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**38TH CONGRESS OF THE EUROPEAN REGIONAL SCIENCE
ASSOCIATION**

**Europe quo vadis? - Regional Questions at the
Turn of the Century**

**A ‘Possibilist’ Approach to Local Financial Systems and Regional
Development: The Italian Experience***

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1. Introduction

Over the last ten years there have been great strides made in the analysis of the regional structure and location of banking and financial systems both from the theoretical and empirical point of view¹. In this chapter we will deal with the subject by focusing our attention on the experience of the Italian banking system.

There are at least three good reasons why the Italian banking system and its geographical distribution offer an advantageous viewpoint from which to study the role of banks in regional development. The first concerns the economic regional disparities of the Italian economy. Italy is still clearly divided into two distinct parts: the Centre-North, which is industrially very advanced, and as such is one of the most developed areas in Europe; and the South (the so-called ‘Mezzogiorno’), which suffers from serious structural economic problems and poor growth prospects. Given this context, we might question if this spatial economic dualism is matched by an analogous financial dualism, and, more generally, how the geographical distribution of industrial activities and financial systems interact and evolve.

Secondly, the Italian banking system has always been characterized by the presence of many small local banks operating in restricted territorial areas and few (not particularly large) national banks. This banking structure is the result of two peculiar elements: (i) the institutional framework of the Italian banking system, which has been marked for a long time by a very restrictive regime both in terms of the geographical mobility of banks and as regards their operative sphere, and (ii) the structure of Italian industry, which is largely based on networks of small and medium firms. Both of these elements have made the local bank a primary actor in the development of many local economies.

¹ Among others, see Chick and Dow (1988), Dow (1990), Vives (1991), Gentle and Marshall (1992), Greenwald et. al. (1993), Corbridge et. al. (1994), Chiapporri et. al. (1995) Jayaratne and Strahan (1996), Zazzaro (1997), and with particular reference to the Italian case Faini, Galli and Giannini (1993), Alessandrini (1992; 1996), Messori (1996).

Thirdly, from the second half of the 1980s the Italian banking system has been affected by radical legislative, administrative and institutional changes, such as the privatization of many banks, the introduction of the “universal banking” model, the nearly full liberalization of credit markets and the consequent intensification of competition². These changes, still in progress, will certainly modify the competitive environment of both local and national banks. The traditional binomial local bank-small firm will have to be completely rethought in the light of the new institutional framework which is a subject certainly deserving of careful analysis.

The rest of the chapter is organized as follows. Section 2 presents a brief description of some of the key structural features of the Italian economy. Section 3 deals with the geographical articulation of the Italian banking system. Section 4 analyzes different approaches to interregional financial integration, while Section 5 discusses models of the structure of regional banking systems and problems of competition between local and national banks. The conclusion explores some possible ways of facilitating the diffusion of financial innovations into peripheral areas.

[insert table 1]

2. Some key features of regional economic disparities in Italy

As is well known, the Italian economy is characterized by marked disparities in regional development. Taking the 179 regions of the European Union³ as a reference (see table 1), at the beginning of the 1990s Italy had 6 regions in the group of the most advanced 20 and 11 regions in the group of the 60, in which levels of GDP per head were above the EU average. All these regions are located in the Centre-North area of the country, which includes also Umbria, with an income level *per capita* near the EU average.

The remaining 8 of the 20 Italian administrative regions are less developed and all of them are located in the South. With the exception of Abruzzo, they are eligible for financial support from

² For a discussion of the main institutional innovations introduced in the Italian banking system see De Cecco (1994)

³ The administrative regions we are considering correspond to the NUTs 1 definition.

the EU regional development programme (objective 1) reserved for the areas whose GDP per head is less than 80 per cent of the EU average. Among several indicators of backwardness that could be shown, one of the most significant is the unemployment rate, which in the Mezzogiorno reaches levels that are clearly above the European average and much higher than those recorded in the Centre-North (see table 1). This development gap between the South and the Centre-North has remained basically the same since the beginning of the 1970s, despite the fact that in the two preceding decades there had been encouraging signs of a narrowing⁴. The continuation of the North-South dualism is the result of two sets of circumstances⁵.

On the one hand, the Southern regions have been lagging behind on account both of contingent obstacles and of failures in public intervention (i.e. the poor performance of state-owned enterprises). Moreover, since the 1970s, there has been a drastic transformation of public policy for the Mezzogiorno, from a policy supporting investments to a policy supporting incomes⁶. On the other hand, there is the striking success of the North-East-Centre regions (the NEC) which in a few decades have reached levels of development close to those of the already industrialized North-West although their pattern of development has been very different. The notable performance of the NEC system, as it has been called by Fuà (1983), is due to a peculiar combination of factors⁷, among which a widespread entrepreneurial attitude (due to historical roots of self-sufficiency), organizational flexibility (due to the small size of the firms), and social cohesion (due to the small size of the towns) stand out as the most important. The result is a model of development based on a large number of diversified local economic systems scattered throughout the NEC area.

Italian economic geography, therefore, is very diversified and complex. For our purposes it will

⁴ See Pettenati (1990), Canullo e Pettenati (1994).

⁵ See Crivellini and Pettenati (1994) for a broad analysis of different phases of Italian regional development over the four decades up to the 1980s.

⁶ See Graziani (1986), Del Monte and Giannola (1997).

⁷ Among others, see Fuà (1986), Becattini (1990), Brusco (1986, 1989), Garofoli (1989).

be sufficient to look at the three main areas of the country: the North-West, an area of long-standing industrialization, the NEC, more recently industrialized, and the South, which is still in need of filling a development gap with the rest of the country. Table 2 shows some distinctive features of firms in each of the three areas. Generally speaking, the Italian productive structure is characterized by a large number of small firms, run at a family level and operating from one plant. There are very few medium sized firms and limited companies. This peculiarity is most evident in the South, where 4 workers out of 5 are employed in firms of less than 50 employees and in artisan workshops, and where the number of limited companies is well below the already low national level.

[insert table 2]

Taken as a whole the territorial and productive features which we have briefly outlined are sufficient to highlight four main sets of problems that local credit systems have to face:

- 1) problems of interaction between real and financial sectors in regions with different levels of development: here we are particularly interested in which reciprocal influence tends to prevail at local level between banks and firms;
- 2) problems of integration between the global and the local level or between centre and periphery: this concerns the financial division of work between central areas and peripheral areas, which is particularly relevant within a unified monetary system;
- 3) problems of dimension connected not only with the size of firms, but also with the size of banks: it is necessary to understand what kind of bank (small or large, local or national, specialized or universal) is best suited to foster the development of peripheral systems of small firms;
- 4) problems of innovation concerning the introduction of those financial innovations which are most suited to facing regional needs; the main point here is how to balance innovative and traditional financial instruments for local savers and investors.

These closely inter-related issues will be discussed in the following paragraphs.

3. Problems of interaction between banking system and regional development.

In principle, a region could do without a regional banking system as so often happens in the case of many other industries. Local borrowers could raise the funds they need from banks located elsewhere. In an ideal world, with perfect information and no transaction costs, the multiplication of local banks would actually represent a waste of resources. However, in such an ideal world the sheer presence of banks would not be justifiable. Investors could directly make over their IOUs to savers, underwriting complete contracts (i.e. contracts which contain clauses for any contingencies) whose fulfilment would be enforceable by a third party like, for instance, a law court. In this hypothetical case, of course, there would be no need for financial intermediaries, as the efficient allocation of saving among productive activities would be ensured by the market mechanism.

The real world is quite different. Transactions are costly and information about agents is poor, so that it is never possible to design complete and fully enforceable contracts. To raise funds on the market, that is to make tradable one's own liabilities, requires the trust of a number of savers. This can be very costly. The role of banks is that of certifying the creditworthiness of investors, monetizing liabilities otherwise not tradable⁸. Banks, therefore, following Schumpeter's view, represent a fundamental device for the selection of successful entrepreneurs.

From this point of view, the existence of banks and their geographical diffusion are then two 'parallel' phenomena: either one cannot justify the existence of banks or one has to recognize that banks must spread throughout the regions. The same market imperfections that explain why banks exist are what make credit markets (partly) spatially segmented. In this context the emergence of powerful economies of agglomeration and the existence of transaction and information costs explain the formation of financial centres and the organization of the financial system on a

⁸ See Minsky (1986); Moore (1988); Stiglitz and Weiss (1988).

hierarchical order from centre to periphery⁹.

Regional banking systems represent the link between local economies and financial centres. On account of the spatial segmentation of credit markets, banks operating in a region (that is both local and external banks) are indispensable for overcoming the isolation of those local agents, who are either so small or so 'new' that transaction and information costs are usually too high to permit them to access financial centres. Thus, banks operating locally are the main channel (often the only one) through which the financial needs of small and medium sized firms are catered for. In turn, however, the geographical distribution of the banking system and its performance are themselves influenced by the level of economic development of the different regions. So, in a sense, the structure of the regional banking system mirrors the local economic system.

[insert fig. 1]

This interaction is clearly confirmed in the case of the Italian banking system. As shown by figure 1¹⁰, the geography of the Italian banking system tends to reflect the geography of the productive system. In Italy there are two financial centres. The most important one is situated in Milan, which operates mainly with private financial flows. Secondly Rome, as the capital, emerges mainly for the centralization of financial flows concerning the public system. Therefore, Lombardia (for Milan) and Lazio (for Rome) are the two regions with the most advanced forms of banking system. The same indicators show an intermediate level of banking development for the other regions of Centre-North and a much lower level for the Mezzogiorno, in line with the disparities in the productive system summarized above (see section 2).

⁹ On financial centres see Kindleberger (1978), Amin and Thrift (1992). On the organization of the financial system on a hierarchical order from centre to periphery and on the differences between international and national levels, see Alessandrini (1989).

¹⁰ The regional classification of the Italian banking system in figure 1 is the result of a cluster analysis conducted by Alberto Alessandrini (1996). He used more than thirty indicators ranging from traditional indicators of banking structure, such as the ratio of the percentage share of branches operating in an area to the percentage share of resident population or the amount of loans per branches, to indicators of financial innovation, as for instance the ratios of portfolio managements and deposit certificates to population.

The deepening of banking in the Mezzogiorno is lower (table 3). In that area the population served by a single bank branch is 36 per cent higher than in Northwestern regions and more than double that of the NEC regions. Only 60% of the municipalities of the Mezzogiorno have an operative bank branch. This fact contrasts strongly with NEC statistics where diffused urbanization and industrialization results in a diffused presence of banks. Finally, in the Mezzogiorno there are less deposits in relation to GDP than in the nation as a whole, and the difference is much wider when the percentage of loans to GDP is considered. The narrow gap from the deposit side is the result of the policy of income support adopted by the Italian Government over the last twenty years as one of the main kinds of intervention in the Mezzogiorno. On the other hand, the wider gap from the loan side is closely related to the slow industrial development of the area.

This geography is confirmed by other key behavioural and performance indicators, such as loan interest rates, the ratio of bad loans to total loans, the share of collateral on loans granted, and the gross operating income or the net earnings of the banks (table 4).

[Insert table 3 and table 4]

The low performance of Southern banks is attributable to several interacting causes. These are partly a result of the low quality of Southern borrowers, and partly of the internal inefficiencies of local banks. Lending to firms located in this area is surely more risky, and this could explain both the higher interest rate and the higher share of bad loans as compared with other areas. However, empirical studies have clearly shown that Southern banks perform a less efficient screening of loan demands¹¹. Moreover, the labour and operative costs of Southern banks are higher. The Southern banks' ineffectiveness in screening investment projects and their higher operative costs are partly transferred to customers through higher interest rates¹² and partly contribute to lowering banks'

¹¹ See Faini, Galli and Giannini (1993).

¹² This transfer of costs on interest rates is a sign of a higher level of monopoly power of the bank operating in the Mezzogiorno. That the South credit market is still less competitive is confirmed by the

income, which in the last years turns to be even negative¹³. But, in turn, this behaviour adversely affects the quality of borrowing firms. All this creates a self-reinforcing vicious circle that can lock local credit markets into long-term situations of high interest rates and high default rates. What is more, phenomena of group reputation can rise, creating discrimination in the credit market. Banks, indeed, base, at least in part, their valuations of new firms on the ex-post average default rates for the same kind of firms operating in that area in the past. Then similar firms, simply because they operate in different areas, will borrow at different interest rates (Lang and Nakamura, 1989; Scalera and Zazzaro, 1997).

Finally, Southern banks tend to concentrate more on traditional banking activities (i.e. deposit collection and lending) than banks operating in other areas, as shown by the wider gap between interest margin and intermediation margin.

4. Problems of inter-regional financial integration.

4.1 Three approaches: pessimism, optimism, and possibilism.

Experience shows that the financial structure is not uniform throughout a country. Usually, it tends to be hierarchical with an advanced financial centre at the top and local credit systems becoming gradually less advanced depending on the local development of peripheral regions in which they operate. It is essential to recognise and deal with this fact and to consider the question of financial integration between the global and the local or, to be more exact, between the centre and the periphery.

There are three basic ways to approach this question¹⁴. The first two approaches present two well-known opposing views concerning the effects of integration: one is pessimistic and the other

higher values of the Herfindhal index (see De Bonis and Ferrando, 1996).

¹³ It should be pointed out, however, these are average figures, which are heavily influenced by the negative results of the Banco di Napoli and the Banco di Sicilia.

¹⁴ See Alessandrini (1996).

optimistic. In our opinion a third point of view, which we will call ‘possibilist’, falls midway between the two extremes and offers a more realistic and accurate picture of financial integration problems. The first two theories, widely discussed in the literature, have certain points in common. In particular, both emphasise a strong contrast between centre and periphery and attempt to ignore one of the two poles in the conviction that the other will prevail.

The pessimistic theory concentrates exclusively on ‘localism’. It maintains that the centre would take advantage of asymmetries in information, behaviour and structure and would invest the savings drained out of the peripheral regions, slowing down their development. This could lead to some radical conclusions. Firstly, local segmentation of capital markets is preferable to integration¹⁵. Secondly, the setting up of banks from outside the region, be it the opening of new branches, mergers or the purchase of a holding in local banks, is considered disturbing. However, this appears to be a misleading view. The idea of keeping the savings of a region within the confines of that region is not only illusory but could be also counter-productive. Inside a wider unified monetary area, savings must be free to move in search of the best portfolio opportunities. Therefore the main problem for a region is to offer the best opportunities for investment, attracting funds both from inside and outside its boundaries. Besides, statistical data show that often, but particularly in the less advanced regions, local banks have a greater ability to collect savings than to invest them in the same area. To the contrary, branches of banks with headquarters in other regions tend to penetrate more easily, with higher market shares, the loan market of the region rather than its deposit market¹⁶. So, the platitude that local banks have a higher commitment to keeping savings in their region is not supported by the evidence. Paradoxically, they tend to have a higher propensity to export capital out of the region than external banks.

¹⁵ For this view see Chick and Dow (1988), Dow (1996).

¹⁶ See Castelli, Martiny and Marullo Reedtz (1995). Indirectly this evidence comes out also from the data on the loans/deposits ratio shown in fig.4.

The optimistic theory, on the contrary, concentrates exclusively on ‘globalization’. The idea is that higher competition will select the best enterprises (banks, firms) and standardise their performance at the levels of efficiency reached in the more advanced centre. This opinion leads one to believe that every region can become a centre in the hope of exorcising its peripheral nature. Clearly the spread of development and efficiency set in motion by the liberalised global market is a simplistic generalisation typical of neo-classical theory. Experience shows that the advantages of globalization are not distributed uniformly among individuals, firms, and regions. They are more easily acquired by the strongest and best organized ones. So, in the absence of corrective policies, regional disparities could tend to widen rather than to narrow.

In our opinion, it is wiser to adopt an open view, what we call a ‘possibilist’ approach, which is based on the continual exploration of the possibility of co-existence, complementarity, and interaction between different areas and therefore also between the centre and periphery¹⁷. The territorial integration of local financial systems, which should not be disputed, must be carried out in a selective and gradual way, by trying to give preference to solutions that are best suited to the characteristics and assimilation ability of local firms and individuals. The main objective of a regional banking system (region) is to have not only passive but active inter-regional integration.

What we define as passive integration is everything which comes to a region from outside: not only financial flows, but also non-resident banks which set up new branches, incorporate resident banks or buy control quotas of their capital holdings. If a region limits itself to this kind of integration it becomes a battleground between inward-looking local banks and outside banks in an inevitably restricted market. Past experience shows that, under these conditions, the quality of credit does not necessarily improve, because the outside banks are most likely to find it profitable to adapt to the conditions prevailing in the local markets.

¹⁷ Becattini and Rullani (1993) and Sabel (1996) give a stimulating general outline of this approach, even

Active integration, on the other hand, is when the local banks are outward-looking both in terms of financial investment and of the multi-location of their branches. It is important for a regional banking system to compete with other areas so as to gain the benefit of both regional and sectoral diversification. This process of inter-regional projection increases the chances of benefiting from the gains of competitiveness. It also sets off that integration process we have called ‘possibilist’, which allows local banks, firms, savers, and institutions to open up to the outside without abandoning their own territorial origins and roots.

4.2 Aspects of interregional integration in Italy.

First of all the integration process can be analysed in terms of regional balance of payments¹⁸, which unfortunately is not easy to reconstruct with the limited statistics available. However, the data in table 5 give an idea of the external constraint of each Italian region, showing the net import of each region relative to its GDP. The existence of a wide and long-standing financial gap between savings and investment among the regions and also among broad areas is clearly evident. This gives rise to the need for inter-regional financial compensatory flows by means of both private and public capital movements and fiscal transfers. The Mezzogiorno is an area in substantial structural deficit and thus very dependent for financing on the rest of the country and, at the supra-regional level, on Central Government. These transfers of financial resources allow the area in the long term to maintain a demand for real resources which is higher than the internal supply. At the same time, the long term financial inflow has contributed to limiting emigration (which in the past was very high).

[insert table 5]

From this point of view, the integration of the South with the rest of the country is passive. In

though it does not refer directly to financial aspects.

contrast, the other two areas of the country, the North-West and the NEC, persistently export more goods and services than they import (see table 5). Lombardia and Piemonte, which are the most industrialised regions of the North-West, have the highest surpluses. In the case of the more recently industrialised NEC regions, either their surpluses are increasing or their deficits are decreasing over time.

Analysis of the inter-regional diffusion of the banking structure gives a clearer picture of the process of integration that is in progress. Since the beginning of the 1990s, the introduction of the new institutional model, which liberalized the options open to banks, has set in motion a series of important changes and inter-regional movements in the Italian banking system. These developments have taken various forms: new branches, mergers, take-overs, acquisitions of holdings and agreements between local banks and those outside the area. Table 6 shows data on the distribution of bank branches in 1996 in the three areas and on the changes from 1990 to 1996. In this period there was clearly a great increase in the opening up of local banking systems, which can be analysed in the light of the two aspects of active and passive integration, mentioned above (see paragraph 4.1).

Signals of active integration are set out in table 6a, which should be read vertically. It becomes clear that the banks which have their headquarters in the Centre-North and above all in the North-West are the most involved in this process of inter-regional projection by means of opening new branches. Lombardia, aided by the fact that Milan is the dominant financial centre there, re-enforces its position as region leader. One branch in four in Italy belongs to banks which have their headquarters in Lombardia. But only 55.7% of their branches are in that region; the rest are to be found all over the country. Counter to this trend, only the banks with their headquarters in the Mezzogiorno increase the number of branches within their own area but reduce them in other areas.

¹⁸ See Alessandrini (1989)

This attitude is indicative of a prevailing defensive strategy and is yet another sign of weakness of the Southern banks in the local banking system in the Mezzogiorno; they try to withstand the competition within their own area but do not have the strength to extend their market horizons to the outside.

[insert table 6a and table 6b]

These tendencies are confirmed if we analyse the second aspect of inter-regional opening which is concerned with passive integration. Table 6b, which should be read horizontally, shows the market quotas in terms of branches owned in each area by the local banks (see data along the main diagonal) and by the banks from other regions. The local banks everywhere have lost market quotas in favour of outside banks. This phenomenon is particularly accentuated in Lombardia, Lazio and the Mezzogiorno. This means that the strategy of territorial diversification in the setting up of new branches has taken two main routes. The first is directed towards the financial centres of Milan (Lombardia) and Rome (Lazio), where the most dynamic peripheral banks have established their new branches in order to benefit, at least in part, from the advantages in information, competitive emulation and relationships, which are typical of financial centres. The second route is directed towards the Mezzogiorno, where many banks of the Centre-North have localised new branches for two main reasons. Firstly, because the Bank of Italy has urged them to be more active in the South, in the purpose to strengthen the banking structure of the area. Secondly, because the Northern banks have decided to acquire local positions in a less developed market considered (often erroneously) easy to capture. As a consequence the Southern banks, although they have expanded almost exclusively in the Mezzogiorno, have lost shares in terms of branches in this area in favour of external banks, above all from Lombardia. Besides, according to table 6b, they are the only ones who have lost shares of branches even in other areas of the country. On the contrary, the local banks in the NEC (with the exception of Lazio) are characterised by the fact that they not only have succeeded in containing the expansion of external banks in their area, but also have actively extended their presence into other regions.

The competitive capacity shown by the NEC local banks can be partly explained in the analysis of mergers and incorporation. These operations represent, together with the opening of new branches, another important aspect of the integration process which has characterized the Nineties. Table 7 shows all the mergers and incorporation that took place in the period. First of all, it is important to note that there have been very many operations: 364 in only six years. Secondly, the majority of these have been realized between banks of the same size and, above all, between small banks (68% of the total). Thirdly, banks resident in the NEC played the most dynamic part in this integration process: in four transactions out of five they appear as incorporating banks, both of other banks within the area (60%) and outside banks (40%).

On the whole the main trend has been towards mergers between similar banks (from the same area, and the same size) rather than between different banks. This is understandable because mergers are undoubtedly a shortcut to achieving both operative and dimensional growth, but at the same time they present a difficult problem of internal integration. It is not easy to put together men, mentalities, and procedures from different business backgrounds and direct them towards a common objective.

[insert table 7]

5. Problems of dimension.

5.1 Local banks versus national banks.

The fact that many banks have opted for opening new branches, mergers or incorporation is indicative of the need to find the adequate dimension to tackle the new institutional and competitive environment.

In Italy two basic models of regional banking system have traditionally co-existed. The first is the model based on big national banks which open their branches all over the country (known in economic literature as the branch-banking system). The second is that based on small, independent, local banks which operate in restricted areas (the unit-banking system). In the next few years, however, the co-existence of banks which are structurally very different is likely to be challenged by increased competition

following the liberalization of the banking system and the beginning of the Euro system. It is then important to analyze the advantages and weaknesses of different models of regional banking system.

The main advantage of the first model is clearly connected to the banks' average size, that is to the presence of scope and scale economies in banking activity. Even though the empirical literature on scope and scale economies in the Italian banking system has not reached unequivocal and conclusive results¹⁹, there is no doubt that in rapidly evolving financial markets the minimal size of banks tends to increase. In more sophisticated financial markets, the ability of banks to attract clientele is dependent on the ability to supply sets of strongly innovative, often customized, financial services. The wider variety of financial products and services needed by their customers requires banks to rely on operative structures and professional abilities which are rarely features associated with small size. Furthermore, large banks, as they are able to diversify their portfolios, can afford to be less risk-averse than local banks.

On the other hand, the second model of geographical articulation, which is based on small local banks, ensures a rooted establishment of the banking system in the local economy which a system of large bank branches cannot easily emulate. The informative advantages of local banks stem both from a firm and long-lasting presence in the territory and from personal elements, linked to the character of bankers and managers who both belong to the local social environment from birth and/or culture. A direct and in depth knowledge of local entrepreneurs emerges and this which is the decisive element of the bank-firm relationship in economic systems of small and medium sized firms. National banks can only slowly acquire this kind of local embeddedness. The distance between decisional and operative centres reduces the availability of information about local firms and the real regional growth prospects. In addition, the local-branch management of national banks is often in the hands of directors only temporarily committed to that branch. They often use their

¹⁹ On this point, see Conigliani (1990) and Favero and Papi (1995).

time in the branch as a stepping stone for their careers²⁰. They tend to be very risk averse, opting for safe, large investments, rather than riskier smaller investments, even to the detriment of important (innovative) projects for the growth of the local economy.

But the close connections between local banks and firms produce both advantages and disadvantages. On the one hand, it tends to promote technological and organizational innovation in the existing firms. The standing and the prospective development of local banks obviously hinges on the performance of the local economy. The local banks are therefore interested in sustaining the market competitiveness of local firms. Since the success of local firms depends on their innovative capacities, local banks have a direct interest in favouring the introduction of innovation.

On the other hand, there are some negative factors. First of all, a deep knowledge of a single economic environment can reduce the response of banks to developments coming from other economic systems, especially from industries not present in the region. To state the creditworthiness of a new firm operating in an industry which is 'new' in that region often requires a competence and a knowledge which local banks do not have²¹. Secondly, continuous and exclusive customer relationships with local firms can induce banks to limit the entry of new and possibly strongly innovative firms. Indeed, financing these kind of firms can create difficulties for locally existing ones and make the old credits of local banks more subject to defaults, reducing the expected returns on them²². Thirdly, this kind of attitude of local banks tends to reduce the innovative efforts of existing firms, which 'protected' by the behaviour of the banks are less stimulated to introduce innovations (Çapoglu, 1991). Finally, informational rents of local banks can make the local credit market less competitive, thus discouraging the entry of outside banks (Sharpe, 1990).

²⁰ As recently shown by Ferri (1997), as regards the Italian banking system, the branch manager turnover is higher for national banks than for local ones.

²¹ See Zazzaro (1997).

²² As Clemenz (1991, pp. 337-8) notes, 'credit markets are quite different from market for ordinary goods such as e.g. bread [...] The baker does not lose money on the bread he has already sold if he sells more

5.2 What model for the regional banking system?

Thus we can say that what are the main advantages of one ideal type of geographical articulation of a banking system are at the same time the main weaknesses of the other. If one accepts this conclusion, then in principle it leads naturally to the implication that the most suitable regional banking system corresponds to an 'intermediate' model (quite similar to that prevailing in Italy), in which local and outside banks co-exist and compete. To the extent that the advantages of both types of banks are brought out, this mixed system has the characteristics and a diversified dimensional structure which best respond to the needs of local development and is well suited to links between the centre and periphery.

Given the increasing sophistication and efficiency of information technologies available, the national banks generally seem better equipped to operate even in the most peripheral local markets. But not all local banks will necessarily disappear. Their strongest point, and one which they must defend and stress, is their competitive edge which stems from their being firmly established in the area. But so as not to relegate the relationship small bank-small firm to one between marginal operators, local banks cannot remain either too small or too isolated. They must inevitably grow large enough to grant them greater possibilities of collection and investment of savings, through active links with more advanced operators in the financial centre.

The regional banking system must ensure an adequate support to local smaller firms not able to access national financial markets. To provide this role, it must have a high degree of attachment to, and embeddedness in, the local community and economy, which allows it to have a deep knowledge of the needs and potentialities of local entrepreneurs. On the other hand, the local banking system must be able to offer the best and most innovative solutions to local customers,

bread. A lender, in contrast, may (adversely) affect his expected returns on existing loans by granting

acting as a connection to the financial centres.

[Insert figure 2, 3 and 4]

Despite the evident process of territorial integration taking place, the structure of the Italian banking has not yet reached stability. More efficient forms of organization are still at the selection stage. As a result, the intermediate model of co-existence between local and external banks has not yet reached its optimum in all the different regions.

In the Mezzogiorno the banking system is still too polarized. Compared with the Italian average, the Southern banks are mainly either small local banks or regional banks (figure 2)²³. There are hardly any national or interregional banks²⁴. In the Southern regions, on the other hand, many branches of national banks with headquarters in other areas of the country are operative (figure 3).

But the most worrying aspect is that in the Mezzogiorno the model of local banks, unlike that prevailing in the Centre-North, is the loser model. Southern banks do not seem to be very dynamic and are geared towards the traditional collection and management of liquidity. This is confirmed by the ratio loans/deposits which in Southern Italy assumes the lowest values for the locally oriented banks (i.e. interprovincial, provincial and local banks; see figure 4), whereas branches of national and interregional banks show values near to one.

This suggests, then, that in this area local banks play a secondary role in financing the economy. On the whole these banks are small, isolated and inefficient. They operate in peripheral and marginal areas exploiting their isolation to carve out strong monopoly positions vis-à-vis the local firms and savers. Besides, given the present trend, the Southern banking system seems

additional ones’.

²³ Since 1995 Bank of Italy provides statistics classifying banks for territorial diffusion, in addition to the traditional classification by size. With regard to this new classification banks are distinguished in National, Interregional, Regional, Interprovincial, Provincial, Local on the base of the geographical diffusion of their distributive network.

²⁴ The only Southern bank operating on a national scale is the Banco di Napoli which, due to its serious financial distress, is about to be absorbed by an outside bank (the Banca Nazionale del Lavoro). The Banco di Sicilia, the most important inter-regional bank in the Mezzogiorno, is also going through a serious crisis

destined to be controlled by large banks outside the area. If this will bring economic benefits to the Southern economy in the long term it is difficult to say. In the short term, however, this appears to be the only way to stimulate an improvement in the efficiency of the Southern banking system, an increase in financial resources and a better credit allocation in the area.

In the Centre-North, on the other hand, the banking system seems to be much more homogeneous both in terms of banks and branches. It is in this part of Italy that the intermediate model of regional banking is gradually developing. Of course, this evolution is occurring in different ways and at different speeds on account of the distinctive characteristics of each region (see figure 2 and 3). In the North-West regions there is a prevalence of banks which have a wide geographical diffusion (i.e. national, interregional and regional banks). On the contrary, in the NEC regions, which are characterized by widespread industrialization and urbanization, there is a slight prevalence of locally oriented banks (i.e. interprovincial, provincial and local banks). It is important, however, to underline that in this areas the local banks play an important role in the development of the local systems of small firms. Their intermediation capacity, measured by the loans/deposits ratio, is not much lower than that of larger national and interregional banks (see figure 4). This result has been obtained because the local banks of the Centre-North, and above all those of the NEC, have known how to bring about changes in terms of active integration, i.e. the opening of inter-regional branches, mergers and incorporation, as has been pointed out in paragraph 4.2. This, obviously, does not mean that the banking system in these regions does not still have elements of backwardness to overcome and important steps to make. Especially if one looks at banking systems in the broader competitive context of the European Union, it becomes clear that on the whole Italian banks are still too small and not innovative enough.

which is likely to conclude with its acquisition by the banks of the Centre North.

6. Geographical diffusion of financial innovations: some concluding remarks

The new institutional and competitive context of the Italian financial system, seen within the process of monetary unification in Europe, poses severe problems for the survival and adaptation of the local credit systems.

The most realistic and promising solutions are of an eclectic type and can be found by adopting a "possibilist" approach. This means favouring every possibility of co-existence between local and global systems and between local and external banks in order to make local markets areas of interchange rather than dispute or isolation. The liberalisation of the operative choices open to banks, which has been introduced by the new Italian and European institutional framework, admits the use of a plurality of financial innovations thus making the achievement of this goal easier. These innovations concern not only banks, but also the institution of new financial intermediaries and new financial markets.

First of all the freedom to open new branches and to carry out operations such as the acquisition of holdings and mergers is an important organisational innovation which favours the growth in size and the inter-regional integration of banks. The possible interventions cannot be limited to quantitative aspects which we discussed in paragraphs 4 and 5, analysing data on branches, collection of savings, investments and mergers. It is also necessary to examine the qualitative aspects of banking. In the present context, no bank, whether large or small, can afford to get left behind using traditional forms of intermediation or loans which are too localised, not marketable, illiquid, and therefore too risky. The survival of every bank, in general, and of small, peripheral banks, in particular, is linked to their capacity to bring in innovations which will significantly improve the quality both of financial services and market relations as well as relations with financial centres and all other intermediaries. The more local banks go in these directions the less pressing do they find the problem of the growth in size.

The importance of being able to establish good business relations is something we have learned from the experience of industrial districts. The same considerations can, in part, be applied to banks. They are able to remain small and peripheral so long as they are not isolated, but enter into a wider network of collaboration and interchange. This explains why, as was the case with groups of firms, there is an increasing number of groups of banks which pool their services, develop complementarity and diffuse the requirements of quality and competitiveness necessary to sustain the impact of vaster and more dynamic markets. In order to remain the chief interlocutor of local firms and local savers, peripheral banks must know how to develop their ability to establish good relations not only with other banks, but also with innovative financial markets, where marketable assets are exchanged. And they must be able to do this without giving up their traditional forms of financing. For those who follow these routes there are many opportunities to be seized but there are also various difficulties to overcome.

An important example of the opportunity for active integration in wider financial circles concerns the two traditional instruments of bank intermediation: deposits and loans. The data on the regional distribution of interest rates on deposits show very low differentials and above all, lower than the differentials of interest rates on loans (see figure 5). This is not a consequence of the greater competition between branch banks which operate only at local level. It is due, above all, to the diffusion in family portfolios of marketable short-term bonds, such as Treasury bills, which have forced the banks to standardise the interest rate on deposits in order to keep them competitive with these alternative forms of investment of savings²⁵. Bank loans are more closely tied to the specific conditions of local debtors, who especially in the local systems of small firms, have no other alternative than to have a bank debt. This explains why the regional differentials of interest rates on bank loans continue to be remarkable (see figure 5).

²⁵ See Niccoli and Papi (1993).

[Insert Figure 5]

Even the typical constraints of bank loans, such as narrow localisation and strict bilateral link between banks and firms, can be overcome by using new forms of interrelation between marketable and non marketable assets and, therefore, between the local and the global financial circuits. The first solution is securitization, which is a brilliant example of the issue of marketable bonds, which can be quoted on the global standardized markets, backed by a certified set of the most reliable bank loans²⁶, which maintain their characteristic of local non-marketable assets. A second solution is that of closed-end investment funds which the banks themselves could set up. We are talking about specialised intermediaries which are more suited to play a complementary role with the banks in the local systems of small firms. They can support the firms, participating in their capital for a limited period. These non-marketable capital assets are backed by the issue of quotas which are marketable on the secondary markets, being refundable only at the expiry date of the investment fund. In both cases (bank loans securitization, closed-end investment funds) the intermediaries act as key bridge that links both marketable-non marketable assets and global-local financial markets. These solutions could also contribute to gradually prepare the field of the direct issue of marketable assets by local firms. This is a third solution which is obviously not suited to all the firms of the local systems. But it does represent a goal towards which the leading medium sized firms must strive. The issue of bonds and the stock exchange quotation of the leading firms both will reinforce their availability of financial resources and, at the same time, will widen their opportunities of financial diversification. Indirectly, the benefits will spread over the wider networks of small firms which operate as sub-contractors of the leaders and, therefore, will contribute to consolidating the development of their local systems.

²⁶ Obviously, in the case of small firm systems the banks could find convenient to issue asset backed securities only against a pool of small loans, on a declaration of their reliability.

While it is quite easy to indicate the possible solutions, it is rather difficult to implement them. There are lags, rigidities, inefficiencies, resistances to be overcome. These constraints are more rooted in the less advanced regions, both as the result and the cause of the vicious circle of backwardness. The most evident difficulties in the geographical diffusion of financial innovations stem from the unwillingness of firms (but also the incapacity of the smallest ones) to issue marketable assets and to the parallel unwillingness of savers to buy them for their portfolios. Figure 6 demonstrates clearly to what extent Italian families still opt for more liquid and thus less risky investments. This tendency is most evident in the South, where there is a high incidence of families who hold bank deposits (which in figure 6 form the basis of reference) and postal deposits. But, in general, everywhere the number of savers who are brave enough to invest in the more sophisticated and risky financial activities is still very limited.

[Insert Figure 6]

All this reinforces our belief in the “possibilist” approach to interregional integration, which is open to the search for every possible solution that could favour the development of local financial systems. But, at the same time, it maintains a realistic view on what could be done to promote the gradual diffusion of those financial innovations which are the most suitable for the different capabilities of the local systems. A key factor in this direction is certainly the development and diffusion of financial culture. Those banks that are seriously investing in the innovative specialization of their human capital and in the promotion of the financial culture will be leading the difficult process of geographical integration.

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Table 1 Regional Economic Development

<i>Regions</i>	<i>Average GDP per capita 1989-90-91</i>	<i>Per capita GDP European Union regions ranking</i>	<i>Average unemployment rates 1991-92-93</i>
<i>North-West</i>	<i>index number</i>	<i>number</i>	<i>index number</i>
Lombardia	134.7	8	41.8
Valle d'Aosta	129.6	9	82.8
Piemonte	119.6	20	76.4
Liguria	115.8	27	94.9
<i>North-East-Centre</i>			
Emilia Romagna	127.5	10	46.2
Trentino Alto Adige	122	18	32.7
Friuli Venezia Giulia	121.6	19	57.5
Lazio	116.8	22	108.8
Veneto	116.6	23	47.5
Toscana	109.4	39	80.7
Marche	104.7	49	66.7
Umbria	98.9	66	94.7
<i>South</i>			
Abruzzi	90.2	100	116.1
Molise	78.8	128	156.5
Sardegna	74.2	139	196.2
Puglia	74.1	140	157.5
Campania	70.2	143	224.4
Sicilia	67.5	145	230.4
Basilicata	64.5	147	223.5
Calabria	57.9	152	206.4
<i>Total EU</i>	100	179	100

Source: European Commission, Report on Regions in Europe (1994)

Table 2 Characteristics of firms; 1991 (percentage in each area)

AREAS	North-West	North-East-Centre	South	ITALY
Classes of employees	<i>Dimension</i>			
< 10	38.4	44.1	61.1	45.4
10 - 49	21.0	21.9	20.4	21.3
50 - 199	11.7	10.1	8.4	10.4
200 -499	6.7	5.1	3.8	5.4
500 - 999	4.3	3.1	2.2	3.4
> 1000	18.0	15.6	4.1	14.2

	<i>Legal Type</i>			
Individual firms	67.3	68.7	80.6	71.7
Companies	32.0	30.4	18.6	27.5
of which: Limited	1.5	0.9	0.4	1.0

	<i>Localization</i>			
Mono-localized	94.2	94.0	94.5	94.2
Multi-localized	5.8	6.0	5.5	5.8
of which: Nationals	0.8	0.6	0.2	0.6

Source: ISTAT

Table 3. Indicators of banking structure

	NW		NEC		S	
	1990	1996	1990	1996	1990	1996
Population/Branches [*]	2772	2680	2650	1659	5059	3751
Municipalities served by banks/Mun.	0,55	0,62	0,84	0,88	0,55	0,62
Deposits/GDP ^{**}	0,57	0,60	0,55	0,56	0,43	0,46
Loans/GDP ^{**}	0,48	0,54	0,42	0,48	0,27	0,31

Source: ^{*} Banca d'Italia and Svimez; ^{**} Banca d'Italia and Istat, the data refer to 1990 and 1993

Table 4. Banking performance indicators (percentage values)

	NW		NEC		S	
	1990	1996	1990	1996	1990	1996
Loan interest rates [*]	14,1	12,4	14,7	12,8	16,2	14,8
Bad Loans/Total Loans [*]	2,9	4,7	5,1	8,8	8,0	26,6
Collateral/Loans [*]	33,9	29,8	45,0	28,3	74,8	55,7
Interest Margin/Total Assets ^{**}	2,7	2,6	3,1	3,1	3,1	3,3
Intermediation Margin/Total Assets ^{**}	4,1	3,7	5,8	4,3	4,1	4,2
Gross Operating Income/Total Assets ^{**}	1,7	1,4	3,1	1,6	1,5	1,2
Net Income After Taxes/Total Assets ^{**}	0,33	0,27	0,31	0,34	-0,24	-1,4

Source: * Banca d'Italia; ** Bilbank, the data refer to 1993 and 1995.

interest margin \equiv interest on loans, bonds + dividends - interest on deposits and other liabilities

intermediation margin \equiv interest margin + fees received + financial trading profits - fees paid

gross operating income \equiv intermediation margin - labor and other administrative costs

net income after taxes \equiv profits (losses) from ordinary activities + unexpected profits (losses) - taxes on income

Table 5 External Regional Disequilibria
(net export/GDP %)

Regions	1980-84	1985-89	1990-93
<i>Nord West</i>	7.5	9.4	9.1
Lombardia	10.0	11.4	11.4
Valle d'Aosta	-15.1	-19.3	-25.9
Piemonte	6.8	9.7	8.0
Liguria	-3.2	-1.1	1.5
North East Centre	0.6	1.9	2.7
Emilia R	5.0	5.1	5.3
Trentino	-10.8	-10.7	-10.4
Friuli	-7.1	-4.7	-2.8
Lazio	2.4	4.1	4.8
Veneto	0.3	1.8	2.4
Toscana	1.2	2.9	3.4
Marche	-2.3	-1.4	-0.7
Umbria	-6.5	-11.2	-8.4
<i>South</i>	-20.3	-19.6	-18.8
Abruzzi	-17.1	-14.7	-13.3
Molise	-37.1	-31.7	-29.1
Sardegna	-22.6	-22.0	-21.3
Puglia	-11.7	-11.0	-10.2
Campania	-15.9	-15.7	-14.7
Sicilia	-23.6	-22.6	-22.0
Basilicata	-36.4	-36.1	-34.4
Calabria	-37.2	-38.0	-38.1
<i>ITALY</i>	-2.4	-3.6	-4.9

Source: ISTAT

Table 6 a Active integration (distribution of bank branches by localisation of headquarters; % by column)

	<i>Headquarters</i> ↓	Lombardia		Other NW		Lazio		Other NEC		South		ITALY	
		1996	1996-'90	1996	1996-'90	1996	1996-'90	1996	1996-'90	1996	1996-'90	1996	1996-'90
Lombardia		55.7	-8.7	19.9	12.5	10.1	0.9	3.9	2	0.9	-0.2	19.2	0
Other NW		10.4	0.8	63.5	-16.3	7.4	-0.1	1.0	0.5	0.6	-0.6	12.1	-0.1
Lazio		5.7	0.9	3.2	1.5	42.0	-3.6	2.5	0.7	2.4	0	7.6	0.1
Other NEC		15.5	2.3	7.5	1.2	19.4	0.1	87.5	-4.9	1.6	-0.7	38.1	0.4
South		12.7	4.8	6.8	1.2	21.1	2.6	5.0	1.5	94.6	1.5	23.0	-0.6
<i>Total area</i>		100.0		100.0		100.0		100.0		100.0		100.0	
<i>Total branches</i>		6167	1951	3159	1317	2594	777	8577	3099	3806	665	24303	7809

Table 6 b Passive integration (distribution of bank branches by regions; % by row)

	<i>Headquarters</i> →	Lombardia		Other NW		Lazio		Other NEC		South		<i>Total branches</i>	
<i>Branches</i>		1996	1996-'90	1996	1996-'90	1996	1996-'90	1996	1996-'90	1996	1996-'90	1996	1996-'90
Lombardia		73.6	-12.9	12.8	9	5.6	0.3	7.2	3.9	0.7	-0.4	4666	1529
Other NW		21.8	4.9	68.0	-5.1	6.5	-0.3	3.0	1.7	0.7	-1.2	2948	936
Lazio		18.9	3.4	5.5	2.9	59.0	-8.0	11.8	4	4.9	-1.2	1849	614
Other NEC		10.3	-0.3	2.6	0.7	5.4	-0.2	81.0	-0.4	0.7	-0.4	9260	3042
South		14.1	5.5	3.9	1.2	9.8	1.2	7.8	2.8	64.5	-10.6	5580	1688
<i>ITALY</i>		25.4	-0.2	13	1.8	10.7	-0.3	35.3	2.1	15.7	-3.3	24303	7809

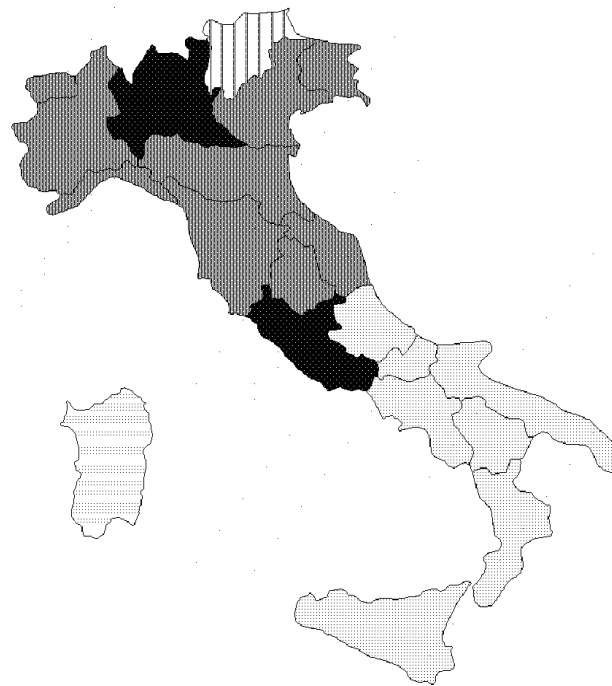
Source: Bank of Italy

**Table 7. Dimensional and geographical distribution of mergers
and incorporations of Italian Banks.**
(1990-1996)

Incorporating Banks	Incorporated Banks												
	Large			Medium			Small			Other			Total
	NW	NEC	S	NW	NEC	S	NW	NEC	S	NW	NEC	S	
Large													
NW	-	-	-	3	1	-	3	1	9	-	2	-	19
NEC	-	5	-	-	1	-	4	4	4	-	12	-	30
S	-	-	-	-	-	-	-	-	-	-	-	-	-
Medium													
NW	-	-	-	1	-	-	8	2	-	2	-	-	13
NEC	-	-	-	-	4	-	1	8	5	-	-	-	18
S	-	-	-	-	-	-	-	-	-	-	-	4	4
Small													
NW	-	-	-	-	-	-	53	-	-	-	-	-	53
NEC	-	-	-	-	-	-	-	117	1	-	3	-	121
S	-	-	-	-	1	-	-	-	76	-	-	-	77
Other													
NW	-	-	-	-	-	-	-	-	-	7	-	-	7
NEC	-	-	-	-	-	-	-	1	-	-	18	-	19
S	-	-	-	-	-	-	-	-	-	-	-	3	3
Total	-	5	-	4	7	-	69	133	95	9	35	7	364

Source: Bank of Italy.

Fig. 1 Geographical evolution of Italian financial system (1992)



More developed

Intermediate

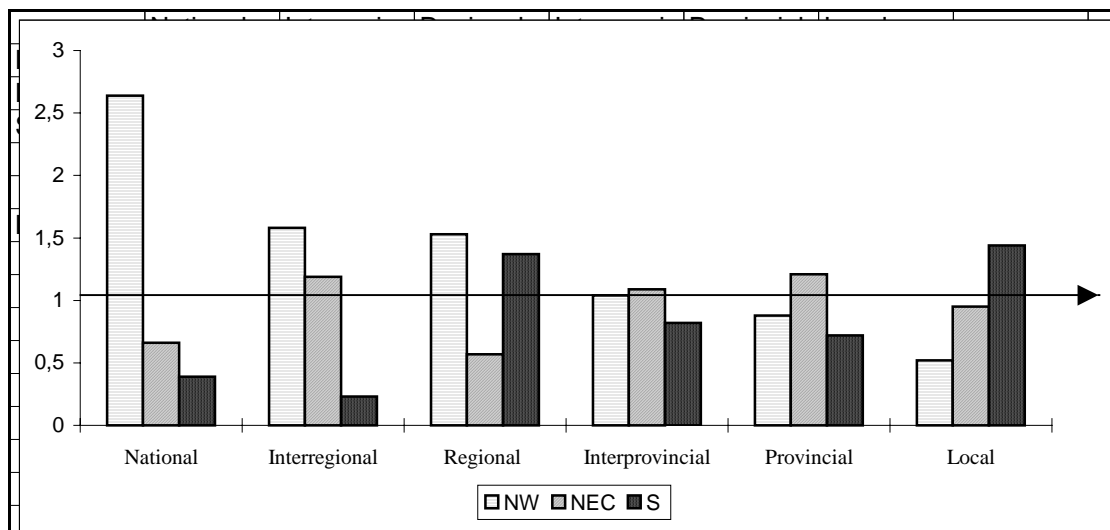
Less developed

N.B. the other regions are not classifiable by cluster analysis

Source: Alessandrini A. (1996)

Figure 2 Banks classified by territorial diffusion in each area

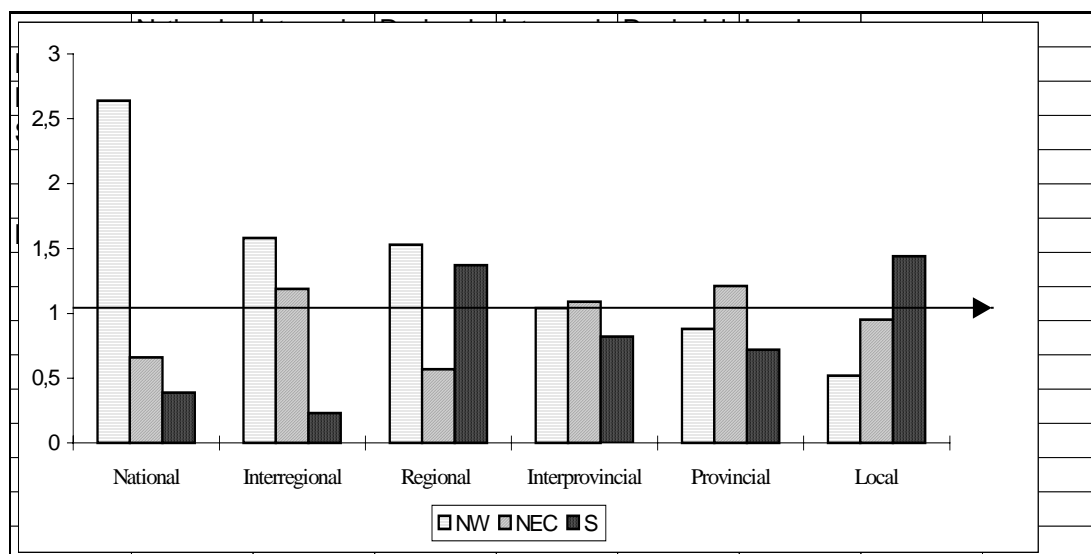
(index number Italy = 1, december 1996)



Source: Bank of Italy

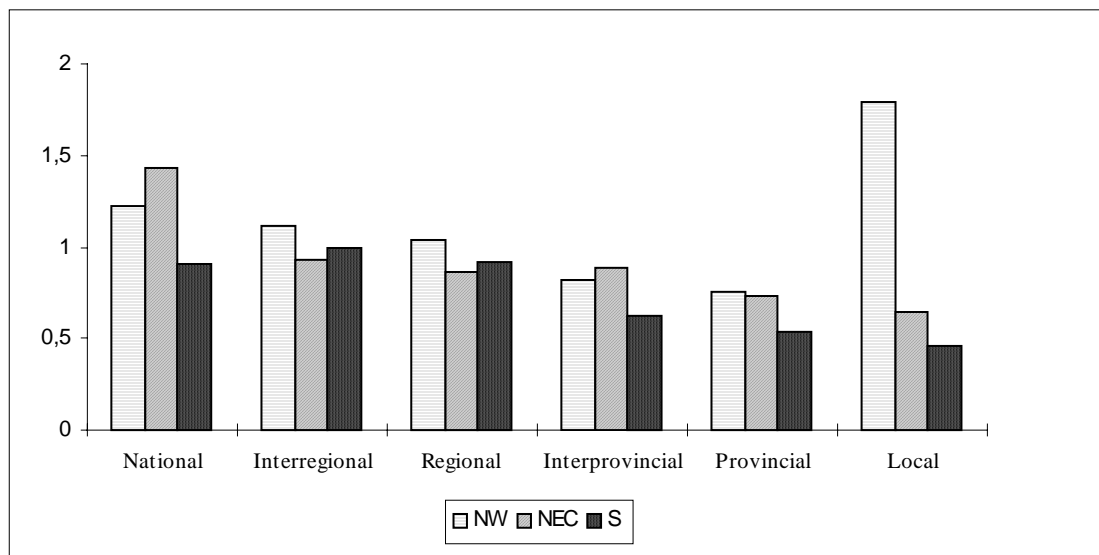
Figure 3. Branches of banks classified by territorial diffusion in each area

(index number Italy = 1, december 1996)



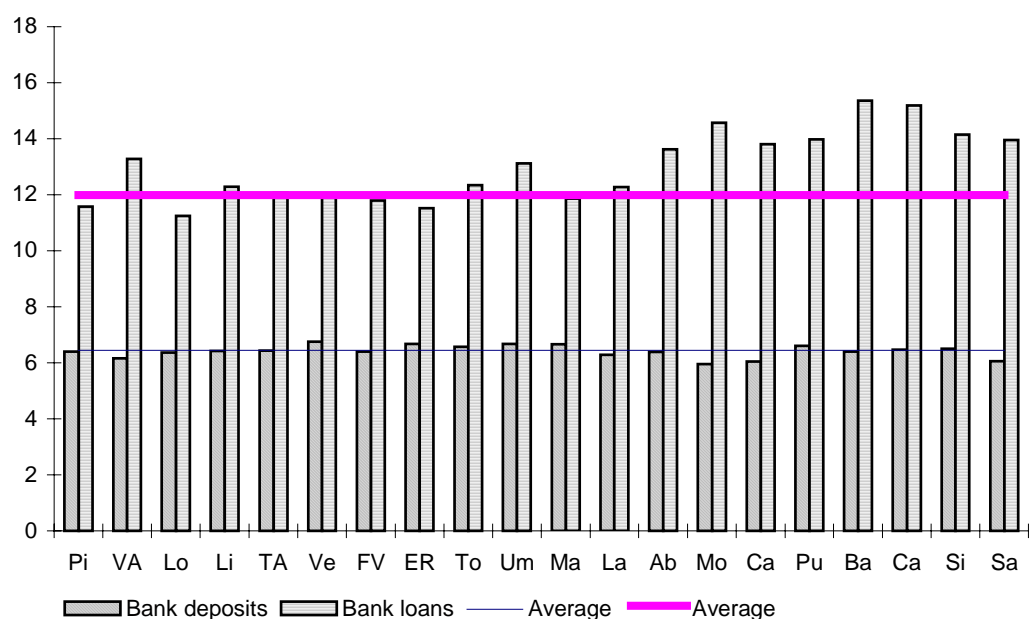
Source: Bank of Italy

Fig. 4 Loans/deposits ratio by branches localization of banks
classified by territorial diffusion
(december 1996)



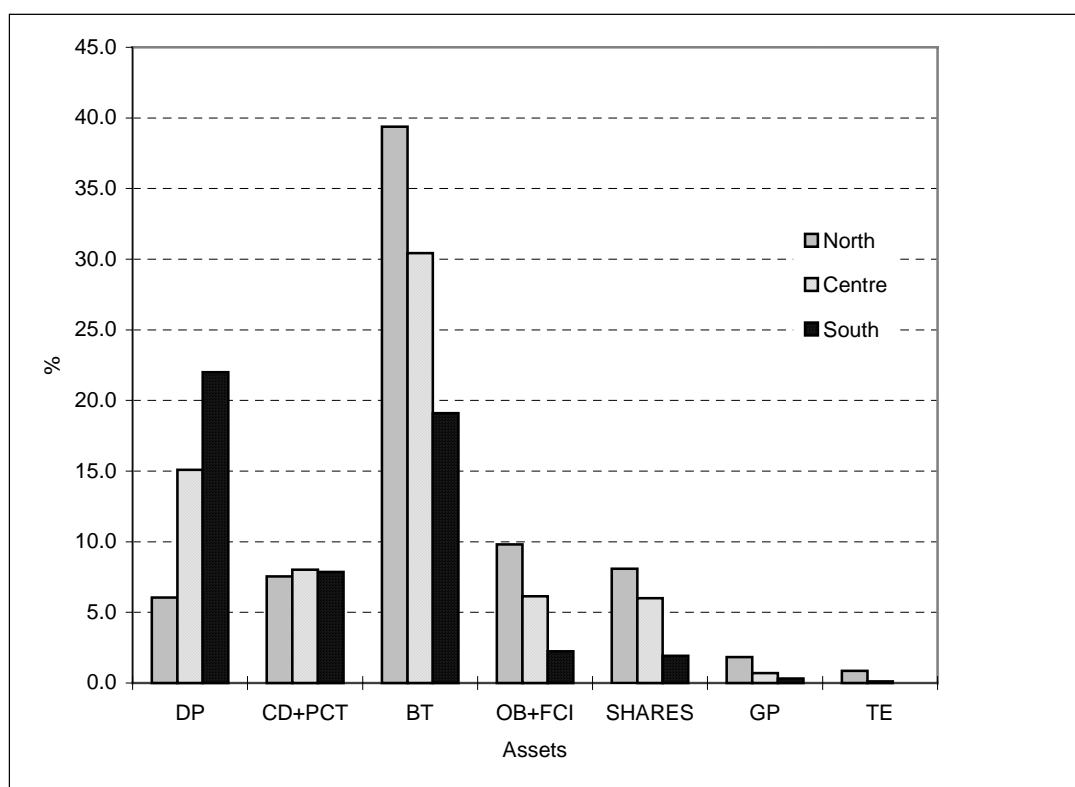
Source: Bank of Italy

Fig. 5 Bank interest rates by regions (september 1996)



Source: Bank of Italy

Fig. 6 Percentage of Household Holding Financial Assets in each area*, 1995



*every 100 households holding bank deposits, by assets

Source: Bank of Italy Survey