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Financial Regulation in Italy

Pietro Vozzella, Giampaolo Gabbi, Massimo Matthias

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Authors Pietro Vozzella, Giampaolo Gabbi, Massimo Matthias

Affiliation of authors: Università degli Studi di Siena [www.unisi.it]

Abstract

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

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

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

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Contact details: Giampaolo Gabbi, Department of Business and Law, Università degli Studi di Siena, P.zza S. Francesco 7, 53100 Siena, Italy. e-mail: giampaolo.gabbi@unisi.it

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1. Introduction

1.1. The organizational model of regulatory and supervisory bodies

Italian financial regulation has been traditionally organised along functional lines. Financial services 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. The twin peaks approach is generally considered, like the integrated approach, to offer the type of flexibility needed to deal with both rapid innovation in the financial sector, along with 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 had 1999 it has played a monetary policy role within the Eurosystem since.. As a prudential regulator its focus is on the safety and soundness of the institutions subject to 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 the 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 that it intends to issue, assess their effects, in terms of costs and benefits, on the interested parties, and carry out a 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 of and reviewing 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). Up until the end of 2012 the Authority was independent and on 1st January 2013, ISVAP changed to become 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 it is also required to perform all activities necessary to promote consumer protection. The Finance Code mandates that the primary purpose of insurance supervision is both 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 both safety and soundness, and 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 that have been 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 a reallocation of 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 to highly scrutinised financial intermediaries, while at the same time, being 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 the 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 be observed 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 insofar as transparency and investor protection, and by the Bank of Italy concerning the "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 to the intermediaries. The recent evolution of the normative framework assigns all the powers in the field of transparency in the market to Consob (secondary regulation of the solicitation of public saving, of insider trading, of takeovers and public offers, etc.). Similarly, the Bank of Italy is considered responsible for stability (this remit 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, which is allowed only to 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 the 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 was a radical reform at the time, as until then the control of stability was managed through a structure-conduct-performance model, that imposed an oligopolistic structure, where 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, while reducing 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 as a result. 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 a 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 where regulators suggested that banks should operate as publically 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, to operate as universal banks, to invest in non-financial stocks and, above all, to 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 has already been authorised by its own regulator, the freedom to establish itself anywhere within 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 2 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) investors protection; (iii) stability and well-functioning of the financial system; (iv) financial system competitiveness; (v) compliance of financial rules. More recently, financial markets within 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 to protect 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 to the rules is the risk of incurring judicial or administrative penalties, financial losses or consequent damages due to a breach in the law, regulations, or the rules of self-regulations 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 to identify the risk of failure to fulfil the obligations referred to in Directive 2004/39/EC from 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 both effective and independent. As a result, domestically: “Intermediaries establish and maintain permanent functions, effective and independent of conformity to standards and if, in line with the principle of proportionality, 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 into the risk of judicial or administrative sanctions, property loss or reputational damage, resulting from violation to 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 markets 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 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 would suggest to split the average in different marginal costs of capital (Saita, 2007). Requiring a global increase of capital quality could generate a wealth inequality by business line. During 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 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 at 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 the consequent impact on the capitalisation.

2. Liberalization of capital movements

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

Regarding the process of the Italian progressive removal of its system of currency payments controls and, more generally, on 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. On April 1976, in order to prevent capital outflows and speculation against the Italian lira (ITL), the Law n. 159/1976 introduced some of the most important defences such as exporting currency and holding capital in foreign accounts.

In the 1980s, the Italian Authority used capital controls with the purpose of ensuring the necessary degree of monetary autonomy and to reduce the risk of speculative attacks against currency stability and central banks' 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 to reach as part of full economic and monetary integration.

The adoption by the EC Council of Ministers of the Single European Act (SEA) in February 1986 set the end of 1992 as a 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 in a very short period; the main step towards the liberalisation process was set with the Law of 26th September 1986 n. 599 that, changed the previous principle “*all is prohibited*” into “*freedom of economic and financial relationship with abroad*”. Starting from this date, some important restrictions, such as the investment of foreign securities, were removed.

Before the 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 exceptions¹, all of the restrictions on commercial and financial transactions by residents with non-resident were abolished.

The Directive 88/361/EEC of 24 June 1988 forced Member States to abolish all remaining restrictions on capital movements between residents of the Member States².

Once again, Italy’s compliance was rapid: the full liberalisation process was realised with the Ministerial Decree 27/4/1990. Its adoption signalled the end of the exchange controls monopoly, the abolition of restrictions on authorised bank’s foreign exchange management, and all remaining foreign exchange restrictions previously established by the Decree of the President of the Republic n. 148/1988. *De facto*, the Currency Italian Office, the agency controlling the exchange rate policy, was abolished, even though its closure was formally settled some years later.

Figure 2.1. shows the net position of the investment dynamics, that is international investments Italian residents hold (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.

During last two decades, net direct investment in Italy have recorded a stable increase until 2006 when they reached the peak (about 31 billion of 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 capability and access to credit. The net inflows of direct investments (new investments net of disinvestments) towards 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. The freedom to take exposure in foreign markets and the elimination of the currency risk within the euro area caused a dependence on foreign institutional investors, equating 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, the 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) represented the most important EU legislative initiative concerning cross-border competition and permitted activities. The aim of the Directive was twofold: a short-term objective with the purpose 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 toward the coordination of monetary policy to economic and monetary union in Europe. With the introduction of the mutual recognition principle, the Directive aimed to compel each Member State to mutually recognise the licenses from 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 each Member State and could freely supply all banking services allowed under the Directive³. The deadline to comply with the Directive was set as 1st January 1993.

Before the adoption of the Second Banking Directive, these issues were regulated in Italy by the Royal Law Decree 375/1936 (Italian Banking Act)⁴ which introduced the separation between commercial banking 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 ownership⁵. 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 act as an origin of instability. As a consequence, new branches could only be opened after a 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, characterised by a special legal status and not being as regulated as the 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 case to the contrary 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 the Royal Law Decree 375/1936, banks could neither underwrite (or in very small shares and with many constraints) shareholdings in industrial companies 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 banks' branch planning (*piano sportelli*) of 1982⁶ and by the Decree n.350/1985. The latter, on the one hand categorised banks as enterprises and not as institutions⁷ and, on the other hand, changed the market structure from a 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 1 proposals (1988), the style of banking supervision changed from structural to prudential. The purpose of regulation (1993 Banking Act, article 5) was not only finalised to maintain the financial stability, but also to promote a higher level of efficiency.

The concentration process accelerated in terms of size: between 1990 and 1995 the total assets of the 5 largest banks was around 30%; in 1999 this value rose to 48%. At the same time, with banking system liberalisation, from 1996 to 2008 the number of branches increased by about 40% (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 per cent of total loans.

The Italian banking system, as it stood until the end of the 1980s, was not able to face the impact of liberalisation and the opening of the market to the 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 which characterise the Italian banks activity, made it difficult to for Italian banks to react to the competition of the European banks.

In the early Nineties, a few legislative bills deeply modified the structure of the Italian banking system. The law 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 were operating in the short-term sector, transferred their banking activities to ad-hoc joint stock banking companies and were converted into Foundations assuming all the socially-oriented tasks provided for by the status of the savings banks.

In 1993 the largest privatisation process had been implemented. The most important public banks and insurance companies had been sold and listed through IPOs. Most of them were directly controlled by banking foundations, with a public nature. At the beginning of the 1990s neither banks nor institutional investors played a significant role in Italian companies' ownership (table 3.2).

At this time, banks still showed a limited presence in non-financial companies capital, whereas ownership by institutional investors significantly increased over the years between 1990 and 2010.

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

Thanks to tax incentives, merger operations - which were very rare until the end of the 1980s - starting from 1990 recorded a remarkable increase and justified the introduction of new organisational set-up 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 of home country control were finally introduced with the Legislative Decree n. 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.

Structural supervision was substituted by prudential supervision. In order to allow the credit institution to freely operate and make commercial choices, in contrast to institutions from the political economy, *supervision did not play on the market but on the company*.

The full implementation of the second Banking Directive realised with the Legislative Decree 385/1993 (New Italian Banking Act). With the purpose to grant a higher 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.

The Decree 385/1993 set forth the end of the principle of specialisation referring to 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 the approval of the 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 the Directive 2013/36/EU, the Bank of Italy has stated 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 n. 285 of 17 December 2013. In order to ensure complete information and transparency in Italian financial markets, the Bank of Italy can demand from branches of community banks necessary documents and data by banks

authorised in Italy, relating to the extent of their Italian activities. In particular, the Italian regulator can demand information referring to the average percentage rate charge applied by foreign banks within 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 May 10th 1993. It was a great step toward the creation of a single European financial services market. Similarly to the Second Banking Directive, the Investment Services Directive, reaffirming the principle of mutual recognition based on home country control, aimed to harmonise essential minimum prudential standards of behaviour.

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: to the extent that an investment firm that was authorised by its home national regulator to provide specified investment services⁸, was able to supply these services in any other Member State. No other authorisation was requested.

With the purpose to fully realise 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 States⁹.

Although the Directive did not aim to harmonise the conduct of business or advertising rules, it was required for Member States to adopt a minimum set of transparency rules for their Exchanges¹⁰.

Before the introduction of the Investment Services Directive, the first existing regulation was Law 2/1991 (1/1/1991) on brokerage activity. It stated that this activity was reserved for 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 neglecting cross-border activities¹¹. With the purpose of improving transparency of securities trading, the Italian legislator set forth 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 the Legislative Decree 415/1996 (also known as the Eurosime Decree). The *single passport* principle was also finally introduced in Italy with the Eurosime Decree.

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

Despite the terminological differences, the guidelines of both were the same: brokerage activity was still reserved for a few types of legal entities; authorised entities were enforced to follow rules of stability, accuracy and transparency towards investors, and the "*functional supervision*" was reserved for the Bank of Italy and Consob. The former, was given the responsibility to implement rules on stability whereas the latter was reserved the power to supervise compliance on accuracy and transparency rules. Indeed, according to the article 4 of the Eurosime Decree, "*supervisory activity has the objective of transparency and accuracy of the conducts and the sound and prudent management of supervised firms having regard for investor protection and to the stability, competition and good operating of the financial system*¹²". It was possible, therefore, 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 investors' protection, stability, competition and, finally, robust operating of the financial system (Pontolillo, 1997).

4. Capital Requirements

The prudential regulation adopted at the integrated level since the approval of the Basel 1 Directive, is essentially based upon the assumption that losses are expected to be covered with a bank's own funds.

In this chapter we explore the way that Italian regulators have designed their regulatory model within the European framework, from the Directive 1898/299, through Basel 2 and, finally to the Basel 3 proposal, which was enhanced in the CRD IV directive.

Along with capital, the response to the crisis has created an emphasis to measure and manage liquidity risk with the adoption of two ratios, the liquidity coverage (LCR) and the net stable funding (NSFR). The last section of this chapter describes how the Italian regulator has exercised a number of alternatives that have changed the original requirements.

4.1. The adoption of the Directive 89/299/CEE and the debate before Basel 2

The purpose of the adoption of the Directive 89/299/CEE was to implement the 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 in 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 to be repaid until all other debts outstanding at the time have been settled.

One of the issues, that are only partly solved with bail-in proposals, is the definition of subordinated debts accepted within regulatory capital which 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 case of residential mortgages;
- 100% for private sector debt, non-OECD bank debt (maturity over a 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 from their inherent riskiness (Gabbi, 1994).

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

In 1993, with the Directive 93/6/CEE, credit risk was associated to market risk within the capital requirement rules set. Particularly, banks with trading book exposures were asked to absorb capital with a standard formula introduced with the Legislative Decree 415/1996. In 2000, with a new Legislative Decree (259/2000), the Italian prudential regulation introduced for the first time 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) The adoption of Value at Risk models;
- b) The use of the maximum between the highest $VaR(t-1)$ and the average VaR of the 60 days before;
- 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 the commitment of the Board and top management over the risk management process, must be independent, specialised and able to report frequently 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 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 each of the three types that require a large number of calculation inputs.

The Italian adoption dates back to December 2006 when Law 297/2006 was approved. The main features of the legal innovations instilled were: market risk remained essentially the same as approved in 2000; The internal model approach was extended to credit and operational risks; and credit risk capital requirement could be estimated using either with the Standard formula or with the 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 between the two approaches.

Italy has allowed banks to use both approaches simultaneously, though on different portfolios and/or portions, and only for a certain amount of time. The general principle is that the option for IRB must be a strategic decision for a financial institution. According to Italian regulation, 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 risks' requirements can be estimated with a basic, standardised or advanced approaches.

In terms of national options adopted by the Italian regulator we list the following ones:

1. *Standard Formula*

- a) Loans to banks based in countries rated between BB+ and B- and countries without any rating the maximum coefficient is 100%;

- b) Regulators can increase the weight for borrowers without any rating when justified by previous critical events;
- c) To apply the deduction of 25% for retail loans, regulators will check the actual 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 applied with a 50% weight instead of 100%, in case the collateral is commercial real estate;
- f) Other minor options have been applied to covered bonds, in line with rating agencies recognised by other countries.

2. *Internal Models*

- a) Minimum capital requirement (floor) 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) Different definition of small and medium enterprises (total assets instead of sales);
- e) Some short term assets are valued not on a yearly basis but coherently with their duration;
- f) Other minor options have been applied to capital instruments, such as the exclusion from IRB methods, market methods vs. PD/LGD methods.

In the subsequent period after the introduction of Basel II framework in 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 have been proposed and some of these 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 were approved that were proposed by the EU Commission in autumn 2008 (CRD II). Other amendments were approved by the EU Parliament in November. The CRD II is focused on critical issues as experienced during the financial crisis: capital requirements, large exposures, securitisations, liquidity, the role of auditors, cooperation between authorities in case of crisis market conditions (third pillar).

The CRD II, shaped by three directives (2009/27, 2009/83 and 2009/111) 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 the individual regulatory capital, and (ii) the calibration of capital ratios.

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

4.3.1. Capital Requirements Revisited

The capital requirement for trading operations had been considered inadequate, particularly for banks adopting a validated internal model. Basel II allowed those banks to use Value-at-Risk metrics based either on statistical distributions or simulations. In both cases, it was required that the time series of data was to be at least one year in length (250 observations). Although most large banks used two years' worth of time series data to build estimations, the effect of this rule was to “forget” many extreme events after a very short period of time and to increase the risk related to “short-termism”.

The first issue we want to look at is the 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: ensure that an adequate share of a bank's capital consists of 'plain vanilla' common equity, with full loss-absorbing potential; simplification in the definition of capital (both 'Tier 1' and 'Tier 2' with separate requirements), focusing on financial instruments which 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 significantly relevant, and there is a marked difference between Basel II and Basel III in this regard. Deductions for banks are as follows: (i) the capital of banks' insurance subsidiaries above a 10% threshold; (ii) the 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 the 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; banks' deferred tax assets in detail and rationalising their portfolio of these assets with respect to both their composition and their amount.

Another change has been introduced for trading book exposures. A number of changes were introduced by the Basel Committee in the summer of 2009 pertaining to the treatment of trading book and market risk. The proposed changes affect both 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, has had the addition of a stressed VaR to the standard VaR calculation. The stressed VaR is measured over a 12m period of stress and based on the 10 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:

$$\text{Stressed VaR} = \max(sVaR_{t-1}, ms \times sVaR_{avg})$$

where:

ms = Multiplication factor (minimum of 3)

sVaR_{t-1} = Latest stressed VaR

sVaR_{avg} = Average stressed VaR over the preceding 60 business days

The multiplication factors for both 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 will be required to add to these multiplication factors a number related to the ex-post performance of the model. This will range between 0 and 1 based on the outcome of back-testing the VaR calculation (not the stressed VaR). If results are satisfactory, this could 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 owed not to defaults but to credit migration, widening credit spreads, and loss of liquidity.

All securitised products, including synthetic ones, will now have to use the ratings-based standard model. This means collateralised synthetic obligations (CSOs) will be treated like assets in the banking book, and their risk weights will 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 subjected 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:

$$CRM = \max(CRM_{t-1}, CRM_{avg})$$

where CRM_{avg} = Average of the Comprehensive Risk Measure over 12 weeks

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

$$IRC = VaR_{mig/def} (99.9\%, \text{capital horizon})$$

through an internal model. Here the regulator requires:

- capital horizon = 1 year;
- P&L is derived from 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:

IRC_{avg} = Average over 12 weeks

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

$$\text{Proposed Regulatory Total Capital for Market Risk} = 3 \times \text{VaR Market (99\%, 10-day)} + 3 \times \text{VaR Stressed Market (99\%, 10-day)} + \text{VaR Incremental Risk (99.9\%, 1 year)}$$

The assumptions and implications of the reform are: (i) specific risk surcharge is abandoned; (ii) no diversification between VaR incremental risk and VaR market; (iii) perfect correlation between credit losses and market losses; (iv) there is an issue of double-counting of risks between the 10-day VaR capital calculation and the IRC calculation; (v) the new proposal is based on the assumption of 'constant level of risk' rather than buy-and-hold for 1 year; (vi) the trading book is an ongoing business, and banks rebalance their portfolio every liquidity period (for example, 1 month).

Regarding the settlement risk, the Bank of Italy has decided to exercise the discretion allowing the prior netting between a convertible and an offsetting position in the instrument underlying it. For this purpose, the Bank of Italy has established two different procedures by which banks are obliged to process the convertible¹³. In the first case, convertibles are included among debt securities whereas in the second case, they will be allocated either among debt securities or among equity securities based 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 the entry into force of the regulatory technical standards established by European Banking Authority for the purposes of the assessment of the own funds requirements for position risk, foreign exchange risk and for commodity risk, Bank of Italy exercised the discretion allowing to apply the national treatment to options and warrants existing before 31 December 2013. Therefore, banks compute own funds requirements both 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 the underlying market price volatility¹⁵.

Other options were adopted by the Italian regulator when the CRR was approved for the credit risk capital requirement revisited within Basel 3.

(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 n.285, the Bank of Italy exercised the discretion, set forth in article 129 of the CRR, regarding the preferential treatment of covered bonds, provided that the institution investing in covered bonds are 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 and currency risks, their 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.

Differently, 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 will be respectively assigned to the covered bonds.

Finally, for banks using the standardised approach for credit risk evaluation, as regards to the 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 to the assessment of the risk weight exposures amounts, consistent with article 113 (7) CRR, the Bank of Italy provided specific provisions aimed to ensure the alignment of the 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 has entered into an institutional protection scheme. It is worthy to note that, as mentioned in chapter 9, in December 2011 in compliance with the regulatory provisions stated in Basel III regarding liquidity standards, mutual banks have established the Institutional Guarantee Fund (Fondo di Garanzia Istituzionale) which allows a risk weight of 0% for the exposures between banks taking part in this Fund.

(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 compromise to financial system stability, higher minimum values of exposure weighted average LGD for exposures secured by property being located within Italy.

The Bank of Italy has exercised the national discretion on the treatment of equity exposures allowed by article 495 (1) CRR, stating that, until 31 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 31 December 2007. For these categories, published by the Bank of Italy, the Standardised Approach to compute the capital requirements will be applied.

4.3.2. Definition of regulatory capital

Capital requirements rules (along with remuneration policies) were introduced in the Italian regulatory system with Bank of Italy interventions and communications respectively, on 30th March 2011¹⁶ and on 4th May 2011¹⁷.

The analysis of the impact to regulatory changes 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.

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

1. The features of items accepted as capital
2. The definition of deductions

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

Moreover, the notion of core tier 1 or common equity was introduced, limited only to ordinary shares. In this case there is no cap for the regulatory capital (RC) definition.

The RC cannot be applied to instruments that give loss absorbing privileges to owners of ongoing 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 and as they give advantages in case of liquidation. Moreover, usually they offer privileged remuneration mechanisms linked to the 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 will be allowed to be computed within core Tier 1. The privilege cannot be a fix payment or linked to the nominal value. The clause to pay a multiple of the dividend distributed by the ordinary shares will be accepted.

The treatment of overpriced shares for those stocks which cannot be computed within bank capital is to be calibrated in terms of its capacity to absorb losses. In case it is characterised by the same features of the overpriced ordinary share amount, it is allowed to be computed within the Tier 1.

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

The most relevant innovations can be listed as follows:

a) bank capital is empowered, especially because of the introduction of the automatic cancellation of the 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 in share mechanisms.

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

c) a new category which is obliged to be converted into common equity in a contingency situation (particularly when the bank is under the capital requirement) or in case the Bank of Italy estimated a potential danger to the 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 provided by article 49 of the CRR concerning the possibility "not to deduct 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 will be considered as equity exposures and they will be risk weighted in accordance with the approach to credit risk used by the bank (Standardised or Internal Rating Based Approach). Moreover, relative to the required level of own funds, the Bank of Italy has decided to not exercise the discretion to allow banks authorised to use of Advanced Measurement Approaches to hold a floor lower than the Basel I floor (8%).

The second issue concerns the deduction from Tier 1. The Bank of Italy instruction (Circolare n. 263, Titolo I, Capitolo 2, Sezione II, paragrafo 1.1, lettera b6) has been changed to be compliant with the CRD III (Article 1, paragraph 6). CRD III has 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), independently from its classification within the trading or the banking book.

Since the introduction of the new capital rules in Italy, the impact has been slow, compared with the EU banks average during the period from December 2011 to June 2013.

In Europe during the period, 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 even though the gap has significantly reduced (figure 4.1)

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

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

The options to manage the grand-fathering (from 2014 to 2019) period by regulators in a phase of recession or slow growth becomes significantly important.

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

- a) full application from 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 the 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 taken at the 30th June 2013 on a sample of 15 bank groups (70% of Italian bank total assets). The outcome found was that the capital need for 2014 would be 0.6 billion euros in the case of option (a).

For smaller banks, a criteria of proportionality 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 a 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 provided by 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 its 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 institution on a consolidated basis or a subsidiary institution on a sub-consolidated basis complies with the obligations on liquidity coverage requirement provided in Part Six of the CRR, 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 within 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, to the satisfaction of the competent authorities, provide for the free movement of funds between them to enable them to meet their individual and joint obligations as they come due, 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, has 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 has been 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 on 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 has exercised the 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 characterized 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.

The Bank of Italy, in accordance with article 421 (3) CRR, has established that credit institutions have to identify and subject to different outflows retail deposits following criteria set by the European Banking Authority

Moreover, in accordance with article 422 (4) CRR, the Bank of Italy in the absence of a uniform definition, provides general guidance that banks shall 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 the liabilities different from those regulated by article 422 (7)¹⁸. Banks authorised in Italy intending to avail of such preferential treatment need the Bank of Italy's prior authorisation. 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 avail of the application of a lower outflow percentage.

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

In accordance with the national discretion provided by 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 conditions provided in paragraph 4 are fulfilled¹⁹.

As we have seen for outflows, this preferential treatment can be allowed also when banks and depositors are not established in the same member state. Again, in these cases the rules set in article 20 (1, b) CRR will be applied. As regards the stable funding requirement, the Bank of Italy has exercised the 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 has 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 notify that with a lower reporting frequency and a longer reporting delay than ordinary provided. This waiver will be grant based on the individual situation of the credit institution and taking into account the scale and complexity of the institution's activities.

Finally, until the full introduction of binding liquidity requirements, the Bank of Italy continues to collect information through monitoring tools 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 the 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 excluding those reserved to non-bank entities. Increasingly, banks 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 in the point of view of prudential supervision. In fact, in the case where each individual group entity is subject to supervision, the conglomerate imposes an evaluation as a subject on its own, with peculiar characteristics in relation to individual firms that form the group.

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

The first time that the issue of supervision on a consolidated basis on credit institutions entered into the European policy agenda was with Directive 83/350/CEE. The aim was to eliminate the differences between Member State's legislations. For this purpose, some important topics were clearly specified, such as credit Institutions, financial Institutions, participation, supervision, and competent authorities. Credit institutions are supervised on a consolidated basis following the principle of *home-country control*. In Italy, the directive

was implemented with the Law 114/1986²⁰, which defined the Bank of Italy as the national Authority enabled to practice the consolidated supervision on banking groups. Controlling the capital adequacy, also using inspections to guarantee the truthfulness of data, was one of the tasks attributed to the Italian Banking Authority.

The implementation of Directive (92/30/CEE) 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 all companies that had a dominant influence in the shareholding meeting, and subsidiaries as a parent undertaking that have a dominant influence on it. The control of the bank's solvency, capital adequacy, and the role to 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 the legislative decree 528 of 30 December 1992, later repealed by legislative decree 385/1993 (Banking Act), which concluded the evolution of the banking law also in 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 Supervision Banking Group Department*, which carries out supervisory tasks both on a consolidated basis, and also as a single component of the group – this applies to precisely 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 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 to be compliant with the rules on consolidated supervision.

The Consolidated Act regarding the topic of Banking and Credit, provides a tripartite typology of 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 June 29th 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, implies a dominant influence.

The Directive was implemented in Italy by the Legislative Decree 333/1999 “Implementation of Directive no. 95/26/EC on strengthening the prudential supervision of credit institutions”. This decree introduced, modifying the Banking Act, the Pension Funds Authority (COVIP). As provided by the Directive, Legislative Decree 333/1999 reiterated the secrecy of the information processed by the Bank of Italy, which can be exchanged both with other responsible organisations for “sectorial” supervision (CONSOB, COVIP, ISVAP and UIC), and with Control Organisations of other Member States. Even though 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 missed 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 to size and business complexity.

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

Finally, the solution to specialise authorities by sectors and goals, biased the capability to centralise the supervision of financial players able to 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

7. The deregulation of domestic financial markets recorded between the 1980s and the 1990s, along with the globalisation of financial markets, has led to new business approaches in the more highly competitive and integrated markets. The competition faced in the last twenty years has driven paradoxically financial institutions towards concentration processes through merger and acquisition operations. The rationale of the conglomeration processes of financial institutions was to create an organisation taking advantage of economies of scale and scope which existed between different financial sectors. Moreover, from an economic point of view, a financial conglomerate was characterised by better diversification both in term of revenues and risks.
8. The possibility to enter, through the formation of the financial conglomerate, different legal and business entities for different and independent financial activities constituted an important competitive factor.
9. 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 same model applicable to individual banks.
10. The system of sector-based supervision, as a consequence of the specialisation principle that characterised the Italian financial system until mid-1990s, was weakened by the deregulation process promoted by the EU starting from the end of 1980 that allowed the integration between different financial sectors. The conglomerates arising from such integration had to deal with different typologies of risk that highlighted the unsuitability of the traditional prudential sector-based supervision.
11. For instance, whereas 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 repay promptly all liabilities at any time.

12. Starting from the end of the 1980s, the growing convergence between the different sectors of the financial system and the creation of large financial groups, also cross borders, which 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 Regulators²¹ which produced a comprehensive report showing a detailed analysis of the prudential issues and formulated specific policy recommendations²². However, a wider international partnership to deal with the issue of financial conglomerates supervision took place in 1996 with the *Joint Forum*²³ that released its recommendations in February 1999.
13. 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/EC²⁴, and applied in January 2005. For the first time, the supplementary supervision of financial conglomerates on a group-wide basis was introduced²⁵.
14. The supplementary supervision did not refer to the consolidated basis like the supervision provided by the sectorial rules but followed the “solo-plus” approach²⁶.
15. In order to identify a financial conglomerate, analytical thresholds to be followed for three consecutive years so as to avoid sudden regime shifts were established²⁷.
16. 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 has been an important innovation of the supplementary supervision. The goal of the introduction of such a figure was to support the cooperation between different supervisory authorities and to solve the problem of overlapping the roles regarding supplementary supervision.
- 17.
18. In Italy, Directive 2002/87/ECC was adopted on May 30th 2005, the 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”.

19. 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 Italy²⁸. The cooperation was aimed at identifying the financial conglomerates submitted to supplementary supervision, and the methods and criteria to measure the capital adequacy of financial conglomerates.
20. 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 capital²⁹, the supervisory authorities established the 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.
21. Legislative Decree 142/2005 stated that regulated entities had to report on a regular basis and at least annually to the competent supervisory authority (the coordinator) any significant risk concentration at the level of the financial conglomerate. Due to the fact that 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. Therefore, the monitoring of intra-group transactions is an important instrument to deal 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.
22. The competent supervisory authorities, by specific agreements of coordination, are allowed to set stronger quantitative limits aimed at achieving the objectives of supplementary supervision.
23. Legislative Decree 142/2005 established that financial conglomerates must have adequate risk management processes and internal control mechanisms and to ensure

supplementary supervision, the coordinator has to judge such procedures and instruments.

24. Another important core issue of supplementary supervision is the exchange of information between competent authorities. Legislative Decree 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 has to provide all the relevant information and communicate on their own initiative all essential information. 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, on November 16th 2005 an agreement between Bank of Italy and ISVAP for the coordination of supplementary supervision was signed³¹.

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

After the adoption of Legislative Decree 481/92, enforcing the Italian Legislation the European Directive 89/646, the banking industry separation principle did not change. It was objective was to avoid the situation were industrial shareholders could undermine the independence of banking choices and, therefore, compromise the sound and prudent management principle. To reach this purpose, 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 is a substantial control of the bank³².

The Bank of Italy was granted the power to refuse or revoke authorisation in case of agreements, affecting a significant concentration of industrial companies, the power to appoint or remove a majority of the directors, or the members of the supervisory board of a bank such that its sound and prudent management was jeopardised³³.

In the past, many scholars have criticised the bank industry separation principle and questioned its effectiveness to ensure banking system stability, and the compliance of the sound and prudent management principle. A new regulation on the procedural rules and evaluation criteria for the 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 January 27th with Legislative Decree 21/2010, relatively late in relation to with the deadline implementation date of 21 March 2009. Legislative Decree 21/2010, modifying article 19 of the Banking Act, sets forth that “*The Bank of Italy approve in advance direct or indirect acquisition in a bank of holdings that assigns the control or which makes possible to exercise a significant influence or that assigns a share of voting rights or capital of at least 10 per cent (up from 5 per cent previously), taking into account the shares or units already owned*”.

The Bank of Italy was assigned 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 on the bank³⁴. This prior approval is necessary both when the agent acts alone or in concert.

Before the adoption of Directive 2007/44/EC, the Decree Law 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 also when the total share of voting rights held exceeded 15 per cent or when the acquisition involved the control of the bank. This can be considered as the formal conclusion of *the bank-industry separation principle*.

Discipline on markets in financial instruments experienced important changes. New rules regarding procedural rules and evaluation criteria for the prudential assessment of acquisitions and increase of holdings in the financial sector also applicable to the Italian Investment Companies (SIM) were introduced³⁵. 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 the operation when it considers that the company's behaviour is not compliant with the safe and sound management principle.

The issues due to the 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 relevant shareholder. Italy has also introduced the responsibility of the Board where loans are delivered to “correlated” individuals or legal

entities. Board of directors are asked to question the convenience of the credit decision and the ensure that pricing is coherent with the 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) The Corporate Officers of the banks and of the supervised intermediaries.
- b) The participants of the banks and of the supervised intermediaries (that is, the parties who have to obtain Bank of Italy authorisation to hold the capital of banks, pursuant to section 19 and following of D.Lgs. 385/1993).
- c) Parties other than participants who are able to appoint by themselves, one or more members of the management or strategic supervision bodies of the banks and of the supervised intermediaries, including if this is 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 the banks and the supervised intermediaries or a company of the Banking Group can exercise control or significant influence.

On the other side, connected persons are:

- e) The companies or businesses, even if not incorporated as businesses, that are controlled by a related party.
- f) The parties that control a related party as indicated in letters b) and c) or the parties subject, either directly or indirectly, to common control with the same related party.
- g) The close relatives of a related party and the companies or businesses controlled by the latter.

Within Italian regulation there is some dissimilarity between the Bank of Italy and Consob regulations

The Consob definition of related parties refers to:

- 1) The 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 this 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 alternates).
- 5) close relatives of one of the persons referred to no. (1) or (4).
- 6) entities in which a person referred to in no. (4) or (5) above exercises control, joint control or significant influence or owns, directly or indirectly, 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 the funds the bank can exercise influence on.

The asymmetric regulation and the uncomplicatedness to by-pass such rules helped give rise to a number of extreme events which also led to unsafe and unsound behaviours, that are difficult to confront 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 of Law 6.11.1926 no. 1830), followed by the Banking Law of 1936 (art. 35, point b), capping the maximum underwrite-able loan within 20% of equity and reserves of the bank. The Bank of Italy was allowed to give discretionary authorisations.

When in the Seventies, the banking system used to ask 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. It was 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 of 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 of December 1986 a EEC recommendation on large exposures was approved, followed by more restrictive changes, by Directive no. 121 of 21st December 1992. The issue of large exposure was introduced in Italy with Directive 92/121/CEE. Particularly, articles 3 and 4 define large exposure as those 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 22 of June 1993 (no. 242633) and, in October 1993, with the Bank of Italy Instructions.

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

- a) The individual limit defined the maximum amount of loans to be given to a single counterparty, within 25% of the regulatory capital. This limit is reduced to 20% when borrowers are connected to each other; it increases to 40% for legal bank entities within conglomerates,
- b) The global limit fixed the cap for banks to concentrate their loans in large exposures within 800% of the regulatory capital.

Finally, a double consolidation was introduced. It considered both the consolidation of borrowers, and the consolidation of lenders, taking into consideration every credit institution, its parent and subsidiary companies.

7.3. Directives 2006/48 and 49/CE

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

- Base capital;
- Supplementary capital.

The level of supplementary capital cannot be higher than that of base capital.

The minimum capital requirement was 8% of risk weighted assets. A large exposure occurs when it is above the limit of 10% of capital of a credit institution.

Directive no. 49 introduces 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 was 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 are taken into account, irrespectively of

the kind of borrowers. Both balance and off-balance sheet exposures were considered. Credit protection providers writing insurance or derivative contracts (e.g. CDS) must be added to the total of all the other exposures to the same counterparty.

Borrowers are all the clients or network of clients whose value is higher than 10% of regulatory capital (article 108).

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

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 or temporal breach of limits.

According to the Italian application, loans fully covered by bank capital can be excluded from the computation, only if the absorbed capital is deducted from banks' own funds. All the 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 finds out whether the banks under scrutiny have adopted an organisational structure able to monitor the existence and changes of large exposures.

The most important discretionary decisions are:

- a) the discipline fixes the upper boundary of an exposure to 25% of capital. This limit can be surmounted, in particular by small banks, in three cases: when the amount is under 150 million euros; the global exposure to bank-related customers is lower than 25% of the capital; the bank estimates the exposures 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 case of intra-group loans for EU banks, the Bank of Italy applied a zero weight when legal entities are involved under the home country control;
- c) a zero weight was introduced for daily, intra daily margins paid to the Cassa di Compensazione e Garanzia by clearing members.

Starting from the observation that “one of the key lessons from the financial crisis is that banks did not always consistently measure, aggregate and control exposures to single counterparties across their books and operations”, the Basel Committee on March 2013 proposed the consultation of the 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).

One of the issues often debated is the level of discretion that banks are allowed to make their own managerial choices, relating to the measurement of the 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 has decided to exercise the discretion allowed for large exposures. Relating to article 493 (3) CRR, the Italian Supervisory Authority has stated that a 0% risk weight factor will be applied to (i) exposures, including participations, held by bank or banking group to its parent undertaking or its own subsidiaries, when they are subject to the supervision on a consolidated basis in a Member State in accordance with the CRR; exposures arising from minimum reserves held relating to central banks which are denominated in their own national currencies; exposures to banks and other investment firms that do not constitute institutions' own funds, with duration not longer than the following business day and not denominated in a major trading currency,

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

Exposures to local institutions within European Union are weighted at 20 per cent in accordance with Part III of 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 banking covered bonds are also weighted at 20 per cent according to article 129 CRR.

Off-balance sheet exposures classified as warranties and guarantees that don't fall under the category of credit substitutes (characterised by a medium-low risk) and as cash exposures in the form of banking covered bonds, are weighted at 50 per cent in accordance with the article 129 CRR, and they are w considered at 50 per cent of their nominal value.

Finally, the exposures arising from mutual guarantee and categorised as either monetary funds or real financial guarantees granted by mutual banks are considered at 80 per cent of their nominal value. Moreover, the Bank of Italy has established that the prudential discipline stated in article 395 CRR concerning limits to large exposures is to be applied to the exposures to investment firms within 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 1996³⁶. This regulation put into operation the approach of implementing only the essential level of harmonisation between member states that would be 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 the parties operating in the markets.

This chapter finds out the way 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 157/1991, which implemented Directive 89/592/ECC concerning regulations on insider dealing³⁷: the insider trading and manipulation discipline was introduced.

The fundamental notion of “*reserved*” information was defined as “information that has not been made public which has a precise nature relating to one or several issuers of transferable securities or one or several transferable securities, and 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 manipulation crime was introduced when, in order to guarantee investors about the integrity and the correct operation of the transferable securities market, false news affected price movements originating unfair profit opportunities³⁹.

Directive 2003/6/ECC on market abuses (MAD), along with Directive 2002/87/ECC about supplementary supervision on financial conglomerates, represented a first step to the

realisation of Financial Services Action Plan (FSAP) concerning the harmonisation and reinforcement of the supervisory rules⁴⁰.

The Market Abuse Directive set forth the concept of maximum harmonisation, which meant that Member States could provide neither more lenient nor stricter rules⁴¹. The EU law on market abuse was the result of the implementation, for the first time, of the *law making method* (Lamfalussy Approach)⁴².

The Directive, covering both insider dealing (or insider trading) and market manipulation, was aimed at ensuring market integrity: “*an 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/ECC was adopted with Law 62/2005. The major changes introduced in the Finance Act of 1998 related to the *disclosure of inside information* and the *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, properly 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 the “*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 of 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 instruments⁴⁴.

Differently to the previous legislation, the effect of inside information on prices should be measured having regard to the normal use within investors decision process.

Law 62/2005 has distinguished between primary insiders (*any person who possess 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) *disclosure unjustifiably of inside information (tipping ban and tuyatage ban)* and (c) *use of inside information by subjects who have obtained, directly or indirectly, such information by the primary insider*. Differently from the previous legislation, secondary insiders are criminally responsible both for insider trading and tipping.

An important innovation concerns the *duties of disclosure* provided for rating agencies which, for the first time, were required to take reasonable care in producing or disseminating the information related to issuers, ensuring that the information is fairly presented⁴⁵.

It is worthy to note that these latter provisions have constituted 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 persons 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 62/2005, different to the previous rules and to be compliant with provisions provided by Directive 2003/6, administrative penalties both for insider trading and market manipulation crime have been introduced in addition to penal sanctions.

A notable sanction exacerbation has also been introduced:

	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 of 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 have been established for the market manipulation crime. The only difference relates to the maximum limit of the fine (five million euros).

Finally, one of the most important innovations introduced by Law 62/2005 was the possibility for CONSOB to impose administrative sanctions⁴⁶, along with regulatory and inspection powers.

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

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

Technological innovations and increasing complexity of financial markets did impose a review of the Directive 92/22/ECC. On April 2004 the Directive 2004/39/ECC on markets in financial instruments (also known as MIFID) was approved⁴⁷ following the “*Lamfalussy approach*”⁴⁸. The set of rules are structured in the “Level 1 Directive”⁴⁹ and by the most detailed provisions contained in a “Level 2 Directive”⁵⁰ and in a “Level 2 Regulation”⁵¹.

The provisions contained in the Regulation made directly applicable in member states without needing to be implemented into national law.

Differently from the Investment Services Directive (ISD), MiFID stated the principle of *maximum harmonisation*, which provided the same rules to be 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 most important rules are aimed at:

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

In Italy, MIFID was implemented by Legislative Decree 164/2007 (17/9/2007) which came into force on 1st of November 2007. It stated the general principles to be followed to comply with European Community rules, referring to the competent supervisory authorities (Consob and Bank of Italy) the task to establish the detailed rules necessary to guarantee the total compliance to Mifid. As a consequence, Consob and the Bank of Italy issued the following main regulations:

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

The implementation of Mifid has involved important changes in national legislation.

One of the most important has been the introduction of "*investment advice*" and of the "*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, the activity of *investment advice* activity was considered among “ancillary services” and as such no authorisation was required. Investment consultancy is the provision of customised recommendations to a customer upon request or as an initiative by the service provider, regarding one or more transaction on an identified financial instrument⁵².

With the purpose of allowing investors to acquire a full awareness both of their rights and their duties deriving from investments, a client classification has been adopted that did not have any corresponding entry in the legislation previous to the Legislative Decree 164/2007. Financial clients have been classified as public professional costumers, private professional and retail customers⁵³.

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 characterised by lower financial knowledge or expertise. Consob Regulation n. 16190/2007 has detailed 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 on the intermediary and his services, on the safeguarding of financial instruments and sums of money of the customer, on costs and charges involved in the provision of services, and about their classification as either a retail customer, professional customer or qualified counterparty.

The obligation to act in a clients’ best interest has meant that investment firms need to conduct specific tests about the nature of the investment services offered to, or demanded by customers. Particularly, Consob Regulation n. 16190/2007 stated that in order to recommend investment services and financial instruments suited to the investor, in the provision of investment consultancy or portfolio management services intermediaries must obtain necessary details from the client in relation to both their 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).

Given that the client is generally not able to supervise the accuracy of the investment firms activity, the “best execution” rule has been introduced. According to Consob Regulation n. 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 164/2007 established the elimination of the trading concentration obligation. Indeed, the Finance Act (art.1), as amended by Legislative Decree 164/2007, stated that *“regulated market” shall mean a multilateral system which permits or facilitates the meeting, internally and according to non-discretionary 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” shall mean the management of multilateral trading systems which permit the meeting, within and on the basis of non-discretionary 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” shall mean 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*”.

Relating to transparency rules, Consob Regulation n. 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, 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 compel sale of holdings. If necessary to ensure investor protections: 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 € 2,500 and € 250,000;). 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 € 5,675 and € 51,646. Failure to comply with Consob requests: fines from € 50,000 to €1,000,000.

Imprisonment sanctions due to wilful hindering of supervisory functions: Imprisonment between 1 and 4 years. This sanction is doubled for listed companies. Making false representations in notifications to Consob: Imprisonment of between 6 months and 3 years. The criminal fines due to wilful hindering of supervisory functions: fines between €5,165

and €619,748 (which may increase by 1/3), and prohibition of professional activity. Making false representations in notifications to Consob: fines between €5,165 and €51,646.

One of the most relevant issues is the supervision made by multiple regulators.

On one side, Consob is responsible for authorisation / withdrawal of investment intermediaries (SIMs) – in consultation with the Bank of Italy; the ongoing supervision of investment intermediaries (SIMs) and credit institutions with regard to transparent and proper conduct in the provision of investment services and activities; the on-going supervision of markets and market operators with regard to transparency, orderly conduct of trading, and the protection of investors.

On the other side, the Bank of Italy is responsible for the authorisation / withdrawal and ongoing supervision credit institutions intending to provide investment services or activities – in consultation with Consob; the ongoing supervision 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 risk management; supervision internal audit.

According to Gabbi et al. (2011) small financial intermediaries are relative late comers in measuring the 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 the compliance risk, which follows a proportionality doctrine, making the largest firms more apt to introduce risk measuring solutions; (ii) different timing to introduce rules for intermediaries (in case of the Italian financial market, regulations on compliance function were not approved simultaneously, as described in our introduction); (iii) the cross-border regulatory asymmetry which makes the approach for banks and intermediaries working on international basis different.

9. Deposit guarantee schemes

The growing interest in deposit insurance is strictly linked with the banking crises management process, the role played by banks within the monetary function, and with the strong interconnections among 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 either the central bank or the State (Hefler, 1999; Garcia, 2001; Cull, Senbet and Sorge, 2004).

As a consequence of the financial crises faced over the Eighties and Nineties, explicit deposit guarantee schemes were widely adopted. However, irrespective of the institutional framework adopted in different countries, deposit guarantee schemes' main purposes 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 the implementation of Directive 94/19/EC in the national legislation. Both of them were based upon the banks' voluntary application. On the one hand, the Central Guarantee Fund (Fondo Centrale di Garanzia delle Casse Rurali ed Artigiane), was introduced in 1978 by Italian Rural and Mutual Banks⁵⁵. The scheme indirectly protected depositors of Member Banks thanks to financial resources provided to mutual banks in critical conditions. On the other hand, in 1986 the Italian banking system established the *Interbank Deposit Protection Fund* (Fondo Interbancario di Tutela dei Depositi), providing protection to all Italian credit institutions apart from mutual banks.

Although the number of members in the Central Guarantee Fund was higher than of Interbank Deposit Protection Fund, because of the small size of mutual banks, the amount of deposits protected by the latter was consistently larger than the amount covered by the former.

The guarantee schemes did not provide recurring contributions aimed at increasing the fund but they were levied on member banks only in the case of an 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 affected by high competitiveness. The case of volunteer deposit protection schemes are 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 because of two reasons:

- a) the possibility that non-participation in the fund would implicitly introduce an asymmetric protection for unaware depositors and, in the case of a large institution, cause a contagion process;
- b) the ex-post mechanism to contribute to the fund was a very critical issue, since in the case of systemic crisis, banks' capability 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 the *mandatory membership* for all credit institutions to the DGS: the 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 659/1996 (4/12/1996) which partially modified Legislative Decree 385/93 (Banking Act).

The most important innovation introduced, both 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 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 Second Banking Directive, Italian Banking Law allowed EU banks’ branches in Italy to subscribe to the Italian guarantee scheme in order to offer an 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* for the 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 the compulsory administrative liquidation of a bank authorised in Italy. When EC banks’ branches are member of an Italian guarantee scheme on a supplementary basis, payments shall be made when the guarantee scheme of the home member state has already intervened (*topping up clause*).

The guarantee schemes may provide for additional cases and forms of intervention. There are three types of interventions considered by the Italian Banking Act: compensation of depositors, interventions in transfers of assets and liabilities, and support interventions.

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 at strengthen the confidence in the stability of the banking system and therefore, 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 the 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 among EU Countries, Italy recorded the highest level of deposit protection (figure 9.1.).

In compliance with Directive 94/19, 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 has been a 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 and negatively affecting the bank's financial situation according to liquidators.

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

The Interbank Deposit protection Fund, from the year of its constitution (1986) to 2011, has put into effect only one reimbursement (table 9.1). In most of the cases, the fund intervened supporting the 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. Particularly, it:

- i. recognises guarantee schemes and approves their rules;
- ii. coordinates the activity of guarantee schemes with banking crises procedures and supervisory activity;
- iii. regulates payment procedures and authorises interventions by guarantee schemes and the exclusions of banks from such schemes;
- iv. verifies that the protection provided by foreign guarantee schemes branches of non-EC banks authorised in Italy is equivalent to the Italian ones;
- v. regulates the public notice informing depositors and the various types of covered claims;
- vi. 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, 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 the cash loans with the 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 of such a level 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 Northern Rock bankruptcy (2007) and the Icelandic banking system crisis (2008) highlighted the unfairness and ineffectiveness of the EU safety net.

In order to restore the confidence in the functioning of the financial system, on 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 49/2011 (24/3/2011) which came into force on May 7th 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 to further changes that may be introduced by the European Commission to adjust it in line with the inflation rate.

The reimbursement of depositors has to be made within 20 working days from the date in which the compulsory administrative liquidation produces 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 have established the Institutional

Guarantee Fund (Fondo di Garanzia Istituzionale) putting into effect Directive 2006/48/EC supervisory provisions amended for *institutional protection schemes*. This is based on a contractual or statutory liabilities arrangement by which the subscribing banks, in order to prevent or avoid their bankruptcy, protect each other against illiquidity and insolvency risks. The Fund aims to find a solution within the mutual banks system in case of a deficiency in short-term liquidity⁵⁹. The main advantage provided by provisions of prudential supervision is the null risk weight for exposures between banks taking part in this Fund⁶⁰. According to Tarantola (2011), this mechanism has centralised surplus resources within mutual banks system promoting an 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 385/1993). It provides a flexible “toolkit” to be activated 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 years⁶¹. The two types of interventions 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 shutdown banking activity.

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

The most important features of crisis regulation can be summarised as follows:

- a) special administration of EC-banks' 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 the administrative irregularities or the violations of laws, regulations or bylaws, or if the losses are exceptionally serious.

Non EC-banks' 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 in 1985 the European Commission had already drafted a proposal of legislation, its progress was slow because of the 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 the collapse of BCCI in 1991⁶². 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 of April 2001 but Member States did not comply until the 5th of May 2004⁶³.

The introduction of the Directive was generally viewed as a significant development within the European Union which would have provided a greater deal of efficiency and certainty in the bank insolvency management process. 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/ECC

The European Directive 21/2004/EC was enacted in Italy with the Legislative Decree 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, within the governance of the Bank of Italy), and the Pension Fund Supervisory Commission (COVIP).

The adoption of the European Directive has significantly changed the way that banking crises would be managed in comparison to 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 the 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 197/2004, no secondary proceedings were allowed as a consequence of the principle of universality.

In accordance with the Home Member State principle, the Legislative Decree 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 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 shall be 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 the enrolment in a register or account) are regulated by the law of the member state in which the property or account is located. Also netting and novation agreements, as well as repurchase agreements and transactions carried out on a regulated market, are regulated notwithstanding the Home Member State principle. Finally, the law of the Home Member State does not apply to the void-ability, void-ness 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 197/2004 and its enforcement set forth the end of the ring fencing practice, and Italy fully adopted the principle the *par condicio creditorum*⁶⁴.

As a consequence, article 95 of the Italian Banking Law was added with articles 95-4 (Cooperation between authorities), 95-5 (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 n.137 (although it only applied to the income statement). The balance sheet of the banking firms remained without a specific regulation⁶⁵. The layout of the profit and loss account introduced by D.P.R. n.137 of 1975 represented a basic milestone in the regulation of banking reports both 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 n. 137 of 1975 and those established by Italian Civil Code until the approval of the Legislative Decree 87/1992 (27/1/1992) which, implementing Directive 86/635/ECC, regulated the annual report of banks and financial institutions for the first time.

The coordination of national provisions concerning annual accounts and reports presentation, and the valuation methods used to draw up such accounts, was considered necessary at the 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/ECC prescribed the same layout and terminology for the report of all credit institutions within the Community. The balance sheet of the 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 detailed⁶⁶ (table 11.1.).

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 87/1992 were applied for the first time to the financial statements of credit institutions for the period ending 31st December 1993⁶⁷. They were applied to: a) banks, as defined by article 10 of Italian Banking Law; b) asset management companies as defined by law 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 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 142/92 (19/2/1992), and also for firms engaged in other financial activities as indicated by art. 59 (1), letter b) of the Italian Banking Act.

As formerly established at the Community level⁶⁸, Legislative Decree 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 statements⁶⁹. Moreover, 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 loss⁷⁰. Where the information provided in compliance with Legislative Decree 87/92 is not be sufficient to give a true and fair view, additional information had to be given to this end in the note to the accounts⁷¹.

Legislative Decree 87/92 gave the Bank of Italy the power to prescribe the layout of both the annual and consolidated accounts, and also with regard to the procedures and terms of their disclosure⁷².

The standards for developing annual accounts, and those concerning accounting evaluation methods, constituted the core of the Legislative Decree 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 with relation to their predisposition to remain within firm. The evaluation of the various entries that composed the annual accounts was based on a cost basis i.e. on the principle of purchase price or production cost.

The annual and consolidated accounts had to be drawn with preference given to *the view of substance over form and settlement timing over that of 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 between annual accounts, the Legislative Decree 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 year⁷³.

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 charges⁷⁴. Hidden reserves are not considered in order to be compliant with the principle of prudence.

11.2 The application of the International Account Standards (IAS) and Directive 2003/51/ECC, the “Modernization 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 the completion of the internal market for financial services.

In order to contribute to a 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. Furthermore, it was important that the financial reporting standards applied by Community companies participating in financial markets were accepted internationally and were truly global standards.

On July 19th 2002, the Community Regulation n. 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 the Member States.

Regulation n. 1606/2002 introduced the *obligation* for EU listed companies to draw up their consolidated accounts by use of IAS/IFRS standards starting from 1st January 2005⁷⁵.

Member States were allowed the *discretion* to permit or require the adoption of the International Accounting Standards for: a) EU listed companies, in reference to annual

accounts; b) companies other than those referred above, with regards to both consolidated accounts and annual accounts.

While during the nineties, with the intention of responding to the demand for international accounting, 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), Italy did not take any clear position towards international accounting standards before Regulation (EC) No. 1606/2002.

This behaviour stems from the specific nature of the Italian economic environment, characterised by great corporate ownership concentration and a greater importance 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 base 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 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, in 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 regards to both 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 regards to both consolidated (mandatory from 2005) and annual accounts (mandatory from 2006 and discretionary from 2005); d) insurance firms with regards consolidated accounts (mandatory from 2005) and annual accounts (excluded). For insurance firms, the application of IAS was required only in cases of listed companies which did not draw up consolidated accounts.

Italy exercised the right, provided by Regulation n.1606/2002, to allow the application of International Accounting Standards to non-listed companies, which were free to adopt IAS for both individual and consolidated accounts.

European Directive 2003/51/ECC of 18th June 2003 amended Directives 78/660/EEC, 83/349/EEC, 86/635/EEC and 91/674/EEC 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 during the last twenty years and the International Accounting Standards.

In Italy, Directive 2003/51/ECC was implemented by Legislative Decree 32/2007 (2/1/2007) which has been in force since 12th April 2007. Only the mandatory section of the Directive has been put into operation; particularly, the most important changes relate to the annual report and the audit report. Although the innovations contained in the Directive were greater than those implemented by the Legislative Decree 32/2007, the Italian Civil Code (art. 2428) has been significantly changed. According to article 2428 of the Italian Civil Code, the annual reports have to include a fair, balanced, and comprehensive analysis of the position of the company. Moreover, such analysis also has to include a description of the principal risks and uncertainties that the company faces⁷⁶. 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 matters⁷⁷. Finally, the analysis has to include where appropriate, additional explanations of amounts reported in the accounts. By modifying the Legislative Decree 127/1991 (art.40), the same changes have been introduced to the consolidated accounts⁷⁸. Relating to the audit report, Legislative Decree 32/2007 has fully complied with the Directive 2003/51/ECC. The changes were brought in to make the minimum contents of the audit report of the listed companies to this of the non-listed companies similar.

With regards to annual accounts, modifying art. 2409 of the Italian Civil Code, it has been 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 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 states clearly whether such accounts comply with statutory requirements and whether they give a *true and fair view* of a company's assets and liabilities, of the financial position, and of the profit and loss and, where appropriate;
- d. a reference to any matters to which the statutory auditors draw attention to 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 has brought the requirement that statutory auditors are to express an explicit opinion in the audit report on the accounts. If the opinion of statutory auditors is either unqualified, qualified, an adverse opinion or, if the statutory auditors has been unable to express an audit opinion, the audit report would have to describe in detail the reasons of the choice.

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

According to article 5 of Legislative Decree n. 32/2007, all provisions mentioned above both for annual accounts and consolidated accounts, must be applied to each financial year starting from the 1st of 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 the IASB. Moreover they are asked to publish reports on:

- a) reconciliations of equity as reported under Italian GAAP (Legislative Decree 87/92), to equity under IFRS as at 1 January 2004, 31 December 2004 and 1 January 2005 (table 11.3.);
- b) a reconciliation of profit or loss as reported under Italian GAAP (Legislative Decree 87/92), to 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 most relevant innovations introduced with the adoption of new accounting principles are:

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

The purpose of this legislation has been to reduce the scope for window dressing policies that act to 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 situation whereby asset devaluation affects credit policy and the consequent credit crunch.

Much of the debate around the introduction of new accounting standards based on market based criteria has been focused on the question whether it is fair value accounting that leads to short-termism in investor behaviour.

The European Financial Reporting Advisory Group (EFRAG) has submitted a letter of comment to the European Commission concerning its Green Paper, that does not deny that fair value accounting may contribute to a "limited degree to short-termism in investor behaviour". 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 the approval of the Basel 1 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 their attention on regulation concerning the *business conduct* within financial firms, for the purpose of better safeguarding financial consumers, generally characterised by inadequate financial knowledge.

The crucial issue of Corporate Governance has triggered a series of initiatives at the 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, starting from the principles of corporate governance set by OECD, published some internal governance guidelines, subsequently revised, to assist the Supervisory Authority of Member States in promoting the adoption of sound corporate governance practices by banking organisations in their countries⁸⁰.

It is worthy to highlight that both the BCBS's and OECD's guidance did not aim to establish a new regulatory framework over national legislations. Principles were non-binding but they would have to represent a reference point for policy makers to build and develop a 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).

The Basel Committee on Banking Supervision in “Enhancing corporate governance for banking organisations” 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 at the international level on corporate governance has produced adoption among countries of different legal framework and standards. The deficit of harmonisation rules has particularly affected large financial companies where financial difficulties resulting from corporate governance failures have involved widespread problems in the financial system.

The international financial crisis has highlighted these deficiencies in terms of Corporate Governance. The issue of remuneration policies of executive directors has received significant attention of regulators, also due to its significant implications at the society level⁸¹.

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 has been given to the Board and control functions roles. The choice should be made on the basis of a self-assessment process, considering:

- (i) The bank's ownership structure and its recourse to the 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 has articulated a number of innovative positions with respect 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 must 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 the members of the management body 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 within of a board of directors, 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 to the CEO or other executive directors; and (v) the entrustment to the supervisory board of strategic supervision must not lead to the 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 within corporate bodies, as well as special committees within the body performing the supervision function. Among the guidelines implementing the above principles, the New Regulation stipulates: (i) the limitations on 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 would be reasonable that the management board comprises a restricted number of members (mostly executives, directly involved in the management of the bank); (iii) an adequate number of independent members should be present within the corporate body performing the strategic supervision function,; (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, to preserve a neutral stance among his or her roles.

The revision of Instruction 263 in 2013 (chapter 7) has introduced a number of relevant 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 placed at the same organisational level of business heads. If a conflict between the business and control arises, the latter can escalate to the higher levels of the organisation and up until the strategic body (often the Board of Directors).

Finally, in order to protect the control functions from harassment or any other hostile behaviour, the Board and the supervisory body must be reported to by the CEO of the

General Director in the case of Chief Risk Officer and Compliance Officer resignation or dismissal.

Even though 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 case where business decisions could damage the bank's safeness; the separation of compliance and risk management could weaken the control process; Board composition still doesn't recognise the importance of a technical background in its members who should 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 directors⁸².

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 divergences 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 be are consistent with the shareholders risk profile (Mieli, 2010). Differently, 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 a safe and sound management and, therefore, that don't comply with shareholders' interest. This latter tendency is known in literature as *short-termism*⁸³. The CFA, Centre for Financial Market Integrity (CFA, 2006, p.3), referred to short-termism as "*the 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 the market's 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 has highlighted a mismatch between executive compensation and the creation of economic value. In fact, businesses that conduct themselves in a short-term oriented manner are, *generally*, characterised by a risk profile aligned with neither to shareholders' interests nor to the principle of sound and prudent management. As a consequence, this could lead to the loss of the 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 did not ensure the alignment between 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 between shareholders and managers and higher performance is not always positive⁸⁶.

The relationship between shareholders and managers in financial firms affects more heterogeneous stakeholders compared to those that are called upon to relate with non-financial institutions. Therefore, the remuneration system for financial institutions should

be designed not only to reach the convergence between stakeholder and executive interests, but also the stability of the economic and financial system as a whole.

The global financial crisis has highlighted how the architecture of remuneration policies of many large financial intermediaries was often poor⁸⁷ and frequently oriented to increase risk appetite.

The issue of executive compensation has received wide attention during the crisis also 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).

Emanating from these considerations, both 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 in response to the crisis, that have been introduced over recent years to create binding principles for a more effective remuneration system⁸⁸.

In April 2009, the Financial Stability Forum (then the Financial Stability Board) issued *“Principles for Sound Compensation Practice”* to discuss the topics 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. 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 April 30th 2009, the European Commission issued Recommendations n.384 and n.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 were on 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 regards 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 have to include an adjustment for current and future risks related to underlying performance, and would have to evaluate the cost of the capital employed and the liquidity required.

Recommendation 385 promoted long term sustainability of the firm granting that remuneration was based on performance. For this purpose, the variable components of remuneration would need to be linked to predetermined and measurable performance criteria, also including those of a non-financial nature. An important role within

compensation structure, already provided in 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 reflected the main orientation already elaborated by other international bodies. In particular, the standards prescribed by Financial Stability Board in 2009 became *binding rules* in the European system. The whole structure of the Directive is both principles based, with regards the remuneration policies of all staff members to apply to all banks according to the principle of proportionality, and rules based particularly addressed to the subject whose professional activities have a material impact on their banks' 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 be addressed 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 referring to the remuneration system with particular attention to its design. In particular, the Directive has provided that fixed and variable components of remuneration should be *appropriately* balanced and that, at the same time, the fixed component should 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* with a long term financial perspective of the company (“*guaranteed variable remuneration is not consistent with sound risk management or the pay-for-performance principle and should, as a general rule, be prohibited*” Whereas n.8). In addition, the directive has established the possibility to activate either *malus mechanisms* or *claw backs clauses* with the intent to decrease the overall variable

remuneration where financial performance of the company was negative or lower than expected⁹³.

In order to strengthen the relationship between individual interests and risk appetite, values and the long term perspective of the financial institution, the Directive has 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 company⁹⁴. 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 three 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), the Whereas 4 has 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) has 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 between a sound and prudent remuneration system and the associated credit institution risk profile has to be supplemented with clear transparency rules. For this purpose, the Directive has asserted that *“credit institutions and investments 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 August 26th 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 follow⁹⁶. In particular, banks were obligated to instil a corporate governance model where the remuneration and incentive systems were aimed to dissuade managers to undertake management choices not aligned with the banks' strategies.

Further provisions referring to this issue were introduced within the Finance Act (TUF) stating that *“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 regards to listed companies, an important point of reference is represented by the

Corporate Governance Code issued in 2006 which was a replacement for the preceding 1999 and amended 2002 versions. It was an intervention based on self-regulation, and the adoption and compliance with the Code was voluntary and non-binding in nature⁹⁸. 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 reach this purpose, 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 company⁹⁹.

With the goal 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 banks¹⁰⁰, indicating the essential features of corporate governance for purposes of sound and prudent management¹⁰¹.

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 regards 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 function¹⁰² 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/EC¹⁰³, 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 subjected 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 the European Directive 2010/76/EC (so called CRD III), the Bank of Italy issued a New Regulation "*Supervisory provisions concerning remuneration and incentive policies and practices in bank and banking groups*" on the 30th of March 2011. The provisions were addressed also to foreign branches of Italian banks and Italian branches of foreign banks¹⁰⁴.

The provisions issued by Bank of Italy followed the European regulatory approach exactly. As in the Directive, the implementation of the new rules provided for some flexibility depending on the characteristics, size and complexity of the activity of the bank (*principle of proportionality*). Only large banking groups are enforced to fully comply with the community rules, while some of the relevant provisions, in particular those referring to the structure of incentive systems, was not binding for smaller banks¹⁰⁵.

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 the "relevant" personnel selected through a self-assessment process. However, it was assumed that people included within the category of relevant personnel were¹⁰⁶:

- 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 strategic, management, and control;
- III. staff members of internal control functions with particular reference to the members of internal audit, risk management, and human resources;
- IV. other members that, either individually or collectively, assume significant risks (other *risk takers*)¹⁰⁷;
- V. any employee whose total remuneration, including discretionary pension benefits provisions, place them into the same remuneration bracket as senior management (mentioned above in II) and other *risk takers*.

The structure of remuneration system and incentives mechanism represents the core of the Bank of Italy provision which, overall, has followed the principles stated by CRD III.

According to paragraph 5.1 of the Regulation of Bank of Italy of 30th March 2011, “*the total remuneration must be split into fixed and variable quota; the distinction between these two components must be strict*”. In accordance with the principle of proportionality The ratio between fixed and variable portion, although balanced, should be evaluated according to the complexity of bank activities and to the features of staff members, with particular regards to the relevant personnel. With the intent to allow for a flexible remuneration policy and variable quota, the Bank of Italy stated that employee fixed compensation had to represent a sufficiently high proportion of total remuneration, providing for the possibility to completely eliminate the variable part when appropriate risk-adjusted performance is not aligned with the targets.

Given that there has been agreement by supervisors and regulatory bodies that inappropriate remuneration structures of some financial institutions have been an important factor in explaining the financial crisis, the design of the variable part of remuneration policies has been focused upon, and it has been judged responsible for the mismatch between personal objectives of executives and the long term interests of the credit institution.

The Bank of Italy, with the goal to align executive compensation with the long term perspectives of credit institutions, established detailed criteria to be followed for determining the variable component of remuneration¹⁰⁸. The key decisions stated that, firstly, a substantial portion of at least 50 per cent, has 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 capital¹⁰⁹. In order to align the incentives with the long term interests of the credit institution, it was stated that these instruments will be subject to an appropriate *retention policy*¹¹⁰.

Secondly, the payment of a substantial portion of at least 40 per cent of the variable remuneration component, has to be deferred over a period of not less than 3 to 5 years so that the remuneration is coherent with risks undertaken by 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 regarding the financial situation of the bank and that it does not limit the bank's ability to strengthen its capital base.

It is worthy to highlight that the Bank of Italy in full compliance with Directive 2010/76/EU, stated that for banks and banking groups receiving special government support, variable remuneration should be strictly limited as a percentage of net revenue when it was 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 any 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 a safe and sound risk management, shareholders have been given the task of approving the remuneration policies addressed to the bodies having supervisory, management and control functions and for the equity based

incentives. The main goal of this has been to increase shareholder awareness of the overall costs and underlying risks of the chosen remuneration system. Shareholders must be provided with clear and complete prior information on remuneration policies and practices that will be adopted, as well as further subsequent information on a yearly basis on the terms of implementation of these policies.

According to the rules 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 having internal control functions. In order to verify correct policy application, the members of the strategic supervision have been forced to find out at least on a yearly basis, the implemented remuneration policy.

For large banks, as defined in paragraph 3.4 of the Regulation, as well as for listed banks, the Bank of Italy has made it an obligation to constitute the “Remuneration Committee” within the bodies with strategic supervision functions. It was stated not only that members had to be non-executives but also that the majority of them had to be independent¹¹².

The functions of the Remuneration Committee have been outlined in detail in paragraph 4.2 of the Regulation. Among these, the Committee were given the responsibility of both 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. Moreover, the Committee has to ensure the involvement of the corporate functions responsible for the supervision and development process of remuneration policies and practices.

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

Following the supervisory provisions of the Bank of Italy of March 2011 and in order to implement the CRD III regarding remuneration and incentive policies and practices, in accordance with article 6 paragraph 2-bis of the Finance Act (TUF)¹¹³, as amended by

Community Law of 2010, on July 29th of 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 of October 2007. In particular, chapter 3-bis (Organisational-precautionary requirements for remuneration and incentive policies and practices) article 14-bis was added stating 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 “*Supervisory provisions concerning remuneration and incentive policies and practices in bank and banking groups*” of March 2011 with 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 states:

- 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;
- the reinforcement of the provisions concerning ex-post risk adjustment mechanisms (malus and claw-back arrangements);
- limits to variable remuneration when banks do not respect 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 has revised the definition of “major banks” to which the whole regulation on remuneration policy is applied to, in order to align it with that of “significant banks” in accordance with the Regulation of European Single Supervisory Mechanism.

13. Conclusions

Analysis of changes to the regulatory framework over the last three decades and the response 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 the adoption of the first Bank Directive (1985) and the application of Basel 1 proposals (1988), the style of banking supervision changed from structural to prudential. The purpose of regulation (1993 Banking Act, article 5) was not only finalised 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 5 largest banks was around 30%; in 1999 this value rose to 48%. At the same time with liberalisation of the banking system, the number of branches increased by about 40% from 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 were able to catch risk factors.

The introduction of capital requirements was aimed at reducing the risk appetite of banks in the cases where their profitability is not able to 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 the proprietary trading exposures in sovereign bonds, without any capital absorption, since the market risk element was calculated out of the 1988 Capital Accord (Basel 1).

Prudential supervision design introduced regulatory arbitrage causing banks 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.

Therefore, the banking business model significantly 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, originating 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 onwards; at the end of 2006 the annual net flows of asset-backed securities issuance 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 that Italian banks held securitised mortgages to households.

The financialisation of commercial banking, along with the adoption in 2003 of the International Accounting Standards (IAS), the mark-to-market approach, and the 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, by moving from one based on relationships toward transaction orientated banking, that led to a higher 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 the asymmetric information between borrowers and lenders

One of the principal effects of the liberalisation of capital movements due to the introduction of the euro has been 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, originating 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 higher duration. 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 fled to quality switching from Italian government bonds to alternative securities, compounding concerns related to the valuation of the assets of banks and capital adequacy.

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

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

Another issue discussed relates to the concept of the 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 to reduce the ring-fencing temptation to protect domestic giants and the 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 designing the new supervisory handbook that follows the consolidated approach. During the first semester of 2014, 15 Italian banks have been subject to the supervisory risk assessment, the asset quality review, and a stress test in order to supervise all the European large banks with a common starting point.

The Bank of Italy is much more sceptical about the way the Single Resolution Fund has

been designed, particularly as the decision making process is complicated and far from being able to effectively face an unexpected banking crisis (Signorini, 2014).

Finally, a significant change underlined by the Italian regulator is that the CRD IV/CRR (with its 686 articles, most of them particularly technical in nature) appears to be 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 and 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/EEC: "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 the 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 the provision of services related to such issues; money broking; 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 n.141 March 7th 1938.

⁵ Other critical changes introduced by the Banking Law of 1936-38 [Law No. 141 of March 7th 1938 (Italy) and Law No. 636 of April 7th, 1938 (Italy)] concern the redefinition of the credit institutions' 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 the 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 n.350 of 1985, art. 1.

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

⁹ See the Investment Services Directive, article 15.

¹⁰ Article 21 established that the authorities had to require for each instrument 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 January 1th 1991, article 3.

¹² Legislative Decree No. 415 of 1996, article 4.

¹³ These provisions correspond with those already established with the Bank of Italy's supervisory Circular n.263 of 27 December 2006 and applied to banks by the 31st of 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 n.285 of 17 December 2013, Part II, Chapter 9, Section III.

¹⁵ These provisions correspond with those already established with the Bank of Italy's supervisory Circular n.263 of 27th of December 2006 and applied to the banks within 31st of December 2013.

¹⁶ Bank of Italy (2011), Supervisory provisions concerning remuneration policies in banking groups, March.

¹⁷ Bank of Italy, Communications of 4 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, (ii) 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, (iii) by the depositor in the context of an established operational relationship other than that mentioned in point (i) and (iv) 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/EEC; 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 n. 114 of 17 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 take 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/EEC on the Supervision of Credit Institutions on a Consolidated basis; Council Directive 93/6/EEC of 15 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 on the fact that, in the latter case, the point of reference used are the financial statements of each individual*

undertaking, which are then corrected to take into account the impact at group level", Christos Vl. 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 on May 30th, 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 in 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 the 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 the Directive 2002/87/ECC.

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 September 1st of 1993, article 19, sub-paragraph 6.

³³ Legislative Decree No 385 of September 1st of 1993, article 19, sub-paragraph 7.

³⁴ Italian Banking Law, article 19, subparagraph 2, as amended by the Legislative Decree n. 21 of 27th of January, 2010.

³⁵ Legislative Decree no. 58 of 24th of February 1998.

³⁶ Council Directive 93/22/EEC of 10th of May 1993.

³⁷ Directive 89/592/ECC of 13th of November 1989 coordinating regulations on insider dealing.

³⁸ Art. 3 Law 157/1991.

³⁹ Art. 5 (1) Law 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 of 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 of 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 of 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 58/1998, as amended by Law 62 /2005.

⁴⁴ Art 181 (3) Legislative Decree 58/1998, as amended by Law 62 /2005.

⁴⁵ Art 114 (8) Legislative Decree 58/1998, as amended by Law 62 /2005.

⁴⁶ Art 187 (septies) Legislative Decree 58/1998, as amended by Law 62 /2005.

⁴⁷ Directive 2004/39/EC of the European Parliament and of the Council of April 21st 2004 on markets in financial instruments amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

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 58/1998, as amended by Legislative Decree 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 n. 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 n. 16190, article 26, letter d); "retail customer" shall mean the customer that is neither professional or a qualified counterparty, Consob Regulation n. 16190, article 26, letter e).

⁵⁴ Art 27 Consob Resolution no. 16190 of 29th of 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 of 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 from the requirements of paragraph 1 of this Article the exposures to counterparties which are members of the same institutional protection scheme as the lending credit institution, 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 into a contractual or statutory liability arrangement which protects those institutions and in particular ensures their liquidity and solvency to avoid bankruptcy in case it becomes necessary (referred to below as an institutional protection scheme); c) the arrangements ensure that the institutional protection scheme will be able to 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) the institutional protection scheme draws up and publishes once in a year 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 aggregated balance sheet, the aggregated 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 Fra zza B. (2011), *"Il Bilancio bancario. Evoluzione e rivoluzione nell'informativa"*, in Rutigliano M. (ed) *"Il bilancio della banca"*, EGEA, Milan.
- ⁶⁶ Directive 86/635/ECC, article 4.
- ⁶⁷ Legislative Decree n. 87 of 27th of January 1992, article 46.
- ⁶⁸ Directive 78/660/ECC, article 2.
- ⁶⁹ Legislative Decree n. 87 of 27th of January 1992, article 2, subparagraph 2.
- ⁷⁰ Legislative Decree n. 87 of 27th of January 1992, article 2, subparagraph 3.
- ⁷¹ Legislative Decree n. 87 of 27th of January 1992, article 2, subparagraph 4.
- ⁷² Bank of Italy, Circular n.166 of 15th of July 1992.
- ⁷³ Legislative Decree n. 87 of 27th of January 1992, article 7, subparagraph 6.
- ⁷⁴ Legislative Decree n. 87 of 27th of January 1992, article 7, subparagraph 8.
- ⁷⁵ The International Accounting Standards were applied starting from the 1st of 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 n. 32 of 2nd of February 2007, article 2428, subparagraph 1.
- ⁷⁷ Italian Civil Code, as modified by Legislative Decree n. 32 of 2nd of February 2007, article 2428, subparagraph 2.
- ⁷⁸ *"The consolidated annual report has to be completed from 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 the Legislative Decree n. 127 of 1991, before the adoption of Legislative Decree n. 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 on February 2006.
- ⁸¹ J. Winter (2011), *"The Financial Crisis: Does Good Corporate Governance Matter and How to Achieve it?"*, DSF Policy Paper Series, n. 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 has been 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 have 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 in Jensen et al. (2004).

⁸⁸ Others 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 of April 2009 on remuneration policies in the financial services sector.

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

⁹² Recommendation 9.2 in Section III of the Commission Recommendation of 30th of 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 the Legislative Decree 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 worthy to observe 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 banks' 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 of 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 the Bank of Italy provisions for the term “major banking groups” only include all intermediaries within the first macro-category SREP.

¹⁰⁶ Bank of Italy (2011), “*Supervisory 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; along with, b) the percentage of variable quota is higher than 20 per cent.

¹⁰⁸ See paragraph 5.2 of the “*Supervisory 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 regards to the *up-front* portion of the variable remuneration component, the retention period has to be at least 2 years in length whereas for financial deferred instruments, the retention period can be shorter allowing for the duration of the evaluation period of performance.

¹¹¹ The “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 the return of the payment already paid to staff members, and it refers to both up-front and deferred portion.

¹¹² Fernandes (2005), “*Board Compensation and Firm Performance: The Role of “Independent” Board Members*”, ECGI Working Paper Series in Finance, n. 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 a 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 which provisions are not applicable to.

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 on Di Giorgio, Di Noia, Piatti (2000)

Table 3.2. Ownership structure of listed banks (Percentages, weighted by market capitalization)

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 on Consob data

Table 4.1. Internal Models 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 authorized 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 cash balances	Deposits from banks
Financial assets held for trading	Deposits from customers
Loans and receivables with banks	Debt securities in issue
Loans and receivables with customers	Financial liabilities held for trading
Financial Investments	Financial liabilities designated at fair value
Hedging Instruments	Hedging instruments
Property, plans and equipment	Provisions for risks and charges
Goodwill	Tax liabilities
Other intangible assets	Liabilities included in disposal groups classified as for sale
Tax assets	Other liabilities
Non-current assets and disposal groups classified as held for sale	Minorities
Other assets	Group Shareholders' Equity:
Total assets	<i>Capital and reserves</i>
	<i>Available for sale assets fair value reserve and cash flow hedging reserve</i>
	<i>Available for sale assets fair value reserve and cash flow hedging reserve</i>
	Net profit (loss)
	Total liabilities and Shareholders' Equity

Table 11.2. The bank income statement structure

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

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

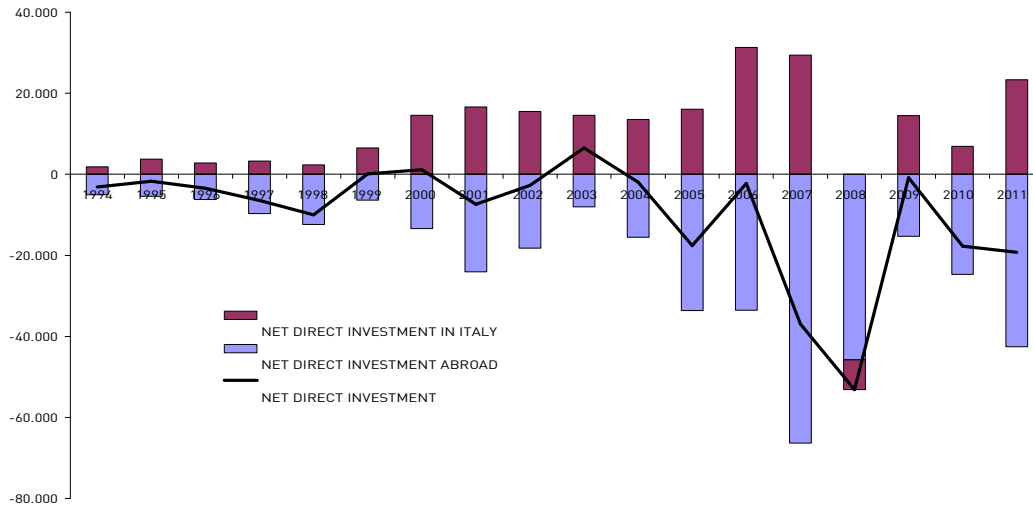
Shareholders' equity under current GAAP (DL 87/92)
Business combinations
Property, plant and equipment
Intangible assets
General banking risk reserve
Loan loss provision
Provision for risks and charges
Employee benefits
Share-based payments
Treasury shares
Deferred tax assets
Recognition of revenue
Consolidation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

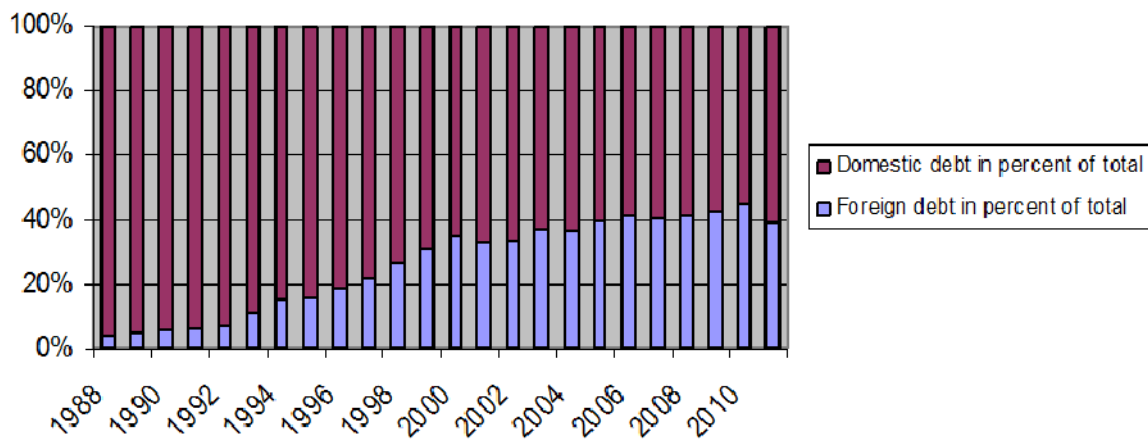
Figures

Figure 2.1. Net Direct Investment (millions of euros) (1994-2011)



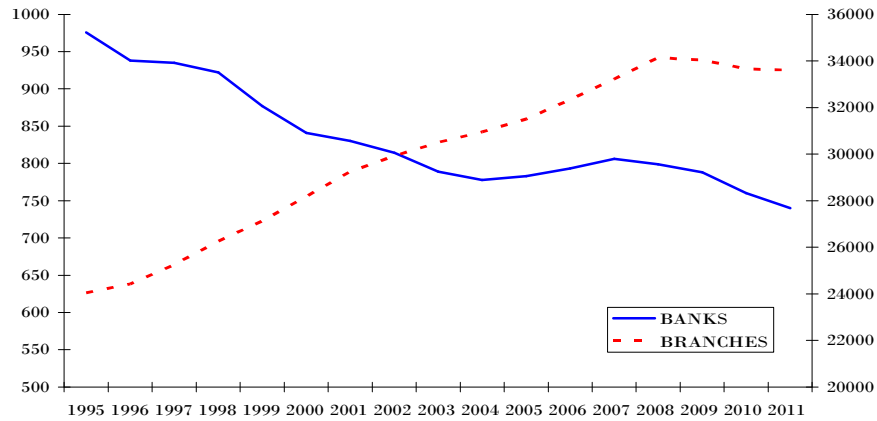
Source: Eurostat

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 5 top banks by size compared with the EU average (in blue the value in December 2011; in red the value at June 2013)

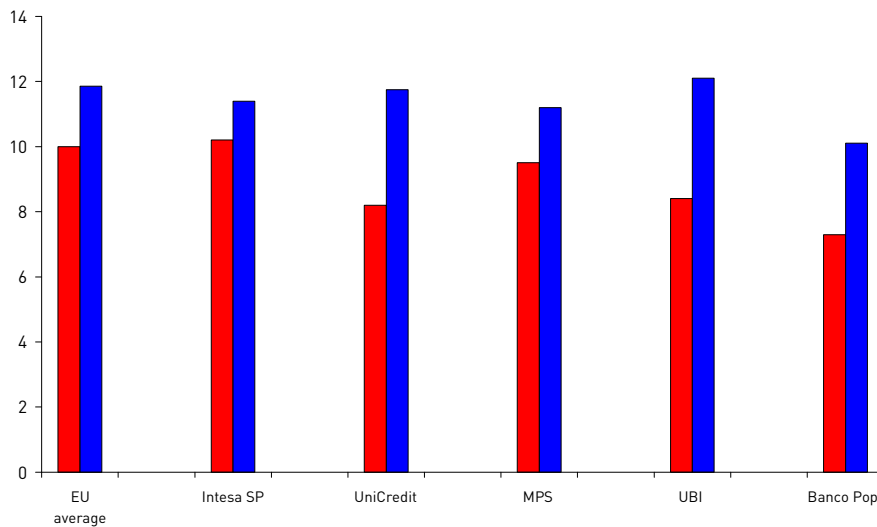
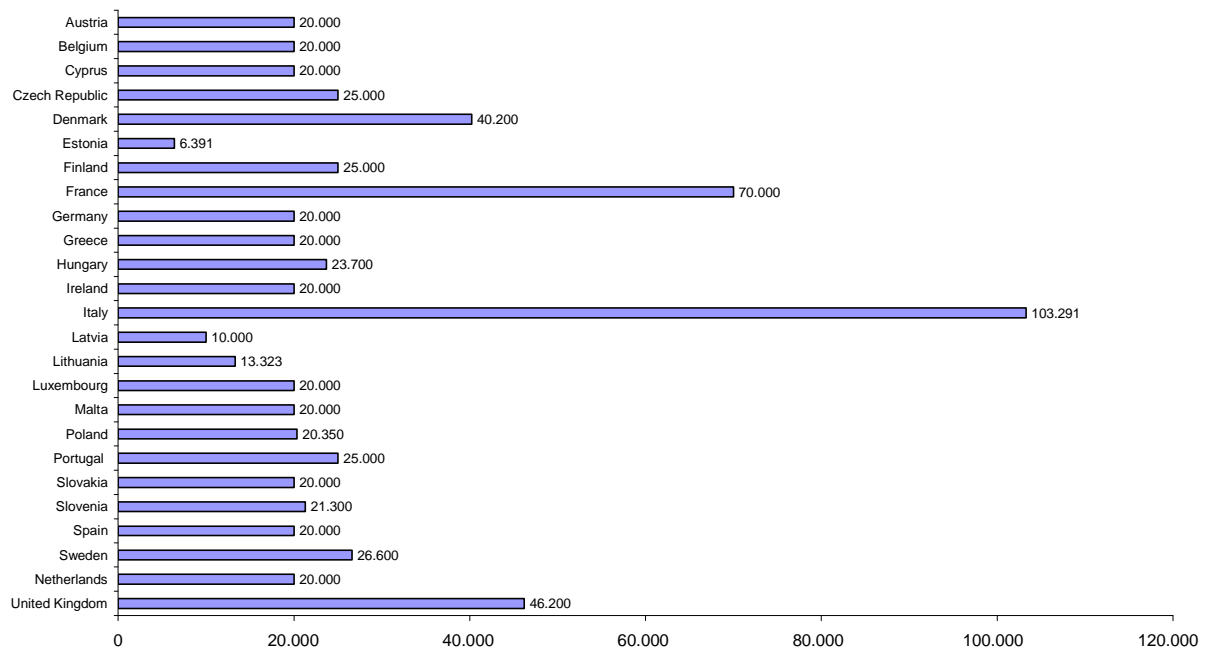


Figure 9.1. Level of deposit coverage in EU-25 at the end of 2005 (values in €)



Source: Interbank Deposit Protection Fund

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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 has financialisation 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 are the requisites of a financial system able to support a process of sustainable development, broadly conceived?'

THE PARTNERS IN THE CONSORTIUM ARE:

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