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What Community Action for Micro-Credit? *


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SUMMARY

The Committee requested an opinion on which aspects of micro-credit could be regulated at European level. This briefing paper endeavours to answer to this complex question and is organized as follows. Paragraph 2 provides a brief overview of the development of micro-credit and microfinance within and outside Europe and shows its current and expected impact on the economy. Paragraph 3 describes the Commission's action plan. Paragraph 4 offers some recommendations on how to possibly fine-tune the proposed EU action plan distinguishing between banks and non-banks MFIs.

a) As regards the banking model of micro-credit (i.e. micro-credit provided for by commercial banks, savings banks, credit cooperatives and micro-finance banks), the focus of community or national legislative initiatives should be, in my view, on the specificities of risk management for micro credit and on the incentives to be given to banks to support financial inclusion and small businesses. I welcome, therefore, the Commission initiative to establish wider provisions on loan guarantees (which should operate, however, according to rules and practices, to be duly supervised, directed at minimizing moral hazard of the borrowers), whereas I am sceptical on securitisation of micro-credit loans portfolios, considered also that micro-loans are often without a formal rating. In addition to that, regulators should endeavour to foster the use of alternative methods and more appropriate credit scoring techniques for assessing the credit risk of micro-credit, recognizing a more favourable treatment under CRD to those micro-credit loans which historical records indicate as less risky (see e.g. loans extended to non profit institutions). In turn, as regards the incentives to be given to existing (small, medium size and big) banks to engage in micro-credit programmes to promote grass-roots entrepreneurship, useful lessons can be drawn from the US 1977 Community Reinvestment Act and its anti-redlining provisions, which proved effective in downscaling the banking activity (both directly and through the Community Development Finance Institutions and Corporations) in the best interest of local communities and of low income borrowers (today 20% of the total loans granted to private clients in the US).

b) As regards non bank providers of micro-credit, the focus should be, in my view, on a (ideally harmonized) regulation of the entities (MFIs). Hard and soft regulation should both be in place and converge and should be directed at instituting appropriate management and internal control systems for MFI, at establishing an adequate public supervision, at fostering networking (also through the establishment of "second level" MFIs federal organizations providing regional and/or national coordination and technical assistance and support to their members) and at developing best practices for lending. There is also a clear need to push MFIs towards optimal scale reorganization, long term self-sustainability and portfolio growth. MFIs should moreover be regularly subject to performance rating. Although MFI do not pose a problem of protection of depositors, a sound regulatory and supervisory framework is nevertheless recommended, in my view, to enhance the protection of the public funds, the protection of borrowers and the trust of donors, banks and other financial institutions on which MFIs rely, at least partially, for their funding and which in turn must rely on the MFIs to overcome in-

 * Briefing paper delivered on the 15 September 2008 to the Economic and Monetary Affairs Committee of the European Parliament.

formational asymmetries and access segments of clients which, in many circumstances, would not be bankable without the "intermediation" (in terms of credit assessment and mentoring) of the MFIs. Regulation and supervision should obviously be proportionate refraining from imposing unnecessary costs. The paper concludes considering also a recent Italian experience deserving, in my opinion, the full attention of European regulators.

1. – The Committee requested an opinion on the following question: "Which aspects of micro-credit could be regulated at European level in order to support growth and employment? What form should a European initiative take? Should existing financial services legislation take micro-credit into account (e.g. the proposed revision of CRD)? If so, what form should it take and if not should an explicit exclusion of micro-credit be stated?". This briefing paper endeavours to answer to these (complex) questions in the few pages requested and is organized as follows. Paragraph 2 provides a brief overview of the development of micro-credit and micro-finance within and outside Europe and shows its current and expected impact on the economy. Paragraph 3 describes the Commission's action plan. Paragraph 4 attempts at answering to the questions raised, considering also some insights from an innovative approach to micro-credit and social banking recently emerged in the Italian practice deserving, in my opinion, the full attention of European regulators.

2. – Micro-credit is the extension of very small loans (micro-loans) to entrepreneurs, to social economy enterprises, to employees who wish to become self employed, to people working in the informal economy and to the unemployed and others living in poverty who are not considered bankable according to prevailing commercial banking standards¹. It has become a popular, albeit controversial², method of facilitating development, not only in poor countries but also in the poorer segments of the richest societies, especially to provide financial support to start ups or micro enterprises, to non profit organizations and to "unbanked" people and other disadvantaged persons. Indeed, traditional commercial banks, with few exceptions³, have failed so far to meet adequately the demand for credit by those who cannot offer physical collateral, but may be nevertheless creditworthy, especially in the light of the entrepreneurial projects they intend to pursue and finance. Responding to such market failure, the last twenty-five years or so have witnessed a rapid expansion, worldwide, in the number and size of micro-finance and micro-credit institutions⁴, often encouraged by public support mechanisms (some

¹ European Commission, *A European initiative for the development of micro-credit in support of growth and employment*, COM (2007) 708 final (Brussels, 13 November 2007).

² For a critical assessment of micro-credit as a suitable development instrument for developing countries see for example R. DYAL CHAND, "Reflection in a Distant Mirror: Why the West has Misperceived the Grameen Bank's Vision of Microcredit", *North-eastern University School of Law, Working Papers Series no. 13*, 2007 (available at <http://ssrn/abstract=962374>); for the lessons to be learnt from the failure of the Canadian Calmeadow Metrofund experience, T. WILLIAMS, *Requiem for microcredit? The decline of a romantic ideal* (2001), available at <http://ssrn/abstract=976211> (showing how peer lending did not work in the US and Canada and advocating for "the imposition on financial institutions of strictly regulated duties to serve disadvantaged communities", albeit at the same time recognizing that "strict regulation is unlikely to happen in Canada given the political economy of the financial services sector and the long-lasting tradition of soft law, codes of practice and other voluntary initiatives")

³ Some illustrative examples in ABI – Fondazione Giordano Dell'Amore, *Banche e microfinanza* (Roma, 2006), 30-36.

⁴ Literature is extremely rich: compare at least *From Microfinance to Small Business Finance*, eds. Leleux and Constantinou (Palgrave Mc Millan, 2007), *passim*; "Microfinance for Poverty Reduction: Building Inclusive Financial Sectors", in *Asia and the Pacific*, UN ESCAP, Development Paper no. 27 (New York, 2006), *passim*; ABI – Fondazione Giordano

of which offered also at the European level: see in particular EU PHARE, European Investment Fund and European Bank for Reconstruction and Development programmes). Nature, size, operational features and economic and financial outcomes of these micro-finance and micro-credit institutions vary significantly from country to country and from institution to institution. Nevertheless, it is well recognized that today micro-finance and micro-credit institutions are already numerous in many developing and developed countries, herein included all Member States⁵, and in aggregate serve a large number of clients (according to CGAP by 2000 they already served worldwide about 12,5 million individuals)⁶. Certainly, it is not to believe that micro-credit is a new phenomenon in Europe; on the contrary, it has a lengthy and distinguished history embracing the early English lending charities, the Irish Loan funds and, above all, the savings banks and credit cooperatives dating back to the 19th century⁷. Interestingly enough, a look at history reveals, however, that organizations that depended on charitable (external) funding were more fragile and tended to lose their focus more quickly than those that obtained funds from depositors⁸. A lesson which could prove useful in tackling today the regulation of the industry.

There are obviously significant differences in the patterns of micro-credit and micro-finance developed in Europe and in developing countries (first of all the Grameen Bank of Bangladesh and the BRI Bank in Indonesia). Existing literature on micro-credit in Europe shows indeed that in Europe: a) potential clients are only a (relatively) small fraction of the overall population; b) the average number of active clients of each institution is low (about 400) and these clients tend to passively respond to micro-credit offers rather than to actively search for a credit opportunity; c) group lending and other peer lending practices used in developing countries and based on community control are not applicable; d) micro-credit and micro-finance institutions are much more financially included in Europe and are therefore exposed to the competition of commercial and cooperatives banks, which are increasingly applying risk management methods less based only on physical collaterals (they increasingly evaluate also the creditworthiness of entrepreneurial projects and the client's re-payment track record); e) micro-loans are usually of significant amount (up to Euro 25.000,00), thereby diminishing the dissemination of risk especially for thinly capitalized institutions; f) average interest rates are around 10/15% (as opposed to the 40-60% in developing countries); g) operating and transaction costs are high; h) only a small percentage of the institutions other than banks operating also in the micro-credit sector reaches economic self-sustainability. As a consequence, given their tendency to make losses or earn below market returns on capital, many and perhaps most of the micro-finance institutions other than banks are associated with NGOs and/or rely on

Dell'Amore (*supra*, n. 3), *passim*; M. NOVAK, *Non si presta solo ai ricchi – la rivoluzione del microcredito* (Torino, 2005), *passim*; M. SCHREINER, *Rural Microfinance in Argentina After the Tequila Crisis* (Edwin Mellen Press, 2004), *passim*; N. UDDIN, *Regional Rural Banks and Development* (Mittal Publications, New Delhi, 2003), *passim*. More recently see J. MIDGLEY, *Microenterprise, global poverty and social development*, *International Social Work* (2008), 467-479; R. MENDOZA – N. THELEN, "Innovations to Make Markets More Inclusive for the Poor", *Development Policy Review*, 2008, 427-458, especially at 444-448.

⁵ For an overview of European experiences, compare L. VIGANÒ, *Microfinanza in Europa* (Milano, 2004), *passim* (where detailed information on more than 50 significant institutions active in the EU-15 Member States).

⁶ D.C. HARDY-P. HOLDEN-V. PROKOPENKO, "Microfinance Institutions and Public Policy", *IMF Working Paper*, September 2002, 3.

⁷ A. HOLLIN-A. SWEETMAN, *Microcredit: What Can we Learn from the Past*, 26 *World Development* (1998), 1875. As opposed to the US experience of credit unions, European credit cooperatives are generally subject to general banking law and supervision: see however, for an exception, the 163 long lasting "casse peote" (informal credit associations) still existing in the Italian Veneto and Friuli Venezia Giulia.

⁸ A. HOLLIN-A. SWEETMAN (*supra*, n. 7), 1877.

support from their (public or private) donors: subsidies can take various forms from initial capital injection or loans at preferential terms to operational subsidies in cash or in kind to the provision of training and/or technical assistance⁹.

These specificities must certainly be taken into consideration in a European regulatory perspective. It should be acknowledged, at the same time, that Europe is also going through several very successful experiences of micro-credit and micro-finance in recent years (to mention but a few: Etimos, Banca Etica, CGM Finance, SEFEA in Italy, Oikokredit in the Netherlands, La Nef in France, GLS in Germany, CREDAL in Belgium). These experiences show that micro-credit and micro-finance succeed where providers are able to build a strong and effective network of on going social controls over the borrowers: a feature which is often reflected also in the risk management techniques applied (see for instance the "VARI" method applied by Italian Banca Etica coupling ordinary risk management methods with additional social indicators). The "know your customer" principle matters here at the utmost: delinquency rates are strictly correlated, indeed, to the effectiveness of *ex ante* and *ex post* social controls over the borrowers. Social proximity and a rigorous and effective creditworthiness assessment are essential.

3. – The Commission, following its Staff Working Document of 2004 on "Microcredit for European small businesses"¹⁰ and the works and recommendations of its Expert Group¹¹, with its Communication on "A European initiative for the development of micro-credit" acknowledged that "in the Member States and regions of the European Union micro-credit is often used as a means of encouraging the growth of self-employment and the formation and development of micro-enterprises. As such micro-credit can play an important role in the realisation of the Lisbon strategy for growth and jobs and the promotion of social inclusion". It also recognized that: a) whilst there is an active micro-credit sector in many Member States and a number of actions have been taken, there is clear evidence that much more can be done"; b) "evidence suggests that banks engage in micro-credit activities (directly or more often in partnership with non bank institutions) where they are encouraged to do so by public support mechanisms"; c) there is scope for Community action in the field, first of all, to improve the legal and institutional environment. In this respect the Commission, blaming that "the institutional framework in the Member States appears to be often ill-suited to the development of micro-credit" due to the fact that micro credit is not specifically addressed in the national or Community legislation, proposes: a) to encourage banks to develop micro-credit operations, directly or through non bank MFIs through a wider provision of loan guarantees and, as portfolio develop, by securitisation; b) to help micro-credit to become sustainable by relaxing interest caps for micro-credit operations; c) to allow MFIs access to borrower databases on default and losses related to micro finance (individuals, enterprises and MFIs);

d) to reduce operating costs applying favourable tax schemes; e) to confirm existing EU

⁹ Records on the increasing role of MicroFinance Investment Funds in ABI – Fondazione Giordano Dell'Amore (*supra*, n. 3), especially at 41-70 and A. LATORTUE-E. LITTLEFIELD-H. SIEDEK-K. MCKEE, "Managing the Floodgates? Making the Most of International Flows of Microfinance Funding", *Working paper*, 2007 (available at SSRN). Compare also D. VON STUFFENBERG, "Rating Microfinance Institutions in Latin America and Africa", *From Microfinance to Small Business Finance*, 169 (explaining that private investment funds are often seduced by the fact that "MFI are nearly always very liquid. Their portfolio quality is very good compared with commercial banks in the same countries. In addition, leverage is low. To top it all off, MFI tend to be much more profitable than banks").

¹⁰ SEC (2004) 1156 of 11 September 2004.

¹¹ Expert Group Report, *The Regulation of Microcredit in Europe* (Brussels, April 2007).

prudential regulation and supervision for institutions engaged in micro-credit when receiving deposits and other repayable funds from the public and to adapt national regulation and supervision to micro-finance institutions not taking customer deposit so as to ensure that it is proportionate to its costs and to the risks MFIs pose, “so that it does not put a brake on the supply of micro-credit and the growth of specialist MFIs”; f) to examine the needs for a European passport for MFIs other than banks engaged in the micro-credit sector; g) to avoid regulatory overkill (as it would be the case if new rules would overly limit the necessary flexibility of operations and impose high burden to the lenders), “by making a prior inventory of best practices and by confronting the proposed legislative framework with the reality of the national micro-credit operations”.

In addition to that the Commission intends to promote the spread of best practices. In fact, it rightly points out that “if non bank organisations have much to learn from the banks, the opposite is also true, as methods developed for providing and recovering micro-credit differ from traditional banking techniques. This exchange of know how would allow inter alia better integration of quantitative methods such as scoring, which are beginning to extend to micro-credit and trust generating contacts, on which the micro-project and its reimbursement depends”. To this purpose the Commission identifies the need for a “central body with financial and social expertise and the ability to monitor and coordinate action in support of micro-credit and to act as a permanent discussion partner for those in the field”.

Finally the Commission calls for a specific micro-credit facility providing funding and technical assistance to new and non-bank MFIs to enhance the supply of micro-credit. In fact, as correctly noted already in the Staff Working Document of 2004, “in addition to micro-loans, the provision of non-financial services, in particular mentoring, is essential to increase the chance of survival of start-ups and small enterprises”.

The Commission’s action plan seems to me generally appropriate. I agree, nevertheless, with part of the industry¹² that in implementing such action plan there is a need for additional fine-tuning.

On one hand, legislation must be effectively proportionate to the “wide ranging variety of institutions offering micro-credit in Europe, whether they are banks, non banks of other types of institutions”. This means, that regulatory challenges are different for banks and non-banks providing micro-credit and micro-finance.

a) As regards the banking model of micro-credit (i.e. micro-credit provided for by commercial banks, savings banks, credit cooperatives and micro-finance banks, where they exist as it is the case of ProCredit in Bulgaria and Romania), since banks are already strictly regulated and supervised, the focus of community or national legislative initiatives should be, in my view, on the specificities of risk management for micro credit and on the incentives to be given to banks to support the growth of small businesses. As already pointed out by the Commission’s Expert Group, “in the banking model it was not so much regulation that hindered the provision of micro-credit but risk and costs. Financial institutions regard microloans as risky if there is no collateral. This combined with asymmetric information effect and the fact that processing microloans involves a certain amount of fixed costs, means that the smaller the loan, the less profitable the loan is likely to be to the lender. There are however, at least in some Member States, systems in place to address these problems. Business support services help to reduce transaction costs. The risk of having no collateral is mitigated by a guarantee consortium or a guarantee fund”. I certainly welcome, therefore, the Commission initiative to establish wider provi-

¹² ESBC’s views on the European Commission Communication, Position Paper (Brussels, 14 February 2008).

sions on loan guarantees: these guarantee funds should operate, however, according to rules and practices to be duly supervised which should be directed at minimizing moral hazard of the borrowers. On the contrary, I am sceptical, and even more so following the recent financial crisis, on securitisation of micro-credit loans portfolios, considered also that micro-loans are often without a formal rating. In addition to that, as already noted in the literature¹³, regulators in developed countries, where peer lending and social collateral is rarely viable, should endeavour to foster the use alternative methods and more appropriate credit scoring techniques for assessing the credit risk of micro-loans. As it has been rightly said¹⁴, "such methods could include landlords references, savings records, and proofs of car payments or utility bill payments. Although it may somewhat increase program administrative costs to access such records, the strategy may help to identify low income individuals who lack a strong credit history but have demonstrated reasonable repayment discipline in the recent past. In addition, programs might secure their loans with items such as television sets, stereo units, furniture, pieces of equipment or cars. Although such non-traditional or creative collateral might not have significant market value compared to the loan amounts disbursed, they are often important to individual borrowers and have been known to serve as effective security against wilful default for some of the more prominent US programs". If the use of more appropriate credit scoring techniques coupled with historical records show that the credit risk diminish, it could be recognized to such less risky micro loans a more favourable treatment under CRD (see e.g. loans extended to non profit institutions). In turn, as regards the incentives to be given to existing banks to engage in micro-credit programmes to promote grass-roots entrepreneurship, useful lessons can be drawn from the US 1977 Community Reinvestment Act and its anti-redlining provisions, which proved effective in downscaling the banking activity (both directly and through the Community Development Finance Institutions and Corporations) in the best interest of local communities and of low income borrowers (today 20% of the total loans granted to private clients in the US).

b) As regards non bank providers of micro-credit, the focus should be, in my view, on a (ideally harmonized) regulation of the entities (MFIs). Hard and soft regulation should both be in place and converge and should be directed at instituting appropriate management and internal control systems for MFI, at establishing an adequate public supervision, at fostering networking (also through the establishment of "second level" MFIs federal organizations providing regional and/or national coordination and technical assistance and support to their members according to organisational model successfully experienced for instance by credit cooperatives in most Member States) and at developing best practices for lending. There is also a clear need to push MFIs towards optimal scale reorganization, long term self-sustainability and portfolio growth. Electronic platforms where supply and demand of small micro-credits could meet should also be encouraged (along the lines of a few pioneering projects already in place) to respond to transaction costs. MFIs should moreover be regularly subject to performance rating: it is essential indeed to measure on an on going basis and through already existing specialised entities (like MicroRate) if the MFIs personnel is successful in conducting needs assessment, in analyzing and approving loans, in developing information systems for tracking repayments, to administer technical assistance to the borrowers and collection procedures, in a word how good is the institution in providing micro-credit. Although MFIs do not pose a problem of protection of depositors, a sound regulatory and supervisory framework is nevertheless recommended, in

¹³ N. BHATT-S. TANG, "Making Microcredit Work in the United States: Social, Financial and Administrative Dimensions", *Economic Development Quarterly*, 2001, 15, 229, at 236

¹⁴ N. BHATT-S. TANG (*supra*, n. 13), 236.

my view, to enhance the protection of the public funds, the protection of borrowers and the trust of donors, banks and other financial institutions on which MFIs rely, at least partially, for their funding and which in turn must rely on the MFIs to overcome informational asymmetries and access segments of clients which, in many circumstances, would not be bankable without the “intermediation” (both in terms of creditworthiness assessment and mentoring) of the MFIs. Regulation and supervision should obviously be proportionate refraining from imposing unnecessary costs.

On the other hand, I would advocate some caution in relaxing too much interest caps for micro-credit operations. Whilst it is clear that interest rate must be fairly related to risk and that anti-usury caps could in some circumstances prevent micro-credit and micro-finance institutions from attain self-sustainability, it should be also considered that micro-credit patterns which proved successful in developing countries are not “exportable” as such in Europe and that excessive interests rates would prevent micro-credit from effectively deliver its expected beneficial social effects. I would spend therefore more regulatory efforts on guarantee funds and other similar arrangements to limit the risk as well as on efforts towards the standardisation of lending practices (to decrease transaction costs) rather than on excessive relaxation of interest rate caps.

4. – To conclude, I believe that in devising an appropriate regulatory response to micro-credit at the European level, it should be considered, first, that micro-credit and microfinance are certainly essential to economic and social development and must be promoted, therefore, also through appropriate public intervention and tax incentives. Second, that microcredit and microfinance institutions should attain economic sustainability and should not be based solely or principally on grants or on any other form of paternalistic philanthropy. In this respect, history shows that deposit taking, self-help (as it is the case of cooperatives and credit unions) and/or strong local bonding (as it is also the case of investments in micro-credit made by established banks or financial institutions – herein included savings foundations – as a firm and long term commitment to their community) matter to ensure sustainability and success in the long run. Third, that both banks (specialized or not specialized) and non banks should be very active in the field: in many circumstances, to be successful both actors must pool their specific knowledge and act together, networking also with external training structures, like Universities or private and public small business development centers (as it has been rightly said, “micro-enterprise development experiences from around the world provide few examples of good lenders being good trainers and vice versa)¹⁵.

I also believe that banks are called to upgrade the degree of financial inclusion and that it is even in their best economic interest to do so, as many examples of recent years show. This can be done through different business models: from the simple extension of loans to MFIs to the creation by a bank or by a banking group of a business unit or even a specialized bank devoted to micro-credit. A remarkable example of this latter model is represented by a recent innovative Italian bank (called “Prossima s.p.a.”), incorporated in May 2007, which started operation on October 2007. This initiative is noticeable in size and in character. It is noticeable in size, because “Prossima s.p.a.” is a fully owned subsidiary of “Intesa San Paolo”, a major Italian player in the national banking industry. As such, it has been adequately capitalized from its very outset and operates nationally and internationally also through the existing network of

¹⁵ N. BHATT-S. TANG (*supra*, n. 13), 239.

“Banca Intesa San Paolo”. Noticeable in character, because the new venture features a remarkable market response to increasing social demand for more financial inclusion. This new venture is thus interesting, in our perspective, under several aspects.

a) First of all, because it has been grounded on the Italian existing regulatory framework for banks and joint stock companies (rather than on that of credit cooperatives) whereby making it clear that the bank, notwithstanding its social orientation, is designed to operate as a viable and lasting economic venture for profit. At the same time, however, the articles of association voluntarily and deliberately depart from profit maximization, by explicitly stressing – already in Article 6 – that the company shall necessarily reconcile between its economic and social performance. As set out in Article 6:

In order to achieve the purposes listed under article 4, the Company shall carry out its lending activities as economically as possible, in order to generate annual profits and to create and add value to the Company and its shareholders. One of its main purposes shall be the provision of favourable lending conditions to social enterprises and other non-profit organisations operating in Italy and/or abroad. The Company shall also engage in lending to micro and small businesses or first-time home buyers and support health, care or training programmes by granting loans to individuals who, because of their race, nationality, social class, sex, age or financial position do not enjoy adequate access to credit. The Company shall provide finance to public or private initiatives promoting support, cooperation and development and contribute to trust funds or other revolving credit facilities for financing or development. The Company shall also be entitled, either individually or in partnership with public or private entities, to set up companies or joint ventures aimed at promoting development. The Company shall support direct and indirect micro loans and micro-credit initiatives in Italy and abroad, partly by pursuing ongoing technical assistance programmes aimed at furthering the creation and development of self-help and micro-credit organisations.

In turn, the same provision is very explicit in excluding from the bank’s corporate scope any confusion between social banking and granting and/or charitable activity.

The Company shall not engage in granting donations or gifts, as it wishes to operate as a going concern over the mid-to-long term in order to gradually increase its customer base, assets and share capital so as to achieve the purposes set out under article 4 above

This would in fact contradict economic sustainability in the long run and would “dissipate” in a one shot game resources which, on the contrary, are intended to be accumulated and serve as an intergenerational engine for social change. The bank, in other terms, does not represent a new vehicle set up to concentrate “in a single shop” all the philanthropic and charitable activities that were and still are carried out by “Intesa San Paolo” group or by its controlling savings foundations. Instead, what is being established is a proper new bank that is willing to profitably operate with the non profit sector and all those who do not have, or have insufficient recourse to credit, for the benefit of its shareholders, stakeholders (herein included its clients) and the community at large. As set out in Article 4 (which posits the foundations of the bank’s social mission):

Subject to articles 5 and 6 of these articles of association, the Company’s purpose shall be the creation of value for its shareholders, ensuring at all time the sustainability of its operations in compliance with the law and the criteria of sound and prudent management. To this end, the Company shall finance the most deserving non-profit initiatives aimed at providing services to individuals, disseminating culture and education, promoting access to and safeguarding the environment and the arts and providing access to credit and employment. The Company shall cooperate with public and/or private entities on initiatives aimed at promoting the common good by making available its human and financial resources. In order to promote the growth of the social economy in Italy and under-

stand and respond to its challenges, the Company shall avail itself of the advice of a dedicated group of representatives of non-profit organisations who shall provide guidance in its solidarity and development initiatives.

Another remarkable feature of this ambitious program is its international reach which is not confined to Italian territory. The closing paragraph of Article 4 recognizes indeed that:

The Company shall undertake to make its products, services and funding schemes available in Italy, as far as possible, and subject to the necessary modifications, to the overseas countries where the "Intesa Sanpaolo" banking group is present.

b) Secondly, the mediation between the reasons of capital and the expectations of the community (in other terms: the mechanism that bridges between the shareholders' expectations for profit and the social expectations of other stakeholders) is translated into an innovative (so, at least, to the best of my knowledge) legal provision concerning the allocation of yearly profits. As it can be read under Article 28 of the by-laws:

"The net profits shown in the accounts, net of the legal reserve and of any other provisions which the Company is required to set aside under the applicable laws in force at the time, shall be distributed as follows:

a) a share equal to the cost of capital invested by the Bank shall be allocated to a non-distributable statutory reserve to be calculated in accordance with the accounting methods generally employed by the market;

b) the net yearly dividend allocated to shareholders shall not exceed 50% of the profits approved by the shareholders' meeting, net of the provisions set out under letter a) above;

c) all remaining profit shall be set aside for solidarity and development initiatives and allocated to a specific Fund for Development and the Social Enterprise. This risk and contingency Fund shall be employed – according to the procedure described here below – to cover losses arising from solidarity and development loans granted by the Company at below-market rates or to persons who do not have, or have only limited access to traditional credit facilities.

If at the end of the financial year the Company should record losses attributable, in full or in part, to solidarity and development programmes, any such losses shall be fully covered by the Fund for Development and the Social Enterprise. If the above losses, being too great to be covered by the above Fund, the net profit generated by the Company in the following financial years shall be set aside, after the mandatory legal reserve provision, to bring the shareholders' equity back to its previous level, net of the above Fund.

If, conversely, the operating losses are due to other causes and do not arise from solidarity and development initiatives the Fund under point c) above may be used to cover such losses only after all other voluntary and statutory reserves have been used to this end, including the reserve under point a) above. If the Fund under point c) above is used to cover losses which do not arise from solidarity and development programmes, the net profit of the next two financial years, net of any legal reserve provisions, shall be used to bring the above Fund back to its previous level.

Any dividends which have not been claimed within the prescribed time limit shall be retained by the Company and allocated to the statutory reserve".

This indicates that yearly disposable profits shall be divided into two principal parts. One part devoted, in a specific amount set by the Articles of association, to the further capitalisation of the bank through a net worth reserve not distributable until dissolution. Whereas the remaining part is virtually shared between shareholders and stakeholders on an equal footing (unless shareholders agree to accept less than the maximum amount of dividends to which they are entitled in principle, leaving more resources to the reserve used for corporate social responsibility operations). Shareholders are indeed free to resolve in their ordinary shareholders' meeting a

distribution of dividends up to the 50% of such remaining net profits. Stakeholders shall benefit from all the remaining part through the accumulation of such amount in a specific reserve, the (so called) “fund for the development and social undertakings”. This fund does not result in a separate legal entity (as would have been the case if the accumulated amount was segregated in trust or allocated to an external charitable foundation) but remains under the management of the bank's board of directors. However, this fund is specifically designated to “face the risks and cover the losses” stemming from the social banking activities undertaken by the bank in favour of its social constituencies. In particular, when the bank, in conformity with the aims set out in Articles 4-6, lends with interest rates which are below custom market interest rates, the “day one loss” (should this loss become a yearly loss) shall be covered by the fund. Similarly, if the bank lends to a person who, according to custom market practices on risk management, is not “bankable” (or is not entitled to receive a loan, according to ordinary practices, in the amount needed), in case of default of such borrower, the loss is covered by the fund. Clearly enough, due to the coexistence of some corporate and non segregated funds for the benefit of shareholders and some other corporate and non segregated funds for the benefit of stakeholders within a single entity, the proper satisfaction of the expectations of all these different constituencies – as well as the fulfilment of the additional corporate mission to perpetuate this banking model through time in an intergenerational bond, on top of that – relies, in this model, on corporate governance devices. It remains, in other terms, under the responsibility of the board of directors to align the behaviour of the company – profitable banking and social banking for the present and the years to come – along the lines of this nexus of multi-stakeholders’ expectations. Losses deriving from for-profit banking and/or social banking are in principle to be resented each by its relevant constituency, as it is shown by the rules concerning coverage of losses which distinguish among the different sources of losses to consistently identify the funds to be used for their coverage. This is true however only if the yearly bottom line is negative (on the contrary it has been set in the Articles that, as long as the company concludes the year with a profit, no constituency should blame the other if profits are less than they would have been if the bank had not operated in the other sector) and it remains true only if and when the constituency being affected by the loss is in condition to face alone such loss or to repay it in due course. This is obviously so, because – as indicated – there is no asset partitioning and segregation.

c) In order to facilitate the board of directors in duly performing its difficult task – being an active and profitable banker on the one hand and, at the same time, a respectable social banker on the other hand – the corporate governance of the bank is enriched with a new and innovative organ: the committee for the solidarity and development (hereinafter – Committee). This Committee comprises of 6 members with staggered office (in order to ensure continuity of action), 3 of which are appointed by the shareholders’ meeting and the other 3 designated by 3 separate external appointing authorities (herein included the President of the EU Parliament), all among candidates possessing consistent professional qualifications. Article 29 sets out in fact that:

“The Company shall set up a Solidarity and Development Committee comprising six members, who shall be authoritative and independent individuals chosen from among former senior officers of Italian or foreign institutions or non-profit organisations, academics, senior managers of private companies or successful entrepreneurs with relevant experience in the non-profit, cooperation and development, microcredit and microfinance sectors”.

The most relevant innovation concerning this new organ refers to its functions. The Committee does not limit itself to advisory functions with respect to the “ethical” profile of the venture (as it is to be found in other cases of corporate social responsibility). Instead, albeit without interfering with the exclusive competence of the board in the management of the company

– the Committee provides framework principles and general indications and recommendations to the board with respect to social banking, focusing in particular on the use of the fund for the development considered above. As stipulated by Article 32:

“in accordance with the purposes listed under article 4 and with the provisions of article 6, the Committee shall issue general or specific guidelines, if necessary by regulation, on the solidarity and development activities to be undertaken by the Company, without prejudice to the powers exclusively reserved to the Board of Directors and in accordance with the criteria of sound and prudent management. In addition, subject to the powers exclusively granted to the internal and external auditors of the Company, the Committee shall monitor the Company’s administrative activities relating to solidarity and development initiatives in order to ensure that they are carried out in accordance with the criteria of sound administration, prudent management and transparency, prioritising the use of the Company’s resources for solidarity and development programmes according to long-term economic sustainability but with the exclusion of gifts and donations. In performing its technical audit functions, the Committee shall avail itself of the Company’s administrative staff and shall notify the outcome of such audits to the chairman and the managing director of the Company. The chairman or the managing director shall report to the Committee, generally every other month, on the solidarity and development initiatives implemented by the Company upon the recommendations of the Committee and on any issues which may have emerged.

Under Article 34, the same Committee is responsible for the social balance sheet and is subject to a transparency requirement:

“The Committee shall report to the shareholders’ meeting on its activities at least annually on the approval of the accounts for the financial year and shall periodically inform, with the agreement of the chairman of the Board of Directors, the markets and the general public of activities carried out and projects approved. Each year the Committee shall draft and issue a year-end report on the achievements and nature of the programmes implemented, which shall be made available to the general public.”

The articles of association discussed herein mark, in my view, an advance in the field and deserve close scrutiny. Indeed, in a regulatory perspective, they call for more attention, on one hand, on the tax incentives which should be granted in order to exempt from taxation profits allocated to the internal guarantee fund; on the other hand, on the specific enabling provisions on corporate governance which might be necessary to allow banks to adapt – as it is here the case through the Solidarity and Development Committee – to the specificity of an activity pooling together profitability, sustainability and social mission.