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Banks' Corporate Governance:
Why, Who and When

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EXECUTIVE SUMMARY

Banks' corporate governance has been (and still is) at the heart of the international debate for academics, policy makers, regulators and prudential supervisors. **There are several good reasons for such an interest, and the aim of this paper is to investigate them along the lines of its title.**

Why is banks' corporate governance so crucial, and why does it differ from that of non-financial firms? **Who** – at a global level, as well as in Europe and in Italy – has been giving attention to this topic and in which direction? **When** did the magnitude of this issue become evident, and why is the debate still on-going?

The importance of banks' governance has been highlighted by an extensive literature. Banks play a key role in the economic system, given their crucial and unique functions as financial intermediaries. On the one hand, they perform two distinctive roles: liquidity creation and risk transformation; on the other, due to these unique roles, their balance sheet is intrinsically fragile, they are prone to liquidity runs, and – given the interconnections among them and within the financial system – may generate systemic risk. Moreover, by selecting firms to lend to and monitoring them, banks are one of the most important external factor for disciplining firms' behavior.

How banks are governed and controlled - ie. the quality of their governance - **is therefore key from various perspectives**. From a micro-prudential viewpoint, it matters for their own soundness and efficiency, since good corporate governance affects – inter alia – the ability of banks' board and managers to detect, manage and control risks. From a macro-prudential perspective, governance is important because weaknesses at banks can produce drawbacks on several categories of stakeholders that may spread across the banking sector and the entire economy. From an even wider angle, banks' efficiency in tuning firms' creditworthiness – which hinges on corporate governance quality – lowers the cost of capital to firms, boosts capital formation and stimulates productivity growth.

Moreover, governance affects the cost of capital, a crucial element for any firm and for banks especially, as shown in the upward trend of capital ratios of European and Italian banks in the last 15 years. Besides the academic literature underpinning the nexus between corporate governance and firms' funding costs – ie. by ensuring better investor protection and reliable reporting, outsider would be less vulnerable to expropriation and therefore more willing to finance firms – the link between the two has also more practical evidence. International institutions and rating agencies regularly assess the quality of corporate governance (at country or at firm level): corporate governance is therefore one concrete driver for investors' choices.

Banks' uniqueness as financial intermediaries uncovers, in turn, special features of their governance. The opaqueness of their balance sheet, their liquidity function, the presence of deposit guarantee schemes and other (implicit) safety nets shape the incentives of creditors, shareholders and managers differently from non-financial firms. These differences explain why a distinct set of rules has been put in place to address banks' governance, at least following the Great Financial Crisis (GFC).

In addition, the evolution of the banking system make good corporate governance even more important than in the past. In Europe and in Italy the number of banks has diminished, but their average size and market power has increased, and so the complexity and relevance of their governance. Important challenges are ahead – such as profitability, digitalization and increased competition from Fintechs and Bigtechs, ESG sustainability – which also need a strong steering capability of banks' boards and efficient internal governance arrangements in order to be addressed.

Banks' poor corporate governance is viewed by many as a key contributor to the GFC. Evidence is most convincing: ill-designed bankers' remuneration; risk management control systems incapable of assessing the overall risk borne by the firm and prone to the business units they should have overseen; boards unaware of the risks faced by their company until too late; shareholders not effective in monitoring their boards.

The lessons learnt from the GFC spurred a deep review of standards and rules on these issues at international level. One of the most important action was taken by the Basel Committee on Banking Supervision with its new Principles of corporate governance for banks issued in 2015. Board and senior management responsibility and role; risk management independence and duties; the CRO role; role and duties of the other internal controls functions (compliance, audit); information flows from and to the board; compensation schemes; market disclosure: these important corporate governance elements were all deeply reviewed in the new Principles in order to factor-in the evidence emerged from the GFC. Along the same line, European rules were thoroughly reviewed: while the Capital Requirement Directive (CRD) in force during the crisis had only one, short and principle-based article on banks' governance, the post-crisis CRD 4 replaced that only article with extensive and detailed rules.

Italy has been a first mover, since it was among the few jurisdictions to have special rules on banks' governance in place even before the GFC, and already containing the seeds of those that were issued internationally after the crisis. Since then, the Italian rules – embedded in Banca d'Italia regulations – have been reviewed more than once, to keep them aligned with the international and European developments.

Growing attention to banks' governance has also been given by prudential supervisors. Corporate governance is one key element that banking supervisors routinely assess. Both the SSM Supervisory Manual for the biggest Eurozone banks (Significant Institutions) and the Banca d'Italia Supervisory Manual for the others (Less Significant Institutions) list internal governance and risk management among the key elements that the supervisors must consider in their on-going assessment. Internal governance and risk management rank at the same level of importance as capital, business model and risks. The score that is being given in this area contributes to the overall score than each bank receives at the end of the SREP process, and it determines the type of actions that the supervisor will take consequently.

Were all these initiatives effective or is there still room for improvement? While the rules on banks' corporate governance have positively evolved, requiring higher standard and tackling major loopholes, **I personally believe that in their implementation banks' governance may still be improved.** This avenue will be important especially if we look at the changes that are occurring in the banking sector landscape and at the challenges that banks are now facing**.** Not surprisingly, banks' corporate governance is one of the top priorities of European prudential supervisors for the years to come.

The paper is organized as follows. Chapter 1 provides the theoretical background, and discusses why banks' governance is important, and why it differs from that of non-financial firms; Chapter 2 sketches the evolution of the banking sector and the challenges ahead that make banks' governance still an open issue. Chapter 3 describes the international standard and rules: we first recall the key flaws in banks' governance that the GFC has shown and then describe the post-crisis regulatory response at international and European level. Chapter 4 is dedicated to Italy and to the role of prudential supervisors: a picture of the evolution and challenges of the Italian banking system is given, along with the rules on banks' governance; a description on how the supervisors (Banca d'Italia and the ECB-SSM) routinely assess banks' governance is also provided. Chapter 5 concludes.

1. THE THEORETICAL BACKGROUND

1.1 WHY BANKS' CORPORATE GOVERNANCE IS IMPORTANT

1.1.1 Banks' uniqueness

Banks perform a crucial role in the economy by intermediating funds from savers and depositors to the real economy, **and their "uniqueness" among financial intermediaries has been stressed by an extensive literature** [1]. On the one hand, they perform two distinctive roles: liquidity creation and risk transformation; on the other, due to these unique roles, their balance sheet is intrinsically fragile, they are prone to liquidity runs, and – given the interconnections among them and within the financial system – may generate systemic risk.

Banks receive deposits, which are repayable at par on demand and are accepted as payment means: therefore, deposits are liquid and available for their owners, and take part in the wider payment system. Deposits received by banks are transformed into loans: in sum, banks convert liquid asset (deposits) into illiquid ones (loans). Because of this maturity mismatching and of their role as payment service providers, banks' balance sheet is inherently unstable: if a bank's creditors ask to withdraw their deposits at the same time, the bank might be unable to meet the obligation to return these funds, given the illiquid asset-side of its balance sheet. Such a situation – or even the perception of a bank non being able to repay its deposits - may generate a bank run, leading to the failure of the bank itself. Insufficient capital or liquidity and poor profitability may also lead to failure. A distressed situation of a bank would most likely spread throughout other players in the financial system because of their interconnectedness (through, for instance, wholesale funding and borrowing), leading to systemic risk [2].

Along with banks' prudential regulation – which, in a nutshell, aims at constraining banks' risk taking and ensuring that banks have sufficient capital to absorb losses and liquidity - the presence of safety nets (such as deposit insurance protection schemes) is intended to minimize such a risk, but generate negative drawbacks from a governance standpoint, as it will be discussed in para 1.2.

Therefore, the way in which banks are governed and controlled – ie. the quality of their corporate governance - is of paramount importance not only for their own stability, but also for the stability of the financial system as well for the economy as a whole.

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1 See, for all: DIAMOND (1996); KASHYAP, RAJAN and STEIN (1999)

2 See: SCHWARCZ (2008); DE BANDT and HARTMANN (2000); ACHARYA, V. and ACHARYA V. (2009).

1.1.2 A definition of corporate governance

But what do we exactly mean by "corporate governance"? According to the academic literature, corporate governance is the system of structures, rights, duties, and obligations by which corporations are directed and controlled. It specifies the distribution of rights and responsibilities among different participants in the corporation (such as the board of directors, managers, shareholders, creditors, auditors, and other stakeholder) and specifies the rules and procedures for making decisions in corporate affairs. It is the framework of rules and practices by which a board of directors ensures accountability, fairness, and transparency in a company's relationship with its all stakeholders; it is a mechanism for monitoring the actions, policies and decisions of corporation and involves balancing or aligning interests among stakeholders.[3]

The OECD Principles of Corporate Governance gives us a more extensive definition: "Corporate governance involves 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." [4]

The definition cited above suggests that the concept of corporate governance can be described under two different dimensions: a wider/external dimension, where corporate governance is intended as a system for allocating powers <u>among the different participants of the firm</u> and aims to answer the following questions: who is in the best position to take decisions within the firm? Who monitors actions and decisions been taken? How are investors protected? Such a wider dimension investigates topics such as: the firms' ownership structure (in particular, the different issues that arise depending on the whether the ownership is concentrated or dispersed), the market for corporate control, the investor protection means, the role and duties of institutional investors, the effectiveness of market discipline. On the other hand, the narrower/internal dimension, describes corporate governance as a system for allocating powers <u>among the board and the managers of the firm</u>, and investigates a set of different issues, such as: the board structure, its role and responsibility, the top managers' role and responsibility, the internal control system, the information flows, the remuneration schemes.

Both these dimensions matter for banks, at least from three viewpoints:

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[3] See: SCHLEIFER and VISNY (1996); BECHT (2005); CHEFFINS (2012)

[4] OECD (2004)

a) From a micro prudential perspective: good corporate governance affects investors' protection (which in turn affects the cost of capital), the reliability of financial reporting (which is relevant for market discipline), and – most of all - the ability of banks' board, managers and control bodies to detect, manage and control risks. Corporate governance is therefore key for a sound and prudent banking management, as relevant as capital adequacy.

In addition to academic scholars, such an importance has been recently recalled by the Bank of Italy Governor: "Supervisory activities pay the utmost attention to the adequacy of corporate governance, to the professional profile of managers, and to the appropriateness of the time that directors spend on performing their duties. Corporate governance systems that value professional skill sets, are open to innovation, and are capable not only of facilitating the formulation of strategies consistent with the new competitive scenario but also of adequately monitoring new risks, are indispensable for the stability of individual intermediaries and that of the banking system as a whole. On the other hand, weaknesses in these areas, especially shortcomings in mechanisms for balancing powers and decision-making processes, have been one of the main causes of banking crises in recent years." [5]

b) From a macro prudential perspective: banks' stability and soundness are key to financial stability, and the manner in which they conduct their business, therefore, is central to economic health. Governance weaknesses at banks can produce consequences on various categories of stakeholders – depositors, bond-holders, employees, suppliers – and affect shareholder capital. The significant role that banks play in the financial system can result in the transmission of problems across the banking sector and the real economy.

c) For the economy at large: banks are one of the most important external factor for disciplining firms financial behavior by tuning their creditworthiness [6]. If banks efficiently allocate funds, they "select" profitable firms to lend to, pushing out of the market the unprofitable ones; in turn, this disciplining effect lowers the cost of capital to firms, boosts capital formation and stimulates productivity growth.

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5 VISCO, I. (2022), p. 8

6 See ALLEN, SANTOMERO (1998); DIAMOND and DYBVIG (1983); DIAMOND (1996); CAPRIO and LEVINE (2002); PADOA-SCHIOPPA (1999).

1.1.3 Corporate governance and the cost of capital

As briefly recalled above, **good corporate governance is a key element for lowering the cost of capital** for any firm[7], as also an extensive economic literature has demonstrated[8]. In a nutshell: "To a large extent, potential shareholders and creditors finance firms because their rights are protected by the law. These outside investors are more vulnerable to expropriation, and more dependent on the law, than either the employees or the suppliers, who remain continually useful to the firm and are thus at a lesser risk of being mistreated [...] All outside investors, be they large or small, shareholders or creditors, need to have their rights protected. Absent effectively enforced rights, the insiders would not have much of a reason to repay the creditors or to distribute profits to shareholders, and external financing mechanisms would tend to break down" [9].

This holds true also for banks. Capital is crucial for banks, not least because prudential regulation and supervision requires them to hold a given amount of capital to absorb losses on their risk weighted assets, and a backstop on banks' leverage (leverage ratio) has been put in place.

Indeed, banks' capital has been growing sharply since the Great Financial Crisis. The ratio between the common equity tier 1 and risk-weighted assets (core equity Tier 1 ratio, CET1 ratio) of EU banks, which includes only capital of the highest quality, was at 14.3% in June 2019, more than double the same ratio in December 2011. Tier 1 and total capital reached 15.6% and 18.9% respectively in June 2019 up from 6.80% and 8.10% respectively in 2011.[10]

Besides the academic literature underpinning the importance of good corporate governance on firms' funding costs, the link between the two has also more practical evidence.

International institutions regularly publish reports where the quality of corporate governance in different countries is assessed and compared, giving world-wide investors useful information to select the countries where to invest: corporate governance is therefore one concrete driver for investors choices.

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7 OECD (2015)

8 For a literature review see SCHLEIFER, A., and VISNY, R.W. (1996)

9 LA PORTA, R., LOPEZ-DE-SILANES, F., SHLEIFER, A., and VISHNY, R. (2000)

10 EUROPEAN BANKING FEDERATION (2021)

One example is the OECD Corporate Governance Factbook, which provides information on the most important corporate governance mechanisms in place for each OECD country. Another example is the World Bank Doing Business Report, where 190 countries are assessed and scored taking into consideration 10 relevant topics, among which the quality of investor protection is considered. A high ease of doing business ranking means the regulatory environment is more conducive to the starting and operation of a local firm, and – therefore - more attractive to investments.

Rating agencies also devote particular attention to corporate governance of firms they rate and have developed indices to measure its quality; here, the link between the effectiveness and quality of corporate governance and funding costs becomes even more evident. Among the more well-known indices are FTSE-Institutional Shareholder Services (ISS) Corporate Governance Index, Standard & Poor's Corporate Governance Scores, Dow Jones Sustainability Index and Business in the Community Corporate Responsibility Index. Rating agencies can act as catalysts for corporate governance by either directly factoring corporate governance into their scoring systems, or complementing their financial scoring systems with corporate governance ones. [11]

With reference to banks, the boxes below show the methodology used by Standard and Poor to assess corporate governance and which element the rating agency considers[12]; it also shows three examples – made anonymous – of a good or poor banks' corporate governance. In particular, according to Box 1, a good corporate governance score appears to be driven by the following factors:

1) Board independence from management and its capacity as the final decision making authority on strategic issues
2) Management and board capacity to avoid being influenced by controlling shareholders and capable of overseeing risk on behalf of all stakeholders, including minorities
3) A management culture conducive to offsetting managerial interests
4) The ability of the bank to effectively manage the compliance risks
5) The effectiveness of the internal and external communication strategy
6) The quality of bank's financial statement, which should be correct and transparent, making market participants able to understand the bank's intent and economic drivers.

11 https://rdmc.nottingham.ac.uk/bitstream/handle/internal/86/Business_edit/33_rating_agencies_corporate_governance_indices.html.

12 STANDARD & POOR'S (2004)

Box 1

Standard & Poor's Corporate Governance Scores

	Neutral	Negative
1. Board effectiveness (see paragraph 44)	The board maintains sufficient independence from management to provide effective oversight of it. The board retains control as the final decision-making authority with respect to key enterprise risks, compensation, and/or conflicts of interest.	The board manifests a lack of independence from management and provides insufficient oversight and scrutiny of key enterprise risks, compensation, and/or tolerates unmanaged conflicts of interest.
2. Entrepreneurial or controlling ownership (see paragraph 45)	Management and the board of directors have professional, independent members who are capably engaged in risk oversight on behalf of all stakeholders, including minority interests. The influence of controlling shareholders is offset by risk-aware professional management and a board that effectively serves the interests of all stakeholders.	Controlling ownership negatively influences corporate decision-making to promote the interests of the controlling owners above those of other stakeholders.
3. Management culture (see paragraph 46)	Management is responsive to all stakeholders' interests, appropriately balances those interests, and acknowledges that the board of directors is the ultimate decision-making authority.	Management's own interests (or those of a narrow group of stakeholders) are its primary concern, where dissent in the executive suite is generally not tolerated, or where management proves incapable of managing conflicts of interest arising between different stakeholder groups. Excessive management turnover can be an indicator of a governance deficiency in management culture. Alternatively, management dominates the board of directors, as demonstrated by the control exercised by the chair or CEO, or as evidenced by compensation and incentive programs that promote outsize risk-taking.
4. Regulatory, tax, or legal infractions (see paragraph 47)	The enterprise generally remains free of regulatory, tax, or legal infractions and has stable relationships with regulatory authorities.	The enterprise has a history of regulatory, tax, or legal infractions beyond an isolated episode or outside industry norms, representing significant risk to the enterprise.
5. Communication of messages (see paragraph 48)	The enterprise generally communicates consistent messages to all constituencies.	The enterprise communicates conflicting information to different stakeholders on significant issues.
6. Internal controls (see paragraphs 49-50)	The enterprise's internal control environment is not viewed as deficient.	The enterprise's internal control environment is viewed as deficient based on available evidence, such as restatements or delays in filings.
7. Financial reporting and transparency (see paragraphs 51-52)	Accounting choices are usually reflective of the economics of the business.	The enterprise's financial statements obfuscate the true intent or the economic drivers of key transactions, or the financial statements are insufficient to allow typical users of the financial statements to understand the intent and the economic drivers.

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Box 2

Corporate governance ratings - Examples on 3 banks

1 «XXX creditworthiness benefits from its strong and highly regarded management team. It has a proven record of successfully integrating acquired entities and implementation of strategic initiatives aimed at protecting the bank's business and financial profile in the downturn.»

2 «We view YYY business position as "moderate" mainly due to what we see as increased challenges to the bank's business stability following the resignations of the majority of the board of directors. Following the renewal of YYY board, and the appointment of a chief executive officer, we expect potential further changes to its other governing bodies; we also believe the developments at the board and management levels have created uncertainties about strategies and their potential effect on the bank's business and financial profiles.
We also take into account what we see as weaknesses in YYY risk management and internal control processes. These became apparent following the results of the inspection done by the Supervisory Authority. »

3 «We regard ZZZ business position as "moderate" as we believe the bank's corporate governance is weaker than peers. In our opinion, the negative impact of this outweighs the benefits to ZZZ business profile from its stable position in the wealthy northern region of .....
The ongoing negative outlook reflects our view that there are still uncertainties surrounding ZZZ implementation of credible corporate governance reform.
On ...., John was appointed CEO of ZZZ. The previous CEO, George, resigned - in our view highlighting, among other things, the difficulties of addressing ZZZ corporate governance problems.
On ...., John announced his proposal for ZZZ corporate governance reform, along with the presentation of its ... year-end results and the ... business plan. The implementation of this reform requires the approval of ZZZ shareholders, which will be sought during the annual general meeting.
In our view, if ZZZ shareholders fail to approve credible corporate governance reform, ZZZ may find it more challenging to finalize the €... million capital increase...
In our view, a failure or delay of the approval of credible corporate governance reform might have negative effects on the bank's business position, including management stability, and its financial profile. »

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Corporate governance ratings are characterized by a rigorous evaluation of the elements described above. Box 2 shows an example of a good rating (n. 1), a medium one (n. 2) and a bad rating (n. 3), characterized by a strong uncertainty about the implementation of a proper governance reform, that negatively deviates the bank business profile from its stable position.

1.2 WHY BANKS' CORPORATE GOVERNANCE DIFFERS FROM THAT OF NON-FINANCIAL FIRMS

Banks' uniqueness as financial intermediaries (which we discussed in para 1.1.1) **uncovers, in turn, special features of their governance**. Among all, there are four important elements that shape incentives of shareholders, creditors and managers differently from non-financial firms. **These differences explain why a distinct set of rules has been put in place to address banks' governance, at least following the Great Financial Crisis** (albeit academic scholars called for the presence of such an output well before).

1. First, banks' assets are informationally opaque and difficult to assess compared to those of other firms[13]. The quality of bank loans is not readily observable as the quality of assets of industrial firms (in particular, physical assets such as machinery, plants etc, is much more easily distinguishable by third parties). The same holds true for other assets banks invest in, such as Asset-Backed Securities (ABSs), Collateralized Debt Obligations (CDOs), and Credit-Default Swaps (CDSs).

   From a corporate governance perspective, such opaqueness generates greater information asymmetries in banks than in other firms, between their creditors, and shareholders on the one side, and their managers on the other [14].

2. Second, banks are highly leveraged institutions, but monitoring incentives of debt-holders are less strong, due to the presence of safety nets. While conflicts between the interest of debtholders and that of shareholders exist in every firm, this problem is greater in the banking context because of the high debt to-equity ratio and the existence of deposit insurance. "In the publicly held corporation, the problem of excessive risk-taking is mitigated by two factors. First, various devices serve to protect fixed claimants against excessive risk-taking. Corporate lenders typically insist on protection against actions by corporate managers that threaten their fixed claims. Second, risk-taking is reduced to some extent because managers are not perfect agents of risk-preferring

13 BERGER, A., MOLYNEUX, P., and WILSON, J. (2022); LEVINE, R. (2004); CAPRIO, G., and LEVINE, R. (2002)

14 To a large extent, the financial turbulence in the autumn of 2008 was caused by these difficulties. After the collapse of Lehman Brothers, the inter-bank-market virtually crashed even for (very) short-term lending since, all of a sudden, an all-out distrust prevailed among banks about the quality of other banks' assets. FURFINE, C.H. (2001)

shareholders. Managers are fixed claimants to that portion of their compensation designated as salary. In addition, managerial incentives for risk-taking are reduced, since managers have invested their non-diversifiable human capital in their jobs. This capital would depreciate significantly in value if their firms were to fail. The second risk-reducing factor—the fact that managers tend to be more risk-averse than shareholders—is present for commercial banks as well as other corporations. What makes banks fundamentally different from other types of firms, however, is the lack of significant discipline of other fixed claimants. FDIC insurance removes any incentive that insured depositors have to control excessive risk-taking because their funds are protected regardless of the outcomes of the investment strategies that the banks select. In a world without deposit insurance, depositors would demand that banks refrain from engaging in risky investment strategies or else demand that they be compensated in the form of a higher interest rate for the extra risk. Thus, depositors of insured financial institutions cannot be expected to exert the same degree of restraint on excessive risk-taking as other fixed claimants, and this enhances the degree of influence exerted by shareholders, whose preference is to assume high levels of risk."[15]

3. Third, banks uniqueness as liquidity providers may cause collective action problems that justify special regulation, both prudential and on corporate governance. We will, again, use Macey and O'Hara words to describe the problem. "By holding illiquid assets and issuing liquid liabilities, banks create liquidity for the economy. The liquidity production function may cause a collective action problem among depositors because banks keep only a fraction of deposits on reserve at any one time. Depositors cannot obtain repayment of their deposits simultaneously because the bank will not have sufficient funds on hand to satisfy all depositors at once. This mismatch between deposits and liabilities becomes a problem in the unusual situation of a bank run. Bank runs are essentially a collective-action problem among depositors. If, for any reason, large, unanticipated withdrawals do begin at a bank, depositors as individuals may rationally conclude that they must do the same to avoid being left with nothing. Thus, in a classic prisoner's dilemma, depositors may collectively be better off if they refrain from withdrawing their money, but their inability to coordinate their response to the problem can lead to a seemingly irrational response - depositors rush to be among the first to withdraw their funds so that they can obtain their money before the bank's cash reserves are drained. Critical to this analysis is the fact that failures can occur even in solvent banks. Thus, one argument used to justify special regulatory treatment of banks is that the collective-action problem among bank depositors can cause the failure of a solvent bank. Deposit insurance is often justified on the grounds that it solves this problem by

15 MACEY, J.R., and O'HARA, M. (2003) p. 98

eliminating the incentive for any single depositor to rush to demand repayment of his deposits."[16]

4. Forth, the special role of banks for the economy and their importance for financial stability have put in place implicit safety nets - such as the "too-big-to fail" paradigm, which well showed during the Great Financial Crisis with Government interventions in rescuing failed banks – that reduce, or even set to zero, creditors' and shareholders' monitoring incentives [17]. Although the vast regulatory response to the GFC has tackled this issue with a wide set of measures (eg. reviewing the micro-prudential rules; introducing new macro-prudential tools; drafting the new resolution framework) at least creditors' monitoring incentives have remained low, even in this new post crisis setting.

16 MACEY, J.R., and O'HARA, M. (2003), p. 97

17 ACHARYA, V., and FRANKS, J. (2009)

2. BANKING SECTOR EVOLUTION AND CHALLENGES

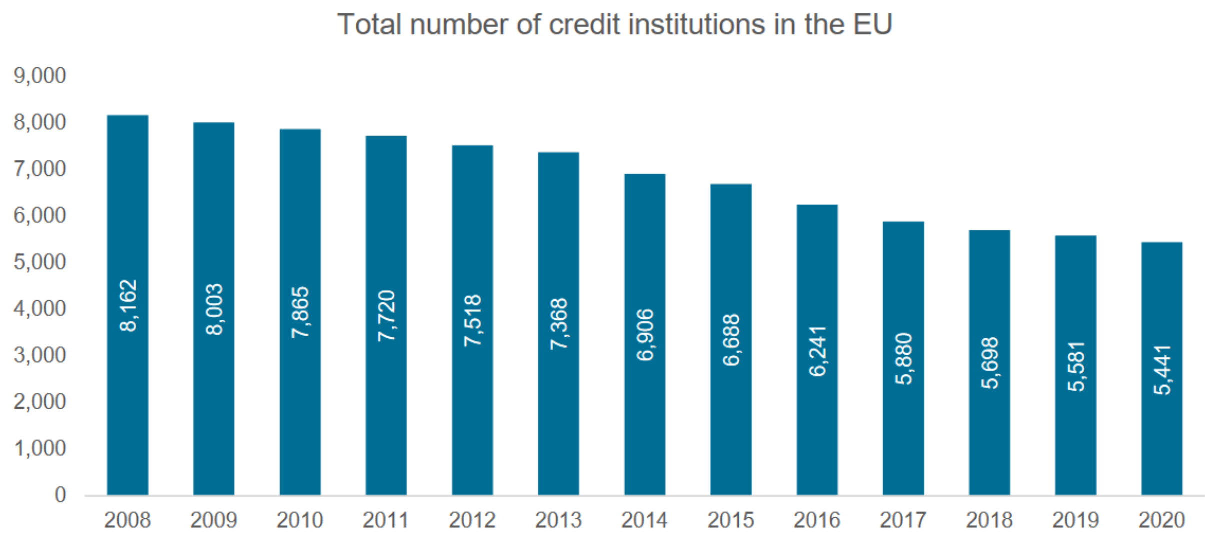
Another driver of the grown importance of banks corporate governance is the evolution of the banking sector and the structural challenges that it is now facing.

Indeed, the European banking system has undergone profound changes in the last years.

First, the number of banks has diminished in Europe, and consolidation has increased their size and importance. While the structure of national banking systems remains different among European countries and, consequently, the pattern of consolidation too, one may safely say that European banks have, on average, become bigger and more complex. **Governing such a greater complexity and bigger size requires efficient corporate governance arrangements, more than in the past.**

The European Banking Federation data show that the number of European banks has fallen by 37% since 2008 (see Figure 1). This downward trend continues, with the number falling to 5,441 in 2020 (-140 units).

Figure 1



Source: EBF Facts and Figures 2021

Moreover, according to ECB data, the share of total assets of the five largest banks has been constantly growing in almost any European country, showing that consolidation is bringing more concentration and market power to few largest institutions. Table 1 displays this pattern.

Table 1

Herfindahl index for credit institutions and share of total assets of five largest credit institutions

	Herfindahl index for credit institutions (based on total assets)					Share of total assets of five largest credit institutions				
	2017	2018	2019	2020	2021	2017	2018	2019	2020	2021
Belgium	1,102	1,218	1,246	1,299	1,319	68.8	73.4	74.0	75.3	75.7
Bulgaria	906	939	992	1,133	1,122	56.5	59.7	62.5	67.1	67.2
Czech Republic	1,039	1,070	1,082	1,109	1,099	63.7	64.5	64.8	65.3	65.4
Denmark	1,123	1,069	1,170	1,250	1,149	65.7	64.5	66.2	67.1	65.6
Germany	250	245	277	325	289	29.7	29.1	31.2	34.0	31.8
Estonia	2,419	2,698	2,545	2,578	2,540	90.3	91.0	93.0	93.7	93.0
Ireland	658	632	665	811	850	45.5	46.1	49.7	55.7	60.0
Greece	2,307	2,304	2,382	2,320	2,273	97.0	96.8	97.4	97.0	98.0
Croatia	1,387	1,554	1,564	1,582	1,589	72.8	79.4	79.8	80.5	81.2
Spain	965	1,138	1,110	1,082	1,270	63.7	68.5	67.4	66.4	69.3
France	574	663	654	688	661	45.4	47.7	48.7	49.2	49.3
Italy	519	579	643	675	779	43.4	45.6	47.9	49.3	51.6
Cyprus	1,962	2,379	2,276	2,285	2,327	84.2	86.9	85.7	86.5	87.3
Latvia	1,237	1,583	1,596	1,912	1,848	73.6	80.9	83.2	87.8	87.4
Lithuania	2,189	2,278	2,289	2,408	2,391	90.1	90.9	90.4	91.8	89.8
Luxembourg	256	261	277	309	293	26.2	26.3	27.7	31.3	29.6
Hungary	802	801	921	1,224	1,767	49.6	50.0	52.7	50.1	51.7
Malta	1,599	1,518	1,548	1,620	1,701	80.9	77.5	75.1	74.8	75.6
Netherlands	2,087	2,178	2,039	2,001	2,143	83.8	84.7	84.7	84.3	84.1
Austria	374	369	369	407	407	36.1	36.0	36.0	38.5	38.7
Poland	645	683	688	753	818	47.5	49.5	49.8	54.3	56.6
Portugal	1,220	1,203	1,225	1,239	1,258	73.1	73.0	73.3	73.6	73.9
Romania	915	962	971	997	997	59.5	61.6	62.6	62.4	62.5
Slovenia	1,133	1,020	1,008	1,189	1,415	61.5	60.8	60.9	67.3	68.7
Slovakia	1,332	1,383	1,404	1,430	1,511	74.5	75.6	75.7	76.8	79.3
Finland	1,700	2,570	2,420	2,250	2,200	73.5	81.6	80.4	80.1	80.0
Sweden	914	785	786	791	773	58.2	54.3	54.8	54.1	55.0
United Kingdom	-	-	-	-	-	-	-	-	-	-

NOTES TO TABLES

1) The data in these tables represent amounts recorded at the end of period, with the exception of the number of employees of credit institutions in Table 1 in which the average number in the period is in question.
2) These data as well as EU and euro area aggregates are available in the Statistical Data Warehouse (http://sdw.ecb.europa.eu/browseSelection.do?type=series&node=SEARCHRESULTS&q=SSI?&DATASET=0&DATASET=1).
3) Following the country's withdrawal from the European Union on 31/01/2020, the business of UK credit institutions is no longer published and is excluded from the EU aggregates.
4) The Herfindahl index (HI) refers to the concentration of banking business (based on total assets). The HI is obtained by summing the squares of the market shares of all the credit institutions in the banking sector. The exact formula according to which data must be transmitted to the ECB is reported in the ECB Guideline on monetary and financial statistics (recast), (ECB/2014/15).

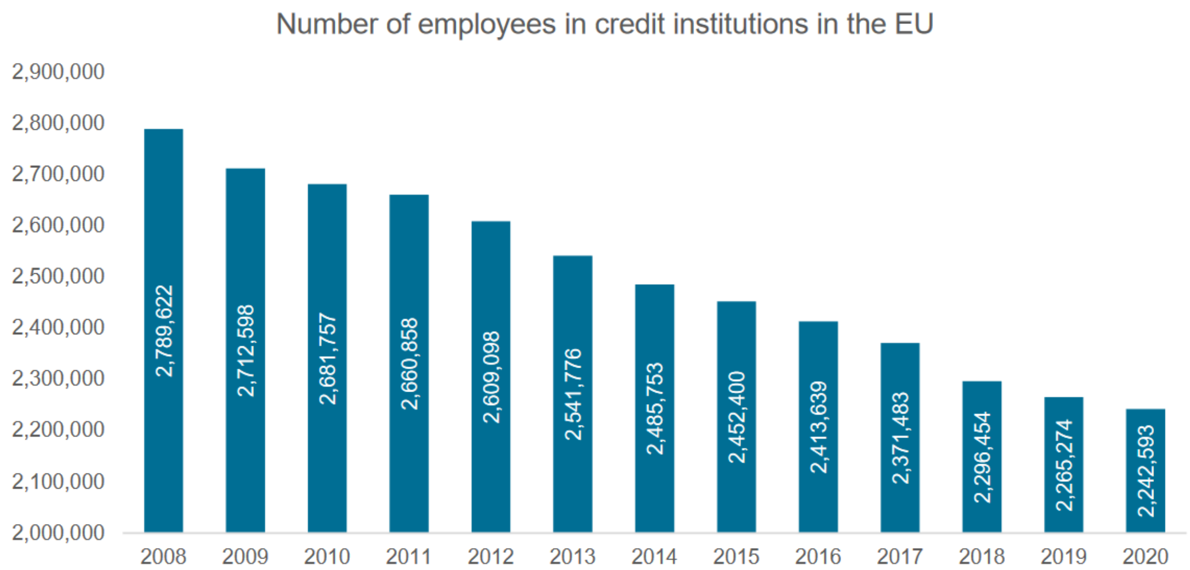
Source: ECB – UE structural financial indicators, 2022

Moreover, European banks are now facing structural challenges that require, as well, good corporate governance to tackle. Profitability, digitalization, ESG sustainability are among the most important ones: in order to address these challenges, a strong commitment by the board and good management are of essence. The Italian rules on banks corporate governance expressly mention these topics (digitalization, ESG) as strategic issues that boards have to consider when assessing the overall strategy of their company. Ensuring a strong steering capability of banks' management and boards vis-à-vis these challenges is also one of the supervisory priority of the ECB-SSM for 2022-2024. [18]

PROFITABILITY

Profitability was already a key challenge for European banks over the last years, for mainly three reasons: first, the ECB ultra-low interest rates policy, which affected banks' interest margins; second, overbanking; third, the growing competition by Fintech and Bigtech firms, which are entering the banking business with many competitive advantages. While the ultra-low interest rate environment is fading (since the ECB is raising interest rates), the other two factors still remain. Banks are, indeed, reacting: as regards overbanking - besides consolidation of the banking sector, as said before - restructuring is taking place too, as shown by the decreasing number of employees that the European banking sector has (see Figure 2). With reference to competition coming from Fintech and Bigtech firms, we will discuss the issue in the next paragraph.

Figure 2



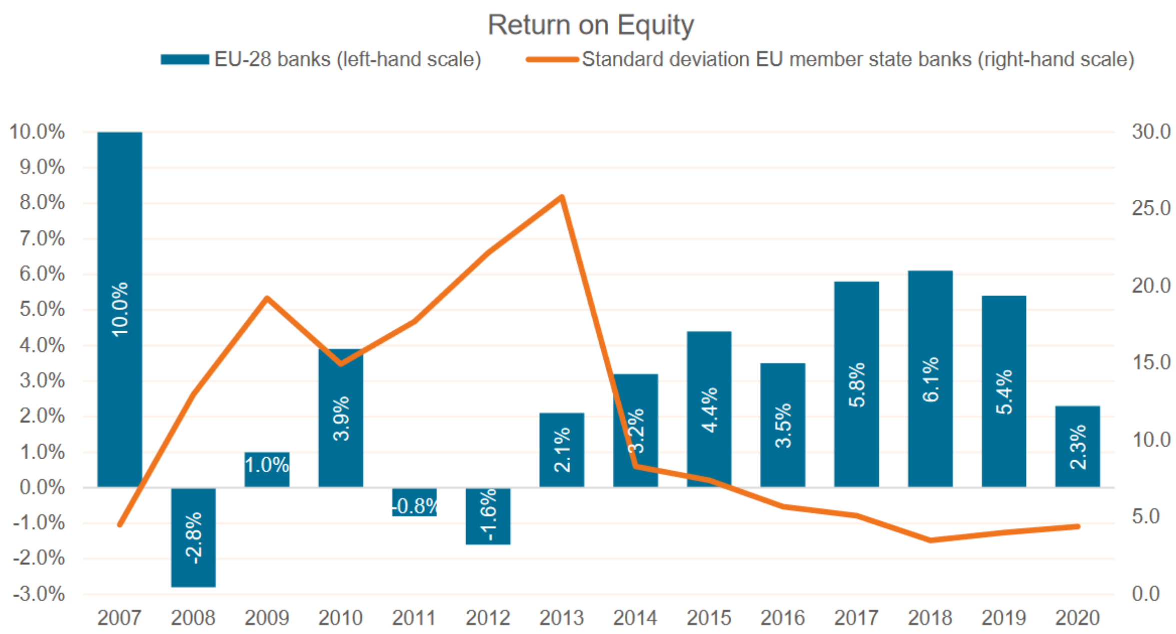
Source: EBF Facts and figures 2022

As the European Banking Federation reports "This challenge [profitability] reached new level with the COVID-19 crisis outbreak, since European banks started facing losses from bad loans and other costs caused by the crisis. The return on equity (ROE), a key indicator to

18 ECB-SSM (2022)

assess the banking sector's attractiveness for investors, was slowly but surely recovering since 2007 (Figure 3).

Figure 3



Source: EBF Facts and figures 2022

The ROE of European banks was 5.4% in 2019 for EU-27 but dropped to 2.3% in 2020, returning to levels seen last time in 2013. Reflecting on the national breakdown, all countries but four have a positive ROE, with two countries having a double-digit ROE, Slovenia (11.3%) and Lithuania (10%). The difference between the highest (Slovenia) and lowest (Greece) ROE was 19.1 percentage points in 2020, higher than the 15.3 in 2019 but very far from the 101.6 recorded in 2013. The ROE across EU countries diverged after 2007, signaling growing fragmentation, particularly across the Euro area. After reaching a peak in 2013 (25.8), the dispersion around the average ROE has substantially decreased. After reaching 4.0 in 2019, the dispersion is at 4.4 in 2020, just below than the 4.5 seen in 2007 before deviation started".[19]

DIGITALIZATION

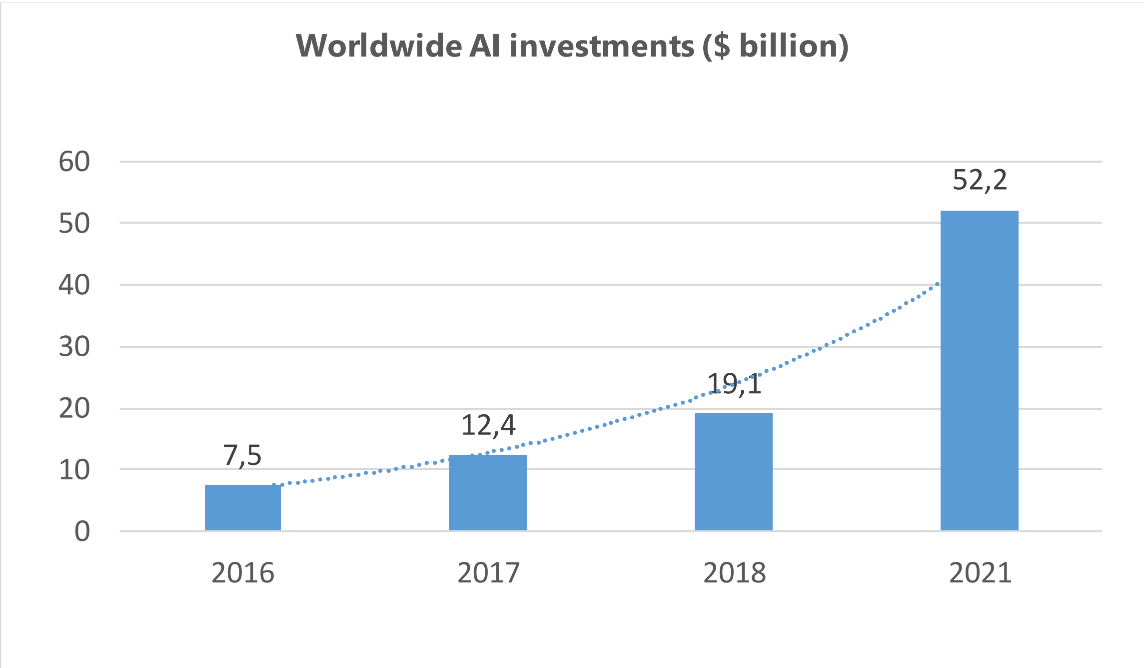
Technological change has brought rapid developments that are transforming the economic and financial landscape. On the one hand, Fintech and Bigtech firms are entering

19 EUROPEAN BANKING FEDERATION (2021), p. 22

the financial and banking market, using their big data to offer financial products to consumers and having several other competitive advantages [20].

According to Earnst and Young data [21], fund raised by Fintechs from 2018 to 2021 has increased by 120 billion of US dollars globally, compared to the period 2015-2018. By 2019 the Fintech markets accounts for a value of 5500 billion of US dollars with more than 20.000 Fintech projects. Investments in Artificial Intelligence has grown dramatically all over the world (Figure 4).

Figure 4



Source: Earnst & Young (2020), p. 51

[20] "Through digital innovation FinTech companies can offer services that are transparent, accessible, effortless and cost-cutting and that are tailoring products to the evolving expectations of new customers. As such, FinTechs represent a disruptive phenomenon for traditional institutions." "As a result of digitalization, FinTechs have acquired several competitive advantages against traditional financial institutions. In fact, they are able to both enhance the customer experience, making the interaction easier and more effective, and respond to clients' financial needs. By operating through an open and innovative infrastructure, FinTech startups also compete on costs against incumbents. In fact, they usually have low installation and operating costs, have slender structures, are composed of a contained but specialized workforce and are often not subject to regulatory supervision. Conversely, incumbents are traditionally characterized by high structural expenses, especially when it comes to technological development plans". EARNST & YOUNG (2020), p. 29 and 30

[21] EARNST & YOUNG (2020)

In Italy, data suggest that Fintech is expanding rapidly. The number of FinTech startups has grown steadily over the years: from 16 in 2011 to 345 in 2020. A Bank of Italy study reports an overall expenditure of 530 million in Fintech projects in 2020 [22].

On the other hand, banks are increasing their use of IT. Indeed, the digitalization of their business brings about many opportunities: technology may reduce banks' costs, by fostering automation and enhancing efficiency; it may increase risk management capability, by using big data and artificial intelligence to better screen and monitor their customers' creditworthiness; it may improve revenues, by increasing the customer base, allowing banks to diversify their products and better tailoring them on their customers' needs.

To reap these benefits, banks are required to change their business models and organization. According to Banca d'Italia data [23], only about 20% of the Italian banks have set up a specific organizational unit for coordinating Fintech initiatives; for the rest of the system, the development of Fintech projects is entrusted to either IT, Organization or Business Operations areas or even lighter organizations (such as working groups or project managers who coordinate the various areas involved in the projects). Intermediaries who have created specific organizational units are those who have invested most in IT (€ 30.7 million on average, against € 5.9 million for those who have not). Indeed, the adjustment of the organizational structure reflects the amount of investments.

Intensive use of technology in banking may also bring additional risks [24]. Cyber risk is one example. The fact that banks are relaying, in most cases, on external IT providers whose efficiency and good organization becomes critical for the banks themselves, is another example: about 80% of the Fintech projects of Italian banks involve outsourcing (either in part or totally) to third parties [25]. Not surprisingly, such risks are mentioned as a supervisory priority for most European Banking Supervisors [26]. Viewed from a corporate governance standpoint, such a revolution of the banking business will require a strong steering capability of banks boards, as also the ECB-SSM highlights [27].

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[22] BANCA D'ITALIA (2021)

[23] BANCA D'ITALIA (2021)

[24] PERRAZZELLI (2022)

[25] BANCA D'ITALIA (2021)

[26] See, for instance, the ECB-SSM (2022)

[27] ECB-SSM (2022)

Year 2020 was the fourth warmest year since 1961, after the records already recorded in 2015, 2018 and 2019. Compared to the period 1961-1990, the average temperature increase was 1.54°C in Italy (1.28°C globally) (Figure 5).

Figure 5

Trend in world and Italy average temperature

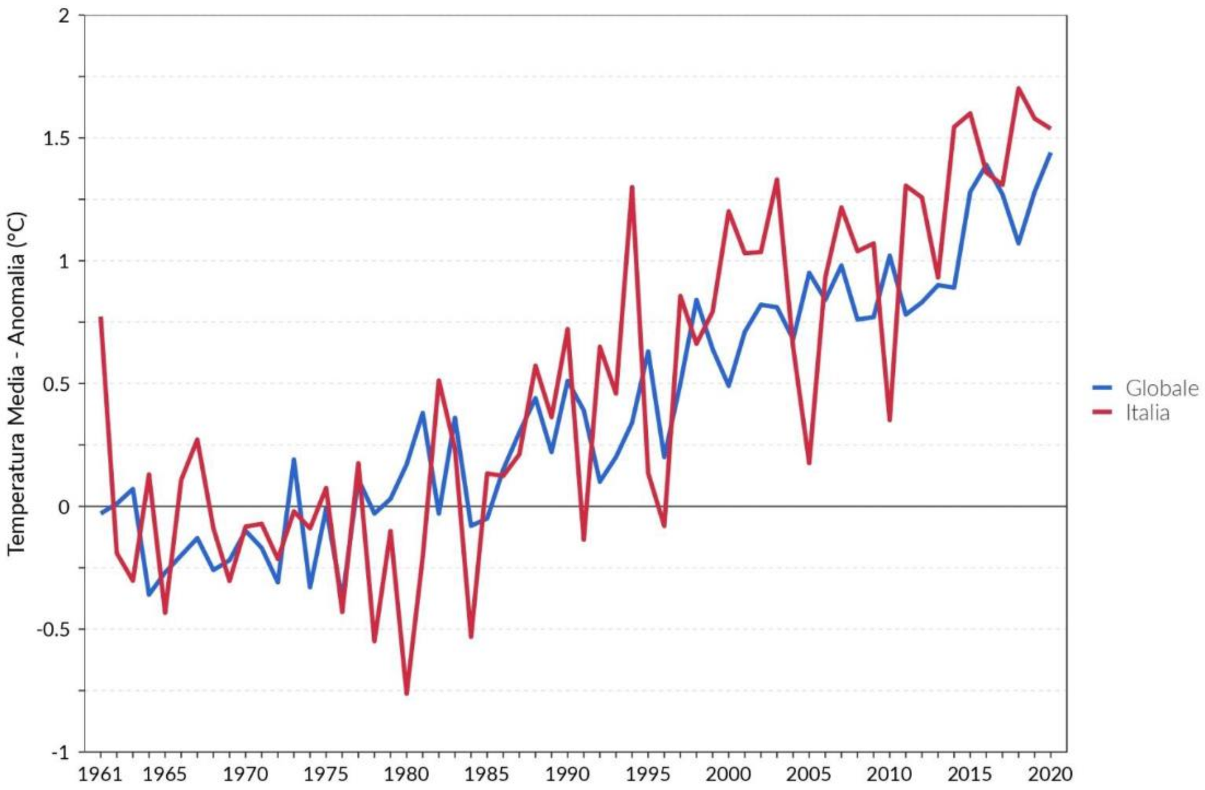

Figura 2.1: *Serie delle anomalie di temperatura media globale sulla terraferma e in Italia, rispetto ai valori climatologici normali 1961-1990. Fonti: NCDC/NOAA e ISPRA. Elaborazione: ISPRA.*

Source: ISPRA (2021)

Raising temperatures is not only alarming per se, but has also heavy negative impacts on social and economic well-being, as different studies point out [28]; in Europe, these drawbacks are not evenly distributed, but affect European southern countries most. Figure 6 shows the impact on GDP on different European regions, assuming an increase of 1.5, 2 or

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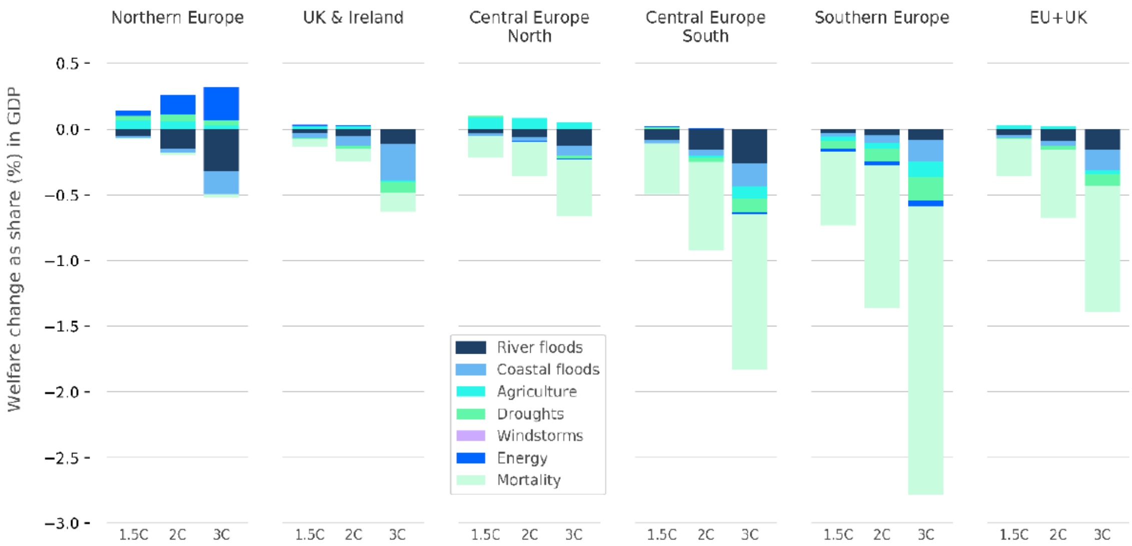
[28] See, for example: FEYEN L. et alia (2020); BERNARDINI E., FAIELLA I., LAVECCHIA L., MISTRETTA A. and NATOLI F. (2021)

3 degrees Celsius in ground temperature and distinguishing the impact of different natural disasters that might happen consequently.

Figure 6

Climate change and GDP



Source: FEYEN L. et alia (2020), p. 57

Europe is committed to achieving climate neutrality by 2050. To realize this goal, investments of about 350 billion euros per year are needed, from 2021 to 2030 (equal to 2.3% of GDP) [29]. The financial system, and the banking sector in the first place, plays a key role in channeling private resources towards sustainable projects and/or activities and in supporting businesses and households during this ecological transition. While this will bring about new business opportunities for banks themselves, it will also – and more importantly – bring new risks to them, since they will have to be able to internalize sustainability in their business strategies and processes while respecting sound and prudent risk management [30].

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29 See EUROPEAN COMMISSION (2018)

30 Needless to say that ESG transition and sustainable finance are not only in the European agenda. The G20, the Financial Stability Board, the Basel Committee and the Network for greening the Financial system (NGFS) are all focusing, albeit from different but intertwined views, on the actions needed to ensure an adequate assessment of climate-related risks, fill data and methodology gaps and promote comparable disclosures and 'sound' supervisory practices.

As the ECB notes "Addressing risks stemming from climate change and environmental degradation will without a doubt be one of the main challenges for banks and supervisors in the years to come. The transition towards a low-carbon economy poses significant risks to banks via a set of transmission channels, for example through exposures to firms with high carbon emissions. Furthermore, a substantial share of banks' exposures is towards firms located in areas that are already highly exposed or increasingly exposed to physical hazards. Recent ECB assessment shows that banks have made some progress in adapting their practices, but at still too slow a pace. For this reason, it is crucial that banks develop a mitigation strategy to soften the long-term impacts of climate-related and environmental risks and adjust their business strategy, governance and risk management frameworks to adequately incorporate these risks"[31].

Indeed, according to an ECB study on banks' climate and environmental (C&E) risk management, banks are making progress in governing C&E risks but much has still to be done. While in some cases boards are increasingly taking formal responsibility on this issue, most frequently they are not comprehensively kept informed, and monitoring of C&E risk remain limited. Moreover, with respect to their organizational structure, few banks have explicitly defined the C&E risk-related tasks and responsibilities in their internal control systems [32].

31 ECB-SSM (2022)

32 ECB (2021)

3. THE INTERNATIONAL RULES

3.1 BANKS' GOVERNANCE: EVIDENCE FROM THE GREAT FINANCIAL CRISIS

Misaligned managerial incentives in the financial sector, under-estimation of risks, ineffective bank boards and shareholders oversight are viewed by many as key contributors to the Great Financial Crisis.

The Great Financial Crisis (GFC) exposed flaws throughout financial markets and prompted much investigation into the way banks work [33]. Evidence was most convincing: ill-designed financial sector remuneration; risk management control systems incapable of assessing the overall risk borne by the firm and prone to the banks' performance targets; boards unaware of the risks faced by their company until too late; shareholders not effective in overseeing their boards, most likely because they were subject to similar short term incentives as traders and managers.

The influence of bad corporate governance practices on the crisis may be summed up by the remarks of Alan Greenspan at a hearing by the US Congress: "I made the mistake in presuming that the self-interests of organizations, specifically banks and others, were such that they were best capable of protecting their own shareholders and the equity of the firm".

The national and international response to the GFC led to a widespread call for further regulation and re-regulation of the financial sector. Banks' prudential framework in particular has been restructured and tightened, and – within that – banks' governance too.

As described above, there are at least four areas of corporate governance that can be linked to the financial crisis: remuneration/incentive systems; risk management practices; boards composition and functioning; and the exercise of shareholder rights. [34] The four areas are also closely related: if remuneration has been excessive and/ or not structured properly, why have the boards or shareholders allowed this state of affairs to occur? If boards weren't aware of risks, was the risk management function working properly? Was the banks' internal control system sufficiently independent from management to have a say? Why have shareholders not been able to ensure accountability?

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[33] OECD (2009); ADAMS, R., and MEHRAN, H. (2011); ADAMS, S., FAUVER, L., MILBACH, L. and TABOADA, A. G. (2022); BEBCHUK, L. A., COHEN, A. and SPAMANN, H. (2010)

[34] MEHRAN, H., MORRISON, A. and SHAPIRO, J. D. (2011)

3.1.1 Remuneration and incentive schemes

Compensation practices were undoubtedly an important contributing factor to the Great Financial Crisis.

Banks executive pay structure was designed to enhance risk taking and create value for shareholders but not to protect debtholders: indeed, bankers' pay (as well as that of non-financial firms managers) were linked to the firm size, complexity or firm's market value, disregarding the fact that banks are highly leveraged institutions (as we discussed previously) and that, consequently, linking pay to such elements and not considering leverage or risks may generate wrong incentives [35].

According to economic literature, pay-for-performance per se may have positive advantages since it links pay to the firm's wealth, but this holds true under some conditions: a) first, that firm performance is reliably measurable, and this is rather difficult in banks, given the opaqueness of their balance sheet; b) second, that performance is measured correctly, taking risks into consideration; c) third that remuneration schemes are monitored externally (either by shareholders or by non-executive board members), in order to avoid managerial gambling on company's results. Empirical evidence after the crisis showed, indeed, that both risk measurements and outsiders' monitoring were lacking in banks.

All in all, the evidence shown by the GFC is that the remuneration/incentive systems had often failed because decisions and negotiations were not carried out at arm's length. Managers and others had too much influence over the level and conditions for performance based remuneration with the board unable or incapable of exercising objective, independent judgement. Remuneration schemes were often overly complicated or obscure; they were also asymmetric, with limited downside risk (thereby encouraging excessive risk taking) and short-sighted, with no look at the bank's long-term performance. Cash pay-outs were most frequently used, rather than deferred compensation, clawbacks, or share-based payments with lock-up clauses: these tools were introduced after the crisis.

3.1.2 Risk management

Perhaps one of the greatest shocks from the financial crisis has been the widespread failure of banks' risk management. Although banks were thought to be the best in this area, it turned out that risk was frequently not managed on a firm basis but rather by product or division. As a result, the overall risk borne by the bank was frequently wrongly assessed.

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[35] See BEBCHUK, L. A., COHEN, A. and SPAMANN, H. (2010); MEHRAN, H., MORRISON, A. and SHAPIRO, J. D. (2011) and the vast literature reported in this paper.

Risk managers were often regarded as a hindrance to banking business rather than an essential part of a bank sound business strategy; in many cases, they lacked status to enforce prudent risk policies, nor did they have the power to inform the board when red flags were detected. [36] Most importantly, in a number of cases boards were unaware of the overall risk facing the company, either because the flow of information coming from the management and the risk control functions was too poor, or because board commitment and skills were too low, or for both reasons.

In sum, the financial crisis showed that effective risk management is key; that it needs to be firm-wide (and not just practiced in particular product/market lines); that risk management failures in banks can have important implications for systemic risk. It also showed that the board should bear primary responsibility for setting the bank's strategy and for the associated risk management, although good risk management needs to be internalized throughout the organisation and be part of the way it does business. Boards should therefore monitor the structure of the company and its culture and ensure or require reliable and relevant flow of information (both to and from the board) about the implementation of its strategy and the associated risks. [37]

3.1.3 Board practices

The financial crisis has also pointed in a large number of cases to bank boards being ineffective and incapable of objective independent judgement. Signs of board failure have been seen not only in poor risk management but also in board structures. In the US, some important banks that failed had long terms of service with the same chair/CEO [38] and there are a number of reports from other countries suggesting clubby boards. Boards in many cases appeared to be captured by their own histories and by management. Individual members were seldom changed by being voted out of office by shareholders indicating significant path dependency.

Diversification of skills within the board were lacking, since the "fit and proper test" would assess boards behavior on propriety and honesty only, and not on their professional competence or experience. For the same reason, independence and objectivity was not tested, nor it was time commitment. In addition, board agendas were frequently primarily focusing on compliance issues (ie. those involving a possible board liability) and much less on strategic issues.

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36 LADIPO, D., and NESTOR S. (2009)

37 OECD (2009)

38 NESTOR ADVISORS (2009)

In sum, ensuring appropriate board composition and behavior turned out to be key.

3.1.4 The role of shareholders

The Dutch Minister of Finance perhaps reflected a widespread view when he said: "We cannot avoid asking ourselves what you, shareholders, have done to prevent and manage the crisis. Unfortunately, and I know you don't like to hear this, the answer is almost nothing" [39].

Have shareholders been inactive as the above quote would suggest? Indeed, individual shareholders lack the incentives to remain informed and to participate, relying on others, especially large institutional shareholders to take the lead. The latter are, however, quite heterogeneous and have, consequently, different targets.

In a number of countries the share of institutional investors continues to increase and the form in which this has occurred (mutual funds and pension funds) means that there is a significant difference between asset ownership and asset management, raising a number of governance issues. Their voting behaviour suggests reluctance on the part of many to play an active role: rather, they prefer "voting by feet" (ie. selling shares, rather than raising hands in shareholders' meeting). One reason for inactivity appears to be important conflicts of interest and incentive structures linked to the corporate governance of these investors. Not surprisingly, as one of the regulatory responses to the Great Financial Crisis shareholder rights have been re-ruled, and institutional investors have been asked to disclose their voting records in order to make more transparent their role in the corporate governance of firms they invest in.

3.2 THE POST-CRISIS REGULATORY RESPONSE ON BANKS' GOVERNANCE

3.2.1 The Basel standards on banks' corporate governance

After the outbreak of the financial crisis, regulators and supervisory authorities increased their commitment in the definition of rules and practices of good corporate governance, in order to overcome the major shortcomings that the Great Financial crisis had shown.

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39 BOS, W. (2009)

One of the most important action on this issue was taken by the Basel Committee on Banking Supervision with its new Principles of corporate governance for banks issued in 2015 [40]. Board and senior management responsibility and role; risk management independence and duties; the CRO role; role and duties of the other internal controls functions (compliance, audit); information flows from and to the board; compensation schemes; market disclosure: these important corporate governance elements were all deeply reviewed in the new Principles in order to factor-in the lessons learnt from the GFC.

In the paragraphs below the most significant excerpts of the new Principles are reported.

BOARD STRUCTURE, ROLE AND RESPONSIBILITY

The bank's organizational structure should be established by the board and approved by it in order for the board and senior management to fulfill their duties and support sound decision-making and good governance. Accordingly, the board is ultimately in charge of the bank's business strategy, financial stability, major hiring decisions, internal organization and governance structure and procedures, risk management obligations, and compliance requirements.

Specifically, the board should:

- actively engage in the affairs of the bank and keep up with material changes in the bank's business and the external environment as well as act in a timely manner to protect the long term interests of the bank;
- oversee the development of and approve the bank's business objectives and strategy and monitor their implementation;
- play a lead role in establishing the bank's corporate culture and values;
- oversee the implementation of the bank's governance framework and periodically review that it remains appropriate in the light of material changes to the bank's size, complexity, geographical footprint, business strategy, markets and regulatory requirements;
- establish, along with senior management and the CRO, the bank's risk appetite, taking into account the competitive and regulatory landscape and the bank's long-term interests, risk exposure and ability to manage risk effectively;

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40 BASEL COMMITTEE ON BANKING SUPERVISION (2015). The BCBS had already issues principles on banks' corporate governance on 2006, which were then deeply reviewed after the GFC.

- oversee the bank's adherence to the RAS, risk policy and risk limits;

- approve the approach and oversee the implementation of key policies pertaining to the bank's capital adequacy assessment process, capital and liquidity plans, compliance policies and obligations, and the internal control system

- require that the bank maintain a robust finance function responsible for accounting and financial data;

- approve the annual financial statements and require a periodic independent review of critical areas;

- approve the selection and oversee the performance of the CEO, key members of senior management and heads of the control functions;

- oversee the bank's approach to compensation, including monitoring and reviewing executive compensation and assessing whether it is aligned with the bank's risk culture and risk appetite;

- oversee the integrity, independence and effectiveness of the bank's policies and procedures for whistleblowing;

Moreover, board members should be and continue to be qualified for their positions, both individually and collectively. They ought to be aware of their position in corporate governance and oversight and be capable of making solid, unbiased decisions regarding the bank's operations. The board must be capable of carrying out its duties and have a structure that makes effective oversight possible. In order to do this, the board should be made up of an adequate number of independent directors who are balanced in their backgrounds, skill sets, and areas of expertise, and who collectively hold the qualifications required given the bank's size, complexity, and risk profile.

As part of the overall corporate governance framework, the board should be responsible for overseeing a strong risk governance framework. An effective risk governance framework includes a strong risk culture, a well-developed risk appetite articulated through the risk appetite statement, and well defined responsibilities for risk management in particular and control functions in general. The board should take an active role in defining the risk appetite and ensuring its alignment with the bank's strategic, capital and financial plans and compensation practices.

The bank's Risk Appetite Statement (RAS) should:

- include both quantitative and qualitative considerations;

- establish the individual and aggregate level and types of risk that the bank is willing to assume in advance of and in order to achieve its business activities within its risk capacity;
- define the boundaries and business considerations in accordance with which the bank is expected to operate when pursuing the business strategy;
- communicate the board's risk appetite effectively throughout the bank, linking it to daily operational decision-making and establishing the means to raise risk issues and strategic concerns across the bank.

The board should also define appropriate governance structures and practices for its own work, and put in place the means for such practices to be followed and periodically reviewed for ongoing effectiveness.

To increase efficiency and allow deeper focus in specific areas, a board may establish certain specialised board committees. The committees should be created and mandated by the full board. The number and nature of committees depend on many factors, including the size of the bank and its board, the nature of the business areas of the bank, and its risk profile.

Each committee should have a charter or other instrument that sets out its mandate, scope and working procedures. This includes how the committee will report to the full board, what is expected of committee members and any tenure limits for serving on the committee. The board should consider the occasional rotation of members and of the chair of such committees, as this can help avoid undue concentration of power and promote fresh perspectives.

SENIOR MANAGEMENT ROLE AND RESPONSIBILITY

Senior management consists of a core group of individuals responsible and accountable to the board for the sound and prudent day-to-day management of the bank.

Under the direction and oversight of the board, senior management should carry out and manage the bank's activities in a manner consistent with the business strategy, risk appetite, remuneration and other policies approved by the board.

Senior management contributes substantially to a bank's sound corporate governance through personal conduct (e.g. by helping to establish the "tone at the top" along with the board). Members of senior management should provide adequate oversight of those they manage, and ensure that the bank's activities are consistent with the business strategy, risk appetite and the policies approved by the board.

The organisation and procedures and decision-making of senior management should be clear and transparent and designed to promote effective management of the bank. This includes clarity on the role, authority and responsibility of the various positions within senior management, including that of the CEO.

RISK MANAGEMENT FUNCTION

Banks should have an effective independent risk management function, under the direction of a chief risk officer (CRO), with sufficient stature, independence, resources and access to the board. The independent risk management function is a key component of the bank's second line of defence. This function is responsible for overseeing risk-taking activities across the enterprise and should have authority within the organisation to do so.

Different activities of the risk management function include: • identifying material individual, aggregate and emerging risks;

- assessing these risks and measuring the bank's exposure to them;
- subject to the review and approval of the board, developing and implementing the enterprise wide risk governance framework, which includes the bank's risk culture, risk appetite and risk limits;
- ongoing monitoring of the risk-taking activities and risk exposures in line with the board approved risk appetite, risk limits and corresponding capital or liquidity needs;
- establishing an early warning or trigger system for breaches of the bank's risk appetite or limits;
- influencing and, when necessary, challenging decisions that give rise to material risk; and
- reporting to senior management and the board or risk committee on all these items, including but not limited to proposing appropriate risk-mitigating actions.

Moreover, the bank's risk governance framework should include policies, supported by appropriate control procedures and processes, designed to ensure that the bank's risk identification, aggregation, mitigation and monitoring capabilities are commensurate with the bank's size, complexity and risk profile.

Risks should be identified, monitored and controlled on an ongoing bank-wide and individual entity basis. The sophistication of the bank's risk management and internal control infrastructure should keep pace with changes to the bank's risk profile, to the external risk landscape and in industry practice.

Risk identification should encompass all material risks to the bank, on- and off-balance sheet and on a group-wide, portfolio-wise and business-line level and should include both quantitative and qualitative elements. In order to perform effective risk assessments, the board and senior management, including the CRO, should, regularly and on an ad hoc basis, evaluate the risks faced by the bank and its overall risk profile. The risk assessment process should include ongoing analysis of existing risks as well as the identification of new or emerging risks. Risks should be captured from all organisational units. Concentrations associated with material risks should likewise be factored into the risk assessment. Risk measurements should also include qualitative, bank-wide views of risk relative to the bank's external operating environment. Banks should also consider and evaluate harder-to-quantify risks, such as reputation risk.

ROLE OF THE CRO

Large, complex and internationally active banks, and other banks, based on their risk profile and local governance requirements, should have a senior manager (Chief Risk Officer – CRO - or equivalent) with overall responsibility for the bank's risk management function.

The CRO has primary responsibility for overseeing the development and implementation of the bank's risk management function. This includes the ongoing strengthening of staff skills and enhancements to risk management systems, policies, processes, quantitative models and reports as necessary to ensure that the bank's risk management capabilities are sufficiently robust and effective to fully support its strategic objectives and all of its risk-taking activities. The CRO is responsible for supporting the board in its engagement with and oversight of the development of the bank's risk appetite and RAS and for translating the risk appetite into a risk limits structure. The CRO, together with management, should be actively engaged in monitoring performance relative to risk-taking and risk limit adherence. The CRO's responsibilities also include managing and participating in key decision-making processes (eg strategic planning, capital and liquidity planning, new products and services, compensation design and operation).

RISK COMUNICATION AND INFORMATION FLOW

An effective risk governance framework requires robust communication within the bank about risk, both across the organisation and through reporting to the board and senior management.

Ongoing communication about risk issues, including the bank's risk strategy, throughout the bank is a key tenet of a strong risk culture. A strong risk culture should promote risk awareness and encourage open communication and challenge about risk-taking across the organisation as well as vertically to and from the board and senior management. Senior management should actively communicate and consult with the control functions on management's major plans and activities so that the control functions can effectively discharge their responsibilities.

Risk reporting to the board requires careful design in order to convey bank-wide, individual portfolio and other risks in a concise and meaningful manner. Reporting should accurately communicate risk exposures and results of stress tests or scenario analyses and should provoke a robust discussion of, for example, the bank's current and prospective exposures (particularly under stressed scenarios), risk/return relationships and risk appetite and limits.

Risk reporting systems should be dynamic, comprehensive and accurate, and should draw on a range of underlying assumptions. Material risk-related ad hoc information that requires immediate decisions or reactions should be promptly presented to senior management and, as appropriate, the board, the responsible officers and, where applicable, the heads of control functions so that suitable measures and activities can be initiated at an early stage. Information should be communicated to the board and senior management in a timely, accurate and understandable manner so that they are equipped to take informed decisions.

COMPLIANCE

The bank's board of directors is responsible for overseeing the management of the bank's compliance risk. The board should establish a compliance function and approve the bank's policies and processes for identifying, assessing, monitoring and reporting and advising on compliance risk.

The compliance function should advise the board and senior management on the bank's compliance with applicable laws, rules and standards and keep them informed of developments in the area. It should also help educate staff about compliance issues, act as a contact point within the bank for compliance queries from staff members, and provide guidance to staff on the appropriate implementation of applicable laws, rules and standards in the form of policies and procedures and other documents such as compliance manuals, internal codes of conduct and practice guidelines.

The bank's senior management is responsible for establishing a compliance policy that contains the basic principles to be approved by the board and explains the main processes by which compliance risks are to be identified and managed through all levels of the organisation.

While the board and management are accountable for the bank's compliance, the compliance function has an important role in supporting corporate values, policies and processes that help ensure that the bank acts responsibly and fulfils all applicable obligations.

The compliance function is independent from management to avoid undue influence or obstacles as that function performs its duties.

INTERNAL AUDIT

An effective and efficient internal audit function constitutes the third line of defence in the system of internal control. It provides an independent assurance to the board of directors and senior management on the quality and effectiveness of a bank's internal control, risk management and governance systems and processes, thereby helping the board and senior management protect their organisation and its reputation. For this reason, the internal audit function should have a clear mandate, be accountable to the board and be independent of the audited activities. It should have sufficient standing, skills, resources and authority within the bank to enable the auditors to carry out their assignments effectively and objective.

A well-functioning internal audit supports the board and senior management in promoting an effective governance process and the long-term soundness of the bank.

COMPENSATION

Systemically important financial institutions should have a board compensation committee as an integral part of their governance structure and organisation to oversee the compensation system's design and operation.

Remuneration systems form a key component of the governance and incentive structure through which the board and senior management promote good performance, convey acceptable risk taking behaviour and reinforce the bank's operating and risk culture. The board (or, by delegation, its compensation committee) is responsible for the overall oversight of management's implementation of the remuneration system for the entire bank. In addition, the board or its committee should regularly monitor and review outcomes to assess whether the bank-wide remuneration system is creating the desired incentives for managing risk, capital and liquidity. The board or subcommittee should review the remuneration plans, processes and outcomes at least annually.

The remuneration structure should be in line with the business and risk strategy, objectives, values and long-term interests of the bank. It should also incorporate measures to prevent conflicts of interest. Remuneration programmes should encourage a sound risk culture in which risk-taking behaviour is appropriate and which encourages employees to act in the interest of the company as a whole (also taking into account client interests) rather than for themselves or only their business lines. In particular, incentives embedded within remuneration structures should not incentivise staff to take excessive risk. The remuneration framework should provide for variable remuneration to be adjusted to take into account the full range of risks, including breaches of risk appetite limits, internal procedures or legal requirements.

DISCLOSURE AND TRANSPARENCY

The governance of the bank should be adequately transparent to its shareholders, depositors, other relevant stakeholders and market participants.

Transparency is consistent with sound and effective corporate governance. As emphasised in existing Committee guidance on bank transparency, it is difficult for shareholders, depositors, other relevant stakeholders and market participants to effectively monitor and properly hold the board and senior management accountable when there is insufficient transparency. The objective of transparency in the area of corporate governance is therefore to provide these parties with the information necessary to enable them to assess the effectiveness of the board and senior management in governing the bank.

Although disclosure may be less detailed for non-listed banks, especially those that are wholly owned, these banks can nevertheless pose the same types of risk to the financial system as publicly traded banks through various activities, including their participation in payment systems and acceptance of retail deposits. All banks, even those for whom disclosure requirements may differ because they are non-listed, should disclose relevant and useful information that supports the key areas of corporate governance identified by the Committee. Such disclosure should be proportionate to the size, complexity, structure, economic significance and risk profile of the bank. At a minimum, banks should disclose annually the following information:

- the recruitment approach for the selection of members of the board and for ensuring an appropriate diversity of skills, backgrounds and viewpoints; and
- whether the bank has set up board committees and the number of times key standing committees have met

The bank should also disclose key points concerning its risk exposures and risk management strategies without breaching necessary confidentiality. When involved in material and complex or non-transparent activities, the bank should disclose adequate information on their purpose, strategies, structures, and related risks and controls. Disclosure should be accurate, clear and presented such that shareholders, depositors, other relevant stakeholders and market participants can consult the information easily.

3.2.2 The European rules on banks' corporate governance

Like in other jurisdictions, European policy makers did not stay apart from the debate on banks' corporate governance after the Great Financial Crisis.

While the Capital Requirement Directive (CRD) in force during the crisis (Directive 2006/48/EC) had only one, short and principle-based article on banks' governance, the CRD review that took place after the GFC (and the following CRD reviews) replaced that only article with extensive and detailed rules on banks' governance. Moreover, to ensure an equal understanding, application and enforcement of such new rules, the latter were coupled with Guidelines issued by the European Banking Authority.

In Box 3 you can see art. 22 of the CRD in force in 2006 and the corresponding new rules in force since 2013 (CRD4) [41]. The difference is striking: indeed, post crisis rules address in depth the lessons learnt from the Great Financial Crisis. In particular:

- in line with the Basel Principles, you would now find provisions on boards functions and major responsibilities, aimed at guaranteeing its steering role and risk awareness, and rules on boards composition, which are meant to ensure that boards are adequately skilled, knowledgeable and experienced, taking into account the size and complexity of the bank to manage, and that they act honestly and with independence of mind. Specific rules on diversification (eg. in terms of gender, age, experience) are set to ensure that a broad set of qualities and competences are present within the board and to limit the risk of "group-thinking" or herding behaviour. In order to ensure that board members have sufficient time to devote to their duties, rules on time commitment and limits on multiple directorships are introduced. Provisions on the independence of the staff engaged in control functions are provided for, so to be sure that they have sufficient authority and independence from the business units they oversee. Market discipline is fostered by a number of provisions requiring banks to publicly disclose information.

- Three entire articles are devoted to remuneration policies; again, in line with the BCBS standards, rules are aimed at ensuring that remuneration is consistent with and promotes sound and effective risk management, and it's in line with the business strategy and long-term interests of the bank.

[41] Please note that the CRD4 has been amended in 2019 but, as long as corporate governance is concerned, the changes are minimal and limited to remuneration schemes (ie. introducing a principle of gender pay neutrality and entrusting the EBA to issue guidelines on this topic).

- In order to achieve such results, some important principles are set. First, fixed and variable remuneration are required to be appropriately balanced. Second, the fixed component should be set sufficiently high to allow the possibility to pay no variable remuneration, should it be the case. Third, the variable component should reflect performance, taking into account individual results as well as the performance of the business unit and that of the bank as a whole. Forth, the variable component should reflect a sustainable, long-term and risk adjusted performance; therefore, a substantial part of the variable remuneration should not be paid up-front, but be deferred over a period of time. Fifth, special rules are set for the remuneration of control functions and other staff members that might have particular conflicts of interests.

Box 3

Article 22, Directive 2006/48/EC[42]

1. Home Member State competent authorities shall require that every credit institution have robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures.

2. The arrangements, processes and mechanisms referred to in paragraph 1 shall be comprehensive and proportionate to the nature, scale and complexity of the credit institution's activities. The technical criteria laid down in Annex V shall be taken into account.

Article 88-96, Directive 2013/36/EU[43]

Article 88 - Governance arrangements

1. Member States shall ensure that the management body defines, oversees and is accountable for the implementation of the governance arrangements that ensure effective and prudent management of an institution, including the segregation of duties in the organisation and the prevention of conflicts of interest.

Those arrangements shall comply with the following principles:

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42 https://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=OJ:L:2006:177:FULL&from=EN

43 https://eur-lex.europa.eu/legal- content/EN/TXT/HTML/?uri=CELEX:32013L0036&from=IT #d1e5117-338-1

(a) the management body must have the overall responsibility for the institution and approve and oversee the implementation of the institution's strategic objectives, risk strategy and internal governance;

(b) the management body must ensure the integrity of the accounting and financial reporting systems, including financial and operational controls and compliance with the law and relevant standards;

(c) the management body must oversee the process of disclosure and communications;

(d) the management body must be responsible for providing effective oversight of senior management;

(e) the chairman of the management body in its supervisory function of an institution must not exercise simultaneously the functions of a chief executive officer within the same institution, unless justified by the institution and authorised by competent authorities.

Member States shall ensure that the management body monitors and periodically assesses the effectiveness of the institution's governance arrangements and takes appropriate steps to address any deficiencies.

2. Member States shall ensure that institutions which are significant in terms of their size, internal organisation and the nature, scope and complexity of their activities establish a nomination committee composed of members of the management body who do not perform any executive function in the institution concerned.

The nomination committee shall:

(a) identify and recommend, for the approval of the management body or for approval of the general meeting, candidates to fill management body vacancies, evaluate the balance of knowledge, skills, diversity and experience of the management body and prepare a description of the roles and capabilities for a particular appointment, and assess the time commitment expected.

Furthermore, the nomination committee shall decide on a target for the representation of the underrepresented gender in the management body and prepare a policy on how to increase the number of the underrepresented gender in the management body in order to meet that target. The target, policy and its implementation shall be made public in accordance with Article 435(2)(c) of Regulation (EU) No 575/2013;

(b) periodically, and at least annually, assess the structure, size, composition and performance of the management body and make recommendations to the management body with regard to any changes;

(c) periodically, and at least annually, assess the knowledge, skills and experience of individual members of the management body and of the management body collectively, and report to the management body accordingly;

(d) periodically review the policy of the management body for selection and appointment of senior management and make recommendations to the management body.

In performing its duties, the nomination committee shall, to the extent possible and on an ongoing basis, take account of the need to ensure that the management body's decision making is not dominated by any one individual or small group of individuals in a manner that is detrimental to the interests of the institution as a whole.

The nomination committee shall be able to use any forms of resources that it considers to be appropriate, including external advice, and shall receive appropriate funding to that effect.

Where, under national law, the management body does not have any competence in the process of selection and appointment of any of its members, this paragraph shall not apply.

Article 89 - Country-by-country reporting

1. From 1 January 2015 Member States shall require each institution to disclose annually, specifying, by Member State and by third country in which it has an establishment, the following information on a consolidated basis for the financial year:

(a) name(s), nature of activities and geographical location;

(b) turnover;

(c) number of employees on a full time equivalent basis;

(d) profit or loss before tax;

(e) tax on profit or loss;

(f) public subsidies received.

2. Notwithstanding paragraph 1, Member States shall require institutions to disclose the information referred to in paragraph 1(a), (b) and (c) for the first time on 1 July 2014.

3. By 1 July 2014, all global systemically important institutions authorised within the Union, as identified internationally, shall submit to the Commission the information referred to in paragraph 1(d), (e) and (f) on a confidential basis. The Commission, after consulting EBA, EIOPA and ESMA, as appropriate, shall conduct a general assessment as regards potential negative economic consequences of the public disclosure of such information, including the impact on competitiveness, investment and credit availability and the stability of the financial system. The Commission shall submit its report to the European Parliament and to the Council by 31 December 2014.

In the event that the Commission report identifies significant negative effects, the Commission shall consider making an appropriate legislative proposal for an amendment of the disclosure obligations set out in paragraph 1 and may, in accordance with point (h) of Article 145, decide to defer those obligations. The Commission shall review the necessity to extend deferral annually.

4. The information referred to in paragraph 1 shall be audited in accordance with Directive 2006/43/EC and shall be published, where possible, as an annex to the annual financial statements or, where applicable, to the consolidated financial statements of the institution concerned.

5. To the extent that future Union legislative acts for disclosure obligations go beyond those laid down in this Article, this Article shall cease to apply and shall be deleted accordingly.

Article 90 - Public disclosure of return on assets

Institutions shall disclose in their annual report among the key indicators their return on assets, calculated as their net profit divided by their total balance sheet.

Article 91 - Management body

1. Members of the management body shall at all times be of sufficiently good repute and possess sufficient knowledge, skills and experience to perform their duties. The overall composition of the management body shall reflect an adequately broad range of experiences. Members of the management body shall, in particular, fulfil the requirements set out in paragraphs 2 to 8.

2. All members of the management body shall commit sufficient time to perform their functions in the institution.

3. The number of directorships which may be held by a member of the management body at the same time shall take into account individual circumstances and the nature, scale and complexity of the institution's activities. Unless representing the Member State, members of the management body of an institution that is significant in terms of its size, internal organisation and the nature, the scope and the complexity of its activities shall, from 1 July 2014, not hold more than one of the following combinations of directorships at the same time:

(a) one executive directorship with two non-executive directorships;

(b) four non-executive directorships.

4. For the purposes of paragraph 3, the following shall count as a single directorship:

(a) executive or non-executive directorships held within the same group;

(b) executive or non-executive directorships held within:

(i) institutions which are members of the same institutional protection scheme provided that the conditions set out in Article 113(7) of Regulation (EU) No 575/2013 are fulfilled; or

(ii) undertakings (including non-financial entities) in which the institution holds a qualifying holding.

5. Directorships in organisations which do not pursue predominantly commercial objectives shall not count for the purposes of paragraph 3.

6. Competent authorities may authorise members of the management body to hold one additional non-executive directorship. Competent authorities shall regularly inform EBA of such authorisations.

7. The management body shall possess adequate collective knowledge, skills and experience to be able to understand the institution's activities, including the main risks.

8. Each member of the management body shall act with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management where necessary and to effectively oversee and monitor management decision-making.

9. Institutions shall devote adequate human and financial resources to the induction and training of members of the management body.

10. Member States or competent authorities shall require institutions and their respective nomination committees to engage a broad set of qualities and competences when recruiting members to the management body and for that purpose to put in place a policy promoting diversity on the management body.

11. Competent authorities shall collect the information disclosed in accordance with Article 435(2)(c) of Regulation (EU) No 575/2013 and shall use it to benchmark diversity practices. The competent authorities shall provide EBA with that information. EBA shall use that information to benchmark diversity practices at Union level.

12. EBA shall issue guidelines on the following:

(a) the notion of sufficient time commitment of a member of the management body to perform his functions, in relation to the individual circumstances and the nature, scale and complexity of activities of the institution;

(b) the notion of adequate collective knowledge, skills and experience of the management body as referred to in paragraph 7;

(c) the notions of honesty, integrity and independence of mind of a member of the management body as referred to in paragraph 8;

(d) the notion of adequate human and financial resources devoted to the induction and training of members of the management body as referred to in paragraph 9;

(e) the notion of diversity to be taken into account for the selection of members of the management body as referred to in paragraph 10.

EBA shall issue those guidelines by 31 December 2015.

13. This Article shall be without prejudice to provisions on the representation of employees in the management body as provided for by national law.

Article 92 - Remuneration policies

1. The application of paragraph 2 of this Article and of Articles 93, 94 and 95 shall be ensured by competent authorities for institutions at group, parent company and subsidiary levels, including those established in offshore financial centres.

2. Competent authorities shall ensure that, when establishing and applying the total remuneration policies, inclusive of salaries and discretionary pension benefits, for categories of staff including senior management, risk takers, staff engaged in control functions and any employee receiving total remuneration that takes them into the same remuneration bracket as senior management and risk takers, whose professional activities have a material impact on their risk profile, institutions comply with the following principles in a manner and to the extent that is appropriate to their size, internal organisation and the nature, scope and complexity of their activities:

a) the remuneration policy is consistent with and promotes sound and effective risk management and does not encourage risk-taking that exceeds the level of tolerated risk of the institution;

b) the remuneration policy is in line with the business strategy, objectives, values and long-term interests of the institution, and incorporates measures to avoid conflicts of interest;

c) the institution' s management body in its supervisory function adopts and periodically reviews the general principles of the remuneration policy and is responsible for overseeing its implementation;

d) the implementation of the remuneration policy is, at least annually, subject to central and independent internal review for compliance with policies and procedures for remuneration adopted by the management body in its supervisory function;

e) staff engaged in control functions are independent from the business units they oversee, have appropriate authority, and are remunerated in accordance with the achievement of the objectives linked to their functions, independent of the performance of the business areas they control;

g) the remuneration of the senior officers in the risk management and compliance functions is directly overseen by the remuneration committee referred to in Article 95 or, if such a committee has not been established, by the management body in its supervisory function;

h) the remuneration policy, taking into account national criteria on wage setting, makes a clear distinction between criteria for setting:

   i. basic fixed remuneration, which should primarily reflect relevant professional experience and organisational responsibility as set out in an employee's job description as part of the terms of employment; and

   ii. variable remuneration which should reflect a sustainable and risk adjusted performance as well as performance in excess of that required to fulfil the employee's job description as part of the terms of employment.

Article 93 - Institutions that benefit from government intervention

In the case of institutions that benefit from exceptional government intervention, the following principles shall apply in addition to those set out in Article 92(2):

(a) variable remuneration is strictly limited as a percentage of net revenue where it is inconsistent with the maintenance of a sound capital base and timely exit from government support;

b) the relevant competent authorities require institutions to restructure remuneration in a manner aligned with sound risk management and long-term growth, including, where appropriate, establishing limits to the remuneration of the members of the management body of the institution;

(c) no variable remuneration is paid to members of the management body of the institution unless justified.

Article 94 - Variable elements of remuneration

1. For variable elements of remuneration, the following principles shall apply in addition to, and under the same conditions as, those set out in Article 92(2):

(a) where remuneration is performance related, the total amount of remuneration is based on a combination of the assessment of the performance of the individual and of the business unit concerned and of the overall results of the institution and when assessing individual performance, financial and non-financial criteria are taken into account;

(b) the assessment of the performance is 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 performance-based components of remuneration is spread over a period which takes account of the underlying business cycle of the credit institution and its business risks;

(c) the total variable remuneration does not limit the ability of the institution to strengthen its capital base;

(d) guaranteed variable remuneration is not consistent with sound risk management or the pay-for-performance principle and shall not be a part of prospective remuneration plans;

(e) guaranteed variable remuneration is exceptional, occurs only when hiring new staff and where the institution has a sound and strong capital base and is limited to the first year of employment;

(f) fixed and variable components of total remuneration are appropriately balanced and the fixed component represents a sufficiently high proportion of the total remuneration to allow the operation of a fully flexible policy on variable remuneration components, including the possibility to pay no variable remuneration component;

(g) institutions shall set the appropriate ratios between the fixed and the variable component of the total remuneration, whereby the following principles shall apply:

(i) the variable component shall not exceed 100 % of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage;

(ii) Members States may allow shareholders or owners or members of the institution to approve a higher maximum level of the ratio between the fixed and variable components of remuneration provided the overall level of the variable component shall not exceed 200 % of the fixed component of the total remuneration for each individual. Member States may set a lower maximum percentage.

Any approval of a higher ratio in accordance with the first subparagraph of this point shall be carried out in accordance with the following procedure:

— the shareholders or owners or members of the institution shall act upon a detailed recommendation by the institution giving the reasons for, and the scope of, an approval sought, including the number of staff affected, their functions and the expected impact on the requirement to maintain a sound capital base;

— shareholders or owners or members of the institution shall act by a majority of at least 66 % provided that at least 50 % of the shares or equivalent ownership rights are represented or, failing that, shall act by a majority of 75 % of the ownership rights represented;

— the institution shall notify all shareholders or owners or members of the institution, providing a reasonable notice period in advance, that an approval under the first subparagraph of this point will be sought;

— the institution shall, without delay, inform the competent authority of the recommendation to its shareholders or owners or members, including the proposed higher maximum ratio and the reasons therefore and shall be able to demonstrate to the competent authority that the proposed higher ratio does not conflict with the institution's obligations under this Directive and under Regulation (EU) No 575/2013, having regard in particular to the institution's own funds obligations;

— the institution shall, without delay, inform the competent authority of the decisions taken by its shareholders or owners or members, including any approved higher maximum ratio pursuant to the first subparagraph of this point, and the competent authorities shall use the information received to benchmark the practices of institutions in that regard. The competent authorities shall provide EBA with that information and EBA shall publish it on an aggregate home Member State basis in a common reporting format. EBA may elaborate guidelines to facilitate the implementation of this indent and to ensure the consistency of the information collected;

— staff who are directly concerned by the higher maximum levels of variable remuneration referred to in this point shall not, where applicable, be allowed to exercise, directly or indirectly, any voting rights they may have as shareholders or owners or members of the institution;

(iii) Member States may allow institutions to apply the discount rate referred to in the second subparagraph of this point to a maximum of 25 % of total variable remuneration provided it is paid in instruments that are deferred for a period of not less than five years. Member States may set a lower maximum percentage.

EBA shall prepare and publish, by 31 March 2014, guidelines on the applicable notional discount rate taking into account all relevant factors including inflation rate and risk, which includes length of deferral. The EBA guidelines on the discount rate shall specifically consider how to incentivise the use of instruments which are deferred for a period of not less than five years;

(h) payments relating to the early termination of a contract reflect performance achieved over time and do not reward failure or misconduct;

(i) remuneration packages relating to compensation or buy out from contracts in previous employment must align with the long-term interests of the institution including retention, deferral, performance and clawback arrangements;

(j) the measurement of performance used to calculate variable remuneration components or pools of variable remuneration components includes an adjustment for all types of current and future risks and takes into account the cost of the capital and the liquidity required;

(k) the allocation of the variable remuneration components within the institution shall also take into account all types of current and future risks;

(l) a substantial portion, and in any event at least 50 %, of any variable remuneration shall consist of a balance of the following:

(i) shares or equivalent ownership interests, subject to the legal structure of the institution concerned or share-linked instruments or equivalent non-cash instruments, in the case of a non-listed institution;

(ii) where possible, other instruments within the meaning of Article 52 or 63 of Regulation (EU) No 575/2013 or other instruments which can be fully converted to Common Equity

Tier 1 instruments or written down, that in each case adequately reflect the credit quality of the institution as a going concern and are appropriate to be used for the purposes of variable remuneration.

The instruments referred to in this point shall be subject to an appropriate retention policy designed to align incentives with the longer-term interests of the institution. Member States or their competent authorities may place restrictions on the types and designs of those instruments or prohibit certain instruments as appropriate. This point shall be applied to both the portion of the variable remuneration component deferred in accordance with point (m) and the portion of the variable remuneration component not deferred;

(m) a substantial portion, and in any event at least 40 %, of the variable remuneration component is deferred over a period which is not less than three to five years and is correctly aligned with the nature of the business, its risks and the activities of the member of staff in question.

Remuneration payable under deferral arrangements shall vest no faster than on a pro-rata basis. In the case of a variable remuneration component of a particularly high amount, at least 60 % of the amount shall be deferred. The length of the deferral period shall be established in accordance with the business cycle, the nature of the business, its risks and the activities of the member of staff in question;

(n) the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the institution as a whole, and justified on the basis of the performance of the institution, the business unit and the individual concerned.

Without prejudice to the general principles of national contract and labour law, the total variable remuneration shall generally be considerably contracted where subdued or negative financial performance of the institution occurs, taking into account both current remuneration and reductions in payouts of amounts previously earned, including through malus or clawback arrangements.

Up to 100 % of the total variable remuneration shall be subject to malus or clawback arrangements. Institutions shall set specific criteria for the application of malus and clawback. Such criteria shall in particular cover situations where the staff member:

(i) participated in or was responsible for conduct which resulted in significant losses to the institution;

(ii) failed to meet appropriate standards of fitness and propriety;

(o) the pension policy is in line with the business strategy, objectives, values and long-term interests of the institution.

If the employee leaves the institution before retirement, discretionary pension benefits shall be held by the institution for a period of five years in the form of instruments referred to in point (l). Where an employee reaches retirement, discretionary pension benefits shall be paid to the employee in the form of instruments referred to in point (l) subject to a five-year retention period;

(p) staff members are required to undertake not to use personal hedging strategies or remuneration- and liability-related insurance to undermine the risk alignment effects embedded in their remuneration arrangements;

(q) variable remuneration is not paid through vehicles or methods that facilitate the non-compliance with this Directive or Regulation (EU) No 575/2013.

2. EBA shall develop draft regulatory technical standards with respect to specifying the classes of instruments that satisfy the conditions set out in point (l)(ii) of paragraph 1 and with respect to qualitative and appropriate quantitative criteria to identify categories of staff whose professional activities have a material impact on the institution's risk profile as referred to in Article 92(2).

EBA shall submit those draft regulatory technical standards to the Commission by 31 March 2014.

Power is delegated to the Commission to adopt the regulatory technical standards referred to in the first subparagraph in accordance with Article 10 to 14 of Regulation (EU) No 1093/2010.

Article 95 - Remuneration Committee

1. Competent authorities shall ensure that institutions that are significant in terms of their size, internal organisation and the nature, the scope and the complexity of their activities establish a remuneration committee. The remuneration committee shall be constituted in such a way as to enable it to exercise competent and independent judgment on remuneration policies and practices and the incentives created for managing risk, capital and liquidity.

2. Competent authorities shall ensure that the remuneration committee is responsible for the preparation of decisions regarding remuneration, including those which have implications for the risk and risk management of the institution concerned and which are to be taken by the management body. The Chair and the members of the remuneration committee shall be members of the management body who do not perform any executive function in the institution concerned. If employee representation on the management body is provided for by national law, the remuneration committee shall include one or more employee representatives. When preparing such decisions, the remuneration committee shall take into account the long-term interests of shareholders, investors and other stakeholders in the institution and the public interest.

Article 96 - Maintenance of a website on corporate governance and remuneration

Institutions that maintain a website shall explain there how they comply with the requirements of Articles 88 to 95.

4. BANKS' CORPORATE GOVERNANCE IN ITALY AND THE ROLE OF PRUDENTIAL SUPERVISORS

4.1 ITALIAN BANKING SECTOR EVOLUTION AND CHALLENGES

Like European banks (see para 1.3), also the Italian ones experienced deep changes over the last decade that make their governance more important than before, and are facing structural challenges that require a good governance to address.

Privatisation; consolidation, followed by the growth in size and market power of financial intermediaries; increased competition, spurred by the internationalisation and digitalization of financial industry and – in the case of Europe – the harmonization of national legislations and supervisory practices, are the most important changes in the Italian banking landscape.

According to Banca d'Italia Annual Report for 2021 [44], in the last decade the number of stand-alone banks has dramatically decreased (from 533 in 2012 to 141 in 2022), in line with the trends that we have described in para 1.1.4 for the whole Europe. The decline of the number of banks has been coupled with an increase of their average size, measured by their assets, which has grown from 5 billion euros in 2012 to above 24 in 2021. As already noticed for the entire European banking sector, an increase in competition has also been observed in Italy, due to Fintechs and Bigtechs entering the banking market.

At the end of 2021 the Italian banking system counted 141 intermediaries (149 in 2020), including 54 groups and 87 stand-alone banks. 11 banking groups were classified as significant institutions within the Single Supervisory Mechanism (SSM) and 2 additional ones have been classified as SI at the beginning of 2022. The share of the Italian banking system's total assets belonging to these 13 groups was 82%, suggesting not only a big size but also a high concentration of market power. As shown in Table 1 (para 1.3), the Herfindahl index for credit institutions and the share of total assets of five largest credit institutions has been growing constantly in Italy, like in other European countries.

Italian banks capital also has increased sharply in the last decade, as it has for their European peers (see para 1.1.3). According to Banca d'Italia figures, the CET1 ratio stood at 15.3 per cent at the end of 2021, almost doubled since 2007. Figure 7 shows the trend on Cet1 ratio for Italian banks. [45]

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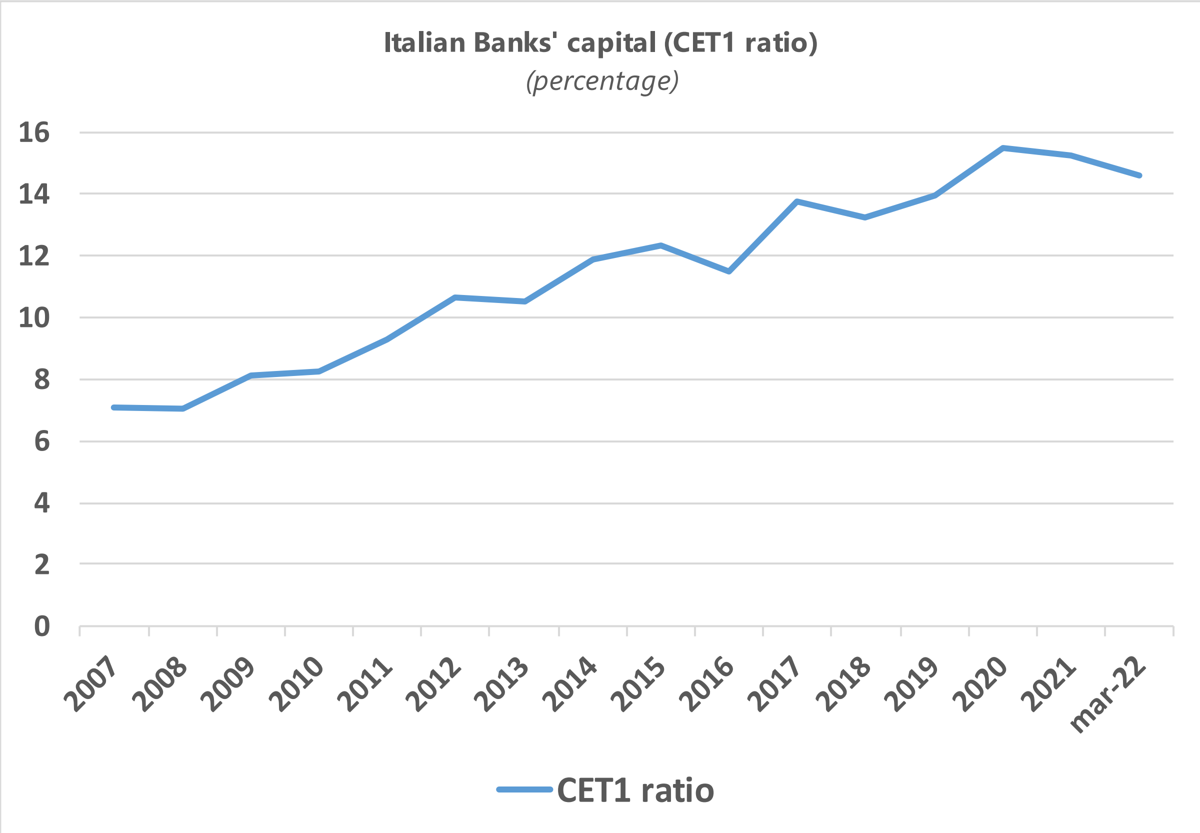
44 BANCA D'ITALIA (2022), p. 160

45 VISCO (2022) figure 10

Moreover, Italian banks have continued re-organizing: since 2012 the number of employees has decreased by 13% and the number of branches by 34%.

Figure 7



Source: Banca d'Italia

As their European peers, profitability, digitalization and ESG are structural challenges for Italian banks as well. Their importance has been recalled by the Bank of Italy Governor in a recent speech: "The difficult cyclical situation should not induce banks to reduce their efforts to respond to structural challenges, in particular those posed by the 'twin' green and digital transitions. Lowering our guard on these aspects would mean making up for lost time over the next few years, trying to catch up with the competition, rather than anticipating it and adjusting to the new rules.

I have often pointed out that it is essential to increase investment in new technologies, innovate products and processes, and upgrade the skills of bank managers and employees in order to respond to the competitive pressures from other market participants (regulated and non-regulated) and to increase efficiency. There is still a long way to go, but there are encouraging signs coming from our surveys.

Last year, a survey of banks showed that the use of artificial intelligence applications, even if still limited, is growing. These applications make risk estimates for customers more precise and speed up assessments of creditworthiness, favouring faster loan disbursement. The survey also indicated that while banks are aware of the need to adopt models that can be easily understood, they are not as alert to the need to strengthen their corporate governance arrangements against risks arising from outsourcing their assessment activities. Safeguards should also be strengthened to ensure that individual rights are adequately protected and that the methodologies used do not result in discriminatory practices."[46]

As already noticed for European banks, all this evidence calls for a greater importance of banks' governance for Italy as well.

4.2 The role of Prudential Supervisors

4.2.1 Banca d'Italia

Banca d'Italia has devoted particular attention to banks' corporate governance since well before the Great Financial Crisis shown how much this issue is crucial. Many speeches by former Governor Draghi and other Banca d'Italia board members [47] addressed this topic in years 2007-2008, and Italy was among the few jurisdictions (if not the only one) to have special and detailed rules on corporate governance of banks already in place in those years.

The first set of rules issued by the Bank of Italy was published for public consultation in 2007 and already contained the seeds of the rules on governance that were issued internationally after the Great Financial Crisis. The Italian rules were then reviewed more than once, to keep them aligned with the international and European developments. The relevant provisions are contained in the Supervisory Instructions for Banks (Communication 285, Title IV, chapters 1,2, and 3) which separately deal with corporate governance (role, tasks, powers, composition and functioning of the board), remuneration schemes and internal control functions.

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46 VISCO I. (2022) p. 12

47 See, for all: DRAGHI M. (2008); FINOCCHIARO A. (2007), TARANTOLA A. (2008)

Going through all these chapters would require an ad-hoc paper; suffice is to say here that – in substance – the Italian rules are coherent with the Basel standards and implement the European regulation, thus meeting the same objectives of the latter. In a nutshell,

a. boards' duties and responsibilities must be clear and clearly allocated;

b. boards must have the complete and clear picture of the overall risk borne by the bank. This implies – inter alia - fixing ex-ante the bank risk appetite and tolerance, and verifying its compliance ex-post; it also implies that strategic decisions must be taken by the board as a whole, and cannot be delegated to single members or senior managers. Among the topics that the board cannot delegate, specific evidence is given to digitalization and ESG transition, as already highlighted above in this paper;

c. board members must be skilled, diversified in terms of gender, age, experience and professional background, and have independence of mind [48]. The presence of non-executive and independent members, highly professional and therefore in a position to engage in discussion with the executives, must be ensured within the board. In addition, special internal committees, provided with advisory, inquiry and proposal powers in matters where risks of conflict of interests are higher (e.g. controls, appointments, remuneration), must be established in case of bigger and more complex banks. Further, an adequate representation within the board of the various components of the shareholder base (institutional investors, qualified minorities etc.) must be ensured, as a prerequisite for a positive internal dialogue;

d. board members must devote sufficient time to performing their functions, in addition to comply with limits on multiple directorships;

e. board functioning and information flows from and to the board must be effective, and the Chairman has a specific duty in ensuring the board smooth operation;

f. strong internal controls - independent from the CEO and from the business lines and with adequate authority - are required, and rules on the appointment, removal, reporting lines and remuneration of staff engaged in these areas are set in order to realize these goals;

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[48] These rules are coupled with fit-and-proper requirements, not contained in Bank of Italy regulation but in a Ministerial Decree which executes the EBA Guidelines on this topic. Note also that the Italian rules on board composition contain some distinctive features that are not present in the European rules: first, they set a maximum number of board members, depending on the size and complexity of the bank; second, they require a share of independent directors; third, more recently, a gender quota has been introduced.

g. remuneration must be balanced between fixed and variable components, long-term oriented and risk-adjusted; a detailed set of rules ensures such a goal. The rules specify the following: i) shareholders meeting must be involved in setting ex ante remuneration policies and equity-based compensation plans; ii) shareholders must be provided with ex post information on the practical implementation of remuneration policies; iii) large banks must set up a remuneration committee within the board, composed by a majority of independent directors, to provide advice and make proposals on directors remuneration and perform advisory tasks in relation to determining the criteria for managers remuneration; iv) remuneration policies and compensation schemes must be consistent with prudent risk management and the company's long-term objectives and must ensure an appropriate balance between their fixed and variable components. The variable component must further ensure an equilibrium between short-term and long-term performance and its consistency with the bank's actual and lasting results, and performance-related compensation must be risk-weighted; v) equity-based compensation or bonuses linked to performance are limited or prohibited for members of control bodies, non-executive directors (especially members of board committees such as the audit committee) and managers in charge of internal control.

Besides rules, corporate governance is one element that the banking supervisor assesses on an on-going basis. While the largest Eurozone banks (ie. intermediaries classified as Significant Institutions, SI) are supervised by the Single Supervisory Mechanism (see the following paragraph), smaller banks, classified as Less Significant Institutions (LSI), are subject to the full range of checks on operations by the Bank of Italy, carried out using methodologies established in conformity with European law and the SSM in the *Guide to supervisory activities*.

The Figure below is taken from the Guide, and shows the different element that are taken into consideration for LSI; as you may see, Governance is among them and, therefore, contributes to the overall score than each bank is being given at the end to the SREP process and determines the type of actions that the supervisor takes consequently.

Figure 8

LSI Supervisory Review and Evaluation Process – Assessment Flow

		A		B			
	DINAMICA VALUTATIVA	**Valutazione quantitativa**		**Valutazione qualitativa**		**SINTESI**	
		Punteggio automatico	Prospetti integrativi	Informazioni "sufficienti"	Informazioni "robuste"	Informazioni qualitative "sufficienti"	Informazioni qualitative "robuste"
a	MODELLO DI BUSINESS E REDDITIVITA'	**Redditività**		**Modello di Business**		A+B	
		1-4	+2/-1	+/-1			
b	SISTEMI DI GOVERNO E CONTROLLO			1-4	1-4	B	B
c	RISCHIO DI CREDITO	1-4	+2/-1	+/-1	1-4	A+B	media (A:B)
d	RISCHI DI MERCATO	1-4	+2/-1	+/-1	1-4	A+B	media (A:B)
e	RISCHIO DI TASSO D'INTERESSE	1-4	+2/-1	+/-1	1-4	A+B	media (A:B)
f	RISCHI OPERATIVI** E DI REPUTAZIONE	2-3		+/-1	1-4	A+B	media (A:B)
g	ADEGUATEZZA PATRIMONIALE	1-4	+2/-1	**Fase 2 ICAAP**		A+B	
				+/-1			
h	RISCHIO DI LIQUIDITA'	1-4	+2/-1	+/-1	1-4	A+B	media (A:B)

** Relativamente ai rischi operativi per i soli intermediari con sistemi di misurazione riconosciuti è possibile modificare il punteggio automatico sulla base di informazioni rivenienti dal modello interno.
La valutazione quantitativa, che individua il livello di esposizione al rischio, è espressa sulla base della seguente scala: basso=1; medio-basso=2; medio-alto=3; alto=4.
La valutazione quantitativa dei profili "modello di business e redditività" e "adeguatezza patrimoniale" esprime invece il grado di adeguatezza del relativo profilo (alto=1; medio-alto=2; medio-basso=3; basso=4).
La valutazione qualitativa è espressa sulla base della seguente scala: buono=1; sufficiente=2; mediocre=3; insufficiente=4.

Source: Banca d'Italia, Communication 269, 13° Update - 22 February 2022, p. 42

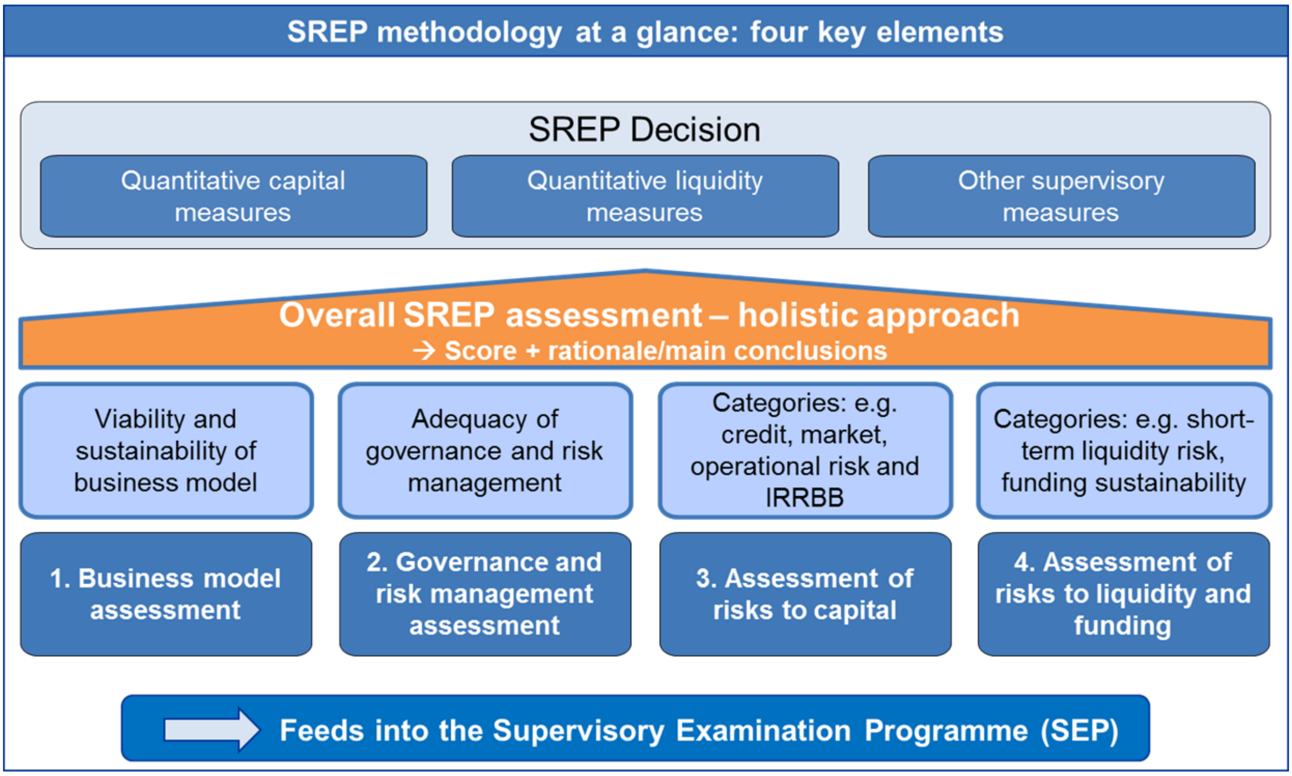
4.2.2 The SSM

As already mentioned, the ECB-SSM directly supervises Significant Institutions, on a day-to-day basis, while national supervisors continue to monitor the remaining banks.

The risks for SI are routinely assessed and measured by teams made up of supervisors from the ECB and national competent authorities (referred to as Joint Supervisory Teams, or JSTs). This routine evaluation and review is done by supervisors to assess the overall situation of each bank and see if it is complying with the appropriate European regulations, rules, and supervisory expectations. The Supervisory Review and Evaluation Process, or SREP, is how supervisors accomplish this.

Figure 9

The SSM SREP methodology



Source: ECB supervisory methodology

As described by the ECB, the SSM SREP is based on four elements (Figure 9) [49]:

1. A business model and profitability assessment;

2. An internal governance and risk management assessment;

3. An assessment of risks to capital on a risk specific basis: i.e. credit risk, market risk, operational risk, interest rate risk in the banking book (IRRBB) and the institution's internal identified risks in normal scenarios and under stressed conditions. These assessments feed into a preliminary determination of a capital requirement to cover the risks and an assessment of capital adequacy.

4. An assessment of risks to liquidity and funding on a risk specific basis: short-term funding, long-term funding, the institution's internal identified risks in normal scenarios

49 See ECB-SSM (2022A)

and under stressed conditions. These assessments feed into a preliminary determination of a liquidity requirement to cover the risks and an assessment of liquidity adequacy.

The assessment on internal governance and risk management covers three main aspects:

1. the institution's internal governance framework (including organizational structure, outsourcing, management body, risk management and compliance function and internal audit function). The definition of the roles and responsibilities of the pertinent individuals, functions, bodies, and committees within an institution, as well as how they collaborate, both in terms of a governance framework and in terms of actual behavior, are all included in internal governance. The internal governance structure also includes all of the organization's rules and conduct expectations, its corporate culture and values, establishing sound remuneration policies and practices, establishing an efficient administration and internal control system, identifying and incorporating the interests of all institution's stakeholders, conducting business in accordance with the principles of sound, prudent management, and adhering to any applicable legal and administrative requirements.

2. its risk appetite framework and risk culture;

3. its risk infrastructure, data aggregation and reporting.

The internal governance and risk management assessment is performed in three phases, shown in Figure 10:

1. Phase 1 relies on various information sources such as:

   - internal documentation outlining features related to, for example i) the management body in its supervisory and its management functions; ii) sub-committees (charter, role, composition, succession planning and the skills and experience of their members, relevant minutes on selected topics, etc.); iii) the risk appetite framework; and iv) remuneration policies, etc.;

   - the organizational structure (organizational chart identifying key functions and committees); reporting lines and allocation of responsibilities, including key function holders and information on their knowledge, skills and experience, absence of conflicts of interest, and reputation; relevant internal policies laying down governance-related processes and organizational arrangements, including those related to the internal control functions (such as internal audit/risk management/compliance policies, charter, plans and findings reports, etc.).

2. Phase 2 encompasses a limited list of questions rooted in regulatory references relating to internal governance and risk management arrangements.

3. Phase 3 aims to check whether the internal governance framework works in practice and allows the institution to comply with regulatory requirements. It is carried out from a holistic, group-wide perspective.

Figure 10

Internal governance and risk management assessment process

Phase 1	Information gathering and preliminary analysis, mainly based on information provided bythe institution itself.
Phase 2	Compliance check of relevant CRD articles relating to internal governance and risk management.
Phase 3	Supervisory assessment including, but not limited to[1]: • internal governance assessment (management body, organisational structure, internal audit, risk management and compliance function, outsourcing); • risk appetite framework, risk culture and remuneration; • risk infrastructure, data aggregation and reporting.

Source: ECB supervisory methodology

5. CONCLUSIONS

Banks' corporate governance is crucial for many reason: for their own sound and prudent management (micro view), for financial stability (macro view), for the economy at large. In addition, good governance is a key element for capital raising, and capital is crucial for banks.

Market developments - with European and Italian banks becoming bigger, more complex and with an increasing market power – and the evidence emerged in the Great Financial Crises suggest that banks' governance matters even more than the pre-crisis conventional wisdom thought, and called for a deep review of banks corporate governance rules and for a renewed attention of policy makers and prudential supervisors on this issue.

Such an intensive review of corporate governance rules dramatically increased the quality of banks' corporate governance "on-the-books"; however, I think that the structural challenges that the banking industry is now facing - such as profitability, digital transformation and environmental social and governance transition – emphasize the importance for banks of actually having in place good corporate governance arrangements.

Indeed, such challenges will require a deep review of their business models, that I personally believe banks will be able to realize only with efficient boards (as well as good managers and effective control systems) in place. While to achieve these goals all the elements of a good corporate governance that are described in this paper are important, in such a scenario two board features, in my opinion, will be key. The first is the board capacity to retain control and be the ultimate decision-making authority on the bank business model, its developments and changes and its connected risks: the challenges ahead are so important that a good "tone from the top" will be decisive. The second is board diversity: having members with different skill, knowledge, age and gender will help board decisions to be supported by adequate expertise, sufficient risk awareness and management, appropriate independence from the banks' managers; for instance, in order to ensure a smooth digital and environmental transition, having IT and ESG experts as board members would be extremely important; another example could be having (more) women in the board, which would help to avoid group-thinking behaviour, stimulating discussion and keeping a grip on risk awareness and on long-term goals. [50]

[50] According to the (vast) literature on gender diversity, these are the most frequent positive effects of women presence in the boards. See, for all, ADAMS, R. and FERREIRA, D. (2008)

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