Italian banking scandal

Brothers in arms

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Many reputations should suffer as a result of a scandal involving Banca Popolare Italiana and the Bank of Italy

“I JUST put my signature on it.” These were the now notorious words of Antonio Fazio, governor of the Bank of Italy, on the phone to Gianpiero Fiorani, the chief executive of Banca Popolare Italiana (BPI), Italy's tenth-largest bank, shortly after midnight on July 12th. Mr Fazio had just given approval for BPI to buy a majority stake in Banca Antoniana Popolare Veneta (Antonveneta). “I'd kiss you right now, on the forehead,” Mr Fiorani replied, in evident relief. (In an actual embrace, shown above, Mr Fazio is on the left.)

This news meant that BPI's bid for Antonveneta, in which a number of leading international banks have been involved, could proceed. It also seemed to spell certain defeat for ABN Amro, a big Dutch bank, with which BPI had been bitterly contesting control of Antonveneta since March. Antonveneta, based in Italy's wealthy Veneto region, is the country's ninth-largest bank but, by capitalisation, was around three times as large as BPI.

The conversation came to light because Mr Fiorani is under criminal investigation; magistrates had been intercepting his telephone calls for several weeks. His alleged offences include market-rigging connected to dealings in Antonveneta shares, false accounting and misleading the Bank of Italy (BOI), which oversees the banking system.

As supervisor, the BOI is responsible for ensuring the sound and prudent management of Italian banks. Each time a buyer of an equity stake in an Italian bank wishes to exceed certain thresholds—5%, 10%, 15%, 20%, 33% and 50%—it must seek permission from the BOI. Broadly speaking, a potential buyer must show that it has competent and honest management; a solvent balance sheet; and a sound plan for the target bank.

So the criminal investigations and the fact that two of the BOI's senior staff, worried about the strength of the bank's balance sheet, had refused to approve BPI's bid made Mr Fazio's decision hard to understand. That it was a grave error of judgment became obvious on July 25th when magistrates impounded BPI's shares (and those belonging to close allies) in Antonveneta. (The BOI declines to comment other than to say it has acted properly.) Two days later, Consob, Italy's stockmarket regulator, had no choice but to freeze BPI's offer for up to 90 days, as it also suspected that BPI's offer documents "seriously lacked important information". Then, on August 2nd, a judge ordered that Mr Fiorani and BPI's finance director be suspended for the next two months.

But the story of BPI's attempt to buy Antonveneta not only raises serious questions about the BOI, Mr Fiorani and his allies. It also raises doubts about the judgment of banks that have lent their reputations and balance sheets to BPI, and about the ethics of some of them.

Based on *The Economist*'s examination of publicly available information, set out below, the first obvious question is: why did any leading bank want BPI as a customer? And the second: why was the BOI, with privileged access to information, so keen for BPI, rather than a bigger and healthier rival, to buy Antonveneta?

Through a buying spree, Mr Fiorani has transformed BPI, until recently called the Banca Popolare di Lodi, from a regional bank into one with a presence nationwide. For instance, it has 137 branches in Sicily after buying eight small banks there in just five years. Between 2000 and 2004, BPI spent roughly €6 billion ($7.4 billion at current rates) on acquisitions, often paying what one analyst describes as "very generous prices".

These purchases have created a complex group: it comprises BPI, the quoted parent bank, which has about 60% of the group's retail branches, and two quoted subsidiaries, one of which is Bipielle Investimenti. Few analysts cover BPI (and even fewer its two quoted subsidiaries), and few big institutional investors own shares. Because of the group's constantly changing shape, comparative analysis of its results is tricky; it is difficult to measure how well acquisitions have performed.

Since 2000, the group has raised €3.6 billion from shareholders in six capital increases. BPI has used its branches to promote its shares (and other financial instruments) to customers, many of whom have become shareholders. Around 40,000 bought shares for the first time in its most recent issue for €1.5 billion in July, taking the total number to over 200,000.

Follow the money

But to the extent that these capital increases and other financial instruments have been paid for with money sitting in customers' accounts, BPI has not actually brought any new cash on to its balance sheet. Although it has improved BPI's capital ratios, such a switch of money from deposits to capital erodes future income by reducing lending possibilities.

An examination of the BPI group's accounts reveals aggressive accounting practices. BPI is treating some costs, such as those of capital increases and extraordinary personnel expenses, as intangible assets to be written off over several years rather than in one.

And how healthy is its balance sheet? The BOI assesses the solvency of a bank by the adequacy of its core capital—the minimum amount of capital a bank is required to hold to support its lending. Under EU rules, this must be kept above the minimum levels at all times. The starting point for the calculation is the net assets shown in a bank's accounts.

However, in BPI's case, there are doubts about the prudence of its accounts. Provisions against loans, which are lower than average, are one issue; if BPI's were adjusted to the level of, for

example, Capitalia, a large Italian bank in which ABN Amro has a 9% stake, its net assets would fall by €337m. And BPI's 20% stake in Cassa di Risparmio di Bolzano, a savings bank, is overvalued by €209m when measured by the price that a purchaser, acquiring a majority interest, paid for a 10% stake last year. If the group's core capital at the end of 2004 were adjusted for just these two items, it would fall short of the mandatory level.

Moreover BPI has off-balance-sheet commitments which, if valued at market prices, would reduce its net assets further. It has promised to pay Deutsche Bank €330m in 2008 for 30m shares of Bipielle Investimenti that the German bank bought for only €198m in 2003. At the end of 2004, these were worth a mere €174m.

BPI will have to apply international accounting standards when it prepares its accounts for 2005. In the absence of reinforcement of its capital, application of these standards might expose the fragility of its balance sheet. For instance, off-balance-sheet commitments, such as that with Deutsche Bank, will have to be marked to market. And goodwill will be subject to an annual impairment test; if it is true that BPI has overpaid for its acquisitions, then substantial write-downs might be necessary.

In addition to its commitment to Deutsche Bank, BPI has others, mainly to the holders of minority stakes in subsidiaries. At the end of 2004, these amounted to €881m, over €500m payable in cash by mid-2005. To the extent that goodwill arises from the purchase in cash of these stakes, BPI's core capital would reduce further. This is because intangible assets do not count towards a bank's core capital.

But the BOI has postponed introducing a directive that would require banks to take account of these prospective commitments in the calculation of their core ratios. If these had been applied to BPI's core capital at the end of 2004 together with the other adjustments, then the bank would have fallen well short of mandatory levels.

Capital ratios are important to supervisors and depositors; investors are more interested in profits. But there is little consolation here. The 2004 accounts show that, at best, the parent company, BPI, the heart of the group with 577 branches, did little more than break even, if dividends from its subsidiaries are excluded. Even then, two factors favourably influenced its results. First, the marking-to-market of its portfolio of securities at the end of the year produced a net profit of €55m compared with a net loss of €9m the previous year.

Second, there was an increase of €30m in “expenses” recovered from customers' accounts, some (or all) of which may be explained by unusual entries in the final quarter. Astonished customers found charges, ranging from €30 to €125, for items such as “urgent commissions”, “post and telephone expenses” and “extraordinary commissions” on their bank statements dated December 31st, the bank's year end. Many asked for reimbursement, and some raised the matter with the judicial authorities. These charges imply a desperate attempt to boost profits.

There are also doubts about the quality of Bipielle Investimenti's profits. Its consumer-credit company booked a profit of €70m—representing an acceleration of future interest—from a securitisation of receivables. This flatters current profits and is only sustainable if consumer debt continues to increase, thereby allowing more securitisations. Another division enjoyed windfall profits of €26m because banker's drafts drawn on it had not been presented within the requisite time. Together, these items accounted for nearly half of Bipielle Investimenti's pre-tax profits.

Another serious concern is transparency. Nowhere is it apparent in the group's 2004 accounts that BPI has an equity investment of €154m in an obscure investment vehicle called Victoria & Eagle Strategic Fund (VESF), based in the Cayman Islands; this holds, or at least did in June, 4.1% of BPI. If BPI had bought the shares directly, disclosure in its accounts would have been

mandatory. And, unlike an investment by BPI in its own shares, the investment in VESF is not deductible from BPI's core capital.

The pact of the matter

In spring 2004, Antonveneta was up for grabs; it was clear that a shareholders' pact, which owned 31% of the bank, would not be renewed in April 2005. The pact's members included ABN Amro, the Benetton family and several businessmen, one of whom was Emilio Gnutti, a controversial financier. These parties had formed the pact in March 2002 to provide stability of ownership and ensure autonomy for the bank's management.

One possibility was a merger between Antonveneta and Capitalia. This deal fell apart when the BOI would not allow ABN Amro—the biggest shareholder in both the banks—more than 15% of the merged bank, whereas ABN Amro wanted 20%.

Mr Fiorani had a different idea; he began to promote BPI as a significant shareholder in Antonveneta. Mr Fazio, whose opposition to foreign ownership of Italian banks is well known, met Antonveneta shareholders. In early December, according to the Benetton group, he encouraged Gilberto Benetton, who was keen to sell his family's 5% stake, to be a good Italian when making his decision. Two weeks later, BPI extended the Benettons a loan of €325m to be repaid in cash or with its shares in Antonveneta.

Mr Gnutti controls Hopa, an investment company, of which Mr Fiorani is a director. And Hopa and BPI have reciprocal shareholdings. Mr Gnutti was keen to increase his stake in Antonveneta, and was a natural ally for Mr Fiorani. Their plan was to gain control of Antonveneta's board at its annual general meeting at the end of April, an objective possible with around 30% of the votes.

Mr Gnutti has recently found himself in various scrapes. He has been found guilty of insider trading, though in Italy no conviction is definitive until confirmed by the final appeals court, which is yet to happen in Mr Gnutti's case. He is also currently on trial with a fellow director of Hopa, the chief executive of Unipol, an Italian insurer which has just launched a €5 billion bid for BNL, an Italian bank, for alleged insider trading in Unipol bonds.

Three reports by Consob show how Mr Fiorani and Mr Gnutti went about their business. BPI could not immediately buy a sizeable stake in Antonveneta. This was because it would need the BOI's permission; it had neither enough core capital nor a credible plan for the bank.

So between December 2004 and the end of February, BPI lent €552m at advantageous interest rates to 18 associates of Mr Gnutti, to buy 9.5% of Antonveneta. The Consob report states that there is a strong presumption that BPI promised these businessmen that it (or its allies) would eventually buy these shares and that they would make a gain. Another 20 people, including Stefano Ricucci, a property developer, bought a further 11.7% of Antonveneta, with BPI providing loans of €666m to 19 of them. BPI should have disclosed details of these loans to the BOI, but did not.

And press releases, which claimed to correct rumours about dealings in Antonveneta's shares, gave misleading information. For instance, on April 6th, BPI correctly stated its own stake but (falsely, on the basis of the Consob reports) denied there were any other agreements—written or oral—with third parties in respect of other shares. BPI's plan of deception was well under way.

When BPI told the BOI on February 11th of its intention to buy up to 14.9% of Antonveneta, the BOI could not have been more helpful. It approved the application over a weekend. The authorisation said that BPI should build up its stake only to the extent it took measures to

strengthen its core capital. This was to ensure full and continuous respect for the minimum level. Normally, however, the BOI achieves this goal by insisting that a bank strengthen its core capital before giving permission. The BOI did not inform Antonveneta about the authorisation until April 23rd, an unusual delay; nor did BPI tell ABN Amro (which it met in March for talks) or the market.

But then ABN Amro made a move, announcing a cash offer for Antonveneta at €25 per share. If this offer succeeded, Mr Fiorani's plan would be in tatters. So to block ABN Amro, BPI would need a majority of Antonveneta's shares.

ABN Amro's offer could not proceed until the BOI gave its permission. However, when the Antonveneta pact expired on April 15th, the Dutch bank, the biggest shareholder with 12.7%, could increase its stake up to 33% if the BOI let it.

At the end of March, ABN Amro asked permission to acquire control, a process likely to take more than a month. To ensure it was free to buy shares as soon as possible after April 15th, it also asked—in the hope it would be granted without delay—to cross the 15% and 20% thresholds.

But, on April 19th, the BOI said ABN Amro could not increase its stake beyond 20%. The principal reason given was that the bank's request was tantamount to one for majority control and therefore needed the same scrutiny as the one to exceed the 50% threshold. This meant the Dutch bank could buy only another 7% of Antonveneta when the pact expired.

Meanwhile, again without informing Antonveneta, the BOI, applying a different standard, had authorised BPI to acquire up to 29.9%, taking only three days to approve BPI's request of April 4th.

The BOI was aware that BPI did not then have enough core capital to acquire more than 20%. However, it was receptive to the idea that BPI acquire voting rights for the remaining 10% by stock-borrowing. This involves renting shares for a limited period in return for a fee. The BOI thought BPI would buy these shares outright once it had strengthened its capital base.

But BPI was working to a different plan. After April 15th, when the Antonveneta shareholders' pact expired, large volumes of that bank's shares would be on the market. By April 18th at the latest, according to Consob's reports, BPI had formed a secret concert party, which included Mr Gnutti, Mr Ricucci and six others. Under stock-exchange rules, people acting in concert to acquire shares in a listed company are regarded as one. This is to prevent the circumvention of takeover law, such as that requiring a mandatory cash offer once a bidder exceeds a 30% threshold.

Altogether now

Between April 15th and 22nd, the concert party group, in some cases with further loans from BPI, conducted a huge buying operation from pre-arranged sellers and at pre-arranged prices. Except for those who became members of the concert party, all the people that BPI had financed earlier in the year sold their shares, making profits of €236m, including €110m by 15 associates of Mr Gnutti which an Italian court froze on August 2nd. The judge described these operations as “financial piracy”.

On April 27th, the BOI relented and gave ABN Amro permission to increase its stake to 29.9%. But by then, BPI's secret concert party had 46.7% of Antonveneta (including BPI's direct stake of 29.3%) and its allies at least a further 8.5%. By the time the BOI finally gave ABN Amro's bid the green light on May 6th, control of Antonveneta was already sewn up; any suggestion

that the market would decide was farcical. Three days later, BPI announced a rival all-paper offer which, it claimed, was more valuable than the Dutch bank's cash offer.

But on May 10th, Consob ruled that BPI was part of an illegally undeclared concert party and said that the concert party must make an all-cash bid for Antonveneta. Suspicious that information was being withheld from the market, Consob had decided in mid-March to investigate all BPI's direct and indirect dealings in Antonveneta shares since November 2004.

Consob sent the detailed report behind its ruling to both BPI and the BOI, and even published it on its website. And soon after, as has been reported in the Italian press, members of the concert party (and most of those who had bought Antonveneta shares with BPI loans) were under criminal investigation for either alleged insider trading or market abuse.

Anything for a fee

Yet none of this put off a syndicate of ten banks, including BNP Paribas, Deutsche Bank, Dresdner Bank and the Royal Bank of Scotland, from making available on May 31st a facility of up to €4.9 billion to fund BPI's mandatory cash offer. Without this financing, BPI's bid would have been dead in the water. As security, these banks took a pledge on BPI's holding in Antonveneta, the very shares that magistrates subsequently impounded on July 25th. And despite all the unanswered questions, both Lazard and Dresdner Kleinwort Wasserstein (DKW), have been acting as financial advisers to BPI. Both Lazard and DKW decline to comment, as do banks involved in the syndicate.

Consob's report should have set alarm bells ringing, particularly at the BOI, not least because BPI and its concert party had acquired more than 30% of Antonveneta in flagrant violation of banking legislation. But the BOI did not begin an inspection at BPI until June 20th. Strangely, it started one at Antonveneta first.

Even before Consob's report, the BOI should have noticed a gaping hole in BPI's core capital. For technical accounting reasons, this hole opened up as soon as BPI's ownership of Antonveneta exceeded the 20% threshold. If BOI officials had monitored BPI's declarations to Consob, they would have noticed that BPI notified the market on April 19th that it had exceeded this threshold. According to calculations submitted by ABN Amro to an administrative court, BPI's core capital reached dangerously low levels after April 18th.

The hole was eventually plugged at the end of June by the last disposal in a series. Between May 18th and June 29th, BPI sold various minority interests of up to 20% in unquoted banking subsidiaries for €1.08 billion. The buyers were Deutsche Bank, Dresdner Bank and a company called Earchimede. (This company, in which BPI has a 12% stake, is controlled by companies associated with Mr Gnutti.) Deutsche Bank paid €721m; Dresdner Bank €220m and Earchimede €139m. In turn, Deutsche Bank sold to BNP Paribas half of each of the stakes it had just bought. BNP Paribas says that Deutsche Bank was its client.

Under banking rules, such disposals improve capital ratios only if they are genuine disposals. Temporary warehousing of stakes with third parties does not count.

Several aspects of the contracts, copies of which *The Economist* has seen, suggest these were not genuine disposals. For a start, BPI trumpeted these deals as industrial partnerships with the banks, but side agreements with Deutsche Bank give BPI the right to buy back within one year the shares that Deutsche Bank and Dresdner Bank had just bought, and for exactly the same amount these banks had paid. (For this right, Deutsche Bank charged fees of €75.6m.)

Then there is the price at which the deals were done. For instance, Deutsche Bank paid €183m for 10% of Cassa di Risparmio di Bolzano, when a stake of the same size sold for €79m just last year.

And BPI has given only a one-year guarantee on the level of dividends that these unquoted banks will pay; this hardly enhances the attractiveness of these illiquid stakes. Furthermore, the contracts contain none of the usual representations and warranties that purchasers usually require from sellers. The list of anomalies goes on.

An indication that these are temporary disposals would be if the purchasers had some right, even if indirect, to their money back from BPI. But BPI has stated in filings with Consob that no such arrangements exist. If this really is true, then Deutsche Bank appears to have acted with cavalier disregard towards its own shareholders' interests; it seems to have no exit route for its large investment. In fact, common sense suggests that Deutsche Bank has some undisclosed mechanisms—probably involving complex derivatives—to protect itself.

Deductive reasoning suggests that the disposals are in effect temporary; if so, the two German banks have helped BPI to window-dress its capital ratios. Deutsche Bank says: "We are comfortable with every aspect of this transaction, and will continue to co-operate with the authorities."

In a call intercepted by investigating magistrates, Mr Fiorani, talking about an Earchimede board meeting on June 29th at which the contract with BPI was to be discussed, described the disposal to Earchimede as "temporary with a capital T".

Whatever the case, BPI has not disclosed in stock-exchange filings important contracts with either Dresdner Bank or Deutsche Bank. No mention has been made of a significant stock-borrowing contract with Deutsche Bank relating to Antonveneta shares, or of derivatives contracts with Dresdner Bank for nearly 2% of Antonveneta shares.

The role of J.P. Morgan also raises questions. It acted as joint bookrunner for a share issue that ABN Amro undertook on March 30th to help finance its purchase of Antonveneta. At the same time, its Italian arm agreed to act as co-ordinating bank for ABN Amro in connection with its offer. However, BPI was then J.P. Morgan's counter-party in two derivatives contracts, dating from January 2005. One was a put-and-call agreement for 5m Antonveneta shares; the other a forward purchase of 5m Antonveneta shares. According to ABN Amro's advisers, J.P. Morgan did not disclose any conflict of interest to the Dutch bank before agreeing to act. J.P. Morgan says derivatives contracts are confidential as are its internal processes for managing conflicts. It claims ABN Amro was aware of the derivatives when it agreed (which it says was on April 12th) to act as co-ordinating bank.

Curtains

This six-month saga, which is gripping Italy, is now near its end. Criminal charges are almost certain. The interesting questions are: who will be charged and what will be the nature of the charges?

Mr Fiorani's tenure as chief executive of BPI is probably over, and his bank's takeover of Antonveneta is unlikely. New management at BPI would take a hard look at the bank's books. It would surprise few in Milan's financial circles if a new team at BPI were to find that the bank was, in reality, bust at the end of last year. (Ironically, as a result of its July share issue and other capital-raising deals, the bank is now flush with cash.)

If so, the question is whether Mr Fazio or others at the BOI knew or suspected this. If Mr Fazio did, this may explain why he wanted BPI to take over Antonveneta; merging a failing bank

with a larger rival is one way of hiding the first's problems, if only temporarily. Or perhaps Mr Fazio's judgment was impaired by the closeness of his relationship with Mr Fiorani.