activities, and other subjects of widespread interest within the field.

Along these same lines, the Fund organized two seminars: the first of these study groups was dedicated to understanding the modifications of the French scheme of deposit insurance that were introduced with law 99-532, while the other seminar focused on recent banking and financial crises at the international level.

Past Interventions

Banco di Tricesimo

There were no significant developments during 1999 affecting the Fund's intervention on behalf of the Banco di Tricesimo, which is in compulsory administration.

The hypothesis that the entire procedure be closed out is being evaluated, in accord with the Supervisory Agency and the bank's "liquidation."

Cassa di Risparmio di Prato

Throughout 1999 the Fund continued to be directly interested in the legal proceedings regarding this bank. Because of the ongoing judicial controversy, and on the basis of an agreement with the Monte dei Paschi di Siena, it has been impossible to reach a final settlement. This controversy carries a risk for the Fund which remains unchanged from the last Annual Report and which is estimated to be on the order of 30 billion lire pending a law suit which is still being appealed in court.

Appendix

The following appendix contains tables and graphs that support the contents of the Annual Report.

These illustrate:

- time series of average weighted values for balance-sheet indicators. They allow the reader to visualize the banking system's behavior from June, 1996 to June, 1999;

- Frequency distributions as of June 30, 1999 of the **A1, A2, B1, B2, D1** and **D2** balance-sheet indicators, and the **Aggregate Indicator**;

- A synoptic table comparing the main features of National Deposit Insurance Schemes.

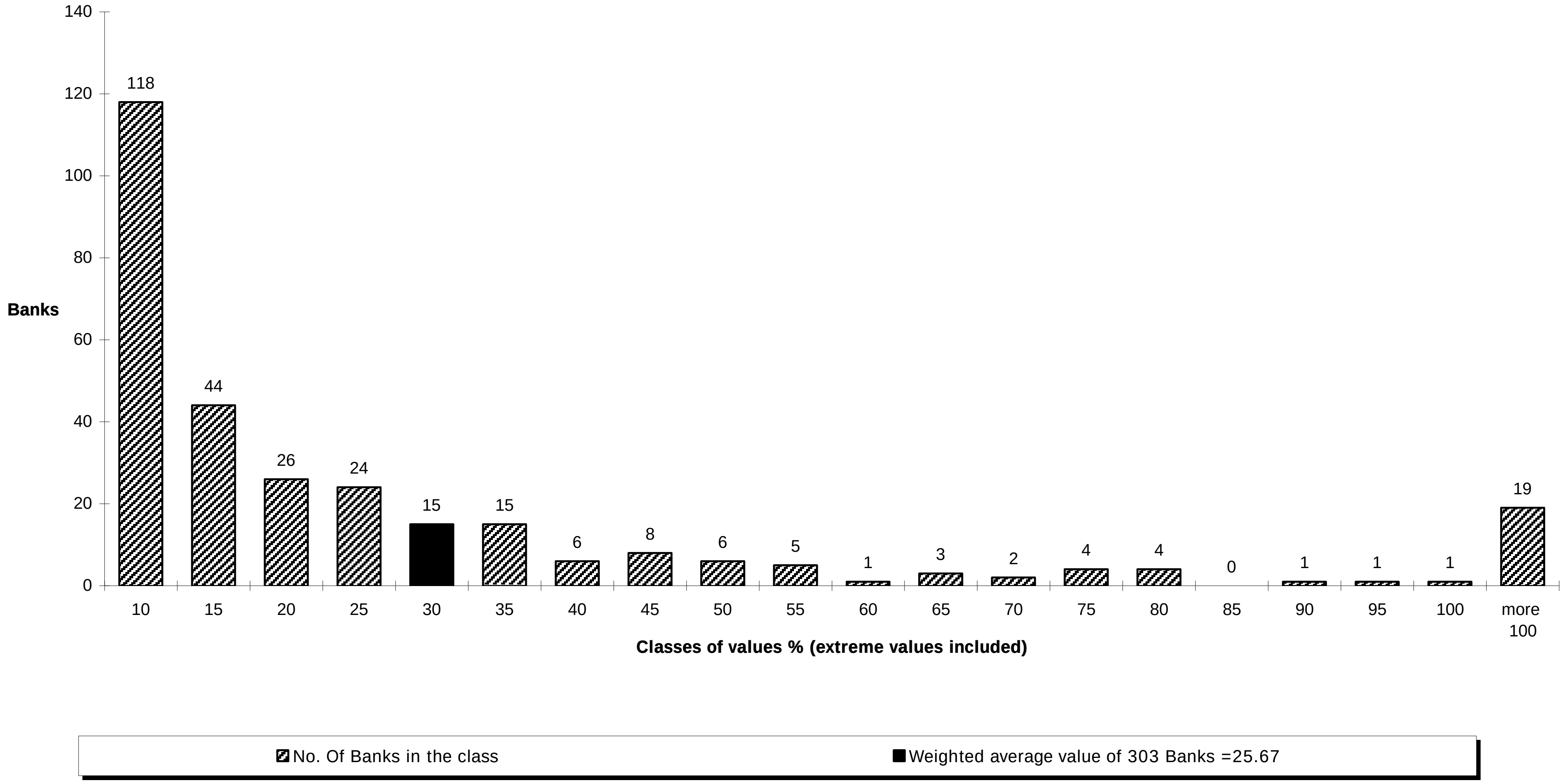
Time Series of Balance-sheet indicators

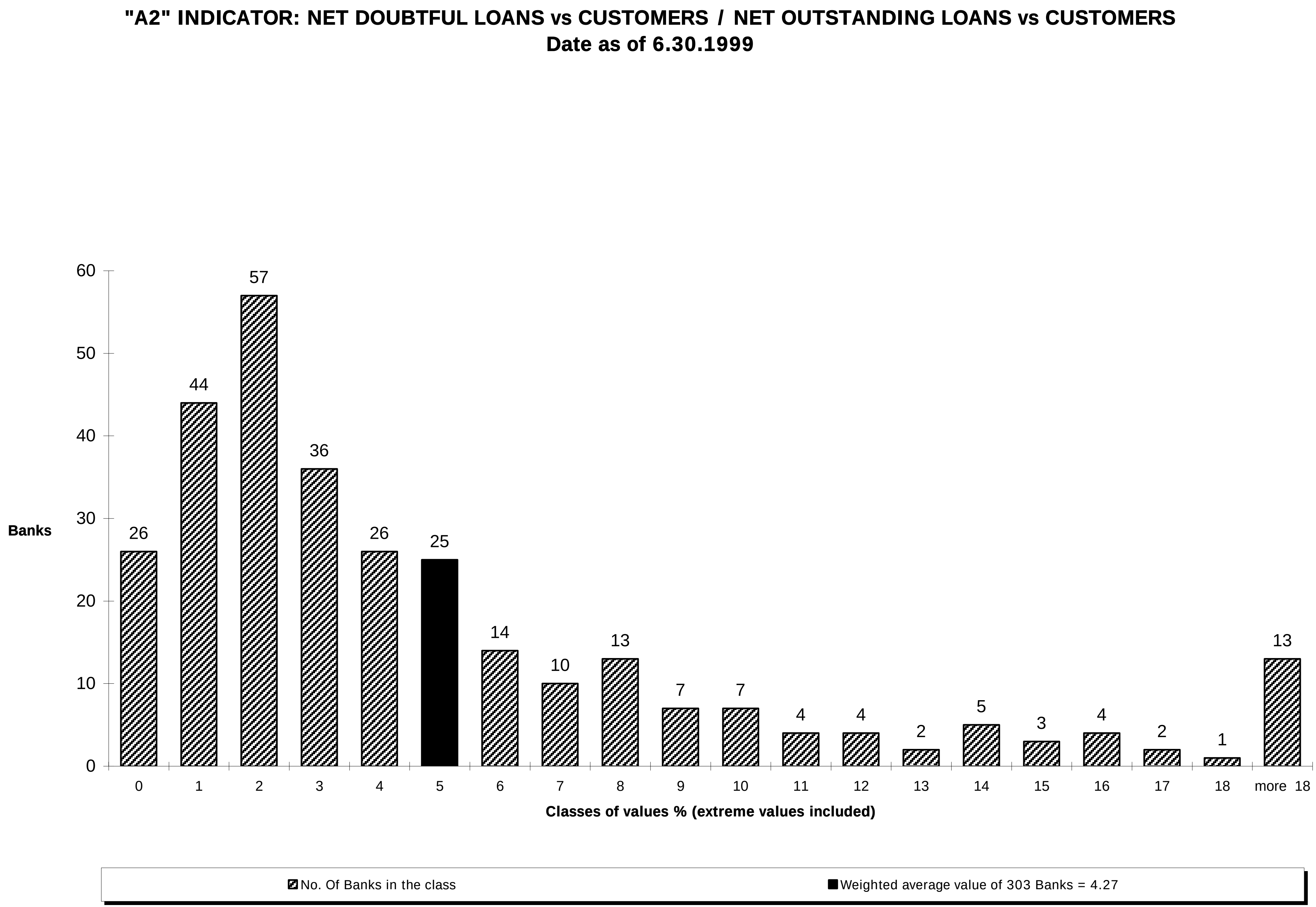
Date	*A1*	*A2*	*B1*	*B2*	*C*	*D1*	*D2*	*Aggregate Indicator*	*Statutory Class*	*Reimbursable Funds (billion lira)*
06/30/96	34,65 Normal	5,44 Normal	169,40 Normal	14,07 Normal	N.C. Normal	67,12 Normal	46,31 Normal	0	N.C.	748.734
12/31/96	37,17 Normal	5,73 Normal	174,48 Normal	13,44 Normal	N.C. Normal	65,45 Normal	35,52 Normal	0	N.C.	771.252
06/30/97	32,71 Normal	5,06 Normal	174,41 Normal	13,54 Normal	N.C. Normal	66,84 Normal	34,66 Normal	0	N.C.	647.401
12/31/97	32,17 Normal	4,83 Normal	169,57 Normal	13,83 Normal	N.C. Normal	66,53 Normal	43,86 Normal	0	N.C.	603.718
06/30/98	29,05 Normal	4,74 Normal	181,08 Normal	15,15 Normal	N.C. Normal	58,39 Normal	26,41 Normal	0	N.C.	561.893
12/31/98	27,81 Normal	4,55 Normal	182,04 Normal	16,08 Normal	N.C. Normal	62,18 Normal	34,12 Normal	0	N.C.	553.798
06/30/99	25,67 Normal	4,27 Normal	179,62 Normal	16,09 Normal	N.C. Normal	62,18 Normal	27,72 Normal	0	N.C.	562.448

Legend: Indicators and Thresholds	*Normal*	*Attention*	*Warning*	*Violation*
A1 Total net doubtful Loans / Shareholders' equity	≤ 40%	≤ 60%	≤ 100%	> 100%
A2 Net doubtful Loans vs cust. / Net outstanding Loans vs cust	≤ 6%	≤ 8%	≤ 12%	> 12%
B1 Capital for sup. purposes ./ Sup. Capital requirement	≥120%	≥100%	≥80%	< 80%
B2 Shareholders' equity / Funds due to customers*	≥ 10%	≥ 8%	≥ 6%	< 6%
C In respect to sup. maturity transfer. Rules	3 rules resp.	1 rule not resp.	2 rules not resp.	3 rules not resp.
D1 Overhead costs / net operating Income	≤ 70%	≤ 75%	≤ 85%	> 85%
D2 Loan losses, net of recovery / Net operating Profit	≤ 50%	≤ 60%	≤ 80%	> 80%

****Previous to the 06/30/97 reports the thresholds of the Attention and Warning categories were respectively equal to < 12% e < 10 %***

"A1" INDICATOR: TOTAL NET DOUBTFUL LOANS / SHAREHOLDERS' EQUITY
Date as of 6.30.1999




"A2" INDICATOR: NET DOUBTFUL LOANS vs CUSTOMERS / NET OUTSTANDING LOANS vs CUSTOMERS
Date as of 6.30.1999
Banks
60
50
40
30
20
10
0
26
44
57
36
26
25
14
10
13
7
7
4
4
2
5
3
4
2
1
13
0
1
2
3
4
5
6
7
8
9
10
11
12
13
14
15
16
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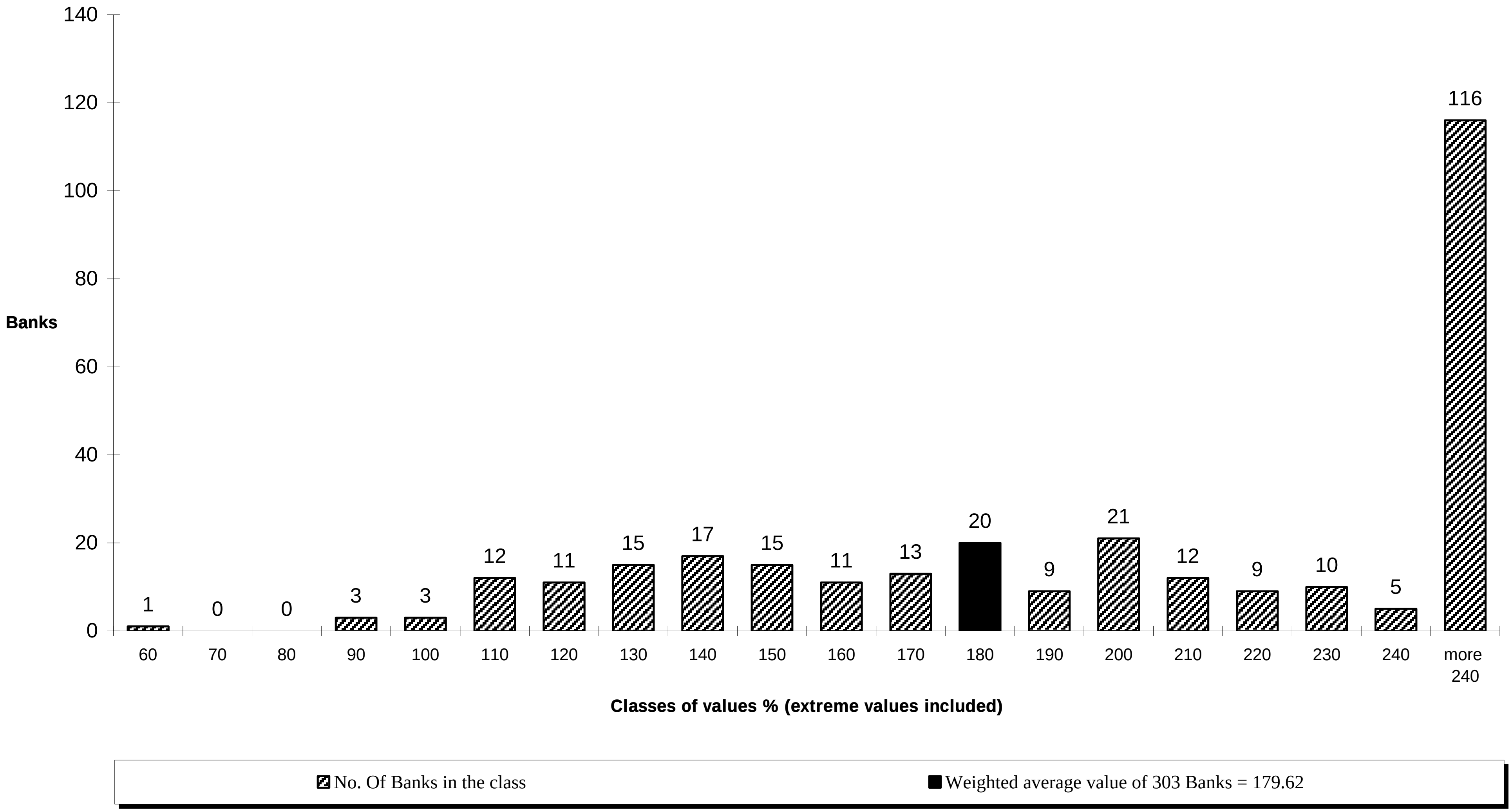
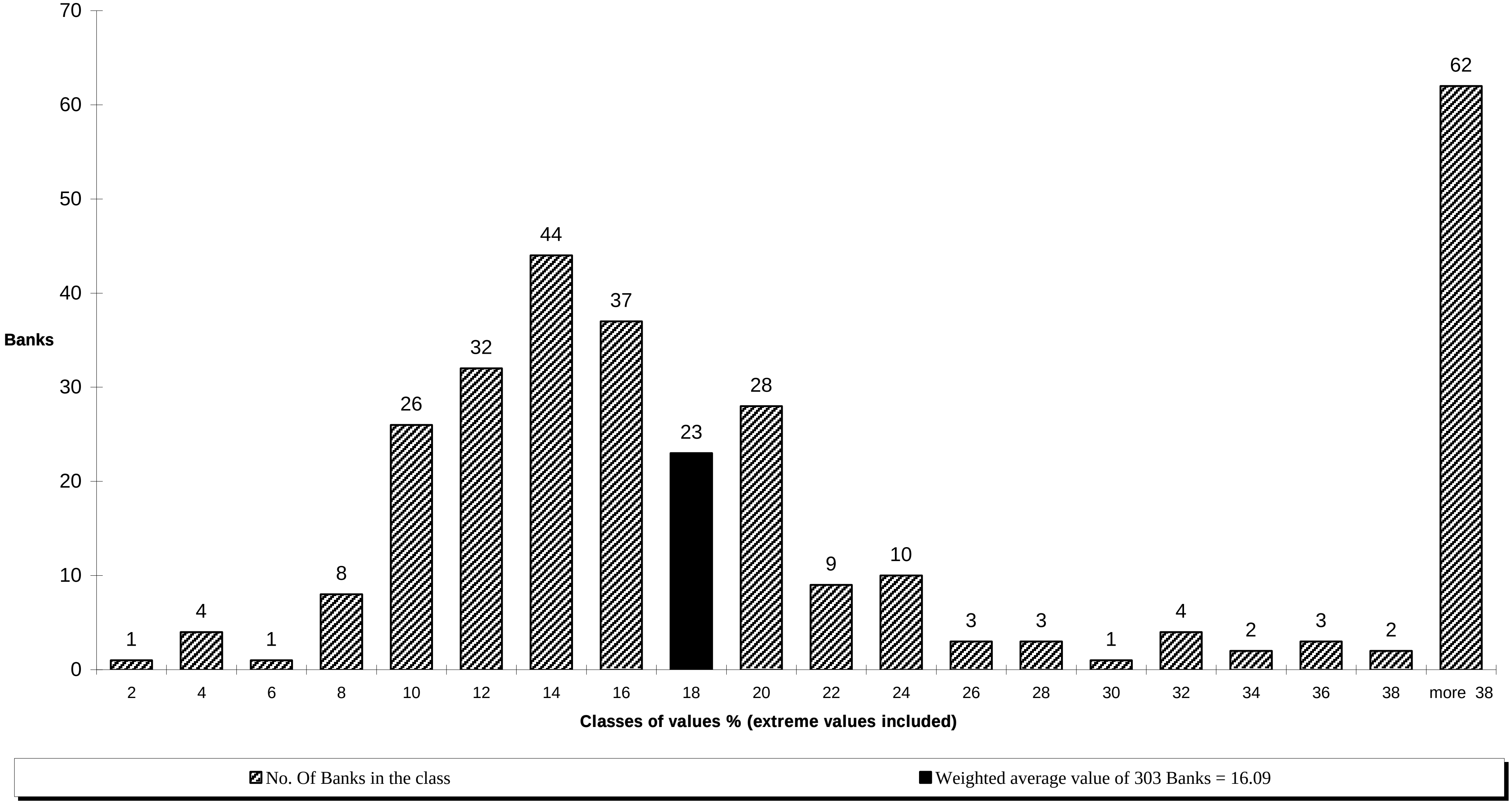
Classes of values % (extreme values included)
No. Of Banks in the class
Weighted average value of 303 Banks = 4.27

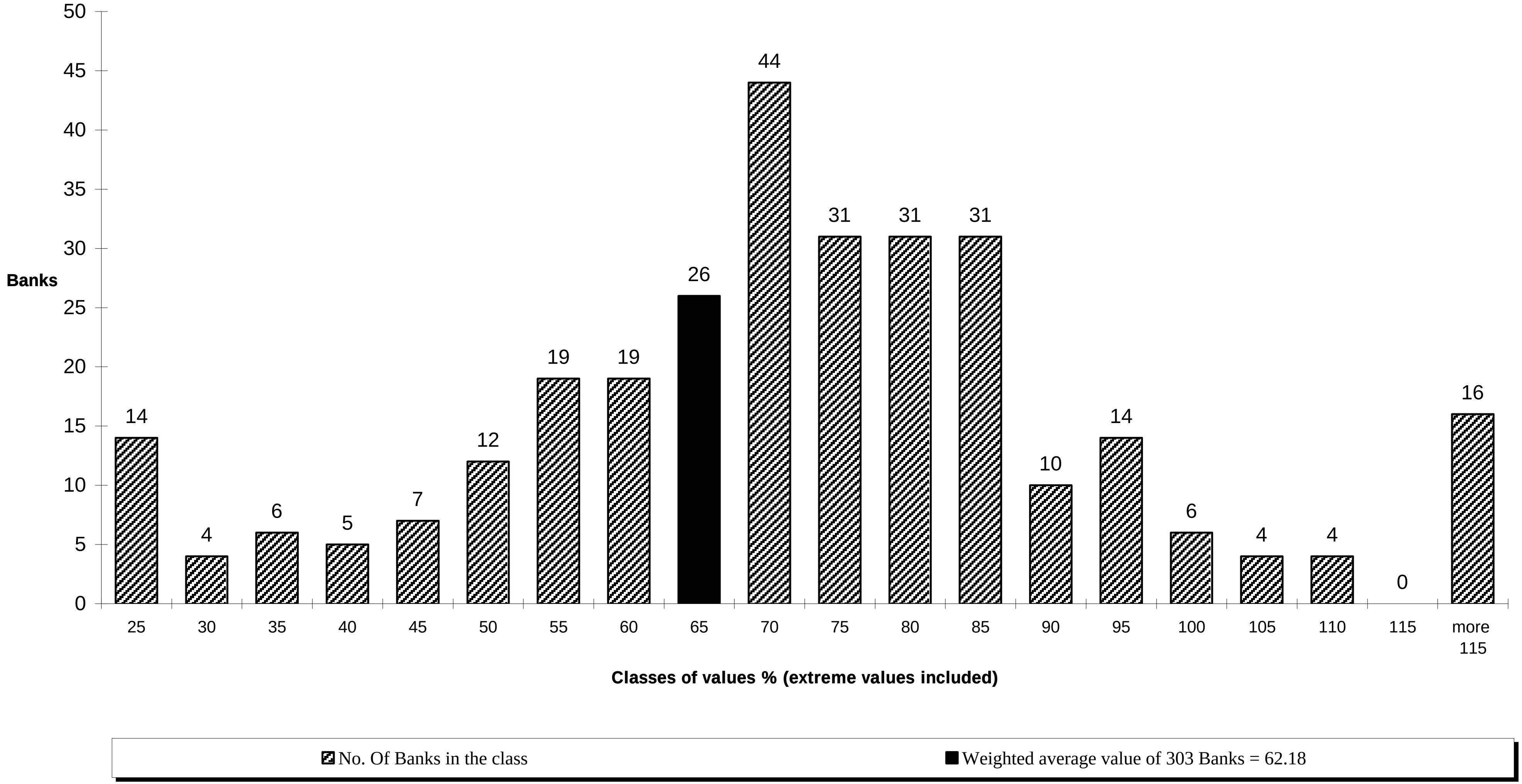
"B1" INDICATOR: CAPITAL FOR SUPERVISORY PURPOSES / SUPERVISORY CAPITAL REQUIREMENTS
Date as of 6.30.1999



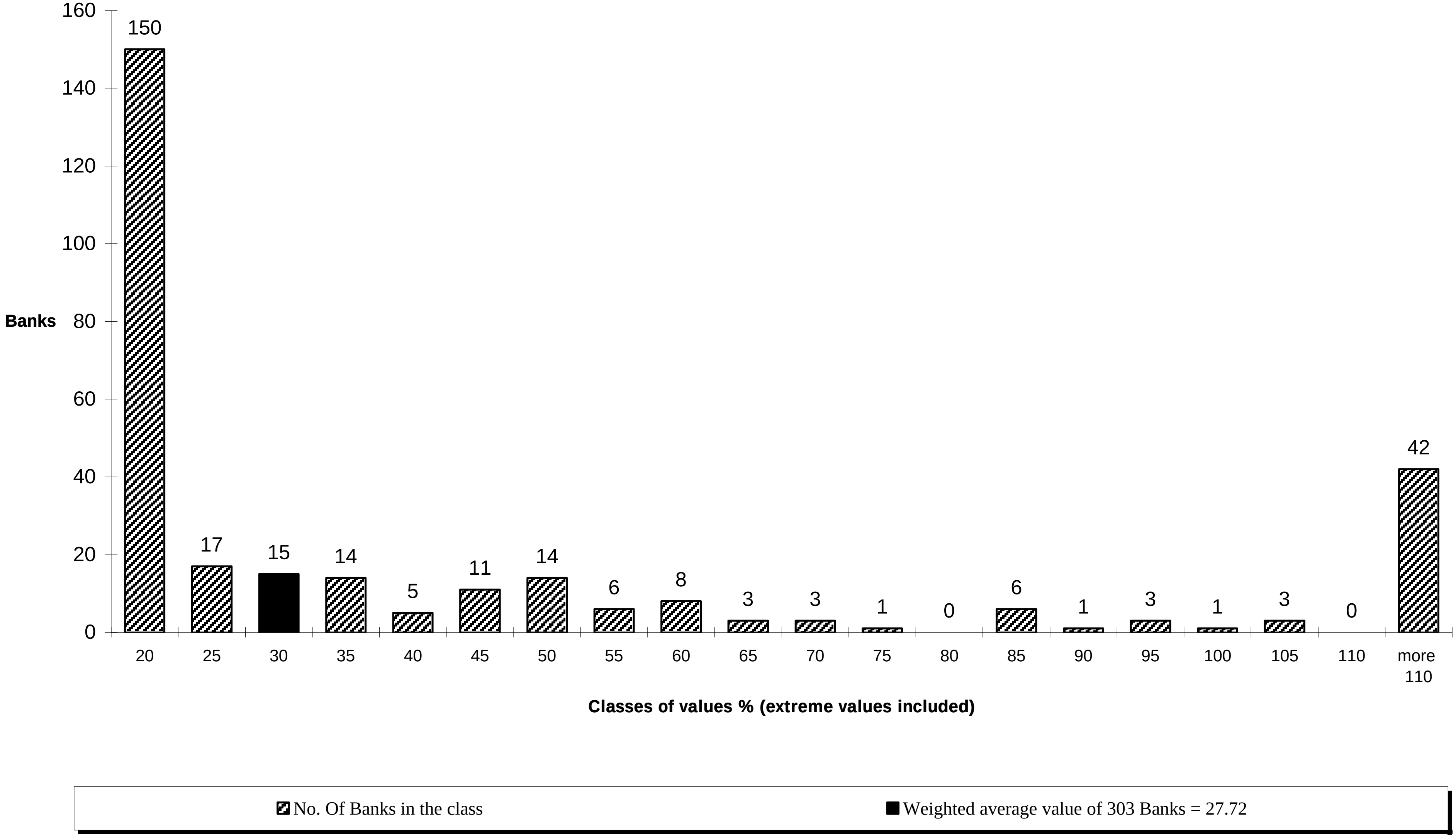
"B2" INDICATOR: SHAREHOLDERS' EQUITY / FUNDS DUE TO CUSTOMERS
Date as of 6.30.1999

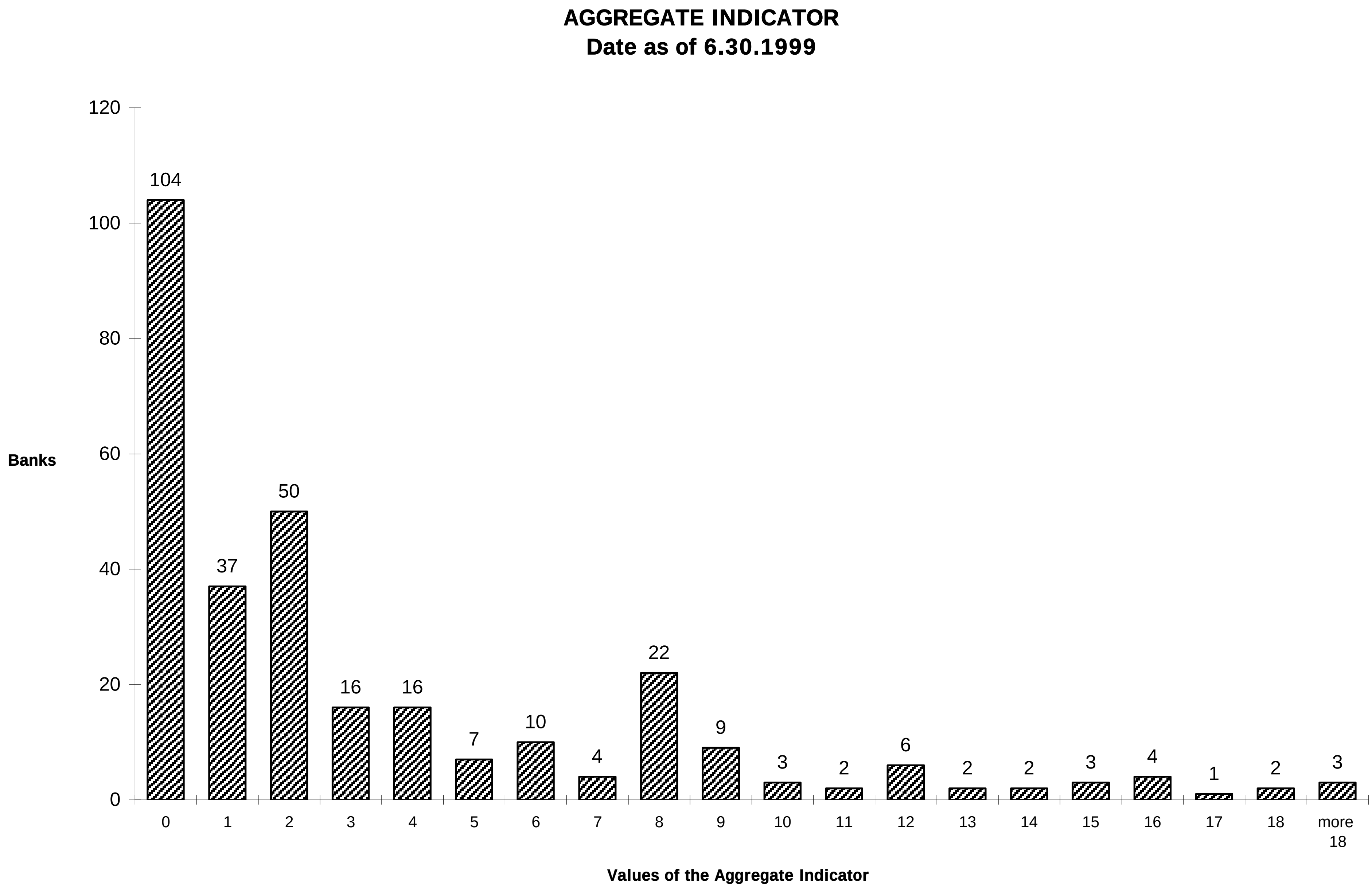


"D1"INDICATOR: OVERHEAD COSTS / NET OPERATING INCOME
Date as of 6.30.1999



"D2"INDICATOR: LOAN LOSSES (NET OF RECOVERIES) / NET OPERATING PROFIT
Date as of 6.30.1999




AGGREGATE INDICATOR
Date as of 6.30.1999
Banks
120
100
80
60
40
20
0
104
37
50
16
16
7
10
4
22
9
3
2
6
2
2
3
4
1
2
3
0
1
2
3
4
5
6
7
8
9
10
11
12
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14
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Values of the Aggregate Indicator

National Deposit-Insurance Schemes			
Country	**Funding Arrangements**	**Amount of contributions by participating credit institutions**	**Amount of coverage**
Austria	Ex-post contribution	The amount payable is computed according to the ratio between bank protected deposits and the total of protected deposits, as per 31 December of the year preceding the one when the crisis occurred	EURO 20,000 *(per depositor)*
Belgium	Ex-ante contribution	0.02 percent of protected deposits (maximum of 0.04 percent in the event of a claim exceeding the financial capacity of the Fund)	EURO 15,000 until December 1999, 20,000 EURO thereafter *(per depositor)*
Canada	Ex-ante contribution	Proportional the riskiness of the bank and variable between a minimum of one-twenty-fourth of one percent and a maximum of one-third of one percent of the insured deposits	CA$ 60,000 = EURO 34,499 *(per depositor)*
Denmark	Ex-ante contribution	Contribution is calculated yearly according to the bank insured deposits. The total amount of contributions shall not exceed the 0.2 percent of total bank deposits	DKK 300,000 = EURO 40,306 *(per depositor)*
Finland	Ex-ante contribution	The contribution consists of two parts: a) a fixed part equal to 0.05 percent of the bank's guaranteed deposits; b) a variable part based on the bank's capital adequacy (this part cannot exceed 0.25% of the bank's protected deposits)	FIM 150,000 = EURO 25,228 *(per depositor)*
France*	Ex-post contribution	The contribution consists of two parts: a) a fixed part, irrespective of the size of the bank, equal to 0.1 percent of any claim settled and with a FRF 200.000 ceiling b) a proportional part, varying according to a regressive scale, based on deposits and one-third credits of the bank	FRF 400,000 = EURO 60,980 *(per depositor)*
Germany**	Ex-ante contribution	0.03 percent of the bank's balance sheet item "Liabilities to Customers"	EURO 20,000 *(per depositor)****
Greece	Ex-ante contribution	The contribution varies according to a regressive scale, relative to the size of the bank measured according the amount of deposits. At the moment the contribution varies between the 0.25 percent and 0.0025 per cent of deposits.	EURO 20,000 *(per depositor)*
Ireland	Ex-ante contribution	0.2 percent of deposits, with a minimum of IR£ 20,000	90 per cent of deposit up to a maximum of EURO 20,000 *(per depositor)*
Italy	Ex-post contribution	Contribution are charged among the participants on the basis of the ratio between bank protected deposits and the total of protected deposits, with a correction mechanism linked to bank size and riskiness	ITL 200,000,000 = EURO 103,291 *(per depositor)*
Japan	Ex-ante contribution	0.048 percent of insured deposits	YEN 10,000,000 = EURO 77,143 *(per depositor)*
Luxembourg	Ex-post contribution	The amount payable is computed according to the ratio between bank protected deposits and the total of protected deposits, as per 31 December of the year preceding the one when the crisis occurred. The amount levied cannot exceed the 5 percent of the bank capital	EURO 15,000 until December 1999, 20,000 EURO thereafter *(per depositor)*
Netherlands	Ex-post contribution	The amount payable is allocated according to the proportion of bank deposits falling within the scheme as compared with the total of all bank deposits covered by the Fund	EURO 20,000 *(per depositor)*
Portugal	Ex-ante contribution	The contribution falls into three parts: a) initial contributions, fixed by the Banco de Portugal; b) annual contributions according to the level of capitalisation of each bank (0.1 to 0.2 percent of deposits); c) special contributions, when the Fund's resources are insufficient for the fulfilment of its obligation	EURO 25,000 *(per depositor)*
Spain	Ex-ante contribution	0.1 percent of bank deposits	EURO 15,000 until December 1999, 20,000 EURO thereafter *(per depositor)*
Sweden	Ex-ante contribution	0.5 percent of covered bank deposits	SEK 250,000 = EURO 27,486 *(per depositor)*
Switzerland	Ex-post contribution	Two components: fixed fee in relation to gross profit; variable fee depending on share of total protected deposits of an individual bank	CHF 30,000 = EURO 18,666 *(per depositor)*
United Kingdom	Ex-ante contribution	Three levels of contributions: a) an initial contribution when a bank joins the scheme (minimum £ 10,0000) b) a further contribution to restore the Fund to between £ 5,000,000 and £ 6,000,000 at the end of any year; c) a special contribution in the case of need	£ 18,000 or EURO 20,000 which ever is the greater *(per depositor)*
USA	Ex-ante contribution	The contribution depends on the level of bank capitalisation and varies between 0 and 0.27 percent of covered bank deposits	US$ 100,000 = EURO 81,500 *(per depositor)*

Source: Federation Bancaire de l'Union Européenne, International Monetary Fund, foreign funds' Statutes and By-laws.
* - System in force before the implementation or the Law 99-532 which provides insured banks shall assure the financial resources needed for the Fund activities through annual contributions (ex-ante).
** - Public system in force since August 1, 1998 following the implementation of the European Directive 94/19.
*** - The coverage raises up to the 30 percent of the bank capital per depositor if the bank maintains the membership to the Private German system of deposit insurance in force before the implementation of the European Directive 94/19.