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Financial Regulation in Italy

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Financial Regulation in Italy

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Abstract

The evolution of the Italian regulatory system is based on five basic principles: (i) maintenance of trust in the financial system; (ii) investor protection; (iii) stability and good functioning of the financial system; (iv) financial system competitiveness; (v) compliance with financial rules. For banks, capital regulation has been a focus since introduction of the first Basel Accord, with a strong impact on financial structure and many M&A cases and exit of the public sector from the industry. The crisis has been tackled with enhancement of prudential supervisory style.

Key words: Italy, financial sector, banking, capital requirement, harmonisation, deposit protection, remuneration policy

Journal of Economic Literature classification: G01, G21, G28, G33

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1. Introduction

1.1. The organisational model of regulatory and supervisory bodies

Italian financial regulation has traditionally been organised along functional lines. Financial service activities are divided among four main industries: banking, investment services, asset management, and insurance. Each industry has its own supervisor, legal framework, and rules. Italy's approach to financial oversight incorporates elements of the Twin Peaks Approach. The twin peaks approach relies on two types of regulators: a prudential regulator and a conduct-of-business regulator generally oriented to protect consumers' interests. Although defined as separate entities, these regulators are expected to employ a high level of coordination, as they are each responsible for overseeing the functioning of different aspects of the same institutions. Like the integrated approach, the twin peaks approach is generally considered to offer the type of flexibility needed to deal with rapid innovation in the financial sector and the blurring of lines between what were once considered "traditional" areas in finance.

The Bank of Italy (Banca d'Italia), the central bank, has supervisory and regulatory authority over Italian banks, and since 1999 has played a monetary-policy role within the Eurosystem. As a prudential regulator its focus is on the safety and soundness of the institutions under its jurisdiction. In addition to its banking supervision responsibilities, the Bank of Italy focuses on the stability of the financial system. It has a statutory mandate to ensure overall stability, efficiency, and competitiveness of the financial system. The Bank of Italy has rulemaking authority and enforcement powers that are exercised through circulars, regulations and supervisory measures. These provisions are generally of a technical nature, and lay down rules and methods for categories of banking and financial intermediaries, operating both individually and in groups. Compliance with the provisions is reinforced by administrative sanctions. For instance, Under Law 262/2005 on the protection of savings, the Bank of Italy must carry out advance analysis of the impact of the measures it intends to issue, assess their effects on the interested parties in terms of costs and benefits, and conduct public consultation. The reasons for regulatory measures must be given, and the measures themselves must be revised periodically.

The Companies and Stock Exchange Commission (CONSOB) is the public authority responsible for regulating securities markets and the provision of investment services in Italy. Its mandate includes: (a) transparency and reviewing of business practices by securities market participants; (b) disclosure of complete and accurate information to the

investing public by listed companies; (c) accuracy of prospectuses related to share and security offerings to the investing public; and (d) compliance with regulation by auditors. CONSOB also conducts investigations related to insider trading and market manipulation.

The supervisor of the insurance sector in Italy is the Insurance Industry Regulatory Authority (ISVAP). Until the end of 2012 the Authority was independent and on 1st January 2013, ISVAP became IVASS, an authority within the Bank of Italy's environment – indeed, the chairman of IVASS is also the general director of the Bank of Italy. IVASS is responsible for regulating and monitoring the activities of insurance intermediaries and is also required to perform all activities necessary to promote consumer protection. The Finance Code mandates that the primary purpose of insurance supervision is the sound and prudent management of the insurance and reinsurance business, the integrity of the insurance market, and consumer protection. Thus, IVASS is a functional regulator of the insurance sector with safety and soundness, as well as conduct-of-business mandates.

Since 2004, there has been significant debate in Italy regarding the need for further structural reform of the supervisory oversight model. Some of the proposals put forward aim to reduce the number of supervisory authorities in the hope of designing a more efficient regulatory model. Specifically, the debate has focused on whether the number of supervisors should be reduced to two — the Bank of Italy and CONSOB — with reallocation of the responsibilities of the other financial regulators. Such reform is moving Italy closer to a Twin Peaks Approach to regulatory oversight.

In the case of pension funds, there is a mixed institutional-functional approach. Here an activity, namely the pay-out of private pensions, is reserved for highly scrutinised financial intermediaries, while at the same time it is an exclusive object falling under the control of Covip (Commissione di Vigilanza sui Fondi Pensione). Nevertheless, the Minister of Industry issues general directives relating to the supervision of pension funds (with the Minister of Finance), and supervises Covip. The Minister of Industry also authorises the exercise of this activity, while the Minister of Finance, after hearing the Commission's opinion, issues regulations setting limits and criteria regarding investments, and the rules to observe in the case of conflicts of interest.

The Supervisory Model by Objectives formally characterises the regulation of entities officially authorised to perform investment services, with regard to such services: banks, investment firms, investment management firms, mutual funds and Sicav (Società di Investimento a Capitale Variabile). These intermediaries are supervised by Consob for

transparency and investor protection, and by the Bank of Italy for "limitation of risk and financial stability" (Article 5, Banking Law).

The Antitrust Authority has exclusive oversight regarding the rules on competition for all authorised subjects, with the exception of banks. A supervisory model by objectives seems to emerge with respect to the entire securities market, and not just the intermediaries. Recent evolution of the normative framework assigns all powers in the field of transparency in the market to Consob (secondary regulation of the solicitation of public saving, insider trading, takeovers and public offers, etc.). Similarly, the Bank of Italy is considered responsible for stability (this task includes the regulation, not necessarily exclusive, of compensation, liquidation, clearing houses, wholesale securities markets, central depositories, and settlement systems). The Antitrust Authority is considered responsible for guaranteeing competition among different exchanges.

Finally, decisions regarding crisis procedures are taken by the Minister of Finance, acting on proposals presented by the Bank of Italy or Consob; responsibility for directing the procedures and performing the related duties is assigned to the Bank of Italy.

1.2. The key changes in banking regulation

In 1981 the Bank of Italy and the Minister of Finance agreed to reform the bid system of government bonds and remove the presence of the central bank; this is only allowed for bonds traded in secondary markets. In 1985 the first Bank Directive (EEC Directive 85/611 of 20 December 1985) aimed at increasing the competitiveness and openness of banking activity. The Directive defines the general rules for engaging in bank management activity, extends the list of harmonised products, and establishes minimum requirements for them.

For Italy, this is was radical reform at the time, as until then control of stability was managed through a structure-conduct-performance model, that imposed an oligopolistic structure, in which banks and branches could not be established without the agreement of the regulatory body. The relationship banking orientation pushes banks to increase the number of branches and to reduce the average distance between customers and distribution units.

Competition among banks in Italy began to intensify in the eighties as a result of the easing of restrictions on operations and due to changes in the geographical structure of the banking system. Areas in which established banks exercised considerable market power saw the entry of competitors from other areas, decreasing the degree of concentration. During the nineties competition intensified even more owing to further regulatory changes,

the removal of exchange controls and the rapid international integration of financial markets (see Chapter 8).

The first banking directive was the first step towards prudential regulation that was confirmed with the introduction of Basel I principles (1988), and was based on a minimum capital requirement defined in a standardised way for credit risk. In the same year, the Bank of Italy published the Second White Book on the banking system, in which regulators suggested that banks should operate as publicly traded entities in contrast to their previous status as non-profit companies. This was eventually designed by the regulator in 1990 with the so called Amato Act, which reformed the entire financial system, allowing banks to issue bonds, operate as universal banks, invest in non-financial stocks and, above all, remove all the constraints between short and long term operations.

In 1992, the second Banking Directive was introduced in the Italian system. This reform allowed a financial firm, that had already been authorised by its own regulator, the freedom to establish itself anywhere in Europe (home country control). The following year in September 1993, the Testo Unico Bancario (TUB) or Consolidated Banking Act was then approved. This act served as the final precursor toward the liberalisation of the financial system. In 2004 the Basel II principles were set out relating to new capital requirements for credit, market, and operational risks. The principles defined that internal capital and risk models could be introduced with the specific validation of the regulator – in this regard, the Italian validation methodology appears to have been generally more severe than other banking systems.

1.3. Market regulation

In 1998 the New Financial Markets Act was approved and provided rules for intermediaries, financial markets, and companies issuing bonds and stocks. The five principles of the regulation are: (i) maintenance of trust in the financial system; (ii) investor protection; (iii) stability and good functioning of the financial system; (iv) financial system competitiveness; (v) compliance with financial rules. More recently, financial markets in Italy have been affected by the introduction of the MiFID directive. We focus on the third level of these regulations, which depends essentially on national decisions, in order to provide evidence of significant differences between the Italian case and other countries in protecting investors in a system characterised by information asymmetries.

As part of the enforcement of regulation of financial markets and financial investments, Italian market players are required to introduce the compliance function. The risk of non-compliance with the rules is the risk of incurring judicial or administrative penalties, financial loss or consequent damage for breaching the law, regulations, or the rules of self-regulation or codes of conduct (Basel Committee, 2005). "To this end, the constitution within banks and bank groups of a control function dedicated to the control and verification of conformity becomes particularly important" (Bank of Italy, 2007). With regard to intermediaries operating in investment services, the call to adopt a conduct in line with the law, already present in Directive 2004/39/EC (MiFID), became an explicit request independent of the compliance function in Directive 2006/73/EC. The link between development of the compliance function for financial intermediaries in investment services and the MiFID compliant "rules of the game" also became increasingly visible at this time. As stated by the European legislator, the Member States ensure that investment companies apply and maintain appropriate policies and procedures for identifying the risk of failure to fulfil the obligations referred to in Directive 2004/39/EC by the company, and the resulting risks, and implement measures and appropriate procedures to minimise such risk and enable the competent authorities to effectively exercise the power conferred on them by the directive. The Member States require that investment companies maintain a function of permanent verification which is both effective and independent. As a result, domestically: "Intermediaries establish and maintain permanent functions, effective and independent of conformity to standards and, in line with the principle of proportionality, of company risk management and internal audit" (art.12 joint Bank of Italy – Consob Regulation, 2007).
From January 2009 the requirement to establish the compliance function was also extended to insurance companies: "Within the internal control system, companies should have, at each pertinent level of the company, specific aid to prevent them from incurring the risk of judicial or administrative sanctions, property loss or reputational damage, resulting from violation of the laws, regulations or actions of the Supervisory Authorities, in other words, self-regulatory norms. Companies establish a compliance function, which is proportional to the nature, size and complexity of the activities they carry out." (Isvap, 2008).

1.4. Changes in regulation in response to crisis

The main purpose of the bank capital reform (Basel III and CRD IV) can be summarised as follows: first, it substantially raises the quality and quantity of capital, with a much greater focus on common equity to absorb losses. Second, it achieves a more comprehensive coverage of the risks, especially related to capital market activities and liquidity exposures. Third, it introduces stronger supervision, risk management and disclosure standards. Large banking groups recognise the importance of specialisation, often applying divisional business models in order to optimise the ability to meet the needs of a variety of customer segments offering personalised services.

The expected impacts of the new regulation on banks are a function of the cost of capital and the cost of liquidity. The latter needs a distinction between expected return for investors and profitability of different business lines. According to the "orthodox" financial literature, when a bank raises capital, investors demand an average cost of capital. Within the company, the profitability and riskiness of single businesses suggests splitting the average into different marginal costs of capital (Saita, 2007). Requiring a global increase in capital quality could generate wealth inequality by business line. In the last 20 years banks have increasingly resorted to "hybrid" or "innovative" capital instruments. Some observed issues are: no dilution of control rights; the qualification of hybrid capital as debt for tax purposes; ambiguity since investors are confident that banks would treat them as plain debt, and would refrain from cancelling any interest or principal payments to avoid reputation costs. The potential misallocation of resources, and shifts in balance between transaction and relationship banking activities is further affected by the beliefs that banks have about their cost of capital. Bankers see capital as being very expensive, and they seem to convey that capital has but one price. Whatever the presumption, capital does not have one price. Standard capital structure theory tells us that the per unit cost of capital depends on the risk to which that capital is exposed. More risk generally implies a higher cost of capital. For Italian banks this problem must also be associated with the country risk and the consequent credit spread.

The second issue is the cost for liquidity assets. The introduction of the liquidity coverage ratio and the net stable funding ratio have increased the allocation cost for high liquidity assets. Moreover, the stock of Italian government bonds largely held by Italian banks affects the fair asset value, with a consequent impact on capitalisation.

2. Liberalisation of capital movements

Exchange rate laws have played an important role in Italian economic policy.

Regarding the process of progressive removal of the Italian system of currency payment controls and, more generally, capital liberalisation, we refer to the general principle contained in the Currency Act of 25 July 1956, n. 786 (Legge valutaria) according to which "*all exchange transactions are prohibited unless specifically permitted*".

The 1970s were characterised by a phase of increasing financial protectionism and typified by restraining measures imposed by Italian authorities on the purchase of foreign securities, international loan and credit transactions, as well as access to forward hedging.

In April 1976, in order to prevent capital outflows and speculation against the Italian lira (ITL), Law n. 159/1976 introduced some major defences such as those regarding exporting currency and holding capital in foreign accounts.

In the 1980s, the Italian Authority used capital controls for the purpose of ensuring the necessary degree of monetary autonomy and to reduce the risk of speculative attacks against currency stability and central bank reserves.

With the presentation of the White Paper on Completing the Internal Market (1985), the European Council clearly identified free capital movement as one of the main goals as part of full economic and monetary integration.

Adoption of the Single European Act (SEA) by the EC Council of Ministers in February 1986 set the end of 1992 as deadline for the completion of an internal market with free movement of goods, persons, services and capital. The Act became effective in July 1987.

Italy complied rapidly; the main step towards the liberalisation process was set with Law no. 599 of 26th September 1986 that changed the previous principle "*all is prohibited*" into "*freedom of economic and financial relationship with other countries*". Important restrictions, such as investment in foreign securities, were removed on that date.

Before Directive 88/361, the liberalisation process was triggered by the New Exchange Control Act (Decree n. 148, March 1988), in which the principle "*all exchange transactions are prohibited unless specifically permitted*" was substituted by "*all exchange transactions can be carried out unless specifically prohibited*".

With some exceptions,[1] all the restrictions on commercial and financial transactions by residents with non-residents were abolished.

The Directive 88/361/EC of 24 June 1988 forced Member States to abolish all remaining restrictions on capital movements between residents of Member States.[2]

Once again, Italy's compliance was rapid: the full liberalisation process was realised with Ministerial Decree 27/4/1990. Its adoption signalled the end of the exchange controls monopoly, the abolition of restrictions on authorised bank foreign exchange management, and all remaining foreign exchange restrictions previously established by the Decree of the President of the Republic no. 148/1988. *De facto*, the Italian Currency Office, the agency controlling exchange rate policy, was abolished, although its closure was settled formally several years later.

Figure 2.1. shows the net position of investment dynamics, that is, international investments held by Italian residents (at least 10% of the ordinary shares or voting power) in a foreign company. It is a proxy of capital movements, which rapidly increased after 2000.

In the last two decades, net direct investment in Italy recorded a stable increase until 2006 when it peaked (at about 31 billion Euros). In 2008 world flows of direct investment were powerfully affected by the financial crisis, owing both to the deterioration in the economic outlook, and to firms' reduced self-financing capacity and access to credit. Net inflows of direct investments (new investments net of disinvestments) into Italy dramatically fell from 29.4 billion in 2007 to a negative value in 2008.

The liberalisation of capital movements has been a source of weakness for the management of public debt in Italy. Freedom to invest in foreign markets and elimination of currency risk within the euro area led to dependence on foreign institutional investors, amounting to about 40% of the total public debt (Figure 2.2.).

3. Cross-border competition and authorised activities

The reduction of Italian banking market entry barriers began around 1985 when the First Banking Directive was established (D.P.R. 350/1985). Since then, liberalisation of the market characterised the number of players, their businesses, the geographical distribution and concentration, and their organisational models. Cross-border competition was pursued as a goal to increase efficiency and, at the same time, market completion in terms of monetary, credit (§ 3.1.) and financial (§ 3.2.) services.

3.1. Italy's compliance with the Second Banking Directive

The Second Banking Directive (89/646/EC) was the most important EU legislative initiative concerning cross-border competition and permitted activities. The aim of the Directive was

twofold: a short-term objective of creating easily enforceable minimum standards regarding the conduct of financial affairs in Europe, and a long-term focus of the European Community which was directed towards coordination of monetary policy with economic and monetary union in Europe. With the introduction of the mutual recognition principle, the Directive aimed to compel Member States to recognise the licenses of other Member States. The so called "*single banking license*" was therefore the centrepiece of the Second Banking Directive. A credit institution could establish branches in any Member State and could freely provide all banking services allowed under the Directive.[3] The deadline for compliance with the Directive was 1st January 1993.

Before adoption of the Second Banking Directive, these issues were regulated in Italy by Royal Law Decree 375/1936 (Italian Banking Act)[4] which introduced the separation of commercial and investment banking, along with specialisation according to the maturity of assets and liabilities, and the classification of banks into categories by the common element of state ownership.[5] All credit institutions were supervised by the Bank of Italy and Comitato Interministeriale per il Credito e il Risparmio (CICR). Supervision was based on the principle of stability and competition was substantially ignored because it could cause instability. As a consequence, new branches could only be opened after specific (and discretionary) authorisation granted by the Bank of Italy.

Until the middle of the 1980s, credit institutions were divided into ordinary banks, organised as limited companies, public credit institutions and credit institutions with mutual functions (Popular and Rural banks). Ordinary banks were allowed to issue short term loans whereas the supply of medium and long term loans was left to the special credit institutions.

By the end of the 1980s, the State-controlled banks, which had special legal status and were not as regulated as ordinary banks, held a large share of industry. Most of them were not joint stock companies, but operated as public foundations, fully controlled by national or local authorities. Moreover, while a public bank was allowed to buy a private one, the opposite was not permitted. As a consequence, State presence in the economy tended to increase and the banking industry was substantially "frozen" (Resti, 1998).

According to Royal Law Decree 375/1936, banks could neither underwrite shareholdings in industrial companies (or only in a very small share and with many constraints), nor could they be controlled by them (bank and industry separation principle).

The first contribution to the elimination of entry barriers was introduced by the Bank of Italy's bank branch planning (*piano sportelli*) of 1982[6] and by the Decree no. 350/1985. The

latter, on one hand categorised banks as enterprises and not as institutions[7] and on the other, changed market structure from an oligopolistic to a competitive one, reducing entry barriers to the banking market and removing the discretionary authorisation power earlier attributed to the Bank of Italy (from structural to prudential model of supervision).

With the First Bank Directive (1985) and the application of the Basel I proposals (1988), the style of banking supervision changed from structural to prudential. The purpose of regulation (1993 Banking Act, article 5) was not only aimed at maintaining financial stability, but also at promoting a higher level of efficiency.

The concentration process accelerated in terms of size: between 1990 and 1995 the total assets of the five largest banks was around 30%; in 1999 this value rose to 48%. At the same time, with banking system liberalisation, the number of branches increased by about 40% in the period 1996-2008 (Figure 3). The distribution of lending activity confirms the small share of southern regions that received a small portion of resources, ranging from 15 to 18% of total loans.

The Italian banking system, as it stood until the end of the 1980s, was not able to withstand the impact of liberalisation and opening of the market to European banks. The legal status of most banks, which was not adapted to firm activity, their very small size that prohibited acquisitions abroad, and the operating constraints of Italian bank activity made it difficult to for Italian banks to react to competition from European banks.

In the early nineties, a few legislative bills profoundly modified the structure of the Italian banking system. Law no. 218/1990 (also known as "Amato Law") aimed to privatise the banking system by transforming public credit institutions into joint-stock companies: the saving banks, which until then operated in the short-term sector, transferred their banking activities to ad-hoc joint stock banking companies and were converted into Foundations and took on all the socially-oriented tasks envisaged for savings banks.

By 1993 most of the privatisation process had been implemented. The major public banks and insurance companies had been sold and listed through IPOs. Most of them were directly controlled by public banking foundations. At the beginning of the 1990s neither banks nor institutional investors played a significant role in Italian company ownership (Table 3.2).

At this time, banks still had a limited share in non-financial company capital, and ownership by institutional investors significantly increased between 1990 and 2010.

The structure of corporate regulation allowed banks to be capitalised during the financial turmoil after 2007. Nonetheless, in some cases, excessive asset concentration and the strategic model of maintaining bank control stimulated their leverage, with doubtful sustainability.

Thanks to tax incentives, merger operations, which were very rare until the end of the 1980s, recorded a remarkable increase from 1990 and justified the introduction of new organisational set-ups known as “gruppo polifunzionale” (bank conglomerate).

The legal implementation of the second Banking Directive in Italy took place in 1992, when the principles of mutual recognition and home country control were finally introduced with Legislative Decree no. 481. The distinction between ordinary banks and special credit institutions was abolished, and the model of the universal bank was indicated as the best solution to pursue.

The full implementation of the second Banking Directive was realised with Legislative Decree no. 385/1993 (New Italian Banking Act). To grant greater transparency of supervisory control, the Bank of Italy published the general measures adopted by credit authorities and other significant measures, such as statistical reports and data. For the first time, in addition to the traditional purposes of stability and efficiency, competitiveness was listed as a primary goal.

Decree no. 385/1993 set forth the end of the principle of specialisation for all financial activities, and included both short-term and medium- to long-term funding. The whole operational and temporary de-specialisation found its definitive consecration with the introduction *the new model of the universal bank.*

After the crisis and approval of CRD IV, new reporting constraints for foreign branches operating in Italy were introduced. Some options were also exercised by the Italian regulator. With regards to the adoption of Directive 2013/36/EU, the Bank of Italy ruled that all community credit institutions with branches in Italy are obliged to send a detailed report on important topics as specified in Part One, Title 2, Chapter 2, Annex A of the Bank of Italy's supervisory circular no. 285 of 17 December 2013. In order to ensure enhance information and transparency within the Italian financial markets, the Bank of Italy can demand from branches of community banks the necessary documents and data on banks authorised in Italy, regarding their Italian activities. In particular, the Italian regulator can demand information about the average percentage rate charge applied by foreign banks in the Italian banking industry.

3.2. Italian compliance with the Investment Services Directive

The European Community achieved the important goal of regulating security markets with the adoption of the Investment Service Directive on 10th May 1993. It was a great step toward the creation of a single European financial services market. Like the Second Banking Directive, the Investment Services Directive aimed to harmonise essential minimum prudential standards of behaviour by confirming the principle of mutual recognition based on home country control.

It was addressed not only to investment firms but also to banks and other financial institutions that provided investment services. Banks that already complied with the Second Banking Directive did not need any other authorisation under the Investment Services Directive.

The core of the Directive was the principle of mutual recognition: an investment firm authorised by its home national regulator to provide specified investment services[8] was able to supply those services in any other Member State. No other authorisation was required.

To complete a European Single Market, investment firms authorised by the authorities of their States to perform the listed activities in the Directive, could become members, or have access, to the Exchanges of the host Member States.[9]

Although the Directive did not aim to harmonise the conduct of business or advertising rules, Member States were required to adopt a minimum set of transparency rules for their Exchanges.[10]

Before introduction of the Investment Services Directive, the first existing regulation was Law no. 2/1991 (1/1/1991) on brokerage activity. It stated that this activity was limited to specific financial firms (Società di Intermediazione Mobiliare, SIM) along with banks. Moreover, only companies with a legal head office in Italy were allowed to provide such brokerage services, completely excluding cross-border activities.[11] To improve securities trading transparency, the Italian legislator defined the principle of *stock exchange trading concentration*, that is, the obligation to trade transferable securities exclusively in regulated markets.

The Investment Services Directive (ISD) was implemented in Italy with Legislative Decree no. 415/1996 (also known as the Eurosim Decree). The *single passport* principle was also finally introduced in Italy with the Eurosim Decree.

The most important changes implemented by the Eurosim Decree, like with the Second Banking Directive, were adoption of the *home country control* principle for the financial sector, abolition of the stock exchange concentration principle, replaced by new regulated market structure and organisation, privatisation of the Stock exchange with introduction of the "*Società di Gestione dei Mercati Regolamentati*", and new rules concerning Supervision. The definition of "brokerage activity" was replaced with "*investment services*".

Despite the terminological differences, the guidelines of both were the same: brokerage activity was still limited to a few types of legal entities; authorised entities were obliged to follow rules of stability, accuracy and transparency towards investors, and "*functional supervision*" was assigned to the Bank of Italy and Consob. The former was given the responsibility of implementing rules on stability, whereas the latter was given power to supervise compliance with accuracy and transparency rules. Indeed, according to article 4 of the Eurosim Decree, "*supervisory activity has the objective of transparency and accuracy of the conduct and the sound and prudent management of supervised firms, having regard for investor protection and the stability, competition and good operation of the financial system".*[12] It was therefore possible to identify two intermediate goals: (i) transparency and accuracy of the conduct of supervised firms, (ii) sound and prudent management. The purpose of this strategy was to achieve the final goals of investor protection, stability, competition and, finally, robust operating of the financial system (Pontolillo, 1997).

4. Capital requirements

The prudential regulation adopted at integrated level since the approval of the Basel I Directive is essentially based on the assumption that losses are expected to be covered by a bank's own funds.

In this chapter we explore the way Italian regulators designed their regulatory model within the European framework, from Directive 1898/299, through Basel II, to the Basel III proposal, which was enhanced in the CRD IV directive. Along with capital, the response to the crisis created an emphasis on measuring and managing liquidity risk by adoption of two ratios, liquidity coverage (LCR) and net stable funding (NSFR). The last section of this chapter describes how the Italian regulator exercised a number of alternatives that changed the original requirements.

4.1. The adoption of the Directive 89/299/EC and the debate before Basel II

The purpose of the adoption of Directive 89/299/EC
was to implement European Community legislation concerning prudential supervision of an operative credit institution with regard to a bank's own funds and the term thereof. The concept of own funds used by a Member State may include other items, provided that, whatever their legal or accounting designations might be, they have the following characteristics:

(a) they are freely available to the credit institution to cover normal banking risks where revenue or capital losses have not yet been identified;

(b) their existence is disclosed in internal accounting records.

Italy decided to activate the option to include fixed-term cumulative preferential shares and subordinated loan capital in the own funds provision. This decision was based on the assumption that, in the event of the bankruptcy or liquidation of the credit institution, the claims of all other creditors have a lower ranking and are not repaid until all other debts outstanding at the time have been settled.

One of the issues, only partly solved with bail-in proposals, is the definition of subordinated debts accepted within regulatory capital. These had to fulfil the following criteria:

(a) only fully paid-up funds may be taken into account;

(b) the loans involved must have an original maturity of at least five years, after which they may be repaid; if the maturity of the debt is not fixed, they shall be repayable only subject to five years' notice unless the loans are no longer considered as own funds or unless the prior consent of the competent authorities is specifically required for early repayment. The relevant authorities may grant permission for the early repayment of such loans provided that the request is made at the initiative of the issuer and the solvency of the credit institution in question is not affected; the extent to which own funds are ranked must be gradually reduced during the last five years before the repayment date;

(c) the loan agreement must not include any clause providing that in specified circumstances, other than the winding up of the credit institution, the debt will become repayable before the agreed repayment date.

On the asset side, risk weighted assets were found to be compliant with the Basel Committee proposals. Risk weightings depend on a standard formula and the number of risk buckets implemented as part of the regulation was relatively small:

- 0% for cash, central bank and government debt and any OECD government debt;

- 0%, 10%, 20% or 50% for public sector debt;
- 20% for development bank debt, OECD bank debt, OECD securities firm debt, non-OECD bank debt (under one year maturity) and non-OECD public sector debt, cash in collection;
- 50% in the case of residential mortgages;
- 100% for private sector debt, non-OECD bank debt (maturity over one year), real estate, plant and equipment, capital instruments issued at other banks.

Off-balance sheet items are converted into on-balance-sheet exposures in order to contribute to the RWA calculation (as 'credit equivalent').

The application of this regulation has been criticised for many reasons: the assumption that banks are exposed to credit risk only; hedged and unhedged exposures are considered equal; the same weight for small and large exposures; adverse selection and moral hazard behaviour, especially with regard to private sector loans for their unique weight which is independent of their inherent riskiness (Gabbi, 1994).

Several elements of this debate led to revision of the prudential regulation.

In 1993, with Directive 93/6/EC, credit risk was associated with market risk in the capital requirement rules set. Specifically, banks with trading book exposures were asked to absorb capital with a standard formula introduced with Legislative Decree no. 415/1996. In 2000, with a new Legislative Decree (259/2000), the Italian prudential regulation for the first time introduced the opportunity to adopt an internal model for market risk exposures. The Bank of Italy introduced some pre-requisites to substitute the standard formula with the internal model:

a) use of Value at Risk models;
b) use of the greater of the highest VaR(t-1) and the average VaR of the 60 previous days;
c) multiplying the value at point (b) by a multiplier ranging between 3 and 4, based on the number of violations;
d) holding periods of 10 days or less;
e) minimum confidence interval of 99%;
f) historical time series of at least 250 daily data points;

Qualitative and organisational requirements, based on commitment of the Board and top management to the risk management process, must be independent, specialised and able to frequently report tests on results.

Table 4.1. shows the main features of internal models adopted by large credit institutions in Italy.

4.2. Adoption of Directive 2006/48/EC and Directive 2006/49/EC

The Basel rules require banks to compute risk weighted assets (RWA) for all relevant types of risk: a number of risk typologies (credit/counterparty, market, and operational) are governed by Pillar 1 minimum requirements, while others (interest rate, concentration, reputational) are part of the Pillar 2 review process. Focusing on Pillar 1, the regulatory framework offers a set of alternative methodologies for the three types that require a large number of calculation inputs.

The Italian adoption dates back to December 2006 when Law no. 297/2006 was approved. The main features of the legal innovations were: market risk remained essentially the same as approved in 2000; the internal model approach was extended to credit and operational risks; credit risk capital requirement could be estimated using either the Standard formula or Internal Ratings-Based (IRB) approaches. A common feature of these approaches is the allocation of exposures across different portfolios ("asset classes"), typically differentiated by type of counterparty (e.g. corporate, retail), to which different risk weights are assigned. In general terms, the definition of these portfolios is broadly similar if not identical in the two approaches.

Italy allowed banks to use both approaches simultaneously, though on different portfolios and/or portions, and only for a certain period of time. The general principle is that the option for IRB must be a strategic decision for a financial institution. According to Italian regulations, the full IRB coverage at group level can be phased-in gradually, over 7 years for Italian banks, so as to allow all group members to become familiar with the more advanced metrics. Operational risk requirements can be estimated with a basic, standardised or advanced approaches.

National options adopted by the Italian regulator include:

1. *Standard Formula*

a) For loans to banks based in countries rated BB+ to B- and countries without any rating, the maximum coefficient is 100%.
b) Regulators can increase the weighting for borrowers without any rating if justified by previous critical events.
c) To apply the deduction of 25% for retail loans, regulators check the current diversification of credit portfolios.
d) In case of residential mortgages, regulators maintain the power to check the real destination of the loan given to borrowers.
e) Non-residential mortgages can be weighted by 50% instead of 100%, if the collateral is commercial real estate;
f) Other minor options are applied to covered bonds, in line with rating agencies recognised by other countries.

2. Internal Models

a) Minimum capital requirement (floor) is set to ensure bank stability.
b) Liabilities linked to share value can be excluded from the capital definition.
c) Banks can be allowed to extend the IRB progressively to other legal entities within the group or use a partial IRB permanently.
d) Small and medium enterprises are defined according to total assets instead of sales.
e) Some short term assets are not valuated on a yearly basis but coherently with their duration.
f) Other minor options are applied to capital instruments, such as exclusion from IRB methods, market methods vs. PD/LGD methods.

In the period after introduction of the Basel II framework into the Italian legal system, the economic crisis changed the perception of the effectiveness of the rules. Regulators did not change their view in terms of the prudential regulation model, but realised that previous definitions of regulatory capital and its quantity were insufficient to cover losses. New rules were proposed and some have already been adopted in the Italian regulatory system.

4.3. The revision of capital requirements regulation after the economic crisis

During 2009 a number of changes to Directives 2006/48 and 2006/49 proposed by the EU Commission in autumn 2008 (CRD II) were approved. Other amendments were approved by the EU Parliament in November. CRD II focuses on critical issues experienced during

the financial crisis: capital requirements, large exposures, securitisations, liquidity, the role of auditors, cooperation between authorities under crisis market conditions (third pillar).

Shaped by three directives (2009/27, 2009/83 and 2009/111), CRD II had to be effective by the end of October 2010, with a final deadline for national instructions by the end of 2010.

The major changes to the previous regulation on capital requirements focused on (i) definition of individual regulatory capital, and (ii) calibration of capital ratios.

Directives 2006/48/EC and 2006/49/EC (also known as the "Capital Requirements Directives –CRD") on prudential supervision of banks and financial intermediaries were changed on 24th November 2010 by Directive 2010/76/EC (CRD III), mainly to strengthen the capital requirements applied to trading books and securitisation operations.

4.3.1. Capital requirements revisited

The capital requirement for trading operations was considered inadequate, particularly for banks adopting a validated internal model. Basel II allowed those banks to use Value-at-Risk metrics based on statistical distributions or simulations. In both cases, the time series of data had to cover at least one year (250 observations). Although most large banks used two-year time series data to build estimations, the effect of this rule was to quickly "forget" many extreme events and to increase risk related to "short-termism".

The first issue we want to look at is optimal capital allocation in light of the quality enhancement purpose of Basel III. According to the Basel Committee: "the quality, consistency, and transparency of the capital base will be raised. […] Under the current Basel Committee standard, banks could hold as little as 2% common equity to risk-based assets, before the application of key regulatory adjustments" (Basel Committee, 2009, p.2).

The proposals can be summarised as follows: an adequate share of a bank's capital should be 'plain vanilla' common equity, with full loss-absorbing potential; simplification of the definition of capital (Tier 1 and Tier 2 with separate requirements), focusing on financial instruments that can absorb losses on a going-concern basis; further international harmonisation of the way hybrid and innovative capital is defined and dealt with by regulators; simpler and more consistent definition of (upper) Tier 1.

Among the new rules, deductions appear to be significant, and there is a marked difference between Basel II and Basel III in this regard. Deductions for banks are as follows: (i) capital of banks' insurance subsidiaries above a 10% threshold; (ii) minority excess capital of banking subsidiaries; (iii) the value of any defined-benefit pension fund asset; (iv) their

investments in unconsolidated financial institutions above a 10% threshold; (v) all deferred tax assets that arise from net-loss carry-forwards. Expected solutions for compliance and for raising capital quality include, for instance, buying out minority stakes or reducing the excess capital of banking subsidiaries; reducing unconsolidated investments below thresholds defined by the regulator for capital deductions; reviewing pension contracts with their actuaries and advisers and developing a more precise understanding of the amount of pension assets that can be easily and promptly withdrawn from the fund; reviewing banks' deferred tax assets in detail and rationalising their portfolios of these assets with respect to composition and amount.

Another change was introduced for trading book exposures. A number of changes were introduced by the Basel Committee in summer 2009, pertaining to the treatment of trading book and market risk. The proposed changes affect general and specific risk measures for the internal model. A first impact study of the results of the quantitative impact was published in October 2009. The general risk, which applies across all products, included a stressed VaR in addition to the standard VaR calculation. The stressed VaR is measured over a 12-month period of stress and based on the ten-day, 99th percentile one-tailed confidence interval. The period used must be approved by the supervisor and regularly reviewed, and the stressed VaR calculated at least weekly:

$$\textit{Stressed VaR} = \max(sVaRt\text{-}1, ms \times sVaRavg)$$

where:

ms = Multiplication factor (minimum of 3)

sVaRt-1 = Latest stressed VaR

sVaRavg = Average stressed VaR over the preceding 60 business days

The multiplication factors for the original and new VaR are set by the individual supervisory authorities based on the quality of the bank's risk management system, subject to a minimum of three for both. Banks are required to add a number related to the ex-post performance of the model to these multiplication factors. This ranges between 0 and 1, based on VaR calculation back-testing outcome (not stressed VaR). If the results are satisfactory, it can be zero. A specific risk charge is added to the general risk measure, aimed at covering factors not included in the VaR calculation, such as default and rating

migration. The three main areas are securitisations, the correlation trading portfolio and other interest rate positions (equities are optional).

One of the concerns in the original discussion about the trading book capital charge was that the traditional VaR measure does not capture incremental default risk, especially for risk associated with credit risk related to illiquid products, i.e. the credit crisis highlighted trading book losses not captured in the current framework, such as losses not due to defaults but to credit migration, widening credit spreads, and loss of liquidity.

All securitised products, including synthetic ones, now have to use the ratings-based standard model. This means collateralised synthetic obligations (CSOs) are treated like assets in the banking book, and their risk weights depend on ratings and seniority, rather than the economic risk of the position as determined by VaR models. The risk weights for re-securitisations, such as leveraged super-seniors (LSS) or CDO squared products, also increase significantly.

For correlation products (such as liquid credit derivatives, index tranches, and nth-to-default baskets), the Basel Committee proposed that banks can also use an alternative risk-based approach, namely the Comprehensive Risk Measure (CRM). The CRM must capture all price risks including incremental default, migration risks, spread risk, volatility of implied correlations, basis risk, and so forth. However, this result is to be subject to a minimum floor, fixed as a percentage of the charge that would be applied using the ratings-based approach. Products measured using this approach are not subject to any further specific risk charge (but must be included in the VaR and stressed VaR calculation). There is no adjustment made for double counting between the CRM and any other risk measure. Netting is not allowed under this model, unless the off-setting positions are exactly the same.

The capital charge for the comprehensive risk measure is:

$$CRM = max(CRMt\text{-}1, CRMavg)$$

where CRMavg = Average of the Comprehensive Risk Measure over 12 weeks.

For all positions in the trading book with migration/default risk, banks must calculate:

$$IRC = VaR\ mig/def\ (99.9\%,\ capital\ horizon)$$

through an internal model. Here the regulator requirements are:

- a capital horizon of one year;
- P&L is derived by a dynamic strategy, where each position is rolled over after the end of its liquidity horizon, in order to keep risk level constant;
- liquidity horizon is position-dependent and is greater than or equal to three months;
- liquidity horizon can be bucketed;
- equities and equity derivatives can be incorporated (at the bank's discretion);
- IRC does not apply to securitised products, such as ABS;
- counterparty risk is not measured;
- IRC must be calculated weekly;
- IRC must be back-tested.

No specific risk charge needs to be added if the supervisor agrees that VaR already incorporates specific risks and the bank's internal model approach already captures incremental default and migration risks.

The precise capital charge for the incremental risk measure is as follows:

$$IRC = max(IRC_{t-1}, IRC_{avg})$$

where:

IRCavg = Average over 12 weeks

On balance, the new capital requirement for the proposed trading book can be modelled as follows:

Proposed Regulatory Total Capital for Market Risk = 3 x VaR Market (99%, 10-day) + 3 x VaR Stressed Market (99%, 10-day) + VaR Incremental Risk (99.9%, 1 year)

The assumptions and implications of the reform are: (i) no specific risk surcharge; (ii) no diversification between VaR incremental risk and VaR market; (iii) perfect correlation between credit losses and market losses; (iv) an issue of double-counting of risks between the ten-day VaR capital calculation and the IRC calculation; (v) the assumption of 'constant level of risk' rather than buy-and-hold for 1 year; (vi) the trading book is on-going, and banks rebalance their portfolio every liquidity period (for example, 1 month).

Regarding settlement risk, the Bank of Italy decided to exercise discretion in allowing prior netting between convertible and offsetting positions in the instrument underlying it. For this purpose, the Bank of Italy has established two procedures by which banks are obliged to process the convertible.[13] In the first case, convertibles are included among debt securities; in the second case, they are allocated among debt securities or equity securities depending on the likelihood of being converted (delta equivalent value).[14] When opting for the latter, the bank is obliged to apply it for each security having the same characteristics.

Moreover, before entry into force of the regulatory technical standards established by the European Banking Authority for the purposes of assessment of own funds requirements for position risk, foreign exchange risk and for commodity risk, the Bank of Italy exercised its discretion, allowing application of the national treatment to options and warrants existing before 31st December 2013. Thus, banks compute own funds requirements for the gamma factor – delta change rate – and for the vega factor – that measures the sensitivity of the option's value to a small change in underlying market price volatility.[15]

Other options were adopted by the Italian regulator when the Capita Requirements Regulation (CRR) was approved for the credit risk capital requirement revisited in Basel III.

(i) *Standardised Approach*. In accordance with the possibility allowed by article 113 (6) of the Capital Requirements Regulation, the Bank of Italy decided to fix a risk weight factor of 0% for banking exposures with counterparties belonging to the same banking group, with the exception of those giving rise to Common Equity Tier 1, Additional Tier 1 or Tier 2 items.

Moreover, with Circular no. 285, the Bank of Italy exercised its discretion, set forth in article 129 of the CRR, regarding the preferential treatment of covered bonds, provided that the institution investing in covered bonds is able to demonstrate to the competent supervisory authority that they receive portfolio information on the value of outstanding covered bonds, their geographical distribution, loan size, interest rate, currency risks, maturity structure and the percentage of loans more than 90 days past due, and that the issuer makes this information available at least every 6 months. In this case, when a credit assessment drawn by an elected ECAI is available, a risk weight factor as specified in Table 4.2 applies.

On the other hand, when an eligible external credit assessment is not available, a risk weight on the basis of those assigned to senior unsecured exposures to the issuing company applies. In particular, if the exposures to the issuer have a risk weight of 20, 50,

100 and 150 per cent, a risk weight of 10, 20, 50 and 100, respectively, will be assigned to the covered bonds.

Finally, for banks using the standardised approach for credit risk evaluation, as regards exposures secured by mortgages on residential property or by commercial immovable property, the Bank of Italy, where appropriate and based on considerations relative to financial market stability, can set a risk weight factor higher than of those established by CRR. In both cases, the risk weight factor can increase to 150% as opposed to 35 and 50%, respectively.

As regards the assessment of risk weight exposure amounts, consistent with article 113 (7) CRR, the Bank of Italy provided specific provisions aimed at ensuring alignment of institutional protection scheme activity with supervisory functions and with banking crisis discipline. This means that with the exceptions of exposures giving rise to Common equity tier 1, additional tier 1 and tier 2 items, credit institutions can apply a risk weight factor of 0% to exposures to counterparties with which they have entered into institutional protection schemes. Note that in December 2011, in compliance with the regulatory provisions stated in Basel III regarding liquidity standards, mutual banks established the Institutional Guarantee Fund (Fondo di Garanzia Istituzionale) which allows a risk weight of 0% for exposures between banks taking part in this Fund, as mentioned in Chapter 9.

(ii) *Internal Rating Based Approach*. When the Internal Rating Based system is used, depending on what is allowed by article 164 (5) CRR, the Bank of Italy can set, without compromising financial system stability, higher minimum values of exposure weighted average LGD for exposures secured by property located in Italy.

The Bank of Italy exercised national discretion on the treatment of equity exposures allowed by article 495 (1) CRR, stating that, until 31st December 2017, the national supervisory authority may exempt from IRB treatment certain categories of equity exposures held by institutions and EU subsidiaries of institutions in a Member State as at 31st December 2007. For these categories, published by the Bank of Italy, the Standardised Approach to computing capital requirements will be used.

4.3.2. Definition of regulatory capital

Capital requirements rules (along with remuneration policies) were introduced into the Italian regulatory system with Bank of Italy interventions and communications on 30th March 2011[16] and on 4th May 2011, respectively.[17] Analysis of the impact of regulatory changes

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has not been estimated by the Italian supervisory bodies, since the EU rules to be introduced did not allow any degree of discretion to member States.

Prudential regulation devoted to the definition of bank capital has mainly focused on two issues:

1. the features of items accepted as capital;
2. the definition of deductions.

The Directive defines the economic features of innovative and non-innovative instruments to include in base capital (hybrids) in terms of duration, payment flexibility and loss absorption capacity.

The notion of core tier 1 or common equity was also introduced, limited to ordinary shares. In this case there is no cap for the regulatory capital (RC) definition. Regulatory capital cannot be applied to instruments that give loss absorbing privileges to owners of on-going concerns and non on-going concerns, while instruments with a constrained dividend distribution are accepted. The application of these criteria implies that privileged and saving shares will not enter the core capital definition, since they do not fully absorb losses, besides giving advantages in case of liquidation. Moreover, they usually offer privileged remuneration mechanisms linked to nominal value. Privileged and saving shares will continue to remain within the Tier 1 definition for 30 years (grand-fathering). The impact of this rule is that only ordinary shares or limited privilege of earnings distribution can be computed in core Tier 1. The privilege cannot be a fixed payment or linked to the nominal value. The clause to pay a multiple of the dividend distributed by the ordinary shares is accepted.

Overpriced shares for those stocks which cannot be computed within bank capital are calibrated in terms of their capacity to absorb losses. If characterised by the same features as the overpriced ordinary share amount, they can be computed in Tier 1.

Cooperative banks are allowed to compute their shares, under the constraint that the supervisory body has the right to veto payback of the nominal value in the case of termination of the shareholder, as it could affect the equilibrium of the bank.

There are four major innovations:

a) Bank capital is empowered, especially by introduction of automatic cancellation of interest payment when the bank is under the minimum capital requirement. Again, the clause to pay interest delivering shares (ACSM) is not allowed. Innovative instruments will include a nominal value cut or transformation of share mechanisms.

b) The limit to including these instruments has increased from 20% to 50%. In case of payment in advance or contract maturity, the limit is 15%.

c) A new category has to be converted into common equity in a contingency situation (particularly when the bank is under the capital requirement) or if the Bank of Italy foresees a potential danger for idiosyncratic or systemic equilibrium. These instruments can be contingent convertible bonds (Co.Co.s) or bail-in bonds. The computational limit here is 50%.

d) Banks can apply the prudential treatment described by article 49 of the CRR concerning the possibility of "not deducting the holdings of own funds instruments of a financial sector entity in which the parent institution, parent financial holding company or parent mixed financial holding company or institution has a significant investment". In this case, the shareholdings are considered equity exposures and are risk weighted in line with the bank's approach to credit risk (Standardised or Internal Rating Based approach). Moreover, relative to the required level of own funds, the Bank of Italy decided not to exercise its discretion to allow authorised banks to use Advanced Measurement Approaches to hold a floor lower than the Basel I floor (8%).

The second issue concerns deduction from Tier 1. The Bank of Italy instruction (Circolare n. 263, Titolo I, Capitolo 2, Sezione II, paragrafo 1.1, lettera b6) is now compliant with CRD III (Article 1, paragraph 6), which substantially extended the capital requirement, previously applied to the trading book (CRD II), to the banking book, measured at fair value.

Primarily, value changes introduced for regulatory purposes added to the balance sheet are expected to be deducted from regulatory capital.

Moreover, for securitisations subject to the most penalising risk weight (1250%), it is now possible to choose between a capital requirement or a deduction from the bank capital (50% from Tier I, 50% from Tier II), irrespective of its classification in the trading or banking book.

Since introduction of the new capital rules in Italy, the impact has been slow, compared with EU bank averages in the period from December 2011 to June 2013, when Core Tier 1 for a sample of 60 large banks increased by about 1.7% (from 10 to 11.7%). The five largest Italian groups are on average less capitalised, though the gap has narrowed significantly (Figure 4.1)

4.3.3. The timing of the introduction of new Basel III rules in Italy

Quality and quantity for bank capital, along with some buffers to increase protection of the economic system from financial contagion are the core of the Basel III framework, translated into the CRD IV Directive.

Regulators' options for managing the grand-fathering period (2014 to 2019) in a phase of recession or slow growth become significantly important.

All national regulators were asked to study the impact of different options, and a Bank of Italy document was published on 5th November 2013, stipulating:

a) full application as of 1st January 2014;

b) application of capital requirements, exactly like option (a), but Tier 1 at 5.5% instead of 6% and a phasing-in for deductions;

c) use of large discretions to ease the introduction of capital deduction and conservation buffer, along with application of capital requirements foreseen in the last stage.

One of the main issues is the weight of EU sovereign bonds in the available-for-sale book, especially for Italy and the other Euro peripheral countries.

The quantitative impact study was run on data of 30th June 2013 on a sample of 15 bank groups (70% of Italian bank total assets). The outcome was that the capital need for 2014 would be 0.6 billion euros in the case of option (a).

For smaller banks, the proportionality criterion was revised in order to reduce the operational complexity (art. 108 TUB) required at some banks to be compliant with the capital regulation, along with the minimum standard needed to ensure safe and sound banking activity.

4.4. Liquidity risk and the Italian regulatory options

In accordance with article 8(2) CRR, the Bank of Italy allows banks belonging to a banking group freedom from the provisions on liquidity coverage requirements on an individual basis. The liquidity requirements of CRR have to be followed by the parent institution on a consolidated basis; moreover, when significant and necessary, the Bank of Italy allows individual institutions to manage their liquidity centrally at sub-group level.

If the waiver affects institutions authorised in more than one Member State, the Bank of Italy may refuse, in full or in part, the application of the provisions on liquidity coverage requirements on an individual basis towards banks and one or more of their subsidiaries, and supervise them as a single liquidity sub-group. In accordance with article 8 (1) CRR, in order to avail of this waiver it is necessary to fulfil the following conditions: a) the parent

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institution complies with the obligations on liquidity coverage required by Part Six of the CRR on a consolidated basis, or a subsidiary institution complies on a sub-consolidated basis, b) the parent institution on a consolidated basis or the subsidiary institution on a sub-consolidated basis monitors and has oversight at all times over the liquidity positions of all institutions in the group or sub-group, that are subject to the waiver and ensures a sufficient level of liquidity for all of these institutions, c) the institutions have entered into contracts that provide for free movement of funds between them, enabling them to meet their individual and joint obligations as they come due, to the satisfaction of the competent authorities, d) there is no current or foreseen material, practical or legal impediment to the fulfilment of the contracts referred to in (c).

If banks satisfy the conditions mentioned above and avail themselves of derogations to the application of the provisions on liquidity coverage requirements on an individual basis, the Bank of Italy can also refuse to apply, in full or in part, the provisions on liquidity risk provided by article 86 of CRD IV.

With regard to the liquidity coverage requirement, the Bank of Italy, in accordance with article 460 CRR, exercised the discretion that allows it to impose a requirement for a higher liquidity coverage requirement up to 100% until the binding minimum standard is fully introduced at a rate of 100%.

Where an institution does not meet, or expects not to meet the liquidity coverage requirement or that on stable funding, the Bank of Italy can allow a lower reporting frequency and a longer reporting delay until compliance is restored. The Bank of Italy grants such authorisation based on the individual situation of an institution, and taking into account the scale and complexity of the institution's activities.

With regard to the reporting of liquidity assets, pending specification of a uniform definition, the Italian regulator provides general guidance that institutions have to follow in identifying assets of high and extremely high liquidity and credit quality.

The Bank of Italy exercised its discretion concerning liquidity outflows, establishing an outflow rate of 5% for trade finance off-balance-sheet related products. In accordance with Annex I of the CRR, off-balance-sheet items characterised by a low-medium risk are (a) documentary credits in which underlying shipment acts as collateral and other self-liquidating transactions, (b) warranties and guarantees that are not considered credit substitutes, (c) irrevocable standby letters of credit not characterised as credit substitutes, (d) shipping guarantees, customs and tax bonds, (e) undrawn credit facilities with an

original maturity of more than one year, (f) note issuance facilities (NIFs) and revolving underwriting facilities (RUFs) and (g) other items also carrying medium risk and as communicated to the European Banking Authority.

Under article 421 (3) CRR, the Bank of Italy established that credit institutions have to identify retail deposits subject to different outflows according to criteria set by the European Banking Authority. Moreover, under article 422 (4) CRR, in the absence of a uniform definition, the Bank of Italy provides general guidance for banks to follow in identifying deposits maintained by the depositor in a context of an established operational relationship.

In accordance with the national discretion provided by article 422(8) CRR, the Bank of Italy allows banks authorised in Italy to apply a lower outflow percentage, on a case-by-case basis, to liabilities different from those regulated by article 422 (7).[18] Banks authorised in Italy intending to avail themselves of such preferential treatment need prior authorisation from the Bank of Italy. Moreover, the Bank of Italy, working together the supervisory authority of other Member States (article 20 CRR), can waive the conditions according to which the institution and the depositor are established in the same Member State, to enjoy application of a lower outflow percentage.

With regard to inflows, banks that intend to become fully or partially exempt from the limit of 75% inflows, where the provider is a parent or subsidiary institution of the institution or another subsidiary of the same parent institution or linked to the institution by a relationship [according to article 12(1) of Directive 83/349/EC], need prior authorisation from the Bank of Italy.

In accordance with the national discretion set out in article 425 CRR, the Bank of Italy allows banks authorised in Italy to apply a higher inflow percentage, on a case-by-case basis, for credit and liquidity facilities when all the conditions in paragraph 4 are met.[19]

As we saw for outflows, this preferential treatment can also be allowed when banks and depositors are not established in the same member state. Again, in these cases the rules defined in article 20 (1, b) CRR are applied. As regards the stable funding requirement, the Bank of Italy exercised its discretion to maintain or introduce national provisions before binding minimum standards for net stable funding requirements are specified and introduced in the Union. The Italian regulator established that, where a credit institution does not meet, or expects not to meet the requirement on liquidity coverage or the general obligation on stable funding, it can request a lower reporting frequency and a longer reporting delay than ordinarily established. This waiver may be granted based on the

individual situation of the credit institution and taking the scale and complexity of the institution's activities into account.

Finally, until the full introduction of binding liquidity requirements, the Bank of Italy continues to collect information for the purpose of monitoring compliance with existing national liquidity standards.

5. The consolidated supervision of banking groups

The increasing integration of banking systems, the formation of groups of systemic importance operating in the domestic and cross-border markets, and the priority of new risks to financial stability require greater cooperation between authorities to preserve stability, ensure equal competitive conditions and encourage the reduction of costs for intermediaries.

At the end of 2013, there were 232 Italian banking groups and 5102 underlying legal entities within these groups. In Italy, banks can engage in any other financial activity except those exclusive to non-bank entities. Banks increasingly belong to banking groups, which comprise: the Italian parent bank and its banking, financial and instrumental subsidiaries, or the Italian parent financial company and its banking, financial or instrumental subsidiaries, provided that the group of subsidiaries includes at least one bank and the banking and financial companies have a significant stake in it.

The development of banking groups has always been a source of concern for the authorities involved in the supervision of financial intermediaries because of the issues raised by this phenomenon from the prudential supervision point of view. In fact, in the case where each individual group entity is subject to supervision, the conglomerate should also be evaluated as a subject in its own right, with peculiar characteristics in relation to the individual firms that form the group.

The issue of consolidation is regulated by three Community directives and their respective transposing laws. This defines general provisions for supervisory authorities of Member States, in order to give a general idea of supervision of credit institutions on a consolidated basis.

The first time that the issue of supervision of credit institutions on a consolidated basis entered the European policy agenda was with Directive 83/350/EC. The aim was to eliminate the differences between Member States' legislations. For this purpose, some

important topics, such as credit Institutions, financial Institutions, participation, supervision, and competent authorities, were clearly specified. Credit institutions are supervised on a consolidated basis under the principle of *home-country control.* In Italy, the directive was implemented with Law no. 114/1986,[20] which defined the Bank of Italy as the national Authority empowered to conduct consolidated supervision of banking groups. Controlling capital adequacy, including making inspections to guarantee the truthfulness of data, was one of the tasks attributed to the Italian Banking Authority.

The implementation of Directive (92/30/EC) on consolidated supervision of credit institutions represented an important evolution of Directive 83/350. Financial holding companies were defined as financial institutions with credit institutions as subsidiaries, mixed-activity holding companies as parent undertakings different from financial holding companies, parent undertakings as companies that had a dominant influence in the shareholders meeting, and subsidiaries over which a parent undertaking effectively exercises a dominant influence. The control of bank solvency, capital adequacy, and the role of promoting cooperation and exchange of information between Member States, was also assigned to the Bank of Italy.

In Italy, directive 92/30/EC was transposed with legislative decree no. 528 of 30th December 1992, later repealed by legislative decree no. 385/1993 (Banking Act), which concluded the evolution of the banking law, including for the regulation of banking groups.

The consolidated supervision of banking groups is the set of controls carried out by the Bank of Italy through *the Banking Group Supervision Department,* which carries out supervisory tasks on a consolidated basis, as well as on single components of the group – this applies to all intermediaries in the group with the exception of asset management firms (SGR, società di gestione del risparmio).

Financial players considered under the function of consolidated supervision of banking groups, are: a) companies belonging to a banking group, b) banking and financial companies, owning at least 20% of the companies belonging to a banking group or a single bank, c) banking and financial companies, which are not part of a banking group but controlled by the legal entity controlling a banking group or a single bank, d) financial companies having their legal office in another EU country, who control a parent or a single Italian bank, when these companies are included in the consolidated supervision responsibility of the Bank of Italy; e) banking and financial companies controlled by persons under point (d).

In the Consolidated Banking Act, "banking group" is a set of banking, financial and instrumental companies (companies with activities that have an auxiliary nature of 'activities of other companies in the group'), to which one bank from the territory of Italy is the parent company.

The parent company shall notify the Bank of Italy of the existence of the group, and its current composition, even though it might differ from what was communicated by the parent company.

The tasks of the parent company involve management, coordination and control of the companies composing the group mainly by issuing provisions, whose ultimate aim is the stability of the group of companies. The Directors and Board members of these companies are asked to provide any information for the enactment of provisions and the necessary cooperation in order to comply with the rules on consolidated supervision.

Regarding the topic of Banking and Credit, the Consolidated Act provides triple supervision:

(i) Informative supervision. The Bank of Italy requires that financial entities transmit, even periodically, information and data on any relevant events. It determines terms and methods for the transmission of events, data and information, and it can also require certification of the financial statements provided by regulated entities.

(ii) Regulatory supervision. The Bank of Italy has the power to give the parent company provisions regarding the banking group as a whole, or its components, concerning capital adequacy, risk management, shareholdings and other participations, administrative and accounting procedures and internal controls.

(iii) Inspective supervision. The Bank of Italy may carry out inspections to examine issues and require the submission of documents and records. It may request the competent authorities of another EU country to carry out investigations at the companies, established in that State, or rather agree on other methods of control and it may conduct inspections at the companies with registered offices in Italy included under the supervision of the applicants.

In order to strengthen consolidated prudential supervision and to allow information exchange between the competent authorities and organisations, Directive 95/26/EC of 29th June 1995 aimed to reinforce and develop some important definitions. The term "financial institution" disappeared, and was replaced by Insurance or Investment Company in line with

the activity of the company, as well the term "close connection" defined as participation, about 20% of the capital share of the subsidiary, implying a dominant influence.

The Directive was implemented in Italy by Legislative Decree no. 333/1999 "Implementation of Directive no. 95/26/EC on strengthening the prudential supervision of credit institutions". Modifying the Banking Act, this decree introduced the Pension Funds Authority (COVIP). As provided by the Directive, Legislative Decree no. 333/1999 reiterated the secrecy of the information processed by the Bank of Italy, which can be exchanged with other responsible organisations for "sectorial" supervision (CONSOB, COVIP, ISVAP and UIC), and with Control Organisations of other Member States. Although the regulation was aimed at improving the effectiveness of supervisory rules for financial conglomerates that have widened the range of business lines and the geographical area of operability, the Italian implementation failed to underline the importance of proportional guidelines. In other words, the set of rules were addressed to all financial and credit institutions within groups, without any practical consideration of size and business complexity.

Moreover, systemic risk was not seen as a priority for Italian (and European) regulators whose assumption was that by ensuring extended supervision to all financial players in the market, contagion was impossible.

Finally, the solution of specialising authorities by sectors and goals biased the capacity to centralise the supervision of financial players that could combine different kinds of businesses and risks. To counterbalance the issue, the Bank of Italy chose to ease the transformation process from financial firms to banks, liberalising *de facto* the banking market.

6. Supervision on financial groups and conglomerates

6.1. Regulating financial conglomerates. Scope and rationale

The deregulation of domestic financial markets recorded between the 1980s and the 1990s, along with the globalisation of financial markets, led to new business approaches in more highly competitive and integrated markets. The competition faced in the last twenty years has paradoxically driven financial institutions towards concentration through mergers and acquisitions. The rationale of the conglomeration processes of financial institutions was to create an organisation that could exploit the economies of scale and scope that existed between different financial sectors. Moreover, from an economic point of view, a financial conglomerate had better diversification in terms of revenues and risks.

The possibility of entering different legal and business entities for different and independent financial activities through formation of a financial conglomerate constituted an important competitive factor.

In Italy, the banking group was subject to the regulation and supervision of the Bank of Italy on a consolidated basis. The scope and performance of consolidated supervision was regulated by law, according to the model applied to individual banks.

As a consequence of the specialisation principle that characterised the Italian financial system until mid-1990s, the system of sector-based supervision was weakened by the deregulation process promoted by the EU starting late in the 1980s weakened the system of industry-based supervision that characterize the Italian financial system until mid-1990s. The conglomerates arising from this integration had to deal with different types of risk that highlighted the unsuitability of the traditional prudential sector-based supervision.

For instance, while insurance supervisors were historically concerned with the liability side of the balance sheet as the main factor to protect, regulations in the banking sector regarded the asset side of the balance sheet as the principal source of risk. Finally, securities supervisors required securities firms to have sufficient liquid assets to promptly repay all liabilities at any time.

Towards the end of the 1980s, the growing convergence between the different sectors of the financial system and the creation of large financial groups, also across borders, that provided services in different financial sectors, led to overlapping risks. The European Commission and the Member States dealt with this issue at the beginning of the 1990s with the creation of the Tripartite Group of Bank, Securities and Insurance Regulators[21] which produced a comprehensive report showing a detailed analysis of the prudential issues and formulated specific policy recommendations.[22] However, a wider international partnership to deal with the issue of financial conglomerates supervision took place in 1996 with the *Joint Forum*[23] that published its recommendations in February 1999.

In compliance with the Joint Forum results, the first step towards a common framework on supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate was introduced in 2002 with the Directive 2002/87/EC,[24] and applied in January 2005. For the first time, the supplementary supervision of financial conglomerates on a group-wide basis was introduced.[25] The supplementary supervision did not refer to the consolidated basis like the supervision provided by the sectorial rules, but followed the "solo-plus" approach.[26]

Analytical thresholds were established in order to identify a financial conglomerate. They had to be followed for three consecutive years so as to avoid sudden regime shifts.[27]

Along with the provisions concerning capital adequacy, risk concentration, intra-group transactions, internal control mechanisms, and risk management processes, the introduction of the *co-ordinator* figure was an important innovation of the supplementary supervision. The goal of introducing this figure was to support the cooperation between different supervisory authorities and to solve the problem of overlapping roles of supplementary supervision.

In Italy, Directive 2002/87/EC was adopted on 30th May 2005 with Legislative Decree no. 142 entitled *"Enforcement of directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate as well as in the institution for preliminary consultation in the area of insurance".* The Italian legislator completely adopted the community rules. In compliance with the Directive, the obligation of cooperation and exchange of information between competent authorities was also established in Italy.[28] The cooperation was aimed at identifying the financial conglomerates subject to supplementary supervision, and the methods and criteria to measure the capital adequacy of financial conglomerates.

The regulated entities in a financial conglomerate had to ensure that own funds available at the level of the financial conglomerate were always at least equal to the capital requirements as calculated in accordance with one of the methods provided by the Directive. With the intent of avoiding the *double gearing* of regulatory capital,[29] the supervisory authorities established implementation of the "accounting method".[30] The evaluation of capital adequacy had to be carried out at least once a year, either by the regulated entities or by the mixed financial holding company.

Legislative Decree no. 142/2005 stated that regulated entities had to report any significant risk concentration at the level of the financial conglomerate to the competent supervisory authority (the coordinator) on a regular basis and at least annually. Since financial difficulties recorded by some entities of a conglomerate may infect other healthy ones, intra-group transactions can significantly magnify problems for a regulated entity once contagion spreads. The monitoring of intra-group transactions is therefore an important instrument for dealing with the risk of contagion within a financial conglomerate. The significant intra-group transaction threshold is defined by the coordinator and is based on the eligible own fund or technical reserves, when insurance companies are involved.

The competent supervisory authorities, by specific agreements of coordination, are allowed to set stronger quantitative limits aimed at achieving the objectives of supplementary supervision.

Legislative Decree no. 142/2005 established that financial conglomerates must have adequate risk management processes and internal control mechanisms and in order to ensure supplementary supervision, the coordinator has to judge such procedures and instruments.

Another important core issue of supplementary supervision is the exchange of information between competent authorities. Legislative Decree no. 142/2005 stated that in following supplementary supervision, the coordinator and the competent authorities responsible for the supervision of regulated entities in a financial conglomerate have to provide all relevant information and communicate all essential information of their own initiative. This provision brought an important change in the supervision of insurance undertakings. The Italian Supervisory Authority on Insurance Undertakings (ISVAP) has to exchange information with the competent authority of a Member State responsible for the supervision of credit institutions or investment firms, before giving an authorisation to an insurance undertaking. As a consequence of these provisions, an agreement between Bank of Italy and ISVAP for the coordination of supplementary supervision was signed on 16th November 2005.[31]

6.2 Directive 2007/44/EC. Towards the end of the banking industry separation principle

After adoption of Legislative Decree no. 481/92, transposing European Directive 89/646, the banking industry separation principle did not change. Its objective was to avoid situations where industrial shareholders could undermine the independence of banking choices and therefore compromise the sound and prudent management principle. To achieve this, article 19 stated that "*Prior authorisation by the Bank of Italy shall be required where the acquisition, in whatever capacity and by whomever effected, of significant holdings in a bank and in any case the acquisition of shares or capital parts that would result, taking account of shares or capital parts already held, in a holding which exceeds 5 per cent of the voting capital of the bank".* Moreover, "*Prior authorisation by the Bank of Italy shall also be required for variations in significant holdings which would result in holdings which exceed the limits established by the Bank of Italy or which, regardless of such limits, would result in control of the bank".*

The separation principle concerned the influence played by non-financial shareholders over banking decisions. Agents who, through subsidiary companies or otherwise, are engaged in significant business activity in sectors other than banking and finance could not be authorised to acquire holdings when the total share of voting rights exceeded 15 per cent or when there was substantial control of the bank.[32]

The Bank of Italy was granted the power to refuse or revoke authorisation in the case of agreements affecting a significant concentration of industrial companies, and the power to appoint or remove a majority of the directors or the members of the supervisory board of a bank, if its sound and prudent management was jeopardised.[33]

Many scholars have criticised the bank industry separation principle and questioned its effectiveness for banking system stability and compliance with the sound and prudent management principle. A new regulation on procedural rules and evaluation criteria for prudential assessment of acquisitions and increase of holdings in the financial sector was adopted with the Directive 2007/44/EC. The Directive was based on the principle of *maximum harmonisation* of the procedural rules and assessment criteria throughout the EU. The main goal was to make sure that all acquisitions of a qualifying holding were treated in the same way throughout the EU and across sectors.

In Italy, Directive 2007/44 was adopted on 27th January 2010 with Legislative Decree no. 21/2010, relatively late in relation to the deadline implementation date of 21st March 2009. Legislative Decree no. 21/2010, modifying article 19 of the Banking Act, sets forth that "The *Bank of Italy approve in advance any direct or indirect acquisition in a bank of holdings that assign the control or which make it possible to exercise a significant influence or that assign a share of voting rights or capital of at least 10 per cent* (up from the previous 5 per cent)*, taking into account the shares or units already owned*".

The Bank of Italy was granted the power to approve in advance changes in holdings when the share of voting rights or capital reaches or exceeds 20 per cent or higher thresholds, and in any event when changes result in the acquisition of control of the bank.[34] This prior approval is necessary whether the agent acts alone or in concert.

Before adoption of Directive 2007/44/EC, Decree Law no. 185/2008 had formerly abrogated some provisions of the Banking Act (art.19, sub 6-7) establishing that subjects who through subsidiary companies or otherwise, engaged in significant business activity in sectors other than banking and finance could request the authorisation of the Bank of Italy to acquire holdings even when the total share of voting rights held exceeded 15 per cent or when the

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acquisition involved control of the bank. This can be considered the formal conclusion of *the bank-industry separation principle*.

Discipline of markets in financial instruments experienced important changes. New regulations on procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase in holdings in the financial sector, also applicable to the Italian Investment Companies (SIM), were introduced.[35] The main changes affected the thresholds in addition to the obligation of prior communication to the competent supervisory authority.

Finance Act (art. 15) established that "*any person who for any reason intends to directly or indirectly acquire or dispose of a controlling investment or an investment that could have a significant influence in an Italian investment company, asset management company or SICAV, or an investment that assigns a share of voting rights or capital of at least 10 per cent, taking into account the shares or units already owned, must notify the Bank of Italy in advance. Advance notice must also be given for changes in investments when the share of voting rights or capital reaches or exceeds, upwards or downwards, 20 per cent, 30 per cent or 50 per cent, and in any event when changes result in the acquisition or loss of control of the company".*

The Bank of Italy may ban an operation when it considers that the company's behaviour is not compliant with the safe and sound management principle.

Issues caused by removal of the separation between banks and non-financial companies arise from conflicts of interest between lenders and borrowers who are directly involved in the bank's corporate governance. As already seen in Chapter 7, large exposure limits are lower when the borrower is a major shareholder. Italy also introduced the responsibility of the Board where loans are delivered to "correlated" individuals or legal entities. The Board of directors is asked to question the convenience of the credit decision and the ensure that pricing is coherent with market conditions.

Banks must approve the Policy for the management of transactions with persons in conflict of interest who are identified as related parties pursuant to CONSOB Regulation 17221/2010; and associated persons pursuant to Bank of Italy Circular 263/2006 (Title V, Chapter 5) who, jointly considered, fall under both categories of the related parties and associated persons.

According to the Bank of Italy, related parties are:

a) Corporate Officers of banks and of supervised intermediaries;

b) participants of banks and supervised intermediaries (that is, parties who have to obtain Bank of Italy authorisation to hold bank capital, pursuant to section 19 et seq. of Legislative Decree no. 385/1993);

c) parties other than participants who by themselves are able to appoint one or more members of the management or strategic supervision bodies of banks and supervised intermediaries, including on the basis of agreements, however stipulated, or clauses in the Articles that explicitly or effectively cover the use of such rights or powers;

d) companies or businesses, even if not incorporated as a company, over which banks and supervised intermediaries or a company of the Banking Group can exercise control or significant influence.

Connected persons are:

e) companies or businesses, even if not incorporated as businesses, that are controlled by a related party;

f) parties that control a related party as indicated in letters b) and c) or parties subject, either directly or indirectly, to common control with the same related party;

g) close relatives of a related party and the companies or businesses controlled by the latter.

In the Italian regulations there is some dissimilarity between the Bank of Italy and Consob regulations. The Consob definition of related parties refers to:

1) parties who directly or indirectly, including through subsidiaries, trustees or intermediaries:

   a) control the bank, are controlled by the bank or are under common control;

   b) hold a stake in the bank such as to be in a position to exert significant influence over the latter;

   c) exercise control over the bank jointly with others.

2) associated companies of the bank;

3) joint ventures in which the bank is a participant;

4) key management personnel in the bank or its controlling company (including executive and non-executive directors and statutory auditors and their substitutes);

5) close relatives of one of the persons referred to in (1) or (4);

6) entities in which a person referred to in (4) or (5) exercises control, joint control or significant influence, or directly or indirectly owns a significant percentage (no less than 20%) of voting rights;

7) supplementary pension funds, collective or individual, Italian or non-Italian, established by the bank, as well as funds over which the bank can exercise influence.

The asymmetric regulation and ease with which these rules could be by-passed prompted a number of extreme events that also led to unsafe and unsound behaviour and are difficult to combat without any stronger and enforceable set of rules.

7. Large exposures

7.1. Italian measures previously applied

The first legal measure on large exposures was introduced in 1926 (art. 16, Law no. 1830 of 6.11.1926), followed by the Banking Law of 1936 (art. 35, point b), capping the maximum underwriteable loan at 20% of the equity and reserves of the bank. The Bank of Italy was allowed to give discretional authorisations.

In the 1970s, the banking system was in the habit of asking for "exceptional" authorisations, the Bank of Italy introduced two instructions (30.3.1973 and 4.6.1976) with the goal of insuring a higher level of autonomy and flexibility. They were based on the ideas of "excess loan", "individual credit limit" and "global maximum credit".

a) the excess loan was a direct or indirect loan (or a new loan) with or without collateral exceeding the limit of 20% of bank capital;
b) the individual credit limit was the maximum loan a single bank could underwrite without any authorisation from the Bank of Italy: it was equal to the whole bank capital;
c) the global maximum credit was the sum of excess loans a single bank could originate without authorisation. The amount was limited by the capital to deposit ratio (a leverage indicator), with a maximum of 40% of deposits for banks with a ratio higher than 8%, and a minimum of 25% of deposits for those with a 3% ratio.

When the risk-weighted assets capital adequacy principle was introduced (Chapter 4) the previous regulation on large exposures lost any restrictive effectiveness.

On the 22nd December 1986 an EEC recommendation on large exposures was approved, followed by more restrictive changes in Directive no. 121 of 21st December 1992. The issue of large exposure was introduced in Italy with Directive 92/121/EC, where articles 3 and 4 define large exposure as loans or mortgages absorbing more than 10% of the regulatory capital.

7.2. The Italian implementation of the Directive

The Directive was transposed with a Finance Minister Decree signed on the 22nd June 1993 (no. 242633) and with the Bank of Italy Instructions in October 1993.

The Italian choice was to apply more restrictive limits to all credit institutions, without any size, legal or business distinction. Lending activity was restricted by the introduction of two quantitative constraints: an individual and a global limit.

a) The individual limit defined the maximum sum of loans allowed to a single counterparty, namely up to 25% of the regulatory capital. This limit was reduced to 20% when borrowers are connected to each other and increases to 40% for legal bank entities within conglomerates.

b) The global limit fixed the cap for banks concentrating their loans in large exposures at 800% of the regulatory capital.

Finally, double consolidation was introduced: the consolidation of borrowers and the consolidation of lenders, including every credit institution and its parent and subsidiary companies.

7.3. Directives 2006/48 and 2006/49

In 2006 two important Directives were approved. Directive no. 48 introduced a definition of regulatory capital based on two components:

- base capital;
- supplementary capital.

Supplementary capital could not be higher than base capital. The minimum capital requirement was 8% of risk-weighted assets. A large exposure was above the limit of 10% of the capital of a credit institution.

Directive no. 49 introduced some requirements to control and calibrate risks of investment and credit institutions.

7.4. The Italian implementation of the Directives

The adoption of Directive 49 on large exposures applied to banks (Instruction no. 263/2006), financial firms ex art. 107 TUB (Instruction no. 216/1996) and SIMs (Regulation 24/10/2007).

When defining "large exposures", the Bank of Italy considered all the criteria established by the Directive. In particular, all forms of exposure were taken into account, irrespective of the kind of borrower. Balance and off-balance-sheet exposures were considered. Credit protection providers writing insurance or derivative contracts (e.g. CDS) had to be added to the total of all the other exposures to the same counterparty. Borrowers were all the clients or network of clients whose value was higher than 10% of regulatory capital (article 108).

Fixing the limits for banks, the Bank of Italy chose the most favourable options. This criterion did not apply to the limit for exposures to connected persons, for whom the more stringent limit established by the Directive was adopted, in line with existing supervisory regulations.

The Bank of Italy allows assets constituting claims and other exposures on recognised third-country investment firms and recognised clearing houses and exchanges to be treated like comparable claims on institutions. In some particular cases checked by the supervisory body, competent authorities may permit institutions which are allowed to use the alternative determination of own funds to use that determination for the purposes of reporting and compliance with limits or temporal breach of limits.

According to the Italian application, loans fully covered by bank capital can only be excluded from the computation if the absorbed capital is deducted from the banks' own funds. All large exposures are expected to be reported to the Bank of Italy, even by financial intermediaries based in other EC countries.

As part of the Bank of Italy's inspections, the supervisory body investigates whether the banks under scrutiny have adopted an organisational structure able to monitor the existence of and changes in large exposures.

The most important discretional decisions are:

a) the discipline fixes the upper boundary of an exposure at 25% of capital. This limit can be exceeded, in particular by small banks, in three cases: when the amount is under 150 million euros; when global exposure to bank-related customers is less than 25% of the capital; when the bank estimates that exposure is within the risk appetite and in any case below the limit of 100% of capital; when the counterparty is a banking group the limit is 40%;
b) in the case of intra-group loans to EU banks, the Bank of Italy applied zero weighting when legal entities under home country control are involved;

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c) zero weighting was introduced for daily and intra daily margins paid to the Cassa di Compensazione e Garanzia by clearing members.

Starting from the observation that "one of the key lessons of the financial crisis is that banks did not always consistently measure, aggregate and control exposures to single counterparties across their books and operations", in March 2013 the Basel Committee proposed consultation for a document titled "Supervisory framework for measuring and controlling large exposures", aimed at reducing concentration risk, especially in terms of counterparty exposures (over-the-counter positions). An often debated issue is the level of discretion that banks are allowed to have for their own managerial choices regarding measurement of related capital, the perimeter of borrowers, and the effectiveness of internal controls.

7.5. The Italian options with the CRD IV

The Bank of Italy decided to exercise the discretion allowed for large exposures. Regarding article 493 (3) CRR, the Italian Supervisory Authority stated that a 0% risk weight factor will be applied to (i) exposures, including shares, held by a bank or banking group in its parent undertaking or its own subsidiaries, when they are subject to supervision on a consolidated basis in a Member State in accordance with the CRR; (ii) exposures arising from minimum reserves held in central banks' accounts denominated in their own national currencies; (iii) exposures to banks and other investment firms that do not constitute an institution's own funds, with duration no longer than the following business day and not denominated in a major trading currency.

Monetary exposures categorised as covered bonds weighted at 10% according to article 129 CRR, are also considered at 10% of their nominal value.

Exposures to local institutions within the European Union are weighted at 20% in accordance with Part III, Title II, Chapter 2 of the CRR. In addition exposures secured by the funded and unfunded credit protection of such institutions, and cash exposures which assume the characteristics of covered bonds are also weighted at 20% according to article 129 CRR.

Off-balance-sheet exposures classified as warranties and guarantees that do not come under the category of credit substitutes (characterised by medium-low risk) and as cash exposures in the form of covered bonds, are weighted at 50% in accordance with article 129 CRR, and are considered at 50% of their nominal value.

Finally, exposures arising from mutual guarantee and categorised as either monetary funds or real financial guarantees granted by mutual banks are considered at 80% of their nominal value. Moreover, the Bank of Italy established that the prudential discipline stated in article 395 CRR concerning limits to large exposures applies to exposures to investment firms in extra-EU States.

8. The evolution of the discipline on investment services

The first attempt to create a single market in financial services dates back to 1993 with the adoption of the Investment Services Directive in 1996[36]. This regulation only implemented an essential level of harmonisation between member states sufficient to secure the mutual recognition of authorisation and of prudential supervision systems (*minimum harmonisation principle*). This introduced a "*single passport*" valid throughout the Community and the principle of home Member State supervision.

The ISD directive also imposed, *inter alia*, significant obligations with regard to transparency and reporting. The heightened level of transparency regarding market transactions aimed to ensure investor protection. The goal of reporting was to ensure appropriate supervision of parties operating in markets.

This chapter describes how Italy regulated market abuse (§ 8.1.) and financial investments (§ 8.2.).

8.1. Market Abuse

In Italy, investor protection against market abuse was ensured for the first time with Law no. 157/1991, which implemented Directive 89/592/EC concerning insider trading and manipulation of the market.[37]

The fundamental notion of "*reserved*" information was defined as "information that has not been made public and has a precise nature relating to one or several issuers of transferable securities or one or several transferable securities, which if it were made public, would be likely to have a significant effect on the price of the transferable securities in question".[38]

The crime of market manipulation was introduced to protect investors and ensure the integrity and correct operation of the transferable securities market against false news that could affect price movements and create unfair profit opportunities.[39]

Directive 2003/6/EC on market abuse (MAD), along with Directive 2002/87/EC on supplementary supervision of financial conglomerates, represented a first step towards the realisation of the Financial Services Action Plan (FSAP) for the harmonisation and reinforcement of the supervisory rules.[40]

The Market Abuse Directive set forth the concept of maximum harmonisation, which meant that Member States could provide neither more lenient nor stricter rules.[41] The EU law on market abuse was the result of implementation, for the first time, of the *law-making method* (Lamfalussy Approach).[42] The Directive, covering insider dealing (or insider trading) and market manipulation, was aimed at ensuring market integrity: "a*n integrated and efficient financial market requires market integrity. The smooth functioning of securities markets and public confidence in markets are prerequisites for economic growth and wealth. Market abuse harms the integrity of financial markets and public confidence in securities and derivatives"*.

In Italy, Directive 2003/6/EC was adopted with Law 62/2005. The major changes introduced in the Finance Act of 1998 related to the *disclosure of inside information* and *market abuse* with particular reference to *insider dealing*.

To disclose market abuse, listed issuers and the entities controlling them *must* make available to the public, *without delay*, inside information that directly concerns them and their subsidiaries. In some cases, regulated by CONSOB, the listed issuers may, under their own responsibility, delay the communication of privileged information to the public, in order to avoid prejudice to their legitimate interests.

According to the Italian rules, inside information is "*information of a precise nature which has not been made public, relating directly or indirectly to one or more issuers of financial instruments or one or more financial instruments and which, if it were made public, would be likely to have a significant effect on the prices of those financial instruments* (*price sensitive information*)*".*[43] It is considered to be of a precise nature if:

a) it refers to a set of circumstances which exists or may reasonably be expected to come into existence or an event which has occurred or may reasonably be expected to occur;

b) it is specific enough to enable a conclusion to be drawn as to the possible effect of the set of circumstances or event referred to in paragraph a) on the prices of financial instruments.[44]

Unlike the previous legislation, the effect of inside information on prices should be measured having regard to normal use in investor decision processes.

Law no. 62/2005 distinguished between primary insiders (*any person who possesses inside information by virtue of his membership of the board, management or supervisory bodies of an issuer, his holding in the capital of an issuer or the exercise of his employment, profession, duties, including public duties, or position*) and secondary insiders (*any person who, possessing inside information and knowing or capable of knowing through ordinary diligence its inside nature, carries out any of the actions referred to therein*).

The alleged crimes are: (a) *use of inside information,* (b) *unjustifiable disclosure of inside information* (*tipping ban* and *tuyuatage ban*) and (c) *use of inside information by subjects who have obtained, directly or indirectly, such information from the primary insider*. Unlike the previous legislation, secondary insiders are criminally responsible for insider trading and tipping.

An important innovation concerns the *duties of disclosure* provided for rating agencies, which for the first time, are required to take reasonable care in producing or disseminating the information related to issuers, ensuring that the information is fairly presented.[45]

It is noteworthy that the latter provisions constitute the first legal provision in Europe aimed at disciplining the duties of rating agencies in the performance of their activity.

Market manipulation refers to the financial instruments listed in a regulated market. According to the Italian Financial Act, market manipulation refers to "*any person who disseminates false information or sets up sham transactions or employs other devices concretely likely to produce a significant alteration in the price of financial instruments*".

With Law no. 62/2005, unlike the previous rules and in order to be compliant with provisions of Directive 2003/6/EC, administrative penalties for insider trading and market manipulation were introduced in addition to penal sanctions. Penalties have also increased:

	D. Lgs. 58/1998	Legge n. 62/2005	
	Penal sanctions	Penal sanctions	Administrative penalties
Insider Trading	Jail Confinement until 2 years Fine from 10.329 to 309.874 €	Jail Confinement from 1 to 6 years Fine from 20.000 € to 3 million €	Fine from 20.000 € to 3 million €
Market Manipulation	Jail Confinement from 1 to 5 years	Jail Confinement from 1 to 6 years Fine from 20.000 € to 5 million €	Fine from 20.000 € to 5 million €

"*Imprisonment between one and six years and a fine between twenty thousand and three million euro shall be imposed on any person who, possessing inside information by virtue of his membership of the administrative, management or supervisory bodies of an issuer, his/her holding in the capital of an issuer or the exercise of his/her employment, profession, duties, including public duties, or position:*

- *buys, sells or carries out other transactions involving, directly or indirectly, for his/her own account or for the account of a third party, financial instruments using such information;*
- *discloses such information to others outside the normal exercise of his/her employment, profession, duties or position;*
- *recommends or induces others, on the basis of such information, to carry out any of the financial transactions."*

The same penal sanctions are established for market manipulation, the only difference being the maximum limit of the fine (five million euros).

Finally, a major innovation introduced by Law no. 62/2005 enabled CONSOB to impose administrative sanctions,[46] and gave it regulatory and inspection powers.

Finally, in order to help regulators identify abuse, financial intermediaries are asked to communicate abnormal cases of investment by customers or employees, in terms of amount, price or concentration, to the supervisory body.

8.2. The impact of the Market in Financial Instruments Directive (MIFID) on the Italian Market

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Technological innovations and increasing complexity of financial markets imposed a review of the Directive 92/22/EC. In April 2004, Directive 2004/39/E
C on markets in financial instruments (also known as MIFID) was approved[47] by the "*Lamfalussy approach*".[48] The rules are structured as "Level 1 Directive"[49] with the most detailed provisions contained in a "Level 2 Directive"[50] and "Level 2 Regulation".[51]
The provisions contained in the Regulation were directly applicable in member states without transposition into national law. Unlike the Investment Services Directive (ISD), MIFID sets the principle of *maximum harmonisation*, according to which the same rules are applied across the EU and single countries can only impose additional requirements in limited circumstances. The Directive is addressed to entities whose regular business is to provide investment services and perform investment activities on a professional basis; the rules are largely aimed at:

- ensuring investor protection (*conflicts of interest* and *best execution rule*);
- reinforcing market integrity and transparency;
- promoting competition between regulated market and other negotiation systems (*elimination of the trading concentration obligation*)

In Italy, MIFID was implemented by Legislative Decree no. 164/2007 (17/9/2007) which came into force on 1st November 2007. It sets out the general principles for complying with European Community rules, assigning the task of establishing the detailed rules necessary to ensure total compliance with MIFID to the competent supervisory authorities (Consob and Bank of Italy). As a consequence, Consob and the Bank of Italy issued the following main regulations:

- Regulation no. 16190 of 29th October 2007 issued by Consob that amended the provisions on Intermediaries of Legislative Decree no. 58 of 24th February 1998;
- Regulation no. 16191 of 29th October 2007 issued by Consob that amended the provisions on markets of Legislative Decree no. 58 of 24th February 1998; and
- Regulation issued jointly by Consob and Bank of Italy on 29th October 2007 that set rules for the organisation and procedures applicable to intermediaries authorised to provide investment services and collective portfolio management.

The implementation of MIFID involved important changes in national legislation.
One of the most important was the introduction of "*investment advice*" and "*multilateral systems of negotiation*". According to the Finance Act (as amended by Legislative Decree no. 164 of 17th September 2007) "*investment services and activities*" refer to:

- dealing for own account;
- execution of orders for clients;
- subscription and/or placement with firm commitment underwriting or standby commitments to issuers;
- placement without firm or standby commitment to issuers;
- portfolio management;
- reception and transmission of orders;
- investment advice;
- management of multilateral trading systems.

Before the adoption of MIFID, *investment advice* activity was considered an "ancillary service" and as such no authorisation was required. Investment consultancy is the provision of customised recommendations to a customer on request or as an initiative by the service provider, regarding one or more transactions on an identified financial instrument.[52]
With the purpose of allowing investors to acquire full awareness of their rights and duties in relation to investments, a client classification was adopted that did not have any corresponding entry in the legislation previous to Legislative Decree no. 164/2007. Financial clients are classified as public professional customers, private professional customers and retail customers.[53]
Although "*all information, including advertising and promotional notices, addressed to customers and potential customers by intermediaries must be correct, clear and not misleading*",[54] this client classification is aimed at protecting clients with less financial knowledge or expertise. Consob Regulation no. 16190/2007 details that intermediaries must provide customers and potential customers with appropriate information about the nature of the investment service, the specific types of financial instruments involved, and related risks regarding the intermediary and his services, protection of financial instruments and sums of money of the customer, costs and charges involved in the provision of services, and their classification as retail customer, professional customer or qualified counterparty.
The obligation to act in a client's best interest means that investment firms need to conduct specific tests on the nature of the investment services offered to, or demanded by customers. Particularly, Consob Regulation no. 16190/2007 states that in order to

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recommend investment services and financial instruments suited to the investor, investment consultancy or portfolio management service intermediaries must obtain necessary details from the client in relation to his awareness and experience of the investment sector relevant to the type of instrument or service, financial position and investment objectives (art. 39). Moreover, intermediaries must verify that the client has the necessary level of experience and awareness to understand the risks deriving from the instrument or investment service, offered or requested (art. 42).

Since the client is generally not able to supervise the accuracy of investment firm activity, the "best execution" rule was introduced. According to Consob Regulation no. 16190/2007 (art. 45), intermediaries must adopt all reasonable measures and therefore implement effective mechanisms to achieve the best possible result for their clients, in terms of price, cost, speed and probability of execution and settlement, size and nature of the order, and any other relevant consideration relating to the service. Intermediaries must provide information with regard to the order execution policy adopted and whether this may involve the execution of orders outside a regulated market or multilateral trading facility.

In full compliance with the MIFID Directive, Legislative Decree no. 164/2007 eliminated the trading concentration obligation. Indeed, the Finance Act (art.1), as amended by Legislative Decree no. 164/2007, states that *"regulated market" means a multilateral system which permits or facilitates the meeting, internally and according to non-discretional regulations, of multiple third party purchase and sale interests with regard to financial instruments, admitted to trading in compliance with the rules of the market, in order to effect contracts, and which is operated by a management company, is authorised and operates regularly*". Moreover, ***"****Multilateral trading systems management****"*** *means the management of multilateral trading systems which permit the meeting, within and on the basis of non-discretional rules, of multiple third party purchase and sale interests relating to financial instruments, in such a way as to give rise to contracts".* Finally, ***"****Systematic internaliser****"*** *means the person who, in an organised, frequent and systematic manner, trades on his own account executing customer orders outside a regulated market or multilateral trading systems".*

With regard to transparency rules, Consob Regulation no. 16191/2007 (art.25) states that "*Management companies and managers of multilateral trading facilities shall make public, for each share admitted to trading on a regulated market, at least the information pursuant to Regulation no. 1287/2006/EC*". Moreover, "*management companies and managers of*

multilateral trading facilities shall provide Consob, at the time of definition of the regulated market rules or at the time of submission of the multilateral trading facilities operating rules, respectively, with adequate information on:

- *the type of trading system to which transparency obligations pursuant to table 1, annex II to Regulation no. 1287/2006/EC are attributable;*
- *the existence of a hybrid system that does not fall within the categories pursuant to paragraph a). In such cases, the management companies and persons authorised to manage multilateral trading facilities shall illustrate the specific transparency rules adopted and guarantee the observance of relevant EU obligations* (*Pre-trading transparency requirements*).

Finally, Italy applied different kinds of administrative measures, fines, and criminal sanctions.

For violations of good repute, experience and independency requirements: disqualification of persons from office, for failure by shareholders to comply with mandatory notifications and good repute; suspension of voting rights and challenge of relevant resolutions for failure to ensure sound/prudent management; prohibition of acquisition/increase of qualifying holding, or compelling sale of holdings. If necessary to ensure investor protection: compulsory extraordinary administration. In case of necessity and urgency: all measures required to ensure investor protection and trading, including taking action in place of market operators.

The administrative fines are: for any of the above violations by a market operator and MTF, fines between € 2500 and € 250,000; for omission of notifications concerning qualifying holdings, violation of the prohibition to exercise voting rights and non-compliance with the obligation to sell the holdings, fines between € 5675 and € 51,646; failure to comply with Consob requests, fines from € 50,000 to €1,000,000.

Imprisonment for wilful hindering of supervisory functions: 1 to 4 years. This is doubled for listed companies. Making false representations in notifications to Consob: imprisonment for 6 months to 3 years. Fines for wilful hindering of supervisory functions: €5165 to €619,748 (which may increase by 1/3), and disqualification from professional activity. Making false representations in notifications to Consob: fines of €5165 to €51,646.

A major issue is supervision made by multiple regulators.

On one side, Consob is responsible for authorisation/disqualification of investment intermediaries (SIMs) (in consultation with the Bank of Italy), on-going supervision of

investment intermediaries (SIMs) and credit institutions with regard to transparent and proper conduct in the provision of investment services and activities, and on-going supervision of markets and market operators with regard to transparency, orderly conduct of trading and protection of investors.

On the other side, the Bank of Italy is responsible for authorisation/disqualification and on-going supervision of credit institutions intending to provide investment services or activities (in consultation with Consob), on-going supervision of investment intermediaries (SIMs) and credit institutions with regard to risk containment, financial stability, sound and prudent management, opening of branches abroad, authorisation of persons wishing to direct the business or acquire shareholdings in investment firms, supervision of business continuity and outsourcing (the latter in collaboration with Consob), supervision of risk management and supervision of internal audit.

According to Gabbi et al. (2011) small financial intermediaries are relative late comers in measuring exposure, and expected and unexpected losses due to non-compliant actions. This depends on three factors: (i) different domestic regulatory approaches to the importance of measuring compliance risk, according to a proportionality doctrine, making the largest firms more apt to introduce risk-measuring solutions; (ii) different timing in introducing rules for intermediaries (in the case of the Italian financial market, regulations on compliance function were not approved simultaneously, as described in our introduction); (iii) cross-border regulatory asymmetry which makes the approach for banks and intermediaries working on an international basis different.

9. Deposit guarantee schemes

The growing interest in deposit insurance is strictly linked to the banking crises management process, the role played by banks in monetary function, and the strong interconnections between the financial and economic systems. Deposit guarantee schemes vary across countries; many studies have focused on differences between countries that have an explicit scheme for deposit insurance and those in which deposit protection is implicitly (and therefore ambiguously) provided by the central bank or the State (Hefler, 1999; Garcia, 2001; Cull, Senbet and Sorge, 2004).

As a consequence of the financial crises of the 1980s and 90s, explicit deposit guarantee schemes were widely adopted. However, irrespective of the institutional framework in

different countries, the main purposes of deposit guarantee schemes relate to consumer confidence and protection, and banking system stability.

9.1. Deposit guarantee schemes in Italy: origins and evolution

In Italy, two deposit guarantee systems were created before implementation of Directive 94/19/EC in the national legislation. Both were based on voluntary application by banks. The Central Guarantee Fund (Fondo Centrale di Garanzia delle Casse Rurali ed Artigiane) was introduced in 1978 by Italian Rural and Mutual Banks.[55] The scheme indirectly protected depositors of Member Banks thanks to financial resources provided to mutual banks in critical conditions. The *Interbank Deposit Protection Fund* (Fondo Interbancario di Tutela dei Depositi) was established by the Italian banking system in 1986 to protect all Italian credit institutions except mutual banks.

Although the number of members in the Central Guarantee Fund was higher than that of the Interbank Deposit Protection Fund, due to the small size of mutual banks, the amount of deposits protected by the latter was much greater than that covered by the former. The guarantee schemes did not provide recurring contributions aimed at increasing the fund but were levied on member banks only in the case of intervention (*ex-post contribution system*).

The two deposit guarantee schemes were introduced in a period when the economic system was characterised by a strong presence of the State in the banking sector and high competitiveness. The case of volunteer deposit protection schemes is one of the first experiences of banking self-regulation. According to Boccuzzi (2011, p.221), "*the creation of a mechanism of self-protection from insolvencies was the most coherent answer of Italian banks to the increasing autonomy that the Banking Law was progressively recognising to banks in the definition of strategic options, organisational structure, operational areas and territorial articulation*".

Nevertheless, the mechanism could fail for two reasons:

a) if non-participation in the fund implicitly introduced asymmetric protection for unaware depositors, causing contagion in the case of a large institution;
b) the ex-post mechanism of contribution to the fund was a very critical issue, since in the case of systemic crisis, banks' capacity to subsidise could be dramatically reduced.

9.2. Italian regulation after the European Legislative interventions

European Directive 94/19/EC on Deposit Guarantee Schemes (DGS) introduced the principle of *minimum harmonisation*. The Directive did not aim to overcome the discrepancies in Deposit Guarantee Schemes across countries but only to harmonise the main deposit guarantee elements. One of the most important issues of the Directive referred to *mandatory membership* of all credit institutions of the DGS: membership of the Deposit Insurance Scheme became a requisite for authorisation to operate in the banking market.

In Italy, the Directive came into force with Legislative Decree no. 659/1996 (4/12/1996) which partially modified Legislative Decree no. 385/93 (Banking Act). The major innovation introduced by the Interbank Deposit Protection Fund and the Mutual Banks Depositors Protection Fund was *mandatory membership* for all banks. Indeed, according to the Italian Banking Act (as amended by Legislative Decree no. 659/1996) "*Italian banks shall join one of the depositor guarantee schemes established and recognised in Italy"*. In full compliance with the Home Country Control principle stated in the Second Banking Directive, Italian Banking Law allowed EU bank branches in Italy to subscribe to the Italian guarantee scheme in order to offer additional protection along with the guarantee scheme of their home country (*topping up clause*). Otherwise, the new rules on deposit insurance established the principle of *mandatory membership* of branches of non-EU banks authorised in Italy "*unless they participate in an equivalent foreign guarantee scheme*".

The intervention of guarantee schemes is mandatory in the event of compulsory administrative liquidation of a bank authorised in Italy. When EC bank branches are members of an Italian guarantee scheme on a supplementary basis, payments are due after the guarantee scheme of the home member state has intervened (*topping up clause*). The guarantee schemes may provide for additional cases and forms of intervention. There are three types of intervention considered by the Italian Banking Act: compensation of depositors, intervention in transfers of assets and liabilities, and support intervention. In case of reimbursement, the coverage level granted to depositors was very high. The Banking Act stated that "*the maximum payment for each depositor may not be less than 103,291 euro"*. Such a high insured deposit level was brought in to protect small depositors and to strengthen confidence in the stability of the banking system so as to avoid the risk of a bank run in the event of financial crisis. In compliance with Directive 94/19/EC, the

Banking Act stated that reimbursement had to be made, up to an amount equivalent to 20,000 euro, within three months of the date of the decree of administrative liquidation. The time limit could be extended by the Bank of Italy in exceptional circumstances or special cases for a period not exceeding nine months.

In 2005, Italy had the highest level of deposit protection among EU countries (Figure 9.1.). In compliance with Directive 94/19/EC, the Italian Banking Act referred to depositor protection and not to deposits per se. This meant that if a depositor had more than one deposit or account in a failed bank, these would be consolidated and covered up to the limit.

The guarantee schemes did not cover: *a)* bearer deposits and other repayable bearer funds; b) bonds and claims arising from acceptances, promissory notes and securities transactions; c) the bank's share capital, reserves and other elements of capital*; d)* deposits arising from transactions for which there had been conviction for crimes (articles 648 and 648 of the Italian Penal Code)*; e)* deposits from central government departments, regions, provinces and municipalities and other local authorities*; f)* deposits made by banks in their own name and on their own behalf as well as banks' claims*; g)* deposits from financial companies (art 59(1,b) of the Banking Act); insurance companies; collective investment undertakings, other companies of the same banking group, and electronic money institutions*; h)* deposits, including those made by nominees, from members of the governing bodies and senior managers of the bank or of the banking group's parent undertaking; *i)* deposits, including those made by nominees, from owners of significant holdings for the purposes of art. 19 of the Banking Act*; l)* deposits for which the depositor has, on an individual basis, obtained from the bank rates negatively affecting the bank's financial situation according to the liquidators.

As an alternative to reimbursement, the Italian legislation provided for two other kinds of intervention: transfer of assets and liabilities to another bank, and support intervention when a bank is under special administration. The purpose here is to maximise the stability of the banking system by preserving the continuity of banking activity (first case) or by avoiding extreme procedures such as compulsory administrative liquidation supporting merger and acquisitions (M&A) operations (second case). The choice of tool granted to IDPF is based on the goal of cost minimisation.

From the year of its constitution (1986) to 2011, the Interbank Deposit Protection Fund only put into effect one reimbursement (Table 9.1). In most cases, the fund intervened supporting transfer of the assets and liabilities of the distressed bank to other banks.

Although the deposit guarantee schemes help the Bank of Italy to deal with bank failures, the Italian Banking Act has clearly defined the role of the supervisor and deposit insurers in the banking crises management process. Indeed, Banking Act art. 5 states that "*the credit authorities shall exercise the powers of supervision conferred on them by this Legislative Decree having regard to the safe and sound management of the persons subject to supervision, to the overall stability, efficiency and competitiveness of the financial system and to compliance with provisions concerning credit".* In order to ensure the protection of depositors and the stability of the banking system, the Supervisory Authority has introduced a wide range of tools to manage a banking crisis:

i. it recognises guarantee schemes and approves their rules;
ii. it coordinates the activity of guarantee schemes with banking crises procedures and supervisory activity;
iii. it regulates payment procedures and authorises interventions by guarantee schemes and exclusions of banks from such schemes;
iv. it verifies that the protection provided by foreign guarantee schemes to branches of non-EC banks authorised in Italy is equivalent to the Italian ones;
v. it regulates the public notice informing depositors and the various types of covered claims;
vi. it coordinates the authorities of EU countries regarding the participation of foreign branches in an Italian guarantee scheme and their exclusion.

There are some differences between the two main DGSs, the Interbank Deposit Protection Fund and Deposit Guarantee Fund of Cooperative Credit Banks. The contribution base for Cooperative Credit Banks is determined taking into account the total amount of deposits and cash loans with deduction of regulatory capital. The level of commitment each bank undertakes to pay annually ranges between 0.4 and 0.8% of the repayable funds of all the IDPF members. If the amount is below 0.4%, the minimum percentage must be restored within four years. Contributions are not risk-based but determined on a proportional quota of insured deposits. They are then adjusted either on the basis of the amount of reimbursable funds and level of risk (Interbank Deposit Protection Fund),[56] or by a

regressive mechanism along with a correction mechanism (Deposit Guarantee Fund of Cooperative Credit Banks).[57]

9.3. Post crisis changes

The goal of Directive 94/19/EC is to harmonise the features of the deposit guarantee schemes and to reduce their discrepancies across countries (*minimum harmonisation principle*). However when financial crisis struck, these differences were evident and they involved an asymmetric loss of confidence of European citizens within the EU's single financial market. Moreover, the bankruptcy of Northern Rock (2007) and the Icelandic banking system crisis (2008) highlighted the unfairness and ineffectiveness of the EU safety net.

In order to restore confidence in the functioning of the financial system, in October 2008 the European Commission proposed a higher convergence among the deposit guarantee schemes of the different countries (Directive 2009/14/EC of 29th March).[58] However, there were many relevant issues to be addressed such as the scope of coverage, funding mechanism, fund size, co-insurance, trigger events, and powers of supervision.

In Italy, Directive 2009/14/EC was adopted with Legislative Decree no. 49/2011 (24/3/2011) which came into force on 7th May 2011. As a consequence of the implementation, the Italian Banking Act (art. 96) was amended. Particularly, it was stated that the maximum payment for each depositor may not be less than 100,000 euro. The Bank of Italy will update the limit to align it with further changes that may be introduced by the European Commission as adjustment to the inflation rate.

The reimbursement of depositors has to be made within 20 working days of the date on which the compulsory administrative liquidation procedure was initiated. The time limit may be extended by the Bank of Italy in exceptional circumstances for a period not exceeding ten working days.

It is important to highlight that, in compliance with the regulatory provisions provided in Basel III regarding liquidity standards, mutual banks established the Institutional Guarantee Fund (Fondo di Garanzia Istituzionale) implementing Directive 2006/48/EC supervisory provisions amended for *institutional protection schemes*. This is based on a contractual or statutory liabilities arrangement by which subscribing banks protect each other against illiquidity and insolvency risks, in order to prevent or avoid their bankruptcy. The Fund aims to find a solution within the mutual banks system in case of a deficiency in short-term

liquidity.[59] The main advantage provided by prudential supervision is the null risk weight for exposures between banks taking part in this Fund.[60] According to Tarantola (2011), this mechanism centralised surplus resources within the mutual bank system, promoting efficient allocation in favour of troubled savings and credit institutions.

10. Crisis Management Schemes

10.1. The Italian framework and the Directive 2001/24/EC

The Italian banking crisis management process is regulated by the Italian Banking Act (legislative decree no. 385/1993). It provides a flexible "toolkit" to be used in the case of a problem bank. Most of the instruments available come from the 1936 Banking Law, which still proved to be effective in recent years.[61] The two types of intervention provided by the Italian Banking Act to deal with banking crisis are special administration and compulsory administrative liquidation. The first refers to the less difficult crisis situation where the recovery of banks through reorganisation is possible. The latter acts to shut down banking activity.

The functions attributed to the Supervisory Authority constitute the core of crisis management regulation. The Home Country Control Principle determines the heterogeneous treatment provided in case of EC banks and branches of non EC banks.

The major features of crisis regulation can be summarised as follows:

a) special administration of EC-bank branches was defined by the Supervisory Authority of the Home Member State (art.77 of the Italian Banking Act) whereas for branches of non EC-banks the competent authority was the Supervisory Authorities of the Host Member State;

b) special proceedings adopted towards EC-banks represented an exception to the Home Country Control principle that was justified by the need to prevent possible crises (art. 78 and 79 of the Italian Banking Act);

c) the Italian Banking Act allowed the Bank of Italy to instruct the compulsory administrative liquidation of branches of EC-banks (*secondary winding-up proceedings*); for branches of non EC-banks the Italian Supervisory Authority can order the compulsory administrative liquidation regardless of the adoption of comparable proceedings implemented by the

Authorities of the Home Member State, where there are administrative irregularities or violations of laws, regulations or bylaws, or if losses are exceptionally serious.

Non EC-bank branches, for banks authorised in Italy, were considered as a separate entity from the Holding Company.

The legislative process of Directive 21/2004/EC on the reorganisation and winding up of credit institutions took its first steps after the First Banking Directive 77/780/EC was enacted. Although the European Commission had already drafted a proposal of legislation in 1985, its progress was slow because of debate within the European Parliament. In 1988, as a consequence of the implementation of the Second Banking Directive, the proposed Directive was halted again. The debate and legislative process was only taken up after collapse of the BCCI in 1991.[62] In 2000 the Member States finally reached an agreement and the Commission's proposal was accepted by the European Parliament. The Directive came into force on 4th April 2001 but Member States did not comply until the 5th May 2004.[63]

The introduction of the Directive was generally viewed as a significant development that would have provided a greater deal of efficiency and certainty in the bank insolvency management process within the European Union. For the first time, in contrast to the Regulation on Insolvency Proceedings 1346/2000 (29/5/2000) for commercial firms, a legislative measure was specifically addressed to banks, recognising the peculiar features of banking crisis procedures.

10.2. The main changes of the Italian framework after Directive 21/2004/EC

The European Directive 21/2004/EC was enacted in Italy with Legislative Decree no. 197/2004 (9/7/2004). The institutional setting for regulation and supervision did not change. The responsibility for supervision and regulation of the financial sector lies with four different authorities: the Bank of Italy, the Securities Commission (CONSOB), the Insurance Supervisory Institute (ISVAP, after 2013 it changed into IVASS, under the governance of the Bank of Italy), and the Pension Fund Supervisory Commission (COVIP).

The adoption of the European Directive significantly changed the way banking crises would are to be managed in comparison with the previous Italian Banking Act of 1993 regulation. The Bank of Italy is asked to notify the supervisory authorities of member states hosting branches of non-EC banks of the opening of the special administration procedure. The notification has to be made, using any means, before the beginning of the procedure or

immediately after. In compliance with Directive 21/2004/EC, the Italian Banking Act provides for adoptable measures by the host Member States "*where it is a matter of urgency*".

Before the Directive, the Italian Legislation allowed the possibility of secondary proceedings of compulsory administrative liquidation for branches of EC banks. With the emanation of Legislative Decree no. 197/2004, no secondary proceedings were allowed as a consequence of the principle of universality. In accordance with the Home Member State principle, Legislative Decree no. 197/2004 stated that the measures and procedures for the reorganisation and winding up of EC banks shall be regulated and implemented without additional formalities in Italy, in accordance with the law of the Home Member State. Moreover, the measures and procedures for special administration, provisional management, and compulsory administrative liquidation of Italian banks shall apply and be applicable in other member states and on the basis of international agreements, in non-member states.

The new rules introduced by Legislative Decree no. 197/2004 allow some deviations from the Home Member State principle. In particular, the effects of reorganisation measures or the start of a liquidation procedure on employment contracts and relationships are regulated by member state employment contract laws, as well as contracts that grant the right to use or acquire real estate which are regulated by the law of the member state in which the property is located. Similarly, rights regarding property and the exercise of property rights (and other rights associated with financial instruments whose existence or transfer requires enrolment in a register or account) are regulated by the law of the member state in which the property or account is located. Netting and novation agreements, as well as repurchase agreements and transactions carried out on a regulated market, are also regulated notwithstanding the Home Member State principle. Finally, the law of the Home Member State does not apply to the void-ability, voidness or unenforceability of acts prejudicial to creditors where the beneficiary of such acts proves that the prejudicial act is regulated by the law of a member state which does not allow any form of challenge.

In compliance with the universality principle, the introduction of Legislative Decree no. 197/2004 and its enforcement set forth the end of the ring fencing practice, and Italy fully adopted the *par condicio creditorum* principle.[64] As a consequence, article 95 of the Italian Banking Law was supplemented with articles 95-4 (Cooperation between authorities), 95-5

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(Public notices and notification of persons having entitlement), 95-6 (Implementing regulations) and 95-7 (Application).

11. Accounting

11.1. The structure of financial institutions annual report

The first attempt to regulate the accounting rules of banking firms dates back to 1975 with Decree no. 137 (although it only applied to the income statement). The balance sheet of banking firms remained without a specific regulation.[65] The layout of the profit and loss account introduced by D.P.R. no. 137 of 1975 represented a basic milestone in the regulation of banking reports because for the first time it was designed with a structured layout and not just as a list of accounting items related to the activities of banking firms.

In Italy, credit and financial institutions continued to draw up their accounts according to the special rules contained in Decree no. 137 of 1975 and those established by Italian Civil Code until the approval of legislative Decree no. 87/1992 (27/1/1992), implementing Directive 86/635/EC, which regulated the annual report of banks and financial institutions for the first time.

Coordination of national provisions concerning annual accounts and reports and the valuation methods used to draw up such accounts was considered necessary at European level to establish the minimum equivalent legal requirements as regards the extent of financial information which had to be made available to the public by companies.

Given the heterogeneous structure and content of the balance sheet of credit institutions in each Member State, Directive 86/635/EC prescribed the same layout and terminology for the report of all credit institutions within the Community. The balance sheet of credit institutions had to be drawn up *exclusively* in a horizontal format, with assets listed on the right side and capital and liabilities shown on the left. Sixteen entries for assets and fourteen for liabilities were listed. In addition, two off-balance-sheet items were also detailed (Table 11.1.).[66] The profit and loss account was organised to include a small number of items and the introduction of the distinction between ordinary and extraordinary items aimed to facilitate the analysis of the different areas contributing to the economic performance of the firm (Table 11.2.).

The provisions established by Legislative Decree no. 87/1992 were applied for the first time to the financial statements of credit institutions for the period ending 31st December 1993.[67]

They were applied to: a) banks, as defined by article 10 of Italian Banking Law; b) asset management companies as defined by law no. 77/83 (23/3/1983); c) parent financial companies of banking groups entered in a register kept by the Bank of Italy; d) Italian Investment Companies (SIM) defined by law no. 2/1991 (1/1/1991); e) subjects operating in the financial sector as defined in Title V of the Italian Banking Act issued according to art.25 (2), law no. 142/92 (19/2/1992), and also firms engaged in other financial activities as indicated by art. 59 (1), letter b) of the Italian Banking Act.

As formerly established at Community level,[68] Legislative Decree no. 87/92 also stated that annual accounts and consolidated accounts should be comprised of the balance sheet, profit and loss account, and notes to the financial statements.[69] The annual and consolidated accounts had to be drawn up clearly, and had to give a true and fair view of the company's assets, liabilities, financial position, and profit or loss.[70] Where the information provided in compliance with Legislative Decree no. 87/92 was not sufficient to give a true and fair view, additional information had to be given to this end in the note to the accounts.[71]

Legislative Decree no. 87/92 gave the Bank of Italy the power to prescribe the layout of the annual and consolidated accounts, also with regard to the procedures and terms of their disclosure.[72]

The standards for drawing up annual accounts, and those concerning accounting evaluation methods, constituted the core of Legislative Decree no. 87/92.

Classification of the various accounting entries indicated their degree of liquidity: assets were sorted according to the decreasing liquidity principle, whereas liabilities were displayed in relation to their predisposition to remain within the firm. Evaluation of the various entries that composed the annual accounts was on a cost basis, i.e. the principle of purchase price or production cost.

The annual and consolidated accounts had to be drawn up with preference to *substance over form and settlement timing over trade timing*. With some exceptions, any set-off between an asset and liability item or income and expenditure item was prohibited.

To promote greater comparability of annual accounts, Legislative Decree no. 87/92 stated the *principle of continuity* of evaluation methods, according to which the opening balance sheet of each financial year has to correspond to the closing balance sheet for the preceding financial year.[73]

Complying with the *principle of accrual basis accounting and that of prudence*, it was established that the accounts of income and charges from the financial year had to be made irrespective of the date of receipt or payment of such income or charges.[74] Hidden reserves are not considered in order to comply with the principle of prudence.

11.2 The application of the International Account Standards (IAS) and Directive 2003/51/EC, *the "Modernisation Directive"*

In order to enhance the *comparability* of financial statements prepared by publicly traded companies, the Lisbon European Council of 23rd and 24th March 2000 emphasised the need to accelerate completion of the internal market for financial services. In order to contribute to better functioning of the internal market, listed companies had to apply a single set of high quality international accounting standards for the preparation of their consolidated financial statements. It was also important that the financial reporting standards applied by Community companies participating in financial markets be accepted internationally and be truly global standards.

On 19th July 2002, Community Regulation no. 1606/2002 on the application of international accounting standards was approved. The most important aspect of the Regulation is that, unlike the Directive, it is immediately applicable to the national legislation of Member States.

Regulation no. 1606/2002 introduced the *obligation* for EU listed companies to draw up their consolidated accounts using IAS/IFRS standards starting from 1st January 2005.[75]

Member States were allowed the *discretion* to permit or require adoption of the International Accounting Standards for: a) EU listed companies, with reference to annual accounts; b) companies other than those mentioned above, with regard to consolidated and annual accounts.

Although in the 1990s, several EU Member States allowed listed companies to draw up their consolidated accounts in compliance with IFRS or US-GAAP instead of national rules (Van Hulle, 2004) with the intention of responding to the demand for international accounting, Italy did not take any clear position towards international accounting standards before Regulation (EC) no. 1606/2002. This stemmed from the specific nature of the Italian economic environment, characterised by great corporate ownership concentration and a preponderance of long term debts provided by banks rather than equity markets. In this context, accounting practices were mainly aimed at safeguarding capital maintenance in the interest of

corporate stakeholders, particularly creditors, justifying conservative accounting practices. Also, financial statements served as the basis for the computation of income taxes. In contrast, international standards like IFRS are intended to assure fair presentation of the company's financial position and performance in order to provide decision-useful information to a wide range of users, with particular reference to investors (Paglietti, 2009).

In Italy, EU Regulation 1606/2002 was implemented by Legislative Decree no. 38/2005 (28/2/2005) which came into force on 22th March 2005. In addition to the subjects explicitly referred to by the Regulation, institutions were also obligated to use the International Accounting Standards: a) listed companies, with reference to annual accounts (mandatory from 2006, discretionary from 2005); b) companies issuing financial instruments widely distributed among the public (as defined by article 116 of the Consolidated Financial Law) with regard to consolidated (mandatory from 2005) and annual accounts (mandatory from 2006 and discretionary from 2005); c) banks and other financial intermediaries supervised by the Bank of Italy, with regard to consolidated (mandatory from 2005) and annual accounts (mandatory from 2006 and discretionary from 2005); d) insurance firms with regard to consolidated accounts (mandatory from 2005) and annual accounts (excluded). For insurance firms, application of IAS was only required in cases of listed companies which did not draw up consolidated accounts.

Italy exercised the right, provided by Regulation no. 1606/2002, of allowing application of International Accounting Standards to non-listed companies, which were free to adopt IAS for individual and consolidated accounts.

European Directive 2003/51/EC of 18th June 2003 amended Directives 78/660/EC, 83/349/EC, 86/635/EC and 91/674/EC regarding the annual and consolidated accounts of certain types of companies, banks and other financial institutions and insurance undertakings. It was created to reduce the comparability issue between European accounting Directives implemented in the last twenty years and the International Accounting Standards.

In Italy, Directive 2003/51/EC was implemented by Legislative Decree no. 32/2007 (2/1/2007) which has been in force since 12th April 2007. Only the mandatory section of the Directive is in operation; specifically, the major changes relate to the annual report and the audit report. Although the innovations contained in the Directive were greater than those implemented by legislative Decree no. 32/2007, the Italian Civil Code (art. 2428) has been significantly modified. According to article 2428 of the Italian Civil Code, annual reports

have to include a fair, balanced, and comprehensive analysis of the position of the company. They also have to include a description of the principal risks and uncertainties that the company faces.[76] The analysis has to be consistent with the size and complexity of the business and, to the extent necessary for an understanding of the development, performance, and the position of the company, it has to include both financial and, where appropriate, non-financial key performance indicators relevant for the particular business, including information relating to environmental and employee matters.[77] Finally, where appropriate, the analysis has to include additional explanations of amounts reported in the accounts. By modifying Legislative Decree no. 127/1991 (art.40), the same changes were introduced into consolidated accounts.[78]

Regarding the audit report, Legislative Decree no. 32/2007 fully complied with Directive 2003/51/EC. The changes were brought in to make the minimum contents of the audit report of listed companies similar to those of non-listed companies.

With regard to annual accounts, modifying art. 2409 of the Italian Civil Code, it was established that the audit report must include:

a. an introduction that identifies the accounts which are the subject of the statutory audit, and the rules applied by the company to draw up such accounts;
b. a description of the scope of the statutory audit that identifies the auditing standards in accordance with which the statutory audit was conducted;
c. an audit opinion on accounts that clearly states whether such accounts comply with statutory requirements and whether they give a *true and fair view* of the company's assets and liabilities, financial position, and where appropriate, profit and loss;
d. a reference to any matters to which the statutory auditors draw attention by way of emphasis without qualifying the audit opinion;
e. an opinion concerning the consistency of the annual report with the accounts for the same financial year.

Finally, the legislation brought the requirement that statutory auditors are to express an explicit opinion on the accounts in the audit report. If the opinion of the statutory auditors is unqualified, qualified or an adverse opinion, or if the statutory auditors have been unable to express an audit opinion, the audit report must describe the reasons in detail.

The changes mentioned above relating to annual accounts were also introduced with reference to the audit of consolidated accounts.

According to article 5 of Legislative Decree no. 32/2007, all provisions mentioned above for annual accounts and consolidated accounts apply to each financial year starting from 1st January 2008.

Under EU Regulation 1606 issued on 19th July 2002, Banking Groups are required to prepare their consolidated accounts in accordance with the IFRS issued by IASB. They are required to publish reports on:

a) reconciliations of equity as reported under Italian GAAP (Legislative Decree no. 87/92) with equity under IFRS as at 1st January 2004, 31st December 2004 and 1st January 2005 (Table 11.3);
b) a reconciliation of profit or loss as reported under Italian GAAP (Legislative Decree no. 87/92) with profit or loss under IFRS as at 31 December 2004 (Table 11.4);
c) explanatory notes on the main material adjustments to the balance sheet and income statement for the specified periods.

The major innovations introduced with adoption of the new accounting principles are:

a) the fair value approach to results on the income statement for trading exposures and minority interests;
b) the fair value approach to capital available for sale securities;
c) amortised cost for held-to-maturity exposures and loans;
d) nominal value for liabilities.

The purpose of this legislation was to reduce the scope for window dressing policies that stabilise or smooth companies' results, however issues still exist with the adoption of IAS - for example, market prices are not always available and it is assumed that assets can be sold or bought at current (or fair) prices.

On balance, the impact of these rules was asset prices bubbles (which could be reduced by accounting valuations of hedging policies) and increasing pro-cyclicality caused by the fact that asset devaluation affects credit policy and the consequent credit crunch. Much of the debate around the introduction of new accounting standards based on market criteria was focused on the question whether fair value accounting leads to short-termism in investor behaviour.

The European Financial Reporting Advisory Group (EFRAG) submitted a letter of comment to the European Commission concerning its Green Paper. The letter does not deny that fair value accounting may contribute "to short-termism in investor behaviour to a limited degree". Moreover, according to Severinson and Yermo (2012, p.34) "the move towards fair value accounting principles will have major impacts on life insurers and pension plans as

they will need to consider to what extent they wish to minimise accounting volatility". Many observers are worried that the prevalence of short-term horizons in financial markets is detrimental to long-term investment and economic growth.

12. Corporate & Internal Governance and Executive Compensation

12.1. Corporate Governance Guidelines

Since approval of the Basel I proposals, the issue of Corporate Governance has become crucial in pursuing financial stability, moving from internal controls and decision making functions to the domain of reputational risks, customer relations and protection of stakeholders. Over the last few decades both regulators and supervisors have focused on regulation of *business conduct* in financial firms in order to better safeguard financial consumers, who generally have inadequate financial knowledge.

The crucial issue of Corporate Governance has triggered a series of initiatives at international level. The first attempts aimed at evaluating and enhancing the framework of corporate governance for banking organisations date back to 1999 when the Organisation for Economic Cooperation and Development (OECD) published "*Principles of Corporate Governance*".[79] In 1999, the Basel Committee on Banking Supervision took up the principles of corporate governance set by OECD and published some internal governance guidelines, subsequently revised, to assist the Supervisory Authority of Member States in promoting adoption of sound corporate governance practices by banking organisations in their countries.[80] It is noteworthy that the BCBS's and OECD's guidance did not aim to establish a new regulatory framework over national legislations. Principles were non-binding but were intended as a reference point to enable policy makers to build and develop good corporate governance with a sound legal and regulatory basis.

According to the principles stated in the OECD guidance, corporate governance was defined as involving "*a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring. The presence of an effective corporate governance system, within an individual company or*

group and across an economy as a whole, helps to provide a degree of confidence that is necessary for the proper functioning of a market economy" (OECD, 2004, p.11).

In "Enhancing corporate governance for banking organisations" the Basel Committee on Banking Supervision highlighted that "*poor corporate governance may contribute to bank failures, which can pose significant public costs and consequences due to their potential impact on any applicable deposit insurance systems and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems. In addition, poor corporate governance can lead markets to lose confidence in the ability of a bank to properly manage its assets and liabilities, including deposits, which could in turn trigger a bank run or liquidity crisis. Indeed, in addition to their responsibilities to shareholders, banks also have a responsibility to their depositors*" (BCBS, 2006, p.4).

The lack of both legal and regulatory systems on corporate governance at international level led to countries adopting different legal frameworks and standards. The deficit of harmonisation rules particularly affected large financial companies where financial difficulties resulting from corporate governance failures involved widespread problems in the financial system.

The international financial crisis highlighted these deficiencies in terms of Corporate Governance. The issue of remuneration policies of executive directors received significant attention from regulators, also due to its significant implications at society level.[81]

In March 2008, the Bank of Italy issued a supervisory regulation regarding banks' internal organisation and corporate governance which implements the general guidelines set forth by Decree no. 200 of the Minister of Economic Affairs of August 2004 (the "Treasury Decree") on the principles to be followed by banks and other financial intermediaries adopting governance systems alternative to the traditional one. According to the New Regulation, banks shall choose the corporate governance model which is most likely to ensure the efficiency of operations and the effectiveness of controls, taking into account the costs involved in each model. Particular attention was paid to the Board and control function roles. The choice should be made on the basis of self-assessment, considering:

(i) the bank's ownership structure and its recourse to equity capital markets;

(ii) the bank's size and the complexity of its operations;

(iii) the bank's medium and long-term strategic objectives; and, if applicable,

(iv) the organisational structure of the group to which the bank belongs.

The Bank of Italy articulated a number of innovative positions with regard to the internal corporate governance of Italian banks. The New Regulation requires that where strategic supervision and management functions are assigned to different bodies, the tasks and responsibilities of each body be clearly identified, with (i) the strategic supervision body being responsible for deciding the bank's strategy and monitoring its implementation, and (ii) the management body being in charge of the bank's management.

The New Regulation requires that (i) the scope of delegated powers of management body members should be set out in a clear and precise fashion, especially with regard to quantitative limits, as well as the manner in which such powers should be exercised; (ii) certain activities — in addition to those set forth by the Italian Civil Code — are not to be delegated to individual members or committees; (iii) the simultaneous presence in a board of directors, of an executive committee and one or more chief executive officers justified in relation to the size and complexity of the bank's operations; (iv) the chairman of the board of directors and, in the two tier model, the chairman of the management board when the supervisory board does not perform the strategic supervision function, must have a non-executive role and not be involved in the current business of the company, except for exceptional circumstances, and provide a balance of power with respect to the CEO or other executive directors; and (v) entrustment of strategic supervision to the supervisory board must not lead to involvement of the supervisory board in the management of the bank, thus changing its nature as a control body and limiting the independence of the management body.

The New Regulation highlights the key roles and functions of non-executive and independent directors in corporate bodies, as well as special committees in the body performing the supervision function. Among the guidelines implementing the above principles, the New Regulation stipulates that: (i) limitations in the number of offices that members of corporate bodies may hold should be defined in the bank's by-laws or in internal regulations; (ii) where the supervisory board is given strategic supervision powers, it is reasonable for the management board to comprise a restricted number of members (mostly executives, directly involved in the management of the bank); (iii) an adequate number of independent members performing the strategic supervision function should be present in the corporate body; (iv) in order to ensure effective controls in the one tier model, the management audit committee should be composed of at least three members; and (v) in the two tier model, where an internal audit body has been appointed, its members should

all be independent and the chairman of the supervisory board, when such a body has strategic supervision functions, cannot be a member of the internal audit body, in order to preserve a neutral stance among his or her roles.

The revision of Instruction 263 in 2013 (Chapter 7) introduced a number of important rules to enforce the effectiveness of the internal control system, particularly the compliance and risk management functions. According to the new guidelines, banks are asked to separate compliance and risk management, and to ask their owners to report directly to the Board, as well as to the audit function. All these functions must be independent from the business lines and their heads should be at the same organisational level as business heads. If a conflict between business and control arises, the latter can escalate to higher levels of the organisation as far as the strategic body (often the Board of Directors).

Finally, in order to protect the control functions from harassment or any other hostile behaviour, the CEO of the General Director must report to the Board and supervisory body if the Chief Risk Officer and Compliance Officer resign or are dismissed.

Although these new rules are an improvement in terms of real prudential banking behaviour, many concerns remain (Gabbi, 2012): control managers cannot report directly to the Bank of Italy in the case of business decisions that could damage the bank's safeness; the separation of compliance and risk management could weaken the control process; Board composition still does not recognise the importance of a technical background of its members who need to be able to understand the assumptions behind the risk and capital metrics.

12.2. The issue of executive compensation. A brief background

Many studies have analysed the relationship between ownership structure (Barontini and Bozzi, 2009), corporate governance (Mehran, 1995; Ferrarini and Moloney, 2004; John et al., 2010; Fahlenbrach, 2009) and the remuneration of executive directors.[82] The issue of executive compensation is an important part of the wider problem of the separation between ownership and control. The stronger this separation, the wider the divergence of objectives between managers and shareholders tends to be. Due to differences in time horizons, short-term for managers whose main concern is often maximising their gain, and long-term for shareholders aimed at increasing the economic value of firm, without an effective remuneration system these divergences tend to grow.

A good remuneration system may play an important role in increasing the economic value of a firm if it is able to attract and hold skilled human capital within company and if it is built so management choices are consistent with shareholders' risk profile (Mieli, 2010). By contrast, if it is designed to incentivise short-term oriented policies, a remuneration system can encourage behaviours characterised by higher levels of risk than those compatible with safe and sound management and which therefore do not comply with shareholders' interests. The latter is known in literature as *short-termism.*[83] The Centre for Financial Market Integrity (CFA, 2006, p.3) described short-termism as "*excessive focus of some corporate leaders, investors, and analysts on short-term, quarterly earnings and a lack of attention to the strategy, fundamentals, and conventional approaches to long-term value creation. An excessive short-term focus combined with insufficient regard for long-term strategy can tip the balance in value destructive ways for market participants, undermine market credibility, and discourage long-term value creation and investment. Such short-term strategies are often based on accounting-driven metrics that are not fully reflective of the complexities of corporate management and investment*".[84]

The financial crisis highlighted a mismatch between executive compensation and the creation of economic value. In fact, businesses that behave in a short-term manner generally have a risk profile which is not in the shareholders' interests and does not observe the principle of sound and prudent management. This may lead to loss of economic value of the company. "*Fund managers with a primary focus on short-term trading gains have little reason to care about long-term corporate performance or externalities, and so are unlikely to exercise a positive role in promoting corporate policies, including appropriate proxy voting and corporate governance policies, that are beneficial and sustainable in the long-term. Risk-taking is an essential underpinning of our capitalist system, but the consequences to the corporation, and the economy, of high-risk strategies designed exclusively to produce high returns in the short-run is evident in recent market failures"* (The Aspen Institute, 2009, p.2).[85]

Many critics have underlined the role of short term incentives, implied in the structure of remuneration systems, which do not ensure alignment of executives' goals and prudent risk taking functions, at the root of the last financial crisis. The results of many empirical studies are not unambiguous, i.e. the relationship between greater alignment of interests of shareholders and managers and higher performance is not always positive.[86]

The relationship between shareholders and managers in financial firms affects more heterogeneous stakeholders than in the case of non-financial institutions. The remuneration system for financial institutions should therefore be designed not only align stakeholder and executive interests, but also to ensure the stability of the economic and financial system as a whole. The global financial crisis highlighted how the architecture of remuneration policies of many large financial intermediaries was often poor[87] and frequently oriented to increase risk appetite. The issue of executive compensation also received wide attention during the crisis because of its great social impact. Indeed, the increasing inequality recorded in recent years has made public opinion very sensitive to this issue. "*This is probably because remuneration is not just a technical issue but has everything to do with perceived fairness, which leads people to make moral judgements*" (Winter, 2011, p.5). As a result, international and national regulators have mainly focused their attention on remuneration policies.

12.2.1. Regulatory intervention on compensation mechanisms during the crisis

Before analysing the rules established by Directive 2010/76/EU, we briefly recall the main international initiatives introduced in recent years in response to the crisis to create binding principles for a more effective remuneration system.[88]

In April 2009, the Financial Stability Forum (then the Financial Stability Board) issued "*Principles for Sound Compensation Practice*" to discuss the topic of effective governance of compensation, and how to align compensation systems with risk management and risk governance. The *Principles* were intended to reduce incentives towards excessive risk taking that may arise from the structure of remuneration systems. Following the principle "*one size does not fit all"*, they were not aimed at indicating a certain threshold of individual compensation.

The guidelines focused on three important issues:

a) effective governance compensation – "*The board of directors of major financial firms should exercise good stewardship of their firms' compensation practices and ensure that compensation works in harmony with other practices to implement balanced risk postures*";
b) effective alignment with prudent risk taking – "*An employee's compensation should take account of the risks that the employee takes on behalf of the firm.*

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Compensation should take into consideration prospective risks and risk outcomes that are already realised";

c) effective supervisory oversight and engagement of stakeholders – "*Firms should demonstrate to the satisfaction of their regulators and other stakeholders that their compensation policies are sound. As with other aspects of risk management and governance, supervisors should take rigorous action when deficiencies are discovered*".[89]

On 30th April 2009, the European Commission issued Recommendations no. 384 and 385 on remuneration policies in the financial services sector and the regime for director remuneration in listed companies, respectively. The crucial issues of both Recommendations regarded the structure of remuneration policy and its long term sustainability, and performance measurement. "*Where remuneration includes a variable component or a bonus, remuneration policy should be structured with an appropriate balance of fixed and variable remuneration components*".[90] Moreover, recommendation 4.2 stated the principle that "*the fixed component of the remuneration should represent a sufficiently high proportion of the total remuneration allowing the financial undertaking to operate a fully flexible bonus policy*". With regard to performance, it was recommended that "*the assessment of performance should be set in a multi-year framework in order to ensure that the assessment process is based on longer term performance and that the actual payment of bonuses is spread over the business cycle of the company*".[91] In addition, the measurement of performance would include an adjustment for current and future risks related to underlying performance, and would evaluate the cost of the capital employed and the liquidity required.

Recommendation 385 promoted long term sustainability of the firm, granting that remuneration be based on performance. For this purpose, the variable components of remuneration would be linked to predetermined and measurable performance criteria, also including those of a non-financial nature. An important role in compensation structure, already provided for by Recommendation 2005/162/EC, was attributed to the Remuneration Committee which "*should ensure that remuneration of individual executive or managing directors is proportionate to the remuneration executive or managing directors and other staff members of the company*".[92]

Directive 2010/76/EU (CRD III), amending Directives 2006/48/EC (CRD) and 2006/49/EC (CAD) intended to harmonise the remuneration policies of banks and other financial firms. It

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reflected the main orientation already elaborated by other international bodies. In particular, the standards prescribed by the Financial Stability Board in 2009 became *binding rules* in the European system. The whole structure of the Directive is both principle-based, with regard to remuneration policies of all staff members, to apply to all banks according to the principle of proportionality, and rule-based particularly addressed to subjects whose professional activities have a material impact on their bank's risk profile (so-called *risk-takers*). The main goal of the remuneration rules detailed in CRD III was to encourage effective risk management and to avoid the pursuit of short-term gain at the expense of long-term results. Remuneration policies are expected to align the personal objectives of staff members with the long term interests of the financial institution. For this purpose, the directive prescribed a set of rules which covered all relevant issues of the remuneration system with particular attention to its design. In particular, the Directive provided that fixed and variable components of remuneration should be *appropriately* balanced and that the fixed component should at the same time represent a sufficiently high proportion of total remuneration. This rule aimed to make remuneration policies flexible and to provide for the possibility that the variable pay component would not be paid if that was *unsustainable* in the long term financial perspective of the company ("g*uaranteed variable remuneration is not consistent with sound risk management or the pay-for-performance principle and should, as a general rule, be prohibited"* Whereas no. 8). In addition, the directive established the possibility of activating either *malus mechanisms* or *claw-back clauses* with the intent to decrease the overall variable remuneration where financial performance of the company was negative or lower than expected.[93]

In order to strengthen the relationship between individual interests and risk appetite, values and the long term perspective of the financial institution, the Directive established that a substantial amount of variable remuneration must be represented by any long-dated financial instrument that adequately reflects the credit quality of the financial company.[94] The variable remuneration cannot be "*paid to the persons who effectively direct the business of the credit institution.*[95]

To see that the interests of the financial institution are aligned with personal objectives of the manager and with staff members more generally, the Directive states that "*the assessment of the performance-based components of remuneration should be based on longer-term performance and take into account the outstanding risks associated with the performance. The assessment of performance should be set in a multi-year framework of at*

least 3 to 5 years, in order to ensure that the assessment process is based on longer term performance and that the actual payment of performance-based components of remuneration is spread over the business cycle of the credit institution or investment firm" (Whereas n. 7).

Given that the globalised economy is dominated by the presence of intermediaries, that are not only too-big–to-fail, but also too interconnected to fail (Iori et al., 2008), Whereas 4 stated that "*because excessive and imprudent risk-taking may undermine the financial soundness of credit institutions or investment firms and destabilise the banking system, it is important that the new obligation concerning remuneration policies and practices should be implemented in a consistent manner and should cover all aspects of remuneration including salaries, discretionary pension benefits and any similar benefits*".

However, following the *one-size does not fit all* principle, the Directive (Whereas 4) confirmed that "*The principles should recognise that credit institutions and investment firms may apply the provisions in different ways according to their size, internal organisation and the nature, scope and complexity of their activities and, in particular, that it may not be proportionate for investment firms referred to in Article 20(2) and (3) of Directive 2006/49/EC to comply with all of the principles"* (principle of proportionality).

Finally, correct alignment of a sound and prudent remuneration system with the associated credit institution risk profile has to be supplemented with clear transparency rules. For this purpose, the Directive asserted that "*credit institutions and investment firms should disclose detailed information on their remuneration policies, practices and, for reasons of confidentiality, aggregated amounts for those members of staff whose professional activities have a material impact on the risk profile of the credit institution or investment firm*" (Whereas 21).

12.2.2. The Regulation of compensation within the Italian Banking Industry

In Italy, general principles on remuneration policies were already present before the crisis although they were particularly or exclusively addressed to listed companies. On 26th August 2004, the Minister for the Economy, as chairperson of the Interministerial Committee for Credit and Savings, acting on a proposal from the Bank of Italy, approved a Decree introducing the general guidelines on the principles that banks and other financial intermediaries adopting governance systems alternative to the traditional one were forced to follow.[96] In particular, banks were obligated to instil a corporate governance model where

the remuneration and incentive systems were aimed to dissuade managers from management choices not aligned with the banks' strategies.

Further provisions regarding this issue were introduced with the Finance Act (TUF): "*Compensation plans based on financial instruments in favour of members of the board of directors or the management board, employees and collaborators not linked to the company by an employment contract and of members of the board of directors or the management board, employees and collaborators of parent companies or subsidiaries shall be approved by the ordinary shareholders' meeting*".[97] The approval process was seen as an instrument by which shareholders were able to align the interests of managers, often short term oriented, with the long term perspective of safe and sound management of risk. With regard to listed companies, an important point of reference was the Corporate Governance Code issued in 2006 which replaced the preceding 1999 and amended 2002 versions. It was based on self-regulation, while adoption and compliance with the Code was voluntary and non-binding in nature.[98] If on one hand the Committee for Corporate Governance recognised that greater incentives to reach certain goals may emanate from higher remuneration levels ("*the remuneration of directors shall be established in a sufficient amount to attract, maintain and motivate directors endowed with the professional skills necessary for managing the issuer successfully*", Principle 7.1), on the other hand, Principle 7.2 outlines that to reduce excessive risk-taking "*the remuneration of executive directors shall be articulated in such a way as to align their interests with pursuing the priority objective of creating value for the shareholders in a medium-long term timeframe*". To achieve this, it was stated that a significant amount of the remuneration of each executive with strategic responsibilities must be linked to the *economic results* achieved by the company.[99]

To effectively implement the Decree of 26 August 2004 regarding banks and parent companies of banking groups, in 2008 the Bank of Italy issued a supervisory regulation for the internal organisation and corporate governance of banks,[100] indicating the essential features of corporate governance for the purposes of sound and prudent management.[101]

The provisions set forth by the regulation were particularly relevant for banks and other financial intermediaries that adopted the two tier governance system, in which it was possible for more than one function to be performed by the same governing body or for more than one governing body to share the same function. According to the principle of

proportionality and in line with the standards defined, provisions were calibrated to the characteristics and size of the banks.

With regard to the crucial issue of executive compensation and incentive mechanisms, the general principle sponsored by the Bank of Italy maintained that although "*the remuneration of persons responsible for the internal control function*[102] *and of the manager responsible for preparing the financial statements must be commensurate with their considerable responsibilities and commitment*", at the same time "*remuneration schemes must not conflict with a bank's prudent risk management policies or its long-term strategy. In particular, equity-based incentives (e.g. stock options) or performance-linked pay must take account of the risk borne by banks and be structured so as to avoid generating incentives that conflict with their long-term interests*". It is worthy to highlight that, in accordance with Recommendation 2004/913/EC,[103] the rules on remuneration policy included the rationale and criteria on which remuneration was based and gave details about the ratio between fixed and variable components (including performance-linked bonuses and equity-based remuneration) and the compensation paid in connection with the termination of service. In order to ensure alignment with prudent risk management and the long term perspective of the company, remuneration policies should be subject to the approval of shareholders. Moreover, for large and operationally complex financial intermediaries an advisory committee composed of independent members is required to determine the executives' compensation and remuneration criteria.

To implement European Directive 2010/76/EC (so called CRD III), the Bank of Italy issued a New Regulation "S*upervisory provisions concerning remuneration and incentive policies and practices in bank and banking groups*" on 30th March 2011. The provisions were also addressed to foreign branches of Italian banks and Italian branches of foreign banks.[104]

The provisions issued by Bank of Italy followed the European regulatory approach exactly. As in the Directive, implementation of the new rules allowed some flexibility depending on the characteristics, size and complexity of the activity of the bank (*principle of proportionality*). Only large banking groups had to fully comply with the community rules, whereas some major provisions, in particular those regarding the structure of incentive systems, were not binding for smaller banks.[105]

The rules on remuneration were addressed to all personnel, but in accordance with the principle of proportionality, the more detailed and constrictive rules only concerned

"relevant" personnel selected by a self-assessment process. However, it was assumed that those included in the category of relevant personnel were:[106]

i. managers with executive tasks;
ii. general directors and other managers of the leading business lines or corporate functions or geographic area, as well as personnel having functions connected with strategy, management and control;
iii. staff members of internal control functions with particular reference to internal audit, risk management, and human resources;
iv. other members who individually or collectively take significant risks (other *risk takers*);[107]
v. any employee whose total remuneration, including discretionary pension benefit provisions, put them in the same remuneration bracket as senior management (ii above) and other *risk takers*.

The structure of remuneration systems and incentive mechanisms is the core of the Bank of Italy provision which on the whole followed the principles stated by CRD III.

According to paragraph 5.1 of the Regulation of Bank of Italy of 30th March 2011, "*total remuneration must be split into fixed and variable quotas; the distinction between these two components must be strict*". In accordance with the principle of proportionality, even if the ratio between the fixed and variable portion is balanced, it should be evaluated according to the complexity of bank activities and the type of staff members, with particular regard to *relevant personnel*. To enable a flexible remuneration policy and variable quotas, the Bank of Italy stated that employee fixed compensation had to represent a sufficiently high proportion of total remuneration, envisaging the possibility of completely eliminating the variable part when appropriate risk-adjusted performance is not aligned with targets.

Since supervisors and regulatory bodies agreed that inappropriate remuneration structures of some financial institutions were a major factor in the financial crisis, they focused on the design of the variable part of remuneration policies, judged responsible for the mismatch between personal objectives of executives and the long term interests of the credit institution. To align executive compensation with the long term perspectives of credit institutions, the Bank of Italy established detailed criteria for determining the variable component of remuneration.[108] The key decisions stated firstly that a substantial portion of at least 50 per cent, had to be balanced between shares, share-linked instruments or for non-listed banks, equivalent financial instruments, *and* where appropriate, non-innovative

capital instruments limited to 50 per cent of Tier 1 capital.[109] In order to align the incentives with the long term interests of the credit institution, these instruments were to be subject to an appropriate *retention policy.*[110] Secondly, payment of a substantial portion of at least 40 per cent of the variable remuneration component had to be deferred over a period of not less than 3 to 5 years so that remuneration was coherent with risks undertaken by the bank over the time period (*malus mechanism*). That portion increases significantly to at least 60 per cent when the remuneration is for executives or more generally, personnel and business areas characterised by a higher risk profile.

Finally, the national Supervisory Authority stated that the variable remuneration component has to be subject to an *ex-post* correction mechanism – *malus or claw back clauses*[111] – in order to ensure that its total amount is sustainable in relation to the financial situation of the bank and that it does not limit the bank's ability to strengthen its capital base.

It is worth highlighting that in full compliance with Directive 2010/76/EU, the Bank of Italy stated that for banks and banking groups receiving special government support, variable remuneration should be strictly limited as a percentage of net revenue when inconsistent with the maintenance of a sound capital base and timely exit from government support.

The provisions issued by the Bank of Italy were aimed at involving corporate structure in building of the remuneration system. In particular, in order to ensure a greater control on the degree of compliance to incentive systems with safe and sound risk management, shareholders were given the task of approving the remuneration policies addressed to bodies having supervisory, management and control functions and for equity-based incentives. The main goal of this was to increase shareholder awareness of the overall costs and underlying risks of the chosen remuneration system. Shareholders were to be provided with clear and complete prior information on future remuneration policies and practices, as well as further subsequent information on the terms of implementation of these policies on a yearly basis.

According to the provisions set forth in paragraph 4.2 of the Bank of Italy rules, the body having strategic supervision functions has to define the remuneration and incentive systems for executive managers, general directors and staff members with internal control functions. In order to verify correct policy application, the members of the strategic supervision are forced to report on the remuneration policy implemented at least on a yearly basis.

For large banks, as defined in paragraph 3.4 of the Regulation, as well as for listed banks, the Bank of Italy made it an obligation to constitute a "Remuneration Committee" in bodies

with strategic supervision functions. Members had to be non-executive and the majority of them had to be independent.[112] The functions of the Remuneration Committee were outlined in detail in paragraph 4.2 of the Regulation. Among these, the Committee was given responsibility for advisory and proposal tasks regarding the remuneration of corporate officers, as defined in article 26 of the Italian Banking Act (TUB), and advisory tasks related to the remuneration of top managers. The Committee also had to ensure involvement of the corporate functions responsible for the supervision and development of remuneration policies and practices.

Finally, great importance was attributed to internal audit, which is expected to verify the congruence between remuneration practices and provisions of the national supervisory authority at least on a yearly basis. Credit institutions were also given the possibility of using external experts to ensure the independence of their activities.

According to the supervisory provisions of the Bank of Italy of March 2011 and implementing the CRD III regarding remuneration and incentive policies and practices (in line with article 6 paragraph 2-bis of the Finance Act (TUF)[113] as amended by Community Law of 2010), on 29th July 2012 the Bank of Italy and Consob jointly amended the "*Regulation on the organisation and intermediary procedures providing investment services or collective investment management services*" adopted by the provision of 29th October 2007. In particular, chapter 3-bis (Organisational-precautionary requirements for remuneration and incentive policies and practices) article 14-bis was added; it stated that intermediaries had to apply the rules adopted in implementation of the Consolidated Law on Banking (TUB). Moreover, in accordance with the principle of proportionality, "*SIM - including their foreign branches wherever established – and, as far as applicable, the branches of non-EU investment companies apply the remuneration policies, according to their operating methods, size and activity performed, as well as according to the type and entity of the risks assumed*".[114]

Throughout 2013 the Bank of Italy enhanced the supervision of remuneration policy through general recommendations (Bank of Italy's communications of 2nd March 2012 and 13th March 2013) and moral suasion addressed to single financial institutions. In December 2013, the Bank of Italy submitted to public consultation the revision of the "S*upervisory provisions concerning remuneration and incentive policies and practices in bank and banking groups"* of March 2011 for the purpose of adopting the innovations introduced by Directive 2013/36/EU (CRD 4). Although the present structure of the discipline remains

unchanged, some important innovations have been proposed. In particular, the Directive specifies:

- a capped ratio of 1:1 between the fixed and variable component of remuneration. It may be raised to 2:1 with shareholders' approval, complying with the conditions and within limits set by the Directive;
- reinforcement of the provisions concerning ex-post risk adjustment mechanisms (malus and claw-back arrangements);
- limits to variable remuneration when banks do not observe capital requirements;
- the European Banking Authority ('EBA') is required to issue regulatory technical standards to specify "qualitative and quantitative" criteria to identify staff whose activities have a material impact on the risk profile of the institution for which they work. Moreover, the European Banking Authority has to specify the characteristics of financial instruments used for the recognition of variable remuneration.

Finally, the Bank of Italy revised the definition of "major banks" to which the whole regulation on remuneration policy applies, in order to align it with that of "significant banks" in accordance with the Regulation of the European Single Supervisory Mechanism.

13. Conclusions

Analysis of changes to the regulatory framework over the last three decades and responses to the financial crisis allows us to conclude that a number of key points have driven transformation of financial regulation in Italy.

Credit and financial markets have experienced liberalisation where entry barriers have been substantially removed. The Italian case was probably harsher due to its previous regulatory style, based on entry barriers and on selected authorisation to diversify business and distribution channels. As seen in our paper, with adoption of the first Bank Directive (1985) and the application of Basel I proposals (1988), the style of banking supervision changed from structural to prudential. The purpose of regulation (1993 Banking Act, article 5) was not only to maintain financial stability, but also to promote a higher level of efficiency.

The concentration process accelerated in terms of size: between 1990 and 1995, total assets of the five largest banks were around 30%; in 1999 they rose to 48%. At the same

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time, with liberalisation of the banking system, the number of branches increased by about 40% in the period 1996 to 2008 (Figure 3). Lending activity distribution confirms the small share of southern regions that received a small portion of resources, ranging from 15 to 18 per cent of total loans.

The liberalisation of the banking market and the introduction of capital requirements, calibrated on risk weighted assets, allowed credit institutions to increase their risk appetites under the assumption that risk management metrics could capture risk factors. The introduction of capital requirements was aimed at reducing the risk appetite of banks in cases where their profitability could not pay back the cost of capital. In fact, until 1996, only credit risk unexpected losses were assumed to be covered by the capital requirement. Banks were induced to increase their financial propensity, chiefly proprietary trading exposures in sovereign bonds, without any capital absorption, since the market risk element was calculated out of the 1988 Capital Accord (Basel I).

Prudential supervision design introduced regulatory arbitrage, causing banks to change behaviour to save capital by securitising loans and mortgages. Some banks used securitisations and other credit transfer operations too aggressively in order to benefit from the possibilities offered by the new techniques to remove risky exposures from their balance sheets and to reduce the cost of capital.

Thus, the banking business model changed from an originate-to-hold model to an originate-to-distribute one. Italy's asset securitisation market developed much later than in the US, beginning with the introduction of a specific law and the launch of the single European currency. The growth in euro-denominated securitisations started in 2000 and accelerated strongly from the end of 2004. At the end of 2006 the annual net flow of asset-backed securities issued in Italy was around 23 per cent of total securitised assets in the euro area. An increase from 1.9% in 2000 to 7.1% in 2006 was seen in the level of securitised mortgages to households held by Italian banks.

The financialisation of commercial banking, along with adoption in 2003 of the International Accounting Standards (IAS), the mark-to-market approach, and pervasive top management incentive schemes aimed at reducing agency conflicts with shareholders' value, all explain the short-termism of many banks. This was especially true for those banks that operated in both domestic and foreign markets. Their business models changed from one based on relationships to transaction-orientated banking, that led to a greater functional distance between branches and corporate headquarters. Negative

effects on local SMEs and industrial districts were a consequence, in terms of higher probability of credit rationing, lower financial innovation, and lower capability to reduce asymmetric information between borrowers and lenders.

One of the principal effects of the liberalisation of capital movements due to introduction of the euro was the continentalisation of financial portfolios. Moreover, capital absorption introduced by capital regulation was an incentive for banks to invest in sovereign bonds, preferably those offering higher returns.

Italian banks were trapped in a vicious circle arising from the deleveraging process experienced after the start of the crisis, the impact of this being a generalised capital loss in trading books, particularly for those exposed to Italian bonds with longer terms. Both capital and liquidity became insufficient to support the credit demand of the private sector and to guarantee the roll-over of sovereign bond issuances. Foreign investors resorted to quality switching from Italian government bonds to alternative securities, compounding concerns about the valuation of the assets of banks and capital adequacy.

Since the onset of the recent financial crisis, a set of proposals to reduce the probability of recurrence has been discussed. Along with new rules related to bank capital and liquidity buffers, the hyper-speculative exposure of some financial players has stimulated debate on recommendations that commercial banks and depositors should be ring-fenced.

Actually, the Italian situation is different from that of other countries, particularly the US, UK and countries with a high degree of financialisation, since the role of investment banks in the economy is relatively less. After the crisis, large Italian banks owning investment divisions (or legal entities) decided autonomously to transform their business orientations to become ancillary with respect to the core commercial business.

Another issue discussed relates to the concept of banking union. The Bank of Italy's point of view (Rossi 2014, Signorini 2014) is that although the process of managing supervisory homogeneity has been driven by heterogeneous purposes, the Single Supervisory Mechanism will help reduce the temptation for ring-fencing to protect domestic giants and different supervisory styles. Rossi (2014) is convinced that some banks are not only "too big to fail" but also "too big to manage" within a single country.

The operational and organisational effort to build up a completely new system is considered exceptional. According to Signorini (2014) Italy has been one of the most effective countries in designing a new supervisory handbook that follows the consolidated approach. During the first semester of 2014, 15 Italian banks were subject to supervisory risk assessment,

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asset quality review, and a stress test to supervise all European large banks with a common starting point.

The Bank of Italy is much more sceptical about the way the design of the Single Resolution Fund, particularly as the decision making process is complicated and far from able to effectively face an unexpected banking crisis (Signorini, 2014).

Finally, a significant change underlined by the Italian regulator is that CRD IV/CRR (with its 686 articles, most of them particularly technical in nature) is extremely rigid and inflexible to changes with future scenarios. The Bank of Italy (Signorini, 2014) suggests a rebalancing of the primary and secondary regulations.

Notes

[1] a) Residents were not allowed to hold funds in foreign bank accounts, but foreign currency could be held in accounts with domestic banks up to 120 days; b) non-resident banks were not allowed to extend credit lines to non-residents or to purchase money market securities abroad with a maturity shorter than 180 days; c) a ceiling limit for a bank's ability to carry out forward operations against Italian lira remained, but it increased by 50%.

[2] Art. 6 of the Council Directive 88/361/EC: "Without prejudice to the following provisions, Member States shall abolish restrictions on movements of capital taking place between persons resident in Member States. Transfers in respect of capital movements shall be made on the same exchange rate conditions as those governing payments relating to current transactions".

[3] The list of banking activities subject to mutual recognition was as follows: "deposit-taking and other forms of borrowing; lending (including in particular: consumer credit, mortgage lending, factoring and invoice discounting, and trade finance; financial leasing; money transmission services; issuing and administering means of payment (credit cards, travellers cheques and bankers drafts); guarantees and commitments; trading for own account or for account of customers in: (a) money market instruments (cheques, bills, CDs, etc.), (b) foreign exchange, (c) financial futures and options, (d) exchange and interest rate instruments, (e) securities; participation in securities issues and provision of services related to such issues; money brokering; portfolio management and advice; safekeeping of securities; credit reference services; safe custody services".

[4] See R.D.L March 12, 1936 n. 375 (*Disposizioni per la difesa del risparmio e per la disciplina della funzione creditizia*) as amended by Law no. 141 7th March 1938.

[5] Other critical changes introduced by the Banking Law of 1936-38 [Law No. 141 of 7th March 1938 (Italy) and Law No. 636 of 7th April 1938 (Italy)] concern the redefinition of credit institution functions and the creation of the Ispettorato per la difesa del risparmio e l'esercizio del credito (IDREC), a supervisory body chaired by the governor of the Banca d'Italia (articles 1-24 of the Banking Law). Moreover, the Banking Law regulated the process of chartering and branching of banks (articles 28-40 of the Banking Law). Finally, several provisions introduced controls and tools targeted at prudential and regulatory supervision (articles 31-33 and 35 of the Banking Law).

[6] See M. Clarich and A. Pisaneschi (2001), "*Le Fondazioni bancarie*", Il Mulino.

[7] See Decree of the President of the Republic no. 350 of 1985, art. 1.

[8] For major details on permitted investment services, see Annex to Investment Services Directive.

[9] See Investment Services Directive, article 15.

[10] Article 21 established that for each instrument the authorities had to require at least: 1) "*the publication, at the start of each day's trading on the market, of the weighted average price, the highest and the lowest prices and the volume dealt in on the regulated market in question for the whole of the preceding day's trading*; 2) *at the end of each hour's trading on the market, of the weighted average price and the volume dealt in on the regulated market in question for a six-hour trading period ending so as to leave two hours' trading on the market before publication*; 3) *every 20 minutes, of the weighted average price and the highest and lowest prices on the regulated market in question for a two-hour trading period ending so as to leave one hour's trading on the market before publication".*

[11] Law No.2 of 1st January 1991, article 3.
[12] Legislative Decree No. 415 of 1996, article 4.
[13] These provisions correspond to those already established with the Bank of Italy's supervisory Circular no. 263 of 27th December 2006 and applied to banks by 31st December 2013.
[14] In this case, the requirements for "*vega*" and "*gamma*" factor also have to be computed. For a more detailed analysis, see the Bank of Italy's supervisory Circular no. 285 of 17th December 2013, Part II, Chapter 9, Section III.
[15] See note 13
[16] Bank of Italy (2011), Supervisory provisions concerning remuneration policies in banking groups, March.
[17] Bank of Italy, Communications of 4th May 2011, "*Modifiche alla regolamentazione prudenziale".*
[18] Liabilities resulting from the institution's own operating expenses, liabilities resulting from secured lending, and capital market-driven transactions as defined in point (3) of Article 192, liabilities resulting from deposits that have to be maintained: a) by the depositor in order to obtain clearing, custody or cash management, or other comparable services from the institution, (b) in the context of common task sharing within an institutional protection scheme or as a legal or statutory minimum deposit by another entity being a Member of the same institutional protection scheme, (c) by the depositor in the context of an established operational relationship other than that mentioned in point (a) and (d) by the depositor to obtain cash clearing and central credit institution services and where the credit institution belongs to a network in accordance with legal or statutory provisions; liabilities resulting from deposits by clients that are not financial customers to the extent they do not fall under paragraphs 3 and 4 of article 422 CRR.
[19] The conditions are: a) there are reasons to expect a higher inflow even under a combined market and idiosyncratic stress of the provider, b) the counterparty is a parent or subsidiary institution of the institution or another subsidiary of the same parent institution; or linked to the institution by a relationship within the meaning of Article 12(1) of Directive 83/349/EC; or a member of the same institutional protection scheme referred to in Article 113(7) of this Regulation or the central institution; or a member of a network that is subject to the waiver referred to in Article 10 of this Regulation, c) a corresponding symmetric or more conservative outflow is applied by the counterparty by way of derogation from Articles 422, 423 and 424, d) the institution and the counterparty are established in the same Member State.
[20] Law no. 114 of 17th April 1986 "*Controllo delle partecipazioni bancarie in attuazione della direttiva CEE n. 83/350 del 13 giugno 1983 in tema di vigilanza su base consolidata degli enti creditizi".*
[21] The Tripartite Group was formed by bank, securities and insurance regulators at the initiative of the Basle Committee on Banking Supervision (Basle Committee) in early 1993 to address a range of issues relating to the supervision of financial conglomerates.
[22] "*The Supervision of Financial Conglomerates*", A report by the Tripartite Group of Bank, Securities and Insurance Regulators, July 1995.
[23] The Joint Forum was established in early 1996 under the aegis of the Basle Committee, the International Organisation of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS) to forward the work of the Tripartite Group.
[24] Directive 2002/87/EC of the European Parliament and of the Council of 16th December 2002.
[25] Before the approval of Directive 2002/87/EC, other important Directives were adopted to deal with consolidated supervision. The most important were: Council Directive 92/30/EC on the Supervision of Credit Institutions on a Consolidated basis; Council Directive 93/6/EC of 15th March 1993 on the capital adequacy of investments firms and credit institutions; Directive 95/26/EC, (the so-called Post BCCI Directive); Directive 98/78/EC of the European Parliament and of the Council of 27th October 1998 on the supplementary supervision of insurance undertakings in an insurance group; Directive 2000/12/EC of the European Parliament and of the Council of 20th March 2000 relating to the taking up and pursuit of the business of credit institutions.
[26] *"The difference between supervision on a consolidated basis and supervision on a "solo plus" basis lies in the fact that, in the latter case, the point of reference used is the financial statements of each individual undertaking, which are then corrected to take into account the impact at group level",* Christos VI. Gortsos (2010), The Supervision of Financial Conglomerates under European Financial law, note 21.
[27] Directive 2002/87/EC, article 3.
[28] Legislative Decree No. 142 of 30th May 2005, article 6.
[29] According to the Joint Forum Report, *double gearing* occurs whenever one entity holds regulatory capital issued by another entity within the same group, and the issuer is allowed to count the capital on its own balance sheet; multiple gearing occurs when the dependant in the previous instance issues regulatory capital to a third-tier entity, and the parent's externally generated capital is geared up a third time; excessive leverage

is defined as situations where a parent issues debt and the proceeds as equity or other forms of regulatory capital to its regular subsidiaries.
[30] The methods specified by the Directive were represented by: a) accounting consolidation method; b) deduction and aggregation method; and c) book value/requirement deduction method. For major details on the calculation methods, see Annex I of Directive 2002/87/EC.
[31] Bank of Italy - Isvap (2005), *"Accordo di coordinamento in materia di identificazione e adeguatezza patrimoniale dei conglomerati finanziari".*
[32] Legislative Decree no. 385 of 1st September 1993, article 19, sub-paragraph 6.
[33] Legislative Decree no. 385 of 1st September 1993, article 19, sub-paragraph 7.
[34] Italian Banking Law, article 19, subparagraph 2, as amended by legislative Decree no. 21 of 27th January 2010.
[35] Legislative Decree no. 58 of 24th February 1998.
[36] Council Directive 93/22/EC of 10th May 1993.
[37] Directive 89/592/EC of 13th November 1989 coordinating regulations on insider dealing.
[38] Art. 3 Law no. 157/1991.
[39] Art. 5 (1) Law no. 157/1991.
[40] The European Union's Financial Services Action Plan (FSAP) is the 5-year legislative program launched in 1999 to accelerate the development of a true single market for financial services across the 28 Member States of the European Economic Area (EEA).
[41] According to CESR, MAD was still a minimum harmonisation directive. For major details see CESR, "*An evaluation of equivalence of supervisory powers in the EU under the Market Abuse Directive and the Prospectus Directive. A report to the Financial Services Committee (FSC)",* June 2007.
[42] The "Lamfalussy Process" is named after Alexandre Lamfalussy who, as chair of the Committee of Wise Men on the Regulation of European Securities Markets, helped formulate the four-level process for implementing regulatory reform in the European financial services industry. The process was proposed in 2001 as a means of accelerating the development of European financial services legislation whilst enabling market experts to participate in the legislative process. The Lamfalussy process advocates a framework Directive under which subordinate 'Level 2' measures are prepared during the Directive's implementation period. Level 2 measures set out the technical detail around the 'Level 1' Directive framework. Commission Directive 2003/124/EC of 22nd December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the definition and public disclosure of inside information, and the definition of market manipulation; Commission Directive 2003/125/EC of 22nd December 2003 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards the fair presentation of investment recommendations and the disclosure of conflicts of interest; Directive 2004/72/EC of 29th April 2004 implementing Directive 2003/6/EC of the European Parliament and of the Council as regards accepted market practices; Commission Regulation (EC) no. 2273/2003 on Market Abuse.
[43] Art 181 (1) Legislative Decree no. 58/1998, as amended by Law no. 62 /2005.
[44] Art 181 (3) Legislative Decree no. 58/1998, as amended by Law no. 62 /2005.
[45] Art 114 (8) Legislative Decree no. 58/1998, as amended by Law no. 62 /2005.
[46] Art 187 (septies) Legislative Decree no. 58/1998, as amended by Law no. 62 /2005.
[47] Directive 2004/39/EC of the European Parliament and of the Council of 21st April 2004 on markets in financial instruments amending Council Directives 85/611/EC and 93/6/EC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EC.
[48] See note 42.
[49] Directive 2004/39/EC
[50] Directive 2006/73/EC
[51] Commission Regulation No. 1287/2006 implementing Directive 2004/39/EC of the European Parliament and of the Council as regards record-keeping obligations for investment firms, transaction reporting, market transparency, admission of financial instruments to trading, and defined terms for the purposes of that Directive.
[52] Art 1 (5-septies) Legislative Decree no. 58/1998, as amended by Legislative Decree no. 164/2007.
[53] "Private professional customer" shall mean a customer in possession of the experience, awareness and competence necessary to make his own informed decisions on investments and to correctly evaluate the risks assumed, Consob Regulation no. 16190, article 26,letter d); "Public professional customer" shall mean a customer that meets the requirements of the regulations issued by the Minister for the Economy and Finance pursuant to article 6, subsection 2-sexies of the Consolidated Law, Consob Regulation no. 16190, article

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26,letter d); "retail customer" shall mean the customer that is neither professional or a qualified counterparty, Consob Regulation no. 16190, article 26, letter e).
[54] Art 27 Consob Resolution no. 16190 of 29th October 2007.
[55] The Bond Holders Guarantee Fund for Cooperative Banks introduced in 2005 is not considered in our analysis, since it is not directly related to bank deposits.
[56] Art. 13-14 of the Appendix to the Statutes of the Interbank Deposit Protection Fund.
[57] Art. 5 By-Laws of the Deposit Guarantee Fund of Cooperative Credit Banks.
[58] Directive 2009/14/EC of the European Parliament and of the Council of 11th March 2009 amending Directive 94/19/EC on deposit guarantee schemes as regards the coverage level and the pay-out delay.
[59] For a detailed analysis on this issue, see F. Cannata et al. (2013),*"Il credito cooperativo alla sfida di Basilea 3: tendenze impatti, prospettive"*.
[60] According to article 80, paragraph 8 of Directive 2006/48/EC, *"With the exception of exposures giving rise to liabilities in the form of the items referred to in points (a) to (h) of Article 57, competent authorities may exempt exposures to counterparties, which are members of the same institutional protection scheme as the lending credit institution, from the requirements of paragraph 1 of this Article, provided that the following conditions are met: a) the requirements set out in points (a), (d) and (e) of paragraph 7; b) the credit institution and the counterparty have entered a contractual or statutory liability arrangement which protects those institutions from bankruptcy if necessary, and in particular ensures their liquidity and solvency (referred to below as an institutional protection scheme); c) the arrangements ensure that the institutional protection scheme can grant support necessary under its commitment from funds readily available to it; d) the institutional protection scheme disposes of suitable and uniformly stipulated systems for the monitoring and classification of risk (which gives a complete overview of the risk situations of all the individual members and the institutional protection scheme as a whole) with corresponding possibilities to take influence; those systems shall suitably monitor defaulted exposures in accordance with Annex VII, Part 4, point 44; e) the institutional protection scheme conducts its own risk review which is communicated to the individual members; f) once a year the institutional protection scheme draws up and publishes either a consolidated report comprising the balance sheet, the profit-and-loss account, the situation report and the risk report concerning the institutional protection scheme as a whole, or a report comprising the aggregate balance sheet, the aggregate profit-and-loss account, the situation report and the risk report concerning the institutional protection scheme as a whole; g) members of the institutional protection scheme are obliged to give advance notice of at least 24 months if they wish to end the arrangements; h) the multiple use of elements eligible for the calculation of own funds (multiple gearing) as well as any inappropriate creation of own funds between the members of the institutional protection scheme shall be eliminated; i) the institutional protection scheme shall be based on a broad membership of credit institutions of a predominantly homogeneous business profile; and j) the adequacy of the systems referred to in point (d) is approved and monitored at regular intervals by the relevant competent authorities. In such a case, a risk weight of 0% shall be assigned".*
[61] L. Cerenza, E. Galanti (1999), Italy, in M. Giovagnoli, G. Heinrich (edited by) "*International Bank Insolvency. A Central Bank Perspective",* Kluwer Law International, London.
[62] Dale (1994), "*Regulatory Consequences of the BCCI Collapse: US, UK, EC, Basle Committee*".
[63] For an analysis of the background and history of the Directive see Galanti (2002), *"The New EC Law on Bank Crisis".*
[64] The ring-fencing practice was contrary to the principle that all claims of a similar type should be treated equally. Where ring-fencing was allowed, branches of foreign banks were treated as separate legal entities and, if necessary, were wound-up as such. Essentially the aim was to ensure that local creditors received preferential treatment over foreign creditors.
[65] Ceriani G. and Frazza B. (2011), *"Il Bilancio bancario. Evoluzione e rivoluzione nell'informativa*", in Rutigliano M. (ed) *"Il bilancio della banca",* EGEA, Milan.
[66] Directive 86/635/EC, article 4.
[67] Legislative Decree no. 87 of 27th January 1992, article 46.
[68] Directive 78/660/EC, article 2.
[69] Legislative Decree no. 87 of 27th January 1992, article 2, subparagraph 2.
[70] Legislative Decree no. 87 of 27th January 1992, article 2, subparagraph 3.
[71] Legislative Decree no. 87 of 27th January 1992, article 2, subparagraph 4.
[72] Bank of Italy, Circular no. 166 of 15th July 1992.
[73] Legislative Decree no. 87 of 27th January 1992, article 7, subparagraph 6.
[74] Legislative Decree no. 87 of 27th January 1992, article 7, subparagraph 8.

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[75] The International Accounting Standards were applied starting from 1st January 2007 for those companies: a) whose debt securities are only admitted on a regulated market of any Member State; b) whose securities are publically traded in a non-member State and which, for that purpose, have been using internationally accepted standards in a financial year prior to the publication of this Regulation in the Official Journal of the European Communities.

[76] Italian Civil Code, as modified by Legislative Decree no. 32 of 2nd February 2007, article 2428, subparagraph 1.

[77] Italian Civil Code, as modified by Legislative Decree no. 32 of 2nd February 2007, article 2428, subparagraph 2.

[78] "*The consolidated annual report has to be accompanied by a directors' report on overall position of the undertakings included in the consolidation and on the development of the business, taken as a whole and in different sectors, having special regard for the costs, incomes and investments*", article 40 of Legislative Decree no. 127 of 1991, before adoption of Legislative Decree no. 32 of 2007.

[79] OECD, "*Principles of Corporate Governance"*, revised on April 2004, originally issue June 1999.

[80] Basel Committee on Banking Supervision (1999), "*Enhancing Corporate Governance for Banking Organisations"*, September, revised in February 2006.

[81] J. Winter (2011), *"The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve it?",* DSF Policy Paper Series, no. 14.

[82] For a wide review of the literature on banking compensation, see Jannuzzi (2011), "*Soundness and disclosure of remuneration practice in the financial industry: an empirical analysis for Italian listed banks"*, and Ferrarini and Ungureanu (2011), *"Economics, Politics, and the International Principles for Sound Compensation Practices: An Analysis of Executive Pay at European Banks".*

[83] The problem of short termism is not attributed to one source but requires attention to a number of facets. For a comprehensive exploration of why financial and non-financial firms engage in short-termism and how to mitigate it, see L. Dallas (2011), "*Short-termism, the Financial Crisis and Corporate Governance".*

[84] CFA Centre for Financial Market Integrity (2006), "*Breaking the Short-Term Cycle Discussion and Recommendations on How Corporate Leaders, Asset Managers, Investors, and Analysts Can Refocus on Long-Term Value".*

[85] The Aspen Institute (2009), "*Overcoming Short-termism: A Call for a More Responsible Approach to Investment and Business Management*".

[86] The opinion that the structure of the remuneration system and incentives was the main factor that triggered the financial crisis is widely shared. For a detailed overview see Brunnermeier (2009), Davies (2010), Jannuzzi (2011), Winter (2011). Conversely, for a comprehensive review of empirical studies that found no evidence that short-term incentives led to excessive risks, see Ferrarini and Ungureanu (2011).

[87] Earlier criticism on the deficiencies of executive remuneration systems can be found in Bebchuk and Fried (2003), and Jensen et al. (2004).

[88] Other important contributions are: Committee of Banking Supervisors (2009), "*High Level Principles for Remuneration Policies"*; Financial Stability Board (2010), "*Thematic Review on Compensation, Peer Review Report"*; Basel Committee on Banking Supervision (2010), "*Compensation Principles and Standard Assessment Methodology".*

[89] For a major detailed analysis of the Principles, see Financial Stability Forum (2009), *"Principles for Sound Compensation Practices".*

[90] Recommendation 4.1 in Section II of the Commission Recommendation of 30th April 2009 on remuneration policies in the financial services sector.

[91] Recommendation 5.2 in Section II of the Commission Recommendation of 30th April 2009 on remuneration policies in the financial services sector.

[92] Recommendation 9.2 in Section III of the Commission Recommendation of 30th April 2009 as regards the regime for the remuneration of directors of listed companies.

[93] Directive 2010/76/EU, Annex I, letter q.

[94] Directive 2010/76/EU, Annex I, letter o.

[95] Directive 2010/76/EU, Annex I, letter k (iii).

[96] Since 2004, Italian corporate law has contemplated three different governance and supervision structures: a) the traditional Italian model, comprising a board of directors and a board of statutory auditors composed of independent members performing oversight functions; b) a one tier model, consisting of a board of directors, including a management audit committee composed of a majority of independent directors; c) a two tier model comprising a supervisory board and a management board.

[97] Art. 114-bis of Legislative Decree no. 58/1998, first introduced by art. 16 of Law no. 262 of 28.12.2005 and later amended by art. 3 of Leg. Decree no. 303 of 29.12.2006.
[98] In March 2010 there was an update of Article 7 on Remuneration of Directors. The latest version of the Corporate Governance Code was published in December 2011.
[99] It is worth observing that new article 7 of the Corporate Governance Code of March 2010 stated that *"The remuneration of executive directors and key management personnel shall be defined in such a way as to align their interests with pursuing the priority objective of the creation of value for the shareholders in a medium-long term timeframe. With regard to directors with managerial powers or performing, also de-facto, functions related to business management, as well as with regard to key management personnel, a significant part of the remuneration shall be linked to achieving specific performance objectives, possibly including non-economic objectives, identified in advance and determined in line with the guidelines contained in the general policy described in principle 7.P.4".*
[100] Bank of Italy (2008), "*Supervisory Provisions Concerning Banks Organisation and Corporate Governance*". These provisions, which govern the role and functioning of the management and control bodies, and the relationship of these bodies with the company's structure, are an integral part of a broader regulatory system bearing on other important aspects of corporate organisation and governance: controls on bank ownership and control structure and amendments to the bylaws, internal control systems, risk management, requirements for corporate officers, conflicts of interest, requirements for disclosure to investors and the market, and special rules established for listed companies and for investment services and activities.
[101] For a detailed analysis of the guidelines see Scassellati, Sforzolini, and Zadra (2008), "*New Rules on Italian Banks' Organization and Corporate Governance"*.
[102] For example the heads of the internal audit, compliance, and risk management functions.
[103] Commission Recommendation of 14th December 2004 fostering an appropriate regime for the remuneration of directors of listed companies.
[104] Employees of the foreign banks in particular were addressed with provisions regarding the remuneration structure, disclosure of information, and those not referring to the role of corporate bodies.
[105] In order to apply the proportionality principle, the National Supervisory Authority, outlining the Supervisory Review and Evaluation Process (SREP) divided intermediaries into five macro-categories: a) intermediaries having a significant international presence; b) national systemically-relevant intermediaries, i.e. entities – including those controlled by foreign-based intermediaries – with total assets of no less than 20 billion euro and, conventionally, other intermediaries, other than those referred to in point 1, which are allowed to use internal risk-measurement systems for calculating capital requirements (intermediaries with "authorised systems"); c) medium-large intermediaries i.e. entities – not falling within macro-categories 1 and 2 – characterised by at least one of the following conditions: 1) total assets between 3.5 and 20 billion euro (banks and Intermediaries 107) , 2) assets under management exceeding 10 billion euro (intermediaries mainly involved in asset management) and 3) annual turnover – dealing for own account or for the account of a third party – exceeding 150 billion euro (intermediaries mainly involved in dealing for own account or for the account of a third party); d) minor intermediaries i.e. entities characterised by at least one of the following conditions: 1) total assets of 3.5 billion euro or less (banks, mainly mutual banks, and Intermediaries 107), 2) assets under management of 10 billion euro or less (intermediaries mainly active in asset management), 3) annual turnover – dealing for own account or the account of a third party – of 150 billion euro or less (intermediaries mostly involved in dealing for own account or for the account of a third party); e) entities subject to specific regulations as EMIs, and Intermediaries 106. According to Bank of Italy provisions, the term "major banking groups" only include all intermediaries in the first macro-category SREP.
[106] Bank of Italy (2011), "S*upervisory provisions concerning remuneration and incentive policies and practices in bank and banking groups",* paragraph 3.2.
[107] "Risk taker" members are considered those whose: a) gross remuneration, irrespective of the variable quota, is greater than 200,000 euro; b) percentage of variable quota is higher than 20 per cent.
[108] See paragraph 5.2 of "S*upervisory provisions concerning remuneration and incentive policies and practices in bank and banking groups",* Bank of Italy (2011).
[109] This rule concerns both the deferred and up-front portion of the variable component.
[110] With regard to the *up-front* portion of the variable remuneration component, the retention period has to be at least 2 years whereas for financial deferred instruments, the retention period can be shorter, allowing for the duration of the evaluation period of performance.
[111] "Malus" systems are mechanisms operating during deferred periods as a result of which the variable remuneration can be reduced in relation to the dynamics of the risk-adjusted results or to capital levels. The

claw-back clause refers to return of payment already made to staff members, both the up-front and the deferred portion.

[112] Fernandes (2005), *"Board Compensation and Firm Performance: The Role of "Independent" Board Members",* ECGI Working Paper Series in Finance, no. 104. The author found that while firms with more non-executive board members paid higher wages to their executives, those with zero non-executive board members had less agency problems, and better alignment between shareholders' and managers' interests".

[113] Article 6, subparagraph 2-bis, *"The Bank of Italy and Consob, shall jointly govern the obligations of authorised persons, by regulation and in reference to the provision of investment services and activities, together with collective asset management services, on matters of: a) corporate governance, general requirements of organisation, remuneration and incentive systems; b) business continuity; c) administrative and accounting organisation, including establishment of a department pursuant to paragraph e); d) procedures, including internal audit, for the correct and transparent provision of investment services and activities together with collective asset management services; e) monitoring of compliance with regulations; f) company risk management; g) internal audit; h) top management responsibilities; i) complaint handling; j) personal transactions; k) outsourcing of essential or important operations, services or activities; l) management of conflict of interest potentially prejudicial to customers; m) record keeping; n) procedures including internal audit, for the receipt or payment of incentives".*

[114] Subparagraphs 4 and 5 of article 14-bis specify the subjects to which the provisions do not apply.

Tables

Table 1.1. Financial regulators and purposes

Intermediaries	Stability	Transparency Compliance	and Competition
Banks	Bank of Italy Minister of Finance	Bank of Italy Minister of Finance Consob	Bank of Italy (Since 2012 Antitrust)
Investments Firms	Bank of Italy Minister of Finance	Consob	Antitrust
Life Insurance	Isvap (now IVASS) Minister of Industry	Isvap (now IVASS)	Antitrust Isvap (now IVASS)
Investment Funds	Bank of Italy Minister of Finance	Consob Antitrust	Antitrust
Pension Funds	Consob Minister of Finance	Covip Minister of Finance	Antitrust

Source: Our elaboration of Di Giorgio, Di Noia, Piatti (2000)

Table 3.2. Ownership structure of listed banks (percentages, weighted by market capitalisation)

Shareholder	1990	1998	2007	2011
Insurance	0.6	3.2	2.1	2.7
Bank	5.8	11.3	3.5	7.3
Foreign	1.8	8.5	6.1	7.8
Foundation	11.1	17.4	13.8	14.5
Institutional Investor	0.5	0.1	0.0	0.0
Private Non-Financial Companies	2.1	0.9	4.2	2.3
State	36.8	1.0	0.0	0.0
Individuals [1]	2.6	1.4	2.0	6.9
Dispersed ownership [2]	38.7	56.2	68.3	58.5

(1) It includes "Società in accomandita per azioni"
(2) Sum of share lower than 2% , according to the Financial services Authority (Consob) regulation
Source: Del Prete (2008) and our elaborations of Consob data

Table 4.1. Internal models of market risk (2000)

Bank Group	Var	Test		Var Method	Violations	Parameters
		Stress	Backtest			
San Paolo IMI	YES	YES	YES	n.d.	0	99% 10 days
BNL	YES	YES	YES	MonteCarlo 5000 simul.	n.d.	99% 1 day
Intesa	YES	NO	NO	Parametric	n.d.	99% 10 days
MPS	YES	NO	NO	n.d.	n.d.	99% 1 day
Comit	YES	YES	YES	Parametric MonteCarlo	4	99% 1 day
Unicredito	YES	NO	YES	Parametric	n.d.	99% 1 day
Bancaroma	YES	NO	NO	Historical Simulation	n.d.	n.d.

Source: Bazzana, (2001)

Table 4.2. Credit quality and risk weight

Credit Quality step	1	2	3	4	5	6
Risk weight	0.10	0.20	0.30	0.50	0.50	1.00

Table 9.1 The IDPF interventions authorised by Bank of Italy since 1987

Name	Type of Interventions	Size of interventions
C.R.Prato (1988)	Support to banks	413 ml€
Banco Tricesimo (1990)	Reimbursement of depositors	4 ml€
Banca di Girgenti (1991)	Transfer of assets and liabilities	37 ml€
Banca di Credito di Trieste (1996)	Transfer of assets and liabilities	78 ml€
Credito Commerciale Tirreno (1997)	Transfer of assets and liabilities	52 ml€
Sicilcassa (1997)	Transfer of assets and liabilities	516 ml€
Banca Valle d'Itria e Magna Grecia (2010)	Transfer of assets and liabilities	5 ml€
BER Banca (2011)	Support to banks	16 ml€
Banca MB (2011)	Transfer of assets and liabilities	40 ml€

Source : De Cesare et al., (2013) Interbank Deposit Protection Fund

Table 11.1. The bank balance sheet structure

ASSETS	LIABILITIES AND SHAREHOLDERS' EQUITY
Cash and cah balance	Deposits from banks
Financial assets held for trading	Deposits from customers
Loans and receivables with banks	Debt securities issue
Loans and receivables with customers	Financial liabilities held for trading
Financial Investments	Financial liabilities designated at fair value
Property, plans and equipment	Hedging instruments
Godwill	Provisions for risks and charges
Other intangible assets	Tax liabilities
Tax assets	Liabilities included in disposal groups classified as for sale
Non-current assets and disposal groups classified as held for sale	Other liabilities
Other assets	Minorities
Total assets	Group Shareholders' Equity
	Capital and reserves
	Available for sale assets fair value reserve and cash flow hedging reserve
	Net Profit (Loss)
	Total liabilities and Shareholders' Equity

Table 11.2. Bank income statement structure

Net fees and commissions
Net trading, hedging and fair value income
Net other expenses/income
OPERATING INCOME
Staff expenses
Other administrative expenses
Operating costs
OPERATING PROFIT (LOSS)
Net write-downs on loans and provisions for guarantees and commitments
NET OPERATING PROFIT (LOSS)
Provisions for risks and charges
Integration costs
Net income for investments
PROFIT (LOSS) BEFORE TAX
Income tax for the period
Profit (loss) from non current assets held for sale, after tax
PROFIT (LOSS) FOR THE PERIOD
Minorities
NET PROFIT (LOSS) ATTRIBUTABLE TO THE GROUP BEFORE PPA
Purchase Price Allocation effect
Godwill in pairment
NET PROFIT (LOSS) ATTRIBUTABLE TO THE GROUP

Table 11.3. Reconciliation of shareholders' equity under Italian GAAP (LD 87/92) to shareholders' equity under IFRS, as at 1st January 2004, 31st December 2004 and 1st January 2005

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Shareholders' equity under current GAAP (DL 87/92)
Business combinations
Property, plant and equipment
Intangible assets
General banking risk reserve
Loan loss provision
Provision for risks and charges
Employee benefits
Share-based payments
Treasury shares
Deferred tax assets
Recognition of revenue
Consolidation
Equity investments
Loans and receivables and other financial instruments at amortised cost
Other financial instruments at fair value
Other effects
Minorities
Total effects of Transition to IFRS
Shareholders' equity under IFRS

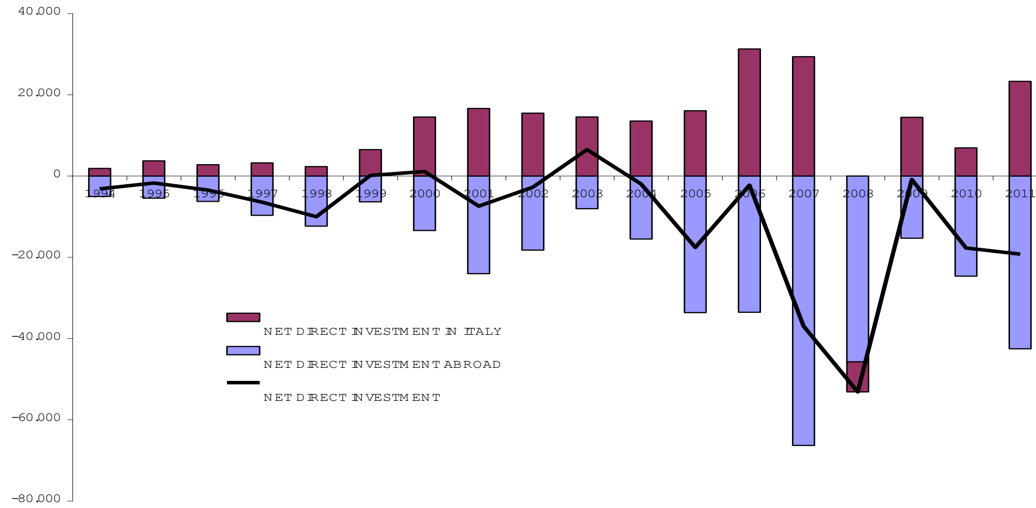
Table 11.4. Reconciliation of net profit under Italian GAAP (LD 87/92) to net profit under IFRS for the 2004 financial year

Net profit under Italian GAAP (LD 87/92)
Business combinations
Property, plant and equipment
Intangible assets
General banking risk reserve
Loan loss provision
Provision for risks and charges
Employee benefits
Share-based payments
Deferred tax assets
Recognition of revenue
Consolidation
Other effects
Minorities
Total effects of Transition to IFRS
Net profit under IFRS

Figures

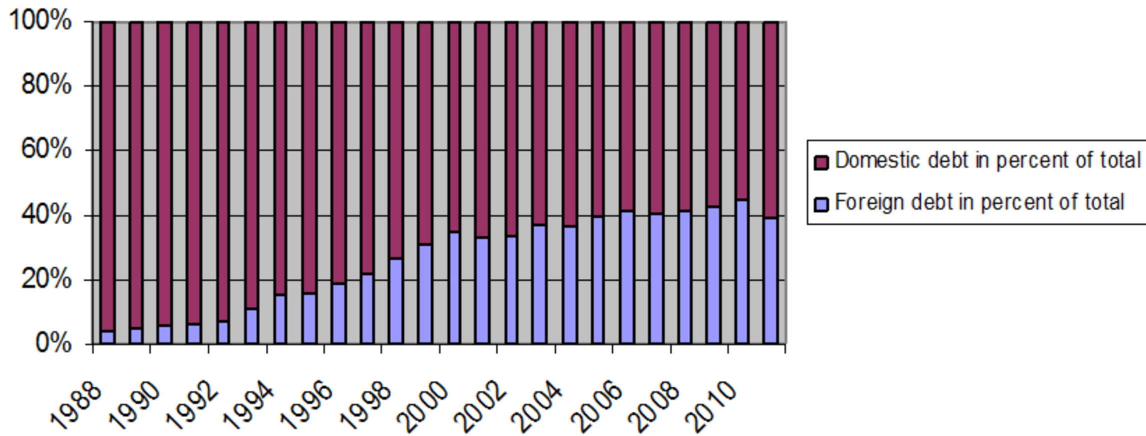
This project has received funding from the European Union's Seventh Framework Programme for research, technological development and demonstration under grant agreement no 266800

Figure 2.1. Net direct investment (millions of euros) (1994-2011)



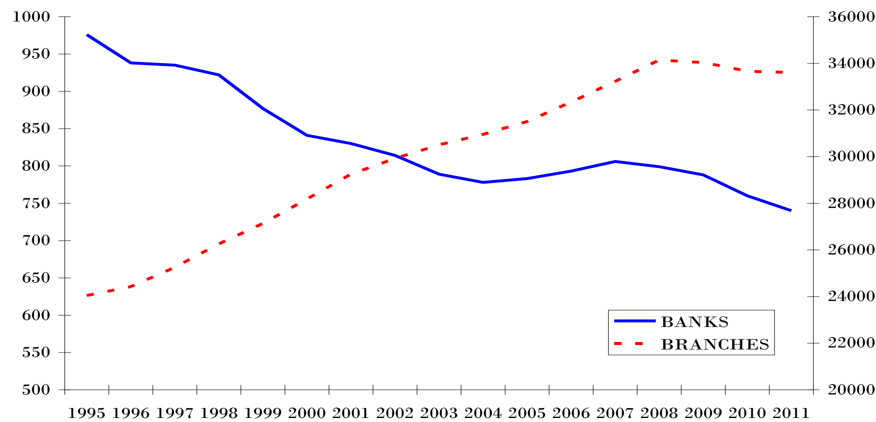
Source: Eurostat

Figure 2.2. Domestic and foreign public debt (1988 – 2011)



Source: Our elaboration of Bank of Italy data

Figure 3.1. Banks (left hand scale) and banking branches (right hand scale) (1995 – 2011)



Source: Our elaboration of Bank of Italy data

Figure 4.1 – Core Tier 1 of the top five banks by size compared with the EU average (in blue the value in December 2011; in red the value at June 2013)

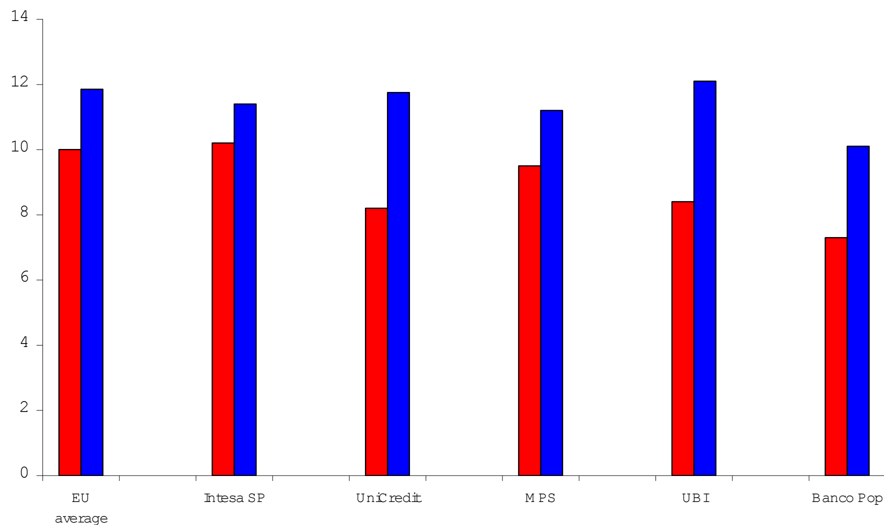


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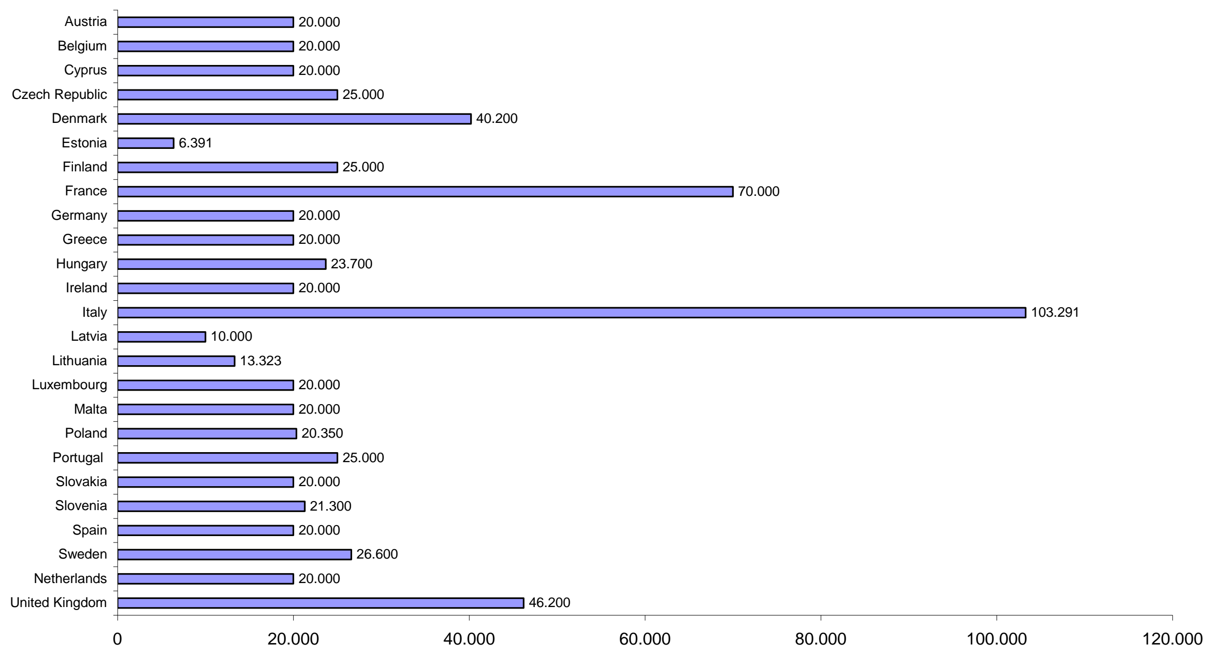
Figure 9.1. Level of deposit coverage in EU-25 at the end of 2005 (values in €)



Source: Interbank Deposit Protection Fund

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Financialisation, Economy, Society and Sustainable Development (FESSUD) is a 10 million euro project largely funded by a near 8 million euro grant from the European Commission under Framework Programme 7 (contract number : 266800). The University of Leeds is the lead co-ordinator for the research project with a budget of over 2 million euros.

THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how financialisation has impacted on the achievement of specific economic, social, and environmental objectives; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment; the lessons to be drawn from the crisis about the nature and impacts of financialisation; what requisites of a financial system are able to support a process of sustainable development that is broadly conceived.

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THE PARTNERS IN THE CONSORTIUM ARE:

Participant Number	Participant organisation name	Country
1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
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