2011

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Abstract

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I. Introduction

Over the last 15 years profound changes have impacted the structure of the banking sector of Southern Italy (also known as the *Mezzogiorno*). In particular, there has been drastic fall in the number of banks operating in the region and, more importantly, a profound change in their ownership structure. Such changes were driven by the acquisition of a number of local banks by Northern Italian banking groups in the wake of the systemic crisis that hit the Southern banking system in the mid Nineties[1]. As a result, in the last ten years the Southern banking market has been firmly in the hands of Centre-North banks in terms of loans and deposit market share.

Such changes have long raised doubts about the ability of the banking sector in supporting the real economy, characterized – more than in rest of the country - by a plethora of small and opaque enterprises, low productivity and high unemployment rates along with large government transfers, plus inefficiencies in the administration of justice due a pervasive presence of organized crime.

According to some studies (Panetta, 2003), following the restructuring process, the performance of the Southern Italian banking sector improved in terms of credit risk, operating efficiency and credit supply. On the other hand, other studies argue that the credit expansion in the South was due to an increase in the supply of personal credit, mainly mortgage loans (Grillo, 2003), while loans granted to firms decreased (Mattesini e Messori 2004). Furthermore, the improved performance of Southern banks can be ascribed to a change in their lending policies superimposed by their parent bank rather than to an improvement in their risk management techniques. The view that credit and financial services offered by banks in the *Mezzogiorno* to businesses and households are inadequate in terms of demand finds support in the fact that over the last few years the Bank of Italy has authorised requests for the creation of new banks mostly coming from local entrepreneurs who claims to have problems in accessing credit from the banking system.

In sum, the ability of banks operating in the South of Italy to offer much needed support to the local economy is still a controversial issue.

In our opinion, in order to evaluate the adequacy of the present structure of the Southern Italian banking system, and more generally its allocative and operational efficiency, the issue

[1] See Bongini and Ferri (2005) for a description of the main causes, both real and financial, of such crisis.

to be addressed relates to the potential heterogeneous behavior between banks which are "truly local" – i.e. those banks whose real decisional centres are located in the Southern regions – with respect to those banks operating in the South but which have their decisional centres located in the Centre-North of the country ("outer banks"). The fact that bank strategies are defined in decisional centres located outside the Southern area could indeed explain the reduced credit support perceived by Southern SMEs.

Following a recent strand of the extant literature, started with the seminal works by Stein (2002), we attempt to explain such heterogeneity by considering the role of banks' internal organization. The focus of this study is on the organizational features of banks operating in the South of Italy, namely major Italian banking groups and local independent banks.

Two are the main research questions of the study. First, have the benefits of localism and relationship lending been deeply and negatively affected by the transfer of control rights outside the *Mezzogiorno*? Second, is the organizational model adopted by local and independent banks (i.e. truly local banks) more effective in dealing with the needs of the local customer base?

Such questions are relevant not only with specific reference to southern Italy, but also to any region which experienced a reduction of locally based banks in favour of foreign banks (i.e. Central Eastern European Countries).

To answer these questions we address three main issues.

First, we describe the extant micro-structure of the Southern banking system and analyze how the market shares of "local" and "outer" banks have changed over the last 5 years.

Second, we investigate bank loan policies and performances, distinguishing between "local" and "outer" banks. At present, this issue is particularly relevant given the fact that the recent financial crisis has brought about a reduction in the credit supply. During harsh times, are "truly local" banks more supportive partners of local firms than "outer banks"?

Third, we consider the organizational structure adopted by banks in their lending activity. In particular, by exploiting a unique dataset on the organizational characteristics of Italian banks operating in the South, we are able to highlight the degree of delegation of power in favor of local branches so as to obtain the well-known advantages of relationship lending. Banks participating in the survey were asked to provide a series of information regarding lending to small enterprises and private clients: the number of hierarchical layers involved in the decision to grant a loan, the kind of information required to take a lending decision (*soft* versus *hard* information), and information about branch loan officers, such as the amount of money up to which they are allowed to lend autonomously.

The study is organized as follows. Section II contains a brief review of the theoretical empirical background. Section III describes the extant ownership structure of the southern banking system and the market shares of the banks operating in this area of the country, while Section IV analyzes their loan policies and performances. Section V introduces the results of our organizational survey. Section VI concludes.

II. Review of the theoretical and empirical background

Italian supervisory authorities, the academia and politicians have long been involved in a debate over the role of the Southern Banking System (SBS) and its ability to offer the essential support to the local Southern economy in order to foster its growth, which since the end of the Second World War has lagged behind the rest of the country and the North in particular.

Over the years, a consensus has been reached in line with the stream of literature studying the link between Finance and Growth (Levine, 2004), which states that the trampoline for economic growth is an efficient banking system. As the inefficiencies of Southern banks were glaringly obvious[2], the main question of the debate turned to the causes of such inefficiencies: were they adding to or were they the consequences of the under-development of the local real economy?

Indeed, though the academia did not reach a conclusive answer over such a question, the supervisory authority favored the thesis of an inefficient local banking system that was on its own hampering the growth of the real local economy[3]. Therefore, when in the mid Nineties the SBS experienced a systemic crisis and almost collapsed, the Bank of Italy prompted a re-solution strategy grounded on a change of ownership of the banks operating in the Italian *Mezzogiorno*. Indeed, a season of M&As began where the leading role was played by (more efficient) Centre-North Italian banking groups acquiring a large number of Southern local banks, both large and famous names, like Banco di Napoli or Banco di Sicilia, and small

[2] Southern financial institutions had higher operating costs, higher default rates and charged Southern firms higher interest rates than Northern banks which reflected their higher operating costs and suggested that they were sheltered from external competition.

[3] Bank of Italy (1990); Faini, Galli and Giannini, (1992).

savings and loans[4]. As a result, since the end of the Nineties the Southern banking market has firmly been in the hands of Centre-North banks in terms of branch network, loan and deposit market share.

Following the restructuring process that inevitably goes along with bank consolidation, the performance of the Southern Italian banking sector has undoubtedly improved in terms of capital adequacy, operating efficiency and in their ability to screen customers, thus increasing their profitability (Panetta, 2003). Therefore, some authors (Guiso, 2006, Tirri, 2008; Bonaccorsi di Patti, 2009) explain the persisting North-South differences in bank performance as a natural consequence of the underdevelopment of the economy and of society as a whole in Southern Italy. Indeed criminality, justice mismanagement and a lack of social capital are the main factors that hinder the growth of the Southern economy and hold back the expansion of enterprises, both financial and non-financial.

More recently, the ability of the Southern banking sector in supporting the local economy, characterized – more than in the rest of the country – by a plethora of small and opaque enterprises, has been analyzed in the context of the stream of literature which considers the links and effects of M&A activities on relationship banking and SMEs lending.

Indeed, right until the 2007 financial crisis, worldwide the banking sector had undergone a substantial consolidation, with the number of small banks shrinking in most countries. Since small banks are a primary source of financing for small firms (De Young, Hunter, Udell, 2003; Scott, 2004; Avery and Samolyk, 2004, Guiso, Sapienza and Zingales,2004; Angelini, Di Salvo and Ferri, 1998), the decline in the number of small banks has raised concern about the reduction of credit to small businesses. Therefore, a fair amount of (mainly empirical) literature has been produced on the effect of bank consolidation on small business lending. The US evidence is that large banks tend to reduce credit to SMEs (Petersen and Rajan, 1995; Berger *et al.*, 1998; Goldberg and White, 1998; Peek and Rosengren, 1998; DeYoung *et al.*, 1999; Boot, 2000; Berger and Udell, 2002; Sapienza, 2002). Similar results were found both in the Italian market (Bonaccorsi di Patti and Gobbi, 2001; Focarelli, Panetta and Salleo, 2002; Gobbi and Lotti, 2004) and in the European one (Degryse, Masschelein and Mitchell, 2005)

There are two main reasons for such an outcome. First, SMEs financing generally is more costly - in terms of screening and monitoring activities - and more risky, given the opacity of the majority of small enterprises. As large banks have access to a larger pool of potential

[4] Colombo and Turati (2002).

borrowers, it is quite likely that small borrowers will be supplied with less credit. Second, large banks may face organizational "diseconomies" that somehow prevent them from being the most efficient providers of certain information-intensive services, such as relationship-based small business lending. Large organizations are deemed less fit to deal with small businesses as their hierarchical structure impedes an efficient use of "soft information" in the lending relationship (Stein, 2002).

Since the Southern banking system is mainly controlled by large banks with headquarters outside the *Mezzogiorno*, a number of authors argue (and try to demonstrate) that local SMEs have been facing a long season of credit rationing, either because these banks have been channelling financial assets from the South to the North (Giannola, 2000), or because they have preferred to increase the supply of personal credit, mainly mortgage loans (Grillo, 2003), while reducing loans granted to firms (Mattesini and Messori 2004). What is more, the improved performance of Southern banks can be ascribed more to a change in the lending policies superimposed by their parent bank than to an improvement in their risk management techniques.

However, none of these studies demonstrate that those small, truly local banks that remain are more efficient in allocating credit to Southern enterprises and therefore are better equipped in supporting the growth of the local economy.

In fact, an important implication of Stein's study is that it is not size *per se* that discourages small business lending, but a bank's organizational complexity; therefore in order to become attractive partners for SME's, large banks need to specifically flatten their organizational structure, with fewer layers of management, or in other words, they need to be closer to their customers. This concept of proximity is no longer declined in terms of physical proximity, but rather in terms of *functional proximity* between the local system where the bank operates and the decisional centre of the same bank, as shown by Keeton (1995) and Alessandrini *et al.* (2005). Functional proximity concerns all banks that, given the localization of their decisional centre and strategic functions – the so-called "thinking head" - , are close to the areas where they operate. Functional proximity has greater significance in marginal areas, such as in the *Mezzogiorno*, than in developed ones: banks with their thinking head in the area where they operate tend to implicitly or explicitly assume a social responsibility towards the local community, which goes beyond the simple financing of the local economy (Alessandrini and Presbitero, 2009).

The importance of functional proximity has dual implications. First, large groups can design their internal hierarchies in order to flatten, as much as possible, their organizational structure and to push downwards decision-making authority; in this way, the benefits deriving from a large integrated bank could be preserved while competing in a setting where information is soft. Second, being a small local bank is not a sufficient condition for being functionally proximate to its territory: if the bank belongs to a banking group, whose decisional centre and strategic functions are far from the bank's territory, intrabank governance mechanisms may affect the credit process of the local affiliate up to the point that soft-information is no longer captured and used, with the final effect that credit to small, young, opaque firms is dampened.

In such a perspective, it is paramount to take simultaneously into consideration features of banks' ownership, size and functional proximity with respect to the local system where they operate. Adopting such a position, we can distinguish three main types of banks that currently operate in the South of Italy: a) small and medium-sized independent banks headquartered in the South (what we will term "truly local" banks); b) small and large banks headquartered in the South but belonging to banking groups headquartered in the Centre–North of the country ("outer local" banks); c) large banks headquartered in the Centre–North ("outer" banks).
Our sample will be classified according to this tri-partition; therefore our analysis can help underline the specific organizational features of "local" and "outer" banks and their links to bank performance and bank loan supply.

III. The southern banking system: ownership and market structure

Three factors distinguish the current situation of the Mezzogiorno's banking system: the low level of principal bancarization indexes; the small size of truly local banks; the high market share of Centre-North banking groups.

As regards the first feature, twenty years after the liberalisation of bank branch openings, at year-end 2009 southern regions still had lower indexes of bancarization in comparison to those of the Centre-North during the early 1990s (Table 1); such a situation can only in part be put down to the differences in the geographical conformation of the two areas, in population density and the yawning gap that exists in terms of economic development and contribution to GDP.

Table 1: Bank branch distribution and bancarization indexes

	1990	*1995*	*2000*	*2004*	*2009*
			Number of branches		
Italy	16.542	23.353	28.166	30.847	34.103
Centre-North	12.623	17.891	21.773	24.042	26.907
South	3.919	5.462	6.343	6.805	7.196
			Branches per 100.000 inhabitants		
Italy	29,2	42,3	48,7	52,8	56,5
Centre-North	35,0	51,1	59,0	63,7	68,2
South	19,1	26,7	30,4	32,8	34,5
			Branches per 1.000 Kmq		
Italy	54,9	77,5	93,3	102,3	113,0
Centre-North	70,8	100,4	122,1	134,8	150,9
South	31,9	44,4	51,5	55,2	58,3
			Branches/GDP (100 mln of euros) (current prices)		
Italy	2,4	2,5	2,4	2,2	2,2[a]
Centre-North	2,4	2,5	2,4	2,3	2,2[a]
South	2,2	2,4	2,2	2,0	1,9[a]

Source: computations on Eramo e Panetta (2006), Bank of Italy and ISTAT data. Foreign bank branches are not included. [a]: GDP figures are as of 2008.

The second peculiarity of the Mezzogiorno's banking system i.e., the small size of most of the independent banks headquartered in the area, stems from the crisis, which in the second half of the 1990s hit large local banks and which as a result meant that the South no longer had local territorial champions able to act as aggregation points for the creation of southern banking groups of any significant size. With the exception of some mutuals (*banche popolari*) in Apulia, the remainder of the Mezzogiorno's banks consists of a plethora of small (often very small) cooperatives (*banche di credito cooperativo*), a few mutuals and some, often very small and recently instituted, limited liability companies.

The third feature of Southern Italy's banking system are the high market shares held by banking groups from the Centre-North, which operate through subsidiaries and branches owned directly by the parent company (Table 2). This situation is mainly the outcome of the 1990s, which for the banks involved in the crisis, determined the transfer of decisional powers relating to control and strategy northwards.

Table 2: The presence of Centre-North banking groups in the Mezzogiorno

Form of group presence	No. of groups	Group size
Via subsidiaries with headquarters in the South	5	Medium or small-sized
Via subsidiaries with headquarters both in the South and in the North	3	Large-sized
Via parent company branches only	14	Medium-sized
Via subsidiaries and parent company branches	1	Large-sized

Source: computations on Bank of Italy data.

In order to understand better the structural changes that have taken place in the banking system of the Mezzogiorno and the effect these developments have had on the importance in the area of truly local banks, we have divided banks with branches in the South into three types:

- banks with headquarters in the South or whose parent company has its headquarters in the South (termed in paragraph 2 'truly local' banks);
- banks with headquarters in the South, whose parent company has its headquarters in the Centre-North ('outer-local' banks);
- banks with headquarters in the Centre-North ('outer' banks).

The importance of these three categories within the Southern Italian banking system was calculated on the basis of their market share in terms of deposits, customer loans and the size of the distribution network in the period 2004-2009[5] (Table 3). Figures show the leadership of 'outer' banks, followed by 'outer local' institutions. 'Truly local' banks' shares are contained although in the period analyzed they do grow more than the other two types.

[5] Available Bank of Italy bank branch data refers to the same period; 2004 was also the last year of similar studies carried out by Bongini and Ferri (2005) and Eramo e Panetta (2006).

Table 3 – Market share (deposits, loans to customers, branches) of the three types of banks ('truly local', 'outer-local', 'outer')

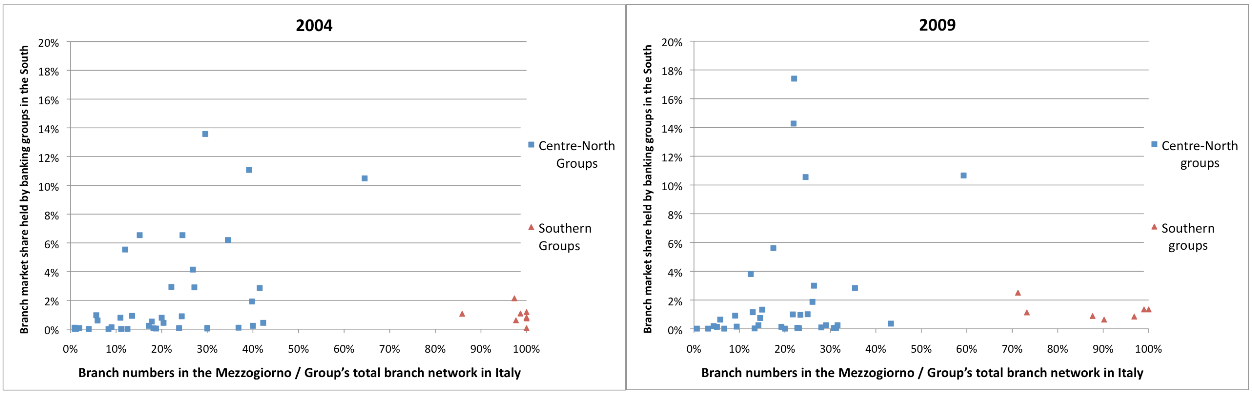
Type of bank	2004			2009			Structural data (2009)			
	Deposits	Loans	Branches	Deposits	Loans	Branches	n° banks	*of which Cooperatives*	Average total asset (Mln Euro)	Average number of branches in Italy
'Truly local'	16.2%	11.3%	17.12%	18.3%	13.4%	19.43%	134	*109*	287	7,1
'Outer Local'	35.4%	23.4%	37.60%	37.6%	25.3%	38.06%	17	-	6.733	13,2
'Outer'	48.4%	65.3%	45.28%	44.1%	61.3%	42.52%	63	*2*	*25.550*	*67,4*

Source: computation of Bank of Italy data; 'Deposits' includes customer deposits and bonds held by customers.

Over the last five years, 'truly local' banks have, in fact, increased their market share – in terms of deposits, loans and branches – by more than 2% in comparison to a fall in the share attributable to banking groups from the Centre-North. This fall is due to two contrasting trends: on one hand, the increase in the market shares of Southern Italian subsidiaries of Centre-North groups and, on the other, the drop in market shares recorded by Centre-North banks and by parent company. Although the reduction in market shares recorded by parent company branches in the area may be the result of the inevitable rationalisation of distribution networks that followed the flurry of M&A activity in the decade before, it also suggests that Centre-North groups intend to (i) maximise the intrinsic value of brands that customers can perceive as being more obviously 'local', and (ii) reduce the operating distance between bank and customer especially in a period of sharply increasing counterparty risk levels. This hypothesis receives support from an analysis of the use of bank brands by Centre-North banking groups in the South. Our findings show that in 2009 few are the cases of a banking group's being present in the same province with more than one brand; more often the brands used for their operations in the Mezzogiorno were those of banks headquartered in the South.

However, the branch network of Centre-North groups in the South tend to have increasingly less importance in relation to their overall network (Figure 1). Groups recording the largest increases in market shares during the period (y axis of Fig. 1), in fact, reveal the increasingly lower contribution of branches in the South in comparison to those in the rest of the country (axis x). The outcome of this is that those banks/groups which thanks to the size of their distribution network are the most frequent interlocutors of customers in the South have increased their levels of territorial diversification, becoming more and more nationwide and in some cases international banking groups.

Figure 1: Market share held by banking groups in the South and branch numbers in the Mezzogiorno as a percentage of a group's total branch network in Italy



Source: computation of Bank of Italy data.

We can conclude therefore that sizeable shares of the Southern Italian banking market are held by groups for whom the strategic importance of the area is progressively declining. Furthermore, in the five year period under examination (2004-2009), also the seven banking groups with headquarters in the South diversified territorially, a choice that enabled them to increase their activity outside the Mezzogiorno, albeit with as yet extremely limited market shares.

IV. Lending policies and bank performance

It could be suggested that the sizeable market shares held by Centre-North groups in the South of Italy along with the comparatively limited number of local enterprises and high credit risk levels may induce outer banks, as is often feared, to use the funds collected in the South to finance the Northern economy, thereby negatively impacting Mezzogiorno borrowers. This hypothesis does not appear to receive support at least from recent data relating to the index of financial intermediation (Table 4): in 2009, in fact, the loan-deposit ratio in the Mezzogiorno was greater than one, above all as a result of the activities of Centre-North banks.

Table 4: Loan-Deposit ratio in the Mezzogiorno

	2004	2009
Truly local Banks	64.1%	78.6%
Outer local banks	60.5%	71.9%
Outer banks	124.1%	148.7%
MEZZOGIORNO	***91.8%***	***107.0%***

Source: computation of Bank of Italy data. Deposits include customer deposits and bonds held by retail customers[6].

This result stems also from the fact that 'truly local' banks cannot transform fully their deposits into loans as they have to diversify their assets, a constraint that affects in particular smaller banks with operations confined to a geographically small area, and to keep part of the funds collected in liquid instruments.

The higher propensity of 'outer banks' to close their intermediation circuits however runs up against continuing complaints by businesses in the South about the lack of credit. These two aspects are not mutually exclusive: lending in the South, rather than being channelled to businesses, might be directed mostly at households, especially in the form of mortgages.

For this reason, we have disaggregated credit data into the economic sector of the borrower (consumer households, producer households, non-financial corporations, other sectors[7]). This allows us to verify whether the composition of the three groups' loan portfolios reveal significant differences, above all as regards households and non-financial corporations.

Table 5: Composition of loan portfolios in the Mezzogiorno

		C_H	P_H	N-F_C	O_S
Truly local banks	**2004**	36.3%	18.9%	41.7%	3.1%
	2009	36.7%	15.0%	45.0%	3.4%
Outer local banks	**2004**	34.1%	13.2%	43.7%	9.1%
	2009	32.3%	12.4%	49.4%	5.8%
Outer banks	**2004**	35.7%	10.2%	46.7%	7.3%
	2009	39.9%	7.1%	45.2%	7.8%

Source: computation of Bank of Italy data C_H: consumer households; P_H: producer household; N-F_I: non-financial corporations; O_S: other sectors

[6] Bonds held by retail customers are used as a proxy of those funds raised by southern branches via bond issuing.
[7] 'Producer households' include micro-enterprises, whilst 'other sectors' are mainly public sector entities.

At first sight, table 5 does not appear to indicate any significant difference in the composition of loan portfolios: around 45% of the total is destined to non-financial corporations and 35% to consumer households. However, on closer analysis, two features emerge. Primarily, only Southern banks, above all those classified as 'truly local', are generally prepared to offer credit facilities to producer households i.e., that category of borrowers that coincides with micro-enterprises and therefore those customers judged to be the riskiest. Secondly, over the five-year period, Southern banks intensified lending to local businesses in contrast with 'outer banks', which instead opted to increase the shares of loans to consumer households.

As shown in table 6, 'outer banks', though maintaining their leadership in the credit market, in fact lost sizeable market shares in the non-financial institution and producer households segments[8]. These figures reflect both an overall increase in proportionally smaller amounts lent in comparison to the market shares recorded at the start of the period and a change in the composition of portfolios in favour of consumer households. On the other hand, 'outer-local' banks increased significantly their lending to businesses.

These changes are consistent with the view that banks from the North, concurrently with the international crisis of 2007-09, shifted lending towards sectors that involved less complex credit scoring procedures and greater use of secured loans, particularly mortgages. Furthermore, following the reorganization of Centre-North groups and the increase of credit risk levels amongst customers, some of these banks appear to have reduced the operational and decisional distance involved in granting credit to businesses where the collection and use of soft information is more important, by transferring market shares to their Southern subsidiaries.

Table 6: Differences in lending market shares 2004-2009

	C_H	**P_H**	**N-F_C**	**O_S**	***All Sectors***
Truly local Banks	0.79%	-0.14%	1.30%	0.10%	**2.06%**
Outer local banks	0.23%	0.07%	2.29%	-0.64%	**1.95%**
Outer banks	1.15%	-2.36%	-2.80%	0.00%	**-4.01%**
MEZZOGIORNO	**2.17%**	**-2.43%**	**0.79%**	**-0.54%**	

Source: computation of Bank of Italy data. C_H: consumer households; P_H: producer household; N-F_I: non-financial corporations; O_S: other

[8] The combination "*outer banks*" – "*producer households*" in fact generates the only net negative variation in total amounts lent during the period under analysis; in all the other cases, differences derive from fairly substantial increases over market shares at year-end 2004.

Further information on the lending policies adopted by the different types of banks can be obtained by an analysis of data relating to the composition of credit portfolios by lending technologies used. This information can be gleaned solely by using data contained in the banks' financial statements, which also enable us to verify whether the different types of bank have differences in terms of profitability, efficiency and risk.

Therefore, we referred to the financial statements of banks with registered offices in the Mezzogiorno for the period December 2006 to December 2009. These three years correspond to the period immediately before and during the international financial crisis and allows us also to see whether during this phase of economic recession, with the worsening of credit levels that came with it, our groups of banks behaved differently. The sample is made up of 'truly local' banks and 'outer local' banks: 'outer banks' were excluded as it was not possible to extrapolate from their financial reports data specifically relating to their operations in the Mezzogiorno.

The sample, which represents more than 97% of the branches belonging to 'truly local' and 'outer local' banks, is made up of traditional retail banks and therefore excludes specialized intermediaries such as private banks. Anomalous values present in the smallest and/or most recently created banks were filtered by eliminating from each index the most extreme fifth percentile[9]. We analysed the composition of assets (Table 7), the structure of the loan portfolio by product type (Table 8), the principal capital, credit quality and earnings ratios (Table 9).

Table 7: Composition of banks' assets (average figures)

		CREDITS/ASSETS				FINANCIAL ASSETS/ASSETS			
		2006	**2007**	**2008**	**2009**	**2006**	**2007**	**2008**	**2009**
TRULY LOCAL	AVERAGE	51.29%	52.64%	55.76%	55.05%	30.29%	26.91%	24.70%	26.26%
	N	117	124	122	113	117	124	121	113
OUTER LOCAL	AVERAGE	62.62%	66.80%	67.24%	65.75%	7.75%	7.03%	4.66%	2.77%
	N	15	16	14	14	15	16	14	14
		INTERBANK/ASSETS				**NET_INTERBANK/ASSETS**			
		2006	**2006**	**2006**	**2006**	**2006**	**2007**	**2008**	**2009**
TRULY LOCAL	AVERAGE	12.21%	13.95%	13.58%	12.62%	11.49%	13.21%	12.89%	11.92%
	N	117	124	122	113	117	124	122	114
OUTER LOCAL	AVERAGE	22.56%	18.98%	20.10%	24.39%	18.21%	14.43%	15.87%	21.17%
	N	15	16	14	14	15	16	14	14

Source: computation of banks' balance sheets. N refers to the number of figures used in calculating the average.

[9] The values passing the filter were therefore those included between the 2.5th and 97.5th percentiles.

As regards the composition of assets, there are significant differences between 'outer local' and 'truly local' banks, with the latter's high share of financial asset portfolio standing out in particular. Given their small size, 'truly local' banks use their financial asset fto improve the level of diversification of their lending and to provide a source of liquidity; in the case of 'outer local' banks, this liquidity can be sourced directly from the parent company. For 'truly local' banks this means that resources are routed away from lending, but it also represents an inevitable diseconomy due to their small size. 'Outer local' banks, however, are more present on the interbank market, where they are major net lenders. This could be seen as a sign of transferring resources towards their parent companies.

Table 8: Composition of banks' loan portfolios (average figures)

		CREDIT OPENING/TOTAL CREDITS				**MORTGAGED LOANS/TOTAL CREDITS**			
		2006	**2007**	**2008**	**2009**	**2006**	**2007**	**2008**	**2009**
TRULY LOCAL	AVERAGE	21.16%	22.02%	22.41%	24.51%*	54.98%	53.70%	52.59%	52.27%*
	N	117	124	122	18	117	124	122	18
OUTER LOCAL	AVERAGE	20.35%	20.59%	20.65%	21.64%	50.77%	51.27%	51.17%	57.95%
	N	15	16	14	14	15	16	14	14
		PERSONAL LOANS/TOTAL CREDITS				**OTHER LENDING FORMS**/TOTAL CREDITS**			
		2006	**2007**	**2008**	**2009**	**2006**	**2007**	**2008**	**2009**
TRULY LOCAL	AVERAGE	2.64%	2.41%	2.35%	3.59%*	11.85%	12.50%	12.99%	17.57%*
	N	103	110	112	15	114	125	122	18
OUTER LOCAL	AVERAGE	5.20%	5.13%	4.44%	4.58%	18.07%	17.13%	16.13%	14.79%
	N	15	16	14	14	15	16	14	14

* the 2009 figure for 'truly local' banks does not include the statements of cooperative banks *(Banche di Credito Cooperativo).*** include mainly self-liquidating loans.

Source: computation of banks' balance sheets. N refers to the number of figures used in calculating the average.

As regards the composition of lending portfolios by product, there is a clear preference in both types of banks for secured lending in the form of mortgages. Not only does the predominance of mortgages suggest that banks seek greater guarantees, but also that there is heightened focus on households, whose principal means of accessing bank credit is via mortgages.

An analysis of lending product types reveals some differences within the group of 'truly local' banks. In particular, cooperative banks (*banche di Credito Cooperativo*) make frequent use of mortgages as a lending instrument, whilst mutuals (*banche popolari)* prefer current account lending forms, such as credit openings or overdrafts, and self-liquidating loans, which are lending technologies typically used in corporate lending. The recourse by cooperatives to secured lending offsets the high risk levels within their lending portfolios which, owing to their relatively small size and their localisation in less developed economic areas, are undiversified and have on average higher degrees of counterparty risk in comparison to other Southern banks.

Table.9: Capital, lending quality, efficiency and earnings ratios (average figures)

		TIER_1				IMPAIRED LOANS/TOTAL CREDITS			
		2006	**2007**	**2008**	**2009**	**2006**	**2007**	**2008**	**2009**
TRULY LOCAL	AVERAGE	22.11%	23.91%	21.13%	20.87%*	7.11%	7.06%	7.05%	5.65%*
	N	116	119	121	18	114	120	122	18
OUTER LOCAL	AVERAGE	7.98%	7.59%	8.18%	11.06%	3.70%	3.53%	4.50%	6.00%
	N	15	16	14	14	15	16	14	14
		COST/INCOME				**R.O.A.**			
		2006	**2007**	**2008**	**2009**	**2006**	**2007**	**2008**	**2009**
TRULY LOCAL	AVERAGE	75.78%	79.21%	77.68%	80.40%	0.93%	0.72%	0.67%	0.45%
	N	117	124	122	113	114	119	116	114
OUTER LOCAL	AVERAGE	71.01%	70.30%	70.85%	75.71%	0.70%	0.67%	0.68%	0.33%
	N	15	16	14	14	15	16	14	14

* the 2009 figure for 'truly local' banks does not include the statements of cooperative banks *(Banche di Credito Cooperativo).*

Source: computation of banks' balance sheets. N refers to the number of figures used in calculating the average.

More substantial differences between 'outer local' and 'truly local' banks emerge in the areas of capital levels, credit quality, efficiency and profitability. 'Truly local' banks have particularly high capital adequacy levels, but lower credit quality and less operational efficiency. 'Outer local' banks progressively improved across all areas, thereby confirming a trend often underlined in research carried out by the Bank of Italy (Panetta, 2003; Eramo *et al.*, 2006).

Both types of banks recorded a similar worsening in performances during the two years of the economic crisis 2008-09; the effects of this was a reduction in the quality of credit, a fall in profitability on the back of falling interest rates and a slow down in growth of operating volumes. Unexpectedly, the crisis impacted the two types of banks in the same way. In fact, 'outer local' banks, thanks to their larger size and/or their belonging to Centre-North banking groups, were expected to have handled the negative effects of the crisis better than 'truly local' banks. Similarly, it seemed likely that the greater involvement of 'truly local' banks with customer segments such as micro-enterprises, which during the crisis generated the highest losses, along with the high concentration of these businesses in their loan portfolios would have negatively impacted profitability and above all the quality of credit[10]. We can conclude therefore that differences between the two types of banks in terms of size, systems of governance or lending policies did not in any significant way influence the results recorded.

V. The organization of lending: results from a questionnaire survey

In order to shed more light on the adequacy of the current ownership structure of the banking system in the Mezzogiorno, we believe that is it essential to verify whether there are significant organizational differences between the three groups of banks operating in the south of Italy. An overview of the literature shows that the capacity to provide finance to informationally opaque enterprises is tied in fact to organisational structure and the degree of decentralisation in decision making.

As no publicly-available sources relating to the organization of individual banks exist, we constructed a data base with input in the form of replies to questions relating to the organisational and operational structure of lending adopted by banks taking part in the questionnaire. The questions focus on extremely specific aspects of banks' credit activities and as such, in order to incentivize banks to take part, we focused our attention on the granting of credit to small and medium-sized enterprises (SMEs) and households[11]. SMEs are significant in any analysis of the economy of the Mezzogiorno both because of the extremely fragmented nature of such an economy and because of the difficulties that exist in assessing the credit rating of these enterprises. In the absence of consolidated, reliable hard information it means that an appraisal of qualitative aspects is of crucial importance.

The questionnaire was sent out during May 2010 to all those banks which at the end of December 2009 had at least 20 branches in the regions of South Italy. We therefore excluded those smaller 'truly local' banks, including all cooperative banks (BCC), whose organizational structures we considered inevitably to be short and flat, as well as 'outer' and 'outer local'

[10] Aggregate data relating to the proportion of total credits represented by impaired loans to customers at year-end 2009 however show that 'truly local' banks were the ones that recorded the lowest credit quality levels.

[11] The questionnaire is provided in the appendix. As regards 'outer' and 'outer local' banks, additional questions were inserted to capture possible differences between the Mezzogiorno branch network and other branches i.e., between the subsidiary headquartered in the South and the subsidiaries and/or the parent company.

banks whose operations in the South were judged to be marginal in the light of the limited number of branches in the area.

A total of 31 banks replied, accounting for 76% of the Mezzogiorno's banking system in terms of branches and around 90% of banks operating in the South with at least 20 branches.

Our data base allowed us to investigate the following aspects:

1. the organisation and structure of lending activities in terms of the number of hierarchical layers of management and their territorial placement. In particular, respondents were asked to provide details of the staff grades and/or decisional bodies involved in the credit-granting process. We considered the first level to be that handling initial loan demands made by customers (usually, the loan officer);
2. the extent decisional powers are delegated within the credit arm in terms of the maximum amounts a grade of bank employee/credit granting body can approve;
3. the methods used in evaluating credit worthiness and the extent of automated credit scoring procedures as well as the importance given to qualitative information in the credit granting process.

As regards the first point, figures show that the average number of hierarchical levels involved in the entire credit-granting process is lower in 'truly local' banks; decisional lines are longer in 'outer local' banks and longer still in 'outer' banks (Table 2). These results are in fact consistent with the average size of the banks' belonging to the three groups: one would expect, *ceteris paribus*, to find more complex and longer decisional lines in bigger banks.

In addition to the overall length of the organisation of a bank's credit activities, we believe that the territorial proximity of the customer to the decisional centre is of considerable significance. In fact, proximity will dictate the extent to which the decisional centre can access qualitative information about the customer and the economic sector the SME operates in. For this reason, we calculated the number of levels operating in an inter-provincial ambitinterp, identified as an operational area that allows for adequate information regarding the territory. The figures shown in Table 10 highlight that although 'outer' banks have longer organisational structures in comparison to those of the other two types, 'outer' banks' first three decisional levels are nevertheless territorially proximate.

The proximity of 'outer' banks' organisational structure is confirmed also by the number of levels operating within the item 'interprovincial ambit/total number of levels', which cleans the results from the scale variable. The value of this indicator is 30% for banks with headquarters in the South, whether they be 'truly local' or 'outer local', and 40% for 'outer' banks.

Table 10: Organizational Indicators (mean values)

	Truly local	**Outer local**	**Outer**	***Sample***
Number of hierarchical levels	7,7	8,7	10,7	***9,3***
Number of hierarchical within the interprovincial ambit	2,3	2,4	3,7	***2,9***
Number of hierarchical levels within interprovincial ambit/total number of levels	0,3	0,3	0,4	***0,3***

The second aspect concerns the extent decisional powers are delegated in terms of the maximum amounts different hierarchical levels can approve autonomously in favour of customers judged by the bank to be low or high risk[12]. The situation that emerges from the answers provided is markedly heterogeneous. As regards low-risk customers, the amounts that can be granted increase moving from 'truly local' to 'outer local' to 'outer' (Table 12). Also in this case, the results are strongly influenced by the size of a bank and its capital base, which in turn represent those management and regulatory limits to the maximum amounts that can be granted compatible with an effective diversification of the loan portfolio.

The fact that decisional power of 'outer' or 'outer local' branches is higher than in 'truly local' branches should be viewed together with the structure and organization of lending discussed above. These two findings suggest that, although 'outer' and 'outer local' banks may have longer organizational structures, the degree of proximity and power delegation ensure that a

[12] In the questionnaire, low risk customers are those with the 'best risk profiles', whilst high-risk customers are those with the worst risk profile, excluding those with non-performing positions (past due, watchlists, bad loans)

significant part of lending decisions is made by loan officers who are very close to the territory.

The results indicate instead that 'outer' banks' impose strict limits on network autonomies in the case of high-risk customers: in fact, the level of autonomy delegated to individual bodies is much lower in comparison to that of banks with headquarters in the South. Moreover, some banks, though limited in number, with headquarters in the Centre-North have actually withdrawn decisional powers previously granted to the network regardless of customer risk profile. These two elements suggest that the lending policies adopted by 'outer' banks are considerably more severe.

Moving from SMEs to households, the territorial area in which at least 75% of decisions relating to loan applications (both for mortgages and consumer credit) are made is smaller for 'truly local' banks than for the others, suggesting that truly local banks are more proximate to their household customers.

Table 11: Power delegation (mean values)

	Truly local	**Outer local**	**Outer**
Maximum credit granted by loan officers (low risk borrowers, thousand of Euros)	72,5	224,2	229,1
Maximum credit granted at municipal level (low risk borrowers, thousand of Euros)	143,0	257,5	241,6
Maximum credit granted by loan officers (high risk borrowers, thousand of Euros)	26,0	164,9	10,0
Maximum credit granted at municipal level (high risk borrowers, thousand of Euros)	126,0	165,7	10,0
Geographical level within which more than 75% of loans to households is granted	Interprovincial	Regional	Interprovincial /Regional

As to the third area of inquiry, a sizeable percentage of respondents declared using automated procedures in assessing households' loan applications, even though in only two cases was the decision based exclusively on credit scoring methods. In the case of SMEs, the use of credit scoring or similar procedures is less common, above all amongst banks with headquarters in the South and in no case was the decision whether to grant credit based exclusively on credit scoring. The limited use of automated procedures by southern banks may stem from problems small banks have in equipping themselves with sophisticated credit evaluation procedures.

The more extensive use of credit scoring by Centre-North banks in evaluating demands for credit by SMEs and households could be one of the factors that allows these banks firstly to maintain an organisational structure, albeit not flat, which is proximate to the customer and, secondly, to grant credit for higher amounts when customer risk levels are low. In the opposite situation, where the customer is judged to be high risk on the basis of credit scoring, the decision to grant credit will be moved considerably further away in order to assess creditworthiness and maintain the qualitative level of the loan portfolio.

Table 12: Credit risk assessment methods

	Truly local	**Outer local**	**Outer**
Banks using credit scoring in consumer households lending	67%	92%	100%
Banks relying exclusively on credit scoring in consumer households lending	0%	8%	8%
Banks using credit scoring in SME lending	50%	46%	100%
Banks relying exclusively on credit scoring in SME lending	0%	0%	0%
Banks using qualitative information in credit scoring assessment	67%	100%	75%

The organizational structures illustrated were those present in May-June 2010, although in many cases these were already in place on average in 2007-2008. There are however examples of structures adopted as recently as in the period 2009-2010, above all in the case of larger banks with headquarters in the Centre-North. With respect to previous organizational structures, the majority of banks in our sample stated having increased the number of levels involved in the credit granting process and with this also the territorial ambit of loan officers hierarchically positioned above branches. These moves have not been accompanied by an increase in the amounts that can be granted autonomously, indeed in

VI. Concluding remarks

In this paper, we have evaluated the adequacy of the present structure of the Southern Italian banking system by focusing on the organizational features of the banks operating in such a low-income area. The approach adopted represents we believe an innovative contribution to the long running debate about the ability of the Southern banking system to offer essential support to the local economy. In fact, as argued by Stein (2002), a bank's internal organization is crucial in determining its vocation towards financing small and opaque enterprises, i.e. those requiring information-intensive services, such as relationship–based lending.

For this reason we collected unique information on the organization and technology used in lending activities with SMEs and households by means of a survey which involved Italian banks operating in the South, namely a) small and medium-sized independent banks headquartered in the South (what we have termed 'truly local' banks); b) small and large banks headquartered in the South, but belonging to banking groups headquartered in the Centre–North of the country ('outer local' banks); c) large banks headquartered in the Centre–North ('outer' banks).

We offer here some tentative remarks on the interpretation of the results of our analysis.

1. Over the last five years, 'truly local' banks have increased their market shares in terms of branches, deposits and above all lending. Despite this, more than 80% of the Southern Italian banking market is in the hands of banks whose strategy is established outside the area and whose Mezzogiorno's branches are more distant from the 'thinking head'.

2. Centre-North banks have higher levels of credit intermediation and reinvest more resources in the area than they receive from it. Southern banks instead are less able to close the intermediation circuit; this problem is particularly acute for Southern banks belonging to Centre-North banking groups in spite of their being less exposed to the diversification and liquidity constraints that affect southern independent banks.

3. Data relating to the composition of loan portfolios confirm that 'outer' banks are increasingly targeting the household sector, with the negative effects this has on

businesses, especially micro-enterprises included in the production household segment. Given that 'outer' banks account for more than 60% of the credit market in the Mezzogiorno, this trend in lending clearly represents a significant problem area. On the other hand, Southern banks – both those belonging to Centre-North groups and independent operators – appear more prepared (and increasingly so) to finance businesses and micro-enterprises.

4. Findings from the organizational survey indicate that 'truly local' banks have a flatter organizational structure in comparison to other banks, although due to the smaller size of these banks, the loan officer or lending unit nearest to the customer has less decisional autonomy, expressed in terms of the maximum amount that can be granted. In contrast, the 'outer local' and 'outer' banks are characterised by less flat organizational structures which are however proximate to customers and whose loan officers have greater decisional autonomy. The key organizational feature of 'outer' banks relates to decisional autonomies regarding high-risk customers: these are sharply curtailed or even cancelled with the effect that decisions relating to the granting of credit are taken by bodies considerably distant from the customer-loan applicant.

5. No significant differences appear in the organizational structures of banking groups operating throughout Italy. As regards 'outer' banks, the organization of their lending activities in the Mezzogiorno does not differ from the models adopted in other areas of the country. In the case of 'outer local' banks, with the exception of one, organization follows the structure of the parent company and the other subsidiaries.

6. Finally, the organizational survey reveals that all Centre-North banks utilise automated risk valuation procedures in assessing demands for credit both from households and SMEs. Southern banks however use credit scoring methodologies much less in the case of SMEs, which are, as is known, informationally opaque.

To conclude, we provide answers to the following two questions that underpin this work: a) have the benefits of localism and relationship lending been deeply and negatively affected by the transfer of control rights outside the Mezzogiorno? b) is the organizational model adopted by local and independent banks more effective in dealing with the needs of the local customer base?

In reply to the first question, the answer is for the most part affirmative: the 'outer' banks, which dominate the lending market in the South, have cut back significantly the decisional autonomy of loan officers with regards to highest risk customers. Although the organizational structure of these banks is in line with models adopted throughout Italy (see point 5), power delegation is in fact often more limited in the case of branches operating in the Mezzogiorno. Above all, due to the specificities of the local economy, Southern branches find themselves having to operate with a higher number of customers defined by the bank as 'high risk'. Secondly, the shifting of lending decisions to hierarchical levels nearer to the bank's headquarters means that these decisions are taken by persons or bodies further away from southern customers than is the case for the same category of prospective borrower living or working in the Centre-North. Thirdly, the widespread use of credit scoring by 'outer' banks produces benefits for the limited number of low-risk customers, who are guaranteed prompt response times to their applications for credit, but above all disadvantages for the more opaque and/or risky enterprises, whose demands for credit are not only automatically moved up the hierarchical scale but also away from them functionally and physically. The likely result of this is a greater recourse to cream skimming and rationing of customers in the Mezzogiorno.

As to the second question, this work shows that the organization of 'truly local' banks' lending activities is not significantly different from that adopted by southern subsidiaries of Centre-North banking groups. All southern banks appear to be prepared to finance the riskiest customer segments, as the data referring to the autonomy of loan officers shows. The comparative inability of these banks to close locally the intermediation circuit does not therefore depend on organizational problems. In the case of 'outer local' banks, the problem is likely to be related to a higher aversion to risk on the part of the parent company, which imposes limits to the reinvestment of resources coming from the territory and makes frequent use of collateralized lending forms. In the case of 'truly local' banks, the problem is related to size: the limited dimension of these banks means that, in avoid to contain overall risk levels of their lending portfolios, they have to diversify their assets by investing in liquid instruments and securities portfolios much more than a bank with a substantial presence throughout the country.

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