

COMMISSION DECISION

of 29 July 1998

giving conditional approval to the aid granted by Italy to Banco di Napoli

(notified under document number C(1998) 2495)

(Only the Italian text is authentic)

(Text with EEA relevance)

(1999/288/EC)

THE COMMISSION OF THE EUROPEAN
COMMUNITIES,

Having regard to the Treaty establishing the European
Community, and in particular Articles 92 and 93
thereof,

Having regard to the Agreement on the European
Economic Area, and in particular Articles 61 and 62
thereof,

Having, in accordance with the abovementioned
Articles, given interested parties formal notice to
submit their comments⁽¹⁾,

Whereas:

1. Introduction

Banco di Napoli is a former public monetary institution. When Law No 218 of 30 July 1990 (the 'Amato' Law) was adopted with its implementing decrees, the Bank's banking activities were entrusted to a joint stock company separated from the former public body, and its social security activities were entrusted to a transferring body (Foundation) which holds the capital of the banking company. Before the aid in question, the Foundation held 48,1% of the equity of Banco di Napoli and 71,2% of its voting rights. The Treasury held 9,1% of the capital, which represents 13,5% of voting rights. The other shareholders had 10,3% of the capital, representing 15,3% of the voting rights. The remaining capital (32,4%) took the form of savings' shares, without voting rights, quoted on the stock market.

The Banco di Napoli group, composed of Banco di Napoli SpA at the head, a sub-holding company, 11 companies controlled directly, two companies controlled indirectly and 16 other major direct or indirect holdings, was present at the end of 1994 throughout the national territory, with 810 branches, of which 684 were located in the south and 126 in central and northern Italy. In addition to that network, it was present abroad, with main subsidiaries in France, Luxembourg, Germany, Great Britain, Spain, United States of America and Hong Kong. The group's activities cover various areas of financial intermediation and credit, movable and immovable property activities, factoring, leasing, management of trust funds and unit trusts, merchant banking and insurance. At the end of 1993, Banco di Napoli ranked seventh in Italy in terms of total balance sheet (total consolidated assets of ITL 126 000 billion), with a capital-debt ratio (9,3%) above the minimum of 8% but with a low profitability (profits for the financial year to net assets ratio of 3,8%).

Banco di Napoli (hereinafter 'the Bank') incurred particularly severe losses in 1994 and 1995 of ITL 1 147 billion and ITL 3 155 billion respectively, which virtually wiped out its assets and made it impossible to comply with the prudential ratios laid down by the rules on credit.

The reasons for such extensive losses are many. For a long time the major reference point for local bodies, the Bank launched a particularly active policy of expansion at the beginning of the 1990s, focusing on its network of branches and loans to the large industrial groups of northern Italy and small and medium-sized enterprises in the south, at a time when the economy had already entered into a recession. The difficulties experienced by debtors, together with unsuitable credit selection methods and inadequate risk control procedures, led to serious losses on loans. The Bank's public status delayed its adjustment to an increasingly competitive environment and the adoption of the measures necessary to increase its technical

⁽¹⁾ OJ C 328, 1.11.1996, p. 23.

efficiency and its organisation. Staff expenditure continued to be particularly high, exceeding the national average. Acquisition and asset management policy was haphazard as it was not based on criteria of profitability, while the risks faced by firms in which it had invested were being insufficiently monitored by the head of the group. The overall management control system, consisting of rules and bodies that are relevant to the financing and supervision of a company ('corporate governance'), proved inadequate.

The further deterioration in the Bank's results, chiefly due to an increase in loan defaults, together with an imbalance between earnings and charges and an increasing proportion of non-performing assets, compelled the Bank to have continual recourse to the inter-bank market, which increased the cost of resources and diminished its profitability. The financing difficulties led to a liquidity crisis which was resolved by means of a debenture loan of ITL 2 365 billion granted in January 1996 by Cassa dei Depositi e Prestiti and other banks.

On 27 March 1996, the Italian Government approved as a matter of urgency a decree-law on the reform, restructuring and privatisation of Banco di Napoli SpA (Decree-Law No 163 of 27 March 1996). By decision of 30 July 1996, notified to the Italian authorities by letter of 12 August 1996, the Commission initiated the procedure under Article 93(2) of the Treaty in respect of various measures in the decree, in particular the recapitalisation of ITL 2 000 billion by the Treasury, the advances from Banca d'Italia under the Ministerial Decree of 27 September 1974 and the tax concessions.

At the same time, however, the Commission decided that other measures to assist the Bank could be implemented as either they did not constitute aid, e.g. the debenture loan of ITL 2 365 billion granted by Cassa dei Depositi e Prestiti and other public and private credit institutions in January 1996, and the capital injected under the 'Amato' Law, or they took the form of a measure which comprised aid, namely the possibility of releasing the mandatory reserve deposited by the Bank with Banca d'Italia, but could be regarded as compatible under the guidelines on rescue and restructuring aid, despite the unlawful nature of such aid due to the fact that it was not notified.

The Italian authorities subsequently informed the Commission that a new decree-law had been approved which amended the preceding decree in order to facilitate and assist the privatisation of the Bank. In

the autumn of 1996, bids were invited for 60 % of the Bank's equity. The procedure ended at the beginning of January 1997 with the acquisition of a 60 % holding in the Bank by a company, in turn owned as to 51 % by Istituto nazionale per le assicurazioni (INA) and as to 49 % by Banca Nazionale del Lavoro (BNL). In the meantime, the Italian authorities had decided to increase the Bank's capital before the end of 1996 in order to prevent it being wound up.

No comments were received by the Commission from other interested parties as part of this procedure within the period specified.

2. Description of the public measures to assist Banco di Napoli

Following a preliminary examination of the case, the Commission concluded, in its initiation of this procedure, that some of the measures provided for in Decree-Law No 293 of 27 May 1996, which replaced and amended Decree-Law No 163 of 27 March 1996, were likely to contain elements of State aid within the meaning of Article 92(1) of the EC Treaty and could not, at that stage and on the basis of the information available at the time, be regarded as compatible with the common market. In particular, the Commission asked for further clarification concerning the following aid measures:

- (1) Treasury contributions to increases in the Bank's capital totalling ITL 2 000 billion, in accordance with the commitments provided for in the abovementioned decree;
- (2) the possibility for Banca d'Italia to grant the Bank, in order to facilitate the restructuring of the group, advances under the Treasury Decree of 27 September 1974 to cover losses resulting from financing and other measures taken by the Bank to assist group companies being wound up and in the interests of creditors of the latter;
- (3) tax measures relating to the registration fee (fixed at a flat rate of ITL 1 million) for acts relating to transfers of enterprises, branches of enterprises, assets and legal relationships established by members of the group before 30 June 1997.

Amendments were then made to the abovementioned decree in order to speed up the restructuring, recovery and privatisation of the Bank (Decree-Law No 396/96). In particular, the Italian authorities made provision for the possibility of setting up a hive-off structure with the task of managing, liquidating and deconsolidating some ITL 12 400 billion of the Bank's less performing assets. They also provided for an accelerated procedure for disposing of 60 % of the Bank's capital by invitation to tender, the procedures for which are provided for in the Treasury Decree of 14 October 1996. The specific measures are described below.

2.1. Treasury participation in the Banco di Napoli capital increase

Decree-Law No 163 of 27 March 1996, as last amended⁽²⁾ by Decree-Law No 497 of 24 September 1996, and converted into Law No 588 of 19 November 1996, provides for a series of financial measures for the reform, restructuring and privatisation of the Bank. In particular, provision is made for Treasury contributions to one or several capital contributions to the Bank, totalling ITL 2 000 billion. The contributions are subject to a number of conditions imposed by the Italian authorities as a guarantee of the commercial nature of the State measure.

First, Treasury funds may not be contributed unless they are accompanied by funds from one or several banks and other institutional investors or an undertaking given by the latter that they will participate in the bidding procedure for the controlling interest in the Bank amounting to 60 % of the capital. This allowed the Treasury to proceed with the capital increase after receiving preliminary offers from the banks and thus being certain of finding a purchaser for the Bank.

Secondly, the Treasury funding was not granted until the equity had been adjusted on the basis of an

assessment of the Bank's assets on 31 March 1996. The reason for this condition was the need to base the Treasury contribution and that of the new shareholders on a more recent picture of the Bank's assets. The writing-off of losses at the end of the first quarter of 1996 involved a reduction in net assets from ITL 3 867 billion to ITL 422 billion and in equity from ITL 1 111 billion to ITL 128 billion. The losses in the second quarter, totalling ITL 389 billion, were carried forward to the end of the year. The decision not to incorporate the first six months' losses in the half-yearly accounts was based on two reasons: on the one hand, the need to maintain a minimum level of capital in order to avoid the statutory obligation to wind up the Bank; on the other hand, the need for the Treasury, as a minority shareholder of the Bank, to obtain from the Foundation, as the majority shareholder, a mandate to manage its shares with a view to the successful sale of the Bank. Thus, the transaction was subject to the transfer to the Treasury, as a guarantee, of the voting shares in the Bank held by the majority shareholder (the Foundation), or to the granting to the Treasury of an open mandate to exercise the voting right attached to the shares in question in order to give it a majority of voting rights in the meetings which would have decided on the capital increases and renewal of the social organs of the Bank.

Thirdly, the decree provided that the administrative bodies of the Bank must adopt no later than 30 June 1996, an appropriate restructuring plan, which must be drawn up with the assistance of an expert appointed by the Treasury, submitted for approval by Banca d'Italia and comply with Community law. The main points of the plan, drawn up with the assistance of the merchant banker Rothschild, were notified to the Commission on 4 July 1996. An amendment to the plan, involving the setting-up of a hive-off structure, was notified to the Commission on 6 December 1996.

Fourthly, Treasury funds were to be granted on condition that trade union agreements were concluded on reducing labour costs by 31 December 1997, in particular by levelling down the unit cost including social security costs to the average for the banking sector. The agreements were concluded between 19 and 22 July 1996. As regards the additional pension costs borne by the Bank, the equalisation mechanisms were suspended until an adequate level of profitability was achieved and, in any event, not before 2000. In addition, the Bank could offer early retirement to some 800 persons.

⁽²⁾ See Decree-Laws No 293 of 27 May 1996, No 394 of 26 July 1996 and No 497 of 24 September 1996.

2.2. *The advances granted by Banca d'Italia under the Ministerial Decree of 27 September 1974*

In order to facilitate the restructuring of the group, Article 3(6) of Law No 588/96 enables Banca d'Italia to grant the Bank advances, in accordance with the procedures in the Treasury Decree of 27 September 1974, to offset the losses incurred by the Bank from loans granted to group companies being wound up and other funding granted to the latter and to their creditors, as well as to other group companies which received, after authorisation from Banca d'Italia, loans and other non-property assets of the Bank. The Treasury Decree of 27 September 1974 provides that the Banca d'Italia may grant 24-month advances at 1% on long-term Treasury bonds to banks which, acting by surrogation on behalf of depositors of other banks in compulsory liquidation, are required to write off bad debts. Banca d'Italia determines the amount of the advances on the basis of the extent of the losses and the write-off requirements.

Initially, the possibility of using the advances in question was limited to any losses which may have arisen in connection with the winding-up of Isveimer. Later, this possibility was extended to losses relating to assets of the Bank transferred to a specific hive-off structure as regards the part not covered by the proceeds from the sale of the Bank's assets.

2.2.1. *The winding-up of Isveimer*

On 3 April 1996 Isveimer, in which the Bank had a 65% holding, entered into voluntary liquidation and the Bank's stake in its capital was reduced from ITL 402 billion (at the end of 1994) to ITL 1. In the course of the winding-up, the liquidators will be able to reimburse Isveimer's creditors on the due dates thanks to the liquidities provided by the Bank. The advances from Banca d'Italia are intended to compensate the Bank for the losses incurred by it as a result of the loans granted to Isveimer to enable the latter to repay its creditors. The intention is to protect fully the interests of Isveimer's creditors. The financing is limited to the negative result of the winding-up

procedure, in so far as Isveimer's assets do not cover the value of its commitments. The transaction is intended to prevent tension and the undesirable effects this can entail for financial markets in view, in particular, of the extent of the involvement of foreign financial institutions in Isveimer.

2.2.2. *The hive-off vehicle*

The hive-off operation enabled the Bank to separate itself from its balance sheet and to transfer a number of less-performing assets to an *ad hoc* structure. The hive-off structure is composed of SGA (Società per la gestione di attività SpA) (SGA), which acquired the non-performing assets (loan defaults, doubtful loans in excess of ITL 100 million, claims restructured or in the process of being restructured) and eight of the Bank's holdings, with the exception of property assets, for a total of ITL 12 378 billion. The assets were acquired at net book value on 30 June 1996, i.e. after provisioning for estimated losses on those assets, which reduces the risk of future losses on the same assets. As regards the holdings transferred, the largest of which is in Banco di Napoli International (BNI), the Bank's Luxembourg branch, those quoted on the stock exchange were valued at market rates, the others by the net assets method. The BNI was valued on the basis of a recent audit by the specialised firm KPMG using a mixed assets/income method.

The purpose of the operation was to avoid the risk of future losses on those assets and thus facilitate the early sale of the Bank. Although in principle the provisioning carried out in June was sufficient to reduce estimated future losses on the assets to zero, it is possible that in future it will be necessary to adjust the book value of the assets to their actual value. The transaction also makes it possible to remove from the Bank's balance sheet assets which would normally, like any other asset, require provisioning in accordance with the rules on solvency. In this way it was possible to minimise the amount of capital injected by the State in order to strengthen the solvency ratio.

The following table shows the values of the hived-off assets.

Table 1a

Value of the assets transferred to SGA

Commitments

(billion ITL)

	Gross value	Provisioning rate	Net value
Short-term liabilities	3 670	49,7 %	1 845
Medium-/long-term liabilities	3 953	28,3 %	2 835
Sub-total	7 623	38,6 %	4 680
Doubtful loans ⁽¹⁾	6 677	17,1 %	5 537
Restructured loans	1 411	10,3 %	1 266
Assets related to developing countries	839	28,1 %	603
Shareholdings ⁽²⁾	292	0,0 %	292
Total	16 839	26,5 %	12 378

⁽¹⁾ Provisioning for bad debt consists of ITL 936 billion in capital and ITL 200 billion in default interest, the amount being subject to change.

⁽²⁾ These concern eight companies, the largest of which is the Bank's subsidiary in Luxembourg, BNI.

In addition, there are the following commitment appropriations:

Table 1b

Value of assets transferred to SGA
Off-balance-sheet commitments

	Gross value (billion ITL)	Provisioning rate (%)	Net value (billion ITL)
Liabilities	27	25,9	20
Doubtful loans	195	3,1	189
Restructured claims	53	0,0	53
Total	275	4,7	262

The hive-off vehicle will be financed with a loan granted by the Bank equal to the value of the assets transferred. The loan will be repaid as and when the hived-off assets are sold. The rate of interest applicable to the loan is based on the principle that the Bank must neither benefit nor incur losses in relation to its position prior to the hive-off. It was therefore decided to use a compound rate based on the

arithmetical mean of the following rates for the preceding year:

— average yearly yield of the 3-month Treasury bills (average of the 24 auctions a year),

— 90-day inter-bank offered rate (average of the day's rates),

— average yearly yield prime rate ABI (Associazione Bancaria Italiana) (average of the day's rates).

The following table shows projections based on objective estimates of the abovementioned rates.

Table 2

Interest rates on the Bank's loan to SGA

	1997	1998	1999	2000
Average 3-month Treasury bills	8,6	6,5	5,6	5,4
Average 90-day rate	8,8	6,7	5,6	5,2
Average prime rate	11,0	8,7	7,5	6,9
Total	9,4	7,3	6,2	5,8

Source: Data provided by the Bank on the basis of forecasts by Prometeia and ABI Financial Outlook.

The hive-off vehicle is expected to operate for five years. The Bank may not repurchase hived-off assets. To avoid conflicts of interest in the management of the hived-off assets, specific measures were provided for. First, the hive-off vehicle would be managed by persons not related to the Bank. Second, asset management would be based on the principle of 'the Bank proposes and the vehicle decides'. To that end, a specific structure would be set up under the general management of the Bank, which would be separate from the rest of the Bank in order to deal with relations with SGA and the Bank's subsidiaries entrusted by the SGA with the task of managing the assets. The administrative and accounting separation between the Bank and SGA will be guaranteed by the adoption of a specific electronic accounting system that is separate from the Bank's internal accounting system.

2.3. *Tax concessions*

Article 3(7) of the Law provides that the registration fee will be replaced by a flat-rate tax of ITL 1 million for acts concluded by 30 June 1997 in connection with transfers of enterprises, branches of enterprises, assets and legal relationships established by members of the Bank's group. The Italian authorities stated that the measure is fully applicable only to debt assignments to third parties and transfers of branches. The tax concessions granted under this heading in 1996 amounted to under ITL 6 billion in respect of debt buy-backs totalling ITL 1 154 billion, and ITL 21 billion for the sale of 50 branches. An additional tax concession of some ITL 10 billion is provided for in respect of the sale of an additional 27 branches. All in all, tax relief will total some ITL 36 billion gross. After deduction of corporation tax, the benefit resulting from the transactions totals ITL 17 billion.

3. Assessment of the aid content of the measures to assist Banco di Napoli

3.1. *The capital increase*

In order to assess assistance granted by the State, the Commission usually applies the 'market economy investor principle' as described in its communication on public undertakings⁽³⁾. The communication states that there is State aid if a private investor operating under normal market economy conditions would not have undertaken the transaction. As regards public holdings in the capital of a firm, the Commission communication of 1984⁽⁴⁾ states that there is State aid where capital is contributed in circumstances that would not be acceptable to a private investor in the following cases:

- (a) where the financial position of the company is such that a normal return (in dividends or capital gains) cannot be expected within a reasonable time from the capital invested, or because the

risks of such a transaction are too great or are spread over too long a period;

- (b) where the injection of capital into companies whose capital is divided between private and public shareholders makes the public holding reach a significantly higher level than originally and the relative disengagement of private shareholders is largely due to the company's poor profit outlook;
- (c) when the amount of the holding exceeds the real value of the company.

The three conditions have been met in the case in question. Firstly, the Treasury's injection of ITL 2 000 billion at the end of 1996 and entered into the accounts for the same year is essential to the survival of the Bank as the losses in 1994 and 1995 and in the first six months of 1996 exhausted virtually all the Bank's own funds, leaving it with a solvency ratio close to zero, i.e. well below the minimum requirement of 8%. Furthermore, owing to further restructuring measures, in particular the entry in the accounts at the end of 1996 of losses relating to the hived-off assets and the restructuring costs, including those for 1997, the Bank's net position plunged into the red which, under the Italian civil code, requires the administrators either to recapitalise it or wind it up.

Secondly, the State is the sole shareholder taking part in the transaction, the other shareholders, in particular the Foundation and the private shareholders, having refused to take part. Thus, as a result of the transaction, the State becomes the major shareholder, having previously held only 9% of the Bank's capital. Its injection of ITL 2 000 billion served to offset the 1996 losses estimated at over ITL 1 650 billion. Obviously no private shareholder would be prepared to inject funds intended to cover losses unless the future income from the remaining capital was able to offset initial losses and loss of profits during the restructuring period. This is not the case, as the Bank's restructuring plan predicts that normal yields only will not be achieved before the end of 1999.

In theory, the State could have recovered at least part of its investment when it sold 60% of its holding in the Bank, but the proceeds of the sale were very modest, amounting to some ITL 61 billion, which was insufficient to recover the capital injection. Although a

⁽³⁾ Commission communication to the Member States on the application of Articles 92 and 93 of the EC Treaty and of Article 5 of Commission Directive 80/723/EEC to public undertakings in the manufacturing sector (OJ C 307, 13.11.1993, p. 3).

⁽⁴⁾ Bull. 9-1984.

valuation of the remaining capital by means of the discounted cash flow and share price methods is likely to provide a higher estimate, it does not guarantee recovery of the difference. In addition, the proceeds from the sale cannot be deducted from the costs of the capital injection, as they are intended to cover any losses incurred by the hive-off vehicle. Accordingly, the net cost to the State of the capital injection can be estimated as equal to the amount of the injection, i.e. ITL 2 000 billion.

As regards the pre-conditions for the capital increase which, according to the Treasury, were designed in principle to guarantee compliance with the principle of the private investor operating in a market economy, the Commission notes that the conditions were included in the decree to ensure that the Treasury contribution did not take place without an accompanying plan for the Bank's recovery. Such conditions, however, are not sufficient for the transaction to be regarded as complying with the private investor principle, for the reasons set out above. However, although the conditions do not preclude the presence of aid, the Commission considers that they are sufficient to ensure the compatibility of the aid (see Section 5 below).

As stated when the procedure was initiated, the Treasury acted initially without the support of private banks. In particular, it should be noted that half of the ITL 2 000 billion capital injected in December 1996 stems from the conversion of the subordinated loan granted by the Treasury to the Bank in June 1996. The subordinated loan, however, resulted from the conversion of the debenture loan of ITL 1 000 billion granted by Cassa dei Depositi e Prestiti to the Bank in January 1996. The transaction whereby the Treasury converted the debenture loan from Cassa dei Depositi e Prestiti, thus enabling the Bank to enter ITL 1 000 billion into its accounts as a subordinated loan, must affect the Treasury since the risk associated with the loan in the event of bankruptcy is increased because the loan is subordinate in relation to other debts of the Bank, without any extra compensation for the Treasury in return for the greater risk.

The conversion of the subordinated loan into capital in 1996 took place before the conclusion of the bidding procedure launched in October 1996 for 60 % of the Bank's capital, although only one public bank expressed an interest in making an offer, on terms that were not disclosed. Thus the conversion by the Treasury of the ITL 1 000 billion debenture loan from

Cassa dei Depositi e Prestiti into a subordinated loan subject to the same interest rates in June 1996 and its subsequent conversion into capital in December 1996, before the end of the bidding procedure, must be regarded as transactions not complying with the private investor principle and hence as containing elements of aid.

The Bank was recapitalised by the Treasury before the Commission took its decision. The Italian authorities stated that the Bank had to be recapitalised before the end of the year, failing which it would have to be wound up. Under Articles 2446, 2447 and 2448 of the Italian civil code, the Bank's administrators are required to convene a shareholders' meeting in the event of huge losses in order to reduce the capital and recapitalise, or wind up the bank. Otherwise, the administrators are legally liable. On 31 July 1996, the shareholders' meeting decided, under a specific derogation provided for in the decree until 31 December 1996, on a partial reduction of the capital (not affecting the savings shares) and a capital increase of ITL 2 000 billion to be carried out before the end of 1996. The authorities stressed that they had complied with the terms of the decree-law which require the Treasury to recapitalise only after receiving a commitment from a bank that it will submit a firm offer for the Bank.

The Commission understands the reasons why the authorities carried out the transaction before the end of the year; however, it concludes that the transaction took place unexpectedly, without a formal request, and before the end of the bidding procedure for the controlling interest in the Bank. In addition, the information supplied at the time to the Commission was incomplete. The Commission was thus unable to decide on the compatibility of the aid to the Bank before the recapitalising as a result of the delayed submission by the Italian authorities of a restructuring plan. The aid must therefore be regarded as unlawful.

The Commission also notes that the transfer procedure ended in January 1997 with the award of the controlling interest in the Bank to the insurance company INA, which took 51 %, and to BNL, which took 49 %, the offer made by Mediocredito Centrale having been considered inadequate.

It must therefore be concluded that a private investor in a market economy would not, unlike the Italian State, have injected capital into the Bank only to recover a small fraction of the investment when the Bank was privatised. Accordingly, on the basis of the information available, the capital increase of ITL 2 000 billion must be regarded as State aid.

3.2. *Advances granted by Banca d'Italia under the Decree of 27 September 1974*

3.2.1. *Liquidation of Isveimer*

In general, when the winding-up of a bank enables all its commercial and intermediation activities to be freely distributed among its competitors, it may be said that the measures intended to cover losses incurred by creditors as a result of the winding-up are not likely to cause distortions of competition within the meaning of Article 92(1) of the EC Treaty. On the other hand, if the assets and liabilities of a bank in liquidation are transferred as a whole to another entity, it is possible that the Decree of 27 September 1974, which allows the purchaser to be compensated for the negative value of the acquisition, could distort competition as it could enable the purchaser to pursue the activities of the wound-up establishment. As the Commission stated in its guidelines on State aid for rescuing and restructuring firms in difficulty, 'it will not be possible to evade control by transferring the business to another legal entity or owner' ⁽⁵⁾.

In the case in question, the Italian authorities stated that the winding-up of Isveimer corresponds to the first possibility described above. They added that the Bank's stake in Isveimer had already been reduced from ITL 402 billion to ITL 1. They stressed that the measures were applicable only in order to resolve difficulties connected with the winding-up of Isveimer. According to the first interim balance sheet of Isveimer in liquidation, drawn up at 31 December 1996, there was a shortfall in own funds of some ITL 1 775 billion, corresponding at that stage to the

estimated discounted value of the probable liquidation losses. From the start of the winding-up procedure on 9 April 1996 to 31 December 1997, the sale of loans to customers and a regular flow of repayments reduced assets by ITL 5 028 billion, bringing them to ITL 6 224 billion, of which ITL 3 086 billion is in the form of liquidities. At the end of the year, liabilities totalled, after deduction of own funds, ITL 6 341 billion compared with ITL 12 077 billion at the beginning of the winding-up procedure. That procedure is thus nearly completed.

The Italian authorities pointed out that the transaction did not distort competition at Community level as it was not intended to save Isveimer but to protect the interests of the creditors of the institution which, as it is being wound up, has withdrawn from the market. They stated that a large number of foreign financial institutions were among Isveimer's creditors. Lastly, they stated that the Bank would not enjoy any particular financial advantage from the advances in question as they were intended purely as compensation, including compensation for the charges borne by the Bank as a result of the loans granted to its subsidiaries to facilitate the winding-up procedure. In other words the advances simply transit through the Bank. The authorities also ruled out the possibility of the bank acquiring any of Isveimer's assets under the winding-up procedure, unless it proved impossible to sell them to third parties or to recover them on more advantageous terms for the winding-up.

The Commission also considered whether the advances in question were intended to offset possible losses incurred by the Bank on loans granted by it to Isveimer, totalling some ITL 800 billion. The authorities stated that the loans were fully guaranteed by mortgages registered for amounts in excess of the value of the loans. Thus the Bank would have recovered its loans under the winding-up proceeding even without the advances from Banca d'Italia. It should also be noted that the Bank's loans to Isveimer are to be repaid only at the end of the winding-up procedure. Accordingly, the Commission considers that there are grounds for considering that the Bank does not enjoy any undue advantage from the application of the Decree of 27 September 1974.

In view of the explanations given by the Italian authorities, the Commission considers that, in the present case, the application of the Decree of 27 September 1974 does not constitute State aid within the meaning of Article 92(1) of the EC Treaty. It nevertheless considers it necessary that it should in the future be notified in advance if the decree is applied to other cases, for example where the assets

⁽⁵⁾ See Community guidelines on State aid for rescuing and restructuring firms in difficulty (OJ C 368, 23.12.1994, p. 12).

and liabilities of a credit institution in liquidation are transferred as a whole to another entity, in so far as this could constitute State aid under Article 92(1) of the Treaty.

3.2.2. *The hive-off operation*

In general, the Commission takes the view, as it has in other cases, that operations to hive-off banking assets constitute State aid since they allow the credit establishment in difficulty to remove from its balance sheet all the commitments and losses it would normally have borne alone, as well as facilitating compliance with the solvency regulations. They also help any future privatisations by enabling potential buyers to avoid undertaking lengthy and difficult valuations, given the nature of the hived-off assets, of the exact amount of provisioning required. The hive-off vehicle is financed from resources granted through the bank conducting the hiving-off operation or through a company specifically set up for the purpose which operates between the bank and the hive-off vehicle. In any event, losses incurred by the hive-off vehicle are eventually borne by the State through public guarantee mechanisms or, as in the present case, through recourse to advances from Banca d'Italia under the Decree of 27 September 1974.

Because of the nature of the hived-off assets, the financial mechanism used and the duration of the operation, it is often difficult to obtain a precise estimate of the final cost of a hive-off. It is, however, essential to quantify the estimated cost to the State in order to approve the aid and determine the necessary compensation to be granted in order to offset distortions of competition. The Commission paid particular attention to this aspect, in the light of its experience in other cases of hive-off operations, chiefly because of the significant disparities between actual results and estimates submitted to it for examination under the rules on State aid. The updating of estimates of the net value of assets in portfolio, variations in market interest rates, a downturn in the rate of sales of assets or in the repayment of the loan granted by a bank to the hive-off structure may significantly affect the cost of the operation borne by the State.

When the hive-off structure was set up, the Italian authorities confirmed that it would not incur

significant losses and that it was intended to reduce uncertainties concerning the valuation of certain balance sheet items which could have delayed the privatisation.

The Italian authorities first pointed out that the structure and mechanisms of the hive-off are very different from those used previously and already examined by the Commission, as the Bank's assets were transferred to the hive-off structure at their net value and not at their gross value. This means that the Bank had already provided in 1995 and 1996 for expected losses on the assets transferred, with the result that it reported losses of over ITL 1 650 billion in 1996 and ITL 3 160 billion in 1995. All in all, the Bank used own resources, i.e. by reducing reserves and equity, to cover losses and loan loss provisions totalling ITL 4 460 billion, i.e. 26,5 % of the total value of the hived-off assets of ITL 16 840 billion. The value of the assets was assessed on an individual rather than on a flat-rate basis. In addition, by means of a computerised system known as the 'Centrale dei Rischi', which provides banks with information on a client's total exposure in other banks and their risk ratings, the Bank was also able to adjust its risk assessment of customers that are also in debt to other banks, in particular as regards its poorly performing assets. As regards the doubtful claims, the Bank applied a particularly prudent classification criterion whereby loans are placed in this category as soon as the second payment has not been made. Lastly, the asset write-off was strictly supervised by Banca d'Italia, the independent authority responsible for banking supervision. The results of the first sales of assets, by SGA appear to confirm that the book valuations were assessed correctly.

While the Commission took the view that the explanations given by the Italian authorities were reasonable as regards the values attributed to the hived-off assets, it nevertheless considered it advisable to commission a detailed report on SGA in view of the financial charges it was bearing. In 1998 therefore, the merchant bankers Rothschild submitted a study to the Commission on SGA and its possible future losses, based on information from Banca d'Italia and the Bank as well as from other sources.

Rothschild examined the following aspects: (a) the organisational structure of SGA, its activities and relations with the Bank; (b) the management policies followed by SGA in its recovery activities; (c) the

proceeds from assets sold in 1997; (d) the financial values at which the assets were transferred to SGA; (e) the balance between the interest paid on the assets transferred and the borrowing interest rate on the loan granted by the Bank, on the basis of the advances from Banca d'Italia.

(a) SGA is organised as follows:

- a structure that is dedicated to directing, stimulating, coordinating and controlling the disposal of assets. Its staff come from outside the Bank and have appropriate experience and skills in the field of debt management and recovery,
- another separate structure composed of a central department which works solely for SGA and a network of the Bank's branches staffed by Bank employees who are responsible for managing claims, and investigating claims and proposing decisions,
- decision-making powers are shared by the Management Board and the managing director, both being empowered to manage the larger, more delicate claims and having sole responsibility for the recovery and sale of assets.

SGA is able to manage the many claims distributed widely throughout the country with efficiency owing to its organisational structure, where tasks are shared by an autonomous and separate structure, a central service and the Bank's branch network. This should allow it to carry out its tasks within a reasonable time and at reasonable cost. In addition, the allocation and separation of management and investigation tasks and those of directing, controlling and deciding between the Bank's employees and those of the SGA, satisfies the requirements for separation between the hive-off vehicle and the Bank.

(b) In accordance with Banca d'Italia rules, SGA based its recovery policy on the principles of maximisation of returns, taking account of the

objectives of limiting the time and money spent by the firm. Out-of-court settlements are preferred to the lengthy judicial procedure which can reduce the value of the assets in question, accompanied by, depending on the case, multiannual repayment plans limiting repayment times to a minimum. This approach allowed account to be taken of the recovery prospects of the debtor firms, avoiding traumatic effects wherever possible. In the case of restructured loans, it was decided not to grant new financing, to reduce, where possible, loans already provided for in restructuring agreements and to avoid converting loans into risk capital.

(c) The sales of assets produced satisfactory results: at 31 December 1997 loans totalling ITL 1 476 billion were recovered, accounting for some 12 % of assets, of which ITL 660 billion stemmed from the sale of foreign securities and loans to risk countries (with a gross added value of some ITL 80 billion) and ITL 780 billion from poor quality loans. A slight rise in added value was also recorded from the sale of Italian securities. In addition, loan repayment agreements were concluded which, from 1998, will produce a total of more than ITL 580 billion. The SGA Management Board examined a total of ITL 3 789 billion and agreed a total of ITL 3 559 billion. The proceeds from the assets sold by SGA one year after it started business are in line with the forecasts made when the Bank's restructuring plan was drawn up.

(d) Rothschild compared the valuation of assets and the provisioning policy adopted by some of the banks comparable in terms of size and geographical location to the Bank. According to the balance sheet at 31 December 1996, when the Bank's assets were transferred to SGA, the Bank's policy of provisioning and restructuring of its balance sheet was either in line with that of the major banks, or was more conservative. However, it is necessary to estimate losses in view of the possibility that, once a high level of asset recovery has been achieved, SGA may decide to cease operating and wind up any remaining cases where the prospects of recovery are uneconomic. The conservative estimate drawn up by Rothschild indicates a 'normal' loss of not more than 10 % of the assets transferred, i.e. ITL 1 000 to 1 200 billion.

- (e) As regards the costs of financing the hive-off vehicle, the Italian authorities pointed out that the interest rate on the loan from the Bank to SGA was based on the principle that the former should not benefit or lose from its loan to the hive-off vehicle. Thus the rate corresponds to the actual interest rate on the hived-off assets. On that basis SGA should be able to use income from the assets in portfolio in order to pay the interest on the Bank's loan.

The analysis carried out by Rothschild of the hive-off vehicle also took account of the possibility of financial imbalances; in particular, it examined the possibility that the borrowing interest rate on the loan from the Bank to SGA is definite and considerable, whereas the amount of interest paid on claims transferred or dividends on securities is at the very least uncertain and not considerable. In 1997, the imbalance between the financial charges borne by SGA for the financing received from Banco di Napoli (ITL 1 089 billion) and the interest received, including default interest (ITL 1 039 billion), amounted to ITL 60 billion. The difference could in theory vary depending on such factors as: the possibility of recovering default interest on claims, the proportion of claims producing a fixed rate of interest to those with a variable rate of interest, a gradual reduction in interest rates as a result of a general cut in rates, a gradual reduction in the loan to SGA as a result of write-offs and repayments, and a gradual deterioration in the assets transferred to SGA. As the events of 1997 may occur again in future years and in view of the expected lifetime of the hive-off vehicle and the factors described above, the difference should, according to a conservative estimate produced by Rothschild's, range from ITL 1 000 billion to ITL 2 700 billion in the next two to three years, including the costs referred to in recital (d).

According to the Italian authorities the results recorded at that date would suggest that SGA was about to wind down its activities without any significant losses. However, as matters stand, the Commission cannot rule out the risk that a gradual decline in the value of the assets of SGA could entail larger losses and an increase in the difference between financing charges and interest received. In view of the difficulty in recovering default interest and on the basis of other factors, the Commission considers it would be more prudent to assume maximum losses of ITL 2 700 billion. In addition, the State guarantee covers the maximum theoretical loss of ITL 12 378 billion resulting from the hypothetical situation

outlined by Rothschild where the assets retained by SGA would not have any positive value.

However, the Commission, as in other cases, also took account of additional factors likely to reduce the cost borne by the State.

With regard to these costs, however, it must be borne in mind that Law No 588/96 provides that any losses incurred by the hive-off vehicle will be offset by proceeds from the sale of shares in the Bank held by the Treasury. As in other similar cases, the net cost to the State is calculated by deducting from the gross cost of the hive-off borne by the State the net proceeds from the sale of the State's holding in the Bank. In addition, the value of the minority holding retained by the State is clearly an asset that is easier to value than when a restructuring plan is still underway, hence making it harder to value the firm in question. The Treasury has stated in this connection that it wishes to sell its holding of 17,4 % in the Bank. On the basis of stock exchange prices in the last six months, the value of that holding may be estimated at some ITL 1 000 billion.

Furthermore, it should be noted that the Treasury should also benefit from the privatisation of BNL, which has a holding of 27,7 % in the Bank. In the light of the increase in the value of the Banco di Napoli shares, confirmed by the prices quoted on the stock exchange in the last six months, the value of BNL's holding in the Bank is estimated at some ITL 1 500 billion. The Treasury will benefit directly from the increase as a result of the privatisation of BNL, already underway in accordance with the undertaking given by the Italian Government and formalised by Decree of the Prime Minister of 28 January 1998, which provides for a direct invitation to bid, in order to set up a stable group of shareholders, and a public invitation which should result in revenue for the State, on the basis of current prices, of some ITL 10 000 billion. Following the participation of several banks, both Italian and foreign, in 'data rooms', the Treasury accepted a bid from Banco Bilbao Vizcaya for 10 % of the capital of the Bank. The second part is to take place in the autumn of 1998, the Treasury having appointed 'global coordinators' for the public sale. It should be noted that, with a view to the future sale of a minimum of 50 % of its stake, the Treasury had transformed the BNL savings shares into ordinary shares, thus reducing its holding in the Bank from 85,5 % to 70 %.

In conclusion, the Commission takes the view that, on the basis of the quantitative estimates, the net costs to the State of the hive-off vehicle, after deduction of proceeds from the sale of the shares in the Bank held by the Treasury and of additional income resulting from the sale of the BNL holding during the ongoing privatisation, may be estimated at ITL 200 billion on the basis of the data provided by the Italian authorities.

However, any amount in excess of those costs could result in supplementary State aid. In particular, variations in the net cost to the State compared with current estimates could result in additional aid to the Bank, as such additional costs would correspond to losses the latter would have incurred if the assets had not been hived-off to SGA. The uncertainty that is tied to the creation of the hive-off vehicle is such that the authorisation by the Commission of the aid must cover the entire mechanism existing at the time of its decision. In the present case, the recent estimates by Rothschild are based on trends following the setting-up of SGA resulting in a widening of the estimated range of loss incurred by the hive-off. The range, as stated above, is now situated between ITL 1 000 billion and ITL 2 700 billion. The amount of aid approved by the Commission cannot exceed the maximum theoretical risk covered by the guarantee, i.e. ITL 12 378 billion.

As regards the effects of the hive-off on the debtor firms, the Italian authorities explained that the management of asset liquidation transactions is subject to strict professional criteria. In accordance with its terms of reference, SGA is required to manage the hived-off assets on a profitable and economic basis. In particular, its aims are to recover debts and sell other assets, collecting the maximum amount within the shortest possible time. The management of SGA is also subject to monitoring by Banca d'Italia. The Commission concludes that SGA acted like a private investor seeking to minimise the costs of liquidating the assets. It reserves the right, however, to examine whether aid was granted to the debtor firms or the assets transferred to SGA.

3.3. Tax concessions

As regards the tax concessions provided for in Article 3(7) of the Law, the Italian authorities stated

that the amount in question was relatively small, i.e. a total of some ITL 36 billion, which amounts to ITL 17,2 billion net, after deduction of the firm's profits. They pointed out that the Bank enjoyed very little benefit from the debt assignments and that a similar result could have been obtained if the Bank had decided not to register the transfer acts, which it was entitled to do as registration is optional. As regards the branches, the purchaser is required to register the sale. From a commercial standpoint, the urgency of the Bank's need to sell the assets puts it in a weak position in relation to potential purchasers and it is therefore unlikely that the tax advantages enjoyed by the purchaser could somehow be totally or partially passed on to the Bank.

However, on the basis of the information in its possession, the Commission considers that the measures in question constitute State aid, although the amount is not considerable. As regards the advantages connected with the debt assignments, it emerged that the Bank had decided to register the acts in order to increase the transparency of transactions and thus reassure the purchasers and its other creditors. The decision was thus motivated by a desire to facilitate the debt assignments and reduce uncertainty concerning the restructuring of the Bank. Its decision thus has an economic value.

The same conclusions apply to the sale of the branches in view of the possibility that, as the registration fee must be borne by the purchaser, the tax concessions represent a financial benefit for the Bank. As it constitutes a derogation from a general measure provided for in a legal instrument aimed at the restructuring and rescue of the Bank, it must be concluded that the measure in question was introduced to assist the Bank and facilitate its restructuring. The maximum amount of aid contained in the tax concessions in question totals, as stated above, some ITL 17 billion net.

The Commission considers that the State aid to the Bank ranges from ITL 4 717 billion to ITL 14 395 billion. These amounts take account of the value of the direct and indirect State holdings in the Bank, amounting to ITL 2 500 billion: the net cost to the State would thus amount to some ITL 2 217 billion, with a potential maximum of ITL 11 895 billion if account is taken of the total hive-off risk.

4. Distortion of trade between Member States

The liberalisation of financial services and the integration of the financial market have the effect of greatly increasing the sensitivity of intra-Community trade to distortions of competition. Aid granted to credit groups such as Banco di Napoli, which provides loans and other financial resources to competing enterprises on the international market and offers financial services in competition with other European credit establishments while at the same time extending its activity abroad through its network of agencies outside Italy, is certainly likely to distort intra-Community trade. This tendency will be heightened by the introduction of the single currency and the complete opening-up of markets, which will increase competitive tension between Community countries.

It should also be borne in mind that although banks are able to carry out their activities essentially consisting in collecting deposits and granting loans, without frontiers, they often encounter obstacles to expansion abroad. Such obstacles are frequently due to the fact that local banks are well-established, which makes it more costly for foreign competitors to enter the market. As liberalisation will increasingly offer banks the opportunity to provide their services in other Member States, for example, *Crédit Lyonnais*, *Deutsche Bank* and *Westdeutsche Landesbank*, all aid granted to a bank, whether international or domestic, is likely to hamper those possibilities. Aid aimed at enabling even local banks to survive which would otherwise have been forced out of the market owing to their low profitability and competitive capacity is thus liable to distort competition in the Community as it makes it more difficult for foreign banks to enter the Italian market.

Without the aid in question, the Bank would probably have been wound up. In that event its assets could have been acquired by one or several foreign competitors wishing to acquire a significant commercial presence in Italy. The Bank's customers would also have had to deal with another bank, possibly a foreign one. Accordingly, it must be concluded that aid to the Bank is covered by Article 92(1) of the EC Treaty as it constitutes State aid which distorts competition to an extent likely to affect intra-Community trade.

5. Assessment of the compatibility of the State aid to Banco di Napoli

5.1. *General considerations*

Having decided that the financial support granted to the Bank constitutes State aid, the Commission must now consider whether the aid may be regarded as compatible with the common market within the meaning of Article 92(2) and (3) of the Treaty. In the case in point, it must first be concluded that the aid does not constitute social aid granted to individual consumers or aid intended to facilitate the development of certain Italian regions. Nor is it aid to remedy a serious disturbance in the economy as it is intended solely to remedy the difficulties of a single recipient, the Bank, and not those of all operators in the sector. The reasons for the Bank's losses are specific to it and appear to be related to a large extent to its aggressive commercial and credit policy and inadequate risk control procedures. The aid cannot therefore be regarded as being in the general European interest.

Only the derogation provided for in Article 92(3)(c) may be taken into account. The compatibility of the aid must be assessed on the basis of the specific rules concerning rescue and restructuring aid⁽⁶⁾. According to the general principle applicable to State aid granted to firms in difficulty, aid is regarded as compatible provided that certain conditions are met, including the following:

- (1) full implementation of a restructuring plan based on realistic assumptions making it possible to restore within a reasonable time-scale the requisite minimum return on capital invested to ensure the long-term viability of the firm;
- (2) the existence of adequate *quid pro quos* to offset the distorting effect of the aid on competition and thus to make it possible to conclude that the aid is not contrary to the common interest;

⁽⁶⁾ See footnote 5.

- (3) the proportionality of the aid to the objective sought and limitation of the amount of the aid to the strict minimum necessary for the restructuring in order that the recovery effort might be borne as much as possible by the firm itself;
- (4) the carrying-out in full of the restructuring plan and of any other obligations provided for in the final Commission decision;
- (5) the setting-up of a system for monitoring compliance with the preceding condition.

In accordance with the rules on restructuring aid, the Commission concludes that the aid in question should normally be necessary only once.

5.2. *Analysis of the restructuring plan*

The Bank's restructuring plan was drawn up by the credit establishment with the assistance of the merchant bank Rothschild, the expert appointed by the Treasury. A first plan was ready by the end of June 1996, and included various measures some of which had already been initiated at the end of 1996. Further measures were added at the end of November 1996 to allow the Bank to be privatised before the end of the year. The new plan included the transfer to a hive-off vehicle of some ITL 12 400 billion of the Bank's assets, the adoption of a stricter provisioning policy and a more stringent plan to reduce staff and general costs.

The plan correctly identifies the reasons for the Bank's failure, which includes a series of structural, financial, management and strategic planning failures on the part of the Bank. In particular, from the management standpoint, there was an inappropriate staff policy, a complex organisational structure, inadequate information systems, undeveloped commercial activities and a risky financial management. From the standpoint of strategic development, the analysis shows non-homogenous territorial expansion, uncontrolled credit policy, non-integrated presence abroad, investment in high-risk transactions and a lack of innovative products. These inadequacies caused

serious economic and financial problems as a result of the losses in the claims portfolio, inadequate capitalisation, a fall in profitability and a liquidity crisis. In particular, the losses on claims increased the operating imbalance (reduction in the interest margin and annual losses) and the asset imbalance (increase in unproductive assets and reduction in liabilities without charges) together with excessive recourse to the interbank market. The network of branches was characterised by uncontrolled expansion: branches opened in northern Italy, where banking is very competitive, proved less profitable owing to inadequate margins, excessive risks and high structural costs. Staff costs were out of proportion to other credit establishments in the area, and to market trends, both individually and overall.

The restructuring plan forms part of a competitive and transparent privatisation which was carried out over a very short period of time, well before any confirmation of the Bank's recovery, and which benefited from a capital injection considerably below the minimum level provided for by the Community prudential rules, thus leaving it to potential purchasers to recapitalise the Bank. In general, the Commission takes a favourable view of such measures since, in principle, they provide a definitive solution to the problem of restructuring a bank from the point of view of the State and contribute to a reform of the corporate governance system which lay at the root of the group's losses. The Commission considers that this solution is appropriate because it allows a more effective control system to be set up without distorting markets.

It must be pointed out that, with the explicit or implicit support of the State, the Bank had in recent years conducted an imprudent policy which had regularly led to considerable losses. Such conduct is particularly ill-advised for two reasons: first, because the ineffectiveness of the corporate governance system led to an increase in the final amount of aid needed, owing to the passive role of the principal shareholders, and thus also created a problem of 'moral hazard'⁽⁷⁾. Second, because the consequences of wrong or unwise decisions generally emerge only with time in the banking sector, a longer period usually being necessary before the consequences of taking excessive risks are reflected in financial losses. That is why certain credit institutions have been able to implement hazardous policies over a period of time, resulting in more serious distortions.

⁽⁷⁾ The 'moral hazard' effect means that the greater the management errors, the greater the aid required by the firm committing such errors.

The restructuring plan covers all the weak areas of the Bank, with a view to rebuilding its operational system, restoring capital, financial and economic equilibrium and guaranteeing privatisation as soon as possible.

In particular, the plan provides for 2 480 redundancies, of which 1 000 already took place in 1996 and another 1 000 in 1997. In accordance with the decree, the average per capita cost, which was ITL 125 million in 1996, will be reduced to the average level of the Italian banking sector, i.e. ITL 117 million. Administrative costs should be cut by 12 % in 1997 and 9 % in 1998.

interest margin between loans and deposits. The growth rate for resources remains slight, although employment should increase more sharply. The brokerage margin remains at satisfactory levels, owing to the increase in commissions, the percentage of which on brokerage margins should reach the levels of the most competitive banks. However, recovery is not based on an increase in the brokerage margin, which will remain below 1995 levels, but on a reduction in general costs and the cost of credit. This is a fact which further guarantees the reliability of the forecasts, other things being equal, as the improvement is based on factors within the control of the firm and does not depend on the growth of the market and of turnover. The reduction in provisions reflects the transfer of the non-performing assets to the hive-off vehicle and the reduction in business activity. The plan also provides, however, for an adjustment of the unremunerated credit rates to more normal levels.

Table 3

Banco di Napoli business plan

	(billion ITL)				
	1995	1996	1997	1998	1999
Interest margin	1 961	1 635	1 597	[...] (*)	[...] (*)
Services margin	534	621	649	[...] (*)	[...] (*)
Brokerage margin total	2 495	2 256	2 246	[...] (*)	[...] (*)
Staff expenditure	-1 512	-1 540	-1 322	[...] (*)	[...] (*)
Administrative expenditure	-613	-550	-518	[...] (*)	[...] (*)
Total general costs	-2 125	-2 090	-1 840	[...] (*)	[...] (*)
Gross operating profit	370	166	406	[...] (*)	[...] (*)
Losses on loans and provisions	-3 112	-1 533	-202	[...] (*)	[...] (*)
Other provisions	-382	-500	-270	[...] (*)	[...] (*)
Net extraordinary profits	-24	201	90	[...] (*)	[...] (*)
Total of other items	-3 518	-1 832	-382	[...] (*)	[...] (*)
Result before tax	-3 148	-1 665	23	[...] (*)	[...] (*)
Tax	-8	-4	-4	[...] (*)	[...] (*)
Result after tax	-3 156	-1 669	19	[...] (*)	[...] (*)

(*) Parts of this text have been edited to ensure that confidential information is not disclosed; those parts are enclosed in square brackets and marked with an asterisk.

The yield on the loan from the Bank to the hive-off vehicle was not fixed rigidly, but was based on an indexing system tying it to the short-term market rates for the preceding year (see point 2.2). It would seem that a mechanism of this type provides the Bank with an adequate return when rates fall, taking account of the normally higher return on loans to customers and the cost of funds.

Having analysed the documents received, it would seem that the restructuring plan is adequate. The support of an international bank like Rothschild ensures that the Bank's basic problems have been taken into account, as the restructuring has affected the main aspects of day-to-day management (employees, organisation, computerisation, commercial aspects) and financial structure (own funds, credit quality, profitability, liquidity). Most of the restructuring measures have already been implemented, especially the reduction in unit and absolute labour costs. Staff costs were cut in 1997 by ITL 142 billion or 11 %. Pension costs were cut by ITL 83 billion, i.e. a relative value of 36 %.

The hypotheses of the plan appear to be sufficiently realistic. They provide for a reduction in short-term interest rates of some 300 basis points between 1996 and 1999, and a 130 basis points' reduction in the

The Bank's results in 1997 confirmed the ongoing recovery and exceeded the expectations of the business plan, despite the reduction in activity. At the end of the first six months, the net result (ITL 16,8 billion) exceeded forecasts as it reached the level originally

forecast for the end of the year. The improvement continued in the second half of 1997, the accounts showing a net result of ITL 142 billion, well in excess of the anticipated result, which allowed the Bank to give a dividend on savings shares (i.e. to shareholders without voting rights but simply having a right to a dividend). In particular, the 1997 accounts show that the Bank was able to halt and indeed reverse the downward trend in the brokerage margin by increasing net commissions and stabilising the interest margin. The considerable reduction in general costs, thanks to radical staff cost measures, is consistent with the predictions of the plan. In view of these results, it can be concluded that the restructuring plan is capable of producing the anticipated results and even improving on them over the next few years.

The credibility of the Bank's restructuring plan was reflected in the full support of the private shareholders for the increase in own funds after privatisation. The capital injection of some ITL 900 billion did not involve the Treasury but a large majority of private shareholders, in particular INA⁽⁸⁾. The Commission takes the view that the majority stake held by INA and the private shareholders in this operation reflects its commercial nature and gives greater credibility to the Bank's restructuring plan.

According to the Italian authorities the long-term viability of the Bank, already secured as a result of the restructuring plan, will be maintained even in the event of a merger with BNL. The authorities pointed to the positive effects of the synergies of the two banks on the profitability of the Bank and the extensive restructuring undergone by BNL with a view to its privatisation. The ongoing privatisation of BNL precludes the risk that control of the Bank could be transferred from the private sector (INA) to the public sector (BNL) and, accordingly, reduces the risk of further public funds being required if the plan's objectives are not attained. On the contrary, the privatisation of BNL confirms the definitive transfer of control of the Bank to the private sector.

As regards the possibility of the Bank integrating with BNL at the end of the latter's privatisation, the Commission notes that no specific date has been set as yet for this project. In any event, should it take place,

as envisaged in the Decree of 28 January 1998, the merger should, in view of the net worth of the two banks and of stock exchange prices, result in a new bank, the capital of which would be owned mostly by the private sector, with the State retaining a minority holding.

However, the Commission nevertheless wished to determine whether the possibility of a merger with BNL would not be prejudicial to the profitability of the entity resulting from the merger and hence to Banco di Napoli. The level of profitability achieved by BNL in recent years was not high enough to conclude, without further information, that the return on own funds of the Bank resulting from the BNL-Bank merger would be acceptable to a private investor operating in a market economy. The Italian authorities pointed out in this connection that BNL had undertaken an extensive restructuring plan, the costs of which would be borne by BNL itself before the merger. In particular, BNL had already made considerable provision for the restructuring costs, which had produced a corresponding reduction in net results. It was therefore reasonable to conclude that the merger would not have negative effects on the profitability of the new banking entity, compared with the forecast for the Bank alone; a beneficial effect could even be expected in the long term.

A report forwarded to the Commission by Rothschild underlines the progress achieved by BNL from 1993, when its management was changed. Apart from the provisioning referred to above, BNL is displaying significant signs of structural recovery. In accordance with the strategies pursued, the Bank succeeded in containing the fall in interest margin which effected the entire banking sector and in increasing the returns on service activities as a result of stronger activity in the savings management and insurance sectors; from the standpoint of costs, BNL succeeded in reducing labour costs in real terms by cutting the number of employees. The ongoing restructuring plan, which also provides for a later reduction in costs and labour (some 3 700 redundancies in the period 1998 to 2000), points to good prospects of an improvement in results over the next few years.

In the opinion of Rothschild, a merger between the Bank and BNL would help to improve the former's results. A merger could produce significant synergies of some ITL 500 billion in view of the geographic and functional synergies of the two banks. The merger should also produce synergies with regard to employees, other general costs and non-financial

⁽⁸⁾ The private status of INA was determined on the basis of information submitted by the Italian authorities concerning its shareholders, in particular the significant presence of private institutional investors and the relevant voting rights.

income. In particular, savings should total ITL 240 billion with regard to employees (i.e. 47,5 % of total staff costs), involving a reduction in management staff and rationalisation of the Italian and foreign branches; ITL 125 billion in respect of other general costs (i.e. 25 % of total general costs); ITL 140 billion with regard to non-financial income (i.e. 27,5 % of the total), in particular in profit and commission centres.

In comparison with other merger cases, the hypotheses used here appear to be sufficiently prudent. The synergies appear to amount roughly to 30 % of operating costs, while in other cases, notably in Italy and the United Kingdom, the synergies achieved amounted to some 35 % of operating costs.

Thus, the rate of return on the Bank's capital in the event of a merger with BNL could rise from 7,6 % to 11,6 %, which would ensure the viability of the entity. Naturally, that result, as pointed out by the merchant bank Rothschild, is achievable only if the entire restructuring plan and the Bank-BNL merger are carried out. In any event, the linking of the Bank to the INA/BNL group, with INA having a majority holding, will ensure the viability of the Bank even if a merger between it and BNL does not take place.

In view of the foregoing, the Commission takes the view that, in the event of a merger between the two banks, the viability of the Banco di Napoli-BNL entity is assured and that State aid will no longer be needed.

5.3. *Proportionality of the aid*

As regards compliance with the other conditions provided for in the guidelines on restructuring aid, the Commission considers that the Bank contributes significantly to the restructuring costs out of its own resources. The Bank bore the provisioning costs for all the commitments transferred to the hive-off structure, totalling some ITL 4 400 billion, i.e. double the capital injection by the Treasury. In addition, there are the transfers, not included in the hive-off, of medium-term claims of ITL 5 300 billion over two years (1995 and 1996), of shareholdings, especially financial holdings,

totalling ITL 210 billion and real estate of some ITL 230 billion.

Under the principle of limiting aid to the minimum strictly necessary, it is necessary to ensure that the Bank has sufficient own funds to comply with regulations but that it does not have more own funds than strictly necessary. The Commission notes that the minimum level of capitalisation should be assessed with due regard for the possibility that the public contribution will be followed by injections of the necessary additional funds by other shareholders. For example, in the case of privatisation in the short term by means of invitation to tender, it is possible that potential buyers will satisfy the statutory requirements.

The Commission notes that the capital injected by the Treasury amounting to some ITL 2 000 billion was not enough to re-establish the solvency ratio in view of the losses recorded at the end of 1996 which reduced the Bank's net worth to some ITL 1 000 billion. The purchasers and other private shareholders recapitalised the Bank in 1997 in order to bring the capital up to the statutory level applicable to the group. It must therefore be concluded that the results provided by the Treasury were limited to the minimum necessary.

5.4. *Compensation*

As regards compensation for competitors to offset the distorting effects of aid, it is useful to restate the Commission's policy in this area. The role of compensation, as provided for in the Community guidelines on State aid for rescuing and restructuring firms in difficulty, is to counterbalance, wherever possible, the negative repercussions for competitors. Otherwise aid would be 'contrary to the common interest' and would not benefit from exemption under Article 92(3)(c).

Such compensation must constitute an additional effort on the part of the assisted firm in relation to the restructuring measures needed for its recovery. As a result, the measures must not be financed directly or indirectly from State aid.

The Commission stated in another recent banking case that it was possible to estimate the theoretical distortion of competition caused by aid. In the banking sector, the existence of a solvency constraint which establishes a direct relationship between a bank's capital and the commitments it is authorised to make, weighted by degree of risk, provides a very direct measurement of the possible theoretical impact of an increase in a bank's capital on its level of activity. Under Council Directive 89/647/EEC of 18 December 1989 on the solvency ratio of credit establishments⁽⁹⁾, as amended by Directive 96/10/EC of the European Parliament and of the Council of 21 March 1996⁽¹⁰⁾, the solvency constraint is applicable to all banking institutions in Europe, which makes it easier to assess the effect of a capital increase or aid having a similar effect. If the aid is in the form of a capital injection, the distortion to competition can be measured in terms of weighted assets. For example, a capital injection of ITL 1 billion or any measure having a similar effect enables a bank, all things being equal, to increase the level of weighted assets in its balance sheet (taking account of the compulsory solvency constraint requiring a firm to have a minimum solvency ratio of 8%, which must be calculated on the basis of own funds, at least half of which must comprise basic own funds) by some ITL 12,5 billion to ITL 25 billion.

In the present case, the aid amounting to some ITL 2 217 billion accounts for almost half of the own funds required in order to comply with the solvency ratio at the end of 1994. Unlike other cases, and as already stated in point 5.3 of this Decision, the aid in question is aimed primarily at covering losses and at the survival of the Bank rather than at maintaining a level of capitalisation in order to sustain the previous level of activity. The solvency ratio requirement is satisfied by the capital increase in 1997 following the privatisation. Thus in practice the aid allows the Bank to stay in business, although at a reduced level following the transfers.

It would seem in this respect that the measures provided for in the restructuring plan will as far as possible offset the impact of the distortions of competition caused by the aid.

First, the measures already adopted produced a considerable reduction in the size of the Bank. The total balance sheet fell from ITL 121 000 billion (end 1994) to ITL 69 000 billion (end 1997), i.e. a 43% reduction in three years. The risk-weighted assets

underwent an even more marked reduction, amounting to nearly ITL 40 000 billion of assets, not including the effect of hiving off ITL 12 400 billion of assets to SAG.

However, the voluntary liquidation of the subsidiary, Isveimer (nearly ITL 15 000 billion in assets at the end of 1994) cannot be treated completely as compensation as the liquidation was a necessary measure under the restructuring plan and will benefit from State resources. Because the case involves a winding-up and the sums concerned are only transiting through the Bank, it was considered that there was no aid in the measures to assist the Bank in the winding-up of Isveimer. The winding-up corresponds to a closure of capacity. The Bank may not acquire any Isveimer assets during the winding-up, unless it proves impossible to sell them to other parties or to sell them at more advantageous conditions for the winding-up.

The Bank also sold ITL 300 billion of property assets and over ITL 200 billion of shareholdings. In particular, the holdings in IMI and Banca di Roma were sold with added value. Further sales of property assets totalling some ITL 100 billion are also planned.

At national level, the Bank has already sold 50 branches to Banca Popolare di Brescia and nine to Banca Popolare Antoniana Veneta. The sale of a further 18 branches is underway and should be completed by the end of the year. The profitability of the branches sold was demonstrated, firstly by the interest displayed on the market and the prices paid (ITL 290 billion and ITL 34,5 billion respectively) and, secondly, by the goodwill paid by the purchaser (ITL 132 billion or 46% of the value of the transaction, and ITL 21,3 billion or 62% of the value). In particular, the sale of the 59 branches included debt assignments in excess of ITL 2 500 billion. A further reduction in claims of some ITL 1 000 billion should result from the sale of the remaining 18 branches. The sale can therefore be regarded as adequate compensation for the aid. Once it has sold the 77 branches, which account for some 10% of its total establishments, the Bank will become essentially a regional institution, with only a few branches abroad and in northern Italy. Other transfers or regrouping of branches will doubtless take place in the event of a merger with BNL.

The Bank has already reduced its presence on the international market considerably: the number of

⁽⁹⁾ OJ L 386, 30.12.1989, p. 14.

⁽¹⁰⁾ OJ L 85, 3.4.1996, p. 17.

branches has been cut from 13 to six in two years, and activity reduced by some 70 %. In particular, the loans granted by subsidiaries were cut by some ITL 22 000 billion. The branches in Paris, Frankfurt, Los Angeles, Moscow and Seoul were closed, while the others, notably Barcelona, were sold. Its departure from the Spanish market will soon be completed. The other branches have experienced reductions in the number of staff and the level of activity. The assessment has taken account of the transfer of the Luxembourg branch (Banco di Napoli International) to the hive-off vehicle, which clearly cannot be regarded as compensation, since the setting-up of the vehicle helped to rescue the Bank.

On the basis of the foregoing, the Commission concludes that the efforts made by the Bank and the measures taken by the authorities, while not totally eliminating the distorting effect of the aid, constitute a very significant level of compensation which considerably offsets the distortion caused by the aid granted to the Bank.

For the reasons set out above, the Commission concludes that the compensation offered by Banco di Napoli is adequate and has the effect of bringing the aid to the Bank into line with the common interest.

5.5. *Other factors*

As provided for in the Community guidelines on restructuring aid, the Commission also examined the Bank's position in relation to tax credits. The guidelines provide that firms having benefited from State aid may not also benefit from a carry-over of tax losses in respect of such losses covered by capital increases which constitute aid. The Italian authorities stated that the Bank did not qualify for this advantage as it did not satisfy the conditions laid down in Article 123 of consolidated Law No 917/86.

It can therefore be concluded that the State contribution did not help to strengthen the Bank's position more than is strictly necessary and does not restrict competition from other European banks. On the contrary, the market share held by the Bank has been considerably reduced. As a result, in view of its

contribution in terms of restructuring and reduced activity, the aid in question may be regarded as complying with the Community guidelines on restructuring aid and is therefore compatible with the common market.

6. Conclusions

In conclusion, in view of the foregoing and on the basis of the information available, the Commission takes the view that the Bank's recovery plan contains substantial State aid in the form, in particular, of a capital increase of ITL 2 000 billion, the utilisation of advances granted by Banca d'Italia under a Ministerial Decree of 27 September 1974 to offset the losses incurred by SGA, and tax concessions totalling ITL 17 billion net. Taking account of the estimated income earned by the State for the ongoing privatisation, the discounted net total cost to the State amounts to some ITL 2 217 billion with a theoretical ceiling of ITL 11 895 billion. On the other hand, the advances granted by Banca d'Italia under the abovementioned decree for the winding-up of Isveimer do not constitute State aid to Banco di Napoli provided that certain conditions are complied with.

The measures have been examined under Article 92(3)(c) of the Treaty in order to establish whether they can be considered compatible with the common market. In the light of the considerations set out above, the aid granted to the Bank would seem to meet the conditions laid down in the guidelines for aid for rescuing and restructuring firms in difficulty, provided that certain conditions are complied with, some of which constitute essential preconditions for viability, while others are necessary *quid pro quos* in return for concluding that the aid is in the common interest.

It is also necessary, in view of the amount of aid concerned, to monitor the proper implementation of the plan, particularly as regards the restructuring measures and the merger plan, to ensure that the recovery plan presented to the Commission is effectively carried out in full. Consequently, the Italian authorities should inform the Commission every six months from the date of approval of this Decision of the progress of the plan and any disparity between results and forecasts. No modifications involving

further aid to the Bank may be made to the plan without the prior approval of the Commission.

Article 2

On the basis of the guidelines on restructuring aid, the Commission considers that it should not be necessary to grant such aid more than once.

Subject to these conditions, the aid in question therefore qualifies for exemption under Article 92(1) of the EC Treaty and Article 61(1) of the EEA Agreement, as it is compatible with the common market pursuant to Article 92(3)(c) of the EC Treaty and Article 61(3)(c) of the EEA Agreement,

HAS ADOPTED THIS DECISION:

Article 1

1. The measures to reorganise, restructure and privatise Banco di Napoli provided for in Decree-Law No 163 of 27 March 1996, as last amended by Decree-Law No 497 of 24 September 1996, converted into Law No 588 of 19 November 1996, in particular the injection into Banco di Napoli by the Treasury of ITL 2 000 billion, the tax concessions and the use of advances granted by Banca d'Italia under the Ministerial Decree of 27 September 1974 to cover the losses of Società per la Gestione di Attività SpA, with a potential ceiling of ITL 14 395 billion, constitute State aid within the meaning of Article 92(1) of the EC Treaty.

The transactions in question, costing the State an estimated ITL 2 217 billion net but with a potential maximum of ITL 11 895 billion, are hereby declared compatible with the common market and with the EEA Agreement under Article 92(3)(c) of the EC Treaty and Article 61(3)(c) of the EEA Agreement.

2. The advances granted by Banca d'Italia under the Ministerial Decree of 27 September 1974 in connection with the winding-up of Isveimer do not constitute State aid to the Bank in so far as the resources in question are utilised in accordance with criteria acceptable to a private investor and with the condition in Article 2(e).

The aid referred to in Article 1 is authorised, subject to Italy complying with the undertaking given by Banco di Napoli to sell or close, by the end of 1998, 18 branches located in northern and central Italy and in Madrid, and with the following conditions:

- (a) it must ensure that all the recovery measures and all the arrangements provided for under the scheme described in Article 1 and contained in the restructuring plan presented to the Commission are implemented;
- (b) it must not amend the conditions laid down in the restructuring plan, after taking into account the conditions imposed by this Decision, without the Commission's prior consent;
- (c) it must prevent Banco di Napoli from benefiting from a carry-over of tax losses in respect of the tax losses covered by the capital increase injected by the Treasury;
- (d) it must earmark the proceeds of sales of branches, shareholdings and other assets for the economic and financial restructuring of Banco di Napoli;
- (e) it must ensure that Banco di Napoli does not repurchase assets from the winding-up of Isveimer, unless it proves impossible to sell them to other parties or convert them on more advantageous terms in the winding-up.

Article 3

The Italian authorities shall cooperate fully in monitoring compliance with this Decision and shall submit to the Commission the following documents:

- (a) a detailed report by the Italian authorities on the implementation of the Commission Decision and of the restructuring plan. The report must in particular:
 - examine the economic and financial viability of any entities of the group remaining under State control by presenting detailed results compared with the estimates contained in the plan,

- detail any State intervention benefiting those entities, in the form of recapitalisation, financing, guarantees, waiver of debts, etc.,
- provide a detailed analysis of the procedure followed in the event of a merger between Banca Nazionale del Lavoro and Banco di Napoli,
- describe the extent to which the undertaking and conditions set out in Article 2 have been complied with.

The report must be sent every six months from the date of the Commission Decision until the date of fulfilment of the undertaking and conditions set out in Article 2;

- (b) the balance sheets, accounts and reports (both annual and half-yearly) drawn up by the management of the companies forming part of the transaction under examination, namely Banco di Napoli and Banca Nazionale del Lavoro, until the date of the privatisation of the latter, the hive-off

vehicle Società di Gestione di Attività SpA, until it has completed its mission, and Isveimer, until it has been wound up. These documents must be submitted to the Commission as soon as they are approved by the boards of directors of the entities in question.

The Commission may ask for such documents and the implementation of the plan provided for in (a) and (b) to be assessed by means of special audits.

Article 4

This Decision is addressed to the Italian Republic.

Done at Brussels, 29 July 1998.

For the Commission
Monika WULF-MATHIES
Member of the Commission