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OPINION

A Breakthrough on the Separation Banks/Industry Principle

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LT Acquisitions; Banks; EC law; Financial regulation; Italy; Share ownership

Introduction[1]

Due to very strict regulatory constraints, so far non-financial entities have not been allowed to acquire, and then maintain, control over an Italian bank and, by the same token, Italian banks were, in general, prevented from becoming holding companies of non-financial/banking companies. A very recent change to the Italian legal framework,[2] and an even more important one which is expected to occur in the near future to implement within the internal legal framework certain principles dictated at EU level,[3] have modified, or are about to modify, the picture in a manner that would enable a non-financial player to acquire control over an Italian bank and vice-versa.

Such legislative changes seem to be a rather significant novelty in the Italian banking and financial legal system, which has always been particularly protective.

One would believe the new regime would bring about quite a vitality to the sector, especially considering the current turmoil affecting the financial market, with respect to the acquisition of a controlling stake over an Italian bank.

Such turmoil has, in fact, brought the share price of most Italian banks to decrease significantly, also making Italian blue-chip banks a possible affordable target.

The absence of regulatory stoppers would make it possible to tender for the acquisition of an Italian bank also to subjects that were not allowed in the past.

Control over an Italian bank

Back in the 1930s, three of the most important Italian banks (Banca Commerciale, Credito Italiano and Banco di Roma) suffered a rather significant financial crisis.

Such crisis was mainly due to their exposure to the industrial sector having any of such bank significantly financed, also by the acquisition of capital stakes and private companies.

The recovery process relating to such banks lead the Italian Legislator to introduce within the Italian legal system the bank/industry separation principle. It was the year 1936.

The bank/industry separation principle is now regulated by art.19 para.6 of the Legislative Decree no.385 of September 1, 1993 (the so-called Single Banking Act, the "SBA") which provides that:

> "Persons who, through subsidiary companies or otherwise, engage in significant business activity in sectors other than banking and finance may not be authorized to acquire holdings when the total share of voting rights held would exceed 15 per cent or when the acquisition would result in control of the bank."

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[1] This article has been drafted in October 2008. As anticipated by the authors, on November 28, 2008, the Italian government, in the context of the approval of the "outi-crisis" decree, inter alia, repeated art.19 paras 6 and 7 of the SBA(as defined in the article). This provided for the limit of 15 per cent for holdings in Italian banks by non-financial companies.

[2] In particular CICR resolution of July 29, 2008. Official Gazette 222 September 22, 2008. The introduction within the internal legal framework of Regulation 276 as defined below.

[3] As better specified in the following sections of this article, reference is made to the implementation process for Directive 2007/44 O.J. L247 September 21, 2007.

The instructions issued by the Bank of Italy to implement the rules dictated by the SBA (the "Instructions") expressly clarify that the relevant activity is not considered to be "*significant*" if the corporate group intending to acquire a participation in an Italian bank provides evidence that the aggregate assets of all group companies involved in non-banking/financial businesses do not exceed 15 per cent of the consolidated group assets.[4]

The Instructions expressly specify that to determine what constitutes a "*financial activity*" for the purposes of the limitation dictated by art.19 para.6 of the SBA, reference shall be made to art.1 para.2 of the SBA, listing the activities that may be subject to mutual recognition according to the EU principles.[5]

The Instructions specify also that insurance activity shall be assimilated to financial activity for the purpose of the applicability of the limit hereof.

The manner in which the bank/industry separation principle is dictated, and more specifically, the qualification of "*financial activities*" given by the Instructions, have turned out to prevent in the past, not only *pure* non-financial entities, but also Italian and non-Italian investment funds and certain types of financial companies (e.g. pure holding companies) becoming controllers of Italian banks. In fact, the above definition of financial activities does not expressly include, as far as collective schemes are concerned, collective asset management functions, nor, as per financial companies, the activity of holding participations in other entities.

Moreover, in providing the second level measures on the separation bank/industry principle, notably Resolution no.1057 of July 19, 2005 (the "Resolution"), the Credit and Savings Committee ("CICR") seem to have opted for a "*look-through*" kind of approach while dictating the criteria that one has to follow in determining when a given activity shall be considered "*significantly*" performed in the non-banking/financial sector. In particular, art.8 para.5 of the Resolution expressly specifies that:

> ". . . the Bank of Italy shall determine the criteria according to which the requiring subject shall be considered as operating in the non bankingfinancial-sector, having regard to the activity actually carried out, the sector in which it operates and the investments performed, directly or on behalf of third parties and also through other subjects and controlled entities".

In light of such principles, while assessing whether a given fund (including private equity) or a given holding company could actually be permitted to acquire a stake exceeding 15 per cent in an Italian bank, the Bank of Italy has argued that one would have had to look at the activity actually performed by the companies in which the portfolios managed by the relevant fund manager or the relevant holding company had actually been invested.

As a matter of fact, this rigid interpretation has precluded to several important foreign groups to acquire a significant position in an Italian bank in the past.

Over the last few years, the separation bank/industry principle has been criticised by many Italian scholars and market players as anachronistic and ineffective to ensure banks' stability and sound management.

Despite this, only very recently things have moved in a manner that would lead to the rule being abrogated in the short term.

On June 28, 2007, the EU Council adopted a Directive, namely Directive 2007/44•, dictating maximum harmonization principles with respect to the elements which have to be taken into account in the context of the approval process for the acquisitions of qualified shareholdings, inter alia, in the banking sector. In particular, Directive 2007/44 sets forth the criteria against which the relevant national supervisory authorities could make subject the process hereof. None of such criteria refers to the bank/industry separation principle. Nor Directive 2007/44, which is aimed at establishing a maximum harmonisation across the European Union, seems to leave Member States room to impose additional limitations.

Thus, it is expected that the Italian legislator would abrogate art.19 para.6 of the SBA in the implementing process of the Directive in question.

[4] For the purpose of this calculation, specific principles apply as indicated in the Instructions, including the principle that the assets of the non-banking financial companies shall be conventionally equal to 10 times the turnover of such companies.

[5] In particular, those activities are: (1) the acceptance of deposits and other repayable funds from the public; (2) lending (including, inter alia, consumer credit, mortgage credit, factoring with or without recourse, and financing of commercial transactions including forfeiting); (3) financial leasing; (4) money transmission services; (5) issuing and administering means of payment (credit cards, travellers' cheques and bankers' drafts); (6) guarantees and commitments; (7) trading for own account or for account of customers in: (a) money market instruments (cheques, bills, CDs, etc.); (b) foreign exchange; (c) financial futures and options; (c) exchange and interest rate instruments; (d) movable assets; (8) participation in securities issues and the provision of services relating to such issues; (9) advice to undertakings on capital structure, industrial strategy and related questions, and advice and services relating to mergers and the purchase of undertakings; (10) money broking; (11) portfolio management and advice; (12) safekeeping and administration of securities; (13) credit reference services; (14) safe custody services; (15) all other activities that by virtue of adaptive measures adopted by Community authorities are added to the list annexed to Second Council Directive 89/646 of 15 December 1989 on the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of credit institutions and amending Directive 77/780 [1997] OJ L311/42 ("the Second Banking Directive") , now Directive 2000/12).

Also acknowledging Directive 2007/44, Mr Mario Draghi, the Governor of the Bank of Italy, publicly announced on several occasions that the Bank of Italy would in the near future revise the current rules on acquisition of relevant shareholding in Italian banks, including the bank-industry separation principle.

Directive 2007/44 needs to be implemented in Member States by March 21, 2009. Thus, this should not occur that far down the line.

The possibility for Italian banks to invest in non-banking entities

While Italian banks would, as mentioned, become more vulnerable to attacks by non-banking players, they would, in turn, have more room to "*hunt*" non-banking preys themselves.

This is due to a very recent change in the rules dictating the conditions upon which banks may acquire stakes in non-banking companies.

The rules on acquisition by banks of positions in other companies are currently dictated by Regulation 242632/1993 of the Ministry of Treasury providing, inter alia, that the acquisition of participations in non-banking financial companies is permitted subject to very strict limitations. In particular:

- 3 per cent and 15 per cent respectively for each participation and for the total of the participations in relation to the relevant bank regulatory capital;
- The Bank of Italy, taking into account:
  - — the experience obtained in that sector;
  - — the capacity to undertake risks, with reference to the capital adequacy, the concentration credits, the s tability of financial situation and the exposure to market risks; and
  - — the appropriateness of the organisational structure, may authorise banks to invest in such participations up to a limit of 6 per cent of the regulatory capital of the participant for each participation and of 50 per cent for the total of the participations.

The Bank of Italy has implemented such principles by dictating, inter alia, that the participation in non-banking financial companies is allowed within the threshold of (i) the 15 per cent of the required prudential capital of the participating entity (i.e. the bank) or the entire banking group on a consolidated basis, or (ii) when the acquisition is aimed at limiting frozen assets, the 50 per cent of the required prudential capital of the participating entity (i.e. the bank) provided that the participated company is not listed in stock exchange markets. Moreover, for the purposes of limiting the risk concentration, banking groups, as well as singular banks not belonging to banking groups, are permitted to acquire participations in the companies at stake or groups thereof within the limit of the three per cent of the required prudential capital of the participating entity (i.e. banking group or bank).

In July 2008, the CICR issued a secondary level regulation ("Regulation 276") dictating anew the principles according to which Italian banks could invest (a) in financial entities (and/or entities performing ancillary functions); and (b) in non-financial entities. Regulation 276 expressly assigns to the Bank of Italy the duty to dictate, in line with EU principles, rules implementing the general principles prescribed by the Regulation itself. Once such measures are implemented, Regulation 242632/1993 shall cease to be in force.

Once the process of implementing the new measures are finalised, in line with EU principles, it would be possible for Italian banks to acquire significant positions in non-banking entities, should this be in line with the prudential rules applicable to the acquiring bank.

The way forward

The above analysis would lead us to imagine that, in the near future, there would be significantly more room for non-banking entities to acquire a controlling stake over an Italian bank. The process however is not that straightforward.

Rather, such a process would still be quite time consuming and surely would require the potential buyer to properly explain the business plan behind the envisaged purchase.

The Bank of Italy has in fact the general duty to assure that the prudent and sound management of Italian banks is guaranteed and, therefore, one would believe such an authority would wish any possible acquirer to follow criteria enabling the prudent and sound management of the target bank to be satisfied.

Along those patterns, it would probably be right to foresee that the Bank of Italy would still dislike a significant investment into an Italian bank by an investor wishing to make a pure "*financial investment*", rather then a proper "*business investment*".

The Bank of Italy would, for instance, still have issues with a private equity fund (or any similar type of investor) wishing to gain control over an Italian bank making recourse to a significant financial leverage and/or having in place an existing strategy for the short run.

Similarly, the Bank of Italy would wish to try and allow the investment in Italian banks to entities wishing to remain in the share capital of the target bank in the long run, in order to try and increase the value of the bank itself, and not simply to maximise on the investment they made.

Whether Italian banks would be prey or hunters, only the future can tell.