

## **Italy: Detailed Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision**

This Detailed Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision for **Italy** was prepared by a staff team of the International Monetary Fund. It is based on consultations with the authorities and other information available at the time it was completed on **June 2003**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of **Italy** or the Executive Board of the IMF.

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**ITALY**

**DETAILED ASSESSMENT OF COMPLIANCE WITH  
THE BASEL CORE PRINCIPLES FOR EFFECTIVE  
BANKING SUPERVISION**

APRIL 2004

INTERNATIONAL MONETARY FUND  
MONETARY AND FINANCIAL SYSTEMS DEPARTMENT

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## GLOSSARY

ABI	Italian Banking Association
BCPs	Basel Core Principles for Effective Banking Supervision
BFS	BI Banking and Financial Supervision Department
BL	1993 Banking Law
BI	Banca d'Italia
CADS	Company Accounts Data Service
CAL	Compulsory Administrative Liquidation
CCR	Central Credit Registry
CLFI	1998 Consolidated Law on Financial Intermediation
Consob	Italian Companies and Stock Exchange Commission
COVIP	Italian Supervisory Agency for Pension Funds
CSD	Central Securities Depository
ECB	European Central Bank
ESCB	European System of Central Banks
EU	European Union
FSIs	Financial Soundness Indicators
IAS	International Accounting Standards
ICCS	The Inter-Ministerial Committee on Credit and Savings
IDPF	Interbank Deposit Protection Fund
IMF	International Monetary Fund
IRB	Internal Rating Benchmark Approach
ISVAP	Italian Supervisory Authority for Private Insurance Companies
LGD	Loss Given Default
MEF	Minister of the Economy and Finance
MFD	Monetary and Financial Systems Department
MoE	Ministry of the Economy and Finance
MoUs	Memoranda of Understanding
NCBs	National Central Banks
PD	Probability of Default
SDBI	BI Statute
SICAV	Open-end Investment Companies
SIMs	Securities Firms
SPVs	Special Purpose Vehicles
UIC	Italian Foreign Exchange Office

## I. BACKGROUND

### A. General

1. **An assessment of the Italian supervisory system's compliance with the Basel Core Principles for Effective Banking Supervision (BCPs) was conducted on-site during June 16–27, 2003 by Mr. Keith Bell and Ms. Maria Nieto as part of an IMF-led mission.**<sup>1</sup> The Italian supervisory system was found to be of a high standard, achieving full compliance with 24 of the 30 BCPs. The Banca d'Italia (BI) conducts a comprehensive, sophisticated, and continuous process of off-site monitoring, closely integrated with a cycle of thorough on-site inspections. The cycle of on-site inspections is long; for small banking institutions identified by off-site monitoring as being without significant weaknesses, inspections are conducted on a three-year cycle and at longer intervals (not more than six years) for large banks. In line with the rapid developments in the scope and complexity of the banking industry, the BI is increasingly relying on focused and thematic inspections, especially regarding the large bank groups. Taking into account thematic inspections, the inspection cycle for large banks has recently been shortened to no longer than three years. There are areas where further regulatory strengthening is recommended, including loan evaluation and loan-loss provisioning, connected lending, and legal protection of supervisors.

### B. Information and Methodology Used for the Assessment

2. The assessment is based on several sources: (i) a self-assessment prepared by the Italian authorities in March 2002; (ii) detailed interviews with senior officials and their technical teams at the BI; (iii) laws, regulations, and other documentation on the supervisory framework and on the structure and development of the Italian financial sector; and (iv) meetings with officials of the Ministry of the Economy and Finance (MoE), ISVAP and Consob, market participants, and representatives of selected financial institutions, industry associations, and members of the accounting and auditing professions.

3. The assessment was performed in accordance with the guidelines set out in the Core Principles Methodology.<sup>2</sup> The assessment of observance of the BCP is not, and is not intended to be, an exact science. Banking systems differ across countries, as do their domestic circumstances. Furthermore, banking activities are changing rapidly around the world, and theories, policies, and best practices of supervision are swiftly evolving. Nevertheless, it is internationally acknowledged that the BCPs are seen as minimum standards.

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<sup>1</sup> The mission was led by Mr. V. Sundararajan (Deputy Director, Monetary and Financial Systems Department—MFD) and included Mr. Alfredo Leone and Ms. Andrea Maechler (both MFD). Mr. Keith Bell, banking supervision expert, is a consultant and was formerly with the Office of the Superintendent of Financial Institutions, Canada; Ms. Maria Nieto, banking regulation expert, is from the Bank of Spain.

<sup>2</sup> Issued by the Basel Committee, October 1999.

4. The detailed assessment is based on the legislation in force at the time of the assessment and does not address proposed plans of reform of the Italian financial sector, initiated after the mission left the site but before the final publication of the report.

5. The assessment focuses only on the regulatory and supervisory framework of Italy's banking sector. A number of other issues relevant to the soundness of the banking sector as a whole—including interlinkages of the banking sector with other financial sectors, the role of banks as “brokers” for financial instruments, related transparency issues, and regulation in nonbank financial markets—are beyond the scope of this assessment and shall be dealt with fully in the context of the upcoming FSAP requested by the authorities.

6. The assessors had full cooperation from the Italian authorities and received all the information necessary for the assessment.

### C. Institutional and Macro Prudential Setting, and Market Structure Overview

7. **Since 1990, the Italian banking system has undergone a rapid process of consolidation.** The number of banks in Italy fell by 26 percent from 1,100 in 1990 to 814 in 2002; in the same time span 583 mergers and acquisitions operations took place. In 2002, there were 253 commercial banks (representing 80 percent of total bank assets); 461 mutual banks (5 percent of total bank assets); 40 cooperative banks (11 percent of total bank assets); and 60 branches of foreign banks (4 percent of total bank assets) (Table 1). The Italian financial sector included also 158 securities firms; 142 asset management companies; and 316 supervised financial companies. A large number of financial institutions are organized in groups operating over an interregional or nationwide network. In 2002, these groups represented 87 percent of total bank assets, of which the top three and five Italian bank groups accounted for, respectively, 38 percent and 52 percent of total bank assets.

Table 1. Financial Sector Structure, 1992–2002

	Number of Institutions		Branches in Italy		Number of Groups		Total assets (Euro billion)		Total assets (percent of total)		Deposits + Bonds (percent of deposits)	
	1992	2002	1992	2002	1992	2002	1992	2002	1992	2002	1992	2002
<i>Banking sector</i>	1,069	814	19,815	29,926	75	74	1147.8	2148.5	100.0	100.0	100.0	100.0
Banks (limited companies)	231	253	14,072	22,924	51	48	946.7	1721.8	82.5	80.1	82.8	80.3
<i>of which</i> : public-owned 1/	49	3	3,054	10	9	-	419.1	2.7	36.5	0.1	37.7	0.1
<i>of which</i> : foundation-owned 2/	88	40	7,138	3,450	33	14	343.6	220.8	29.9	10.3	29.8	10.6
Cooperative banks	104	40	3,712	3,704	23	18	136.7	232.8	11.9	10.8	12.4	11.7
Mutual banks	694	461	1,979	3,192	1	8	39.3	106.3	3.4	4.9	4.7	7.2
Branches of foreign banks	40	60	52	106	-	-	25.1	87.6	2.2	4.1	0.1	0.8
<i>of which</i> : incorporated in EU	15	48	21	91	-	-	15.7	77.5	1.4	3.6	0.0	0.7
<i>Securities firms</i>	287	158	-	-	-	-	-	24.6	-	-	-	-
<i>of which</i> : bank-controlled	126	64	-	-	-	-	-	22.1	-	-	-	-
<i>Asset management companies</i> 3/	60	142	-	-	-	-	31.3	553	-	-	-	-
<i>of which</i> : bank-controlled 4/	-	88	-	-	-	-	20.9	427	-	-	-	-
<i>Financial companies</i> 5/	-	316	-	-	10	4	-	126.5	-	-	-	-

Source: BI

1/ Banks controlled by the State or by other public entities.

2/ Participation of Foundations in banks.

3/ Since 1999 total assets for Asset management companies include amounts relative to individual portfolio and pension funds. These data are netted out of the amounts of individual portfolios that are invested in mutual funds.

4/ Participation in financial companies.

5/ Includes only financial companies listed in the Special register held by BI.

**8. The banking sector remains a core funding source for the domestic economy.**

Households hold almost three quarters (70 percent) of their liabilities in the form of short-, medium- and long-term bank loans, while firms hold less than one third of their liabilities in bank loans, with the remaining being primarily held in shares (around 50 percent). Between 1996 and 2002, household indebtedness (as a percent of GDP) rose from 19 percent to 24 percent, largely driven by real estate investment.<sup>3</sup> The leverage of the corporate sector (debt as a percent of equity) fell from 103 percent in 1996 to 56 percent in 2000 before rising to 69 percent in 2002. While Italian corporate bonds are held primarily by private investors (95 percent),<sup>4</sup> Italian government securities are held by a broader set of investors, including private investors (45 percent), nonbank residents (43 percent) and domestic banks (9 percent).

**9. Since 1992, the state has significantly reduced its direct ownership in the Italian banking system.** While in 1992 banks controlled by the state or by (nonprofit) foundations (Fondazioni) accounted for 66 percent of total bank assets, successive waves of privatization have drastically shrunken the share of state ownership in the banking system to 10 percent in 2002. As of end August 2003, Fondazioni have lost control in all large bank groups and own a majority stake<sup>5</sup> in only 18 small banks representing less than 4 percent of total bank assets.<sup>6</sup> Market discipline has improved with the greater transparency regarding the ownership structure of banks and the reduction in cross-shareholdings.<sup>7</sup> There are still a few cases where cross-shareholdings allow a group of Fondazioni to control jointly more than 50 percent of a bank's capital.

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<sup>3</sup> The share of residential loans to total loans rose from 8 percent in 1997 to 12 percent in 2002.

<sup>4</sup> Private investors comprise private sector firms, pension funds, insurance companies and collective investment undertakings.

<sup>5</sup> I.e., a majority stake of the voting rights at ordinary general meeting.

<sup>6</sup> The government has attempted to restrict the significant role of the (nonprofit) foundations (Fondazioni) in the financial sector, requiring a single Fondazione (or two or more Fondazioni which jointly control a bank) to: (i) sell the majority shareholding in a bank before June 2003 or entrust them to an independent asset management company until June 2006, at which point they would have to be sold; and (ii) prohibit a Fondazione (or two or more Fondazioni which jointly control a bank) from appointing the majority of a bank's board of directors. However, in 2003, these reforms were appealed to the Supreme Court and in June 2003, a government decree abolished the compulsory divestment of small Fondazioni (with assets below €200 million) and the deadline for divesting controlling shareholdings by major foundations was postponed until December 2004. In August 2003, this deadline was extended to December 2005. It is expected that the Fondazioni will be allowed to keep controlling stakes in small banks, as these tend to supply credit to small and medium enterprises through their regional network, but will be required to clarify the appointment procedures for their board members.

<sup>7</sup> There are cases where majority shareholders have agreed to restrict their voting rights for the benefit of minority-holding Fondazioni. Shareholders are required to disclose the existence and content of such private agreements to the BI; for listed banks this information is also disclosed to the public. For more information on ownership structure and shareholder agreements, see also the description of BCP 4 below.

10. **Over the last decade, Italian banks' asset management products grew strongly, providing an important source of growth in commission income.** This trend is reflected in banks' greater income diversification. At the start of the 1990s, over 75 percent of banks' gross income came from the traditional banking business of deposit-taking and lending. Ten years later, net interest income accounted for only 52 percent of gross income.

11. **The integration between the banking and insurance sector is increasing, although financial conglomerates remain relatively less developed than in other large financial systems.** Italian banks have expanded the range of their financial services to respond to customers' greater demand for diversified investment products, in line with a general trend in Europe as well as worldwide. The major cross-linkages between insurance companies and banks take place mainly through commercial agreements that allow banks to sell standard life insurance products.<sup>8</sup> So far, the creation of major bancassurance groups has not taken place in Italy, as has been the case in some other European countries. At end-2002, Italian banks had equity holdings in 74 insurance companies, of which they controlled 32 (representing less than 20 percent of insurance companies total assets). Insurance companies held interests in 32 Italian banks, including controlling interests in seven small banks (representing 0.4 percent of total bank assets).

12. **The life insurance industry grew rapidly over the last few years, more than doubling its total premium from €26.5 million in 1998 to €55 million in 2002, representing 4.4 percent of GDP.** At end-2002, 202 insurance companies (life and nonlife) were operating in the Italian financial sector, of which eight were companies incorporated abroad (five in the EU, and three in non-EU countries) and ten were listed on the stock exchange. In 2002, life insurance companies held up to 92 percent of their investment in bonds and less than one percent in real estate. Re-insurance activities remain limited, accounting for 4.4 percent of total life insurance premium.

### **Italy's financial stability framework**

13. The Italian banking system seems to exhibit a high degree of resilience to possible macroeconomic shocks, as supported by the evolution of some Financial Soundness Indicators (FSIs) (Table 2) and by the results of various model simulations, including stress tests, conducted by the BI. The mission did not conduct an independent assessment of the soundness of the banking sector, its potential vulnerabilities, and the main risks it faces. However, the evolution of Italy's FSIs and discussions with the authorities and industry representatives suggest some key challenges looking forward. These include managing the high level of nonperforming loans and maintaining adequate provisions for credit losses and sustaining cost-cutting and restructuring efforts.

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<sup>8</sup> According to a recent BI survey, in 2002, 80 percent of new life insurance premiums were collected through banks' branches.

Table 2. Financial Soundness Indicators, 1996–2002 1/

	1996	1997	1998	1999	2000	2001	2002
	(In percent, unless otherwise noted)						
<i>Core Set</i>							
<i>Deposit-taking institutions</i>							
<i>Capital adequacy 2/</i>							
Regulatory capital to risk-weighted assets 2/	12.2	11.4	11.3	10.6	10.1	10.4	11.2
Regulatory tier 1 capital to risk-weighted assets 2/	10.5	9.7	9.4	8.6	7.8	7.8	8.2
<i>Asset quality</i>							
Nonperforming loans to total gross loans	13.9	12.6	11.8	9.8	7.8	6.7	6.5
Nonperforming loans net of provisions to capital	64.4	58.4	51.1	38.9	30.1	26.8	25.0
Sectoral distribution of loans to total loans							
General government	9.0	8.8	8.0	7.6	6.4	5.8	5.3
Financial corporations	11.4	12.7	12.5	13.0	14.5	14.7	14.6
Nonfinancial corporations and sole proprietorships	63.3	61.7	61.3	59.4	59.2	59.3	59.1
Building and construction	9.5	8.6	8.3	7.6	7.0	6.8	6.9
Consumer households	16.3	16.8	18.2	20.0	19.9	20.2	21.0
Large exposures to capital 2/	63.7	66.5	44.7	66.1	66.9	66.8	60.2
<i>Earnings and profitability</i>							
Return on assets	0.2	0.1	0.5	0.6	0.8	0.6	0.5
Return on equity 3/	0.3	1.5	7.4	9.6	11.5	8.8	6.2
Interest margin to gross income	75.7	71.6	60.6	55.0	52.2	52.3	56.7
Noninterest expenses to gross income	66.8	68.8	60.8	60.6	55.9	55.3	59.8
<i>Liquidity</i>							
Liquid assets to total assets (liquid asset ratio)	13.3	11.8	12.9	11.3	8.9	8.7	7.8
Liquid assets to short-term liabilities	43.4	36.9	37.2	34.0	27.1	26.0	23.4
<i>Sensitivity to market risk</i>							
Duration of assets	7M-11D	6M-1D	8M-13D	7M-28D	7M-18D	7M-21D	8M-18D
Duration of liabilities	4M-9D	4M-19D	7M-7D	6M-26D	6M-20D	7M-1D	8M-4D
Net open position in foreign exchange to capital 2/	...	5.9	5.2	4.4	5.6	4.9	3.9
<i>Encouraged Set</i>							
<i>Deposit-taking institutions</i>							
Supervisory capital to assets 2/	6.6	6.5	6.8	6.7	6.8	7.1	7.4
Average risk weight (ratio of risk-weighted assets to assets)	0.54	0.57	0.60	0.63	0.67	0.68	0.67
Geographical distribution of loans							
North	54.5	56.0	57.1	59.3	61.9	62.2	62.2
Center	28.5	27.5	26.9	25.2	23.9	24.1	24.1
South	17.0	16.5	16.0	15.6	14.2	13.7	13.6
Geographical distribution of nonperforming loans							
North	33.2	34.0	33.7	34.8	37.0	37.9	40.4
Center	27.5	29.7	29.7	26.5	28.0	27.1	27.4
South	39.3	36.4	36.8	38.7	35.0	34.9	32.2
Gross asset position in financial derivatives to capital	21.6	31.3	31.3	25.6	36.8	50.8	46.8
Gross liability position in financial derivatives to capital	21.5	31.9	32.7	25.1	25.2	37.0	44.9
Trading income to total income	10.5	8.8	9.1	5.1	3.9	3.5	2.1
Personnel expenses to noninterest income	64.0	62.1	60.4	58.4	56.3	54.5	54.6
Spread between reference lending and deposit rates (CDs up to 6 months)							
Household lending (average for new loans)	5.0	4.4	3.1	3.1	3.0	3.3	3.0
Corporate lending (average for new loans)	2.9	2.0	1.4	2.2	2.3	2.2	2.1
Customer deposits and bonds to total (noninterbank) loans 4/	127.1	120.0	116.4	107.8	100.3	100.5	103.7
Foreign currency-denominated loans to total loans 4/	8.3	9.4	9.1	5.9	6.1	5.5	4.2
Foreign currency-denominated deposits to total deposits	3.3	4.3	4.3	4.1	4.5	4.5	4.7
Net open position in equities to capital	...	2.8	3.7	5.2	5.7	11.4	2.6
<i>Market liquidity</i>							
Average bid-ask spread in the securities market	0.07	0.05	0.02	0.04	0.05	0.04	0.03
Average daily turnover ratio in the securities market	...	...	...	0.96	0.89	0.90	0.81
<i>Nonbank financial institutions</i>							
Assets to total financial system assets	21.3	26.2	34.4	37.4	36.9	36.6	34.6
Assets to GDP	39.8	53.2	76.7	92.3	92.5	89.8	85.5
<i>Corporate sector</i>							
Total debt to equity	103.4	86.9	73.4	57.2	56.2	65.9	68.9
Return on equity	6.4	8.0	8.7	9.3	7.3	4.8	...
Earnings to interest expenses	152	175	276	341	265	214	233
Corporate net foreign exchange exposure to equity	...	...	-6.7	-3.1	-3.5	-2.6	-2.6
Number of applications for protection from creditors 5/	...	...	1,255	1,164	571	605	883
<i>Household sector</i>							
Household debt to GDP - Italy	18.6	19.0	19.8	22.0	22.8	22.9	24.1
Household debt service and principal payments to income	1.8	1.7	1.6	1.3	1.8	1.9	1.7
<i>Real estate markets</i>							
Real estate prices (1990=100, deflated by CPI)							
Residential	97.9	98.5	94.6	92.3	93.6	98.3	106.9
Commercial	39.2	37.1	45.9	50.8	62.9	...	...
Residential real estate loans to total loans	...	7.5	8.3	9.6	10.3	10.3	12.0
Commercial real estate loans to total loans	9.5	8.6	8.3	7.6	7.0	6.8	6.9

Sources: Bank of Italy; and Eurostat.

1/ Some data were provided directly by the Bank of Italy and have not been sourced to a published document.

2/ Consolidated data.

3/ Net earnings include the net change in the fund for general banking risks; capital and reserves are calculated as centered 13-month average.

4/ Including loans to nonresidents and excluding bad loans.

5/ Special administration and private preemptive agreements.

14. **Despite significant improvements over the last few years, the quality of banks' loan portfolios remains moderate.** The ratio of nonperforming loans net of provisions to capital fell to 25 percent in 2002 from its record high of 64 percent in 1996, but it remains high relative to other European countries. Non-performing loans (*“sofferenze”*) and Substandard Loans (*“incagli”*) account for 3 percent of banks' assets. Securitization has allowed some Italian banks to reduce the level of problem loans in their portfolios and better manage credit risk.<sup>9</sup> Looking forward, continuing slow economic growth in Italy and abroad and increasing corporate indebtedness could contribute to pressures on the quality of the banks' loan portfolio.<sup>10</sup> In 2002, the largest share of credit exposure of the banking system was the nonfinancial sector (59 percent), followed by the household sector (21 percent), the financial sector (15 percent), and the government sector (5 percent).

15. **Rising capital buffers mitigate banks' vulnerability to external shock.** Given the significant increase in subordinated liabilities and strong credit growth, in 2001 the BI called for a significant increase in the capital of the main banking groups. In response, between 2000 and 2002, on the aggregate the largest 14 bank groups increased their Tier 1 capital ratio from 5.4 percent to 6.1 percent and their overall capital ratio from 8.7 percent to 10.3 percent.<sup>11</sup> The solvency ratio of the banking system, which had fallen progressively from 12 percent in 1994 to 10.1 percent in 2000, rose to 11.2 percent in December 2002.

16. **Despite the improvements achieved so far, cost-cutting and restructuring remain key challenges for Italian banks, with several conjunctural factors putting pressures on costs and income.** Since the mid-1990s, banks progressively reduced their operating expenditures, and the ratio of non-interest expenses to gross income fell from 67 percent in 1996 to 55 percent in 2001. More recently, however, with the poor performance of the financial markets, non-interest income, particularly commission-related activities, slowed down and the ratio of non-interest expenses to income increased again to 60 percent in 2002.<sup>12</sup> With net interest income also declining generally since 1996, Italian banks experienced a 7.5 percent reduction in operating profits in 2002 and return on equity declined to 6.2 percent. In the current low interest rate environment, and with deposit interest rates being sticky downward, any further fall in interest rates would translate primarily into lower interest rate margins. A sharp reduction in operating costs, or an increase in productivity

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<sup>9</sup> Partly due to tax incentives, which encouraged banks to securitize their bad loans, the ratio of nonperforming loans to total loans fell from its record high of 14 percent in 1996 to 6.5 percent in 2002. This ratio, however, is still very high in comparison to other industrialized countries, except Japan.

<sup>10</sup> Corporate sector debt-to-equity ratio increased to 69 percent in 2002 from 56 percent in 2000.

<sup>11</sup> In 2001, the BI encouraged the 14 largest bank groups to reach capital adequacy targets of 6 percent for Tier 1 ratios and 10 percent for overall capital ratios. In 2002, the number of banking groups that achieved the target values rose from four to seven for core capital and remained at six for overall capital.

<sup>12</sup> The number of bank branches increased from 26,300 in 1998 to 29,900 in 2002. Most of these branches are small.

would therefore be necessary to balance the impact of downside risks of a further reduction in interest rates.

17. **The prospects for costs and income, in conjunction with the ongoing and envisaged structural changes, translate into pressures for further consolidation in the Italian banking sector.** Achieving a critical mass would be a key factor determining the success of Italian banks in facing future challenges in the banking industry.

18. **The BI has a sophisticated system for monitoring the stability of Italy's financial system.** It has established a highly comprehensive reporting system, which requires banks to submit very detailed data on the activity performed domestically and at the foreign branches, both on an individual and consolidated basis. This data allows the BI to monitor the evolution of a wide range of financial indicators. For example, in its *Central Credit Registry (CCR)*, the BI records detailed information on individual credit relationships.<sup>13</sup> Also, the BI monitors the distribution of bank credit to firms by statistical estimates of borrowers' bankruptcy risk, by matching credit information contained in the CCR with financial statements collected in private data bases (the *Company Accounts Data Service* and *Cerved Data Service*).<sup>14</sup> At the microprudential level, the monitoring system focuses on banks' risk areas and their organizational structure. A rating methodology, whose acronym is PATROL, focuses on five components: capital adequacy, asset quality, organization, profitability, and liquidity. An overall rating for each bank is derived based on the five components and additional available qualitative information.

19. **At the macroprudential level, the BI examines four broad types of risks: credit risk, market risk, country risk, and interest rate risk.** Given its access to a large pool of highly detailed data, the BI has adopted a "bottom-up" approach to financial surveillance. For credit risk, the BI monitors the overall credit quality (bad loans, and sectoral exposures) and estimates one-year default probabilities (PDs) over one business cycle of corporate borrowers. Based on these indicators, the BI conducts various types of model simulations and stress tests on a yearly basis.<sup>15</sup> For interest rate risk, the BI conducts periodic stress tests

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<sup>13</sup> The CCR records detailed monthly information on customer loans above a certain amount (€75,000), all bad debts, and interest rates on individual loans for a sample covering approximately 70 percent of all short-term loans.

<sup>14</sup> The Company Account Data Service contains balance sheet information and income statements for 40,000 medium-and large-sized nonfinancial corporations, whereas the Cerved Data Service includes slightly less detailed information for 500,000 nonfinancial institutions.

<sup>15</sup> In particular, the BI conducts three types of tests: (i) it estimates the direct effects on banks' balance sheets of a macroeconomic shock with characteristics similar to those experienced in Italy's sudden corporate sector deterioration in 1993–94; (ii) it estimates the consistency between loan interest rates differentials and the cost of regulatory capital, by risk categories and borrowers' size, as implied by the Basel II proposal; and (iii) it estimates the probability of a bank being downgraded in its PATROL (CAMEL) rating. In the future, the BI intends to extend its macroeconomic model to take into account the linkages between the real sector and the financial sector and their impact on credit risk.

according to the standard Basel procedure, which estimates the economic loss as a share of regulatory capital due to a given shift (from 100 b.p. to 60 b.p.) in the yield curve. The BI measures also banks' exposure to market risk on a continuous basis, and assesses exposures to country risk on a quarterly basis.

**20. Preparations for Basel II and the adaptations for the new IAS have provided a major push toward strengthening credit risk management.** The large banks are at an advanced stage of preparation for adopting Basel II and IAS requirements, supported by the BI and the Italian Banking Association (ABI). At this time, two banks, accounting for roughly 30 percent of the system's total assets, have had their market risk models validated by the BI and a few more banks are in the process of submitting their models to the BI. Reflecting the specifics of the Italian credit granting practices and loan recovery environment, Italy was allowed a five-year transition period to use 180-day past-due as the basis for estimating default rates (instead of the proposed 90-day past-due criteria in Basel II).<sup>16</sup> The transition period will provide a valuable opportunity for banks, the BI, and the government to align credit practices, credit risk monitoring, and loan recovery arrangements with international practices. The BI works in close cooperation with all major banks to follow their progress in strengthening their data systems and credit processes in order to adopt the IRB approach to capital adequacy; most of these banks are already using internal rating systems in the credit evaluation process of corporate customers.

**21. All insurance undertakings, including mutual insurance companies, are supervised and regulated by ISVAP (the *Istituto per la Vigilanza Sulle Assicurazioni Private e di Interesse Collettive*).** Since 1998, ISVAP is a fully autonomous public institution established by law. Its responsibilities include the solvency of insurance companies, the sound development of the insurance sector, and transparency and fairness in customer relations.<sup>17</sup> The promotion of competition is regulated by the Antitrust Agency, to which ISVAP sends, upon request, its non-binding opinion. ISVAP conducts both off-site (based on annual accounts and market data) and on-site examinations. In the case of violations, ISVAP has the power to propose sanctions to the Ministry of Production Activities and to impose them. The major supervisory challenges include the implementation of supervision on a consolidated basis,<sup>18</sup> the prevention of cross-sectoral regulatory arbitrage,<sup>19</sup> and the adoption

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<sup>16</sup> See the third consultative paper on the new Basel Capital Accord issued in April 2003 by the Basel Committee on Banking Supervision (paragraph 414, page 80).

<sup>17</sup> The President of ISVAP is appointed by a decree of the President of the Republic, while the six members of its Board of Directors are appointed by a decree of the Prime Minister.

<sup>18</sup> EU Directive 98/78/EC, laying down the principles of consolidated supervision for insurance groups, has been transposed into national legislation. ISVAP is currently drawing up the relevant supervisory rules and regulations.

<sup>19</sup> Italy must transpose the new EU Directive on the supplementary supervision of credit institutions, insurance undertakings, and investment firms in a financial conglomerate (EU Directive 2002/87/EC) in its national legislation by August 2004.

of risk management techniques in line with new financial products, such as securitization operations.<sup>20</sup>

22. **Italian securities market is supervised and regulated by the Italian Companies and Stock Exchange Commission (Consob)**, It aims at ensuring: (i) transparency and correct behavior of securities market participants; (ii) disclosure of complete and accurate information to the investing public by listed companies; (iii) accuracy of the facts represented in the prospectuses to offerings of transferable securities to the investing public; and (iv) compliance with regulations by auditors entered in the special register. Moreover, it conducts investigations regarding potential infringements of insider dealing and market manipulation laws. Consob manages its operating expenses autonomously on the basis of an annual budget approved by the Commission and its annual accounts are audited by the State Audit Office.

#### **D. Summary of Assessment of Observance of the BCPs**

23. The 30 BCPs are grouped into seven major categories as follows: (i) preconditions for effective banking supervision (BCP 1(1)–1(6)); (ii) licensing and structure (BCPs 2–5); (iii) prudential regulations and requirements (BCPs 6–15); (iv) methods of ongoing supervision (BCPs 16–20); (v) information requirements (BCP 21); (vi) formal powers of supervisors (BCP 22); and (vii) cross-border banking (BCPs 23–25).

24. **Overall, Italy’s observance of the BCPs is high.** The Italian supervisory system was found to be in compliance with twenty-four BCPs; largely compliant with five; and non-compliant with one BCP. On BCP 8 (Loan Evaluation and Loan-Loss Provisioning), BCP 10 (Connected Lending), BCP 14 (Internal Control Audit), BCP 19 (Validation of Supervisory Information), and BCP 21 (Accounting Standards), the system was assessed as “largely compliant.” On BCP 1(5) (Legal Protection for Supervisors), the system was assessed as “non-compliant.”

#### **Preconditions for effective banking supervision (BCP 1(1)–BCP 1(6))**

25. **The broad objectives and responsibilities of the credit authorities are set out in the legislation (BCP 1(1)).**<sup>21</sup> Under the law, the Inter-Ministerial Committee on Credit and Savings (ICCS) is the administrative body, which issues broad guidelines on prudential supervision in the area of credit activities and the protection of savings. In practice, the BI takes the initiative in recommending regulatory and supervisory policy and has operational independence on day-to-day application of supervisory methods (BCP 1(2)). The BI has the

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<sup>20</sup> According to ISVAP, insurance companies are not yet major sellers of credit risk insurance through Special Purpose Vehicles (SPVs).

<sup>21</sup> According to Article 1(1)(a) of the 1993 Banking Law (1993 BL), the Italian credit authorities are: (i) the BI; (ii) the Inter-Ministerial Committee for Credit and Savings (ICCS); and (iii) the Minister of the Economy and Finance.

legal responsibility to promote competition in the banking sector, in addition to fostering the overall stability of the financial system (1993 BL, Art.5(1)).

26. **The BI's supervisory program is wide-ranging.** It covers prudential supervision (both on- and off-site) of deposit-taking institutions (many of which are components of large and complex financial groups), as well as of other financial companies, assessment of transparency controls in banking and financial transactions (other than investment services), promotion of competition in banking, and cooperation with the judicial authorities in various matters, including the prevention of financial crime.

27. **The legal framework and practices governing the entry of credit institutions (BCP 1(3)) and the enforcement powers of the bank supervision authorities (BCP 1(4)) are satisfactory.** The BI's enforcement capacity, derived from well-designed coordination arrangements between on-site and off-site supervisors and sound legal enforcement powers (BCP 1(4)), is generally adequate. The BI, ISVAP, Consob, the Pension Fund Supervisory Authority (COVIP), and the Italian Foreign Exchange Office (UIC) are required to cooperate through ongoing formal and informal contacts, and may not invoke official secrecy against one another. To ensure an adequate cross-border information exchange, the Italian supervisory authorities have signed bilateral Memoranda of Understanding (MoUs) with their EU counterparts; Memoranda of Understanding and bilateral confidentiality agreements have been signed with a number of non-EU countries (BCP 1(6)).

28. **The Italian system does not offer legal protection to its supervisors against court proceedings stemming from measures adopted in the performance of their functions in good faith (BCP 1(5)).** The BI's practice to cover the costs of legal defense for its employees represents a form of protection for its employees in performing their functions, but it is not fully equal to legal protection.

#### **Licensing and structure (BCPs 2–5)**

29. **The framework and practices governing the activities of credit institutions, their licensing and investment criteria, as well as their ownership structure are satisfactory.**

#### **Prudential regulations and requirements (BCPs 6–15)**

30. **Prudential regulations are in line with established best practices and close consultation between the regulators, and the banking community facilitates the smooth introduction of regulatory reforms.** Capital requirements (BCP 6) comply with the current Basel Capital Accord, and the regulatory framework regarding the internal controls of credit institutions and the monitoring by the supervisory authorities of their implementation (BCP 7) is satisfactory. Prudential supervision of large exposures (BCP 9), country risk and market risk (BCPs 11 and 12) are of a high standard. The supervisory and regulatory framework to ensure sound internal controls and risk management systems and to control money laundering (BCPs 13, 14, and 15) are satisfactory, with the caveat that the supervisory authority lacks sufficiently clear legal authority to require expeditious change in the composition of a bank's board of directors and management whenever an incumbent no

longer meets “fit and proper” criteria. Further areas where regulatory strengthening is required concern the classification of nonperforming loans and their related provisioning (BCP 8), and connected lending (BCP 10).

31. **In comparison to practices in other G–7 countries, the impairment of loans and cessation of interest accrual appear to be recognized later in Italy.** The BI’s guidance for loan classification, particularly regarding the classification of ‘substandard loans,’ leaves scope for Italian banks to overstate their performing loans and income in their reporting to the public and to the BI,<sup>22</sup> although the BI’s monitoring of loan performance (and cross-comparison of loan classifications by different lenders to one borrower) through the CCR is a mitigating factor. On-site inspections, which occur on a cycle of up to six years for large banks (three years if thematic inspections are taken into account), often lead to the BI’s downward re-classification of loans from the ‘performing’ status accorded by the bank. The BI may wish to consider revision of the applicable supervisory instructions on loan classification so that they more closely match the practice in other G–7 countries, and provide further guidance on provisioning policies to be adopted by banks. In the context of the ‘New Basel Capital Accord,’ the Basel Committee has granted Italy, on the basis of its local credit conditions, a five-year transition period to use a 180-day past-due definition for impaired loans (as opposed to the standard “more than 90 days past-due” criteria).<sup>23</sup> We note that the BI acknowledges the need to introduce more stringent objective criteria for the classification of impaired loans, notably with regard to “substandard” loans.

32. **Securitization of loans is monitored comprehensively by the BI through very extensive reporting requirements, both to the BI and in banks’ annual reports (BCP 8).** Securitization has allowed banks to improve credit risk management, and the BI regulatory approach allows it to accurately assess the capital requirements of banks involved in this type of transactions. This, in turn, will facilitate the adoption of Basel II requirements on securitization.

33. **There is no comprehensive definition of, or limits on, “connected lending or lending to related parties” (BCP 10).** Discretion is granted to the supervisors to make judgments about the existence of connections between the bank and other parties only in the context of large exposures. In order to minimize possible conflicts of interests, the 1993 BL and the related supervisory instructions provide for particular procedures for loans granted to banks’ connected and related parties. However, there is no provision (in law or regulation or supervisory instruction) requiring that exposures to connected or related parties only be granted on market terms. Neither do special reporting nor do limits exist on this type of

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<sup>22</sup> See also paragraph 12 above.

<sup>23</sup> See the third consultative paper on the new Basel Capital Accord issued in April 2003 by the Basel Committee on Banking Supervision (paragraph 414, page 80).

lending, except those made in the context of large credit exposures.<sup>24</sup> The authorities are strongly recommended to issue a comprehensive regulation on connected lending to address its definition, overall limits, and reporting to the BI.

***Methods of Ongoing Supervision (BCPs 16–20)***

34. **The information available to the supervisor for monitoring and early detection of troubled institutions is abundant and timely.** Integrated on-site inspections and off-site analysis (BCP 16), coupled with very detailed statistical data requirements (BCP 18) and frequent contact with banks' management and staff (BCP 17), allow the BI to keep well informed on banks' financial condition and management quality.

35. **The BI can, and does, request auditors to examine specific aspects of banks' financial accounts, but it does not rely on external auditors for the purpose of on-site inspections (BCP 19).** The cycle of on-site inspections is long; for small banking institutions identified by off-site monitoring as being without significant weaknesses, inspections are conducted on a three-year cycle and at longer intervals (not more than six years) for large banks. Taking into account thematic inspections, the inspection cycle for large banks has recently been shortened to no longer than three years. In order to complement the BI's reliance on its comprehensive process of off-site supervision, and taking into account the limitations on the frequency of on-site inspections, the BI should review the means by which it may derive greater benefit from the work of external auditors in the execution of its own mandate. Revising the 1993 BL would be desirable, so as to obtain the authority to revoke the appointment of the external auditors of a bank when their performance is deficient and to establish the standards of banks' external audits and the scope of bank's audit programs. In light of the rapid changes in the banking industry and risk management technology, the BI should continue to keep the adequacy of resources under review.

36. **For banks that do not issue securities listed on a regulated exchange, there is no requirement to have external auditors examine and validate key supervisory reports and aggregates, or financial statements as a whole.** Key supervisory aggregates, such as regulatory capital ratios, large exposures, or impaired loans, are included in the notes on the accounts but, at present, only those banks with securities listed on a regulated exchange, and the banks controlled by them (overall, 166 out of 814 banks as of December 2002), are required to have their accounts audited by external auditors. There are about a further 180 banks that have their accounts audited on a voluntary basis, leaving approximately 470 banks, mostly very small, that, for the time being, do not produce audited financial statements. However, the banks subject to external audit account for over 90 percent of the system's total assets, and the current requirement for audit of accounts by external auditing firms is to be further expanded in January 2004.

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<sup>24</sup> Supervisory instructions require banks to disclose loans and guarantees granted to General Managers, members of the Board of Directors and Board of Statutory Auditors.

37. **In the course of on-site inspection of large banks the BI, in addition to its judgmental methods, may want to extend the use of statistical sampling methodologies for the evaluation of the credit risk of homogeneous categories of loans, which is at present applied only to consumer credit banks.** This would ensure that its assessment of credit risk is based on a statistically representative sample of loans. The scope for thematic inspections could also be expanded.

***Information Requirements (Accounting Standards (BCP 21))***

38. **Accounting rules and regulations are in line with EU Directives.** However, the mission's discussions with banks' managements suggest that the system currently in use delays the recognition of impairment in the performance of a loan and the suspension of recognition of income from impaired loans. As noted above (paragraph 29), Italian banks will have a transition period of five years to move to the Basel II "default" definition. The adoption of the new IAS in 2005 (and in particular IAS 39) will also help align loan-loss recognition with international practices.

***Formal Powers of Supervisors (BCP 22)***

39. **The BI's enforcement capacity is adequate (BCP 22).** The power of the BI derives from a flexible and comprehensive set of notification and corrective action procedures, effective bank resolution procedures, and sound enforcement powers.

***Cross-Border Banking (BCPs 23-25)***

40. **Prudential regulations for banking groups are in line with established best practices and the close cooperation between the BI and foreign regulators supports the growth of sound cross-border financial activities.** The regulatory framework for globally consolidated supervision over internationally active banking groups is satisfactory (BCP 23). Coordination with foreign supervisors to cover foreign operations by Italian banks (BCP 24) and operations in Italy by foreign banks (BCP 25) is adequate.

**General preconditions for effective banking supervision**

41. **In the past five years, the Italian financial system was affected by major structural changes, including the creation of the European Monetary Union and the introduction of the Euro in 1999.** With the launch of the Monetary Union, the BI has become an integral part of the Eurosystem, which comprises the European Central Bank (ECB) and the 12 national central banks (NCBs) of the Monetary Union. As a member of the European System of Central Banks (ESCB), the BI no longer conducts independent monetary policy. It participates in formulating monetary policy within the Eurosystem, and implementing the decisions at the national level. Also, the BI is responsible for managing its foreign exchange assets and performs all of the government's treasury functions.

42. **The 1993 BL and the 1998 Consolidated Law on Financial Intermediation (CLFI) define the general principles governing the activity of both bank and nonbank**

**financial intermediaries.** Detailed technical rules are deferred to secondary legislation, allowing for prompt adjustments to the evolving needs of financial intermediaries and markets. The institutional arrangements defining Italy's financial system regulatory and supervisory framework are summarized in Table 3.

Table 3. Regulatory and Supervisory Institutional Arrangements, 2003

	Management	Supervision	Regulation
<i>Banking System</i>			
Banks	largely private 1/	BI 2/	BI 2/
Cooperative banks	private	BI 2/	BI 2/
Mutual banks	private	BI 2/	BI 2/
Branches of Foreign banks	private	BI 2/	BI 2/
<i>Non-bank financial intermediaries</i>			
Asset management companies	private	BI, Consob 3/	BI, Consob 3/
Securities firms	private	BI, Consob 3/	BI, Consob 3/
Financial companies (Art. 106 of Banking Law)	private	UIC 4/	UIC 4/, Mof E 6/
Financial companies (Art. 107 of Banking Law)	private	BI 2/	BI, Mof E 2/ 5/ 6/
Post Office	MofE 6/ 10/	BI 2/	BI 2/
Insurance companies	private	ISVAP 7/	ISVAP 7/
Pension funds	private	COVIP 8/ 9/	COVIP 8/ 9/
<i>Settlement Systems</i>			
Securities settlement systems (SSSs)	Private	BI	BI, Consob 5/
Central securities depository (CSD)	Private	BI	BI, Consob 5/
Clearing houses for derivatives	Private	BI	BI, Consob 5/
<i>Financial Markets</i>			
Relevant to conduct of monetary policy			
Wholesale markets for government securities (MTS)	MTS S.p.A.	BI	BI, Consob, Mof E 5/ 6/
Screen-based interbank deposit market (e-MID)	e-MID S.p.A.	BI	BI
Other financial markets	Private	Consob 5/	Consob 5/

Sources: BI and ECB

1/ In 2002, the assets of banks controlled by public entities or by foundations amount to 10 per cent of total bank assets.

2/ Consob is the exclusive supervisory authority for investment services in matters regarding transparency and proper conduct.

3/ BI is responsible for prudential supervision; whereas Consob is responsible for matters regarding transparency and proper conduct.

4/ UIC is the Italian exchange office (Ufficio italiano dei cambi).

5/ Consob is the Italian Companies and Stock Exchange Commission.

6/ MoE stands for Ministry of Economy.

7/ ISVAP is the supervisory authority for private insurance companies (Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo).

8/ COVIP is the supervisory authority for pension funds.

9/ BI is responsible for banks' internal pension funds.

10/ Since February 1998, the Post Office is a company, entirely owned by the Ministry of Economy.

**43. The BI has extensive powers and responsibilities as the supervisor of the banking system.** It is also responsible for supervising the financial markets that are relevant for monetary policy purposes, such as wholesale markets for government securities and interbank markets. The BI plays also a pivotal role in the drafting of regulations, the settlement of interbank payments, and the oversight of the securities clearing and settlement procedure. It is legally required to cooperate closely with Consob, the securities market authority responsible for matters regarding transparency and proper conduct of business, and has signed a protocol with ISVAP, the insurance sector supervisory authority, establishing a

formal procedure for mutual cooperation between the two institutions on matters of common interest.<sup>25</sup>

44. **The Italian corporate insolvency regime results in lengthy judicial proceedings, and a slow realization of collateral in the event of borrowers' default.** In the case of legal procedures, the main issues are lengthy bankruptcy procedures (lasting 6 to 7 years), costly recovery proceedings (approximately 2 percent of total operating expenses), and low recovery rates (around 38 percent of total amount owed, gross of legal fees).<sup>26</sup> Banks prefer private out-of-court arrangements, which have a shorter settlement horizon (2 years versus 6 to 7 in the case of legal procedures) and a higher recovery rate (70 percent of total unsecured assets versus 20 percent in the case of legal procedures). But private agreements provide no legal protection to the creditors if the borrowers are eventually declared bankrupt. In 2000, the ABI issued a code of practice to promote private agreements. The government is examining a legal reform aimed at simplifying legal proceedings and maximizing the value of the distressed enterprise through restructuring. Significant changes in the legal framework for corporate insolvency would be needed to reduce the cost and time involved in loan recovery and to contain the loss given default (LGD).<sup>27</sup> In contrast, the insolvency regime for individual banks, based on administrative procedures led by the BI, is fast and efficient, supported by deposit insurance and a framework for public intervention designed to prevent the distress in one bank resulting in systemic stress.

45. **The legal framework for the liquidation or restructuring of single credit institutions is well defined.** The BI plays a key role in the management of bank resolution. In the case of a bank liquidation, a strict coordination system is in place between the relevant parties, which procedures derive from rules and agreements set out in EU Directives and the ESCB legal framework.<sup>28</sup> When a bank encounters serious problems, the BI can propose to the responsible minister that it be placed under 'special administration,' in essence a program for the bank's rehabilitation. Should it be determined that rehabilitation is not possible, the

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<sup>25</sup> The protocol envisages periodic high-level meetings and more frequent technical meetings.

<sup>26</sup> In 1999, the BI surveyed 235 banks accounting for almost 91 percent of total lending to Italian residents to determine the length and cost of action to recover nonperforming loans and the percentage recovered. According to this survey, the most common credit recovery procedures are private settlements (41 percent), followed by bankruptcy procedures (21 percent), and foreclosure (10 percent).

<sup>27</sup> At the time of the publication of this report, a decree law passed a new emergency bankruptcy procedure for large companies (with more than one thousand employees and liabilities above one billion euros) akin to Chapter 11 in the United States, aimed at shielding companies from their obligations to creditors in case they might have the opportunity to restructure their business.

<sup>28</sup> In particular, the procedures for the exclusion of counterparties from ESCB Monetary Policy Instruments derived from the "Manual of Internal Procedures" issued by the ECB; the January 2001 MoU on cooperation between payment system overseers and banking supervision signed in the context of stage three of the Economic Monetary Union; and the EU directive on settlement finality in payment and securities settlement systems (98/26/EC).

bank may be taken over by another bank (or group of banks) or, in the alternative, the BI can propose that the bank be placed in “compulsory administrative liquidation” (CAL), a procedure equivalent to the bankruptcy of a commercial enterprise.

46. **The BI determines the type of intervention and transmits its proposal to the Minister of the Economy and Finance.** In the case of a proposal for the compulsory administrative liquidation of a bank, the BI Banking and Financial Supervision Department (BFS) coordinates with other relevant BI departments so that they are able to prepare in a timely fashion the necessary measures for managing a bank’s crisis before the actual proceedings begin. In particular, the Payment System Department ascertains whether the insolvent bank is a direct counterparty in the Italian payment system; the Monetary and Exchange Department ascertains whether the bank is a direct counterparty in the monetary operations; and the Market Oversight Office ascertains whether the bank is a direct counterparty in Italian markets. The relevant deposit insurance scheme is also informed about the BI’s proposed intervention. To minimize the disruption on the international payment system in the case of cross-border payment activities, the “International Contact Point” within the BI payment system is immediately notified. After the Minister of the Economy and Finance has signed a ministerial decree validating BI’s proposal, the BI appoints the special body or liquidating body, depending on the suggested solution. The BFS also gives notice of the date of issue of the ministerial decree (i.e., the effective intervention date) to the relevant parties, including agencies outside of the BI such as Consob (to inform the financial markets), Monte Titoli (to exclude the bank from its retail payment activities and securities settlement), the Casse di Compensazione e Garanzia (to exclude the bank from its clearing activities); the deposit insurance schemes (to initiate their guarantee intervention); and the International Contact Point (to transmit the information abroad to other competent authorities).

47. **Italian banks benefit from a relatively generous deposit insurance scheme.** Depositors in all banks incorporated under the Italian law (a total of 297 institutions), with the exception of mutual banks, are protected by the Italian *Interbank Deposit Protection Fund* (IDPF).<sup>29</sup> The EU Directive 94/19 requires member countries to offer a minimum deposit insurance coverage of €20,000 per depositor. In Italy, the IDPF provides a much higher coverage than the required minimum, protecting deposits up to €103,291 per depositor.<sup>30</sup> The IDPF can pay-off depositors, cover the shortfall between assets and liabilities in case of transfer of the failing bank to a third party, or provide support interventions such as credits, guarantees, and acquisitions of equity. These interventions can only be initiated when a bank is put under special administration. The money paid out by the

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<sup>29</sup> The mutual banks are protected by another deposit insurance scheme, the *Mutual Banks Depositor Protection Fund*. This deposit insurance scheme protects depositors of a larger number of banks (463 as compared to 297 in the case of the IDPF) but guarantees a far smaller amount of insured deposits (€34.7 billion, as compared to €332 billion in the case of the Fund).

<sup>30</sup> This amount represents the conversion of the deposit insurance coverage initially quoted in Lira.

IDPF is funded by the surviving banks, which are charged, on an ex-post basis, a risk-adjusted premium calculated on the basis of the size of their protected funds and risk of their portfolio.<sup>31</sup> Members' commitment ranges between 0.4 percent and 0.8 percent of total reimbursable funds (or, between 0.4 percent and 0.8 percent of €332 billion). All interventions of the IDPF are subject to the authorization of the BI and the choice of intervention is determined by the "least-cost" principle. Since its creation, the IDPF has been activated in only six cases.<sup>32</sup> In addition to the guarantees provided under the IDPF, the BI has used public funds to substitute or complement the coverage of the IDPF (resolution of December 23, 1986 of the ICCS and law 588/96).<sup>33</sup> So far, the IDPF seems to have worked well under the strict surveillance of the BI. However, the relatively generous coverage, including its various guarantee and credit facilities, may need to be further revised in light of growing consolidation in the banking industry.

48. **The IDPF does not have supervisory powers.** It monitors the overall situation of its members on the basis of a number of financial ratios. If a member does not comply with the IDPF's guidelines (in particular, regarding the bank's risk profile and unpaid contributions), the IDPF can impose four types of sanctions. It can suspend a member's voting rights at the General Meeting; remove a bank's representative; impose pecuniary sanctions; and exclude a member from the IDPF. The latter action can only be imposed with the prior agreement of the BI. Since its creation, the IDPF has suspended a member's voting right in only two cases and has never expelled a member.

49. **The BI conducts its supervisory policies with a high degree of transparency, with confidentiality considerations to preserve both the effectiveness of its actions and the market sensitivity of information regarding individual financial institutions.** The BI makes public the principles and criteria of its supervisory activity; establishes the time limits for the adoption of measures; and specifies the person responsible for each administrative procedure. The BI also publishes an annual report on its supervisory activity and disseminates continuous information on the state of the Italian banking and financial system.

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<sup>31</sup> Annual contribution quotas, both for intervention and annual operating expenses, are calculated in three steps: (i) the total amount of reimbursable funds; (ii) a regressive mechanism that reduces the proportional contribution of the largest members; and (iii) a weighted average of an aggregate risk indicator, which reduces the proportional contribution of members with a low risk profile. At present, the Fund does not make adjustments to account for the presence of bank groups.

<sup>32</sup> In 1988, the Fund provided financial support intervention (€413 million); in 1990, it reimbursed depositors (€4 million); and in the remaining four cases, it covered the negative equity in the transfer of assets and liabilities of the failing bank to a third bank (€37 million in 1991, €78 million in 1996, and €52 million and €516 million in 1997).

<sup>33</sup> In the last ten years, this procedure was used twice, for the crises of Banco di Napoli (1996) and Sicilcassa (1997); the total amount of public funds used for the interventions since the beginning of the crises was equal to about 0,5 percent of gross domestic product of 2002.

An abridged version of the BI's annual report is available in English in hard copy and on the BI's web site.

50. **Prospective changes in transparency and disclosure framework for banking will further strengthen market discipline.** Banks already disclose a highly detailed set of data to the BI, which uses this information both for micro- and macroprudential surveillance purposes. In addition, listed banks are required to disclose a large body of information to the markets. A key challenge is to continue to strengthen the transparency and disclosure of banks' balance sheets and income statements as well as corporate governance practices. Further efforts in facilitating cross-country comparisons and investors' analysis of this information would contribute to enhance market discipline. The market disclosure requirements for banks (currently governed by BI regulations issued following EC Directives in 1992) are in the process of major changes in order to implement IAS by 2005, and the prospective changes under Pillar III of Basel II. While a range of Financial Soundness Indicators (FSIs) and their analysis are presented in the BI's Annual Report and other publications, a more systematic dissemination of the BI's macro-prudential surveillance and financial stability analysis could also contribute to making market discipline more effective.

## II. DETAILED ASSESSMENT OF OBSERVANCE OF THE BCPS

### A. Principle-by-Principle Assessment

51. The assessment of each principle is made on a qualitative judgment basis using five categories: compliant, largely compliant, materially non-compliant, non-compliant, and not applicable.

52. A principle will be considered **compliant** whenever all essential criteria are generally met without any significant deficiencies. A principle will be considered **largely compliant** whenever only minor shortcomings are observed, which do not raise any concerns about the authority's ability and intent to achieve full compliance within a prescribed period of time. A principle will be considered **materially non-compliant** whenever, despite progress, the shortcomings are sufficient to raise doubts about the authority's ability to achieve compliance. A principle will be considered **non-compliant** whenever no substantive progress toward compliance has been achieved. Principles will be considered **not applicable** whenever the BCP does not apply given the legal, structural, or institutional features of a country.

53. For each principle there is a descriptive part, which sets out the pertinent laws, regulations, policies, and practices. Based on this, and on its implementation, the assessment is concluded. There is also a comment section, specifying the character of any deficiency and providing guidance on how it might be remedied in order to improve compliance with the principle.

Table 4. Detailed Assessment of Compliance with the Basel Core Principles for Effective Banking Supervision

<b>Principle 1.</b>	<p><b>Objectives, Autonomy, Powers, and Resources</b></p> <p>An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks. Each such agency should possess operational independence and adequate resources. A suitable legal framework for banking supervision is also necessary, including provisions relating to the authorization of banking establishments and their ongoing supervision; powers to address compliance with laws, as well as safety and soundness concerns; and legal protection for supervisors. Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.</p>
<b>Principle 1(1)</b>	<p>An effective system of banking supervision will have clear responsibilities and objectives for each agency involved in the supervision of banks.</p>
Description	<p>Italy's system of banking supervision is a component of the supervisory framework for the financial services sector that is organized around three main agencies; (a) the <i>Banca d'Italia</i> (BI) for the banking industry; (b) the Supervisory Authority for Insurance (<i>Istituto per la Vigilanza sulle Assicurazioni Private e di Interesse Collettivo</i> (ISVAP) for the insurance industry; and (c) the Companies and Stock Exchange Commission (<i>Commissione Nazionale per le Società e la Borsa</i> (Consob), together with the BI, for the securities industry.</p> <p>The BI's broad objectives and responsibilities are set out in: (a) the 1993 Banking Law (Legislative Decree 385 of September 1, 1993) (1993 BL) and, for the BI and Consob, in (b) the 1998 Consolidated Law on Financial Intermediation (Legislative Decree 58 of February 24, 1998) (1998 CLFI).</p> <p>The 1993 BL provides for exercise of supervision over banks, banking groups and financial intermediaries (Art. 5(2)), identifies the credit authorities (Art. 1(a)), namely: (a) the BI; (b) the Interministerial Committee for Credit and Savings (Credit Committee or ICCS); and (c) the Minister of the Economy and Finance (MEF) (who also serves as Chairman of the ICCS); and specifies their respective and related powers. The credit authorities' stated objectives are: (a) the sound and prudent management of institutions subject to supervision; (b) compliance of supervised institutions with legislative provisions concerning credit; and (c) the overall stability, efficiency and competitiveness of the financial system (1993 BL, Art. 5(1)). The 1993 BL, complemented by the 1998 CLFI, sets out the general principles governing the activity of both bank and nonbank financial intermediaries. They refer detailed technical provisions to secondary legislation (such as resolutions of the ICCS, regulations issued by the MEF, BI's regulations and supervisory instructions, and Consob regulations). This permits timely adjustment of prudential regulation to the evolution of intermediaries' operations and the markets. A major factor in this adjustment process is Italy's membership in the EU. A requirement of EU membership is to incorporate all EU Directives into country law and practices. Taken together, the general principles and the detailed technical provisions delineate a framework of minimum prudential standards that banks must meet.</p> <p>The ICCS (1993 BL, Art 2(1)) comprises five ministers: The Minister of the Economy and Finance (Chairperson), together with the Ministers for Agricultural, Food and Forestry Policies; Industry; Infrastructure; and European Affairs. The BI's Governor attends its meetings. The ICCS is the administrative body which, under the Law, issues broad guidelines on prudential supervision in the area of credit activities and the protection of savings. The BI (which provides the Secretariat for the ICCS (1993 BL, Art 2(4))) takes the initiative in recommending regulatory and supervisory policy and has operational independence on the day-to-day application of supervisory methods.</p> <p>The BI's stated objectives are the sound and prudent management of supervised institutions, their compliance with the legislation and the financial system's overall stability, efficiency and</p>

competitiveness (1993 BL, Art. 5(1)). In pursuit of those objectives, the BI is responsible for the functions of banking supervision based on prudential returns, regulatory powers and inspections (1993 BL, Arts. 51 through 69). Within this latter framework, the BI formulates and implements ICCS general resolutions by issuing regulations concerning capital adequacy, risk limitation, permissible holdings, administrative and accounting procedures and internal controls (1993 BL, Arts. 53(1) and 67(1)) and implements measures within the scope of MEF's authority (1993 BL Art.3). On its own authority, the BI issues regulations and supervisory instructions and implements institution-specific measures (1993 BL, Art. 4(1)). The BI makes public the principles and criteria of its supervisory activity (1993 BL, Art. 4(2), establishes the time limits for the adoption of measures and specifies the person responsible for each administrative procedure (1993 BL, Art. 4(3)). The BI is also responsible for granting first authorization to a company to carry on banking business (1993 BL, Art. 14) and for authorizing provision of investment services by banks and registered financial intermediaries (1993 BL, Arts. 106 and 107 (1); 1998 CLFI, Art. 19(4)).<sup>34</sup> All general measures adopted by the credit authorities and those institution-specific measures adopted by the BI are published in the BI's Bulletin (1993 BL, Art. 8(1)) while resolutions of the ICCS and general measures adopted by the MEF must be published in the *Gazzetta Ufficiale della Repubblica Italiana (Gazzetta)* (1993 BL, Art. 8(2)). The general measures adopted by the BI are published in the *Gazzetta* when their scope extends to persons other than those subject to supervision.

The Italian Foreign Exchange Office (*Ufficio Italiano dei Cambi*— UIC) is chaired by the BI Governor and checks compliance with anti-money laundering legislation on the part of all intermediaries pursuant to Law 197/1991.<sup>35</sup>

Banks and banking groups providing investment services, as defined and governed by the 1998 CLFI, are supervised by the BI regarding financial stability and limitation of risk and also by Consob regarding transparency and proper conduct of business (1998 CLFI, Arts. 5(2) and 5(3)). The BI is also responsible for prudential supervision of nonbank financial intermediaries, namely Italian securities firms (*Società di Intermediazione Mobiliare*— SIM) and asset management companies and of collective investment schemes (i.e., investment funds and *Società di Investimento a Capitale Variabile*—SICAV). The BI and Consob are required to check compliance with the provisions governing matters within their respective authority and to operate in a coordinated manner, *inter alia*, to minimize costs to authorized institutions, and must notify each other of supervisory measures adopted and any irregularities discovered (1998 CLFI, Arts. 5(4) and 5 (5)). They must also notify each other of inspections they undertake and each may ask the other to carry out on-site visits on its behalf (1998 CLFI, Art.10(2)).

Both the 1993 BL (Art. 7(5)) and the 1998 CLFI (Art. 4(1)) provide for cooperation among the supervisory agencies. The BI, Consob, the Pension Fund Supervisory Authority (*Commissione di Vigilanza sui Fondi Pensione*—COVIP), ISVAP and the UIC must cooperate with one another, *inter alia*, by exchanges of information and may not invoke professional secrecy against each other. Memoranda of Understanding (MoUs) exist between the BI and UIC (1992), the BI and ISVAP (2001) and the BI and Consob (1997 renewed in 2001), and there is senior management involvement in their practical application. Provision is also made for the BI's cooperation (including information exchange) with banking supervision homologues in EU-member states (1993 BL, Art. 7(6)) and, under appropriate agreements, with those in non-EU-member states (1993 BL, Art. 7(7)). Similar provision is made for cooperation by both the BI and Consob with homologues in EU-Member and non-EU-member states regarding supervision of intermediaries

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<sup>34</sup> See BCP 1(3).

<sup>35</sup> See also BCP 15 below.

<p>delivering investment services (1998 CLFI, Arts. 4(2) and 4(3)).</p> <p>The 1993 BL incorporates crisis procedures to deal with distressed banks and banking groups. These provide, <i>inter alia</i>, that in cases of serious contravention of applicable laws, regulations or corporate by-laws or where serious losses are anticipated, the Minister of the Economy and Finance—acting on the BI’s proposal—may issue a decree to dissolve the administrative and control bodies of the bank concerned. Thereafter, the BI is empowered to supplant those bodies. In extreme urgency, the BI may provide administrators (and may use its own officers) to take over provisional management of the bank for up to two months (1993 BL, Art. 76). In other instances, (and at the expiration of provisional management) the BI may appoint (and instruct) special administrators and an oversight committee (1993 BL, Arts. 70(1) and 71(1)), to eliminate irregularities and promote solutions that are in the interest of the depositors’ (1993 BL, Art. 72(1)). <i>Special Administration</i> lasts one year, unless the decree establishes a shorter period or the BI authorizes early closure. (1993 BL, Art. 70(5)). In exceptional cases the procedure may be extended for a period of up to six months. Before termination, the special administrators reconstitute the bank’s administrative and control bodies (1993 BL, Art. 75 (3)). A similar procedure applies for banking groups (1993 BL, Arts. 98 and 100).</p> <p>For <i>exceptionally serious</i> contravention of applicable laws, regulations or corporate by-laws or where <i>exceptionally serious</i> losses are anticipated, or in the course of a <i>Special Administration</i> or liquidation procedure, the Minister of the Economy and Finance—acting on a proposal of the BI—may issue a decree revoking a distressed bank’s authorization to engage in banking and order its Compulsory Administrative Liquidation (CAL) (1993 BL, Art. 80(1)). Upon issue of the decree, all of the bank’s instruments of corporate governance cease to function (1993 BL, Art. 80 (5)) and the BI is empowered to appoint liquidators and an oversight committee (1993 BL, Art. 81(1)). The BI is empowered to give direction on implementation of the liquidation procedure (1993 BL, Arts. 84(3) and 84(7)) and, in certain instances, to authorize actions of the liquidators (1993 BL, Arts. 90(2)(3) and (4), Art. 92(1), Art. 93(1)). A similar procedure applies for banking groups (1993 BL, Art. 99 and 101). The BI is required to coordinate its crisis procedures and supervisory activity with those of mandatory depositor guarantee schemes (1993 BL, Art. 96-<i>ter</i>) to which all Italian banks must belong (1993 BL, Art. 96(1)). The depositor guarantee schemes make payments to the eligible depositors in cases of CAL (1993 BL, Art. 96-<i>bis</i>).</p> <p>As another means of achieving orderly resolution of a distressed bank situation, the BI is empowered to authorize mergers with sound banks, provided the merger does not jeopardize the principles of sound and prudent management (1993 BL, Art. 57(1)).</p> <p>Each year, senior management drafts a Corporate Plan (Plan) for the BI’s fulfillment of its mandate over a three-year planning period. The draft Plan is submitted to the BI’s Board of Directors for approval. As approved, the Plan sets out strategies in support of the BI’s business objectives (all drawn from its statutory mandate and based on senior management’s assessment of the financial and economic situation). Related business plans and supporting initiatives detailing the conduct of operations in implementing each business strategy are drawn up on a corporate-wide basis, including that of the Banking and Financial Supervision Department (BFS). Components of these plans, including key initiatives and corporate level performance measures and targets, are rated in performance reports drawn up for presentation to the BI’s Board of Directors. There is presently no means for the assessment of the BI’s performance beyond that conducted by its own Board.</p> <p>The Corporate Plan goes through a complex procedure, whose first step is represented by an assessment of the performance of the various BI’s Departments with respect to the objectives</p>
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<sup>36</sup> See BCP 1(2) below.

	<p>established in the previous Plan; both the past performance and the projects for the following three years are examined by an Inter-Departments Committee (composed by Central Managers in charge of the various Depts. of the Bank). The final step is the transmission of the Corporate Plan to the Board.</p> <p>The BI maintains an extensive database and regularly disseminates information on the Italian banking and financial system through a range of publications. Some of these publications are on the BI's website, including the BI's Annual Report (a section of which, entitled <i>Supervision of Banks and Other Intermediaries</i>, satisfies the statutory obligation to report on the BI's supervisory activities (1993 BL, Art. 4(4)), selected speeches by the Governor and other members of the BI's Board of Directors,<sup>30</sup> and the BI's Statistical Bulletin and Supplements, with data on the main Italian credit and financial aggregates.</p> <p>The BI's Annual Report (1993 BL, Art. 4(4)) includes an entire chapter on developments in the regulation and structure of the Italian banking and financial system, the risks, profitability and capital adequacy of intermediaries, and inspections carried out in the course of supervisory activity. The periodic BI's Statistical Bulletin and its Supplements contain reports on the main Italian credit and financial aggregates.</p>
Assessment	COMPLIANT
Comments	<p>The 1993 BL and the 1998 CLFI establish the general framework of laws governing the banking and financial system and clearly identify the powers and tasks of the different authorities involved in supervising the financial sector. The 1993 BL identifies the ICCS as the administrative body which, under the law, issues broad guidelines on prudential supervision in the area of credit activities and the protection of savings. In practice, the BI takes the initiative in recommending regulatory and supervisory policy; issues regulations; when provided for by the 1993 BL, implements general resolutions of the ICCS; has operational independence in the day-to-day application of supervisory methods. The BI has also legal responsibility (1993 BL, Art. 5(1)) to promote competition in the Italian banking system, in addition to fostering the overall stability of Italy's financial system.</p> <p>The legislation provides the BI a range of instruments to achieve remedial action at individual institutions, its choice depending on its assessment of the gravity of the situation; in some cases (<i>Special administration</i> or <i>Compulsory Liquidation</i> procedures, and administrative sanctions), the final decision to use a particular instrument is, at the discretion of the Minister of the Economy and always acting on the BI's proposal.</p> <p>The BI's supervisory program is wide ranging. It covers prudential supervision (both on and off-site) of deposit taking institutions (many of which are components of large and complex financial groups) as well as other financial companies; assessment of transparency controls in banking and financial transactions (other than investment services); promotion of competition in banking; and cooperation with judicial authorities in various matters, including the prevention of financial crime.</p>
<b>Principle 1(2)</b>	Each such agency should possess operational independence and adequate resources.
Description	<p>Under the 1993 BL, the BI plays a central role both in producing secondary legislation and performing inspections, issuing regulations and instructions, and adopting measures concerning intermediaries. It proposes measures for adoption by the ICCS (whose meetings, chaired by the Minister of the Economy and Finance, are attended by the BI's Governor) and provides the staff necessary for the performance of the ICCS's functions.</p> <p>Under its own Statute (<i>Statuto della Banca d'Italia</i>: SDBI), the BI's main governing bodies are the General Meeting of Shareholders, the Board of Directors, the board of auditors and the Governor (SDBI, Art. 5). Its shares are registered and may be held only by commercial banks, social security institutions, and insurance companies and, pursuant to Art. 27 of Legislative Decree of May 17, 1999, by <i>Banking Foundations</i>. Its shares may be transferred with the consent of the Board of Directors, but only to another entity included in the aforesaid categories. In all circumstances, the majority interest in the BI's capital must be retained by public institutions or</p>

by companies wherein the majority of the voting shares are held by public institutions (SDBI, Art. 5)). The BI's shareholders currently include supervised banks.

The Board of Directors is responsible for the BI's overall administration (SDBI, Art. 20). It comprises the Governor, who acts as Chairman, and 13 Directors who are elected by the *local shareholders meetings* held at the main branches. A director's term of office is 5 years and an incumbent is eligible for re-election. (SDBI, Art. 17). Persons holding political office cannot be Directors (SDBI, Art. 59 and 60). The Director-General takes part in the Board meetings but only in an advisory capacity, unless he is standing in for the Governor. The two Deputy Directors-General, one of whom performs the duties of Secretary to the Board, also attend the Board meetings. The Executive Committee of the Board of Directors has advisory and administrative responsibilities. The Board of Auditors, with five members and two alternates, scrutinizes the BI's administration and compliance with the law and its own Statute (SDBI, Art. 23).

The Governor represents the BI, signs on behalf of the BI, and presides over the General Meeting and other governing bodies. The Governor is responsible for banking and financial markets supervision. He advises the Government on economic and financial matters, both domestic and foreign. The term of office of the Governor is indefinite. According to the ECB, the Governor's mandate is in line with the statute of the ECB in that the Governor: (a) is independent from political interference; (b) has a term of office that exceeds five years; and (c) can only be dismissed for reasons given in Art. 14(2) of the statute of the ECB which can only be appealed to the European Court of Justice.

Neither members of the Directorate (i.e., the Governor, the Director-General, and the two Deputy Directors-General), nor the BI's Central Managers, Branch Managers or any other employees may belong to other credit institutions, engage in commerce, carry out stock exchange transactions or be directors or members of the board of auditors of any company (SDBI, Art. 59). Detailed obligations, prohibitions, incompatibilities, and liabilities are established in the BI's Staff Rules. In particular, officers and employees are bound by official secrecy regarding the BI and its relations with third parties.

At the senior operational level, the Central Managers are organized in three Interdepartmental Committees for: (a) Central Banking Activities; (b) the Banking and Financial System; and (c) Internal Management. (The Central Manager of the BFS is a member of Committees (a) and (b)). The BFS' budget is a component of the BI budget (revenues being primarily derived from seigniorage and investment income) and has allocations for salaries, staff training programs, inspections, equipment, and recruitment of outside experts when needed. BFS staff is equipped with effective information technology (IT) systems for monitoring both on an institution-by-institution basis and at the aggregate level. In addition to the archives containing supervisory statistics, BFS staff can use the data of the Central Credit Registry (CCR) and outside databases such as the Company Accounts Data Service (CADS) and the archives of the Fitch IBCA. The diversity of the BI's activities and the close collaboration among the different Departments via the three Committees noted above enable the BI to conduct in-depth studies of the evolution of the banking and financial system and the securities markets.

BFS' staff is hired on a permanent basis by means of screening procedures based on qualifications and examinations aimed at selecting qualified personnel distributed across four Divisions: (a) Competition, Regulation, and General Affairs; (b) Banking Supervision; (c) Financial Supervision; and (d) Supervision Inspectorate. The BFS also provides the 13 staff of the ICCS' Secretariat. On June 27, 2003, BFS staff numbered 1,064, including 540 staff employed in the 95 branches of the BI.

Typically, the BI recruits entry-level personnel with undergraduate and often graduate degrees, and/or professional qualifications, particularly in accounting, economics, law, and finance.

Salary scales and employment conditions generally appear to allow the BI to compete with the private sector in attracting qualified professional staff at *entry* level. Retaining its staff is proving

	<p>difficult, in light of the higher salaries offered by the private sector.</p> <p>The BI has an in-house training program and, in addition, staff members attend courses at universities in Italy and abroad on key risk areas in the banking and finance sectors (such as derivatives, and e-commerce). Funds are budgeted for supervisory staff to obtain advanced degrees and external certification and attend specialty courses/seminars organized by outside groups. Examiners also receive extensive on-the-job training from experienced BI staff.</p> <p>Currently, the BI has responsibility for supervision of approximately 1,430 credit institutions and investment firms in Italy. Despite the large absolute number of participants there is a fairly high level of asset concentration in the system. The BI has committed significant resources to an advanced off-site monitoring capacity.<sup>37</sup> The conduct of on-site inspections of those large institutions identified by off-site monitoring to be without significant weaknesses proceeds on a six-year cycle; taking into account the conduct of thematic inspections, the frequency is three years. The smaller institutions are examined on a three-year cycle.</p>
Assessment	COMPLIANT
Comments	<p>Under the Law, the ICCS is the administrative body, which issues broad guidelines on prudential supervision and in the area of credit activities and the protection of savings. This makes it difficult to determine whether supervisory policies, plans, and processes are entirely independent from the government and whether the latter is involved in operational supervisory and regulatory activities. For example, the ICCS has not yet taken action to regulate conflicts of interest between banks and their significant shareholders relative to other banking activities (1993 BL, Art. 53 (4)). However, in practice, neither the ICCS nor the Minister of the Economy and Finance has direct operational involvement in the supervision and regulation of financial institutions.</p> <p>The 1990s' privatization of government holdings in banks has substantially reduced the scope for conflicts of interest between the government's role as an owner of financial institutions and the BI's mandate to supervise these institutions. Also, there is no evidence that the practice of allowing members of supervised institutions to be shareholders of the BI has led to industry interference in the operational independence of the BI.</p> <p>There is no evidence of government or industry interference in the staffing of the supervisory personnel.</p> <p>The manner in which the BI funds its supervisory operations does not undermine the BI's authority or independence or hamper the conduct of supervision and oversight. Sufficient funds are available for salaries that allow the BI to attract qualified staff; to provide it the ability to hire outside experts to deal with specific situations as they arise; for training opportunities for staff; for computers and other equipment to monitor the condition of the banking industry; and for funding appropriate on-site work.</p> <p>According to the credit institutions with which the mission met during its visit to Italy, the BSF's supervisory staff demonstrates a high level of integrity and professionalism in their dealings with them as well as a clear and comprehensive understanding of the institutions' operations.</p> <p>Although a definite term of office for the BI Governor may be considered preferable, the ECB has taken the view that the indefinite term of office of the BI's Governor is in line with the statute of the ECB in so far as "indefinite" is interpreted to mean "in excess of five years."</p>
<b>Principle 1(3)</b>	A suitable legal framework for banking supervision is also necessary, including provisions relating to authorization of banking establishments and their ongoing supervision.
Description	The 1993 BL, Art. 14(1) provides that the BI <u>shall</u> grant authorization to engage in banking business when it is of the opinion that the applicant meets specified conditions. These conditions

<sup>37</sup> See BCP 16.

include; (i) a satisfactory corporate form and by-laws; (ii) the location of the applicant's registered and head offices in Italy; (iii) adequate initial capitalization; (iv) a satisfactory plan of operations; (v) shareholders (each above a quantum ownership threshold) that meet the integrity requirements set out in a regulation of the MEF(1993 BL, Arts. 25(1) and 25(2)); (vi) a management complement that meets the experience and integrity requirements specified in a regulation of the MEF(1993 BL, Art. 26(1)); and (vii) the absence of close links between the applicant group and any group it belongs to and to any other person that would prevent the exercise of effective supervision. The BI is required to refuse authorization where, after its review of the applicant's proposal vis-à-vis the specified conditions, it is of the opinion that *sound and prudent management is not ensured* (1993 BL, Art. 14(2)).

The BI is responsible for authorizing establishment of branches of Italian banks in non-EU member states (1993 BL, Art. 15(2)), for the authorization of Italian banks to operate in a non-EU member state without the establishment of branches (1993 BL, Art. 16(2)), and for authorizing the provision of investment services by banks authorized in Italy and by registered *financial intermediaries*. Establishment of the first branch in Italy of a bank from a non-EU member state requires a decree of the Minister of the Economy and Finance, in agreement with the Minister of Foreign Affairs in consultation with the BI (1993 BL, Art. 14(4)). The opening of subsequent branches by a bank from a non-EU member state requires authorization by the BI (1993 BL, Art. 15(4)), as does the commencement of activity by banks from non-member states without establishing a branch in Italy (1993 BL, Art. 16(4)).

The 1998 CLFI (Art. 19(4)) provides that the BI shall authorize provision of investment services by banks authorized in Italy and registered financial intermediaries (1993 BL, Arts. 1(2)(g) and 106). The BI, after consulting Consob and subject to specified conditions being fulfilled, shall also authorize the provision of service by asset management companies (1998 CLFI, Art. 34(1)) and the establishment of *SICAVs* (1998 CLFI, Art. 43 (1)).

The BI has extensive regulation-making powers under the 1993 BL. In certain instances, regulations follow upon ICCS' resolutions for, *inter alia*: (a) EU-member banks carrying on activities in Italy that are not subject to mutual recognition (1993 BL, Art. 17); (b) authorization to hold prescribed levels of the banks' voting capital (1993 BL, Art. 19 (9)); and (c) prudential supervision (1993 BL, Arts. 53, 67 and 107 (2)). In particular, regarding prudential supervision, the BI—acting in compliance with resolutions of the ICCS—is empowered to issue regulations of general application concerning: (a) capital adequacy; (b) risk limitation; (c) permissible holdings; and (d) administrative and accounting procedures and internal control mechanisms. When appropriate, the BI has the power to impose requirements on specific institutions, by using the powers provided for by the 1993BL (Art.53 (3)(d)) ; similar measures can be adopted in the authorization procedure itself (1993 BL Art. 14).

The revocation of an authorization (together with a decree for CAL), in cases where exceptionally serious administrative irregularities, violations of laws, regulations or by-laws, or losses are found (1993 BL, Art. 80(1)), is declared by the Minister of the Economy and Finance on the BI's proposal. In similar circumstances in the case of an asset management company or a SICAV, the Minister of the Economy and Finance has the power to revoke the authorization to conduct business (and decree a CAL) on the proposal of the BI or Consob (1998 CLFI, Art. 57(1)).

The 1993 BL (Art. 51(1)), states that banks shall send the BI periodic returns, as well as other figures or documents it may request, in the manner and within the time limits it establishes. Similar provisions for reporting to the BI are made in the case of *financial intermediaries* (1993 BL, Art. 107(3)). The BI's information requirements are communicated to banking authorization applicants during discussions regarding the application. Changes to the BI's information requirements are communicated to all banks when changes occur (1993 BL, Art. 4(2)).

Regarding its performance of consolidated supervision, the legislation provides the BI the power

	<p>to request relevant information from all companies included within the scope of such supervision (1993 BL, Arts. 65(1) and 66)). To ensure provision of such information to the BI, both custodial and monetary penalties exist for persons in administrative, managerial or control functions at companies within the scope of consolidated supervision who misrepresent or conceal facts concerning such companies' economic condition (1993 BL, Art. 134).</p> <p>The 1998 CLFI provides that the BI and Consob, 'within the scope of their respective authority,' may require authorized persons (i.e., investment firms, asset management companies, SICAVs, financial intermediaries registered pursuant to the 1993 BL (Art. 107) and banks authorized to engage in investment services) to communicate data and information and to transmit documents and records in the manner and within the time limits they establish (1998 CLFI, Art. 8(1)). The external auditors of 'authorized persons' may also be required to provide data and information and to transmit documents and records to the BI and Consob upon request.</p>
Assessment	COMPLIANT
Comments	<p>The BI is empowered to verify the existence of legal, technical and management conditions, both at the time of the authorization to engage in banking and subsequently, to ensure compliance with the legislation and regulations and the prudent operation of the authorized bank. The BI may propose to withdraw the authorization to engage in banking, in the context of a CAL procedure; the revocation of the authorization is enforced with a decree of the Minister of the Economy and Finance.</p> <p>The legislation requires total transparency of banks' affairs vis-à-vis the BI. In its monitoring and inspection activities, the BI may obtain all data that it considers relevant for the purpose.</p> <p>The legislation allows prudential rules to be set administratively, that is, without having to change laws. However, in certain instances, ICCS resolutions are required before the BI can issue the appropriate regulation.<sup>38</sup></p>
<b>Principle 1(4)</b>	A suitable legal framework for banking supervision is also necessary, including powers to address compliance with laws, as well as safety and soundness concerns.
Description	<p>In the exercise of their supervisory powers the credit authorities have the objective to enforce the sound and prudent management of those institutions subject to their supervision, their compliance with the legislative provisions concerning credit, and the overall stability, efficiency and competitiveness of the financial system (1993 BL, Art. 5(1)). Supervision has five facets: (a) regular data reporting requirements imposed on supervised institutions; (b) special reporting requirements on boards of auditors and the external auditors to alert the BI to breaches of banking legislation or the principles of sound and prudent management of banks (1993 BL, Arts 52(1)(2) and 61(5)); (c) development and issuance of prudential regulations (1993 BL, Arts. 53(1)(2)(4) and 67); (d) on-site inspections (1993 BL, Arts. 54 and 68); and (e) imposition of measures to achieve remedy where, in the judgment of the BI, there are infractions of the legislation and regulations or the financial condition of the bank is seriously weakened (1993 BL, Arts. 53(3), 70, 76 and 80). The 1993 BL permits the BI to apply qualitative judgment where it is of the opinion that action must be taken. The BI is explicitly allowed, if necessary, to convene the administrative and control authorities of a bank to examine its condition and, if necessary, to demand from them the adoption of remedial action (1993 BL, Art. 53 (3)(a)(b) and (c)).</p> <p>As noted in BCP 1(3) above, for the exercise of prudential supervision, the legislation contemplates total transparency of banks' affairs vis-à-vis the BI, and provides significant rule making powers to the BI.</p>
Assessment	COMPLIANT
Comments	The 1993 BL enables the BI to address compliance with laws and the safety and soundness of

<sup>38</sup> See comments to BCP 1(2).

	banks and to apply qualitative judgment in forming its opinion. The BI has full access to banks' files so as to verify compliance with the banks' internal policies and procedures as well as the legislation. When, in the BI's judgment, a bank has infringed applicable laws, regulations and supervisory instructions, or its management practices are unsound and imprudent, the 1993 BL provides the BI the means to take, or require a bank to take, prompt remedial action. A range of sanctions is available, culminating—with the approval of the MoE—with the revocation of the bank's authorization to conduct business.
<b>Principle 1(5)</b>	A suitable legal framework for banking supervision is also necessary, including legal protection for supervisors.
Description	There is no legal protection offered to the BI and its officers against the possibility of legal action resulting from measures adopted <u>in good faith</u> in the exercise of their supervisory functions. As a matter of practice, the BI will pay the defense costs of a staff member subject to such legal action where the staff member's actions were legitimate, and are responsible for the payment of its own legal costs.
Assessment	NON-COMPLIANT
Comments	The payment of defense costs and legal fees does not amount to proper legal protection. This requires legal amendments.
<b>Principle 1(6)</b>	Arrangements for sharing information between supervisors and protecting the confidentiality of such information should be in place.
Description	<p>All data obtained by BI by virtue of its supervisory activity are covered by 'professional secrecy' (1993 BL Art. 7), which is extended to all governmental authorities. However, exceptions are made for the Minister of the Economy and Finance (as Chairman of the ICCS), the judicial authorities when the information requested is needed for investigations or proceedings regarding crimes (1993 BL Art. 7(1)), and other national authorities having supervisory responsibility in the financial sector as a whole. (As mentioned above (BCP 1(1)), both the 1993 BL (Art. 7(5)) and the 1998 CLFI (Art. 4(1)) require that the BI, Consob, COVIP, ISVAP and UIC cooperate with one another by exchanges of information).</p> <p>Provision is also made for the BI's cooperation (including information exchange) with banking supervisors in EU-member states. Information received by the BI under such arrangements may be transmitted to other Italian supervisory authorities in the financial sector unless transmission is denied by the supplying authority (1993 BL, Art. 7(6)). Under appropriate cooperation agreements, the BI may also exchange relevant supervisory information with banking supervisors in non-EU-member states. Information received by the BI under such arrangements may be transmitted to third parties only with the explicit consent of the authority that supplied it (1993 BL, Art. 7(7)).</p> <p>Similar provision is made for cooperation by both the BI and Consob with homologues in EU-member and non-EU-member states in regard to supervision of intermediaries delivering <i>investment services</i> (1998 CLFI, Arts. 4(2) and 4(3)). Information received by the BI and Consob under such arrangements may not be transmitted to other Italian authorities or to third parties without the prior consent of the supplying authority (1998 CLFI, Art. 4(4)).</p> <p>The procedures of cooperation with such authorities are formalized in MoUs.<sup>39</sup> Cooperation has been instituted by means of an exchange of letters with some of the major non-EU states. Procedures have been established for carrying out inspections of branches of <i>home-country</i> banks in the respective <i>host</i> jurisdictions, for exchanging information at the time of authorization of the foreign branch, in the course of ordinary supervisory action, and where certain situations of need</p>

<sup>39</sup> See BCP 24.

<sup>40</sup> See also BCP 24 below.

	arise. Similar cooperation agreements are now being drafted with the authorities of some non-EU countries in which Italian banks have recently developed a significant presence. <sup>40</sup>
Assessment	COMPLIANT
Comments	There is a well-developed framework of cooperation and information sharing between all of the Italian agencies with responsibility for the safety and soundness of the financial system and with foreign homologues for banking operations of significant interest to the BI. The 1993 BL enables the BI to provide confidential information to another financial sector supervisor, provided that reasonable steps are taken to ensure that the shared information will be treated on a confidential basis by the receiving supervisor and used only for supervisory purposes. The BI may refuse any request for confidential information in its possession; exceptions are made for the Minister of the Economy and Finance (as Chairman of the ICCS) and the judicial authorities investigating criminal offences.
<b>Principle 2.</b>	<b>Permissible Activities</b> The permissible activities of institutions that are licensed and subject to supervision as banks must be clearly defined, and the use of the word “bank” in names should be controlled as far as possible.
Description	<p>The 1993 BL defines <i>bank</i> as an undertaking authorized to engage in fund raising on a public basis and the granting of credit (Arts. 1(1)(b) and 10(1)). Banks may engage in financial activities subject to mutual recognition according to the Second European Banking Directive and in related or instrumental activities (1993 BL, Arts 1(2)(f) and 10(3)). They may not engage directly in collective asset management and insurance business. Banking is restricted to banks (1993 BL, Arts. 10(2) and 11(2)).</p> <p>Banks have a typical corporate name and corporate purpose that are restricted to them. Both of these elements must appear in the banks’ by-laws and are examined by the BI both when a new bank is formed and when by-laws are amended. In particular, the name must be consistent with the corporate purpose and not capable of confusion with the names of other banks.</p> <p>The 1993 BL prohibits the use by persons other than banks of the words <i>banca</i>, <i>banco</i>, <i>credito</i>, <i>risparmio</i> or other words or expressions in Italian or in a foreign language likely to deceive as authorization to engage in banking (1993 BL, Art. 133(1)). Violators are punished with administrative sanctions (1993 BL, Art. 133(3)).</p> <p>Fund-raising on a public basis is prohibited for persons other than banks (1993 BL, Art. 11(2)). Violators are punished with penal sanctions (1993 BL, Art. 130).</p>
Assessment	COMPLIANT
Comments	The name <i>bank</i> and the activities in which banks may engage are clearly defined by the Law in accordance with the European model. Use of the word <i>banca</i> and its derivations is protected by law. Deposit-taking activities are restricted exclusively to banks.
<b>Principle 3.</b>	<b>Licensing Criteria</b> The licensing authority must have the right to set criteria and reject applications for establishments that do not meet the standards set. The licensing process, at a minimum, should consist of an assessment of the banking organization’s ownership structure, directors and senior management, its operating plan and internal controls, and its projected financial condition, including its capital base; where the proposed owner or parent organization is a foreign bank, the prior consent of its home country supervisor should be obtained.
Description	<p>Banking authorization is granted by the BI, provided that the requirements of the 1993 BL (Art. 14(1)) and the BI’s supervisory instructions are satisfied, namely:</p> <ol style="list-style-type: none"> <li>1. the legal form adopted must be that of a <i>società per azioni</i> (joint stock company) or <i>società cooperativa per azioni a responsabilità limitata</i> (joint stock cooperative limited liability company);</li> <li>2. the registered office and head office must be located in Italy;</li> <li>3. the paid-up capital must be at least €6.3 million and €2 million for <i>banche di credito</i></li> </ol>

	<p><i>cooperativo</i> (mutual banks). (Directive 2000/12/EC requires €5 million for the general operation of banks and €1 million for minor banks);</p> <p>4. a program of initial operations must be submitted, together with the instrument of incorporation and the by-laws. In particular, the program must indicate:</p> <ul style="list-style-type: none"><li>▪ the sectors of activity, operations, and services in which the bank intends to engage;</li><li>▪ the bank's technical, organizational, and geographical structure; its procedures for internal controls; and the characteristics of its information system;</li><li>▪ the forecast budgets for the first three years.</li></ul> <p>5. the shareholders (direct or indirect) must satisfy the integrity requirements established by statutory and regulatory provisions (ICCS Resolution dated April 19, 1993; 1993 BL, Art. 25 (1); and Ministerial Decree 144/1998). Also, the requirements for authorization to hold shares of banks must be satisfied. In particular, the applicant must submit the following:</p> <ul style="list-style-type: none"><li>▪ a list of the bank's shareholders (direct or indirect), together with the proportionate interest of each and, for indirect shareholdings, the identity of the beneficial shareholders(s);</li><li>▪ information on the origin of the funds for the initial subscription of capital; and</li><li>▪ documentation showing that persons directly or indirectly holding more than 5 percent of the voting capital or control of the bank satisfy the integrity requirements and attesting to their quality;</li></ul> <p>6. The persons performing administrative, managerial or control functions must satisfy the experience and integrity requirements (1993 BL, Art. 26; Ministerial Decree 161/1998).</p> <p>In particular, the experience requirement must be satisfied by all persons performing administrative or managerial functions in banks formed as joint stock companies or <i>banche popolari</i> (cooperative banks) and by chairmen and general managers of mutual banks. The general manager and managing director must in all cases satisfy a specific requirement of managerial experience in the fields of banking, finance, securities and insurance. In verifying satisfaction of the requirements, the applicant company's board of directors must verify that the previous experience of the appointees to the offices of general manager, managing director, and board chairman are consistent with the specific management and operating needs of the bank.</p> <p>With regard to the integrity requirement, corporate office may not be held by persons who, for example, have been subjected to preventive measures by the judicial authorities or sentenced to a term of imprisonment of at least one year or two years for the crimes indicated in Ministerial Decree 161/1998;</p> <p>7. Close links must not exist between the bank or the components of the group to which the bank belongs and other persons that would prevent the effective exercise of supervisory functions.</p> <p>The evaluation preceding the granting of authorization is conducted in light of the ordinary supervisory criteria and rules for banking. The supervisory instructions concerning the formation of new banks explicitly address the main supervisory provisions applicable (including, ownership structures, requirements for corporate officers, capital adequacy, internal controls, and investment services). Use is also made of the same instruments employed in ongoing supervisory activity, such as requests for information from other authorities, requests for additions and amendments to programs of operations, meetings with the promoters of new banks, and on-site inspections at financial companies intending to transform themselves into banks.</p> <p>Banking authorization will be denied when examination of the application brings to light shortcomings precluding the conditions for sound and prudent management.</p> <p>The most frequent causes of authorization being denied are:</p>
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<ul style="list-style-type: none"><li>- inadequate capital base;</li><li>- deficiencies in the program of operations;</li><li>- record of criminal conviction or investigation of major shareholders; and</li><li>- negative results of inspections of financial companies applying to become banks.</li></ul> <p>The BI verifies that there are no close links between the bank or the components of the group to which the bank belongs and other persons that would prevent the effective exercise of supervisory functions. In particular, the group's configuration, the transparency of its ownership structure, the location of its components, the adequacy of supervision of its foreign components (if any) and the BI's ability to perform adequate consolidated supervision are evaluated.</p> <p>The suitability of major shareholders is evaluated primarily on the basis of the documentation attached to the application for banking authorization. The BI also uses other data in its possession and may avail itself of confidential information obtained from cooperation with other public authorities or with the competent supervisory authorities in any foreign countries concerned. Importance is also attached to links of whatever nature, including family or associational ties, between shareholders and other persons whose situation is likely to jeopardize the sound and prudent management of the bank.</p> <p>The shareholders may be required to offer specific commitments intended to safeguard the sound and prudent management of the bank. Given the importance of the quality of shareholders, in considering an application for authorization attention is paid to any record of criminal conviction or investigation of shareholders, even where shareholdings are below the first prescribed threshold (5 percent of voting capital) established by the provisions on the ownership structures of banks.<sup>41</sup></p> <p>Compliance with the integrity and experience requirements is first verified by the bank's board of directors, which transmits to the BI a copy of the minutes of the meeting in which the verification took place along with the relevant documentation. The BI then conducts its own assessment and, where grounds exist, acts in lieu of the board of directors and declares the disqualification of the officer concerned.</p> <p>The quality of corporate officers, like that of shareholders, is evaluated by the BI not only on the basis of the information provided by banks but also in the light of the information it gathers in the course of supervision or derived from data in its possession.</p> <p>Meetings with corporate officers of banks being established also serve to ascertain their knowledge of the operations and organization described in the program of operations. The BI verifies that the new bank's program of operations, which must fully describe its business plan and strategy, is based on principles of sound and prudent management.</p> <p>The new bank's proposed corporate governance system is assessed on the basis of the company rules and by-laws and shareholders' agreements. The composition, functioning, tasks and responsibilities of the corporate bodies are examined in order to ensure that there are no areas of uncertainty or overlap of tasks that can damage the company's functional efficiency.</p> <p>In examining the program of operations, the BI evaluates the consistency of the banks' technical, organizational and geographical structure and its intended internal controls with the objectives set for business growth. In particular, the internal control system chosen by the board of directors and senior management are checked for consistency with the complexity, specific operations and scale of the activities to be carried on. Where the bank intends to supply innovative financial products, the human and technical resources assigned to such activities are evaluated.</p> <p>The information system that the bank will use must be adequate to control the bank's business</p>
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<sup>41</sup> See BCP 4 for a more detailed analysis of the BI's assessment process.

	<p>and satisfy the supervisory reporting requirements.</p> <p>With regard to the technical report containing the forecast budgets for the first three financial years, the BI evaluates the bank’s capacity to maintain profitability and comply with the rules of prudential supervision during the start-up of its operations. The amount of the investment to create the technical and organizational structure and the related financial cover, the volume of business that the bank proposes to achieve, and the expected outturn are considered.</p> <p>The BI requests changes in the governance system, corporate structure or internal control system or adjustments to the business development plan when conditions of sound and prudent management are not ensured.</p> <p>The BI also requests changes in the program of operations and/or increases in initial capital when the bank’s own funds are inadequate in relation to the planned scale of business or in the event of actual or likely future non-compliance with capital adequacy ratios.</p> <p>The BI consults the home-country authority before authorizing a branch or subsidiary of a foreign bank to engage in banking in Italy. In the case of a branch or subsidiary of a non-EU member bank, the BI evaluates the adequacy of regulation from the point of view of supervisory controls on a solo and consolidated basis in the bank’s home country and of agreements for the exchange of information. The BI obtains the home-country supervisor’s prior consent to the establishment abroad and statements attesting to the soundness of the capital base and adequacy of the organizational, administrative and accounting procedures of the parent company or banking group to which the branch or subsidiary belongs.<sup>42</sup></p> <p>In any case where a banking authorization is found to have been granted on the basis of false information, the authorization may be revoked not only on the basis of the general principles of law but also pursuant to 1993 BL (Art. 80(1)), under which the bank is liquidated on the grounds that the false information provided to the supervisory authority constitutes an <i>exceptionally serious</i> administrative irregularity.</p>
Assessment	COMPLIANT
Comments	<p>The 1993 BL, regulations and supervisory instructions set out comprehensive criteria and conditions for banking authorization. The evaluation conducted by the BI is designed to permit market entry only to intermediaries potentially able to carry out banking activities in accordance with the principles of sound and prudent management. To this end, the BI scrutinizes the integrity and experience of the shareholders and managers, the corporate governance arrangements, the operating plans and the organizational structures of the new bank and verifies the existence of conditions for effective supervision. Authorization is denied if inadequacies are found. Authorization may be revoked where the information provided is shown to be false.</p> <p>The BI complies with the Essential Criterion concerning <i>fit and proper tests</i> for proposed directors and senior management at the initial authorization for a bank to commence business. According to the BI, there is no specific provision for it to require subsequent removal of a director or senior officer who may have become unfit as the current <i>fit and proper</i> tests are not sufficiently flexible, as discussed in assessment of BCP 14, below.</p> <p>In the case of the establishment of branches or subsidiaries of foreign banks, the BI obtains the prior consent of the home-country supervisory authority and evaluates the existence of conditions for effective supervision.</p>
<b>Principle 4.</b>	<p><b>Ownership</b> Banking supervisors must have the authority to review and reject any proposals to transfer significant ownership or controlling interests in existing banks to other parties.</p>

<sup>42</sup> See also BCP 25.

Description	<p>The BI's prior authorization is required when there is an acquisition of shares (directly or indirectly) which results, taking into account any existing holdings of shares, in an ownership interest of more than 5 percent of the voting capital of a bank (or its holding company) or which results in control of a bank or its holding company (1993 BL, Arts. 19(1), (3) and 22). The notion of <i>control</i> is defined (1993 BL, Art. 23). The BI's prior authorization is also required where an acquisition of shares results in a shareholding that exceeds the thresholds of 10, 15, 20, 33 and 50 percent of a bank's voting capital (1993 BL, Art. 19(1)). The BI has the power to specify the persons required to apply for authorization where voting rights are exercised by or attributed to a person other than the shareholder (1993 BL, Art. 19(4)).</p> <p>Any holding of a bank's voting capital that exceeds the prescribed percentages must be notified to the BI and to the bank concerned (1993 BL, Art. 20(1)).</p> <p>The prescribed percentages are calculated based on all voting shares. When the holding is acquired indirectly, the request for authorization must be made by the company at the top of the shareholding chain and by the one that directly holds the shares of the bank (or holding company). For transactions involving separation between ownership of the shares and exercise of the voting rights, an authorization must be requested both by the company owning the shares and by the company exercising the voting rights. A company intending to carry out transactions that would involve acquisition of control of a bank or bank holding company must notify the BI in advance, so that it can point out possible impediments to the transaction. There are mechanisms for coordination with Consob in the case of transactions involving listed banks.</p> <p>Where prior notification is required and in all cases subject to authorization requirements, a request for authorization to acquire the prescribed holding must be sent to the BI before the transaction is concluded. The BI thereupon verifies that:</p> <ul style="list-style-type: none"><li>• the shareholder satisfies the integrity requirements (1993 BL, Art. 25(1)). Where the shareholder is a company or institution, the integrity requirements must be satisfied by all the members of the board of directors and by the chief executive officer (1993 BL, Art. 26(1));</li><li>• conditions are likely to ensure the sound and prudent management of the bank or holding company. Account is taken of the correctness of business dealings and reliability of the financial situation of the applicants for authorization, the existence of links of whatever nature between the applicants and other persons, and any indebtedness of the applicants to the bank or holding company in which they intend to acquire an interest. In the case of acquisition of control, the verification also involves the business plan that the acquirer is to draw up for the management of the bank or banking group;</li><li>• the proposed acquisition complies with the <i>principle of separation</i> laid down by law, according to which companies with significant business activity in non-financial sectors may not acquire holdings of more than 15 percent of the voting capital, or control, of a bank or bank holding company (1993 BL, Art. 19(6)).</li></ul> <p>The BI decides within sixty days of receipt of the application for authorization. The time limit may be suspended or interrupted in a number of specified cases.</p> <p>If the person intending to acquire control of a bank or holding company is a foreign bank, the matter is the subject of prior consultation with the competent authorities of the state where the acquiring bank has its registered office.</p> <p>As with ownership structures at the time of banking authorization (1993 BL, Art. 14), the BI will deny authorization for the acquisition of the prescribed shareholdings where one or more of the requirements indicated above are not satisfied (1993 BL, Art. 19). Also, regulations provide that where changes in ownership structures result in a bank becoming a member of a group not qualified as a banking group (as defined in 1993 BL, Art. 60), the BI evaluates whether the structure of the group and the possible location abroad of some of its components may obstruct</p>
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	<p>the performance of supervisory controls.</p> <p>Authorization, once issued, may be suspended or revoked where the requirements and conditions on the basis of which it was granted cease to be satisfied (1993 BL, Art. 19(5)).</p> <p>In the event that authorization has not been obtained or has been suspended or revoked, the voting rights attached to the shares may not be exercised (1993 BL, Art. 24(1)).</p> <p>In the event of omission of notifications, the voting rights attaching to the unreported shares may not be exercised (1993 BL, Art. 24(1)).</p> <p>Where the capital of banks or bank holding companies is widely distributed, the BI may establish lower percentage thresholds for notification.</p> <p>The 1993 BL (Arts. 20(2) and 63) makes it mandatory to notify the BI of agreements governing or possibly giving rise to the concerted exercise of voting rights in a bank (or in a company that controls it) or in a holding company. Where the agreement gives rise to a concerted exercise of voting rights such as to jeopardize the sound and prudent management of the bank or holding company, the BI may suspend the voting rights of the parties to the agreement (1993 BL, Art. 20(3)). To this end, the BI assesses the practical impact of the agreement on the management policies of the supervised institution.</p> <p>Under Legislative Decree 87/1992, implementing Directive 86/635/EEC on the annual and consolidated accounts of banks and other financial institutions, banks are required to publish in their annual reports the names of the persons holding shares in the bank above a defined percentage as well as the shareholdings of the members of the board.</p> <p>The BI has the power to require a bank and the companies and entities that are its shareholders to provide the names of the shareholders of the latter (1993 BL, Art. 21(1) and (4)). A trust company registered as a shareholder of a bank is required to identify the beneficiary of the shareholding at the BI's request (1993 BL, Art. 21(3)). Holding companies and banks, except for <i>banche popolari</i> (cooperative banks) and <i>banche di credito cooperativo</i> (mutual banks), annually transmit to the BI a list of shareholders owning more than 2 percent of their voting share capital.</p> <p>The BI promptly obtains data for the correct identification of the owners of prescribed holdings, even where these are held through a nominee, and the size of their interests.</p>
Assessment	COMPLIANT
Comments	<p>While there is no precise definition of <i>significant</i> ownership the BI supervisory instructions introduce the concept of <i>significant shareholder</i> as being a person that directly or indirectly holds at least 5 percent of the voting capital or, in any case, control of the banking group holding company or an unaffiliated bank. The concept is consistent with various provisions of the statute. In particular, the 1993 BL and regulations:</p> <ul style="list-style-type: none"> <li>• establish the amount of the thresholds triggering authorization requirements;</li> <li>• establish the conditions for obtaining authorization;</li> <li>• grant the BI the power to deny authorization for the acquisition of prescribed holdings, or to revoke authorizations previously granted, where the established conditions are not satisfied.</li> </ul> <p>The statutory provisions extend to holding companies of banking groups. The acquisition of controlling interests in companies owning a prescribed interest in a bank or a banking group's holding company is also subject to authorization.</p> <p>Further efforts in limiting the practice of private agreements between majority-shareholders and Fondazioni would benefit the transparency and soundness of the banking sector. In this regard, a step in the right direction is the new company law, which will enter into force in January 2004 and make it compulsory for all firms with more than 200 shareholders to disclose any agreement between shareholders to the public.</p>
<b>Principle 5.</b>	<b>Investment Criteria</b>

	<p>Banking supervisors must have the authority to establish criteria for reviewing major acquisitions or investments by a bank and ensuring that corporate affiliations or structures do not expose the bank to undue risks or hinder effective supervision.</p>
<p>Description</p>	<p>The BI regulations made pursuant to ICCS resolutions, govern acquisition of shareholdings by banks (1993 BL, Art. 53(1)(b)(c)) and by banking groups, as defined (1993 BL, Art. 67(1)(b)(c)).</p> <p>Authorization depends on the nature of the companies to be acquired. In particular, holdings in <i>banks, financial companies and insurance companies</i> require prior authorization if the interest exceeds one of the following thresholds: 10, 20 and 50 percent of the investee company's voting share capital and any percentage involving control, or 10 percent of the investor's supervisory capital. Equity investments in <i>instrumental companies</i> (non-financial undertakings that perform activities of an auxiliary nature to that of the controlling bank or banking group) are always subject to prior authorization.</p> <p>Holdings in <i>non-financial companies</i> may be acquired without authorization, but are subject to quantitative limits, namely:</p> <ul style="list-style-type: none"> <li>• each such investment may not exceed 3 percent of the investor's supervisory capital;</li> <li>• the total of such investments in non-financial companies may not exceed 15 percent of the investor's supervisory capital;</li> <li>• the maximum permissible holding is generally 15 percent of the investee company's share capital. The 15 percent limit can be exceeded for investments below 1 percent of the investor's supervisory capital and provided that the total amount of investments exceeding the 15 percent limit is contained within 1 percent of the investor's supervisory capital ;</li> <li>• banks and banking groups satisfying particular requirements in terms of size and/or operations may be authorized on a general basis to comply with less stringent limits.</li> </ul> <p>Banks must also comply with the following general quantitative limits:</p> <ul style="list-style-type: none"> <li>• the book value of real estate and participations may not be greater than the bank's supervisory capital;</li> <li>• the total of investments in insurance companies is limited to 40 percent of consolidated supervisory capital or of supervisory capital in the case of an unaffiliated bank (60 percent of supervisory capital in the case of banks belonging to banking groups, as defined).</li> </ul> <p>The BI has the power to prohibit acquisitions of holdings in banks, financial companies and insurance companies if such initiatives are likely to limit or impede the effective performance of supervision on a consolidated basis.</p> <p>Authorization is granted following an evaluation of the technical and organizational situation of the acquiring bank or banking group and an assessment of the initiative's compatibility with the overall strategy of the acquirer and its impact on the capital requirements of the participants. Special attention is paid to verifying the availability of the necessary financial resources and the existence of a system of internal controls able to ensure correct management of the proposed shareholdings. In the case of acquisitions of banks, the evaluation extends to the aspects described in the discussion of BCP 4. The methods to be followed are described in the <i>BI's Guide for the Performance of Banking Supervision</i>; the principles inspiring these methods are published in the Supervisory Bulletin.</p> <p>Also, every three months banks and banking groups must report all of the equity interests they hold, directly or indirectly, in Italy or abroad, that exceed 2 percent of the investee company's capital, 0.5 percent of the supervisory capital of the bank or banking group, or €5 million.</p>
<p>Assessment</p>	<p>COMPLIANT</p>

Comments	Regulations define the types and amounts (absolute or in relation to the investor's supervisory capital) of acquisitions and investments which need the BI's approval and provide criteria to judge individual proposals. Consistent with the banking authorization limits, <sup>43</sup> among the objective criteria that the BI uses to assess acquisitions and investments, is that any new acquisitions and investments should not expose the investor to undue risks or hinder effective supervision. The BI determines that the investor has, from the outset, adequate financial and organizational resources to handle the acquisition/investment. Regulations define the cases for which notification after the acquisition/ investment is sufficient.
<b>Principle 6.</b>	<p><b>Capital Adequacy</b></p> <p>Banking supervisors must set minimum capital adequacy requirements for banks that reflect the risks that the bank undertakes, and must define the components of capital, bearing in mind its ability to absorb losses. For internationally active banks, these requirements must not be less than those established in the Basel Capital Accord.</p>
Description	<p>Arts. 53 and 67 of the 1993 BL establish that the BI, in compliance with the resolutions of the ICCS, issues general regulations concerning capital adequacy and the limitation of risk in its various forms for individual banks and banking groups.</p> <p>The BI has issued specific provisions governing the method of calculation of supervisory capital, the solvency ratio, market risks and large exposures on both a solo and a consolidated basis, and has established rules for compliance.</p> <p>The supervisory provisions, which apply to all banks and banking groups, conform with the Basel Accord of July 1988 on supervisory capital and the solvency coefficient, the January 1996 Amendment to the Capital Accord to incorporate market risks, and with European Union legislation on banking. The national regulation is more stringent than that given by the EU Directive mainly because of two deductions from the definition of own funds: (a) minimum level of provisions for country risk, and (b) net potential capital loss on financial fixed assets. Banks (including those belonging to a banking group) transmit quarterly reports on the above-mentioned supervisory profiles. Holding companies of banking groups transmit half-yearly consolidated reports on the same profiles with the exception of large exposures, which are reported on a quarterly basis. These reports provide an analytical indication of the different on- and off-balance-sheet components determining the risk profile of banks and banking groups. When a bank is already or about to become non-compliant with a supervisory parameter, its governing bodies must promptly take appropriate steps to bring the ratio back into line with the requirement. The decisions adopted must be submitted to the BI for review.</p> <p>The BI may establish a requirement (on both a solo and consolidated basis) higher than the minimum when it finds elements of accentuated risk regarding: the quality, concentration and valuation of loans; the liquidity of the loan portfolio; and the adequacy of the organizational structure in terms of organization and management systems (including, planning and control). In the case of banking groups, specific measures may be adopted if the group's balance sheet position, while satisfying the minimum capital adequacy requirement, is nonetheless strongly conditioned by the presence of <i>minority interests</i>.</p> <p>The governing bodies of the bank are required at least twice a year to evaluate the consistency of their business growth with supervisory capital, in order to ensure satisfaction of capital adequacy requirements in the future.</p> <p>The supervisory instructions require banks and banking groups to have an efficient and effective system of internal controls permitting, among other things, capital adequacy to be evaluated in</p>

<sup>43</sup> See BCP 4.

	relation to the underlying risks. The adequacy of the system of internal controls is ascertained by the BI by means of: (a) meetings with banks' corporate officers; (b) on-site inspections; and (c) periodic questionnaires or self-evaluations.
Assessment	COMPLIANT
Comments	The BI may impose specific requirements where banks' risk and organizational profiles show significant problem areas or where risks are perceived to have increased. In addition, in 2001, the BI required the 14 largest banking groups to submit plans for achieving capital adequacy targets higher than the regulatory minimums. This policy was made known to the general public in the BI's 2001 Annual Report and the BI's 2002 Annual Report discusses the success of these policy targets and their implications for the investment activities of banks.
<b>Principle 7.</b>	<b>Credit Policies</b> An essential part of any supervisory system is the independent evaluation of a bank's policies, practices, and procedures related to the granting of loans and making of investments and the ongoing management of the loan and investment portfolios.
Description	<p>The boards of directors of Italian banks approve strategic guidelines and policies for lending. The BI's supervisory instructions require banks' senior management to establish the methods of measuring credit risk and procedures for monitoring credit risk in accordance with such policies, with the knowledge and approval of the board of directors.</p> <p>Compliance with the rules is verified by the BI on an on-going basis by means of off-site supervision and on-site inspections. The Supervisory Guidance empowers the BI to make the independent evaluation of banks policies, practices and procedures.</p> <p>The supervisory instructions establish that:</p> <ul style="list-style-type: none"> <li>▪ the entire lending process (origination, credit-granting, monitoring of positions, revision of credit lines, actions on non-performing loans) must be governed by internal rules periodically subject to revision;</li> <li>▪ during loan examinations banks must acquire all the documentation necessary to conduct an adequate evaluation of the applicant's creditworthiness on the basis of its financial position and income, and correctly price loans according to credit risk;</li> <li>▪ the documentation must allow the bank to evaluate the consistency between the amount of the loan, its technical form, and the project financed. It must also permit the bank to identify the current and prospective characteristics and quality of the borrower in light of all of the borrower's dealings with the bank;</li> <li>▪ the delegations of lending authority must be approved by a resolution of the board of directors. The delegating person must be periodically informed of the use made of the delegations of authority;</li> <li>▪ the tasks of operating units in monitoring credits must be established by the internal rules, which also should set the procedures and time limits for intervention in the case of non-performing loans;</li> <li>▪ banks must always have an exact picture of their exposure to each customer or group of connected clients, inter alia for prompt revision of credit lines where appropriate. They must have information systems adequate to this purpose; and</li> <li>▪ the system of controls must permit evaluation and monitoring of the exposure to credit risk arising from transactions other than typical loans, including transactions in derivative instruments.</li> </ul> <p>Compliance with all the above requirements is verified by the BI:</p> <ul style="list-style-type: none"> <li>• through ongoing off-site supervision. Analysis of the system of credit-granting, loan management, and control of credit risk is a key part of organizational analysis, conducted using information gathered during meetings with corporate officers on the basis of a detailed</li> </ul>

	<p>questionnaire; and</p> <ul style="list-style-type: none"><li>• through inspections, allowing on-site verification of the adequacy of the structures and procedures supporting the process.</li></ul> <p>The rules on separation between banks and non-financial companies (Art. 19 of the 1993 BL and BI supervisory instructions) offer a primary line of defense against conflicts of interests and pressure from outside parties.</p> <p>The organizational requirements of the supervisory instructions regarding the granting of credit are aimed at ensuring, inter alia, that loans are granted on the basis of purely technical considerations.</p> <p>Art. 136 of the 1993 BL and the related supervisory instructions provide for particular procedures for loans granted to: (a) persons performing administrative, managerial, or control functions in a bank; (b) officers of other banks or companies belonging to the same group as the lending bank; and (c) a bank's employees.</p> <p>Compliance with the rules is verified both in meetings with management and in supervisory inspections (Arts. 54.1 and 68 of the 1993 BL), which permit direct access to customer records.</p> <p>The supervisory instructions make senior management responsible for establishing rules enabling the bank to assess creditworthiness, evaluate loan quality, and monitor loan performance over time; and for ensuring that these rules are clearly disseminated in the organization.</p> <p>The supervisory instructions require banks to prepare specific internal rules on lending. The BI urges banks to prepare manuals for use by all staff involved in the credit-granting process containing formal descriptions of all the formalities relating to the process, including the criteria for evaluating customers and granting credit.</p> <p>The BI has full access to the information on banks' loan portfolio (Art. 51 of the 1993 BL). It uses the data contained in banks' supervisory returns and the archives of the CCR:</p> <ul style="list-style-type: none"><li>• the supervisory statistics contain detailed information on the sectoral and geographical distribution of credit outstanding, flows and average monthly stocks. Non-performing loans are divided into various categories and data on stocks and flows are supplied;<sup>44</sup></li><li>• the CCR has records of all of the banking system's exposures exceeding €75,000. Exposures classified by intermediaries as bad debts are reported regardless of their amount;</li><li>• the quality of the loan portfolio is evaluated by comparing the different banks' classifications of multi-bank borrowers. Also, the probability of companies' failing is calculated on the basis of their financial statements and CCR data;</li><li>• requests for examination of specific aspects of the loan portfolio are made in letters or meetings with banks' corporate officers (including lending officers); and</li><li>• banks' files on individual loan positions are examined in the course of inspections (Arts. 54 and 68 of the 1993 BL and the related supervisory instructions).</li></ul> <p>The supervisory instructions provide that delegations of lending authority must be approved by resolution of the board of directors, and that the grid of limits resulting from any chain of delegations of authority must be documented.</p> <p>Where as a result of analysis or on-site inspections the BI finds that the distribution of delegated</p>
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<sup>44</sup> See BCP 8.

	<p>authority is not consistent with the type of risk assumed, it takes appropriate steps to correct the distribution and may request banks to raise the level of authorization required for large or particularly risky transactions.</p> <p>The supervisory instructions specifically require banks to have a continuously updated database containing customer's identification data, their legal and economic connections with other customers, the overall exposure of the individual borrower or group of connected clients, the technical forms giving rise to the exposure, and the updated value of collateral.</p> <p>The supervisory instructions require banks to use the data supplied by the CCR in order to monitor the customer's exposure to the entire financial system.</p>
Assessment	COMPLIANT
Comments	<p>The rules on the disbursement and monitoring of loans require: the involvement of senior management in determining methods of risk measurement and control consistent with lending policies; the preparation of internal rules made known to all staff assigned to lending operations; the evaluation of all the information on individual customers, including their exposure to the credit system as a whole.</p> <p>The above rules and those requiring separation between banks and non-financial companies contribute to preventing conflicts of interest and outside pressures in lending activity and ensuring that credit is granted on the basis of exclusively technical considerations.</p> <p>Compliance with these rules is constantly verified by the BI, which has complete access to banks' internal records.</p>
<b>Principle 8.</b>	<p><b>Loan Evaluation and Loan-Loss Provisioning</b></p> <p>Banking supervisors must be satisfied that banks establish and adhere to adequate policies, practices, and procedures for evaluating the quality of assets and the adequacy of loan-loss provisions and reserves.</p>
Description	<p>The rules that banks must follow for <i>loan valuation</i> are established in the Legislative Decree 87/1992, which implements Directive 86/635/EEC on the annual and consolidated accounts of banks and other financial institutions and Directive 89/117/EEC on the obligations, regarding the publication of annual accounting documents, of branches of credit institutions and financial institutions established in a member state having their head offices outside that member state.</p> <p>In particular, Art. 20 of Legislative Decree 87/1992 establish that loans are to be valued at their estimated realizable value in the annual accounts. The realizable value is to be calculated, taking account of market prices, on the basis of: (a) borrowers' solvency; and (b) country risk of the borrowers' country of residence.<sup>45</sup></p> <p>The estimated realizable value may be adjusted to account for the negative patterns regarding homogeneous categories of loans. The related revaluation deficits may also be calculated applying standard value-adjustment coefficients, like those applied under point (b) above.</p> <p>These criteria also apply to guarantees provided and to commitments that involve the assumption of credit risks.</p> <p>The rules banks must follow for <i>loan classification</i> are established by the BI supervisory instructions. In particular, Circular 49 of February 8, 1992—Manual for Completing Prudential Returns and other rulings requires that loans are classified as performing loans or non-performing loans, the latter category comprising four sub-groups:</p>

<sup>45</sup> See BCP 11.

(i) **Bad debts** are loans and guarantees to borrowers that are (a) in serious non-temporary economic and financial difficulties for which legal action to recover the loans is advisable, although such course of action may not be taken for special reasons; (b) who are insolvent (whether or not insolvency has been officially declared by a Court); or (c) are subject to insolvency proceedings.

(ii) **Substandard loans** comprise “loans and guarantee commitments to persons in a situation of difficulty, that is likely to be eliminated within a reasonable period of time” and include:

(a) residential real estate or building loans fully secured by a mortgage and where the borrower has received notice of seizure;

(b) other loans which meet the following two conditions:

(1) at least 7 monthly installments are past due in the case of a loan with an original life of more than 36 months, or 5 monthly installments for those with an original life of 36 months or less. If the repayment plan calls for quarterly installments, the number of installments past due must be 5 for loans with a life of more than 36 months or 3 for those with a life of 36 months or less; if the repayment plan requires half yearly installments, the number of installments past due must be at least 3 in the case of loans with an original life of more than 36 months or 2 for those with an original life of 36 months or less; and if installments are annual, at least six months must have elapsed from the due date; and

(2) the amounts overdue—excluding interest on arrears but including any amounts overdue on loans to the same borrower other than those indicated in (1)—are equal to at least 20 percent of the exposure (excluding interest on arrears); and

(c) claims on companies under supervised administration.

A repayment moratorium in itself does not alter the substandard status of the loan where the borrower’s situation of objective temporary difficulty persists. If the moratorium is accompanied by the other condition envisaged by the regulations (such as renegotiation of the debt at lower-than-market interest rates) the position in question has to be transferred to another category of nonperforming loans (restructured loans).

(iii) **Loans being restructured** comprise exposures in which the counterparty is indebted to a plurality of banks and the borrower has applied for consolidation within the last twelve months, and

(iv) **Restructured loans** comprise exposures in which a pool of banks or an individual bank, upon granting a moratorium on loan repayment, renegotiates the loan at a lower-than-market interest rates.

As regards impaired loans, full provision is made—going forward but not retroactively—for the accrual of interest once the bank management has classified a loan as bad debt. In all other cases, unpaid interest is not fully provisioned for:

- All interest on bad loans (*sofferenze*) is considered interest on arrears (*interessi di mora*) and is effectively totally provisioned for;
- In the case of sub-standard loans (*incagli*), banks make an estimate of the recoverable amount; all sums due (for capital and interest) in excess of this amount are provisioned;
- In the case of other past-due loans, “penalty interest” (*interessi di mora*) is largely provisioned for (70 percent of such interest, according to a survey covering 80 percent of banks by volume of assets) but “contractual” interest continues to accrue to income.

Provisioning is contained in the item *Doubtful debts and Write-downs* of the supervisory

<sup>46</sup> See BCP 21.

statistics. Legislative Decree 87/1992 leaves the level of asset-adjustment provisioning to the exclusive responsibility of the Board of Directors. If the BI assesses the level of provisioning of a particular bank to be inadequate for prudential purposes, it may require it to deduct the short-fall from regulatory capital (as is currently done for country risk) or to adopt a higher-than-minimum capital requirement. Banks must review their loan classification at least half-yearly.

The BI regulations on banks' annual accounts refer to the classifying criteria used in automated prudential returns. In addition, pursuant to Art. 20 of Legislative Decree 87/1992, the regulations provide that:

- Losses of value on guarantees provided and commitments are included in the *Provisions for liabilities and charges*, sub-item c): *Other provisions*, of the balance sheet; and
- Provisions charged to the profit and loss account may be used to create *Loan loss provisions*, which are set up against contingencies and have no asset-adjustment function.

Since Art. 20 of Legislative Decree 87/1992 allows standard value-adjustment coefficients (i.e., on a portfolio basis) only for claims belonging to homogeneous categories of loans (as well as for claims subject to country risk), it follows that loans of substantial size must be valued case by case.

The BI continually assesses the reliability of banks' classifications, using the information contained in the supervisory statistics and on file with the CCR. A particularly effective method of evaluating the correctness of the classifications of multi-bank borrowers is to compare the classifications of a specific borrower adopted by the different lenders.

During on-site controls BI inspectors examine the bank's files on a large sample of individual positions, always including the riskiest, in order to verify whether the bank's classification and valuation decisions comply with the legislative framework in force.

Controls on the classifications and valuations effected by banks are also carried out by the independent auditors that audit the annual accounts.<sup>46</sup>

The supervisory instructions require that the *criteria for the valuation, management and classification of substandard loans* and the units responsible for these tasks must be decided by a resolution of the board of directors, which must also indicate the manner of reconciling such rules with those established for supervisory reports. The board of directors must be regularly informed of the situation of non-performing loans and the procedures for recovery.

Where the level of non-performing loans is high, the BI may request the bank to strengthen the organizational structure and the procedures connected with every phase of the lending process. Where the problem is particularly serious, the supervisory intervention consists in requesting the bank to carry out a plan for organizational restructuring of the lending process.

When elements of pronounced risk are found regarding, *inter alia*, loan quality, concentration and valuation methods, and the adequacy of the organizational structure, the BI may set a higher minimum capital requirement for individual banks.

In less critical cases, supervisory action usually consists in a request that the bank strengthens its capital base, by increasing self-financing, and/or curbs the growth in risk assets.

The set of organizational requirements to be satisfied during credit-granting and monitoring (see BCP 7) are essential to enable banks to estimate the realizable value of their loans correctly.

The supervisory instructions also require banks to have a continually updated database showing, among other information, the value of collateral received. The valuation of collateral at realizable value is necessary in order to calculate the estimated realizable value of the loans it secures, as required by Legislative Decree 87/1992.

Assessment	LARGELY COMPLIANT
Comments	<p>The rules for the recording of loans in the annual accounts are established by law in compliance with the European Union Directives.</p> <p>The BI requires banks to review loan valuations at least half-yearly. Banks have to classify non-performing loans into different categories and the BI checks the manner in which they do so in the process of off-site supervision. At the same time, banks are required to monitor the value of collateral constantly, so as to update the estimated realizable value of the loans secured by the collateral.</p> <p>In comparison to practices in other G-7 countries, the impairment of loans and cessation of interest accrual appears to be recognized later in Italy. The rules for loan classification, particularly those defining the classification of “substandard loans,” leave scope for Italian banks to overstate their performing loans and income in their reporting to the public and to the BI.<sup>47</sup></p> <p>The writing off of nonperforming loans may take a number of years, inflating the gross level of nonperforming loans. and the recognition of probable losses on principal and unpaid interest does not take place until the bank recognizes the loan as substandard, for which the current subjective criteria are not sufficiently stringent. Even if over time parts of the claims are recovered, the financial statements of the institution need to be accurate in the interim period. Unpaid contractual interest continues to accrue to income, further overstating banks’ income. In view of presenting a true and fair view of the banks’ financial condition to other stakeholders, the BI should align its practice to that of the tax authorities, which encourage provisioning through partial tax deductibility for unpaid contractual interest accrued, soon after contractual interest payments cease, regardless of whether the bank has classified the loans as substandard (provisions on penalty interest accrued are fully tax deductible).</p> <p>Furthermore, the means available to the BI to learn of any inaccuracies in banks’ reported income have limitations. Inspections take place not more frequently than once every three years, many banks – admittedly small - are not subject to an external audit. The BI does not have powers to revoke the appointment of banks’ external auditors when their performance is deficient, nor does it have authority to set the scope and standards for external bank audits (see also BCP 19).</p> <p>Against this background, the Italian authorities may want to consider, in the exercise of its regulatory powers as described in Art. 53 of the 1993 BL, revising the applicable supervisory instructions on loan classification so that they more closely match practice in other G-7 countries, and better aligning the provisioning with that of the estimated losses of the loan portfolio of the banking system. This initiative would be welcomed by some market participants. Pending these changes, the BI could usefully reinforce, by issuing administrative guidelines, the implementation of provisioning policies that would help reflect appropriately the risk of non-payment associated with specific categories of loans.</p> <p>Sensitive to the particularities of the Italian credit market, the Basel Committee in Banking Supervision, in the context of the new Basel Capital Accord (April 2003), has granted the Italian authorities a five-year transition period during which it can use a 180-day past-due default criteria (as an exception to the rule of 90 days).<sup>48</sup> This can be considered a relevant step in the right direction of aligning loan classification criteria in Italy with other countries.</p> <p>Following the introduction of the law on asset securitization in Italy in 1999, many banks have used securitization operations as a way of removing loans, and in particular bad loans, from their</p>

<sup>47</sup> See also paragraphs 12 and 30 above.

<sup>48</sup> See the third consultative paper on the new Basel Capital Accord issued in April 2002 by the Basel Committee on Banking Supervision (paragraph 414, page 80).

	balance sheet. The BI monitors this process through a very extensive prudential reporting system and banks also have to report on their asset securitization in their annual reports. Securitization has allowed banks a better management of credit risk and the BI's regulatory approach allows the accurate assessment of the regulatory capital requirements of banks involved in this type of transaction. This, in turn, will facilitate the adoption of Basel II requirements on securitization.
<b>Principle 9.</b>	<b>Large Exposure Limits</b> Banking supervisors must be satisfied that banks have management information systems that enable management to identify concentrations within the portfolio, and supervisors must set prudential limits to restrict bank exposures to single borrowers or groups of related borrowers.
Description	<p>The provisions governing large exposures and loans to connected clients were established by the BI under the powers conferred on it by law and in the implementation of Directive 92/121/EEC of December 21, 1992 on the monitoring and control of large exposures of credit institutions.</p> <p>The provisions on large exposures define a <i>client</i> as a single person or group of connected clients vis-à-vis which the bank takes on risks. This definition includes banks, international organizations and states.</p> <p>A group of connected clients means two or more natural or legal persons that constitute a single risk because:</p> <p>(a) one of them has control over the other(s) (<i>legal connection</i>); or</p> <p>(b) independently of the existence of the relationship of control referred to in point (a), the persons in question are so interconnected that the financial difficulties of one are likely to involve repayment difficulties for the other(s) (<i>economic connection</i>).</p> <p>The BI may interpret the provisions on a case-by-case basis.</p> <p>The exposure to a <i>client</i> consists of the sum of on- and off-balance-sheet claims on that client, weighted by factors similar to those used for the solvency ratio.</p> <p>Banking groups and banks that do not belong to banking groups are required to limit:</p> <ul style="list-style-type: none"> <li>▪ the total amount of <i>large exposures</i> (i.e., exposures equal to 10 percent or more of supervisory capital) to within eight times supervisory capital (overall limit); and</li> <li>▪ each exposure to within 25 percent of supervisory capital (individual limit).</li> </ul> <p>A more restrictive regime applies to significant shareholders of banks and to companies of which the bank is a significant shareholder (both are defined as <i>connected persons</i>).<sup>49</sup> The individual limit on large exposures to such persons is equal to 20 percent of supervisory capital.</p> <p>Each single bank belonging to a banking group is subject to an individual limit equal to 40 percent of its supervisory capital.</p> <p>The supervisory instructions provide that the BI may establish more stringent individual and overall limits for banks and banking groups that show profiles of accentuated risk in relation to</p>

<sup>49</sup> More precisely, connected persons are defined as:

- the significant shareholder, i.e., the person that directly or indirectly holds at least 15 percent of the capital or a controlling interest in the group holding company or unaffiliated bank (the central government is not included in the definition significant shareholder);
- the companies in which there are significant shareholdings, i.e., those in which the bank has holdings of at least 20 percent or controlling interests. Companies belonging to the banking group and those within the scope of the consolidation are excluded.

	<p>their balance-sheet and organizational situation. Particular importance is attributed to the adequacy of the organizational structure in selecting customers and in monitoring the economic and financial situation of major clients and loan performance.</p> <p>The BI requires banks to have adequate organizational procedures to ensure compliance with the concentration limits and guarantee the good quality of loans, especially those of large amount.</p> <p>Particular emphasis is placed on the role of the holding company, so that the arrangements for delegating powers ensure that large exposures are fully known. The holding company, and specifically its board of directors, is charged with periodically reviewing the situation of large exposures and loans to connected persons.</p> <p>Checks on the adequacy and efficiency of the procedures with which banks monitor the concentration limits are carried out primarily during inspections, although the lack of effective organizational procedures for monitoring the limits may also be inferred indirectly through off-site supervision. In particular, overshoots may point to deficient internal monitoring procedures. In such cases the BI takes appropriate supervisory action (Arts. 53, 61 and 67 of the 1993 BL, Credit Committee Resolution of August, 2 1996 and BI supervisory instructions).</p> <p>Banks are required to report quarterly to the BI the amount of their large exposures on both a solo and a consolidated basis (Arts. 51 and 66 of the 1993 BL and supervisory instructions). The supervisory reports also permit the BI to obtain detailed information on the concentration of the bank's credit portfolio by sector, branch of economic activity, and geographical area. The BI is studying the influence of the geographical and sectoral composition of loans on the <i>value at risk</i> of intermediaries' credit portfolios. The analytical tools employed by the BI in evaluating an intermediary's risk profile include an examination of portfolio concentration using the Herfindahl index and a procedure for measuring the overall credit granted by individual banks to the major industrial groups.</p>
Assessment	COMPLIANT
Comments	<p>Prudential limits on large exposures and "connected clients" are set consistently with the European Union directives on large exposures, and with tighter limits for connected persons, on both a solo and a consolidated basis.<sup>50</sup></p> <p>Banks are required to have information systems and procedures able to ensure constant compliance with the rules on large exposures, and the BI continually checks compliance.</p> <p>The concentration of credit portfolio is examined by means of off-site supervision and on-site inspections. Statistical techniques are being developed for calculating the value at risk of loans. No deviations are allowed on the regulation on large exposures under any circumstance.</p>
<b>Principle 10.</b>	<p><b>Connected Lending</b></p> <p>In order to prevent abuses arising from connected lending, banking supervisors must have in place requirements that banks lend to related companies and individuals on an arm's-length basis, that such extensions of credit are effectively monitored, and that other appropriate steps are taken to control or mitigate the risks.</p>
Description	<p>The supervisory instructions indicate a special notion of <i>connected persons</i> comprising: (a) the <i>significant shareholder</i>, i.e., the person that directly or indirectly holds at least 15 percent of the capital or, in any case, control of the group holding company or the unaffiliated bank; (b) the <i>companies in which there are significant shareholdings</i>, i.e., those in which the bank holds at least 20 percent of control. Companies belonging to the banking group and those consolidated with the line-by-line or proportionate methods are excluded. Also, special procedures are</p>

<sup>50</sup> The concentration limit for exposures to "connected persons" is equal to 20 percent of supervisory capital, compared with 25 percent for other exposures. Loans to the group of customers connected to such persons by legal or economic connections are counted in computing the exposure (see BCP 9).

<p>contemplated in the legal system to prevent the board of directors, board of auditors as well as management and employees of the banks to derive improper benefit from their position.</p> <p>As a general rule, banks are required to have adequate loan application procedures for the correct evaluation of clients' creditworthiness and of lending conditions. As far as lending to connected parties is concerned, the banking legislation establishes more severe procedures to prevent abuses by those involved in the decisions. The provisions of the Civil Code and banking legislation establish procedures to prevent conflicts of interest by those involved in the decisions to grant loans. Compliance with these provisions is reinforced by the civil and penal sanctions established for violations.</p> <p>Within the scope of its powers of control and verification for the purposes of sound and prudent management of banks, the BI acts to prevent or remove conflicts of interest.</p> <p><b>Board of directors</b></p> <p>Art. 136 of the 1993 BL establishes that a special procedure must be followed for persons performing administrative, managerial or control functions (such as members of the board of directors and of the board of auditors, and general managers) in a bank to contract obligations of any kind with the bank either <i>directly or indirectly</i>. Such transactions are allowed only following a resolution adopted unanimously by the administrative body and the favorable vote of all the members of the control body, with the corporate officer concerned abstaining.<sup>51</sup> Violations of the rule are punished by penal sanctions. According to the BI's supervisory instructions, the notion of <i>direct</i> obligation extends to cases where the person, even if not formally a contracting party, has personal and unlimited liability for the obligation (e.g., as a member of a partnership, a general partner in a partnership limited by shares, or sole shareholder of a public limited company). The notion of <i>indirect</i> obligation identifies a relationship which is established <i>de facto</i> with the corporate officer even if it is formally entered into with a legal person or another natural person (e.g., spouse or other relative of the corporate officer). In particular, with regard to obligations contracted by companies, Art. 136 of the 1993 BL applies where the corporate officer has <i>control</i> of the contracting company. Art. 23 of the 1993 BL provides a very broad notion of control (both direct and indirect) by means of a series of indices of influence on corporate operations.</p> <p>As far as members of the board of directors are concerned, the implications of Art. 136 are reinforced by the application to banks of the rules on conflicts of interest (Art. 2391 of the Civil Code, recently amended in the framework of the general reform of Company Law, passed on January 2003). According to these rules, directors give detailed notice to other directors as well as to the control body of any interests they have in a given activity of the company; CEOs must even abstain from the activity and submit it to the administrative body. Also, the administrative body, when deciding on such business, must give an adequate motivation of decisions and of the related advantages for the company. Decisions voted with the decisive vote of the director having an interest in the business may be challenged if they may cause any damage to the company. Such rules apply to directors who act both in their self-interests and on behalf of third parties' interest. Third parties' interests include interests which derive from corporate links and personal connections with third parties (such as contracts with family members, and loans to companies in which corporate officers of the bank are directors or members of the board of auditors). Penal sanctions are established for directors who have conflict of interest with the company, when the</p>
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<sup>51</sup> A similar procedure also applies to persons performing the above-mentioned functions in a bank or company belonging to a banking group with regard to the obligations and agreements entered into with such company and to loans contracted with other companies or banks belonging to the group.

<sup>52</sup> See BI's Supervisory Instructions, tit. IV, cap. 5, sez. II.

	<p>company is damaged as a consequence of their transactions involving its assets.</p> <p><b>Board of Statutory Auditors</b></p> <p>Art. 136 of the 1993 BL is applicable (see above).</p> <p><b>Management and employees</b></p> <p>According to the BI's supervisory instructions (tit. IV, cap. 11, section II, par. 2.1), banks establish ad hoc procedures in order to prevent the occurrence of conflicts of interest when lending money to their employees (including managers). In particular, banks must comply with the principle that such loans must be approved at a level higher than that of the borrower.</p> <p><b>Significant shareholders</b></p> <p>Italian legislation (see, in particular, Art. 19 of the 1993 BL and BI's Supervisory Instructions, tit. II, cap. 1,) establishes controls <i>upstream</i> on the quality and independence of the bank's ownership structures and lays down provisions for the separation of banking and industry. The quality of a bank's shareholders is also evaluated having regard to: the correctness in business dealings and soundness of the financial situation of persons applying for authorization to acquire a shareholding; any links of whatever nature—including family or organizational—between the shareholder and other persons that could jeopardize the conditions mentioned above; the person's outstanding debt to the bank or the holding company in which the shareholding is to be acquired. The BI may require the shareholder to submit a specific declaration undertaking to respect the autonomy of the bank's management.</p> <p>The existence of links with a bank is also significant for the purposes of prudential supervision, notably in the context of the rules on risk concentration. According to Art. 53 of the BL: <i>banks in granting credit to persons connected with or having significant holdings in them must observe the limits of the BI in compliance with the resolutions of the Credit Committee. Such limits shall be determined exclusively with reference to the capital of the bank and the holding therein of the person applying for the credit.</i> The ICCS has not issued a specific resolution on such limits as yet. Connected lending is only subject to the limits envisaged in the regulation of large exposures.<sup>52</sup></p> <p>Banks are required to send the BI quarterly reports on their large exposures, including those to connected persons.</p> <p>If a member of the board of directors is related to a significant shareholder, Art.136 of the 1993 BL and Art. 2391 of the Civil Code are applicable (see above).</p>
Assessment	LARGELY COMPLIANT
Comments	<p>There is no comprehensive definition of, or lending limits on, <i>connected or related parties</i> and there is no discretion granted to the supervisor to make judgments about the existence of connections between the bank and other parties, except in the context of large exposures. Although the 1993 BL and the related supervisory instructions provide for particular procedures for loans granted to banks' connected and related parties, there is no provision—in law or regulation or supervisory instruction, requiring that exposures to connected or related parties only be granted on market terms. Neither do special reporting nor do limits on this type of lending exist, except those made in the context of large credit exposures. In addition, Circular No. 166 requires banks to inform in their annual reports on lending and guarantees granted to administrators. The authorities are strongly recommended to consider the issuance of a comprehensive regulation on connected lending to address the issues of definition, overall limits, and reporting to the BI.</p>
<b>Principle 11.</b>	<p><b>Country Risk</b></p> <p>Banking supervisors must be satisfied that banks have adequate policies and procedures for identifying, monitoring, and controlling country risk and transfer risk in their international lending and investment activities, and for maintaining appropriate reserves against such risks.</p>
Description	According to the legislation on internal controls, banks must carefully monitor the risk of loans

	<p>with suitable internal procedures. The amount of provisioning against unsecured loans to counterparties resident in countries subject to country risk may not be smaller than that calculated on the basis of specific supervisory rules on country risk. Countries subject to country risk are either defined as non-OECD members or OECD members which have restructured their foreign debt in the last five years.</p> <p>In Italy the rules on country risk were introduced in the supervisory instructions in 1993. An important amendment was adopted in 1998 to reflect both the experience gained up to then in applying the rules and the intervening changes in the structure and functioning of the international financial markets.</p> <p>Countries where the Italian banking system's exposure exceeds €12.5 million are classified into 6 risk classes, corresponding to asset adjustment factors of between 15 and 60 percent. Countries are classified according to a score based on four groups of indicators: market indicators (rating, spread and access to the market); macroeconomic indicators (debt-service ratio, foreign debt in relation to GDP and exports); performance indicators (moratoria, defaults, debt restructurings); and exceptional factors normally not reflected in quantitative data. The classification method was developed by the BI together with the banking system. The necessary data are collected and disseminated by the BI's International Relations Office, which participates in updating and refining the country-classification method.</p> <p>In calculating value adjustments, trade credits are considered at 15 percent of face value.</p> <p>Banks with an exposure smaller than €200 million may opt to apply the "simplified" method instead of the "analytical" (case-by-case) method. The simplified method involves a standard adjustment of 30 percent.</p> <p>Where provisions are lower than the minimum amounts determined according to the above methodology, the shortfall is deducted from supplementary capital. The ordinary rules of tax deductibility apply to them to the extent that such allocations refer to credits granted to private nonbank counterparties.</p> <p>Countries' risk scores and the adjustment factors applicable to them are re-evaluated every six months with the method described above. In addition to the half-yearly evaluation, countries' economic and financial conditions are reviewed quarterly for possible situations of vulnerability. The problems involved in applying the method are discussed on these occasions.</p> <p>Banks send to the BI two reports on their foreign exposure: a report on unsecured credits to countries at risk, for purposes of asset adjustment, and another report with information by country for national, ECB, and BI statistical purposes. The first report is transmitted ever six months on both an individual and consolidated basis. Loans and guarantee commitments are reported by individual country and divided into "trade" (tied to international commercial transactions, with a maturity of 18 months or less) and "other." The second report is transmitted separately for the banking units operating in Italy (monthly) and for branches and subsidiaries abroad (quarterly). All balance-sheet assets are classified according to the country of the counterparty and details are given on technical form, currency, location of disbursing unit, original maturity and residual maturity, counterparty's sector, guarantor's state and sector. For off-balance-sheet items, banks must report details of guarantee commitments, commitments and derivative (nominal values and credit equivalents) positions.</p>
Assessment	COMPLIANT
Comments	<p>Banks are required to adopt internal procedures to evaluate country risk and monitor their own exposure.</p> <p>The minimum amount of provisioning against country risk is determined by a comprehensive method that uses a wide range of variables to define the degree of risk attributable to each country. The resulting classification provides a useful reference point for the valuations effected using banks' internal procedures.</p>

	The evolution of countries' economic and financial conditions is frequently the subject of joint review by the banks and the BI.
<b>Principle 12.</b>	<b>Market Risks</b> Banking supervisors must be satisfied that banks have in place systems that accurately measure, monitor, and adequately control market risks; supervisors should have powers to impose specific limits and/or a specific capital charge on market risk exposure, if warranted.
Description	<p>Pursuant to Arts. 53 and 67 of the 1993 BL, the BI has issued specific regulations on the capital adequacy, administrative and accounting procedures and internal control systems of banks and banking groups with respect to market risks.</p> <p>Compliance with the capital requirements must be accompanied by the existence of internal control procedures and systems ensuring sound and prudent management of market risks.</p> <p>Accordingly, banks and banking groups must have:</p> <ul style="list-style-type: none"> <li>• an information system permitting constant monitoring of the exposure to risk in securities and foreign exchange operations;</li> <li>• a method of measuring exposures that is shared by the different sectors (operating and monitoring staff) and makes possible an integrated approach to risk management;</li> <li>• a detailed system of limits governing the assumption of market risks by single operating units. This system must clearly define the lines of responsibility for risk management;</li> <li>• a management information system enabling senior management to understand the exposure to risk at any time; and</li> <li>• an effective system of internal auditing.</li> </ul> <p>The systems and procedures used must be consistent with the type and level of securities and foreign exchange activity. In order to ensure such consistency even at times of rapid change in the operations of a bank or banking group, or the markets in which the bank or banking group is active, the adequacy and effectiveness of the control procedures and systems must be verified periodically.</p> <p>The supervisory instructions provide for continuing compliance on both a solo and a consolidated basis with a capital requirement against market risks that are defined in accordance with the 1996 Amendment to the Capital Accord and European Union directives. The requirement refers to: (a) the trading book (position, settlement, counterparty, and concentration risk); and (b) the whole balance sheet (foreign exchange risk and position risk on commodities). Banks may measure market risks with an internal model validated by the BI as an alternative to the standardized model.</p> <p>Supervisory capital must cover the set of credit and market risks, in accordance with the Amendment to the Capital Accord.</p> <p>The BI may establish additional capital charges to be included in calculating the overall minimum requirement. Banks and banking groups are required to send the BI periodic reports regarding capital adequacy (quarterly at the solo, and half-yearly at the consolidated level).</p> <p>Banks and banking groups also transmit detailed monthly data on their financial activity, which are used by the BI to analyze different market segments.</p> <p>The rules on disclosure in financial statements establish that specific data are to be provided on banks' securities and foreign exchange trading and on supervisory capital cover for market risks.<sup>53</sup></p>

<sup>53</sup> See also BCP 21.

	<p>The BI continuously monitors the exposure to market risks using the periodic reports on capital adequacy and the statistical data on banks' balance-sheet and income items. The BI has formulated guidelines for the analysis of financial risks and developed instruments for calculating the VaR of the trading book.</p> <p>The BI analyzes the documentation sent by banks on their internal control systems and holds periodic meetings on risk management issues, especially with intermediaries that engage in highly complex operations. Specific aspects are evaluated, notably: senior management's awareness of the bank's actual exposure, the adequacy of the risk measurement and risk monitoring procedures, the adequacy of the limits for the different types of risk, and the system of controls in place. For banks most heavily exposed to market risks and users of VaR methodologies, the BI validates the models and checks that provision is made for stress testing and back testing. One bank had its model validated and other is in the process. Also, the human and technological resources assigned to risk management are evaluated.</p> <p>Specific analyses are performed on the occasion of general and sectoral inspections.<sup>54</sup> Verification intensifies in the case of validation of an internal model. To be recognized, a model must meet the qualitative (organizational) standards and quantitative requirements (restrictions on the choice of risk measurement parameters) established by the BI's supervisory instructions. The following organizational standards must be satisfied: integration of the model into the daily risk management process; existence of a risk control unit independent of the front-line; active participation of senior management in the risk control process; and a rigorous program of stress testing, whose outcome is evaluated by senior management.</p> <p>Validation is effected by a team of qualified BI specialists with prior analysis of the documentation presented and meetings with the banks' risk management officers, followed by a period of on-site verification of the model's effectiveness.</p> <p>Following a BI model validation, a data flow to the BI is determined, including data not only on the VaR but also on daily results and the model's performance. Banks must promptly notify the BI of significant changes in the model's characteristics and financial operations. Changes in managerial staff assigned to the operating desks and to the risk management units are specified among the significant organizational changes to be reported to the BI.</p> <p>In the event that the BI is not fully satisfied with the compliance of the qualitative and quantitative criteria required by the 1996 Amendment to the Capital Accord and the European Union directives, it has the capability to set a multiplier larger than 3 for the calculation of the necessary regulatory capital to cover market risk.</p> <p>The larger banking groups have been asked to promptly adopt internal models that meet the characteristics specified for validation, particularly with regard to stress testing and back testing.</p>
Assessment	COMPLIANT
Comments	<p>Legislation provides all the necessary informational and regulatory instruments for exercising the supervisory function for this specific area.</p> <p>Capital requirements and organizational standards are well prescribed for the measurement and control of market risks by banks. Internal systems must cover the various types of risk and be subject to periodic review. Management must be able to monitor the risks assumed.</p> <p>Compliance with the rules is ensured through model validation, statistical analysis, meetings with risk control managers, and on-site inspections.</p>

<sup>54</sup> See BCP 16.

	<p>Specific requirements for stress testing and back testing are laid down for the validation of internal models. Validation is effected by specialized and well qualified BI staff.</p> <p>Pursuant to Art.53(3) of the 1993 BL, the BI can require banks to reduce market risks in the event of insufficient or inadequate risk management systems.</p>
<b>Principle 13.</b>	<p><b>Other Risks</b></p> <p>Banking supervisors must be satisfied that banks have in place a comprehensive risk management process (including appropriate board and senior management oversight) to identify, measure, monitor, and control all other material risks and, where appropriate, to hold capital against these risks.</p>
Description	<p>Pursuant to Arts 53 and 67 of the 1993 BL, the BI has issued specific regulations on the internal control systems and exposure <i>to interest rate risk</i> of banks and banking groups.</p> <p>The supervisory instructions require that the board of directors be aware of the risks the bank is exposed to and approve the procedures for identifying, measuring and managing the different risks.<sup>55</sup></p> <p>Banks must put in place internal risk management systems (rules, procedures and organizational structures) to identify, measure and control the exposure to the individual types of risk and to manage the exposures comprehensively, taking into account possible correlation between the different risk factors. There must be an adequate flow of information to enable the board of directors and senior management to monitor changes in the profile of the different types of risk. The limits established must be monitored continuously and reviewed periodically; they must be communicated to all persons responsible for acquiring and controlling risk.</p> <p>Banks must also establish procedures to identify anomalous situations that may indicate inefficiency of the risk measurement and control system.</p> <p>For banks that have complex operations, the functions of measurement and integrated control of risk must be entrusted to a separate and independent unit.</p> <p>Banks must carefully evaluate plans to expand into new markets or sectors of business, identifying the associated risks and establishing adequate control procedures in advance. These procedures must be submitted to the board of directors for approval.</p> <p>The supervisory instructions expressly address not only credit risk and market risk but also <i>interest rate risk, liquidity risk, operational risk, legal risk, and settlement risk</i>.</p> <p>For <i>interest rate risk</i>, banks must equip themselves with systems for integrated management of interest rate risk with other types of risk.</p> <p>For <i>liquidity risk</i>, rules on maturity transformation are applied on both a solo and a consolidated basis.</p> <p><i>Operational and legal risks</i> are addressed in the broader context of the rules on internal controls and reporting, which are applied both on individual banks and banking groups</p> <p>The annual accounts must include a table showing the distribution by maturity of on-and-off-balance-sheet assets and liabilities.</p> <p>Banks with complex business in derivatives, structured securities, and securitizations must make more extensive disclosure in their annual accounts on the basis of case-by-case indications from the BI.</p> <p>The supervisory statistics capture the residual maturity of contracts, the period to the interest</p>

<sup>55</sup> See BCP 14.

<p>rate revision date and the currency of settlement. They enable the BI to establish statistical indicators for the evaluation of liquidity, interest rate and exchange rate risk. To provide banks reference data for their risk management systems, the BI sends them a quarterly data flow containing system-wide statistical and financial indicators.</p> <p>In evaluating the other risks, the BI makes use of quantitative approaches, documentation sent by the banks on their internal control systems, and periodic meetings with corporate officers on specific issues of risk management.</p> <p>The following are evaluated: the awareness of senior management as to the bank's actual exposure, the adequacy of the procedures for measuring interest rate risk and monitoring other risks (especially settlement risk and liquidity risk), the adequacy of the system of limits for the various types of risk (interest rate risk, settlement risk, liquidity risk), the adequacy of the structures and instruments available to internal auditing, and the adoption of controls on the reliability and functional effectiveness of information systems.</p> <p>The BI verifies that banks have appropriate procedures to record and monitor operational risk and to record significant losses. It has also issued guidance to the banks on the issue of outsourcing and it is preparing guidance on IT security and contingency planning.</p> <p>Under a self-regulatory arrangement, Italian banks systematically transmit to the Italian Bankers' Associations (ABI) data on thefts and robberies for use in benchmarking.</p> <p>Continual verification of organizational arrangements is supplemented by both general inspections and inspections targeted to specific areas.</p> <p>In evaluating banks' risk profiles, a specific half-yearly analysis of each intermediary's exposure to interest rate risk is performed using the measurement criteria indicated by the Basel Committee.</p> <p>The BI identifies banks for which the amount of risk is found to be particularly high and evaluates their position, intervening where the risks acquired are disproportionate to the bank's own funds and income-earning prospects. These quantitative elements are supplemented with evaluations of the organizational arrangements for managing and controlling such risks.</p> <p>The BI may subject the banks in question to limits on the future acquisition of such risks or to a specific capital cover (Title IV, Chapter 8, of the supervisory instructions).</p> <p>Liquidity risk is analyzed with a statistical method supplemented by qualitative elements referring to organization (see BCP 16). The model is consistent with the guidelines established by the Basel Committee, which have been sent to all banks.</p> <p>Primary legislation provides adequate informational and regulatory instruments for performing the supervisory function for this specific area.</p> <p>The supervisory instructions require banks to set up internal control systems, to be approved by the board of directors that cover all the types of risk and manage them in an integrated manner. Specific rules apply to interest rate risk and liquidity risk. Banks that carry out more complex operations are required to supply information on their transactions in derivatives and other sophisticated instruments in their annual accounts.</p> <p>The BI checks organizational arrangements by means of meetings with banks' risk control officers and inspections. It monitors the exposure to risk using indicators based on the residual maturity and the currency of transactions.</p> <p>With regard to operational risk in the context of the new Basel II requirements, the BI has collaborated with the ABI in defining criteria for the identification of relevant events that have been published by the Association. A structured system for recording losses due to operational risks has been initiated.</p>
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Assessment	COMPLIANT
Comments	<p>Primary legislation provides for adequate information and regulatory instruments for performing effective supervision of the full spectrum of risks.</p> <p>The supervisory instructions (<i>Sistema dei controlli interni, compiti del collegio sindacale</i>) require banks to set up internal control systems both on a solo and consolidated basis, to be approved by the board of directors. These guidelines refer to the control of risks, the internal audit function, IT systems, and control of foreign branches. It also clearly defines the responsibilities of the Board of Auditors, internal auditing, and external auditors in controlling these risks.</p> <p>Banks that carry out more complex operations are required to supply information on their transactions in derivatives and other sophisticated instruments in their annual accounts. The BI has not recommended banks to follow the EC Recommendation 23/6/00 on banks public information on financial instruments. However, it encourages banks to follow the recommendations of the Multidisciplinary Working Group on Enhanced Disclosure when reporting on interest and liquidity risks in their annual accounts.</p> <p>The BI checks organizational arrangements by means of meetings with banks' risk control officers and inspections. It monitors the exposure to risk using indicators based on the residual maturity and the currency of transactions.</p> <p>The supervisory regulations do not establish specific capital charges in respect of interest rate risk and other material risks (liquidity risk and operational risk). However, these risks are analyzed and evaluated by the BI, which may impose minimum capital requirements to cover them.</p> <p>Although legally empowered to do so, the BI does not require banks to hold capital against operational risks, which are addressed in the broader context of the rules on internal controls. However, it is planning to do so in the context of the implementation of Basel II. The BI's assessment of banks' operational risk takes place during off-site supervision and is based on the supervisor's assessment of management procedures. Action is being taken (e.g., constitution of a data base on event losses by a consortium of banks and securities firms) in order to fulfill the obligations imposed by Basel II on operational risk.</p>
<b>Principle 14.</b>	<p><b>Internal Control and Audit</b></p> <p>Banking supervisors must determine that banks have in place internal controls that are adequate for the nature and scale of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding its assets; and appropriate independent internal or external audit and compliance functions to test adherence to these controls, as well as applicable laws and regulations.</p>
Description	<p>The Italian Civil Code (Arts. 2368 and 2404) delineates a corporate model based on an administrative body (board of directors) and control body (board of auditors), to which it assigns tasks and responsibilities<sup>56</sup>. The 1993 BL adapted this model to banks. The 1998 CLFI assigns accounting control to independent auditing firms and entrusts the board of auditors with assessing the adequacy of the company's organizational structure and control system.</p> <p>The BI has issued supervisory instructions to ensure that functional governance and risk control arrangements essential for sound and prudent management are in place at banks. The rules on internal controls adapt the general principles and best practices identified by the Basel Committee</p>

<sup>56</sup> A recent reform of the Civil Code (due to come into force on January 1, 2004) allows companies to adopt, in addition to the present model, either the "Anglo-Saxon" model (board of directors only) or the "German" one (management board and supervisory board).

	<p>to the specific features of the Italian banking system. The supervisory instructions also contain a series of indications on the control procedures to be implemented at group level so that the holding company can effectively provide direction and coordination as provided for by law.</p> <p>The instructions define internal controls as the set of rules, procedures and organizational structures designed to ensure that corporate strategies are complied with and the following objectives achieved.</p> <ul style="list-style-type: none"><li>• effectiveness and efficiency of corporate processes (including administration, production, and distribution);</li><li>• preservation of the value of assets and protection from losses;</li><li>• reliability and integrity of accounting and management systems; and</li><li>• conformity of transactions with laws, supervisory regulations and internal policies, plans, rules and procedures.</li></ul> <p>According to the supervisory instructions, internal controls comprise:</p> <p>(i) line controls, to ensure that transactions are carried out correctly. These controls are performed by the production units themselves (e.g., hierarchical controls), incorporated in procedures or carried out as part of back-office activity;</p> <p>(ii) risk management controls that contribute to defining the risk measurement system, check compliance with the limits assigned to the various operating functions and control the consistency of individual production areas' transactions with the assigned risk-return targets. These controls are entrusted to units not involved in production; and</p> <p>(iii) an internal audit function, to identify anomalous developments and violations of procedures and rules and to assess the functionality of internal controls as a whole. Internal audit must also identify possible corrective measures and verify that the shortcomings found have been eliminated.</p> <p>Banking regulations require banks to adopt organizational solutions that:</p> <ul style="list-style-type: none"><li>• ensure separation between operating and control functions and prevent conflicts of interest in the assignment of tasks;</li><li>• be able to adequately identify, measure and monitor all the risks that have been incurred or may be incurred in the different business segments;</li><li>• establish controls at every operating level and permit unequivocal, formal attribution of tasks and responsibilities;</li><li>• ensure reliable information systems and appropriate reporting procedures at the different levels of management entrusted with control functions;</li><li>• guarantee that anomalies found by operating units, the internal audit function or other staff assigned to controls are promptly reported to the competent corporate structures; and</li><li>• permit the recording of every operational event and, in particular, all individual transactions in adequate detail and ensure their correct recognition.</li></ul> <p>The board of directors, as the body responsible for policymaking, guidance and monitoring of the company's strategy, must:</p> <ul style="list-style-type: none"><li>• approve risk management strategies and policies, specifying the levels of risk deemed acceptable;</li><li>• approve the company's organizational structure; and</li></ul>
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<ul style="list-style-type: none"><li>• check that management adopts adequate control procedures and measurement systems, and see that the overall system remains efficient over time.</li></ul> <p>For the sake of efficiency, the board of directors may establish an audit committee.</p> <p>The supervisory instructions require that an effective and reliable reporting system be put in place permitting the administrative bodies to have full knowledge of and an ability to govern corporate events.</p> <p>Management is required to plan and maintain a system of controls integrated with the operating units and able to adjust rapidly to changes in the bank's situation.</p> <p>The board of auditors, which is responsible for checking the regular functioning of each main organizational area, conducts its own assessments of internal controls, possibly availing itself of the internal audit function.</p> <p>Art. 26 of the 1993 BL establishes the requirements of persons performing administrative, managerial or control functions. It also provides for the disqualification of such persons from their duties in cases where the requirements are not met.</p> <p>The BI evaluates the adequacy of internal controls as part of the analysis it performs of the intermediary's overall organization with a view to identifying so-called <u>organizational risk</u>, i.e., any weaknesses in the different components of the organizational system that could negatively affect the bank's profitability, balance sheet, financial position and competitiveness, without prejudice to the bank's freedom to choose what it considers the most appropriate internal arrangements.</p> <p>This assessment is performed by means of an examination of all the documentation concerning controls (including by-laws, organization charts, and internal rules) and periodic meetings with the bank's officers for joint review of the problems brought to light by off-site analysis and on-site inspections. During these meetings, the BI checks:</p> <p>With regard to the organizational structure, the following are checked:</p> <ul style="list-style-type: none"><li>• the composition of the board of directors and senior management (and of the audit committee, if any), <i>inter alia</i>, to evaluate the adequacy and experience of the members of these bodies. Where a member is found to be unfit, his/her replacement is requested;</li><li>• the board and senior management's level of understanding of the bank's policy on exposure to risk;</li><li>• the distribution of responsibilities among the governing bodies, the structure of delegated authority and its appropriateness for ensuring correct internal relations and avoiding overlapping responsibility;</li><li>• that the bodies or persons delegating authority (board of directors, executive committee, managing director and general manager) are served by a reporting system adequate in terms of both frequency and content; and</li><li>• the relations between the board of auditors and the board of directors (type and frequency of information flows).</li></ul> <p>With regard to the process of risk identification and management, the following are checked:</p> <ul style="list-style-type: none"><li>• the separation of responsibilities between operating and control personnel;</li><li>• the adequacy of back-office resources in relation to the bank's transactions;</li><li>• the existence of procedures for mapping company risks and the integrated management of the different types of risk (credit, market and operating risks);</li></ul>
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	<ul style="list-style-type: none"> <li>• the efficiency of the risk-control unit;</li> </ul> <p>With regard to the information system, the following are checked:</p> <ul style="list-style-type: none"> <li>• the existence of an executive and management information system permitting the administrative, managerial and control bodies to monitor effectively the evolution of the risks incurred by the bank;</li> <li>• the availability to control personnel of timely, up-to-date and accurate information for the management and control of corporate processes and activities; and</li> <li>• the adequacy of the internal reporting system and, in particular, the ability of the information used to signal any anomalous situation promptly, the level of detail of such reports, their frequency and the use made of them.</li> </ul> <p>For internal audit activity, the following are examined:</p> <ul style="list-style-type: none"> <li>• the tasks assigned to the special units, the number and experience of staff assigned, the criteria for planning the activity, the manner of auditing (at a distance, with periodic visits, etc.) and the methods and instruments used;</li> <li>• the auditing plans and schedules;</li> <li>• the audit results and the action taken to follow up on the indications supplied by internal audit;</li> <li>• the checks conducted by the internal audit unit at the request of the board of auditors or carried out by the latter on the functioning of internal audit; and</li> <li>• the degree of autonomy of the internal audit function vis-à-vis the governing bodies.</li> </ul> <p>The BI requires that the internal audit function of the bank reports to the audit committee and that the BI supervisors have access to these reports.</p>
Assessment	LARGELY COMPLIANT
Comments	<p>Legislation and the supervisory instructions identify precise tasks and responsibilities for a bank's governing bodies in determining its strategies and controlling risk.</p> <p>Banks are required to have internal control systems approved by the board of directors that are consistent with the complexity of their operations. The supervisory instructions call for line controls, controls on risk management entrusted to units not engaged in production, and an internal audit function. A specific function is performed by the board of auditors, which must check that laws have not been violated and evaluate the adequacy of internal controls, availing itself of the internal function.</p> <p>The BI verifies the functioning of internal controls during on-site inspections and in meetings with banks' corporate officers and determines that there is an appropriate balance in the banks' skills and resources devoted to control and operative functions. As indicated above, it is the practice of the BI to use periodic meetings with bank officials, inter alia, to evaluate the adequacy and experience of the members of a bank's board of directors and its senior management and, whenever an incumbent is found unfit, to request his/her replacement. It has been the BI's experience that Art. 26(2) of the 1993 BL, when considered in relation to provisions set out in Ministerial Decree 161/1998 concerning necessary attributes of those performing "administrative, managerial or control functions in banks," does not provide the authorities with sufficient legal authority to require expeditious changes in the composition of a bank's board of directors and management whenever incumbents are found to be unfit. An amendment of the 1993 BL and applicable regulations is required to provide: (a) a more qualitative definition of "fit</p>

	<p>and proper,” and (b) the legal power to the supervisors to <i>require</i> removal of a director or member of management who no longer meets the amended “fit and proper” tests.<sup>57</sup></p> <p>While the BI has a wide range of sanctions at its disposal, including the right to require a special shareholders’ meeting, this does not imply certainty as to the outcome of the meeting, which could decide not to follow the recommendations of the BI. Putting a bank under special administration or withdrawing its banking license, because its failed to dismiss a manager at the recommendation of the BI, could in many cases be seen by a court of law to be disproportionate use of power. At the very least, the burden of proof upon the supervisor, i.e., that special administration or license withdrawal were the only appropriate tools, could be very heavy. The BI should have at its disposal a more gradual scale of measure to ensure effectively the adequacy of a bank’s senior management.</p>
<p><b>Principle 15.</b></p>	<p><b>Money Laundering</b> Banking supervisors must determine that banks have adequate policies, practices, and procedures in place, including strict “know-your-customer” rules that promote high ethical and professional standards in the financial sector and prevent the bank being used, intentionally or unintentionally, by criminal elements.</p>
<p>Description</p>	<p>Banks’ governance and internal controls contribute not only to ensuring sound and prudent management but also to promoting proper conduct and preventing banks being involved in fraud or used for criminal purposes.<sup>58</sup></p> <p>Keeping banks from becoming involved in transactions originating from criminal activities is among the aims of the Anti-Money-Laundering Law (Law 197/1991 as amended by Legislative Decree 153/1997), which incorporates the positions adopted in international fora and, most notably, the recommendations of the Financial Action Task Force. The law lays down strict requirements regarding:</p> <ul style="list-style-type: none"> <li>(i) customer identification;</li> <li>(ii) the recording of data in computerized company data banks; and</li> <li>(iii) the reporting of suspicious transactions.</li> </ul> <p>As Italy’s financial intelligence unit, the Italian Foreign Exchange Office (UIC) receives suspicious-transaction reports from intermediaries, carries out the necessary financial analysis and transmits the reports to the investigative authorities. Intermediaries are nonetheless required to report to the judicial authorities any act they consider a violation of penal law.</p> <p>To assist intermediaries in fulfilling the reporting requirements, the BI has issued “Operating instructions for identifying suspicious transactions.” These instructions help intermediaries to take appropriate steps to know their customers better, including the setting up of computerized systems permitting data to be centrally managed and constantly updated. Intermediaries are required, among other things, to: acquire data on connected persons and on contractual, financial, commercial and other kinds of connections; exchange information with other intermediaries of the group and with units based abroad; collect data on companies that perform corporate functions under outsourcing agreements; and evaluate information concerning penal proceedings or news reports and other public information.</p> <p>The anomaly indicators set out in the instructions discuss the techniques used to disguise the nature and purposes of transactions or the identity of the person for whose benefit the transaction is set up, and the techniques used to split up the amount to be transferred. The indicators also</p>

<sup>57</sup> See also BCP 3.

<sup>58</sup> See also BCP 14.

	<p>cover transactions having an unusual form or an illogical configuration. Specific indicators concern transactions in financial instruments and the use of cash or bearer securities.</p> <p>For the use of new distribution channels, such as the Internet, banks are required to examine the transactions carried out with statistical methods and to check on the provenance of the financial resources. Visits to customers may be necessary. Prudence requires refusing to carry out transactions electronically in the absence of adequate information.</p> <p>The instructions lay down operating rules designed to produce “virtuous” conduct, such as refusal to carry out anomalous transactions or to set up or maintain relationships showing anomalous profiles, reporting rejected and unexecuted transactions, and prompt and complete response to requests for information from the UIC and the judiciary.</p> <p>Intermediaries must plan and carry out staff training programs and take steps for the prevention or prompt detection of fraud by employees or other collaborators.</p> <p>The procedure for transmitting reports to the UIC must be speedy, confidential, uniform and transparent vis-à-vis the UIC. Each bank must have an anti-money-laundering officer responsible for conducting an overall evaluation of all transactions with anomalous profiles.</p> <p>The UIC and the BI check compliance with the rules by means of requests for information and documents and on-site controls.</p>
Assessment	COMPLIANT
Comments	<p>The law establishes strict requirements to ensure that banks know their customers fully and promptly report suspicious transactions to the competent authorities. Banks must refuse to execute suspicious transactions.</p> <p>The BI has issued instructions, which are to be made known to all bank staff, for the identification of suspicious transactions. Banks’ boards of directors are required to play an active role in checking compliance with the money laundering rules. Banks must have a company anti-money-laundering officer and staff training programs. The supervisory instructions also aim at preventing frauds by banks’ staff. The BI promotes the adoption by banks and financial intermediaries of policy statements on ethics and professional behavior. Fundamental principles on this topic are included in the “Code of conduct”, issued by intermediaries’ associations including the Italian Bankers’ Association, on a self-regulatory basis. In 1993 a special agreement was reached in order to establish a Banking Ombudsman scheme, whose activity is described in an annual report.</p>
<b>Principle 16.</b>	<p><b>On-Site and Off-Site Supervision</b> An effective banking supervisory system should consist of some form of both on-site and off-site supervision.</p>
Description	<p>For evaluation of the banks’ financial and organizational situation, the BI uses monthly statistical reporting, regularly transmitted non-quantitative information (bylaws, rules, etc.) and other data collected on an ad hoc basis.</p> <p>Every year the BI prepares a general report on off-site supervision and identifies the priorities for subsequent action on the basis of individual banks’ risk levels.</p> <p>Analysis is supplemented by regular meetings with corporate officers (chairman and/or members of the board of director, general manager) and/or managers in charge of the various corporate functions.</p> <p>On-site activity is conducted on the basis of an annual plan that takes account of the priorities identified by off-site supervision.</p> <p>Topics of current relevance for the banking system are examined during half-yearly meetings between the Directorate of the BI and the heads of Italy’s major banking groups. Managers of the BI branches meet with the heads of minor banks to examine general issues of concern.</p> <p>Off-site supervision is based on the methodological rules set out in the Guide for Banking</p>

<p>Supervision, which is periodically revised and updated in the light of developments in banking operations and markets.</p> <p>The activities performed by the operating units can be grouped into three phases:</p> <ul style="list-style-type: none"><li>• periodic (monthly and quarterly) controls of the volume of assets and liabilities and of financial indicators serving, <i>inter alia</i>, to verify compliance with the prudential requirements. Specific analyses are carried out when banks publish their annual accounts and half-yearly reports. The results of controls are entered in summary form in the file containing all the information on each bank;</li><li>• annual analysis of the financial situation; and</li><li>• identification of problem banks.</li></ul> <p>The annual analysis of the financial situation is performed by following an evaluation path covering banks' areas of risk and their organizational structure. Like CAMEL, the model, whose acronym is PATROL, focuses on five technical profiles: capital adequacy, profitability, risk, liquidity and organization. A specific section of the Guide is devoted to the problems of analyzing the activity of the finance area.</p> <p>The analyst gives an evaluation for each profile examined (scores from 1 to 5 for all the profiles except organization and liquidity, for which the scores range from 1 to 4, and the finance area, for which there is no numerical score). The evaluations given and the supervisory actions taken are summarized in a report.</p> <p>All of the model's quantitative aspects are managed by a computer procedure that automatically makes available the summary assessment and allows analysts to conduct guided inquiries into the various areas of evaluation. The same procedure allows supervisors to run "what-if" simulations and to access the bank's file.</p> <p>Each analyst has a computer workstation allowing him/her to access analytical models and all the statistical information transmitted by the banks, the bank's general file containing the most important data and the results of previous analyses (evaluation scores, summary of inspection reports, minutes of meetings), and relevant outside archives (the Company Accounts Data Service, Bankwatch, etc.).</p> <p>In addition, economic analysis is performed to identify current developments in the banking system. This activity makes use of other sources besides supervisory returns, including the records of the CCR (loans and interest rates), databases containing the financial statements of borrower companies (the Company Accounts Data Service and Cerved), and databases with time series of equity prices. Analysis of the banking system also takes account of the reports on the economic situation, analyses of world and Italian economic developments and studies of the financial markets produced by the Economic Research Department of the BI.</p> <p>The overall situation of the banking system is analyzed referring to a multiplicity of profiles: asset quality, credit risk, exposure to market risks, exposure to country risk, income and cost structure, profitability and capital adequacy.</p> <p>Early warning methods are an established practice for evaluating the overall trends of the system. Experiments are under way for the inclusion of these techniques among the instruments of supervision, so as to identify the banks closest to distress on which to focus attention.</p> <p>Inspections examine the entire situation of the bank and analyze in depth the most important weaknesses. The results of inspections are acquired by off-site supervision and may give rise to</p>
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	<p>follow-up action. The methods, procedures and tasks of bank inspections are set out in the Guide for Bank Inspection.<sup>59</sup></p> <p>The frame of reference for on-site controls consists of the information and evaluations performed by off-site supervision. The database is enriched by the information acquired during inspections by means of documentary controls and discussions with bank officers and managers at various levels, and particularly with the heads of internal control units. The subject and method of investigation are selected by taking into account the complexity of the bank inspected and its financial condition.</p> <p><i>General inspections</i> consist of a review of the analyses performed by off-site supervision, with the dual aim of checking the conformity of supervisory data with the actual situation and arriving at an independent evaluation of the conditions of the bank. Inspectors rely on the analytical approaches and quantitative models used by off-site supervision (PATROL and the related database), supplemented by information acquired on-site bearing mainly on managerial and procedural matters. The evaluations of the individual profiles are summarized in a final assessment (the “inspection opinion”) alongside the evaluation given by off-site supervision.</p> <p>In summary, inspections focus on the following issues:</p> <ul style="list-style-type: none"> <li>• quality of the activity performed by the administrative, executive and control bodies to ensure informed management of business risks, constant compliance with internal and external rules, rational utilization of human and technical resources. To this end, the inspectors check the extent to which a bank achieves its planned objectives, the functionality and reliability of its organization, the soundness of its financial position and profitability, and its ability to compete;</li> <li>• quantification of significant corporate risks and correct recognition of them by the responsible units. Time and resources are allocated mainly to verifying credit risk, as the checks are based on analytical examination of samples consisting of a large number of positions (bearing in mind the importance of lending to the middle market in Italy). The ability of the bank to monitor borrowers’ performance and to record non-performing loans and foreseeable losses according to reasonable and documented standards are verified. Considerable attention is also paid to the risks of financial intermediation; and</li> <li>• reliability of accounting data for prudential supervision and public disclosure. Material results and processes are checked in the light of the findings of the bank’s control bodies (board of auditors, internal and outside auditors, back-office, etc.).</li> </ul> <p>On-site and off-site activities are coordinated by means of organizational procedures ensuring:</p> <ul style="list-style-type: none"> <li>• full sharing of the methodologies used;</li> <li>• identification of priorities for inspection;</li> <li>• collegial discussion of sanctions to be imposed.</li> </ul> <p>There is a coordinating committee of the department heads of the Supervisory Area and a technical coordinating committee of the heads of operating units. Inspection results are examined jointly by the heads of the inspection team and off-site analysts.</p>
Assessment	COMPLIANT
Comments	The supervisory approach of the BI is heavily reliant on off-site supervision, while on-site supervision often takes place at somewhat long intervals of 3 to 6 years. Pursuant to Arts. 51, 144, and 134 of the 1993 BL, the BI has strong legal authority to ensure the reliability of the data

<sup>59</sup> For further details, see BCP 19.

	<p>submitted by the banks.</p> <p>Under Art. 7 of the 1993 BL, the BI is legally required to treat as confidential the information it receives as part of the supervisory process. According to the same Article, the BI is allowed to disclose information in certain defined circumstances.</p> <p>Under Art. 52(2) of the 1993 BL, the BI has the right to access copies of records submitted to the board by the board of auditors and external auditors. However, in the latter case <i>“only in the case of acts or facts that may constitute a serious violation of the provisions governing banking, jeopardize the continuous existence of the undertaking or result in an adverse or qualified opinion or a disclaimer. Such firms shall send the BI any other information or documents requested.”</i> The BI stated that Art. 52(2) <b>is not to be construed in the sense that there are limitations to the right of the BI to require external auditors to provide information or documents.</b></p> <p>Banks’ financial situation is analyzed continuously on the basis of comprehensive statistical data, information gathered in meetings with corporate officers and evaluations formulated in on-the-spot inspections. Off-site and on-site analyses are well integrated: assessments are scored on homogeneous scales and correspondence between inspection results and the findings of off-site analysis is examined.</p> <p>The BI’s supervisory procedures are subject to control by the BI’s internal auditors. However, no procedures seem to be in place to assess the effectiveness of on-site and off-site functions and to address any weaknesses that may be identified.</p> <p>The performance of individual banks is considered against the background of the broader trends of the banking system, taking real macroeconomic variables and financial market developments into account.</p>
<p><b>Principle 17.</b></p>	<p><b>Bank Management Contact</b> Banking supervisors must have regular contact with bank management and a thorough understanding of the institution’s operations.</p>
<p>Description</p>	<p>Meetings with bank management, which are expressly provided for by the 1993 BL (Art. 53) and supervisory instructions, are held periodically by the units responsible for assessing banks and are among the instruments available to the Supervisory Authority for the performance of its institutional tasks.</p> <p>Such meetings may be <i>general</i> or <i>sectoral</i>. The former are conducted with banks’ corporate officers and concern the main strategic and management profiles, whereas the latter focus on specific operational segments (credit area, finance, organization, internal controls, foreign operations, etc.).</p> <p>The meetings are designed to improve the Supervisory Authority’s understanding of the situation of individual banks and enable it to explore the more complex aspects of activity (e.g., corporate restructuring, securitization transactions, and innovative capital instruments).</p> <p>Meetings may also be held with a view to preventing deterioration in a bank’s financial situation. In such cases, the Supervisory Authority verifies first the corporate officers’ grasp of the problems. During such meetings the banks’ governing bodies are asked to take concrete steps to redress the balance-sheet situation. The commitments given are subsequently formalized with an exchange of letters.</p> <p>In the case of mergers and acquisitions, which for larger groups require considerable time for completion, a detailed schedule of meetings is prepared for checks on the implementation of the overall plan and its specific components.</p> <p>Under Title II of the 1993 BL, the BI requires banks to notify a wide range of substantive changes in their activities. Pursuant to Art. 52, banks’ Boards of Auditors and external auditors (when appointed) are obliged to inform the BI of breaches of legal and prudential requirements.</p>

	Under Arts. 19, 25 and 26 of the 1993 BL, the BI considers the quality of the management as part of the licensing process. Also, the BI considers the quality of the management on an on-going basis during the off-site supervision. The revocation of members of the administrative and managerial bodies is contemplated in Ministerial decree 161/1998 (see BCP 14).
Assessment	COMPLIANT
Comments	Regular meetings with senior and middle management (including the board, non-executive directors and heads of individual units) are an instrument of supervisory analysis. The information acquired on the quality of management, corporate policies, operations and organizational matters supplements the data derived from other sources.
<b>Principle 18.</b>	<b>Off-Site Supervision</b> Banking supervisors must have a means of collecting, reviewing, and analyzing prudential reports and statistical returns from banks on a solo and consolidated basis.
Description	<p>Art. 51 of the 1993 BL requires banks to send to the BI periodic reports and financial statements in the manner and within the time limits established by the BI.</p> <p>Art. 61 of the 1993 BL empowers the BI to conduct supervision on a consolidated basis. Under these powers, the BI requires the holding company (parent bank or financial company with registered office in Italy) to transmit consolidated reports and data (including data on a sub-consolidated basis relating to specific sectors of activity of the banking group) concerning the banks, financial companies and instrumental companies belonging to the group and the companies in which the group has an equity interest of at least 20 percent. The procedures for completing statistical reports and consolidating accounts are established by the BI.</p> <p>The responsibility for the correctness of the reports sent to the BI rests with the board of directors, the board of auditors, the general manager and the chief accountant of the bank within the scope of their respective duties. The chairman of the board of directors, the chairman of the board of auditors and the general manager send the BI a <u>letter of attestation</u> guaranteeing that the supervisory reports are based on the company's accounting data and show the bank's profits and losses, assets and liabilities and financial position. The BI has developed computerized procedures for checking the reliability of the data; further checks are performed during inspections.<sup>60</sup> Where there are errors, banks are required to produce the necessary corrections. In the event of serious organizational anomalies in banks' information systems or recurrent errors, the BI may propose to the Minister of the Economy and Finance that pecuniary administrative sanctions be imposed pursuant to Art. 144 of the 1993 BL.</p> <p>Accounting supervisory reports on a solo basis, the most important data flow transmitted to the BI, are divided into nine sections. These are the same for all banks. The first eight sections cover financial statement data useful for the evaluation and control of the basic profiles of banks' operations: credit risk, country risk, liquidity risk, interest risk, foreign exchange risk, sources of income, and the sectoral and geographical distribution of assets and liabilities. The ninth section is the prudential report covering capital adequacy indicators: supervisory capital, solvency ratio, large exposures, capital requirements against trading-book risks, capital adequacy (sum of a bank's capital requirements).</p> <p>The frequency of these reports is the same for all banks. Different reporting intervals are set for different types of information. The minimum frequency for balance-sheet information is monthly for the more aggregated data, whereas the analytical balance-sheet data are provided at quarterly, half-yearly, or yearly intervals. The analytical data on the profit and loss account are transmitted half-yearly and the summary data are provided on a quarterly basis. Data referring to units operating in Italy are kept separate from those on branches abroad. The items reported are measured at the reference date (e.g., the last day of the month) and on the basis of the average</p>

<sup>60</sup> See BCPs 16 and 19.

	<p>monthly level for the period. For numerous items, banks are also required to report the flow of transactions in the period between two successive observations. Prudential reports are produced quarterly and cover the bank as a whole (units in Italy and abroad). Supervisory report data are generally transmitted within the 25th day of the month following the reference date; the data that the BI transmits to the ECB are supplied within the twelfth working day after the reference date.</p> <p>On the basis of the data received, the BI produces two feedback flows enabling banks to compare their activity with the rest of the banking system.</p> <p>Pursuant to Art. 66 of the 1993 BL and for the purpose of carrying out supervision on a consolidated basis, banks submit periodic <b>consolidated reports</b> by the holding company, which also consists of statistical reports and prudential reports.</p> <p>Statistical reports are divided into:</p> <ul style="list-style-type: none"> <li>- a balance sheet and profit and loss account containing both consolidated data and information on individual foreign banks and financial institutions<sup>61</sup> of substantial size that are included in the consolidation; and</li> <li>- a supplementary section with information on the sectoral and geographical distribution of assets and liabilities and off-balance-sheet transactions, flows of securities and non-performing loans, and intra-group transactions, among other items.</li> </ul> <p>Statistical reports are prepared half-yearly (with the exception of intra-group reports, which are produced quarterly) and are transmitted to the BI by the 25th day of the fourth month following the reference date.</p> <p>Consolidated prudential reports cover: (1) supervisory capital, (2) the solvency ratio, (3) large exposures, (4) market risks on the trading book, and (5) overall capital adequacy. The information is produced half-yearly (except that on large exposures, which is prepared quarterly) and transmitted to the BI by the 25<sup>th</sup> working day of the fourth month following the reference date.</p> <p>Responsibility for the correctness of consolidated reports rests with the governing bodies of the parent banks and subsidiaries. The BI performs quality controls on consolidated reports similar to those established for solo reports. Consolidated reports are also protected by the administrative fines provided for in Art. 144 of the 1993 BL. Reporting is also protected by penal sanctions provided for in Art. 134 of the 1993 BL.</p> <p>Accounting supervisory reports are the primary source for off-site analysis of banks' situations and provide essential background information for inspections.<sup>62</sup></p>
Assessment	COMPLIANT
Comments	<p>The BI relies on an adequate information system that is used for on-site and off-site supervision. The BI receives monthly, quarterly and half-yearly flows of very detailed statistical information on every aspect of banking, on both a solo and a consolidated basis. The BI defines the items to be reported. It may request any additional information of intermediaries. The BI has an integrated analytical framework that uses the statistical and prudential information for the ongoing monitoring of the financial situation and performance of individual banks. The information is used in both off-site and on-site supervision.</p> <p>The bank's board of directors, board of auditors, and top management are responsible for the</p>

<sup>61</sup> Information on Italian nonbank intermediaries supervised by the BI is also available for the performance of supervision.

<sup>62</sup> See BCP 16.

	<p>quality of the data transmitted. The BI enjoys strong legal powers to ensure the accuracy of data submitted by banks. Penal sanctions are envisaged in the 1993 BL (Art. 134) if a bank willfully communicates wrong information. Also, Art. 144 establishes administrative sanctions if a bank transmits wrong information.</p> <p>The BI has the capacity to perform macro-prudential analysis and thereby to assess the risks of systemic financial crisis. At present, the BI assesses the probabilities of default (PD) of a large number of borrowers and evaluates capital adequacy of the banking system from the regulatory point of view. Also, it assesses the risk premia of borrowers in the different cohorts of PD and compares them with those embodied in banks' loan rates. In order to evaluate the resilience of the banking system to shocks, the BI performs stress tests and simulations.</p>
<p><b>Principle 19.</b></p>	<p><b>Validation of Supervisory Information</b> Banking supervisors must have a means of independent validation of supervisory information either through on-site examinations or use of external auditors.</p>
<p>Description</p>	<p>The 1993 BL empowers the BI to carry out inspections of individual banks (Art. 54) and of banking groups, as defined, within the scope of consolidated supervision (Art. 68). On-site inspection seeks to verify the reliability of the data transmitted periodically to the BI, supplementing those data with information acquired on the spot and evaluating the bank's financial situation (including compliance with prudential requirements) and the effectiveness of its internal risk-control systems (see BCP 16).</p> <p>The BI personnel of the Banking and Financial Supervision (BFS) Department is distributed across four Divisions, namely: (a) Competition, Regulation and General Affairs (119 persons); (b) Banking Supervision (129 persons); (c) Financial Supervision (75 persons); and (d) the Supervision Inspectorate (188 persons). It is the latter that is primarily concerned with on-site inspections, although BFS management makes provision to supplement inspection teams with employees with relevant expertise from other Divisions as the occasion demands. In addition to the members of the Supervision Inspectorate, 540 persons from the BI branches are available for the conduct of on-site inspections in local banks.</p> <p>Inspections are performed under annual plans drawn up taking account of the results of off-site analysis, frequency of visits, and other specific factors. Apart from on-site inspections conducted when particularly critical weaknesses emerge, for small banking institutions identified by off-site monitoring as being without significant weaknesses, inspections are conducted on a three year cycle and at longer intervals (currently not more than six years) for large banks. Inspections of the latter last considerably longer (an average of 5-6 months) and are conducted by teams of up to 10-12 inspectors. However, taking into account thematic inspections, the inspection cycle for large banks has recently been shortened to no longer than three years. Thematic inspections are being implemented in both large and small banks. For example, the BI performed six thematic inspections in 2001, three of which in small banks, and five in 2002, two of which in large banking groups. An institution that is being inspected is required to cooperate with inspectors by supplying them with all documents and information of use for carrying out controls. Non-compliance with this rule is punished by penal sanctions (1993 BL, Art. 134).</p> <p>An inspection is performed by a team of specialists led by a head inspector, who signs the final inspection report and takes responsibility for it. The BI has the policy of rotating head inspectors assigned to banks.</p> <p>The methods of on-site inspection are established in the Guide for Bank Inspection. A variety of risks (credit, liquidity, operational, market) may be addressed in the course of on-site inspections, with particular attention to the assessment of internal control systems, adequacy of regulatory and management reporting, internal audit and management capabilities. In the process of evaluating the credit risk of large banks, inspectors do not use statistical but judgmental methodologies for the sampling of loans. In the conduct of the inspection, the inspection team has access to the databases of the CCR (which includes every loan contracted for an amount of Euro 75,000 and above, interest rate, together with its repayment performance) and the CADS, which contains the</p>

	<p>financial statements of a large sample of incorporated businesses in Italy.</p> <p>The Guide for Bank Inspection lays down the manner in which findings are to be drawn up and communicated to banks. Inspection results are set out in a two-part inspection report:</p> <ul style="list-style-type: none"> <li>– the “open” part, delivered to the bank, comprises the findings on actions, situations and developments contrary to rules or principles of sound and prudent management, along with “further observations” intended to stimulate remedial action and guide the bank; and</li> <li>– the confidential assessment of the bank’s technical and organizational situation.</li> </ul> <p>The head inspector delivers the open part of the report to the bank in a special meeting of its board of directors also attended by the members of the board of auditors and the general manager. The list of loans reclassified as non-performing by the inspectors is signed by representatives of the bank and included as an annex to the report. The BI requests—and obtains—establishment of specific provisions on such loans. The bank submits its responses to the issues raised within 30 days. The bank is required to redress the irregularities immediately or to indicate the corrective measures adopted for their definitive elimination.</p> <p>Further meetings with the board of directors or persons responsible for banks’ different operating areas are held in the course of ordinary supervisory activity.<sup>63</sup></p> <p>In contrast with other countries, in Italy the law does not contemplate delegation of any facet of on-site inspection to external auditing firms and it is not the practice of the BI to hold meetings with banks and their external auditors to discuss the results of the work of the latter. The BI has the legal right (1993 BL Art. 52) to access copies of records submitted to the board by both the board of auditors and the external auditors.<sup>64</sup></p> <p>For listed banks (and other banks that voluntarily commission audited financial statements), external auditors verify information included in regulatory reports such as the capital adequacy return. For those banks that do not produce audited financial statements (rural banks), there is no provision for key supervisory returns to be examined by an external auditor and for a report to be submitted thereon to the BI.</p> <p>Currently, the BI does not have the powers to revoke the appointment of a bank’s external auditors where performance is deficient, and nor does it have the authority to establish the scope and standards to be achieved in external audits of individual banks or the scope and conduct of audit programs in banks. The Consob has both such powers in relation to banks listed on a recognized exchange.</p> <p>Italian law makes the board of auditors (a body independent of and separate from, the board of directors, management and shareholders of a company) responsible for controlling the bank’s supervisory statistics, financial statements and compliance with prudential requirements as part of its auditing of the bank’s internal controls.<sup>65</sup></p>
Assessment	LARGELY COMPLIANT
Comments	The BI has in place a coherent process for planning and executing on-site inspections. The process is particularly reliant on the analysis performed off-site by the Banking Supervision Division (and the quality of the data submitted to the latter by the supervised institutions which is well protected by the 1993 BL), regular, in-depth meetings with banks’ senior managers that are

<sup>63</sup> See BCP 17.

<sup>64</sup> See BCP 16.

<sup>65</sup> The respective roles of the board of auditors and auditing firms are further discussed in BCP 14.

	<p>held at least annually, and the performance of the board of auditors at each institution.</p> <p>In the cases of banks that do not issue securities listed on a regulated exchange, there is no requirement to have external auditors examine and validate key supervisory reports and aggregates, or the financial statements as a whole. Key supervisory aggregates, such as regulatory capital ratios, large exposures or impaired loans, are included in the notes to the accounts but, at present, only those banks with securities listed on a regulated exchange, and the banks controlled by them (overall 166 out of 814 banks as at December 2002), are required to have their accounts audited by external auditors. There are approximately a further 180 banks that have their accounts audited on a voluntary basis, leaving approximately 470 banks, mostly very small, that, for the time being, do not produce audited financial statements. However, it is noted that the banks subject to external audit account for over 90 percent of the system's total assets and the current requirement for the audit of accounts by external auditing firms is to be further expanded in January 2004.</p> <p>The BI can, and does, request external auditors to examine specific aspects of banks' financial accounts, but it does not rely on external auditors for the purpose of on-site inspections. In order to complement the BI's reliance on its comprehensive process of off-site supervision, and taking into account the limitations of the frequency of on-site inspections and the broad discretion given to banks in classifying their loans and determining provisions, the BI should review the means by which it could derive greater benefit from the work of external auditors in the execution of its own mandate. An independent validation of supervisory information is especially important in a system that is strongly reliant on off site analysis, in particular to be able to verify the accuracy of asset quality information and the appropriateness of provisioning levels. Revising the 1993 BL would be desirable so as to obtain the authority to revoke the appointment of a bank's external auditors when their performance is deficient and to provide it with the authority to establish the scope and standards to be achieved in banks' external audits. In view of the rapid changes in the banking industry and risk management technology, the BI should continue to keep the adequacy of resources under review.</p> <p>The methods of on-site inspection are clearly established in the Guide for Bank Inspection and are in line with those of other industrial countries. In the course of on-site inspection of large banks, the BI, in addition to its judgmental methods, may want to extend the use of statistical sampling methodologies for the evaluation of the credit risk of homogeneous categories of loans, which is at present applied only to consumer credit banks. This would ensure that its assessment of credit risk is based on a representative sample of loans. The scope for thematic inspections could also be expanded.</p>
<p><b>Principle 20.</b></p>	<p><b>Consolidated Supervision</b> An essential element of banking supervision is the ability of the supervisors to supervise the banking group on a consolidated basis.</p>
<p>Description</p>	<p>The 1993 BL and its regulations define the notion of banking group. Banking groups (made up of banks, financial companies and instrumental companies) must be registered with the BI. If the holding company is a financial company, as defined, this is treated from a regulatory point of view as a bank and is therefore subject to all the requirements applicable to banks as regards the protection of ownership structures and the independence, experience and integrity of the members of the governing bodies (1993 BL Arts 62 and 63). All plans to modify the structure of a group have to be approved in advance by the BI, which assesses whether the new structure permits the effective exercise of supervision on a consolidated basis (1993 BL Arts. 59, 60, 61 and 64). The BI may also exclude companies from the group that appear likely to prevent or influence the effective exercise of supervision on a consolidated basis. This is especially important for the setting up of foreign establishments of Italian banking groups, which the BI can prohibit; circumscribe the range of operations, and order the establishment's disposal if the regulatory framework of the host country does not offer adequate guarantees of transparency and access to information.</p>

	<p>Banks and banking groups can perform the activities specified in the 1993 BL, including connected and instrumental activities. Connected activities consist of non-financial activities which, by creating opportunities for contact with the public, allow banks to promote and develop their primary business but which remain of marginal importance and of an accessory nature with respect to the overall activity carried out, including that carried out by individual branches. Instrumental activities are defined as those of an auxiliary nature with respect to banking business.</p> <p>The BI supervises—on an individual basis—all Italian banks and financial intermediaries (investment firms, investment fund management companies, and nonbank financial companies with special size and/or operational features) belonging to banking groups. As regards insurance companies belonging to banking groups, there is close cooperation with ISVAP.<sup>66</sup> The supervision of foreign companies is performed within the framework of agreements concluded with the regulatory authorities of other countries and understandings reached at the international level.<sup>67</sup></p> <p>The BI performs consolidated supervision by means of on-site inspections, prudential supervision (large exposures, credit risks, market risks, supervisory capital, with the right to impose more stringent requirements where necessary) and information monitoring vis-à-vis companies belonging to a banking group. The holding company is required to transmit information and statistics covering the entire group (1993 BL Arts. 65 and 66). As regards companies not included in a banking group (financial companies in which a major but not controlling interest is held), the BI may require, via the holding company, information to be provided and carry out on-site inspections to verify the data transmitted, and require annual accounts to be audited. The BI may take the operations of such companies into account when calculating capital requirements on a consolidated basis and require their accounts to be included in the consolidation if they are material for the purposes of the stability of the banking group (1993 BL Arts 66, 67 and 68).</p>
Assessment	COMPLIANT
Comments	<p>The BI is able to know the structure of banking groups, obtain complete information on the activity of each company, assess the risk profiles of such groups from the understanding obtained from that information and apply capital requirements and rules of conduct at the consolidated level. It approves the composition of groups after verifying that its effective exercise of supervision will not be impeded.</p> <p>The 1993 BL empowers the BI to perform supervision across the entire activities of an institution, whether those activities be carried on directly (including via branch operations outside of Italy) or via subsidiaries and/or affiliates.</p> <p>Information exchange agreements with both Italian and foreign supervisory agencies allow the BI adequate access to information on the financial condition, risk management practices and frameworks of corporate governance across the entities in a banking group.</p> <p>In Italy, financial conglomerates are relatively less developed, although the integration between the banking and insurance sector is increasing. At the end of 2001, there were 32 banking groups holding significant equity interests (from 20 percent to 100 percent) in the capital of insurance companies and 10 insurance groups with participations in the capital of banks and securities firms. Using the thresholds specified by the Directive 2002/87/EC on the supplementary</p>

<sup>66</sup> See BCP 1.

<sup>67</sup> See BCPs 23–25.

<sup>68</sup> See BCP 1(1) above.

	<p>supervision of credit institutions, insurance undertakings and investment firms in a financial conglomerate, eight “financial conglomerates” have been identified, holding a 22 percent share of the insurance market and a 34 percent share of the banking market. None of the eight conglomerates has significant cross border activities. The Italian authorities are working toward the enhancement of the mutual cooperation agreements already in place with other national supervisory authorities.<sup>68</sup> EU member states are to transpose the Directive in their national legislation by August 2004.</p>
<p><b>Principle 21.</b></p>	<p><b>Accounting Standards</b>  Banking supervisors must be satisfied that each bank maintains adequate records drawn up in accordance with consistent accounting policies and practices that enable the supervisor to obtain a true and fair view of the financial condition of the bank and the profitability of its business, and that the bank publishes on a regular basis financial statements that fairly reflect its condition.</p>
<p>Description</p>	<p>The BI, in compliance with resolutions of the ICCS, has power to issue regulations of a general nature concerning, <i>inter alia</i>, the organization of administrative and accounting procedures and internal control mechanisms (1993 BL Art. 53(1)(d)). On the subject of internal controls, the BI’s supervisory instructions lay down, in particular, that -- without usurping the responsibility of a bank’s governing bodies for the choices made with regard to the organization of internal control mechanisms—banks must adopt solutions that: (a) permit the recording of every transaction and, in particular, of all individual transactions in adequate detail and ensure their correct recognition; and (b) put in place reliable information systems and appropriate reporting procedures at the different levels of management entrusted with control functions. Similar statutory provisions apply to banking groups (1993 BL Art. 67).</p> <p>Responsibility for the accuracy of the information transmitted to the BI in automated prudential returns lies with the board of directors, the board of auditors, the General Manager and the Chief Accountant of a bank, within the scope of their respective authority.<sup>69</sup> Responsibility for the accuracy of consolidated reports lies with the governing bodies of the holding companies and their subsidiaries. (The BI provides direction to banks in its Manual for the compilation of Automated Prudential Returns and Manual for the Compilation of Consolidated Returns).</p> <p>The accuracy of the data contained in supervisory reports is checked by means of computerized procedures at the BI.<sup>70</sup> The correct recording of transactions in the accounts and the reliability of information systems are checked by periodic-checks of the board of statutory auditors and during the BI’s on-site inspections. As noted above (CP 19), for small banking institutions identified by off-site monitoring as being without significant weaknesses, inspections are conducted on a three year cycle and at longer intervals (currently not more than six years) for large banks. Taking into account thematic inspections, the inspection cycle for large banks has recently been shortened to no longer than three years.</p> <p>For banks listed on a recognized exchange and the unlisted companies they control, auditing firms are required to verify: (a) that the accounts are kept properly and that transactions are reported correctly in the accounting records; (b) that the annual accounts on a solo and a consolidated basis correspond to the results of the accounting records and tests performed and that they comply with the relevant statutory and regulatory provisions (1998 CLFI Arts. 155 and 165). Banks whose shares are listed on a recognized exchange must produce half-yearly and quarterly reports that are based on the model of their annual reports but of a more summary</p>

<sup>69</sup> See BCP 18.

<sup>70</sup> See BCP 18.

<p>nature.</p> <p>For unlisted banks (and any other kind of unlisted company), responsibility for the foregoing controls is assigned to the board of auditors,<sup>71</sup> in accordance with Article 2403 of the Civil Code. In the cases applicable, the engagement of an auditing firm is granted/revoked by the annual general meeting of the shareholders of a bank, after hearing the opinion of the bank's board of auditors.</p> <p>The 1993 BL provides that: "Firms that audit the accounts of banks shall notify the BI without delay of acts or facts found in the performance of the engagement that may constitute a serious violation of the provisions governing banking, jeopardize the continued existence of the undertaking or result in an adverse or a qualified opinion on the annual accounts or a disclaimer. Such firms shall submit the BI any other information or documents requested." (1993 BL Art. 52 (2)).</p> <p>The board of auditors must inform the BI without delay of every act or fact they come to know of in the performance of their duties that may constitute an irregularity in the management of banks or a violation of the provisions governing banking. (1993 BL Art. 52(1)). The 1993 BL Arts. 52(1) and (2) also apply with respect to companies that control banks or are controlled by banks (1993 BL Art. 23).</p> <p>The procedures and time limits for transmitting such information to the BI are laid down in its supervisory instructions.</p> <p>Consob supervises those entered in its register of auditing firms which satisfy a series of requirements laid down by law and are judged as having the necessary independence and technical adequacy to perform the external audit of a company listed on a recognized exchange (1998 CLFI Art. 162). Where performance is deficient, Consob may impose disciplinary measures, including deletion from its register. (1998 CLFI Art. 163). The BI has no similar powers in relation to auditing firms: for example, it does not have the right to revoke the appointment of a bank's external auditors. As indicated above, any such revocation rests with the annual general meeting of the bank's shareholders.</p> <p>Consob, as part of its supervisory process, may recommend principles and methods to be adopted for auditing activity, after consulting the Consiglio Nazionale dei Dottori Commercialisti e dei Ragionieri ('CNDCR') and to date has recommended that when auditing the annual accounts of any firm listed on a recognized exchange, auditing firms should use the auditing standards laid down by the CNDCR in accordance with international standards. These standards cover all the main aspects of the annual accounts (receivables, securities, tangible fixed assets, intangible fixed assets, payables, etc.).</p> <p>The BI has no similar power of recommendation and nor does it have the authority to establish the scope and standards to be achieved in external audits of individual banks or the scope and conduct of audit programs in general in regard to banks. However, it normally meets annually with representatives of the CNDCR to examine accounting issues with a view to addressing ex ante accounting matters of importance for the performance of the activities within the scope of the respective authority of the supervisor and the external auditor.</p> <p>Regarding the annual accounts of Italian banks, Legislative Decree 87/1992 transposes Directive 86/635/EEC on the annual accounts and consolidated accounts of banks and other financial institutions, and the BI supervisory instructions set out the "technical forms" to be adopted, including the layout for the preparation of the annual accounts.</p>
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<sup>71</sup> See BCP 14.

	Legislative Decree 87/1992 establishes general valuation principles (i.e., consistent application of methods, use of a going concern basis, prudence and separate determination of items) and specific methods for the main balance sheet items (loans, securities, investments, derivative instruments, and tangible and intangible fixed assets).
Assessment	LARGELY COMPLIANT
Comments	<p>The BI has the authority to hold management responsible for ensuring that financial record-keeping systems and the data they produce are reliable and that reports required by the BI are submitted on a timely and accurate basis. Periodic verification of the information from bank records (with the exception of that performed by the board of auditors) is conducted during the on-site inspection cycle for a significant number of small banks, which are not required to have their books validated by an external audit. (According to a recently approved amendment to commercial law that will come into force on January 1, 2004, the scope of application of mandatory audit is going to be expanded to all firms with the exception of those that do not issue securities to the public and that are not required to produce consolidated account.)</p> <p>Accounting rules and regulations are in line with EU Directives. The BI provides instructions that establish the accounting standards to be used in preparing supervisory reports. Circular 49 of February 8, 1992 (Manual for Completing Prudential Returns) provides for classification of loans as “Substandard” on the basis of two criteria: a judgmental one, which makes reference to a situation of temporary difficulty of the borrower in meeting its obligations, and an objective one, which requires classification when two tests are met. The first is based on the number of installments “past due” (as described in the assessment of BCP 8) and the second requires that the total of the “past due” installments, together with any other unpaid claims be at least 20 percent of the bank’s overall exposure to the borrower.</p> <p>The mission’s discussions with banks’ managements suggest that the combined effect of these two tests is to delay recognition of impairment in the performance of loans and the suspension of recognition of income from impaired loans beyond the period usual to other G-7 countries.</p> <p>The prudential accounting rules for loan classification and reporting, as discussed in the assessment of BCP 8, may not provide a true representation of the financial condition of the bank owing to the scope for delayed recognition of loan impairment and overstatement of income from impaired loans till they are classified as such.</p> <p>The BI may wish to consider revision of the applicable supervisory instructions on loan classification so that they more closely match practice in other G-7 countries, and to provide further guidance on provisioning policies to be adopted by banks. The “New Basel Capital Accord” discussion document, published in April 2003, cites local market conditions as the basis for allowing Italy a transitional provision of 180 days past due (as against the standard “more than 90 days past due”) for classifying a corporate loan as in default. The transitional provision will apply for a period of five years, thus providing time to modify rules and procedures to conform in due course to the widely accepted international practice of 90 days past due.</p>
<b>Principle 22.</b>	<p><b>Remedial Measures</b></p> <p>Banking supervisors must have at their disposal adequate supervisory measures to bring about timely corrective action when banks fail to meet prudential requirements (such as minimum capital adequacy ratios), when there are regulatory violations, or where depositors are threatened in any other way. In extreme circumstances, this should include the ability to revoke the banking license or recommend its revocation.</p>
Description	<p>The legal framework provides the BI a series of powers of intervention, backed by penalties, aimed at correcting problems at banks and avoiding development of crisis situations. The grounds for intervening are extensive. The powers are graduated according to the seriousness of the problems, are flexible and primarily for the BI to evaluate technically.</p> <p>Where a bank’s situation makes it necessary, the BI can convene the bank’s governing bodies to examine the situation and identify the measures to overcome the problems found (1993 BL Art.</p>

	<p>53(3)(a)). To this end, the BI sends the governing bodies a letter analyzing the problems found and indicating the measures needed, for example, to restore profitability. Upon receipt of such letters, banks are required to draw up an action program to overcome the problems and a timetable for implementation.</p> <p>The BI can also order a bank’s board of directors to be convened, or convene it itself, and propose the adoption of certain choices, such as forms of consolidation (1993 BL Art.53(3)(b)).</p> <p>The BI may also impose more stringent requirements than those established on a general basis for capital adequacy, risk limitation, eligible equity holdings, internal organization and control mechanisms (1993 BL Art. 53(3)(d)).</p> <p>Where a bank fails to comply with the foregoing prescriptions or violates supervisory rules, the BI can submit a proposal to the Minister of Economy and Finance for imposition of pecuniary administrative sanctions on the members of the board of directors and employees responsible for specific functions (1993 BL Art. 144).</p> <p>In the event of violations of legislative or regulatory provisions or of management irregularities, including failure to implement corrective measures indicated by the BI, the latter can also prohibit the bank from engaging in new business or order the closure of branches (1993 BL Art.78).</p> <p>In more serious cases, the BI can submit proposals to the Minister of Economy and Finance for adoption of specific crisis procedures: i.e., Special Administration and Compulsory Administrative Liquidation (CAL).</p> <p>In particular, where serious administrative irregularities or serious violations of laws, regulations or by-laws are found, the Minister of the Economy and Finance can place a bank in Special Administration. The BI appoints one or more special administrators who replace the management, take over the running of the bank and exercise all the functions and powers of the dissolved administrative and control bodies. The aim of the procedure is to determine the real situation of the bank, eliminate the irregularities and promote solutions in the interest of depositors. Such solutions can be in the form of injections of capital by the shareholders, a reorganization of the ownership structure, or takeover by banks that are financially and organizationally sound so as to restore conditions of sound and prudent management.</p> <p>In an emergency, the BI can arrange directly for one or more special administrators to take over the provisional management of the bank for a period of not more than two months.</p> <p>Where a crisis is irreversible or the administrative irregularities or the violations of laws, regulations or bylaws are exceptionally serious, the bank is placed in CAL, a procedure equivalent to the bankruptcy of commercial enterprises that is implemented by one or more liquidators appointed by the BI. It directs the procedure, which is normally characterized by the disposal of assets and liabilities to another bank in order to enhance the value of the business as a whole and limit the repercussions of the failure.</p> <p>Within the ambit of these procedures, the BI closely coordinates with the deposit guarantee schemes, which are private-law entities funded by participating banks. This facilitates the repayment of deposits and the disposal of assets and liabilities.</p> <p>Both in the case of special administration and in that of CAL, the conservation of the banking business achieved by means of the instruments described above does not prevent the functioning of the mechanisms for the punishment of the bank’s governing bodies.</p>
Assessment	COMPLIANT
Comments	The BI is able to activate a broad range of measures graduated according to the seriousness of the problem bank’s situation, concluding with Special Administration and CAL. In 2001, five Special Administration procedures were initiated, together with four CALs. In 2002, seven Special Administration procedures were initiated, together with one CAL. Almost all initiatives

	involved small mutual banks. <sup>72</sup> The BI has the power to impose penalties on a problem bank's governing bodies.
<b>Principle 23.</b>	<b>Globally Consolidated Supervision</b> Banking supervisors must practice global consolidated supervision over their internationally active banking organizations, adequately monitoring and applying appropriate prudential norms to all aspects of the business conducted by these banking organizations worldwide, primarily at their foreign branches, joint ventures, and subsidiaries.
Description	<p>All the business of a banking group, including that of foreign branches and subsidiaries, is subject to supervision (1993 BL Arts. 59, 60, and 61).</p> <p>The statutory and regulatory provisions governing internal control mechanisms establish principles and procedures (for accounting systems, decision-making powers, delegated powers, central and local internal audit functions, professional qualifications of internal audit managers and the information to be transmitted to the top management) which banks' managements must observe in order to ensure constant and effective control of the operations of foreign branches and subsidiaries.</p> <p>The BI can prohibit the setting up of new foreign branches and subsidiaries; it can also set limits on the business of those whose organization appears inadequate in terms of risk control and management and where the host country's application of the internationally-agreed principles for the supervision of international banking groups appears inadequate. In particularly serious cases the BI can prohibit the foreign branches of Italian banks from taking on new business or order their closure. Establishments in off-shore centers have been permitted in the past provided their transactions were recorded in the accounts of other on-shore branches or the parent bank itself. The BI does not allow new establishments to be set up in jurisdictions considered uncooperative by the Financial Stability Forum or the Financial Action Task Force (FATF).</p> <p>The evaluation of the activity of Italian banks' foreign branches and subsidiaries is carried out both on-site and off-site as part of consolidated supervision. The information collected regularly on banks' foreign networks refers both to individual branches and subsidiaries and to the situation on a consolidated basis. Once a year bank holding companies must also transmit a report on the checks carried out on their foreign networks. Where the latter are particularly widespread and complex, bank holding companies are required to transmit additional information defined on a case-by-case basis on the business of their foreign units. The BI's annual inspection program normally includes visits to foreign branches and subsidiaries with access to the parent bank/bank holding company to verify the control system in place for the entities to be inspected. In addition, as part of general and sectoral inspections of banks, the BI assesses the desirability of extending the checks to the bank's main foreign establishments.</p> <p>The possibility of sharing information with the supervisory authorities of host countries and to carry out on-site inspections is expressly provided for by Italian law and is activated, where necessary, without any difficulty within the European Community (1993 BL Art. 69). As regards establishments located in non-EU countries, the extent of information sharing depends on the willingness of the local supervisory authorities to cooperate. The procedures for sharing information and carrying out inspections are often laid down in bilateral MoUs between the supervisory authorities of the two countries involved. Meetings are held periodically with the authorities of the countries in which units belonging to Italian groups are located to discuss matters of interest for consolidated supervision. When the foreign establishments of Italian banks or groups are inspected, the inspectors meet with the local supervisors at the beginning and end of inspection for an exchange of information. In turn, the BI receives information on the results</p>

<sup>72</sup> See BCP 14 with regard to dismissal of managers.

	of inspections carried out at the foreign establishments of Italian banks and banking groups by the host-country supervisory authorities. In order to facilitate relationships with these authorities, human resources with special expertise have been allocated to the units responsible for off-site analyses.
Assessment	COMPLIANT
Comments	<p>The focus of control is on banks' internal procedures for verifying and analyzing the performance of Italian banks' foreign establishments (branches and subsidiaries).</p> <p>The BI is allowed to request data and information over and above that normally prescribed to be made available, whenever the situation makes it necessary. Analogously, the BI can carry out checks or order such checks to be carried out more frequently than normal or with reference to parts of the business. In addition, the BI can prohibit the setting up of foreign establishments, impose limits on their operations, forbid them to undertake new operations, and order them to be closed.</p> <p>Cooperation agreements have been entered into with a large number of countries for the sharing of information, periodic meetings and the performance of supervisory activities.</p>
<b>Principle 24.</b>	<p><b>Host Country Supervision</b> A key component of consolidated supervision is establishing contact and information exchange with the various other supervisors involved, primarily host country supervisory authorities.</p>
Description	<p>Collaboration among supervisory authorities is governed by the 1993 BL (Arts. 7(6) and (7)) as amended by Article 2 of Legislative Decree 333/1999) and by the 1998 CLFI (Arts 4 (2) and (3)). (See also BCP 1(6)).</p> <p>Under the 1993 BL Art. 15 and the supervisory instructions, cooperation with the host country authorities begins with establishment in the foreign country of an Italian bank or banking group.</p> <p>On the basis of the harmonization of the banking legislation in the countries belonging to the European Union, the establishment of a branch of an Italian bank or banking group in another EU country does not have to be authorized. The supervisory instructions only lay down a procedure whereby the intention to open an establishment abroad has to be communicated by the bank concerned to the BI and by the latter to the competent authority of host EU country. The BI may prohibit the establishment of a new branch in another EU country for reasons pertaining to the adequacy of the bank's organizational structure or to its financial situation, profits and losses, and assets and liabilities (1993 BL Art. 15).</p> <p>By contrast, the establishment of a branch of an Italian bank or banking group in a non-EU country has to be authorized by the BI, after the competent authority of the country concerned has issued its opinion on the initiative. Before granting an authorization, the BI verifies:</p> <ul style="list-style-type: none"> <li>• the existence in the host country of an adequate supervisory legal framework and supervisory system; and</li> <li>• the possibility for the parent bank and the BI to have easy access to the information they need, <i>inter alia</i> under agreements for the exchange of information with the competent authority of the host country and by means of on-site inspections at the foreign branch.</li> </ul> <p>Collaboration with the supervisory authorities of the countries belonging to the European Economic Area is both multilateral, given the institutional organization of the collaboration in matters concerning banking supervision within the European Economic Area, and bilateral.</p> <p>At the bilateral level, the collaboration procedures have been specified in formal agreements signed by the BI with, in particular, the authorities of Austria, Belgium, France, Germany, Greece, Ireland, Luxembourg, the Netherlands, Spain and the United Kingdom. The content of these agreements is uniform and they generally provide for a detailed exchange of information on the organization, operations and balance sheet situation of the bank intending to open an establishment abroad; they provide for periodic bilateral meetings aimed, among other things, at keeping the parties informed about important statutory and regulatory innovations regarding</p>

	<p>supervision in the respective countries; they ensure a regular exchange of information on the business of the establishments concerned and the prompt notification of the authorities involved when problems arise. The agreements also specify the ways in which home country authorities can carry out inspections at the establishments of the banks subject to their supervision.</p> <p>Collaboration with the supervisory authorities of some of the leading G–10 countries not belonging to the European Economic Area is based on exchange of letters that specify the procedures for carrying out inspections at the establishments of national banks in each country and for the exchange of information at the time foreign branches and subsidiaries are authorized, during the course of ordinary supervision and when given situations of necessity arise. With other non-EU countries in which the presence of Italian banks has recently become significant, cooperation agreements have been or are being concluded similar to those the BI has already signed with EU countries.</p>
Assessment	COMPLIANT
Comments	<p>The BI is allowed to conclude cooperation agreements with the supervisory authorities of other countries. Supervisory cooperation is determined by the exchange of information that must be guaranteed at the time the authorization of an Italian establishment abroad is granted. This cooperation is safeguarded in the subsequent operational phases by means of agreements concluded with foreign authorities regarding not only specific operations but also all the other situations in which the authorities of the home country and the host country deem such exchanges to be necessary.</p> <p>Before granting an authorization, the BI verifies the adequacy of supervisory activity in the host country and the possibility of obtaining access to material information.</p>
<b>Principle 25.</b>	<p><b>Supervision Over Foreign Banks’ Establishments</b></p> <p>Banking supervisors must require the local operations of foreign banks to be conducted with the same high standards as are required of domestic institutions and must have powers to share information needed by the home country supervisors of those banks for the purpose of carrying out consolidated supervision.</p>
Description	<p>The activities carried on in Italy by the branches of foreign banks are subject to the same rules of supervision-based reporting duties, prudential requirements and on-site inspections as Italian banks.<sup>73</sup> Specific adjustments have been introduced for the branches of EU-member banks; the 1993 BL (Arts. 15 and 16) gives effect to the principles of mutual recognition and home country control that underlie the single European market in banking services.</p> <p>The supervisory instructions specify the rules applicable to EU-member banks and the controls the BI may carry out in accordance with Community law.</p> <p>Under the 1993 BL (Art. 79), the BI may order EU-member banks, in the event of violations of the provisions concerning branches or the supply of services in Italy, to put an end to such violations. The order is notified to the competent authority of the home country in question, which can be asked, where necessary, to take the measures needed to ensure that the bank puts an end to the violations. Where the competent authority takes no measures or measures that prove inadequate, where the irregularities committed could jeopardize the general good, or where it is a matter of urgency to protect the interests of depositors, investors and other customers, then the BI—after informing the competent home country authority—directly adopts the measures needed to put an end to the violations.</p>

<sup>73</sup> The Italian subsidiaries of foreign banks are Italian banks by definition; for an analysis of the related authorization procedures, see BCP 3.

	<p>For the authorization of the opening of branches or the setting up of subsidiaries by <b>non-EU member banks</b>, the relevant factors are: the adequacy of the system of controls carried out in the home country, the conditions of reciprocity, and any restrictions on the branch’s transactions decided by the applying bank. The supervisory instructions explicitly require the BI to verify:</p> <ul style="list-style-type: none"> <li>• the existence in the bank’s home country of an adequate regulatory framework from the point of view of supervisory controls, on a consolidated basis where appropriate;</li> <li>• the existence of agreements for the exchange of information, or the absence of obstacles to the exchange of information, with the home country supervisory authorities of the bank intending to open a branch;</li> <li>• the prior agreement of the home country supervisory authority to the opening of the branch in Italy and to the carrying on of the activities chosen by the bank subject to its supervision; and</li> <li>• the declaration of the home country supervisory authority regarding the capital adequacy as well as the adequacy of the organizational, administrative, and accounting structures of the parent bank and of the banking group to which the bank belongs.</li> </ul> <p>The supervisory instructions list the provisions applicable to the branches of non-EU member banks, including, in contrast with the procedure for the branches of EU member banks, the rules on: (i) individual supervisory capital and solvency ratio; (ii) the individual capital charges for market risks; (iii) the overall capital requirement; (iv) the limits on risk concentration; (v) the limits on medium and long-term lending; (vi) the limits on maturity transformation; and (vii) the control of exposure to interest rate risk. The BI has the same powers of intervention with regard to such branches as for Italian banks for violation of laws, regulations or by-laws, for management irregularities and for insufficiency of funds (1993 BL Art. 78).</p> <p>The BI is also empowered to exempt the branches of non-EU member banks from the prudential rules specified above. Such exemptions—which may be temporary and subject to compliance with specific restrictions on the operations of the branch in Italy—are granted provided the activities carried on by the bank are subject in the home country to forms of supervision equivalent to those applied in Italy to Italian banks.</p> <p>Furthermore, the supervisory treatment of the branches of non-EU member banks of the G–10 countries takes account of the harmonization of the main prudential mechanisms implemented by the Basel Committee on Banking Supervision countries. Accordingly, the branches of non-EU member banks with registered office in one of the G–10 countries are expressly excluded from the rules on individual solvency ratios and individual capital charges for market risks.</p> <p>As regards the possibility for the BI to exchange information with the home country authorities of the foreign banks established in Italy and the possibility for such authorities to carry out inspections at their Italian branches, this is discussed in BCP 24 above.</p>
Assessment	COMPLIANT
Comments	<p>Statutory provisions and supervisory instructions ensure the uniform treatment of Italian and foreign banks.</p> <p>Contacts with the competent foreign authorities are expressly required when foreign banks intend to enter the Italian market.</p> <p>The timely exchange of information with other authorities and foreign authorities’ right to carry out inspections at the establishments in Italy of banks subject to their supervision are guaranteed both by statutory provisions and by cooperation agreements entered into with the leading foreign authorities concerned.</p>

Table 5. Summary Compliance with the Basel Core Principles

Core Principle	C <sup>1/</sup>	LC <sup>2/</sup>	MNC <sup>3/</sup>	NC <sup>4/</sup>	NA <sup>5/</sup>
1. Objectives, Autonomy, Powers, and Resources					
1.1 Objectives	X				
1.2 Independence	X				
1.3 Legal framework	X				
1.4 Enforcement powers	X				
1.5 Legal protection				X	
1.6 Information sharing	X				
2. Permissible Activities	X				
3. Licensing Criteria	X				
4. Ownership	X				
5. Investment Criteria	X				
6. Capital Adequacy	X				
7. Credit Policies	X				
8. Loan Evaluation and Loan-Loss Provisioning		X			
9. Large Exposure Limits	X				
10. Connected Lending		X			
11. Country Risk	X				
12. Market Risks	X				
13. Other Risks	X				
14. Internal Control and Audit		X			
15. Money Laundering	X				
16. On-Site and Off-Site Supervision	X				
17. Bank Management Contact	X				
18. Off-Site Supervision	X				
19. Validation of Supervisory Information		X			
20. Consolidated Supervision	X				
21. Accounting Standards		X			
22. Remedial Measures	X				
23. Globally Consolidated Supervision	X				
24. Host Country Supervision	X				
25. Supervision Over Foreign Banks' Establishments	X				

<sup>1/</sup> C: Compliant.

<sup>2/</sup> LC: Largely compliant.

<sup>3/</sup> MNC: Materially non-compliant.

<sup>4/</sup> NC: Non-compliant.

<sup>5/</sup> NA: Not applicable.

### B. Recommended Action Plan

54. The BI conducts a comprehensive, sophisticated, continual process of off-site monitoring, that is well integrated with a cycle of thorough, although less frequent, on site inspections. As a result, observance of the Basel Core Principles for Effective Banking Supervision is at a high level. Those principles where total compliance has not been attained are reported below, together with recommended actions for the BI's consideration.

Table 6. Recommended Action Plan to Improve Compliance with the BCPs

Reference Principle	Recommended Action
BCP 1.5. Legal protection	The authorities should give consideration to amendments to the legislation to provide legal protection to the supervisory authority and its officers against the possibility of legal action stemming from measures adopted in good faith in the performance of their functions.
BCP 8. Loan Evaluation and Loan-Loss Provisioning	<p>During the transitional period allowed by Basel II for the case of Italy to use less stringent 180 days past due requirements, rules and procedures should be modified to conform in due course to the widely accepted international practice of 90 days past due.</p> <p>The BI may wish to consider, in the exercise of its regulatory powers (1993 BL Art. 53), revising the applicable instructions so as to better align provisioning with the estimated losses of the loan portfolio of the banking system so that banks can better withstand a sudden deterioration in credit conditions. Some market participants would welcome this initiative.</p>
BCP10. Connected Lending	The BI is strongly recommended to consider the issuance of a comprehensive regulation on connected lending to address the issues of definition, overall limits, and reporting.
BCP14. Internal Control and Audit	The authorities should consider amending the 1993 BL and applicable regulations to legally empower the BI to remove expeditiously those banks directors or senior officers who may have become unfit for their duties.
BCP19. Validation of Supervisory Information	Given its current level of resources, and the related factor of its 3- to 6-year inspection cycle, the BI should review the means by which it may derive greater benefit from the work of external auditors in specific areas (e.g., money laundering) in the execution of its own mandate. It should also review the status of some banks, albeit extremely small institutions, which are not subject to external audit. The BI should also consider revising the 1993 BL so as to obtain the power to revoke the appointment of a bank's external auditors when their performance is deficient and to provide it with the authority to establish the scope and standards to be achieved in banks' external audits. In light of the rapid changes in the banking industry and risk management technology, the BI should continue to keep the adequacy of resources under review.
BCP 21. Accounting Standards	See recommendation on loan evaluation in BCP 8 above.

### C. Authorities' Response to the Assessment

55. The BI considers that the assessment recognizes the high degree of compliance of the Italian supervisory system with the Basel Core Principles. The assessment highlights a number of very positive features of the Italian supervisory framework, such as the adequacy of prudential regulations, the effectiveness of controls, achieved, *inter alia*, thanks to the fruitful interaction between on- and off-site methods and to the flexible and wide-ranging supervisory tools.

56. The interaction with the IMF mission has stimulated the BI's own considerations on a number of issues related with the subjects covered during the assessment.

57. On a number of issues the IMF's recommendations and findings back up some strands of work to which the BI had already began to devote consideration, such as: the importance of providing legal protection to the supervisory authority and its officers against the possibility of legal action by third parties in response to measures adopted in good faith in the performance of their functions; the issuance of a comprehensive regulation on lending to related parties in order to address more thoroughly, in addition to the existing provisions in the context of large exposures, the issues of definition and overall limits. The BI stated its commitment to take the necessary steps in order to meet the recommendations of the IMF's mission. To this end, it will be necessary to amend existing laws (BCP 1.5) and to ask for the issuance of guidelines by the ICCS (BCP 10).

58. The BI believes that the observations of the IMF's mission on BCP's 14 (Internal control and audit) and 19 (Validation of supervisory information), although grounded in principle, do not imply that the existing framework does not allow the BI to fully achieve the goals laid down in the BCP's. However, initiatives will be taken in order for the issues to be addressed by the competent authorities.

59. On BCP's 8 (Loan Evaluation and Loan-Loss Provisioning) and 21 (Accounting Standards) the BI has already taken steps toward the definition of more objective criteria for the classification of impaired loans in line with the prevailing practices in most G-10 countries. As explained to the Basel Committee in 2002, the BI has already begun to tackle the issue and will amend the supervisory regulations consistently with the time frame envisaged by the New Capital Accord. However, the BI does not agree with the IMF's view that the existing classification criteria may determine an overestimation of income of Italian banks.

60. Specific comments from the supervisory authority on the recommendations in the table above are as follows:

- On *BCP's 1.5 and 10* the BI noted that it is not empowered to act on its own authority, but requires either amendments of the BL or the issuance of specific guidelines by the ICCS. To this end the BI will approach the competent authorities.
- On *BCP 14* the BI remarked that, at present, although the law does not provide it with formal authority to require changes in the composition of a bank's board of directors and management, it can rely on a wide scope of enforcement tools in order to achieve its goals, among which the power to order a special meeting of shareholders with a predetermined agenda and to put the bank under special administration if the situation so requires.
- On *BCP 19* the authorities noted that, according to the Italian commercial law, the board of statutory auditors, which is primarily responsible for the validation of supervisory information, carries out the same task that is discharged by external auditors in those jurisdictions which do not envisage such a body. Furthermore, the banks subject to external audit account for over 90 percent of the system's total assets, and the requirement for audit of accounts by external auditing firms is to be further expanded as a result of the entry into force of the new company law in January 2004.
- As to the power to revoke the appointment of banks' external auditors, due consideration will be given to the IMF recommendation of an extension of the BI's powers in this field, which entails in any case an amendment of the existing laws
- On *BCP's 8 and 21* the BI is aware of the need to introduce more stringent objective criteria for the classification of impaired loans, notably with regard to "substandard" loans, and has already taken steps in order to bring the loan classification criteria more in line with the practices prevailing in other industrialized countries. This shall be done in the near future in accordance with the New Capital Accord (Basel II), which provides a more objective definition of impaired loans. However, the BI remarks that the use of the data provided by the Central Credit Registry is a mitigating factor, driving banks to downgrade loans from the "performing status".

As to the alleged impact on net income deriving from the recognition of interest accrued on such impaired loans, BI confirms its views – stemming from empirical evidence – that current accounting rules do not produce any material overestimation of net income for the Italian banks:

1. All interest on bad loans is considered interest on arrears and is effectively totally provisioned for, even though part of it is actually recovered.
2. As for sub-standard loans, banks make an estimate of the recoverable amount; all sums due (for capital and interest) in excess of this amount are provisioned.
3. As regards other past-due loans, while "contractual" interest accrues to income, "penalty interest" is to a very large extent provisioned for (70 percent of such interest, according to a survey covering 80 percent of banks by volume of assets). Considering that 80 percent of "other past-due loans" become current again within one year, this implies that such provisions tend to offset interest on the 20 percent of loans that eventually will be classified as bad loans or sub-standard loans.