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# IMF Working Paper

## Reforming the Corporate Governance of Italian Banks

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**Reforming the Corporate Governance of Italian Banks**

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## Abstract

*Sound corporate governance is essential for a well-functioning banking system and the integrity of financial markets. The paper discusses the corporate governance of Italian banks, its regulatory framework, and the specific challenges arising from the role played by foundations and large cooperatives. Although Italian banks have recently made progress in improving their corporate governance, more needs to be done. In this regard, further improvements should include: (i) strengthening further the existing banking regulations through stricter fit-and-proper rules for directors and controlling shareholders; (ii) implementing the new related party lending regulation with tightened definitions; (iii) strengthening oversight of foundations when they are the controlling shareholders in banks; and (iv) facilitating the transformation of large cooperatives into joint stock companies.*

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## I. Introduction

The recent financial crisis revealed several corporate governance failures in the banking sector, both in the United States and in Europe. The Boards of several key financial institutions were found to have been unable either to monitor risk management systems and executive salaries effectively (United States and United Kingdom), or guard against conflicts of interest (Spain, Germany). Italy also experienced its own cases of governance shortcomings, both in large banks and in medium-sized banks.

Sound corporate governance is critical for a well-functioning banking system and for the integrity of financial markets. Corporate governance determines the systems, principles, and processes by which banks are governed and influences banks' behavior toward their employees, clients, and shareholders.

In Italy, the ownership structure of some banks—foundations without shareholders and cooperatives— raises specific challenges for corporate governance. The foundations do not have shareholders and are subject to political influence, which in turn affects the composition of the decision-making bodies and the activities of Italian banks. Foundations are major shareholders in 23 percent of Italian banking assets through participations in 20 percent or more of bank capital. Moreover, in several large banks, they control bank Boards with an even smaller share of ownership, often through shareholders' agreements. In the large cooperative banks (Banca Popolare), restrictions on ownership and voting rights (one member-one vote) weaken market diligence and the bank's capacity to raise capital from outside sources. Both large cooperatives and banks owned by foundations tend to display lower buffers and weaker asset quality metrics than the system average.

Italian banks have recently made progress in improving their corporate governance, as a result of the implementation of European Directives, specific provisions introduced by the Bank of Italy (BoI), and industry codes of conduct. However, further reforms are needed to strengthen the oversight and management of banks. This will require: (i) applying stricter fit-and-proper rules for directors and controlling shareholders; (ii) implementing the new related party lending regulation with tightened definitions; (iii) strengthening oversight of foundations when they are the controlling shareholders in banks; and (iv) facilitating the transformation of large cooperatives into joint stock companies.

The paper is organized as follows: Section II discusses the role of foundations in governing Italian banks; Section III discusses the governance challenges raised by large cooperative banks; Section IV takes stock of the recent regulatory initiatives to enhance corporate bank governance in Italian banks; and Section V draws upon the recent Financial Sector Assessment Program (FSAP) recommendations for further strengthening corporate governance in Italy.

## II. FOUNDATION-CONTROLLED BANKS

**Foundations are major shareholders in Italian banks**, **either through large participations or the capacity to appoint the majority of the Board.** In the past, the foundations spurred Italian banks to expand and modernize. They also served as stable long-term shareholders and, in the recent crisis, supported bank recapitalization efforts. However, the financial position of several foundations has weakened, raising concerns about their capacity to provide further support. As foundations are also subject to political influence, their ownership in banks influences the composition of the decision-making bodies and banks' activities.

### A. Foundations as Bank Owners

**Italian foundations have played a critical role in the privatization of community-owned banks.** The Italian government decided in the early 1990s to privatize the community-owned banks (savings banks owned by the province or region)[2] and transform them into joint stock companies. To address the limited availability of domestic capital, the government created 88 community-owned nonprofit foundations to serve as temporary trustees for the capital of the newly privatized banks. As a result, foundations ended up as exclusive owners of these banks. They use their proceeds (bank dividends) to fund philanthropic projects for the local communities.

**Although the foundations were mandated to relinquish control, exceptions remain.** The law (1998) mandated the foundations to dispose of the majority of their ownership stakes in their original banks, including "positions of control," within four years. However, there were exceptions. Small foundations and foundations located in special statute regions[3] were exempted from the rule. In addition, the definition of "position of control" was interpreted narrowly by the Courts, to cases where a foundation owned a 50 percent plus one share.[4] Moreover, foundations can act in concert on a broader array of matters than those explicitly spelled out in shareholder agreements or without signing such agreements.

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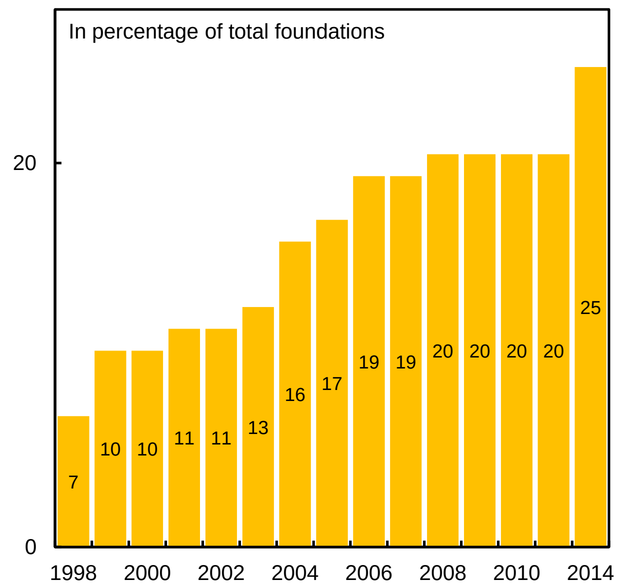
[2] Italian savings banks go back to the fifteenth century.

[3] The Italian constitution grants a certain autonomy to five regions (Sardinia, Sicily, Trentino-Alto Adige/Südtirol, Aosta Valley and Friuli-Venezia Giulia), with regard to legislative, administrative and financial powers.

[4] The application decree of the 1998 law was broad in its definition of "positions of control." Control was considered "joint," when a foundation appointed the majority of the Board of Directors jointly with other shareholders through agreements made in whatever form ("accordi in qualsiasi forma stipulati").

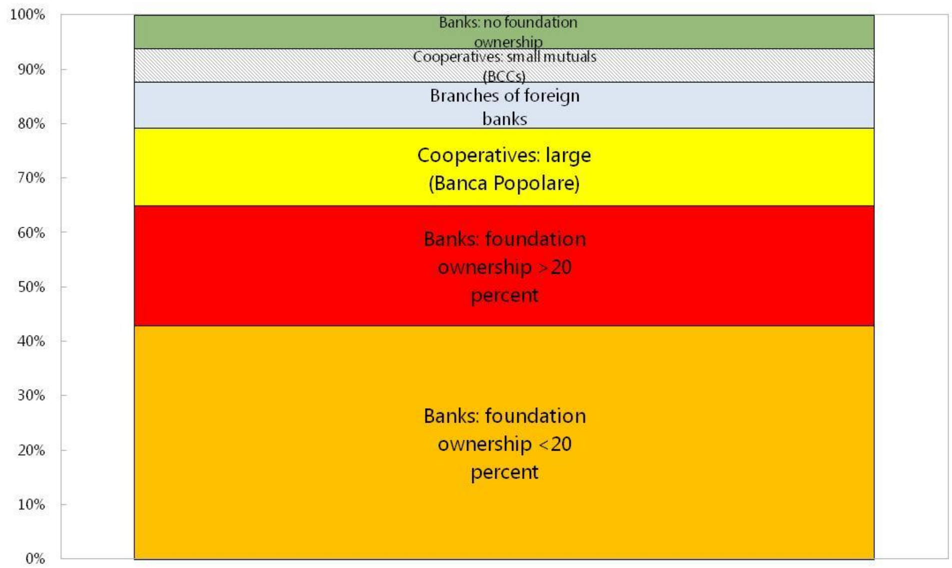
**Foundations are still major shareholders in Italian banks.** Only one fourth of the foundations have disinvested fully from their original banks (Figure 1). In 35 banks, accounting for 23 percent of Italian banking assets, foundations hold more than 20 percent of banks' equity (Figure 2), which is, in many cases, enough to ensure they remain the controlling shareholders.

Figure 1. Foundations Having Fully Disinvested from Their Original Banks




Sources: ACRI and Ministry of Finance.

Figure 2. Structure of Ownership in Italian Banks and Presence of Foundations
(In percentage of total assets)




Sources: BoI 2013 data, updated by IMF staff

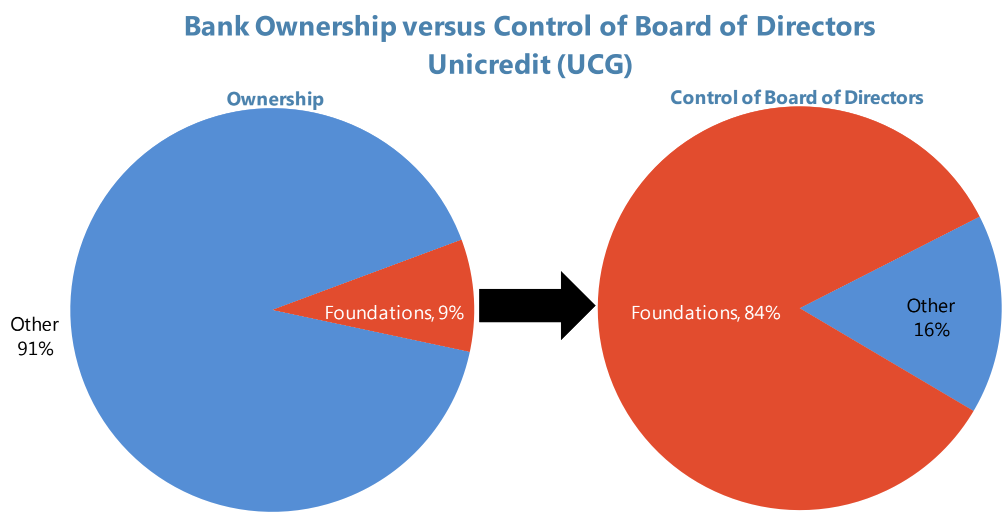
**Some foundations have also maintained control in the three largest Italian banks, through shareholder agreements.**

- In the two largest banks, Unicredit and Banca Intesa, foundations nominate the majority of the Board's members, despite lacking a controlling share. In both cases, the foundations have signed specific shareholder agreements, where they commit to vote for a common list of Board members.[5] At Unicredit, the three largest foundations, owning 9 percent of the shares, nominate more than 80 percent of the Board of Directors (Figure 3). At Banca Intesa, five foundations, owning 25 percent of the shares, nominate a similarly high share of representatives on the Supervisory Board.[6]

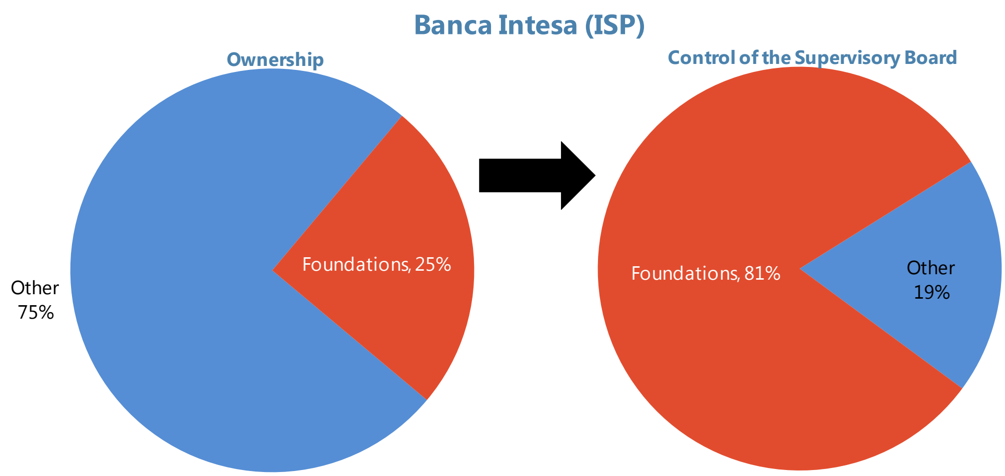
[5] The list that receives the majority of the votes in the shareholder's assemblee ("majority list") is usually entitled to nominate the majority of the Board.

[6] Intesa is one of the few Italian banks with a two-tier Board structure.

Figure 3. Intesa-Unicredit – Foundations as Controlling Minority




Sources: UGC website; IMF staff estimates.
As of May 2013. Foundations in the majority list: four foundations with ownership above the two percent reporting threshold (Carimonte Holding -jointly controlled by two foundations (Modena and Ravenna); Cariverona, Caritorino).

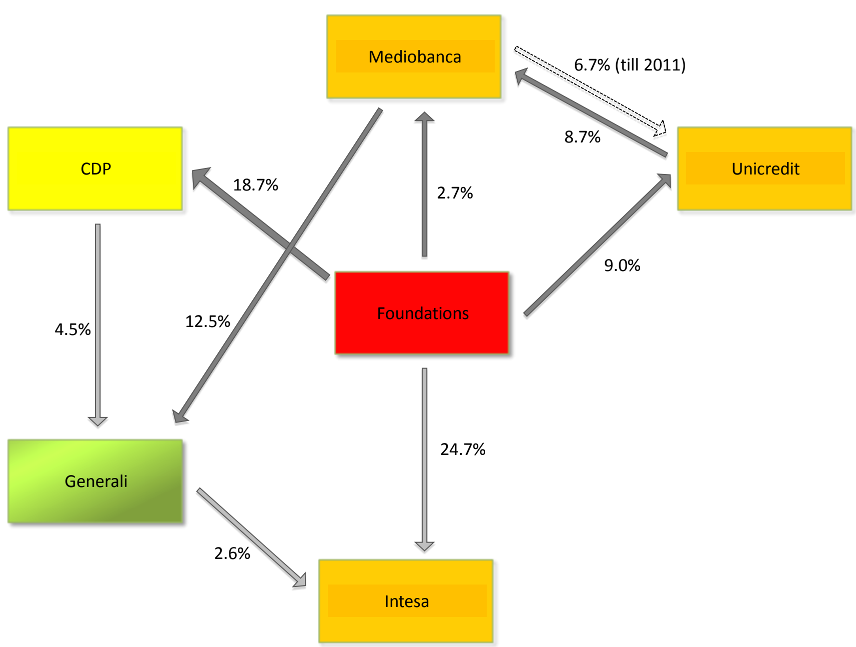



Sources: ISP website; IMF staff estimates.
As of May 2013. Foundations: five foundations with ownership above the two percent reporting threshold : Compagnia di San Paolo; Cariplo; Cariparo; Cassa di Risparmio di Firenze; and Fondazione Casa di Risparmio in Bologna.

- In the third largest bank, Banca Monte dei Paschi di Siena (MPS), the foundation (MPS Foundation) was able, until July 2013, to maintain full control through the combined effect of its ownership share (46 percent in 2011) and a voting rights ceiling on non-foundation shareholders.[7] While MPS Foundation has disinvested most of its shares in MPS (Box 1), it still possesses a significant influence on the bank's governance through a shareholder agreement with two foreign shareholders.

- Foundations also exercise a significant influence on the Italian financial system through a complex network of cross shareholdings (Figure 4). The foundations hold shares in several financial companies[8] that are themselves interlinked by cross shareholdings. They are the second largest shareholder in the Cassa Depositi e Prestiti (CDP), a state-controlled development bank. Cross-shareholdings create vulnerabilities in the banking system, with higher risks of financial contagion and cascading losses in times of crisis.

Figure 4. Cross-Shareholdings in the Largest Italian Financial Institutions




Source: Bloomberg, financial statements

[7] MPS had a 4 percent voting cap on non-foundation shareholders until July 2013. This cap was removed, upon request from the EU Commission for fulfilling State Aid criteria.

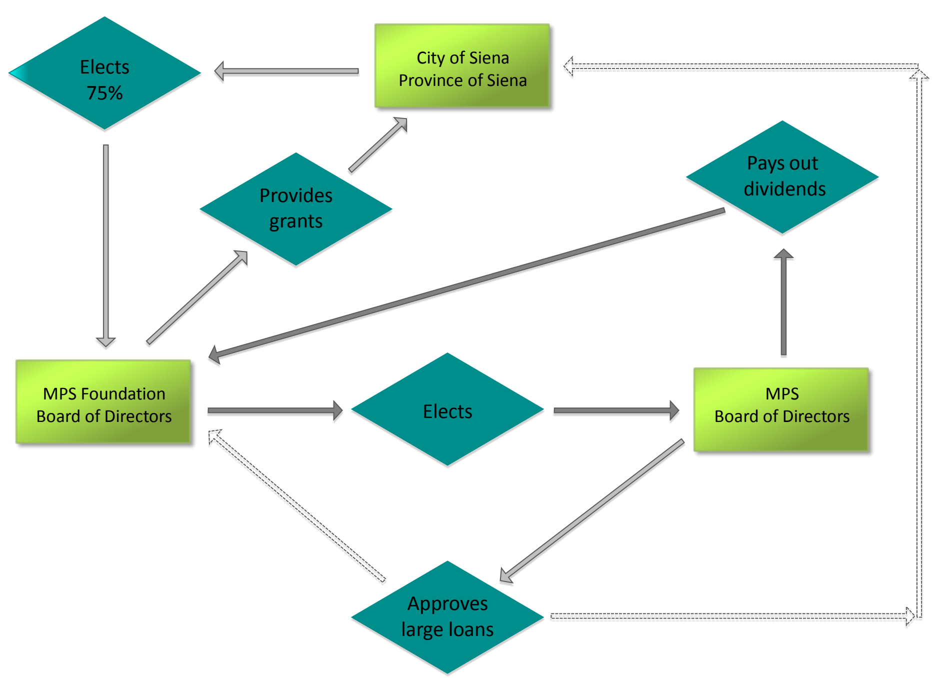
[8] For the detailed holdings, see the special report of the Antitrust authority on Italian banking foundations, 2009.

## Box 1. Monte dei Paschi, Foundation Monte dei Paschi, and the City of Siena

*Monte dei Paschi di Siena (MPS) is the world's oldest bank and ranks as Italy's third largest. Since 2011, the bank has accumulated large losses (€9 billion), mainly due to a large acquisition of another bank in 2008 and risky structured repo transactions on Italy's sovereign debt. These problems reflect weak governance and management. The bank also has close ties to the city and province of Siena, and their politics.*

MPS has historically been controlled by a majority shareholder, the banking foundation of the city of Siena (the MPS Foundation), whose Board is composed mainly of local political appointees. The MPS Foundation also played an important role in selecting MPS's own Board—including the bank's Chief Executive Officer— until 2012. The foundation's statutes dictate that grants are directed only to Siena province, making MPS one of the major contributors to the local economy. The bank's headquarters (domicile and operating base) and at least 50 percent of its bank's Board members —including the Chairman—should also reside within the province of Siena.

Foundation 'Political and Grant' Cycle




The foundation-shareholder has become over-leveraged, after participating in successive bank capital increases in order to avoid dilution of its stake. In the context of a large acquisition by MPS in 2007 (Antonveneta), the Foundation subscribed to MPS' capital increase for about €3 billion, with an additional 0.5 billion through a convertible instrument, indirectly issued by MPS with no upfront disbursement ("*Fresh securities*"). In 2011, the MPS Foundation borrowed €600 million from a consortium of domestic and foreign banks to subscribe to the €1 bn capital increase by MPS. Sharp declines in the MPS share price in 2012 triggered the loan covenants and forced the foundation to liquidate a quarter of its shares and default on its debt. The foundation's stake in MPS dropped from 45.8 percent of MPS in 2011 to 33.5 percent in 2012.

**Box 1. Monte dei Paschi, Foundation Monte dei Paschi, and the City of Siena (continued)**

The financial situation of MPS worsened in 2012. Due to its large portfolio of sovereign debt and thin capitalization, MPS was one of four European banks not to pass the June 2012 European Banking Authority recapitalization exercise. Therefore, it received €4 billion of public funds in January 2013, in the form of a loan, of which two-thirds has to be repaid by early 2015 (or converted to State-owned equity).

MPS reimbursed most of its State Aid (€3 billion) after raising €5 billion fresh capital in June 2014. While MPS Foundation sold most of its stake to various foreign investment firms, it still possesses a relevant influence on MPS through a shareholder agreement. MPS Foundation, Fintech Advisory Inc. and BTG Pactual Europe LLP have entered into a shareholders' agreement accounting for around 9 percent of MPS' capital stock (2.5 percent for MPS Foundation, 4.5 percent for Fintech Advisor Inc. and 2.0 percent for BTG Pactual Europe LLP), which provides for, *inter alia:* (i) a lock-up agreement that ensures they will keep their outstanding shares for a certain period of time;[9] and (ii) a voting agreement for the joint appointment of the Board of Directors[10] (MPS Foundation will propose the Chairman, with Fintech and BTG proposing the CEO).

As of March 2014, the bank's common equity capital ratio stood at 10.8 percent. Its nonperforming loans have reached 28.3 percent.

**It is important to note that Italy is not the only European country with banking foundations.** A few other European countries also have banking foundations, albeit on a smaller scale than in Italy. The experience of these countries is summarized in Box 2.

[9] Fifteen months for the shares already outstanding and 24 months for the new shares subscribed to after the capital increase.

[10] According to the MPS statutes, the list that receives the majority list is entitled to nominate 6 Board members out of 12.

**Box 2. European Experience with Foundation and Banks**

*Similarly to Italy, non-profit foundations have played a critical role in the privatization of community-owned banks in Austria, and more recently in Spain. By contrast, other European countries have adopted more cooperative models (France) or kept their community-owned banks (Germany and Switzerland).*

**Austria has adopted a similar foundation-based model to Italy.** Austrian savings banks—Sparkassen—were privatized in the early 1990s and split into two types of entities—joint stock companies and holding companies—that became banking foundations with a philanthropic nature (1999). The largest banking foundation (Erste Foundation) is currently the primary shareholder of the second largest Austrian banking group (Erste group), holding 22 percent of the shares. The foundation's Supervisory Board is elected by an association (Savings Bank Association or "Verein"), whose members are admitted and renewed through personal sponsorship. The foundation has close ties to the bank, with two members of the Supervisory Board of the foundation sitting on the bank's Supervisory Board. Unlike in Italy, Austrian foundations' Board members are also Board members of the banks they own, raising the potential for conflicts of interest.

**Spain has recently set up banking foundations to reform the governance of its community-owned savings banks.** The financial crisis revealed several governance weaknesses in the Spanish savings banks (*cajas*), including political influence in their governing bodies. The savings banks were split in 2012; their banking activities were turned into for-profit joint stock companies, while their non banking philanthropic activities became non-profit foundations owning the banks' capital (effective in 2013). The Spanish banking foundations are supervised by the Banco de Espana (BdE) and subject to regulatory requirements that are proportional to their share in the banks' capital. Foundations that own more than 30 percent of a commercial bank are required to have: (i) a management protocol describing their ownership policies; (ii) asset diversification rules; and (iii) a reserve fund of liquid assets that can be used for recapitalization needs. However, foundations that own less than 30 percent—even if they still exert a significant influence—are subject to softer requirements.

**Other countries from continental Europe have adopted a more cooperative approach.** France privatized its community-owned savings banks (Caisses d'Epargne) in the 1990s. This was achieved by converting the savings banks into one cooperative banking group (Caisse Nationale des Caisses d'Epargne, CNCE), where customers became the new shareholders, along with the state-owned development bank (Caisses des Depots et Consignations). Following large investment losses during the subprime crisis, this cooperative group was merged with another banking group (Banques Populaires).

**Other countries like Germany and Switzerland have maintained part of their banking sector under public local ownership.** German savings banks (with a few exceptions) are public-law institutions that can only be set up by local authorities, like municipalities. Their Board usually includes representatives appointed by the bank's staff and the local authorities. In Switzerland, cantonal banks are either fully owned by municipalities (e.g. Zurich Cantonal Bank) or partially, in partnership with private shareholders. Despite a general trend to depoliticize their Boards, some cantonal banks remain subject to political appointments.

## B. Strengths of Foundation Ownership

**In the past, the foundations spurred Italian banks to expand and modernize.** Since privatization, the foundations have supported two large consolidations of the banking sector: (i) a national consolidation in the late 1990s, when several domestic banks merged to gain scale, and (ii) a wave of international acquisitions and capital raising in the mid-2000s. This latter consolidation gave birth to three large international banking groups, Unicredit, Intesa, and MPS. For instance, Unicredit's market capitalization surged from €2.5 billion in 1994 to €75 billion in 2007, and the ownership of the foundations was diluted.

**The foundations have also served as stable long-term shareholders and, in the recent crisis, supported bank recapitalization efforts.** In December 2012, the book value of their assets amounted to €51 billion (3 percent of GDP), making the foundations one of the largest domestic long-term investors (Table 1) after CDP and the pension funds. Foundations have also supported the recapitalization effort of Italian banks, providing a quarter of the €27 billion capital raised by the largest banks from 2008 to 2012. They were also able to retain their shares, despite sharp declines in their values.

**Table 1. Largest Italian Foundations by Total Assets, December 2012**

(In billions of euros)

| Name | Bank Holding | Asset Size |
|---|---|---|
| Fond. Cariplo | Intesa | 6.6 |
| Compagnia di San Paolo | Intesa | 5.6 |
| Fond. Cariverona | Unicredit | 2.7 |
| Fond. Caritorino (CRT) | Unicredit | 1.9 |
| Fond. Cariparo | Intesa | 1.7 |
| Fond. Roma | --- | 1.4 |
| Fond. CRC | UBI | 1.3 |
| Cassa di Risparmio di Firenze | Intesa | 1.3 |
| Fond. Carilucca | Banca Popolare | 1.2 |
| Fond. Carige | Carige | 1.0 |

Source: ACRI 2013.

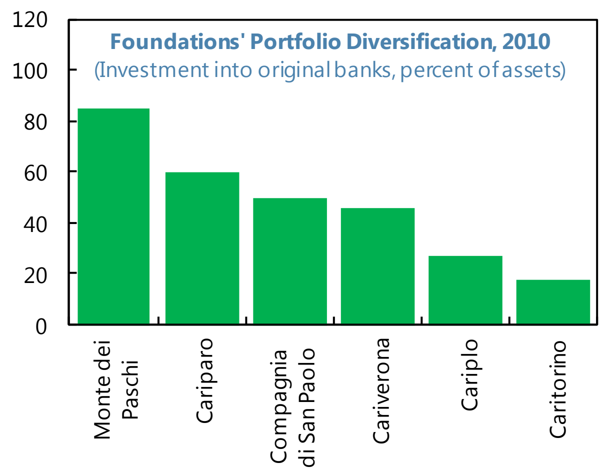
## C. Challenges Raised by Foundation Ownership

### Further support to banks

**The financial position of several foundations has weakened, raising concerns about their capacity to provide further support, if needed.** Several foundations are currently running operational deficits. Foundations' profitability has been heavily impaired by the downturn in banks' profits, while operational costs and grants have continued to grow. Foundations have hired significantly more staff over the last decade, with staff costs more than doubling between 2000 and 2010, in the expectation of growing resources for grants and an increasing number of projects.

**Foundations are also exposed to a concentration of risks.** Despite provisions in Law 461/98, which require diversification of obligations, some large foundations still have portfolios heavily concentrated in their "original" bank, with stakes reaching 90 percent in certain cases (Figure 5). This pattern can be linked to their corporate governance structure that is subject to strong political influence and encourages local investments. Some foundations have also made use of bank credit (mortgages, credit lines) to fund miscellaneous expenditures such as bank capital increases or real estate acquisitions. Others have invested in risky products (derivatives and structured investments). These activities have increased their portfolio risk and raised the pressure on banks to generate dividends to support the weak financial position of the foundation. As a result, some of these banks paid out dividends, despite having incurred significant net losses (e.g. Unicredit and Intesa in 2014).

Figure 5. Foundations' Portfolio Diversification




Source: Mediobanca.

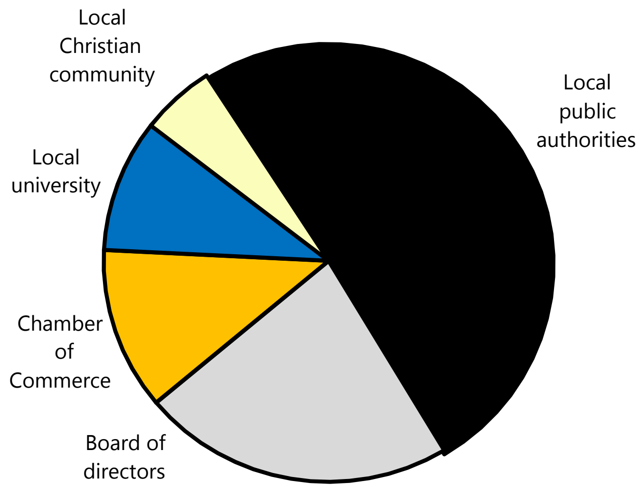
**Foundations are also subject to political influence.** The foundations are strongly influenced by the stakeholders they serve, which vary depending on each foundation's own statutes. According to Mediobanca research,[11] 47 percent of foundations' Boards are elected by local authorities (by the city, region, or province), while another 21 percent are appointed directly by the elected Board of Directors (Figure 6). Usually, the local mayor is appointed as the foundation's President, giving local politicians a direct role in the foundations' governance bodies. Recent academic studies confirmed that local politicians dominate the Boards of foundations,[12] with, for example, 60 percent of the Board seats at the Fondazione

[11] Mediobanca research analyzed the composition of the Board of Directors of six of the largest Italian foundations.

[12] "I politici ai vertici delle fondazioni bancarie", lavoice.com, January 2013.

MPS, and 55 percent at Fondazione Cariplo (Intesa).These local politicians, in turn, can influence the governance of Italian banks.

Figure 6. Large Electors Appointing Boards of Directors in Foundations




Source: Mediobanca Securities

**Foundations have limited internal accountability and external oversight.** Even though the law on foundations includes some general corporate governance principles, governance practices remain weak. For example, the appointment of governing bodies is often nontransparent and foundations do not follow uniform accounting and disclosure rules. The law requires the Ministry of Economy and Finance (MEF) to oversee the foundations. However, in 2003, the Constitutional Court[13] curtailed the MEF's supervisory power, by qualifying foundations as private entities that are not subject to administrative acts by the Supervisory Authority.

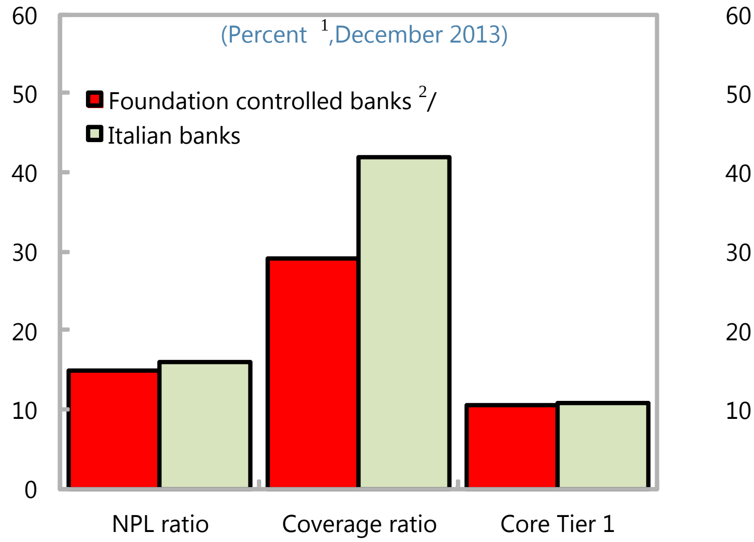
## D. Foundations and Bank Performance

**Banks with foundation ownership display weaker asset quality metrics, on average, than other Italian banks.** Data of June 2012 shows that banks with majority foundation

[13] Constitutional Court decision number 301 of September 24, 2003.

ownership have lower provision coverage, about 10 percentage points below the system average (Figure 7).

Figure 7. Foundation Controlled Banks Selected Indicators




Sources: Bank of Italy.
1 / NPL in percentage of total loans; Coverage ratio in percentage of NPLs
2 / Majority ownership. Data as of June 2012, unweighted.

**Banks with foundation ownership[14] also are less resilient to macroeconomic shocks.** The FSAP undertaken in 2013 conducted three solvency stress tests, on 90 percent of Italian system assets, including a baseline and two downside scenarios. [15]

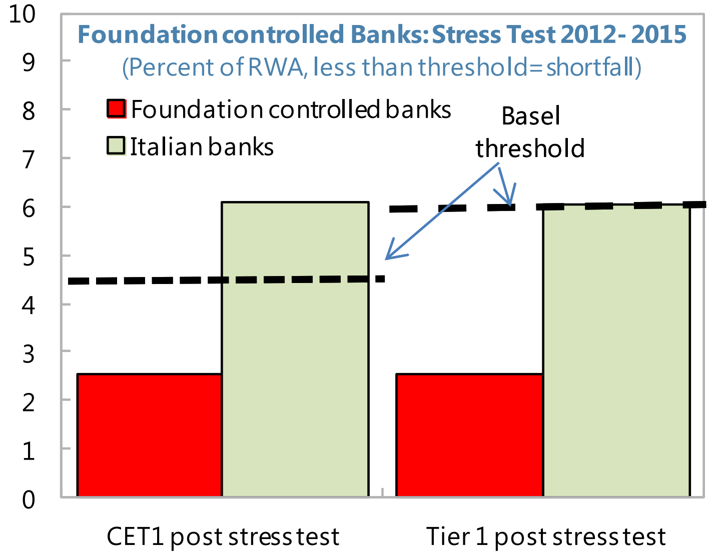
- The baseline scenario forecasted a five-year cumulative real GDP growth rate at 2.8 percent, based on the April 2013 World Economic Outlook (WEO).
- The two downside scenarios envisaged first, "slow growth" with a five-year cumulative growth rate negative by 0.1 percent, and second, an "adverse" scenario simulating a double dip over a three-year period (2012–2015), with growth declining by 5.6 percent.

In the latter "adverse" scenario, the Tier 1 ratio of banks with foundation ownership would fall from 8.8 percent in December 2012 to 2.5 percent in 2015, far below the Basel III

[14]The stress test is based on June 2012 data. It defined banks influenced by foundations as banks in which one single foundation controls at least 20 percent of shares. Hence, it does not include either Intesa or Unicredit but includes MPS at that time.
[15] Based on the April 2013 World Economic Outlook.

minima of 6 percent. The capital shortfalls of this category of banks would account for almost half of the shortfalls of all Italian banks in the stress test (Figure 8).

Figure 8. Stress Tests Results from Banks Controlled by Foundations




Sources: Bank of Italy.

## III. Cooperative Banks

**Unlike Italian foundations, cooperative banks are common worldwide, but some governance aspects of Italian cooperatives can be problematic.** While there is no single definition of a bank cooperative in Europe, they share some common ownership features, including membership requirements and voting rights limited to one vote per member regardless of the investment. These limitations on ownership may hamper effective governance once the bank grows beyond a certain size, as well as limit interest from potential outside investors.

### A. Cooperative Sector in Italy

**There are two categories of bank cooperatives in Italy.** The first is the *Banche di Credito Cooperativo* (BCCs), comprised by small entities that account for 6 percent of the banking system. These cooperatives' main lending activity is to grant credit to their members. Their shares are non-tradable and held only by members, and they allocate three-quarters of their profits to building reserves. The second category are the *Banche Popolari* (BPs). These entities' assets account for 14 percent of the banking system, can list their shares in the stock exchange. They have to allocate only 10 percent of their profits to reserves. Both types of cooperatives give equal voting rights to all members (one member-one vote) and place limits to ownership rights, to €50,000 for the BCCs and 1 percent of capital for the BPs (with larger amounts permitted for institutional investors).

**Some of the largest Italian banks are cooperatives.** The fourth and fifth largest Italian banks (Banca Popolare and UBI) are cooperatives of the second type. In contrast with the situation of other large cooperative banking groups in other European countries, the Italian BPs do not have any form of mutual support mechanism (solvency and liquidity) that may supplement the safety net provided by the domestic deposit insurance schemes. They also have no overseeing national structure or centralized treasury function. The seven largest BPs account for one-third of Italian listed banks.

### B. Strengths of Cooperatives

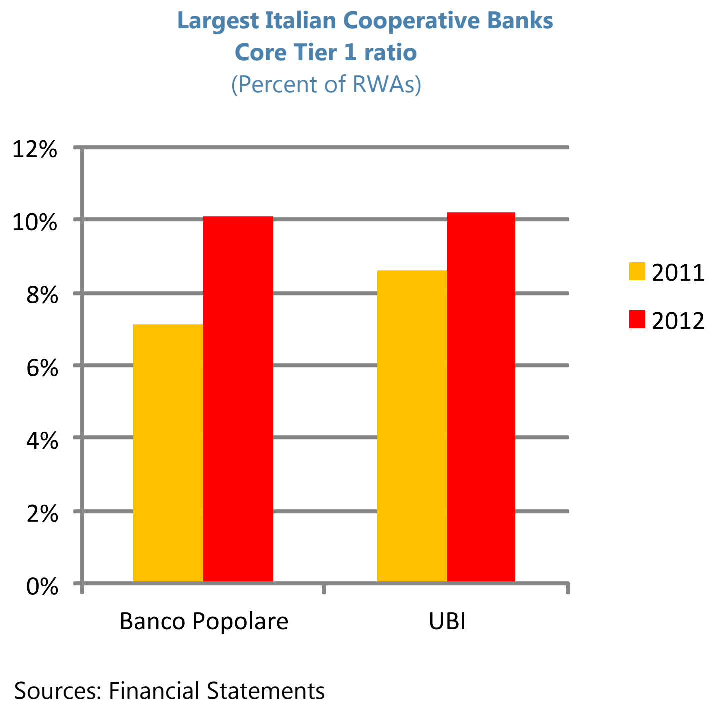
**Cooperatives are a major source of credit to local business.** Due to their legal status and geographical remit, cooperatives tend to have no exposure to global financial markets and the international economy and focus mainly on servicing local borrowers. Italian BPs lend up to two-thirds of their funds to small and medium-sized enterprises (SMEs) and have been the main provider of credit to those firms since 2008.

**In spite of the adverse environment, Italian cooperatives have managed to increase their capital ratios.** Retained earnings have played a key role in supplying fresh capital for cooperatives. The boost in capital ratios has also reflected moves to more sophisticated Basel 2 risk models. In 2012, the two largest Italian cooperative banks mostly relied on the adoption of Internal Rating-Based (IRB) models to pass the European Banking Authority recapitalization exercise[16] (Figure 9). More recently, the third largest BP, Banca Popolare Dell' Emilia Romagna (BPER) has announced that its new internal IRB model would 'more than offset' the expected capital shortfall from the ECB Balance Sheet exercise. In addition, BoI has recently agreed to remove the add-ons imposed on Banca Popolare di Milano (fourth largest BP),[17] which will help boost its capital ratio.

[16] The Risk Weighted Assets of Banca Popolare and UBI fell by 44 percent and 20 percent, respectively from 2011 to 2012.

[17] This capital add-on was requested by Bank of Italy in 2011, after identifying significant governance weaknesses in this cooperative. It was deemed to remain until governance was reshuffled. However, Banca Popolare di Milano's proposal to give institutional shareholders the right to appoint 6 out of the 13 members on its Supervisory Board was rejected by the shareholders' meeting in April 2014. Currently, employees and retirees, as a group, hold 65 percent of the seats at the bank's Board.

Figure 9. Capital Positions of the Two Largest Italian Cooperatives 2011-2012




## C. Challenges Raised by Large Cooperatives

**Restrictions on ownership may hamper effective shareholder control once cooperatives grow beyond a certain size.** Cooperatives impose restrictions on ownership, caps on voting rights, and limits on proxy voting.[18] These restrictions make it difficult for any shareholder, even with a large capital stake, to change the governance structure, replace poorly performing managers, or stand in the way of Directors nominating their successors. It also gives incentives to insiders with special interests to find ways of controlling the cooperative, such as member employees, pensioner former employees or local entrepreneurs.[19] In times of bad economic conditions, these relationships can distort the allocation of credit and slow down work-out procedures with some types of creditors.

**Restrictions on ownership also make it difficult to raise private capital.** Cooperative ownership restrictions make it virtually impossible to attract strategic investors, as these do not have a chance of acquiring management control. As a result, cooperatives have to rely

[18] A 2012 Law on cooperatives established a maximum of 10 votes by proxy.

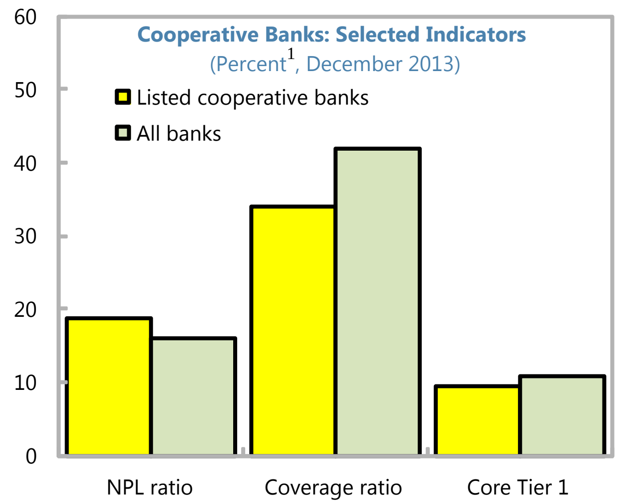
[19] For example, at Banca Popolare di Milano (BPM).

mostly on internal capital generation or tapping their retail base investors to raise funds. This raises a multitude of risks, including overselling capital instruments to retail investors. Cooperative governance structures were originally designed for small institutions functioning within close communities, but are now being applied to large and more complex banking groups.

## D. Financial Characteristics of Cooperative Banks

**Large cooperative banks have lower buffers than other banks.** Listed BPs in Italy have an average core Tier 1 ratio of 9.4 percent[20] in December 2013, compared to 10.9 percent for the rest of the system (Figure 10). Their provisioning ratios are also lower than the average. If listed cooperatives were to increase their provisioning ratio to reach the Italian market average, they would need an additional €4.5 billion (€6.5 billion to reach the provisioning level of the large banks). Their recent capital increase, i.e €3.5 billion as of May 2014 has covered much of the gap. Smaller cooperatives (BCCs) also have low provisioning ratios, although their capital buffers are higher.[21]

Figure 10. Listed Cooperatives: Selected Indicators




Sources: Bank of Italy.

**Cooperative banks are also significantly less resilient to shocks.** In the stress test undertaken in the 2013 FSAP for Italy, large cooperative banks were found to be outliers

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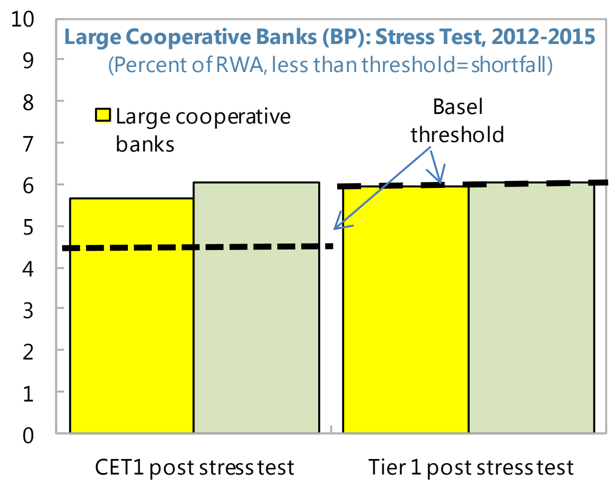
[20] Covering the six largest listed BPs: Banco Popolare, UBI, BPER, BPM, Banca Popolare Dell'Etruria El Del Lazio, Banca Popolare di Sondrio, Credito Valtellinese.

[21] Based on June 2012 data, from the Association of BCCs. BCCs, however, display higher capital ratios than BPs.

compared to the other Italian banks. They accounted for around half of the capital shortfall of Italian banks in the "adverse" scenario, with their Tier 1 ratio dropping from 9.3 percent in 2012 to 4.2 percent in 2015 (Figure 11).

Figure 11. Stress Test Results from Large Cooperative Banks




Sources: Bank of Italy.

## IV. Governance Regulatory Framework

**Italy has made efforts to strengthen banking regulations on corporate governance since the global financial crisis.** A ban on cross-appointments in financial institutions was enacted in 2011 and is aimed at preventing conflicts of interest in governing bodies. Also a new related party transaction regulation introduced prudential reporting duties in 2012. More recently, a regulatory reform imposed new requirements for Board qualification and composition, implementing the requirements of Capital Requirements Directive (CRD) IV, and included specific provisions on cooperatives.

### A. Regulations on Corporate Governance

**Italy has implemented all the EU directives and recommendations on corporate governance.** These include the directives on disclosure (2005), shareholder rights (2004 and 2007) and accounting (2006). The latter introduced disclosure requirements on related party transactions and corporate governance for listed companies. Italy also implemented the 2003 EU Action Plan on corporate governance as well as the EC recommendations on Board structures (2003 and 2005).

**Italy also introduced a specific regime to protect minority shareholders.** Under the Italian "*slate voting*" regime,[22] minority shareholders are entitled to present lists of Board candidates when they own a minimum amount of share capital. Bank by-laws establish the mechanisms according to which Board seats are distributed among the slates presented. Generally, the slate receiving the highest number of votes takes all Board seats, but the quota reserves at least one seat for minority shareholders. This representative of the minority shareholders chairs the internal control body.

**A specific banking regulation on governance was introduced in 2008.** The BoI regulation requires Board members to be responsible for approving the overall bank governance framework, including the strategies and policies for the management of the bank's business, maintaining a holistic view of the activities and related risks. Senior management shall ensure the existence and functioning of an adequate internal control system.

## B. Recent Improvements

**The global financial crisis showed that existing international regulation had been insufficient and the reform agenda has put a specific emphasis on governance reforms.** Since 2009, the Organization for Economic Co-operation and Development (OECD), the Financial Stability Board (FSB), and the Basel Committee on Banking Supervision (BCBS) have revised their standards for corporate governance in areas such as risk management, Board structures, compensation, and the role of the supervisors. The European Commission and the European Banking Authority have developed new laws and sub-laws to implement these new standards for the European Union (Box 3).

**The Bank of Italy has further strengthened its bank governance regulation framework, with a specific focus on the qualification and composition of Boards**. In line with the strengthened international standards since 2009, BoI issued a circular requiring for bank boards to be appropriately skilled in risk management and control tasks and recommended a sufficient number of non-Executive Directors, with well-defined roles and duties. In May 2014, BoI further strengthened its governance regulations, requesting an enhanced 'suitability test' for Directors, greater transparency on appointments, improved commitment from and information on non-Executive Directors (Table 2).

**The Industry has revised its code of conduct for listed companies.** The new code provides guidance in terms of diversity and independence for Board members. In particular, it stipulates that companies listed in the FTSE-MIB index should have "at least one-third" of independent Directors on their Boards. Although the definition of independence is more

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[22] Slate voting has been mandated for the election of statutory auditors since 1998, and it was extended to the election of directors in 2005 (by the "Protection of Savings" Law, which was conceived as a response to the bankruptcy of Parmalat); it became effective in June 2007.

stringent than in the current Italian banking law, the norms only applies to the 21 listed banks and on a "comply or explain" basis.[23]

**A decree law bans cross-appointments at the Boards of financial institutions but the scope of application remains limited.** The 2011 decree stipulates that Board members or executive officers cannot be appointed in other financial companies that compete in the same relevant market segments. Only 10 percent of Boards of Directors in financial institutions had to be renewed to comply with the decree law.

**A new related-party transaction regulation was introduced in 2012 but may not be encompassing enough.** According to this BoI regulation,[24] banks shall report: (i) all risk exposures toward related and connected parties, irrespective of the amount; and (ii) any other transactions with related parties (other than loans), where the transaction value exceeds 5 percent of the bank's regulatory capital. In addition, banks must report on an aggregated basis all other transactions with related parties that are below the 5 percent threshold and above certain materiality thresholds. By imposing quantitative reporting thresholds, this regulation is more strict than in other countries. Nonetheless, it has three weaknesses. It does not capture adequately influential stakeholders that do have large formal ownership (e.g. foundations).[25] It allows related-party transactions that carry more favorable terms than those with unrelated parties, and it allows Board members that benefit from related party transactions to be part of the decision.

**New provisions for large cooperatives have also been introduced by Bank of Italy but further improvements to the cooperative status would require legislative amendments.** According to this, each BP should allow a minimum of five[26] proxies for each member in order to improve their involvement in shareholder meetings. Votes may also be cast by correspondence or by other remote voting mechanisms allowed by the civil code. For listed BPs, institutional shareholders that meet a certain threshold will be able to propose a list of Board members to the General Assembly and benefit from the slate voting.

**Box 3. Governance and Recent International Financial Regulations on Bank Governance**

*Since the early 2000s, several international bodies—OECD, BCBS—have been active in setting corporate governance standards for banks. Building on the lessons of the financial crisis, these standards have been recently*

[23] In the Code of conduct, independence is defined with broader criteria than in the civil code, looking at the remuneration of Board members (whether they receive substantial amounts from group companies or related parties) and the length of their mandate (whether they have been in place for more than nine years).

[24] BoI circular 263 "New regulations for the prudential supervision of banks" (Title V, Chapter 5, Section II).

[25] The regulation on related parties considers as a related party only the foundation as an entity, and not the foundation's Board members or ultimate owners (municipalities, regions).

[26] The maximum number of proxies remains limited to 10 by law.

*updated with a greater focus given to the qualification and composition of the Board. These enhanced standards have also been incorporated into EU law and implemented in Italy since January 2014.*

**International level**

**OECD.** *The OECD is the international standard setter in corporate governance. The principles for good governance published in 1999 are part of the FSB's 12 Core Standards for sound financial systems. They have been revised and updated several times to take into account the lessons from the Enron/Worldcom/Parmalat bankruptcies in 2004 and the subprime financial crisis in 2009.*

The recent OECD updated action plan on corporate governance has reinforced the responsibility of the Board in setting remunerations. It also recommended that (i) internal control functions report directly to the audit committee or equivalent; and (ii) the risk management function report directly to the Board. It also made several proposals to promote competent Boards: (i) Board members shall have access to training programs, underpinned by periodic external Board evaluations; (ii) Board nomination committees shall specify the skills and experience required in order to identify appropriate individuals; (iii) a "fit and proper person test" by a supervisor should be extended to the technical and professional competence of Board members; and (iv) the length of time members have served under the same Chief Executive Officer (CEO) should be taken into account when assessing the independence of Board members.

**Basel Committee on Banking Supervision.** *The Basel Committee on Banking Supervision (BCBS) is the international standard setter for bank prudential regulation. It published initial guidance on bank corporate governance in 1999, with revised principles in 2006. Those principles serve as a reference point for the banks' own corporate governance efforts and for supervisors to adopt sound corporate governance regulations.*

The initial BCBS 2006 governance principles focused on four key recommendations: (i) the bank's Board should be appropriately involved in approving the bank's strategy; (ii) clear lines of responsibility should be set and enforced throughout the organization; (iii) compensation policies should be consistent with the bank's long-term objectives; and (iv) the risks generated by operations that lack transparency should be adequately managed.

These principles were revised in 2010 to emphasize the importance of the Board's qualification and composition, the independent risk management function, and the Board's oversight of the compensation systems. Corporate governance was added to the formal list of Basel Core Principles for Effective Banking Supervision in 2012.

**Financial Stability Board.** *Among other tasks, the Financial Stability Board (FSB) monitors implementation of regulatory, supervisory and other financial sector policies in member countries, by means of peer reviews. These reviews complement the IMF-World Bank Financial Sector Assessment Program (FSAP).*

In 2013, the FSB carried out a peer review on risk governance. One of the key recommendations was to enhance the supervisory assessment of banks' risk governance framework.

## Box 3. Governance and Recent International Financial Regulations on Bank Governance (continued)

**European Level**

**European Banking Authority.** *The European Banking Authority (EBA) is an independent EU Authority established on January 1, 2011 as part of the European System of Financial Supervision (ESFS). Its main task is to contribute to the creation of the European Single Rulebook (sub-law) for the banking sector. It also issues guidelines that are not binding.*

In 2011, the EBA issued specific recommendations focused on the composition of bank governing bodies, appointments and successions as well as on risk management and remuneration, and in 2012, it published guidelines on fit-and-proper criteria for banks' managers.

**European Commission.** *The European Capital Requirement Directive IV package transposes, via a Regulation and a Directive, the new global standards on bank capital (commonly known as the Basel III agreement) into the EU legal framework. These rules include provisions on bank governance (Article 88). These rules have been in force since January 1, 2014.*

The CRD IV governance provisions primarily focus on the effectiveness of risk oversight by bank Boards. The latter shall approve the bank's strategy and internal governance, ensure the integrity of the bank's accounting, its financial reporting systems, disclosure practices, and provide effective oversight of senior management.

The new provisions also establish the setting up of a "nomination committee." Composed of non-executive Board members, this committee will identify and recommend candidates to fill Board vacancies (for approval by the Board or shareholder meeting), taking into account the balance of knowledge, skills, diversity (including gender), and experience. Periodically, and at least annually, it will also assess the structure, size, and composition of the Board, including of individual Board members. In addition, CRD IV requires that the Chairman of the Board, in his/her supervisory function, does not exercise simultaneously CEO functions within the same institution.

Table 2. Italy Main Changes to the Bank Governance Framework in 2014

| Qualification and Composition of Boards | |
|---|---|
| Board size and agenda | For large banks, maximum 15–22 depending on Board model (one tier/two tier).<br>Focus on strategic issues. |
| Appointment procedure and skills required for Board members | More disclosure and accountability: ex-ante identification of the skills required; candidates are required to have matching skills.<br>More detailed rules on Directors' duties, responsibilities, time allocation, and diversity (non-executives included).<br>One quarter of independent Board members. |
| Board self-evaluation | Rules on scope, timing (at least annually), methodologies (defined ex ante) and actions taken to remove weaknesses. |
| Role of the Chairman | Chairman as a non-Executive Director and Board manager. |
| **Large Cooperatives** | |
| Shareholders' activism | ▪ Number of proxies: introduce a possibility of at least 5 proxies (from 1 previously)<br>▪ Mail voting or other distance voting systems<br>▪ For listed BPs: right for shareholders representing a certain amount of capital to submit list for the election of Board members (slate voting system) and to request change in the shareholders meeting agenda. |

Source: Bank of Italy.

## V. Summary and Remaining Challenges

**Further reforms to corporate governance would be important to strengthen the oversight and management of Italian banks.** The ownership structure of Italian banks—foundations without shareholders and a prominent cooperative sector—would benefit from arrangements that ensure strong governance and market orientation. In particular, as recommended by the 2013 FSAP to Italy, efforts should focus on: (i) strengthening further the existing banking regulations through stricter fit-and-proper rules for Directors and a soundness assessment for controlling shareholders; (ii) implementing the new related party lending regulation with tightened definitions; (iii) strengthening oversight for foundations when they are the controlling shareholders in banks; and (iv) facilitating the transformation of large cooperatives into joint stock companies.

**"Fit-and-proper" rules for bank Directors should become the norm.** Recent changes to governance regulations will improve the fit-and-proper rules in Italy. However, the regulation should be strengthened to ensure that individuals who have been fined in other sectors are banned from being Board members in banks. It should also allow the supervisor to change the composition of the bank's Board, when it believes that a Board member is not fulfilling his/her duties related to the fit-and-proper rules.[27]

**Supervisors should also assess the financial soundness—including the capacity to provide additional capital—of controlling shareholders.** Some foundation bank owners have been able to borrow funds to make the initial subscription of capital, and became over-leveraged. These loans were typically linked to market price covenants on the bank shares, which had been pledged as collateral. These operations create risks for financial stability. To avoid operations like this in the future, supervisors should assess the financial soundness of the controlling shareholder, ensuring that the latter can provide further capital if needed.

**The new regulation on related-party lending should be enforced and strengthened.** It will be important that the supervisor uses its supervisory discretion to tighten the definition of related parties, including for economic influence. Further, to be in line with international best practices, the regulation should be amended to ensure that the related-party transactions do not carry more favorable terms relative to those with unrelated parties, and that Board members with conflicts of interest are excluded from the decision.[28]

**Foundations that are major shareholders in banks should be required to publish audited accounts, limit their leverage, and follow proper governance rules.** To enhance the quality of disclosure and comparability, a foundation's financial statements should be audited by a third party. Foundations should also be subject to a cap on leverage and minimum reserves invested in safe assets. Their corporate governance should also be strengthened by (i) introducing term-limits for Board members; (ii) establishing a cooling-off period between holding political office and the appointment to a foundation (and vice versa)—a provision currently left to the "Code of Ethics"; and (iii) prohibiting persons from moving between the governing bodies of foundations and banks. Finally, to ensure that rules are correctly applied, foundations should be subject to strict oversight with prompt corrective actions by the Ministry of Finance or other supervisors.

**The ban on foundations controlling banks should be applied in practice, and, over time, foundations should reduce their stake in banks within proper concentration limits.** In the spirit of the law, the separation between foundations and banks should be enforced. Foundations should not control banks, even when this control is not exercised "*de jure*" but only *"de facto."* It should apply to all banks without exception.

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[27] A Draft Decree pending parliament's approval will address this recommendation.

[28] The latter recommendation is addressed in a Draft Decree pending Parliament's approval.

**International experience contains useful lessons for the reform of foundations.** In Anglo-Saxon countries, foundations invest in a broadly diversified range of sectors and are not inextricably linked to ownership of banks' shares. Their Board members typically include investment experts, professors, researchers, and professionals, allowing for a wide range of specific knowledge. None of these foundations include politicians in their Boards. They mandate an Investment Committee—made up of investment professionals and supervised by the Boards—to draft investment policies and set the investment targets that asset managers must pursue in their investments and also the constraints.

**The largest cooperative banks should be encouraged to convert to joint stock companies.** Cooperative banks were designed as intermediaries whose business was restricted to a limited geographical area. Today, this structure appears inadequate, as large intermediaries now operate at national and even international levels while being listed on the stock exchange. Listed cooperative banks should look to turn themselves into joint stock companies. Those reforms will improve governance and should also create incentives for new shareholders to inject fresh capital, rationalize costs, and provide opportunities for mergers.

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