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Bank Nationalizations of the 1930s in Italy: The IRI Formula

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This Article draws lessons from Italian history as to how the state may possibly intervene in economic crises without jeopardizing the economy or affecting competition. It first describes how and why Italy got to the point in the 1930s where the government had to save the financial system. That was accomplished by setting up a public financial holding company (IRI), which became the majority shareholder of banks and companies in the telecommunications, steel, shipping, engineering, and energy industries, among others. The so-called IRI formula has long been considered a model both in the European Union and outside it, with many countries setting up similar companies. Initially, the IRI performed well in Italy and acted as a market player. In the 1960s, however, its performance deteriorated under pressure from political parties. This degeneration combined with pressure from the European Union prompted Italy to gradually (or partially) privatize the state-owned companies, a process that ended only recently. Ironically, the pendulum is now swinging back. In preparation for the next crisis, Italy is currently planning to go "back to the state." The Article presents different ways of public intervention in the economy and offers suggestions for future reforms.

Introduction

The public intervention in the banking system as a consequence of the financial crisis has prompted a remarkable revival of the debate over the

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role of the state in a contemporary economy. The purpose of this Article is to bring to the discussion the example of an Italian institution set up in 1933 to bail out the credit sector, further elaborate on this past experience, and to evaluate whether any lessons can still be drawn from it.

In 1933 the Italian government created a public body called the Institute for Industrial Reconstruction (IRI). It became the owner not only of the three most important Italian banks, which were clearly too big to fail, but also of the lion's share of Italian industries, owing to the proprietary interlock among these and the banks. The IRI example is particularly notable as it represents a case where the state acted as a market player. The IRI injected capital into the banks to rid them of their junk assets and to separate retail from investment activities. On top of that, the state coupled this action with long-term regulatory reforms that remained in place until the early 1980s.

The foundation of the IRI should be historically framed. It was set up not as the result of a sudden financial crisis, but rather as the final outcome of a long series of public interventions that began more than a decade earlier and definitively changed the landscape of the credit sector and the industrial economy. Each intervention represented an alternative mode of state involvement in the economy. In fact, it may be observed that the government behaved in various ways during banking crises. For instance, in one case it acted as an arbiter between a group of would-be conquerors and the targeted banks, while in another it participated in a debt restructuring plan in favor of the creditors of a few ailing banks. It further injected money into the Central Bank so that the latter could rescue institutions in financial distress, and finally it directly gave financial support to distressed credit institutions.

For our purposes, the historical perspective is also necessary to understand the progression and the deterioration of the interconnections between banks, industry and public bodies. Despite the IRI's having played a pivotal role in industrial development by creating a widespread system of state-owned enterprises, our focus will be on the reorganization of the banking sector.

The Article is organized as follows: Part I describes the development of the structural weakness of the Italian economy in which the creation of the IRI was rooted, namely the interconnections among banks and industries, and how the state timidly started to intervene in banking affairs. Parts II and III analyze the first massive round of bailouts, how they were designed by the government, and how the 1929 Wall Street meltdown urged a new wave of interventions that eventually led to the creation of the IRI. Parts IV, V and VI focus on the IRI's creation, governance, funding and actions, Part VII draws some lessons, and the last Part concludes.

I. The Italian Banking-Industry Alliance and the First Signs of Clashes

State intervention in the modern Italian economy was originally justified by the need to bail out those banks whose high level of exposure to ailing industrial sectors had put the financial stability of the entire system in peril. The banking-industry relationship had deep roots in the Italian economy, deriving from the attempt to create a liberal capitalist system where little or poor space was left to public autarchy.[1] This framework seemed to work rather well until the first decade of the twentieth century.

Before World War I, in fact, Italy was in the first phase of industrialization and in the full tide of economic growth, with an expanding and protected domestic market and increasing outlets abroad.[2] In this favorable economic cycle the market for industrial shares thrived, and banks were thus able to quickly and profitably trade their participations whenever needed. By contrast, after the war ended financial markets lost their vitality and the economic recovery was very slow. During the conflict, credit institutions played a sponsoring and funding role in war-related contracts,[3] such as loans, imports of raw materials and production of weapons.[4]

At the end of the hostilities, then, banks found themselves exposed to highly immobilized activities too expensive to reconvert. Furthermore, they had to face higher capital costs because the market was no longer subject to the fixed currency exchange rate, which had been kept intentionally low during the world conflict. On top of that, in the years before and after World War I, banks started to engage in speculative behaviors aimed at artificially increasing industries' share prices and in high-risk activities, making use of depositors' money. On their part, some industrial sectors, such as shipping, car-making and heavy engineering, were confronted with corresponding problems: highly difficult reconversion of production and higher interest rates.

Against this background, the executive directors of these highly indebted industrial groups planned to take over the banks with the ultimate aim of easing

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1 Stuart Holland, *The National Context*, *in* The State as Entrepreneur 57 (Weidenfeld & Nicolson eds., 1972).

2 Pasquale Saraceno, *IRI: Its Origin and Its Position in the Italian Industrial Economy (1933-1953)*, 3 J. Indus. econ. 197, 198 (1955).

3 Confederazione Generale dell'Industria Italiana, L'industria Italiana alla metà del secolo XX [Gen. Confederation of It. Indus., Italian Industry in the Second Half of the Twentieth Century] 55 (1953).

4 Given the amount of liquid resources banks could rely upon, they were by definition well placed to play that role and indirectly sustain financial efforts at the central level.

their own financial difficulties. More precisely, their goal was threefold: to make direct use of banking funds, lower the level of competition by restricting their peers' access to financial resources, and gain political prestige.[5] And so, in the 1920s two of the four universal banks at the time experienced hostile takeovers led by, respectively, directors of Ansaldo (an engineering, steelmaking and shipping group) and of FIAT (the car-making industry).

This marks a first mode of government intervention in favor of banks, albeit timid. In both cases the Finance Minister played a fundamental role in settling the disputes between the would-be conquerors and the targeted banks. He held talks with the parties, mediating between the opposing stances and suggesting possible solutions. Stepping in as the referee, he avoided the proprietary upset. The ride was eased by setting up defense consortia in which shares were conferred. However, that had two main shortcomings: a strong consolidation of the bank-industry relationship[6] and the concentration of economic power among very few financial players.[7]

Almost anticipating the conditions imposed in today's bailout plans, the Finance Minister asked the most important Italian banks (Credit, Comit, Banca Italiana di Sconto, and Banco di Roma) to participate in an agreement that was to have resulted in a more stable credit system, more favorable and standardized conditions for contracts with customers, as well as greater support for the post-World War I recovery. In spite of this imposition, it could still be argued that this involvement started to encourage a hazardous attitude on the part of the banks. In fact, they may well have understood which side

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5 Ernesto Cianci, Nascita dello stato imprenditore in Italia [Rise of the State as an Entrepreneur in Italy] 21 (1977).

6 Eventually, these defense consortia were mixed financial-industrial parent companies. Owing to the abovementioned fights, the level of interconnection between banks and industry reached its height, since their shares were no longer publicly dispersed and credit institutions and industries became mutual shareholders. As seen, the governance system was concentrated at the parent level of the banking group headed by the mixed holding company, which managed the industrial and financial participations. Pasquale Saraceno, *Salvataggi bancari e rifome negli anni, 1922-1936* [*Banking Bail Outs and Reforms, 1922-1936*], *in* Banca e industria tra le due guerre: Le riforme istituzionali e il pensiero giuridico [Banks and Industries Between the Two Wars: Institutional Reform and Legal Thinking] 10, 16 (IL Mulino ed., 1981). As a consequence, interlocking directorates were in place as well, Michelangelo Vasta & Alberto Baccini, *Banks and Industry in Italy, 1911-36: New Evidence Using the Interlocking Directorate Technique*, 4 Fin. Hist. Rev. 139, 151 (1997).

7 Luigi Einaudi, La condotta economica e gli effetti sociali della guerra italiana [Economic Behavior and Social Effects of War in Italy] 73 (1933).

the government was supporting and as a consequence they engaged in even more risky behavior and reckless lending.

II. The 1920s Bailouts and the Role of the Banks of Issue

Against this backdrop of interdependencies, financial difficulties, and possibly public policies prone to moral hazard, the first bank to collapse was Banca Italiana di Sconto (BIS). BIS was one of the universal banks that had linked its fate to that of the Ansaldo group. Furthermore, BIS was tremendously exposed to shipping, land and marine, and the cotton industry, all hit by postwar inflation and the fall of demand. Its share price decreased sharply after World War I, together with those of the majority of industrial sectors.[8] Soon after the war, the bank had also followed an expansionist policy, opening new branches all across Italy.[9]

At the very beginning of the crisis in 1921, the government opted not to step in, probably because of an underestimation of the adverse consequences, or maybe because it wanted to pursue noninterventionist policies. However, in 1922 the new government decided to intervene once the real magnitude of BIS's financial distress and the systemic impact of an uncontrolled default had been more clearly assessed. Yet, although the previously adopted *laissez faire* public policy came to an end with the fall of BIS,[10] the state still preferred not

8 It has been calculated that at the time of the collapse in 1921, the bank's debt amounted to 5,300,000,000 liras, Donato Menichella, Conferenza tenuta alla settimana di studi bancari indetta dall'ABI in collaborazione con l'Università Cattolica del Sacro Cuore, Passo della Mendola, 21-26 giugno 1954 [Speech Delivered at the ABI Conference on Banking Studies, June 21-26, 1954], *reprinted in* Scritti e Discorsi scelti [Selected Writings] 125 (Bank of Italy ed., 1984).

9 *See* Peter Hertner, *Modern Banking in Italy*, *in* Handbook of the History of European Banks 561, 568 (Pohl Manfred & Freitag Sabine eds., 1994) (arguing that the bank's meteoric rise during the war and its sudden fall in the postwar crisis were symptomatic of a type of financial institution which had neglected all principles of risk dispersion and violated all basic rules of liquidity preservation).

10 Obviously, during the war, the state had to intervene to ease financial and industrial sectors' difficulties. In 1914 a general moratorium was declared that helped restore confidence in the system and avoid a run on the banks. Further, R.D. no. 1375/1914 established a consortium to aid industrial securities, called "*Consorzio per le sovvenzioni industriali*." Its members were the banks of issue, some state-owned banks and savings banks. Its tasks were to give credit to firms in need by discounting their bills and rediscounting them with the banks of issue and to anticipate industrial instruments, *see* Cianci, *supra* note 5, at 15-17.

to inject capital into the bank. The BIS experience is notable because the state decided to let the bank go bust. It preferred to channel its financial contribution into the protection of creditors and thus opted to sustain the liquidation plan.

Also, it did not do so directly, but asked for the support of the banks of issue, as has actually happened in some E.U. Member States today. Banks of issue were privately owned credit institutions that, besides engaging in typical credit activities, had been granted the privilege of issuing banknotes. For our purposes, the most remarkable bank of issue was the Bank of Italy. To counterbalance the privilege, the state had imposed on these banks two issuing-related fees based upon certain thresholds. The first fee was levied only if the bank's revenues related to the "ordinary" issuing activity were higher than five percent. The second fee was related to "extraordinary" issuing of banknotes. This latter circulation was typically needed in wartime or in particular situations and provided banks with extra earnings. In order not to give them an incentive to issue extraordinary levels of banknotes, the state used to impose on these banknotes a fee equal to the percentage of the interest rate applied.[11]

Having said that, here is how the bailout plan worked. The government first created a new though completely autonomous and independent section of the already existing *Consorzio per le sovvenzioni industriali* (Consortium for Industrial Funding).[12] The new special section of the consortium (SSC) had no legal personality, was not endowed with its own funds, and was set up as an office of the Bank of Italy. As mentioned, the plan was initially designed as a very last interventionist resort. Basically the state, by means of the SSC, would have helped BIS repay its creditors, but only as long as the bank did not collect enough revenues from the sale of its activities or the compensation of credits.

In today's jargon, the SSC was a special purpose vehicle. In fact, it worked as follows: When the principal of the liquidation agreement (*concordato*) fell due and the ailing bank had not realized enough money from the sale or liquidation of assets, it could issue a paper (*cambiale*) to the SSC endorsing it, for instance, to the Bank of Italy, which in turn provided the ailing bank with the needed liquidity. On its part, the bank of issue would finance itself by issuing new banknotes. In order to protect the bank of issue from losses,

11 Luigi Einaudi, *I metodi e il costo dei salvataggi bancari* [*Methods and Costs of Banking Bailouts*], Corriere della Sera, Oct. 5, 1923.

12 *See* Hertner, *supra* note 9. Accounting problems were one reason for the creation of the new section: The regulator did not want to increase exponentially the bank of issue balance sheet, so it had to set up an instrument in which to write the new debt, Menichella, *supra* note 8, at 152.

the government initially authorized the banks to keep one third of the levy on the extraordinary circulation.[13] However, when it became clear that there was a systemic problem in the financial sector, that amount was increased to three quarters.

As a result, the state gave up part of the earnings that it used to collect from the "extraordinary circulation" fee, to place them in a rescue fund to which the banks of issue could have had access in case of need. Although the measure was meant to be temporary, a further decree was issued that extended the validity of the fund to December 31, 1925. Even more, it backdated the three-quarter fee to January 1, 1922. Lastly, a new decree finally extended the fund's validity to December 31, 1930.[14] The main reason for these subsequent layers of intervention was that, although the SCC was originally designed for the BIS bailout, in the following years other banks requested aid from the fund as well. At this stage, state intervention was justified by the domino effect that uncontrolled defaults could have had on the system as a whole.

Consequently, whenever a bank had liquidity problems the Bank of Issue would anticipate the sum. In this way a large slice of all the Italian banks were rescued by the SSC. Anticipating here what will become clearer later, we see how the Bank of Italy was becoming tremendously and dangerously exposed to the credit sector, laying the foundation for the creation of the IRI.

Another (in)famous bailout case was that of Banco di Roma. The abovementioned depreciations of industry share prices had the same jeopardizing effect on that bank. To make things worse, the bank had also heavily engaged in speculative operations and had lent money without adequate guarantees and collateral.[15] Luigi Einaudi labeled the bank's directors as "megalomaniac" and "inexpert in banking matters."[16]

However, when during 1922-1923 Banco di Roma faced financial distress, the government was again faced with the dilemma whether or not to rescue the bank. After a careful evaluation of the situation, and despite the actual intention of the banks of issue not to save the bank, the state had no option but to provide financial support to Banco di Roma. This time a "too interconnected to fail" problem arose that made the Prime Minister impose a bailout.[17] In

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13 By virtue of R.D. of Nov. 12, 1921.

14 Einaudi, *supra* note 11.

15 Alberto De Stefani, Baraonda Bancaria [Banking Chaos] 35 (1960).

16 Einaudi, *supra* note 11.

17 Although at the time Italy was not yet under Mussolini's dictatorship (though he was Prime Minister), nor did he directly intervene in banking issues, which were left to the responsible officers, on November 12, 1922, he wrote to the Finance Minister: "Due to economic, national, international and obvious highest reasons, I command ('esigo') to make any effort to save Banco di Roma. It is

this case, the plan encountered strong opposition from some directors of the banks of issue.[18] They agreed that the main financial efforts had to be borne by the Bank of Italy, making use of the SSC. Nonetheless, due to statutory limits the initial endowment of the fund was not sufficient to cover the costs and a new funding mechanism was actually needed.

And so in 1926 the government decided to create a brand new institute, *Istituto Liquidazioni* (IL — Institute for Liquidations). In November 1926 the SSC's activities were transferred to the IL, which inherited the onerous legacy of the SSC that amounted to roughly 44,000,000,000 liras given to ailing institutions in five years of existence against only one billion in returns.[19] However, the dynamics of the funding mechanism were left unchanged: Troubled banks issued papers payable by the IL, which in turn asked for an advance payment from the Bank of Italy. In this case, the Bank of Italy had the exclusive responsibility of financing the ailing banks. In 1926 a new banking law was passed that, among other provisions, granted the Bank of Italy the exclusive right to issue banknotes and some supervisory powers.[20]

III. The 1929 Wall Street Crash and a New Wave of State Intervention

The twentieth century's most disruptive crisis hit Italy in 1930-1931.[21] Although Italian banking activities were not tightly interlocked with those of Wall Street players, nor was the country dependent on American lending,

necessary that in the shortest term possible and with all its good will, Banco di Roma proves that it deserved to be rescued." De Stefani, *supra* note 15, at 75 (translated by the author).

18 The solution described is indeed the outcome of a long period of bargaining and transactions between the bank's managers and the then-directors of the banks of issue, among whom Mr. Stringher from the Bank of Italy played the most active role, and the Treasury Ministers, first Mr. Tangorra and then Mr. De Stefani.

19 Cianci, *supra* note 5, at 57.

20 L. n. 812/1926 (It.). Also, banks were forced to sign in a register at the Bank of Italy and had to keep ten percent of revenues aside and up to forty percent of their capital. Furthermore they had to invest a certain percentage of capital in treasury bills and liquid instruments. Lastly, maximum levels of exposure against single borrowers were fixed and banks had to ask for the authorization of the Minister of Finance to open new branches, Renzo Costi, L'ordinamento bancario [Banking Law] 78 (4th ed. 2009).

21 Bruno G. Foa & Piero G. Treves, *Italian Finance and Investment*, 23 Economica 270, 272 (1939).

it nonetheless felt the financial strain caused by the cessation of exports and the slump in share prices.[22]

Furthermore, in Italy the Wall Street crunch was aggravated by some particular factors. The crisis found the credit market already on the verge of depression. Due to some monetary policies adopted in the mid-1920s,[23] following a period of credit growth and expansion, stock markets had become strongly inflated. Banks could no longer profitably trade their industrial participations and were actually forced to consolidate their levels of exposure through mutual subscriptions of capital increases under the illusion of preserving the value of their activities.[24]

When the 1929 crisis hit Italy with full force, the interconnections among industry and banks spread the meltdown in both the financial and the industrial sectors, provoking a sharp increase in the unemployment rate and a reduction in foreign trade, as well as the virtual closure of the stock market because of the steep share value depreciation.[25] Moreover, the former bank-industry fights and the bailouts of the mid-1920s had seriously weakened the financial system's ability to absorb any unexpected and severe losses and withstand a crisis. This is how, because of these cyclical and structural causes, the state had to step in again to ease banks financial difficulties.

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22 By the end of the 1920s Italian industries engaged in heavy sectors had only just started long-run credit relationships with the United States and were in the process of finally settling some debts still related to World War I, *see* Valerio Castronuovo, L'industria italiana dall'ottocento ad oggi [Italian Industry from 1800 Until Today] 179 (1980).

23 For example, the decision to link the Italian lira to gold-related currencies such as the dollar and pound sterling, and to set the exchange rate at a fixed level. This deflationist movement brought about, as an immediate consequence, a growth in the aggregate levels of liquidity owing to the increased level of aggregate lending to industries, but a few years later an inflationist trend started which made the banks more vulnerable to any possible shock, *see* Giangiacomo Nardozzi & Giandomenico Piluso, Il sistema finanziario e la borsa [Financial System and the Stock Exchange] 56 (2010). Also, in 1931, following the British government's decision to devaluate the pound sterling, banks were expecting a corresponding move by the Italian government, which nonetheless decided to leave the same conversion rates, probably to enhance the prestige of Fascism, *see* Cianci, *supra* note 5, at 134. The monetary policy prompted also speculative behavior by international players, which was to the financial detriment of the banks.

24 *See* Nardozzi & Piluso, *supra* note 23, at 62.

25 *See* Holland, *supra* note 1, at 75.

This new wave of financial support was handled by means of the Bank of Italy, which intervened both directly and through the IL. This time, however, the state designed a more organic and coherent plan, since it coupled the bailout mechanism with regulatory reforms and imposed structural interventions targeting banks' capital. While increasing the amount of funding and the types of credit lines the Bank of Italy could grant, it also called for regulatory reforms aimed at isolating retail banking activities from investment activities. Conversely, in 1931 the government also created the Istituto Mobiliare Italiano (IMI) whose statutory objective was to give loans to ailing industries. Financial aid was granted by IL both to insolvent banks and to banks merely facing liquidity problems.[26]

Constrained by political pressures, the distressed banks engaged in a proprietary reorganization to remove industrial shares from their balance sheets. To this end, they set up *ad hoc* holdings where industrial stocks were handed over.[27] The divesture procedure was conducted as follows: IL financed the holdings to purchase the industrial shares, and in turn borrowed the sum to be transferred from the Bank of Italy. This time the related bill was guaranteed by the holding, the IL and the banks so that the Central Bank could (though only apparently) rely on three guarantors. In some instances, the Bank of Italy directly intervened to fund the companies.

Yet this setup could not work efficiently. The holdings were left with the onus of managing the conferred shares at a historical moment when industries were awash in debt and there was no possibility of finding investors willing to buy these stocks. It is no surprise, then, that they had to ask for the Bank of Italy and IL's support to cover losses. This latest bailout plan required the banking holdings that were asking for public funds to submit their accounts to the Bank of Italy. Also, the Central Bank could appoint the chairman and half of the directors. However, the direct involvement of public bodies had the side effect of making the governance of the holdings opaque, especially

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26 Together with some local and Catholic-oriented credit institutions, the most troubled banks were again Banco di Roma, Credit and Comit.

27 Among others, the most remarkable examples were those of Sofindit, Elettrofinanziaria and SFI. Sofindit was a subsidiary of Comit to whom in 1931 the bank transferred the industrial shares it owned in more than four hundred companies. Elettrofinanziaria was the result of the merger between two former financial institutions, Compagnia Finanziaria Nazionale and Istituto Finanziario Nazionale and it was created to receive the industrial shares of Banca Nazionale di Credito. To Societa' Finanziaria Italiana (SFI) were transferred participations from Credito Italiano and Banca Nzionale di Credito, *see* Cianci, *supra* note 5, at 190-98.

in relation to decision-making processes.[28] For the first time, in fact, the Bank of Italy was somehow involved in the management of bailed-out institutions.

Finally, banks could not experience the expected relief, since the whole operation turned out to be nothing but an accounting scam. In fact, against the price they received from the transfer of shares, credit institutions were still the shareholders of the holdings and so the final burden of losses was on them: In this regard, the holdings acted merely as bridge companies.

IV. The Creation of the IRI

As mentioned above, the emergency measures hitherto adopted did not bring about any efficient result. Also, as a side effect they created a dangerous surge in the financial exposure of the Bank of Italy towards both the credit and the industrial sectors. It thus became clear that a new and final plan was needed. In 1933 the government decided to set up a new body called the Institute for Industrial Reconstruction (IRI).[29] Among other things, it had the task of unraveling the complex web of ties between commercial banks and industrial firms, between the government and the commercial banks, between these and the Central Bank, between these and the agencies set up to carry out the earlier emergency policies, and finally between the government and the Central Bank.[30]

Careful evaluation and planning preceded the decision to create this body, since the state was still reluctant to take on banking shares as the creation of a public banking system was not part of the state's industrial planning. Among the proposed alternatives, the preferred option was the dismissal of the banking holdings, followed by the transfer to a new body of theirs and of all the remaining industrial participations and any obligations towards industries that were still in banks' hands. With this solution, not only would the IRI — a public body — have become the direct debtor of the banks for the corresponding amount of shares and credits transferred, but also the complete separation between banks and industries would have finally been effected.[31]

The institute was meant to be temporary; it should have lasted until its objectives had been accomplished. The overall plan required: 1) that the loans granted by the Central Bank to the commercial banks for the purposes of industrial financing be transferred to the IRI and repaid, as quickly as

28 *See id.* at 198.

29 Established by virtue of R.D. n. 5/1933 (It.) (converted into L. n. 512/1933).

30 Marco Maraffi, *State/Economy Relationships: The Case of Italian Public Enterprise*, 4 Brit. J. Soc. 507, 509 (1980).

31 Cianci, *supra* note 5, at 241-60.

possible, directly by the latter; 2) that the capital of the banks no longer be in the hands of industrial firms or of financial companies controlled by the banks themselves; and eventually 3) that commercial banks' deposits be used only for short-term lending and for investments in bond securities, while all other business related to the management and the long-term financing of industrial firms be transferred to the IRI.[32]

To accomplish these aims, the IRI: a) incorporated IL; b) purchased all the remaining credits banks had towards Sofindit, Elettrofinanziaria and SFI,[33] as well as all the other tied-up participations not yet transferred to the holdings; c) liquidated the latter; d) took on banks' net liabilities; d) paid back to the Bank of Italy the credits it had towards IL and the ailing banks; and e) required the banks to put an end to any ties still existing with industries, such as interlocking directorates and voting agreements.[34]

Industrial participations and immobilized funding were thus written into the IRI balance sheet. The institute became the main shareholder of one fifth of all Italian industries, and because of the ownership reciprocity it owned ninety-four percent of Comit and Banco di Roma and seventy-eight percent of Credit. To appreciate the magnitude of IRI intervention, we should consider this data: In 1933 the total amount of anticipations and discounts the Central Bank was engaged in amounted to more than half of the aggregate level of monetary circulation, while mixed banks had invested in immobilized positions more than eighty percent of the deposits held.[35]

As a whole, banks' industrial immobilizations amounted to more than 12,000,000,000 liras, deposits and bank accounts to 14,000,000,000, while 5,000,000,000 was the amount due to the Bank of Italy. Moreover, the entire credit of the Bank of Italy to both IL and the banks corresponded to roughly 8,000,000,000.[36] By the same token, it has to be considered that in 1933 the total amount of the IRI's holdings had an aggregate face value of 10,277,000,000 liras. Specifically, the IRI held 83.13% of the telecommunication sector, 55.88% of the shipping, 38.92% of the banking, 37.92% of the heavy engineering, 34.28% of the fishing, 32.18% of the financial sector, and 29.33%

32 Saraceno, *supra* note 2, at 199.

33 *See supra* note 27.

34 Donato Menichella, *Le origini dell'IRI e la sua azione nei confronti della situazione bancaria* [*IRI Origins and Its Action Towards the Banking Sector*], *in* Scritti e Discorsi scelti, *supra* note 8, at 120.

35 Saraceno, *supra* note 2, at 199.

36 Cianci, supra note 5, at 57; Mario Giotti, *La gestione dell'IRI dalla costituzione alla vigilia della trasformazione in ente permanente* [*IRI Management from Its Constitution to Its Transformation into a Permanent Body*], *in* Banca e industria fra le due guerre, *supra* note 6, at 182 .

of the electricity industry. In this way, Italy became the European country with the second largest public sector of the economy, after the Soviet Union.[37] Unquestionably, then, the creation of the IRI marked a fundamental turning point in the Italian economy, as the state moved from a system of "private autarchy" to one of "public autarchy."

In spite of the initial propaganda and plans, in 1937 the IRI became a permanent body. The government explained this change of status with the worsening of economic conditions, which indeed was among the reasons that led soon after to the second world conflict, and by the inability of the market to actually absorb that huge amount of participations. So the IRI then became part of wider industrial planning that included many "public managing bodies" active in every sector of the economy. This interplay among private and public bodies came to an end only with the privatization movement in the 1990s (carried out under pressure from the European Union) and the final liquidation of the IRI in 2000. This unplanned shift to a permanent status should be kept clearly in mind as a risk that the state might face even today when entering into the market economy.

V. IRI Governance and Funding

In the initial stage of the IRI's activities, its governance and course of actions represent a remarkable example of the state playing a surprisingly passive role in the decision-making process and in the allocation of the industrial assets in the capital market. There is no straightforward explanation for this attitude because a variety of causes may have contributed to what has been called the "non-antagonist" or "adaptive" character of IRI interventions. So we may only suppose that it was likely because the IRI's technicians were granted the complete trust of the Prime Minister, or because it was truly not yet in the government's mind to become a player in the capitalist system, or maybe because the institute was not yet strong enough to counterbalance the monopolistic industrial powers then in place. Whatever the cause, before slowing or even shutting down its trading activities as a consequence of the transformation into a permanent body, the IRI managed to sell back almost thirty-seven percent of the total value of the shares and credits in its hands.

What we can more pragmatically say is that — again surprisingly, though — the IRI was a public body that was able to introduce innovative financial instruments for the time being. Also, the IRI did not modify the legal status of the participating firms and did not grant them any privileges or exemptions.

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37 Maraffi, *supra* note 30, at 509.

By so doing, the IRI tried not to alter the equilibrium in the market but rather to abide by the rules of competition. Finally, it set up an incentive-compatible policy to create a share-oriented culture. This,[38] were it not for the degeneration of the IRI, would have contributed to the development of the capital market long before the last few decades when it actually happened.

Managed by an independent chairman with full representative powers, appointed by Royal Decree on the recommendation of the Prime Minister together with the Minister of Finance and Corporations, the IRI was organized into two sections: *sezione smobilizzi* (section for shares' transfer) and *sezione finanziamenti* (financing section). Each of them was independently managed by a different board of directors. The remit of the *sezione smobilizzi* was to manage and sell to private investors shares and financial participations acquired by the IRI and the activities and liabilities of the IL; the *sezione finanziamenti* had the task of giving long-term loans to private Italian nonfinancial institutions. The *sezione finanziamenti* was in full operation until 1936; afterwards it was incorporated into IMI and worked under that name. Its activities targeted both the now-state-owned firms managed by the *sezione smobilizzi* and those privately owned.[39]

The first operations handled by the sections were the reorganizations of the telecommunication, shipping and heavy engineering industries. The IRI then followed with the reorganization of the electric, banking and mechanical sectors. The operations were conducted under clear directions: The Institute should not become or remain the final owner of industrial enterprises, but should be an emergency temporary body created to reorganize banking

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38 This tendency seemed to have reversed with the post 2008 crisis bailouts. In fact, according to a recent study, states are involved in banks' management only to a limited extent and favor early exit, *see* Gerard Hertig, *Government as Investors of Last Resort: Credit Crisis Comparative Case Studies*, 13 Theoretical Inquiries L. 385 (2012). On the characteristics of some E.U. bailout plans and their possible shortcomings, see Costanza Russo, *Bail Out Plans: Do They Really Envision State Exit and Bank Repayments? A View from a Competitive Assessment Perspective*, 21 Eur. Bus. L. Rev. 497 (2010).

39 In the first three years of operation, 182,000,000 liras in loans were channeled to non-IRI enterprises, corresponding to nearly twenty percent of the aggregate funding, *see* Francesco Cesarini, *Alle origini del credito industriale: la gestione dell'IMI dalla costituzione ai provvedimenti per l'autarchia (1933-1938*) [*The Origins of Industrial Credit: IMI's Management from Its Constitution to the Autarchy Measures (1933-1938)*], *in* Banca e industria tra le due guerre, *supra* note 6, at 80 (quoting original documents of the board, the author also points out the special rigor and independency used to handle the requests for funding, which positively contributed to the success of SME's industrial development).

activities and consequently to realize industrial participations. Its intervention should have been as quick and profitable as possible, while the ailing industries had to be finally liquidated. Private investors could buy stocks only making use of their own funds and they could not ask for loans to credit institutions. In this way, the possibility that in case of insolvency of the former the credit institutions might again become shareholders of those industries was avoided.

The initial design of the IRI seems to resemble that of today's private equity funds. The state injected capital into the firms with a clear objective in mind, namely a structural reorganization of the firms through the imposition of related governance decisions, extraction of profits, and eventual divestiture of the firms. One big difference is, of course, that the IRI would bring in fresh capital instead of indebting the company with buyout operations.

One other hint of the government's tendency to act as a market player was the way the IRI was funded. The most remarkable amount of funding came from the issuance of convertible bonds. Though widespread now, it was a successful intuition the IRI's managers had, since at the time these types of bonds did not exist in Italy.[40] In this respect, then, we should acknowledge that the IRI's funding represents a unique case of financial innovation coming from a public body. Obviously, owing to the still weak market conditions and to the priority of operating at a fast pace, the first emission was subscribed by a quasi-state-owned consortium (*Consorzio di credito per le opere pubbliche*). The bonds, called "IRI special series," carried 4.5% interest and had to be reimbursed in twenty years. The IRI immediately used the greater part of the borrowed amount to repay the debt to the Bank of Italy. Part of the remaining amount was reimbursed to the Central Bank by the end of 1936, with funding raised in the market.

Despite this first public support for the IRI, the subsequent reorganization and offering of the nonfinancial participations was carried out in the market. The IRI used to issue bonds related to each sector, such as IRI-STET for the telecommunication sector, IRI-MARE for the shipping industry, and IRI-FERRO for the heavy mechanical industry. They carried a minimum interest rate of four percent and had a convertibility option.[41] This clause had been thought to accomplish a twofold aim: to protect bondholders from any future inflation and to start introducing a share-oriented culture in the country. For instance, the convertibility right could be exercised also in case of capital increase. Lastly, to make the bonds more appealing, they were covered by

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40 Cianci, *supra* note 5, at 272.

41 However, in some cases limitations were attached to the bond convertibility, *id.* at 264.

state guarantee and carried extremely convenient interest-up clauses related to the dividend distribution.[42]

VI. The Reorganization of the Banking Sector

Owing to the aforementioned ties between commercial banks and the industrial sector, with its acquisition of the banking holdings, the IRI became the majority shareholder of those banks whose shares were in industries' pockets. Here we should recall that since the first takeover attempt in the 1920s, bank shares were no longer publicly dispersed and had been bought back by the defense consortia. The final bank-industry separation was the initial task of the *sezione smobilizzi*. The section accomplished its aim by 1934, the effort coupled with a more stringent banking regulatory reform in 1936.[43] This law gave the state more intrusive controlling powers over banking activities.

Relationships between the IRI and commercial banks were regulated by conventions. By virtue of these agreements, all the shares, debts and credits towards the industrial, agricultural and real estate sectors had to be handed over to the section. The sum the IRI gave in exchange was supposed to restore banks' financial capability. It was then set at a level to cover banks' minimum capital requirements, deposits and other liabilities, plus an extra amount fixed at twenty percent of the capital to be set aside as a reserve.[44] The institute could not immediately pay the whole sum, owing both to monetary concerns and because the operation represented a loss to the IRI.[45] In fact, the transfer price was much higher than the shares' market value and the IRI balance sheet was already encumbered by the IL legacy.[46] It was thus agreed to repay commercial banks in twenty years, with the interest rate set at four percent. Banks were left nonetheless with the possibility of asking the IRI for anticipations, in case of real and demonstrable liquidity concerns. By 1953 the IRI had completely reimbursed the debt, taking advantage of the high levels of inflation following World War II.

Obviously, the bailout came at some cost to the banks. First of all, the state imposed a complete ban on engaging in investment activities: Banks could only

42 *Id.* at 272-75.

43 Saraceno, *supra* note 6, at 47.

44 Cianci, *supra* note 5, at 265.

45 Giotti, *supra* note 36, at 182-83.

46 The total amount paid by the IRI was 12,339,000 liras against a market value of the transferred activities of 7,736,000. The net loss for IRI was then 4,603,000, *see* Rapporto IRI (1934).

take deposits and extend credit to customers or small clients. Second, it delisted the three banks. That actually happened before the official announcement of the bailout plan was released, to avoid any possible speculative movement.[47] Third, the IRI required the banks not to pay dividends for a certain period of time and reduced directors' pay. Also, the agreement imposed on banks' managers the duty to act in a fit and proper manner. Fourth, banks' directors and managers sitting on the boards of the participating industrial companies were removed, and finally a cost-efficient internal reorganization was required.

The way in which the banking reorganization was carried out is further evidence of the IRI's innovative spirit. Indeed, it anticipated some of the solutions that today's regulators have applied to the financial crisis, particularly the imposition of stringent conditions on bank governance, managers' pay, and dividend distribution. Furthermore, the IRI was particularly innovative in relation to the separation of banking activities. Whereas in these days regulators are struggling to find a light-touch solution to separate investment from retail activities, the IRI immediately went to the core of the problem and vigorously cut the tight ties among banks and industries. In addition, it has to be acknowledged that in the first stage of its intervention the IRI did not exercise any political interference in business decisions and left the banks free to operate without pressure. Unfortunately, however, at a later stage the IRI's managers used these banks as a means of favoring the concession of credit to certain industries.

As for settling the Bank of Italy's financial conditions, it could be argued that this was probably the most sensitive issue faced. We have seen how deeply the Central Bank had intertwined its financial health with that of the credit institutions as the final bearer of any bailout plan. In this respect, the creation of the IRI was necessary to save the Central Bank from a run whose consequences would have been unthinkable. That is why the IRI devoted the greatest part of its initial funding to repaying the Bank of Italy the credit it owed to the banks and the industries that had now come into the IRI's hands.[48] The settlement between the IRI and the Bank of Italy was regulated by an *ad hoc* convention. As mentioned above, the debt was initially reimbursed

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47 The IRI made a first attempt to again list banks' shares only in the early 1970s, but with no success. The IRI offered 600,000 shares of Comit, 4,500,000 shares of Credit and 400,000 shares of Banco di Roma. The quotation did not add any vitality to the market, probably because the virtual closure of the stock market and so of the allocation of capital towards investment came as a consequence of the condition imposed on the banks not to engage in investment activities, Cianci, *supra* note 5, at 296-315.

48 Where possible, part of the debt was nevertheless repaid by the same commercial banks.

making use of the first issue of bonds. In 1936, the previous fifty-four percent ratio of debt over monetary circulation was reduced to twenty-nine percent. The convention also stated that the remaining debt, though it amounted to only very few billions, could be repaid in thirty-five years at advantageous conditions to the IRI. Eventually the larger part of the debt was repaid by 1944.[49]

VII. Lessons from the IRI

By creating the IRI, the state actually corrected a huge market failure: the inability of the capital market to exchange industrial stocks among private nonbanking investors. However, the state's intervention was not duly assessed from the beginning. From the time of the 1920s bailout the state acted in an incoherent way. This kind of schizophrenic behavior brought about inefficient consequences: Bank collapses still happened and the Central Bank became exponentially exposed to the possibility of going bankrupt. Additionally, at the beginning the state was not able to tackle the very core of the problem, namely the dangerous bank-industry relationship. Moreover, the state's intervention undoubtedly created moral hazard. This tells us that any action has to be organically and rationally planned, bearing in mind its long-term consequences. Otherwise, there is a risk of intervening with drastic measures that may be difficult to exit.

The IRI example delivers a well-known lesson: There are cases where the market may not be able to fix its failures and the consequent negative externalities require public intervention. This happens when the market reaches levels of interconnection and interdependency nearly impossible to unravel that pose a risk to the stability of the entire system. Such has been the case with the bank-industry relationship in the past, as it is nowadays, with the complex interconnections among financial players that prompted many states to bail them out.

If we acknowledge the need for public investment, we should then figure out how it can best be shaped. State intervention should be market-oriented and should not enter directly into the banks' capital. The IRI proved — and the recent European and American bailout plans confirmed — that a direct injection may have serious long-term consequences. A market-oriented solution requires, first of all, that distressed and unsound institutions be taken out of the market, hence liquidated. This is one rationale for having in place a legal framework that provides for the orderly resolution of ailing banks.

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49 *See* Menichella, *supra* note 34, at 183.

However, the problem in this case is the need for the timely protection of deposits so as not to generate panic: The temporary transfer of "good assets" to a bridge bank may well be taken into account.

In the case where a bank has only temporary liquidity problems, one possible way to intervene would be through the creation of a private equity-like fund or an *ad hoc* investment company. This fund/company could be created by public bodies exclusively or in cooperation with private financial players. It would issue bonds backed by the state and sell them to the market. The obtained amount could be used to subscribe banks' capital increases or to give them loans. In the latter case, the bond could have step-up clauses to give the bank an incentive to repay the debt as soon as possible. The initial capital injection would bring fresh relief to banks' activities and might possibly be enough for the bank to survive until internal structural reforms are implemented and funding mismatching has eased.

To avoid any possible exploitation or misuse of the received funding, funds' participating bodies should appoint one or more *ad hoc* directors to oversee the bank's restructuring. They should act in a professional and independent way. Former central bank governors, deputy directors or high-level members of supervisory bodies should be given eligibility priority. Nonetheless, the degeneration of the IRI has shown that there is a huge problem of political capture. In fact, due to the strong interference of political parties, in the long run the IRI abdicated its original functions and became an instrument in their hands.

Furthermore, an intervention that was meant to be temporary lasted more than sixty years because politicians indulged in the power deriving from the control of Italian industries. That is why an intervention of this kind has to be strictly defined *ex ante*. Above all, the *ex ante* conditions should include a credible and timely exit strategy, otherwise the fund risks being locked into the bank's capital. It would be impossible, however, to predict the exit criteria here, as it seems more realistic to design them on a case by case basis.

The lessons of the IRI may be an important reminder even today, especially in light of the current Italian regulatory proposal. In 2011 the Italian government passed a controversial provision that allows a public body to subscribe shares of companies "of relevant national interest." Those companies have to be "strategically important in relation to the sector, aggregate production, employment levels or in terms of possible consequences to the economic and productive system."[50] However, the provision also admits the possibility that

50 D.L. n. 34/2011 (converted into L. n. 75/2011), *available at* http://www.normattiva.it/uri-res/N2Ls?urn:nir:stato:decreto-legge:2011;34 (translated by the author).

shares may be acquired through a special purpose vehicle or an investment fund in which state-owned companies participate. As far as the funding is concerned, the initial endowment to subscribe the shares may come from the income related to the retail investor's subscription of postal products.

Despite providing for what seems to be a market-oriented option, the law is extremely dangerous. The provision contains loopholes that may easily be exploited by interventionist governments. If no other conditions regarding the involvement are provided, such as the rationale behind the subscription, its timeframe, and the boundaries of the intervention, that may perversely give the state an incentive to enter the economy indiscriminately, as has happened in the past. Also, the possibility of using postal savings may put the money of small investors unfairly at risk and create moral hazard problems.

Conclusion

The creation of the IRI is a formidable example of enlightened technocratic policymaking. Its action was highly innovative and anticipated some of the solutions of contemporary bailout plans. The "IRI formula" was based on a set of simple intuitions: the IRI would (1) operate in the market under the same rules as market players; (2) use the same tools they used; (3) keep the form of stock company of the participating firms so that they could be sold back more easily; and (4) not grant them any monopoly unless it was already such under private management.

The IRI was created with the aim of "finalising the reorganisation of the credit sector" and to realize "the technical, economic and financial reorganisation of Italian industrial activities" as specified in the decree that instituted the IRI.[51] This in turn meant that the state initially had no intention of becoming the final and perpetual owner of those economic entities that only accidentally came into its pocket. Another proof of this policy is that the IRI did not initially take part in the "corporative system" set up at the time by Mussolini.[52]

Shortly after the IRI's creation its formula proved successful. Once freed from their semi-frozen activities and the huge conflict of interest they had entered into, banks were able to go back to their core functions. This renaissance came at great benefit to depositors whose money was no longer endangered by the unhealthy relationships described above. Moreover, small and medium sized enterprises were finally granted access to bank loans,

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51 R.D. no. 5/1933, art. 1.

52 Maraffi, *supra* note 30, at 520.

a market that had been previously inaccessible to them since banks were spending all their financial efforts to sustain big industries. On the other hand, those industries that had been kept artificially afloat were liquidated, while those fundamentally sound were reorganized and sold to the market; private investors responded positively, possibly because they felt confident in financing or buying shares backed by a public guarantor.[53] By the same token, owing to IRI support some industries were able to open new lines of production and to fund new investments.

The value of the IRI formula has been widely recognized, among others by E.U. Member States that set up IRI-like public bodies. For instance, Great Britain created the Industrial Reorganisation Corporation, France the Institute pour le développement industriel, Sweden the Statsföretag, and West Germany the VAIG.[54] In 1937 the IRI acquired permanent status.[55] As a consequence of its permanent status, coupled with the worsening of market conditions and the aforementioned attitude of political parties, the IRI abandoned its initial remits. From then onwards it started to actually manage industries instead of selling back their shares to the private market.

The same thing happened with banking participations. According to Donato Menichella, the IRI had to keep their shares because Italy did not yet have a pure "financial and investment class" to which it could sell the stocks. In any event, he asserts, giving complete autonomy to credit institutions might have resulted in a sudden increase in the requests of anticipations and/or extinctions of the debt the IRI owned. Nor was it viable to transfer those banks' shares to the Central Bank. The Bank of Italy could not be interconnected again with the credit sector.[56] The IRI then became an instrument of public industrial policy and, as the owner of credit institutions, could very well serve in this function.

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53 Economic theories show that state-owned financial institutions benefit from the political and economic power of the state. State-owned banks are also typically able to raise money at lower rates than private banks because of the implicit state guarantee, *see* James Hanson, *The Transformation of State Owned Banks*, *in* The Future of State Owned Financial Institutions 13 (Gerard Caprio et al. eds., 2004).

54 *See* Stuart Holland, *Adoption and Adaptation of the IRI Formula*, *in* The State as Entrepreneur, *supra* note 1, at 242.

55 By virtue of R.D. 24 giugno 1937, n. 905; *see also* Dror Goldberg, A comment on 1930s Bank Nationalizations in Italy: The IRI Formula, Paper Presented at Back to the State? Government Investment in Corporations and Reregulation Conference, Tel Aviv Univ., Isr. (June 1, 2011) (claiming that the outturn into a temporary body is actually a common feature of public bodies of this kind — an attitude labeled by economists as the "ratchet effect").

56 *See* Menichella, *supra* note 34, at 138-44.

Yet IRI action was still driven by efficient and profit-oriented intentions. The situation worsened when, in the second half of the twentieth century, the IRI became part of the patronage system of the most powerful political party at the time.[57] Under this governance, the IRI's actions came to be prompted by purely political reasons and it stopped acting as a market player.

To conclude, we should acknowledge that even today state intervention in the market may be inevitable when the latter is unable to correct its own failures. There may still be ways in which this intervention can be conducted in a profitable manner and according to market-oriented criteria. It is nonetheless crucial to include a system of "safety net" provisions to avoid any possible long-term inefficiencies and misuses of the instrument.

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57 Alan R. Posner, *Italy: Dependence and Political Fragmentation*, 31 Int'l Org. 809, 815 (1977).