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TECHNICAL NOTE

BANKING REGULATION AND SUPERVISION AND BANK GOVERNANCE

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**Monetary and Capital Markets
Department**

This Technical Note was prepared by IMF staff in the context of the Financial Sector Assessment Program (FSAP) in Italy during November 2018 – March 2019. It contains the technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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Glossary

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| ACRI | Associazione di Fondazioni e di Casse di Risparmio |
| AML | Anti-money Laundering |
| BCBS | Basel Committee on Banking Supervision |
| BCC | Banche di Credito Cooperativo |
| BCP | Basel Core Principles for effective banking supervision |
| BdI | Banca d'Italia |
| BoD | Board of Directors |
| CBG | Cooperative Banking Group |
| CDD | Customer Due Diligence |
| CET1 | Common Equity Tier 1 |
| CFRP | Contingency Funding and Recovery Plan |
| CFT | Countering the Financing of Terrorism |
| CM | Council of Ministers |
| CONSOB | Commissione Nazionale per le Società e la Borsa |
| COVIP | Committee for the supervision on pension funds |
| CP | Core Principle |
| CRD | Capital Requirement Directive |
| CRR | Capital Requirements Regulation |
| DAR | Detailed Assessment Report |
| DGFSR | Directorate General for Financial Supervision and Regulation |
| ECB | European Central Bank |
| EU | European Union |
| IVASS | Istituto per la Vigilanza sulle Assicurazioni |
| EBA | European Banking Authority |
| EC | Essential Criterion |
| ESCB | European System of Central Banks |
| FATF | Financial Action Task Force |
| FSAP | Financial Sector Assessment Program |
| HP | High Priority |
| HQLA | High Quality Liquid Assets |
| ICAAP | Internal Capital Adequacy Assessment Process |
| ICCS | Inter-ministerial Committee for Credit and Savings |
| ICT | Information and Communication Technology |
| IFRS | International Financial Reporting Standards |

| | |
|-------|---|
| ILAAP | Internal Liquidity Adequacy Assessment Process |
| IPS | Institutional Protection Scheme |
| IRB | Internal Ratings Based |
| IRRBB | Interest Rate Risk in the Banking Book |
| ITS | Implementing Technical Standard |
| JSC | Joint Stock Company |
| LCR | Liquidity Coverage Ratio |
| LP | Low Priority |
| LSI | Less Significant Institution |
| MEF | Ministry of Economy and Finance |
| MEL | Minimum Engagement Level |
| MoU | Memorandum of Understanding |
| MP | Medium Priority |
| NCA | National Competent Authority |
| NPE | Non-performing Exposure |
| NPL | Non-performing Loan |
| NSFR | Net Stable Funding Ratio |
| P1 | Pillar 1 |
| P2G | Pillar 2 Guidance |
| P2R | Pillar 2 Requirement |
| PEP | Politically Exposed Person |
| OCR | Overall Capital Ratio |
| RCAP | Regulatory Consistency Assessment Program |
| ROA | Return on Assets |
| ROE | Return on Equity |
| SEP | Supervisory Examination Programme |
| SI | Significant Institution |
| SME | Small and Medium Enterprises |
| SREP | Supervisory Review and Evaluation Process |
| SSM | Single Supervisory Mechanism |
| SSMR | Single Supervisory Mechanism Regulation |
| STR | Suspicious Transaction Report |
| TUB | Testo Unico Bancario, or Consolidated Law on Banking |
| TUF | Testo Unico della Finanza, or Consolidated Law on Finance |
| UTP | Unlikely to Pay |
| UIF | Unità di Informazione Finanze |

EXECUTIVE SUMMARY

This note presents a targeted review of selected aspects concerning the regulation and supervision of banks in Italy and their governance framework. The review was carried out as part of the 2019 Italy Financial Sector Assessment Program (FSAP) and was based on the regulatory framework in place and the supervisory practices employed as of March 2019. Since the regulation and supervision of significant banking institutions (SIs), including Italian SIs, was extensively covered as part of the 2018 Euro Area FSAP, this note focuses on the prudential regulation and supervision of less significant institutions (LSIs). In addition, the note reviewed regulatory and supervisory areas not covered by the wider EU regulatory framework, such as the supervision of anti-money laundering and countering the financing of terrorism (AML/CFT) and related party transactions, which apply to both SIs and LSIs in Italy.

The overall banking and legal regulatory framework has been significantly enhanced since the last FSAP, but further improvements can be made to upgrade the powers of the Banca d'Italia (Bdl) in some areas. As part of the transposition of the CRD IV in the national legal framework, the banking law (TUB) has enhanced Bdl regulatory powers, particularly in sanctioning supervised entities, removing banks' board and senior management members, and increasing pecuniary sanctions. These powers enable the Bdl to better address weaknesses and problems in the banking system. However, the banking law gives the Ministry of Economy and Finance (MEF) the power to put banks under compulsory administrative liquidation and to set a decree on the fit and proper requirements of banks' shareholders, board members and management. Given the prudential nature of these topics, it is advised that they be left to the purview of the Bdl.

The Bdl adopts a risk-based proportional approach to the supervision of LSIs. The risk assessment framework applied by the Bdl for LSIs is based on the EBA guidelines on common procedures and methodologies for the supervisory review and evaluation process (SREP) and is already broadly aligned with the SSM SREP approach. Therefore, the completion of the transition into the application of the SSM LSI SREP methodology should be smooth. In addition, the Bdl has a structured process for planning supervisory activities and determining priorities that are focused on the main weaknesses in the LSI sector. The offsite assessment of LSIs is based on a thorough set of prudential reports and indicators that take into account the banks' main risk areas. In addition, onsite reviews thoroughly assess banks' policies and risks and are well coordinated with the findings of the offsite process.

Some supervisory processes, particularly in onsite inspections, can be streamlined to improve timely remedial actions. The Bdl should streamline its inspection processes to ensure timelier communication of supervisory findings and remedial actions. In addition, a review of supervisory processes across Bdl's branches should be made to increase the harmonization of supervisory processes across Bdl's locations, building on the recent reform of supervision at branch level. In addition, the Bdl should continue to enhance its interaction with banks' external auditors and its cooperation with CONSOB to discuss operational bank-specific issues and incorporate the

takeaways from these activities in its assessment of banks' risk profiles, leveraging on the recent revision of the general MoU and the ongoing work on the other agreements with CONSOB.

While the Bdl identifies the relevant supervisory priorities, more targeted supervisory activities should be performed focusing on those priorities. Bank governance, credit risk, and business models have been at the core of Bdl supervisory objectives with respect to LSIs. To ensure proper oversight of these issues, the Bdl should increase the frequency of supervisory activities over these topics by performing more deep dives and increased targeted and thematic onsite inspections and reviews in these areas. This would ensure a quicker and a more effective approach to early detect and address LSI weaknesses and problems.

More timely escalation of corrective actions for problem LSIs with persistent weaknesses are needed. The enhancements in the Bdl's corrective and sanctioning powers have provided a better platform to address weaknesses in the banking sector in a more decisive way. However, in a context of sub-par growth of the Italian economy, several LSIs still have weaknesses in relation to their profitability, governance and high level of NPLs. In tackling weak banks, escalation of corrective measures has generally taken time as consideration has been given to systemic implications and contagion risk. The efforts of the Italian authorities have focused on market solutions. Going forward, with the bolstering of the banking system in recent years, the Bdl should consider timelier and more escalated corrective measures for those banks with unsustainable business models or whose situation (e.g., in relation to governance, asset quality or capital levels) is in persistent deterioration, so that weaknesses do not persist or even become exacerbated if not dealt with in a timely manner.

The Bdl should continue to closely supervise LSIs' credit risk and problem assets and oversee LSIs' NPL reduction efforts. Bdl's supervisory activities have been rightly focused on monitoring banks' credit risk and problem assets and the 2018 Bdl's guidelines on NPL management established a more structured process to reduce LSIs' NPL portfolio. Supervisory activities on credit risk and problem assets should be further increased and adequate corrective measures should be taken in case of imprudent credit risk management practices, insufficient provisioning, or undue forbearance practices. In addition, the Bdl supervisors should continue to scrutinize banks' NPL reduction plans and regularly monitor the progress of these plans during the year and provide more detailed guidance about specific aspects of loan classification and forbearance practices.

While Italian LSIs are subject to the EU capital framework, some improvements to the pillar 2 requirements (P2R) approach could be adopted. Given that some deviations in the EU capital framework from Basel requirements could be very relevant for Italian LSIs, the Bdl should regularly monitor the effect of these deviations on LSIs' capital ratios and positions. The Bdl supervisors have a detailed process for reviewing banks' ICAAPs and comparing them with their own supervisory tools and proxies to determine P2R. Given the extensive use of supervisory judgment and proxies, the choice of the proper add-on should be subject to additional criteria and ex-ante checks to ensure better consistency and horizontal benchmarking in applying P2R across LSIs.

The Bdl has enhanced its requirements and regulations for related party transactions but, the overall prudential limit for related party lending should be further tightened. The new regulation establishes extensive definitions for a bank's related parties and requires banks to establish internal procedures to oversee related party transactions and ensure that they are free from conflict of interest. The regulation sets individual limits on lending to related parties and their respective connected persons. In addition to these limits, the Bdl is advised to set an aggregate limit on all related party lending that is as strict as the large exposure limit, in line with the respective Basel Core Principles. As recommended in the Euro Area 2018 FSAP, a harmonized EU framework on related party transactions compliant with the Basel Core Principles would help establish a level playing field in this area.

The Bdl should also enhance its regulations and supervisory practices in relation to IT, cyber, and ML/TF risks. The regulations on operational risk management should be improved and the Bdl resources and activities on IT and cyber risk should be increased. Given that many of the LSIs outsource their IT systems and services to a small number of firms, it would be useful for the Bdl to perform inspections over these firms to confirm they are subject to minimum IT security requirements, in line with recently adopted inspection plans. The Bdl has enhanced its regulations and supervisory practices on AML/CFT, but further efforts are needed to better risk-based allocation of its supervisory resources and activities and to incorporate AML/CFT findings in banks' risk assessment.

The authorities have recently passed a series of significant reforms to enhance banks' governance, but critical actions and effective implementation are still needed. The move to reduce the foundations' role in the banking sector, the reform of the popolari banks, and the conversion of most banking cooperatives into cooperative banking groups (CBG) represent strong measures to address some longstanding governance weaknesses in the sector.¹ The reform of popolari banks has been implemented for eight out of the ten banks affected, and the reform of banking cooperatives is operational. Going forward, it is key to continue the effective implementation of these reforms. In addition, the MEF should quickly issue the draft decree on the fitness and propriety of banks' corporate officers and revise the decree on the suitability of major shareholders. As outlined earlier, more targeted and thematic supervisory activities should be performed on bank governance and further actions should be explored to deal with the weak smaller popolari banks.

¹ Popolari banks have a cooperative nature and give equal voting rights to all members while setting limits on ownership levels. Their shares can be listed in the stock exchange and they have to allocate only 10 percent of their profits to reserves (see Box 1 for more details on popolari banks and their reform). On the other hand, CBGs have been established based on the reform of the mutual banks or the Banche di Credito Cooperativo (BCC) where most BCCs were required to join one of two CBGs. BCCs comprise small financial entities whose main lending activity is to grant credit to their members. Their shares are non-tradable and held only by their members. They also give equal voting rights to all members and place limits to ownership rights of Euro 50,000 (see Box 2 for more details on the reform of the BCCs).

Table 1. Italy: Main Recommendations

| Recommendation | Responsible Authorities | Timing* |
|--|-------------------------|---------|
| Banking Regulation and Supervision | | |
| Powers, Independence and Resources | | |
| Amend the banking law to shift the power of putting banks under compulsory administrative liquidation from the MEF to the supervisory authorities, with a proper consultation process with the MEF | Italian Authorities | ST |
| Supervisory Approach, Processes and Cooperation | | |
| Further oversee the supervisory activities of Bdl's branches to ensure maximum harmonization of supervisory processes and practices across all Bdl's locations, leveraging on the reform recently launched | Bdl | I |
| Perform more frequent deep dives and thematic and targeted inspections, particularly on key LSI weaknesses, including bank governance, credit risk, and business models | Bdl | I |
| Enhance the interaction with CONSOB to discuss bank-specific issues as well as findings related to CONSOB's oversight of external auditors, building on the recent revision of the MoUs | Bdl, CONSOB | ST |
| Corrective Action and Sanctioning | | |
| Consider timelier escalation of corrective measures for banks with unsustainable business models and those whose situation shows persistent deterioration (e.g., in relation to governance, asset quality, or capital levels). | Bdl | I |
| Capital Adequacy | | |
| Review banks' pillar 2 process and capital requirements to ensure better consistency and horizontal benchmarking in applying P2R across all LSIs | Bdl | C |
| Credit Risk | | |
| Make the necessary refinements to align the Bdl NPL guidelines to the EBA guidelines on the management of non-performing and forborne exposures | Bdl | I |
| Grant the Bdl the power to require banks to adjust their asset classification and increase provisioning levels | Italian Authorities | I |
| Continue monitoring the implementation of banks' NPL plans and further scrutinize banks' NPL plans for reliability and ambitiousness | Bdl | C |
| Other Risk Areas | | |
| Introduce an aggregate prudential limit for all related party exposures that is at least as strict as the single large exposure limit | Bdl | ST |
| Increase the Bdl's supervisory capacity in relation to IT and cyber risk | Bdl | ST |
| Perform inspections over IT outsourcing firms to ensure they are subject to minimum IT security requirements | Bdl | I |
| Revisit the approach to AML/CFT inspections conducted by the Bdl over banks' branches and use these resources in doing more targeted AML/CFT reviews or more prudential inspections over banks | Bdl | I |

Table 1. Italy: Main Recommendations (concluded)

| Bank Corporate Governance | | |
|---|---------------------|----|
| Quickly issue the draft decree on the fitness and propriety of banks' corporate officers and revise the decree on the suitability of major shareholders | MEF | I |
| Grant the supervisory authorities the power to issue such fit and proper requirements for banks' shareholders and corporate officers given the prudential nature of these requirements | Italian Authorities | ST |
| Complete the implementation of the reform of the large popolari banks (<i>i.e.</i> , with total assets of more than Euro 8 billion) and continue to explore further ways to address problems and push for solutions for the smaller popolari banks | MEF, Bdl | I |
| Closely supervise the new CBGs during their first years of operations to ensure that the challenges associated with the reform are successfully overcome | SSM, Bdl | ST |
| Note: * C= continuous; I (immediate)= within one year; ST= Short Term (within 1-2 years); MT= Medium Term (within 3-5 years) | | |

INTRODUCTION²

A. Scope and Approach

1. This note presents a targeted review of selected aspects concerning the supervision of less significant banking institutions (LSIs) in Italy, as well as a review of banks' governance.

The review was carried out as part of the 2020 Italy Financial Sector Assessment Program (FSAP) and the findings and recommendations were based on the regulatory framework in place and the supervisory practices employed as of March 2019. They were also informed by insightful discussions with the Banca d'Italia (Bdl) in Rome, the European Central Bank (ECB) in Frankfurt, and meetings held with banks, industry associations, audit firms, and other stakeholders and market participants in Rome and Milan during November–December 2018 and March 2019.

2. The mission focused on selected topics based on their macro-financial relevance, especially for LSIs, and on previously identified weaknesses in the Italian regulatory and supervisory framework. The main themes in relation to banking regulation and supervision included: the powers and responsibilities, independence, accountability and resourcing of the Bdl; the supervisory approach and tools to assess banking risks and perform supervisory activities over LSIs; and the enforcement and sanctioning powers and practices of the Bdl. This note also covers key aspects of the prudential framework, particularly in relation to capital adequacy, risk management, credit risk and problem loans, concentration risk and related party transactions, liquidity and funding risks, operational risk, and abuse of financial services. While the review of the prudential framework focused on LSIs, it also covered some regulatory and supervisory areas that are not governed by the wider EU regulatory framework such as the supervision of anti-money laundering and countering terrorism financing (AML/CFT) and related party transactions which apply to both significant banking institutions (SIs) and LSIs. The note also discusses the main recent

² This note was prepared by Rachid Awad (IMF).

reforms to enhance bank governance and the main future challenges and priorities, including on bank governance regulations and supervision.

3. The mission maintained close coordination with other FSAPs in the Euro Area. Many aspects of the legal and regulatory framework for LSIs in Italy are based on the European regulations and directives. Therefore, the mission built its analysis and review on the findings and recommendations of the 2018 Euro Area FSAP. It also maintained close coordination with recent and ongoing FSAPs in Euro Area countries.

4. The IMF team wishes to thank the authorities and private sector participants for their excellent cooperation. The Bdl provided a partial self-assessment of compliance with the 2012 Basel Core Principles and responses to a complementary questionnaire. The ECB has also provided responses to a dedicated questionnaire. The authorities also provided examples of actual supervisory practices and assessments. The FSAP review team benefitted greatly from the inputs received and exchanges of views during meetings with supervisors, banks, industry associations and other market participants. The team would like to thank the authorities for their excellent arrangements that have greatly facilitated the work of the mission.

5. This note is structured as follows. The next two sections of this part discuss the market structure of LSIs in Italy, including a brief overview of their prudential indicators, and the institutional setting for banking regulation and supervision in Italy. The next part discusses the findings and recommendations in relation to banking regulation and supervision processes and practices, focusing on the LSI sector in Italy. The last part discusses the key features of the recent reforms to enhance banks' governance, the main challenges and priorities ahead, and the related recommendations in this respect.

B. Market Structure

6. At the end of 2017 there were 113 banks belonging to 60 banking groups, 347 stand-alone banks and 78 branches of foreign banks operating in Italy. Eleven banking groups, holding 74 percent of the total assets of Italian banks, were classified as significant institutions (SIs) for the purposes of the European Single Supervisory Mechanism (SSM). 289 institutions were mutual banks or banche di credito cooperativo (BCC), 23 were popolari banks and the remaining banks were joint stock companies (JSC).

7. The LSI sector in Italy consists of banks with diverse legal forms but with a main focus on a traditional business model. LSIs include BCCs, popolari banks, as well as banks established as JSCs. Table 2 shows the evolution of the number of LSIs and their assets since 2015. A significant reduction in LSI numbers has been taking place over the past few years, which is mainly due to the consolidation in the sector, mainly BCCs. This consolidation has been driven by the weak situation faced by many LSIs, including BCCs. The vast majority of LSIs (95 percent in terms of the system's assets) operate with a traditional banking business model.

Table 2. Italy: Evolution of LSIs in Number and Size

| | Dec. 2015 | Dec. 2016 | Dec. 2017 | Dec. 2018 |
|--------------------------------|-----------|-----------|-----------|-----------|
| Number of LSIs | 472 | 436 | 386 | 361 |
| - of which: BCC | 365 | 335 | 289 | 268 |
| LSIs' Assets (in Euro Billion) | 549 | 547 | 542 | 519 |
| - of which: BCC | 238 | 235 | 230 | 214 |

Source: Banca d'Italia.

8. The key financial and prudential indicators of the LSI sector show a number of weaknesses. These are due to the high NPL ratios and low profitability of the LSI sector. Table 3 and Figure 1 show the progress of the LSI sector's key indicators over the last three years. While the capital ratios are well above the minimum requirements, a number of LSIs continue to have weak profitability and high NPL ratios. The more granular data show that the popolari sector has the weakest indicators relative to other LSIs, followed by mutual or BCC banks, then banks established as JSC.

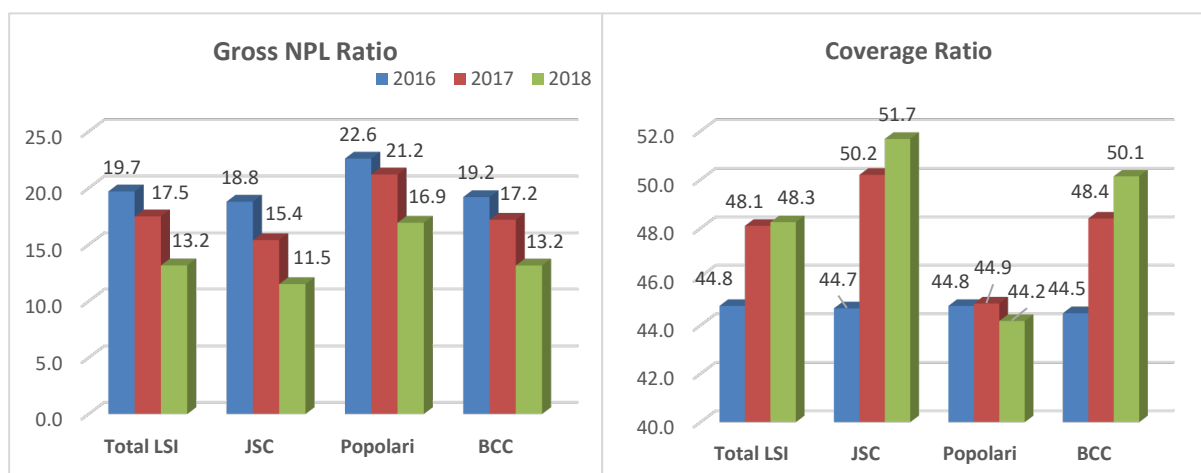
Table 3. Italy: Capital and Profitability Ratios of the Italian LSI Sector

(in percent)

| | 2015 | 2016 | 2017 | Q2-2018 |
|---------------------------|-------------|-------------|-------------|-------------|
| CET1 Capital Ratio | 15.3 | 16.0 | 16.8 | 16.3 |
| Of which: | | | | |
| • JSC | 14.3 | 15.5 | 17.5 | 16.9 |
| • Popolari Banks | 15.4 | 15.4 | 15.4 | 15.3 |
| • BCC | 16.6 | 16.7 | 16.4 | 16.0 |
| ROE | 1.4 | 1.7 | 1.9 | 5.7 |
| Of which: | | | | |
| • JSC | 4.7 | 4.6 | 2.3 | 8.7 |
| • Popolari Banks | -3.7 | 0.6 | 2.1 | -3.1 |
| • BCC | -0.3 | -0.3 | 1.2 | 3.8 |
| ROA | 0.1 | 0.2 | 0.2 | 0.5 |
| Of which: | | | | |
| • JSC | 0.5 | 0.4 | 0.3 | 0.8 |
| • Popolari Banks | -0.4 | 0.1 | 0.1 | -0.2 |
| • BCC | 0.0 | 0.0 | 0.1 | 0.3 |

Source: Banca d'Italia.

Figure 1. Asset Quality Ratio for LSIs



Figures are in percentage terms and refer to loans to customers. End-2018 Figures are preliminary.

Source: Banca d'Italia.

9. A reform of the whole mutual banking sector and popolari banks has been taking place. A law was passed in 2015 to convert the largest Italian popolari banks (with total assets of more than Euro 8 billion) into JSC. Eight of the ten popolari banks above the size threshold converted into JSC while the remaining two are pending a legal review of the law. The law has also introduced some improvements in the legal framework applicable to popolari banks with total assets of less than Euro 8 billion. The reform of the BCC sector passed in 2016 envisaged that BCCs will have to join a cooperative banking group (CBG) established as a JSC. Two cooperative groups have been formed and are undergoing the process of becoming CBGs. They will be directly supervised by the ECB (one of the two is already supervised by the ECB) since they became SIs. The remaining 39 BCCs located in Alto Adige were given the option of establishing an institutional protection scheme (IPS).³ For a more thorough explanation of the reform and the two types of banking structures, see Boxes 1 and 2.

³ An IPS, within the sense of article 113 (7) of the CRR, is a contractual or statutory liability arrangement that protects the participating institutions and, in particular, ensures their liquidity and solvency to avoid bankruptcy where necessary. As such, an IPS is not a legal entity but rather a contractual arrangement between distinct financial undertakings aimed at providing mutual support in financial stress situations.

Box 1. The Reform of the Popolari Banks

The main features of popolari Banks in Italy:

Popolari banks operate according to a cooperative nature but they can list their shares in the stock exchange and have to allocate only ten percent of their profits to reserves. Popolari banks give equal voting rights to all members (one head one vote) and have limits of one percent of capital on ownership rights (with larger amounts allowed for institutional investors).

The main components of the reform:

In 2015, the Italian Parliament approved the reform of popolari banks (Decree Law 3/2015, converted into Law 33/2015) which required those popolari banks with assets of more than Euro 8 billion to be converted into JSC by end-2016. The rationale behind the reform is that the cooperative nature of popolari banks, originally conceived for small and local banks, was no longer coherent with the complexity and the size of some of them. Several popolari banks had significantly grown over time, expanding their operations from local to national and international levels and also being listed on the stock market. At the same time, the law has also introduced some improvements in the legal framework applicable to popolari banks with total assets of less than Euro 8 billion.

The Progress in the reform implementation:

- Eight out of the ten large popolari banks converted into JSC within the set deadline. The remaining two did not complete the transformation process and appealed the reform. The Italian Council of State asked, in December 2016, the constitutional court to review certain parts of the law and suspended the implementation of the reform. Three issues were raised by the Council of State: the use of decree law rather than parliamentary procedure to enact the reform, the legal limits to redemption of shares for members withdrawing from the banks as a result of the transformation, and the delegation granted to Bdl in the decree law to enact secondary regulation to support the reform implementation.
- The Constitutional Court published its decision in May 2018 confirming the constitutionality of the reform and rejecting all illegitimacy issues. As a result, a new decree law 91/2018 was issued setting end-2018 for the completion of the reform.
- However, the Council of State extended again the freeze of the reform in October 2018 saying it would only rule on the appeal following a decision by the European Court of Justice. Most recently, the decree law 119/2018, as converted into the law 136/2018, postponed the completion of the reform to end-2019. Hence, the reform was still pending as in March 2019.

Box 2. The Reform of Banche di Credito Cooperativo (BCC)

The Main features of BCCs in Italy:

BCCs comprise small financial entities whose main lending activity is to grant credit to their members. Their shares are non-tradable and held only by their members. They must allocate three-quarters of their profits to building reserves. They also give equal voting rights to all members (one head one vote) and place limits on ownership rights of Euro 50,000.

The main components of the reform:

In 2016, Decree Law n. 18/2016, converted into law in April, has introduced relevant innovations for BCCs. It stipulated the establishment of CBGs and required BCCs to join these groups. According to the new regulatory framework, the CBG is composed of: (i) a parent company, formed as a JSC and authorized to engage in banking, the majority of whose capital is held by the BCCs belonging to the group and that exercises management and coordination over the group companies pursuant to a cohesion contract; (ii) the BCCs that have entered into the contract; and (iii) other banks and ancillary services undertakings controlled by the parent company. Based on the reform, each Italian BCC should be a member of a CBG in order to hold or retain its banking license. The net assets of the parent company of the CBG should not be less than Euro 1 billion, and more than 60 percent of its share capital should be held by the BCCs belonging to the group. The parent entity shall also have the operational and organizational structures able to ensure access of the affiliated banks to national and international interbank markets and to provide operational and accounting services as well as technology and infrastructure services to the affiliated banks.

The CBG is based on two main elements:

- A cohesion contract: it is a contractual agreement amongst the participating BCCs through which the BCCs agree to be subject to the parent company's direction and coordination. The contract aims at ensuring unity of strategic direction and of the internal control system as well as compliance with the prudential regulation applicable to the group and to its members by way of binding instructions from the parent entity to the affiliated BCCs. Compliance with the parent entity's instructions is ensured by the parent's activity of control and intervention which shall be exercised proportionately to the risk level of the affiliated banks.
- A cross-guarantee scheme: where both the parent company and the affiliates are jointly liable for the liabilities of each participating bank that, within the limits of its individual obligation, defaults on its creditors. In addition, the participating banks offer each other the financial support needed to ensure their solvency and liquidity, particularly to comply with the prudential requirements.

The Progress in the reform implementation:

Three CBGs were to be formed after the reform. However, at the end of 2018, the Italian government opened the option to one of the BCC groups to either create a CBG or establish an IPS. As a result, the remaining 39 BCCs will join an IPS, leaving the number of CBGs at two. As of March 2019, the terms and conditions of the new IPS were not defined yet. This will be the subject of further discussions between the group and the Bdl.

The two CBGs have been approved and the approval of their enrollment in the banking group register was granted in December 2018 and March 2019. The next step, as of March 2019, was to undergo the comprehensive assessment in the context of becoming directly supervised by the ECB.

C. Institutional Setting

10. The relevant legislation, in particular the law on banking (Testo Unico Bancario or TUB) and the law on finance (Testo Unico della Finanza or TUF), establishes the competences of all the Italian financial authorities. These texts determine how the authorities exercise their powers also in the context of the European Union (EU). Furthermore, the Italian law defines the general principles for the cooperation and exchange of information among the Italian supervisory authorities as well as with other EU Member States, third countries authorities and the European Central Bank (ECB). The overall framework has been amended in recent years to implement the Directive 2013/36/UE (CRD IV) and to make the TUB consistent with the Single Supervisory Mechanism Regulation (SSMR).

11. The Italian competent authority for the banking sector is mainly the Bdl. The Inter-ministerial Committee for Credit and Savings (ICCS)⁴ and the Minister for Economy and Finance also play some roles in the oversight of the banking sector. There are also other authorities responsible for the oversight of other financial sectors. These are: the Italian securities and market regulator (CONSOB), the Committee for the supervision of pension funds (COVIP), and the Institute for the Supervision of Insurance (IVASS).

12. Following the entry into force of the SSM, banking supervisory powers are split between the ECB and the National Competent Authorities (NCAs), the Bdl in Italy's case, respectively on SIs and LSIs. For what relates to licensing and acquisitions of qualifying holdings, the ECB is the competent authority for all banks: the Bdl is the "entry point" of all notifications and is responsible for their first assessment, as well as for submitting to the ECB specific proposals regarding the possibility to grant authorizations or not. The NCAs plan and carry out their ongoing supervisory activities using their own resources and decision-making procedures. Additionally, NCAs perform supervision in areas that are not covered by the SSM Regulation. The ECB is entrusted with an oversight responsibility to ensure that the supervisory activities carried out by NCAs for LSI supervision are in line with high supervisory standards, also with a view to fostering consistency of supervisory outcomes within the SSM.

13. Pursuant to the TUB, the ICCS is the authority responsible for "high-level supervision". However, this does not involve the exercise of any power of intervention in respect to banks and banking groups, given that the TUB limits the functions of the ICCS to the issuance of guidelines (following a proposal by the Bdl) on transparency and consumer protection and few other topics (e.g., collection of savings by non-banking entities). When the TUB provides so, the ICCS provides guidelines that serve as a basis for the Bdl detailed regulations.⁵

⁴ Based on the TUB (Article 2, Para. 1), the ICCS shall be composed of the Minister for Economy and Finance, who shall be its Chairman, the Minister of International Trade, the Minister for Agricultural, Food and Forestry Policies, the Minister for Economic Development, the Minister for Infrastructure, the Minister of Transport and the Minister for European Community Affairs. Meetings of the Committee shall be attended by the Governor of the Bdl.

⁵ The scope of the ICCS regulatory powers has been significantly revised on the occasion of the transposition of CRD IV and taking into account the SSM supervisory framework: in particular, the ICCS is not involved any longer in the regulation of prudential matters; as a consequence, only the Bdl is currently endowed with regulatory powers on prudential issues such as capital and liquidity adequacy, risk management, governance, and internal controls.

14. The Ministry of Economy and Finance (MEF) plays also some roles of prudential dimension. The MEF has the power to adopt decrees on the suitability requirements of major shareholders and managers (fit and proper requirements) and on some organizational aspects of CBGs. It is also vested with the power to put banks and companies belonging to banking groups into compulsory administrative liquidation, acting on a proposal by the Bdl, as well as to approve the decision of the Bdl to initiate the resolution of banks and companies belonging to banking groups. The MEF is also mainly involved when transparency and consumer protection issues are concerned and in case of non-banking intermediaries

BANKING REGULATION AND SUPERVISION

A. Supervisory Objectives, Powers, Independence and Resources

Objectives

15. The objectives of Italian supervisory authorities are well defined in the banking and financial legislation. The TUB mentions that the national credit authorities (i.e., the Bdl, the ICCS, and the MEF) exercise their powers having regard to the: (i) sound and prudent management of supervised institutions; (ii) financial system stability, efficiency and competitiveness; and (iii) the compliance of supervised institutions with laws and regulations. The TUF also specifies the objectives of supervisory activities as follows: (i) the safeguarding of faith in the financial system, its stability, competitiveness and correct operation; (ii) the protection of investors; and (iii) the observance of financial regulation. In regard to the provision of investment services, the TUF assigns to the Bdl the responsibility of risk containment, asset stability, and sound and prudent management of intermediaries and to CONSOB the responsibility of transparency and correctness of conduct.

Powers

16. The Bdl is the primary authority responsible for the prudential supervision of banks and banking groups (within the limits and in accordance with the SSM rules). In line with the EU regulatory framework and in transposition of the CRD IV, the TUB (Articles 53 and 67) empowers the Bdl to issue general regulations on various topics including: capital adequacy, risk containment, permissible holdings, governance, disclosures, remuneration policies, connected lending and other transactions with related parties.

17. The scope of the ICCS regulatory powers has been significantly narrowed following the transposition of the European framework. According to the TUB (art. 2), the ICCS is still deemed to be the highest supervisory authority for credit and the protection of savings. The ICCS can receive and decide on complaints filed by parties having an interest in a measure adopted by the Bdl in the performance of the supervisory functions conferred to it by the TUB. Based on discussions with the authorities, the ICCS has not played any role in this respect practically. In addition, the ICCS issues guidelines, following a proposal by the Bdl, on transparency and consumer protection and other topics, such as collection of funds on a public basis.

18. As mentioned earlier, the MEF has also regulatory powers involving prudential matters. It has the power to adopt decrees on the suitability and fit and proper requirements of major shareholders and corporate officers,⁶ after consultation with the Bdl. However, the current decrees are very old (they were stipulated in 1998) and set very limited requirements in relation to the fitness and propriety of corporate officers and major shareholders. The MEF has prepared a draft decree to replace the one applicable to corporate officers but the draft has been in discussion since many years without being finalized or passed yet (see the section on banks' governance for further discussion of this issue and the related recommendations). The MEF is also vested with the power to put banks and companies belonging to banking groups into compulsory administrative liquidation, acting on a proposal by the Bdl, as well as to approve the decision of the Bdl to initiate the resolution of banks and companies belonging to banking groups.

19. It is important to clarify further in the TUB the role of the ICCS and MEF in relation to prudential supervisory issues and ensure that their role does not interfere with the prudential powers of Bdl. While the role of the ICCS has been practically limited, it is important to reflect the limited scope of this role in the banking law and clarify its exact role in deciding on supervision-related complaints. In addition, the role of the MEF in setting fit and proper criteria for shareholders and corporate officers may limit the ability of the Bdl to upgrade these criteria and change them as needed without undue political influence. Furthermore, the MEF powers in relation to deciding on compulsory administrative liquidation may limit the ability of the ECB in withdrawing bank licenses. Given the technical nature of these issues and to limit the scope of political considerations in setting the fit and proper criteria for banks' shareholders and corporate officers as well as in deciding on a bank's compulsory administrative liquidation, the authorities are encouraged to consider the possibility of shifting these powers to the supervisory authorities and replacing them with a thorough consultation process between the Bdl and MEF, to ensure relevant aspects are still discussed with the MEF.

Independence

20. The Bdl has a high level of operational independence in the exercise of its prudential and supervisory responsibilities. The Bdl statute stipulates that the Bdl and the members of its decision-making bodies shall act autonomously and independently in the performance of their functions and managing the bank's finances and may not seek or accept instructions from other public or private sector entities. While there is no public authority empowered to influence, veto, overcome or void the Bdl regulations or supervisory decisions, they are subject to judicial review if they are against the law (Article 24 of the Italian constitution).

21. In the last six years, the Bdl statute has been amended twice to set new rules for Bdl capital and ownership structure. The Bdl's ownership structure reflects its past history and is mainly composed of banks and insurance firms. The amendments to the Bdl statute, aimed at broadening and redistributing the shareholder base, cap single institutions' stakes at 3 percent and

⁶ Corporate officers include members of the banks' board of directors, general managers, and heads of control functions.

make the profit distribution process more transparent. As a consequence of this process, the capital of the Bdl was held by 70 banks, ten insurance firms, 11 social security institutions, 21 foundations and eight pension funds. The Bdl has a Board of Directors (BoD) chaired by the Bdl Governor and composed of thirteen directors appointed by the shareholders' meeting.⁷

22. The Governing Board is the Bdl's main decision-making body and consists of the Governor, the Senior Deputy Governor, and three Deputy Governors. The Governor is appointed for a term of six years (possibly renewed only once) based on a decree issued by the President of the Republic, acting on a proposal from the President of the Council of Ministers, following the adoption of a resolution by the Council of ministers (CM), after hearing the opinion of the Bdl's BoD. The Bdl's BoD, acting on a proposal from the Governor, shall appoint the Senior Deputy Governor and the Deputy Governors. The appointment, reappointment and removal of the deputy governors must be approved by a decree of the President of the Republic, acting on a proposal from the President of the CM in agreement with the MEF after consulting the CM.

23. Based on the statute, the removal of the Governor, the Senior Deputy Governor, and the Deputy Governors from office can be made based on the cases provided by Article 14(2) of the Statute of the European System of Central Banks (ESCB). These cases apply when the persons no longer fulfill the conditions required for performance of their duties or if they have been guilty of serious misconduct. In its opinion (CON/2014/19), the ECB advised that the members of the Governing Board, other than the Governor, must have the right to submit any decision to dismiss them to an independent court of law, in order to limit the potential for political discretion in evaluating the grounds for their dismissal.⁸

24. The legal framework gives the Bdl a high level of independence in performing its institutional functions, but a few aspects may benefit from being reviewed to ensure they do not potentially pose an indirect constraint on the Bdl's independence and resources. While the statute (Article 19) gives the BoD the responsibility for the general administration, management supervision and control of the Bdl, it stipulates that the BoD shall not interfere any way in matters pertaining to the exercise of the public functions of the Bdl and its Governor for the pursuit of the bank's institutional aims. However, the statute also gives the BoD some responsibilities that may indirectly impact the ability of the Bdl to duly perform its functions such as: (i) determining staffing levels, appointing and dismissing employees, (ii) approving the annual expenditure budget,

⁷ A nominations committee composed of three directors and two alternates shall select the candidates for nomination or reelection. Article 16 of the Bdl statute establishes some criteria for the position of director. They should have significant experience in business, the professions, university teaching or high-level public management and should also meet requirements of integrity and independence. They should not hold and should not have held, within the two years preceding their nomination, positions with banks or companies operating in the financial or insurance sector or with other entities that by reason of their nature, activity or other circumstances, even contingent, are subject to the powers of control, supervision or authorization of the Bdl.

⁸ In its opinion, The ECB mentioned that it understands that this right is made available under Italian law on the basis of overriding principles of constitutional law and relevant procedural rules. However, for reasons of legal certainty, the ECB advised to refer to such a right of review in the Bdl statute. The Bdl Governor was excluded from this recommendation since, based on the statute of the ESCB, national central bank governors who have been dismissed from office may refer such a decision to the European Court of Justice.

and (iii) adopting resolutions regarding the general organizational structure of the bank. The discussions with the Bdl have clarified that, in performing all of its administrative duties, the BoD acts on a proposal from the Governing Board and there is a clear separation between the preparatory phase (where the competent structures within the Bank prepare a draft proposal which must be first be approved by the Governing Board for its subsequent submission to the BoD) and the decision-making phase, which rests with the BoD. The above-mentioned separation applies for all the BoD's administrative functions, including the determination of staffing levels, the approval of the annual expenditure budget and the adoption of resolutions concerning the Bank's general organizational structure. As a consequence, these powers have not practically impacted the Bdl's ability to perform its institutional public functions (such as banking and financial supervision, monetary policy within the framework of the Eurosystem, oversight of payments system).

Resources

25. The Bdl employs an internal budgeting process that allows a good level of autonomy in setting the amount of funds needed to perform its activities. Based on a guidance given by the Senior Deputy Governor, the organizational units of the various functions, including the supervisory functions, propose a budget request for the following year. The heads of general directorates are also involved in planning staff resources by formulating their needs on a yearly and more medium-term basis to both the Human Resources Directorate and an advisory committee. These needs are evaluated and decided upon by the Bdl Governing Board. The discussions with supervisors did not reveal any practical limitations on supervisory budgeting and resourcing. However, as mentioned above, the Bdl statute gives the board of directors the powers to approve staffing levels and the annual budget. The Bdl is in the process of moving into a three-year budgeting process which would allow a better medium-term budget visibility and planning.

Table 4. Italy: Employed Supervisory Resources Based on Full Cost Figures

(Figures are in millions of Euros)

| | 2013 | | 2014 | | 2015 | | 2016 | | 2017 | |
|----------------------------|--------------|------|--------------|------|--------------|------|--------------|------|--------------|------|
| | SI | LSI | SI | LSI | SI | LSI | SI | LSI | SI | LSI |
| Offsite Supervision | 14.6 | 68.3 | 9.6 | 59.3 | 19.8 | 70.3 | 21.7 | 62.7 | 21.7 | 62.5 |
| Onsite Supervision | 28.9 | 48.9 | 9.7 | 37.2 | 21.8 | 42.1 | 21.2 | 41.4 | 22.5 | 31.9 |
| Horizontal Activities | 33.8 | | 75.0 | | 29.8 | | 24.1 | | 25.6 | |
| Crisis Management | 1.2 | | 0.2 | | 0.5 | | 0.5 | | 0.8 | |
| Statistics | 6.4 | | 7.1 | | 7.5 | | 8.1 | | 7.5 | |
| SSM Macro-prudential tasks | n/a | | 3.2 | | 5.6 | | 6.8 | | 8.0 | |
| TOTAL | 202.2 | | 201.2 | | 197.4 | | 186.5 | | 180.5 | |

Source: Banca d'Italia.

26. Based on the full cost figures provided by the Bdl, the expenditures spent on supervision of LSIs has decreased particularly in 2017. However, based on discussions with the Bdl, one of the drivers mentioned behind the decrease in supervisory expenses over the last years is the consolidation taking place in the sector and the decrease in the number of LSIs. The budgetary

process is mainly driven by the guidance of the governing board and the input of the various financial supervision and regulation directorates. The discussions with stakeholders during the mission did not reveal pressures on supervisory cost and budgeting either from the Bdl's BoD nor indirectly from the treasury.

27. The Bdl's supervisory activities are carried out by the Directorate General for Financial Supervision and Regulation (DGFSR) at the Bdl's Head Office in Rome and by its branch network.⁹ The DGFSR is composed of seven Directorates with the following responsibilities:

- **Banking Supervision 1 Directorate:** helps define supervisory interventions for the Italian or foreign banking groups in Italy subject to the direct supervision of the ECB. It monitors the technical situation and carries out supervisory interventions at non-European bank branches and at banking groups and banks that are not subject to the direct supervision of the ECB;
- **Regulation and Macroprudential Analysis Directorate:** draws up proposals for the Governing Board and implements strategic guidelines on regulation, international cooperation, balance sheets and statistical reporting. It also has various roles in relation to developing methods of financial analysis, produces risk analysis reports, manages the information systems of the directorate general and carries out supervisory macroprudential stress test;
- **Banking Supervision 2 Directorate:** monitors and carries out supervisory interventions at banks and banking groups not subject to the direct supervision of the ECB; it also coordinates the supervisory activities performed by Bdl's branches.
- **Financial Supervision Directorate:** supervises the non-bank financial intermediaries;
- **Inspectorate Directorate:** conducts inspections of banking groups and banks, non-bank financial intermediaries and the other entities subject by law to forms of control by the Bdl, including inspections;
- **Consumer Protection and Anti-Money Laundering Directorate:** conducts verifications, for prudential purposes, concerning usury, money laundering and terrorist financing; and
- **Supervisory Institutional Relation Directorate:** liaises with judicial authorities, other national authorities and investigative bodies. It also monitors communications of relevance for supervisory purposes and manages the information systems of the Directorate General. It carries out tasks connected with access to the market and irregularities detected in the course of supervision. The Directorate also monitors development of financial innovation and provides the secretariat to the ICCS.

⁹ The Bdl carries out supervisory activities at central level through the DGFSR and at the territorial level through the branches. Branches supervise banking and financial groups and intermediaries active mainly in the local area. The branches perform supervisory activities and are involved in the planning process for these activities and the identification of the main risks and vulnerabilities for the supervised banks. The supervisory plans and activities of the branches are coordinated by the responsible directorate at the Bdl's head office.

28. The DGFSR has been undergoing a reorganization since end-2018. The main changes are the following:

- Creating a new Quality Assurance Division reporting to the Director General to improve supervisory processes and promote best supervisory practices.
- Moving the SSM Coordination division from the Banking Supervision 1 Directorate to put it under the Director General, with the aim to facilitate cooperation and information sharing within the Directorate to support the participation in the SSM decision-making bodies.
- Putting 18 decentralized problem non-BCC LSIs (i.e., supervised by Bdl branches) under the supervision of the Banking Supervision 2 Directorate, with the objective to guarantee that detected critical issues are rapidly reported to the appropriate level of responsibility and timely actions taken. Seven banks were moved since November 2018 and the 11 remaining banks were moved at end March 2019; the need for eventual further moves will be assessed on a semi-annual basis.
- Putting the two newly formed CBGs under the direct supervision of Banking Supervision 1 Directorate since they will become SIs.
- Establishing 11 networks of branches and mapping the 27 Bdl regional branches into these networks. The networks will act as a “polo”-leader, i.e., as the reference point and main interlocutor for the affiliated branches. They will assist in defining supervisory activities with HQ and the affiliated Bdl branches and they will be responsible for implementing the operational plan and monitoring its execution.

29. The Bdl has maintained an overall steady level of supervisory staffing resources for the last four years. While there was a slight decrease in the staffing of some divisions particularly in the last two years, this does not seem to have impacted the supervisory resources for LSIs. The low turnover rate of two percent over the last three years is another indicator of the stability in supervisory staffing resources. The Bdl sees no difficulties in attracting qualified staff since it hires only young people at basic levels and can select them, through public competitive exams, from a wide number of very qualified candidates.

30. The Bdl has rules and procedures on conflict of interest and post-employment for staff. New rules on avoidance of conflict of interest for staff have been adopted in 2017. These rules aim to prevent the misuse of insider information and avoid conflict of interest arising from private financial circumstances or investments. Specific procedures were also set to manage and deal with situations of conflicts of interest. In 2015, a decree of the prime minister set rules governing post-employment restrictions for the senior management of Bdl and IVASS. These rules stipulate that members of the Bdl governing board and senior managers performing supervision can’t assume, directly or indirectly, partnerships, consulting or employment with regulated or supervised entities for the two years following the termination of the office or the employment. The Bdl code of conduct stipulates that all staff should continue to avoid any conflict of interest that could arise from

any new private or professional activities during the first year after the end of the employment relation with the Bank.

31. The Bdl has enhanced the conditions for protecting its staff against the costs of defending their actions or omissions while discharging their duties in good faith. According to the Law no. 262 of 2005, the Bdl and the components of its governing bodies and employees are only responsible for gross negligence and for acts committed intentionally. The Bdl internal rules provide reimbursement for legal expenses incurred by the Bdl's employees but only after the conclusion of the proceeding. This was considered an unfavorable treatment based on the previous FSAP since it meant that the employees would have to personally bear the costs of defending their actions at a time when the Bdl faces frequent legal challenges and the judicial proceedings may take a very long time before being concluded. As a solution, the Bdl introduced changes to its internal circular allowing its employees to ask for advance payments in order to cover the costs of defending their actions.

Table 5. Italy: Evolution of the Bdl Supervisory Staffing Resources

| Directorates | 2015 | 2016 | 2017 | August 2018 |
|---|--------------|--------------|--------------|--------------|
| Banking Supervision 1 | 122 | 128 | 135 | 123 |
| Regulation and Macprudential Analysis | 89 | 99 | 99 | 96 |
| Inspectorate | 187 | 184 | 177 | 173 |
| Financial Supervision | 73 | 69 | 57 | 55 |
| Banking Supervision 2 | 71 | 78 | 73 | 73 |
| Consumer Protection and Anti-Money Laundering | 49 | 57 | 65 | 65 |
| Financial Supervision Coordination and External Relations | 106 | 115 | 118 | 117 |
| Total Head Office | 697 | 730 | 724 | 702 |
| Total Branches | 496 | 500 | 499 | 491 |
| Total Number of Bdl Supervisory Staff | 1,193 | 1,230 | 1,223 | 1,193 |

Source: Banca d'Italia.

Recommendations

32. The Bdl has broad prudential powers, a high level of independence, and a reasonable autonomy over its resources and budgeting. However, some actions may further enhance the Bdl prudential powers in some areas and reduce any potential situations that might impact its independence and autonomy in the future. These actions are as follows:

- The Banking law should be amended to: (i) clarify the exact role of the ICCS and remove any overlapping or oversight role that interferes with the Bdl prudential mandate, and (ii) remove the power of the MEF to put banks under compulsory administrative liquidation and replace it with a consultation process between the prudential supervisor (the ECB/ The Bdl) and the MEF.

- The Bdl is encouraged to consider the merits of amending the Bdl statute to:
 - Grant further autonomy to the Bdl's Governing Board in areas linked with its institutional responsibilities such as determining staffing levels, appointing and dismissing employees, approving the annual expenditure budget, and adopting resolutions concerning the organizational structure of the Bdl.
 - Implement the ECB recommendation of explicitly referring to the right of the Bdl's Deputy Governors to submit any decision to dismiss them to an independent court of law.

B. Supervisory Approach, Processes, and Cooperation

33. The Bdl plans its supervisory activities over LSIs and allocates its resources on an annual basis according to a set of key priorities that take into account the risks to which LSIs are exposed and their weaknesses. The supervisory process is outlined in Bdl circular 269 and the overall planning process is based on the ECB joint supervisory standard on supervisory planning. The planning consists in three phases: strategic planning, operational planning, and monitoring. The supervisory priorities for LSIs for 2016-2018 have identified business models and profitability, credit risk, and internal governance and risk controls as key risks. These priorities seem very relevant given the main risks Italian LSIs are exposed to. Most of these issues remain on the Bdl priority list for LSI supervision in 2019.

34. The Bdl applies a risk-based approach to the supervision of LSIs. While the Bdl has started applying the SSM LSI SREP methodology for HP LSIs, the risk assessment framework that is being applied to non-high priority (non-HP) LSIs is highly similar to the SSM approach. The Bdl risk assessment framework focuses on relevant risks and controls and provides for supervisory discretionary judgment in assigning risk scores. It is applied on solo LSIs and on LSI consolidated groups and includes the following areas of assessment: (i) business model and profitability, (ii) internal governance and risk management, (iii) capital adequacy and risks to capital, and (iv) liquidity and funding risks. The assessment of risks ranges from 1 (best) to 4 (worst) and is based on a mix of quantitative and qualitative assessments. The evaluation of net risk results from the combination of the assessment of risk exposures and indicators on one side and risk controls and mitigants on the other side.¹⁰ Supervisory judgment is applied at several phases of the assessment based on the supervisors' perception of the risks. The indicators used to assess risks are often based on peer group analysis, which allows to differentiate between banks with different characteristics (like business models, legal structure, size, etc.).

¹⁰ The methodology relies on qualitative criteria for the assessment of governance and control systems and quantitative criteria for the assessment of capital adequacy and profitability. The scores assigned to risks to capital (credit risk, IRRBB, market risk, operational risk) and the capital adequacy score are combined to produce a single score for the element called "Capital Adequacy and risks to capital". Then the scores assigned to each of the four elements (business models and profitability, internal governance and risk management, capital adequacy and risks to capital, and risks to liquidity and funding) are finally combined based on a predefined mechanism, while allowing for a discretionary judgment (+/-1) to assign the final overall SREP score to each bank on a scale from one to four.

35. The Bdl has started applying the SSM SREP methodology for HP LSIs starting from SREP 2018 and will extend it to all LSIs over the coming years. The transition should be smooth given that the Bdl approach is similar to SSM LSI SREP methodology in various aspects.¹¹ While the SSM LSI SREP methodology provides for a harmonized assessment of LSIs across the Euro Area, some aspects related to flexibility and local context may be foregone. However, some flexibility can be restored through a constrained and justified application of supervisory judgment. Based on that, the Bdl decided to make use of its own risk assessment tools by including in its implementation of the SSM LSI SREP all the instances where the data reported and stored at national level allow additional and relevant information. The Bdl believes that this will allow its supervisors to take into account national specificities and additional relevant information in the process of applying their supervisory judgment when overriding the risk scores. In addition, the SSM LSI SREP approach does not provide the proper tools and flexibility for a differentiated assessment for LSIs with specialized business models. While the relative size of these LSIs is still small, they are increasingly growing and may deserve a more adapted risk assessment methodology.

36. Proportionality is embedded in the supervisory approach of the Bdl which includes a mix of offsite and onsite activities. Circular 269 classifies the LSIs in four classes of priority (very high, high, medium, and low) based on their impact and risk. Excluding the very high priority entities (which represent SIs for the ECB and other systemically important institutions based on the Bdl classification), the three other categories of entities align with the ECB methodology for LSI prioritization.¹² Based on this classification, the Bdl defines minimum engagement levels (MEL) for its supervisory activities setting minimum levels for frequency, scope, and granularity of control during its assessment process. The supervisory activities are laid down in operational plans or supervisory examination programmes (SEP). It is worth mentioning that some banks that have a regional presence are supervised at a decentralized level by supervisors in the Bdl branches.

37. The off-site or ongoing supervisory function assesses the bank's performance and prudential indicators. The data periodically submitted by banks (e.g., Finrep, Corep and non-harmonized reporting) represent one of the bases for prudential analysis and monitoring activities, which also benefit from other sources of information regularly reported to the Bdl (e.g., those included in the central credit register data warehouse). Furthermore, the supervisory activities encompass an assessment of the financial statements and audit reports, the ICAAP and ILAAP, recovery plans, and the quarterly report (Tableau de Bord) as well as the annual report of the

¹¹ The SSM LSI SREP methodology was developed under the umbrella of the SSM methodology applicable to SIs. It preserves the structural elements and building blocks of the SSM SREP methodology. While the SREP is expected to be updated annually for all LSIs, a full SREP assessment is required annually only for HP LSIs and a lower minimum frequency is applied for non-HP LSIs. The risk assessment consists of three phases: (i) data gathering, (ii) automated anchoring score, and (iii) supervisory judgment and the four-grade risk score is a combination of risk levels and risk controls. The supervisory judgment allows automated scores to be improved by one notch or worsened by two notches. For more details on the SSM LSI SREP methodology, see https://www.bankingsupervision.europa.eu/ecb/pub/pdf/ssm.srep_methodology_booklet_lsi_2019~15ce18ff7f.en.pdf?2e33cff10a3115ea7ce685de4a309402.

¹² The criteria for LSI prioritization depend mainly on the LSI's SREP score and size. As of November 2018, there were nine HP, 63 medium-priority (MP), and 293 low-priority (LP) LSIs. Excluding the BCC sector, there are 8 HP, 34 MP, and 53 LP LSIs.

internal control functions. The offsite assessment takes also into account the information gathered during the meetings regularly held with the banks. This analysis aims to assess compliance with the prudential limits and requirements. It also allows to evaluate the level and evolution of the banks' exposure to relevant risks as part of the SREP and to monitor the evolution of a set of predefined early warning indicators, in order to promptly intercept any evidence of potential banking distress.

38. The Bdl has a structured process for planning onsite inspections but more integration is needed across various Bdl's supervisory functions. Onsite inspections are mainly planned based on the inputs received from the offsite assessment. The frequency of on-site inspections depends on the institution's risk assessment and the time passed since the last inspection. However, the inspection plan is an aggregate of several components that are not always well coordinated and integrated. The inspection needs for centrally inspected institutions are defined based on an interaction between the Bdl's central offsite and onsite functions. For those institutions that are supervised by the Bdl branches, the inspection plan is defined by the local branch itself under the coordination of the Inspectorate directorate. This component is then added to the overall inspection plan.¹³ A review of the inspection plan reveals cases where some decentralized institutions have not been subject to an inspection for a very long time (beyond the SEP defined in the Bdl's supervisory approach). This illustrates the need to better oversee the supervisory and inspection planning processes and frequency of onsite inspections for decentralized institutions to ensure that the Bdl's supervisory practices are well harmonized across various Bdl locations and branches.¹⁴

39. The reorganization that the Bdl has been implementing for its DGFSR is a step in the right direction to better oversee and coordinate the Bdl branches' supervisory practices. While the main current change is to move the decision-making functions for a set of decentralized problem banks to the central Bdl supervisory functions, a more comprehensive process aiming at more harmonized supervisory practices and processes at the level of branches compared to the central functions is desirable.¹⁵ The process of organizing branches into 11 networks may help in addressing this issue but the effectiveness of this very recent step remains to be seen. The authorities could also consider the benefits of letting the Bdl head office teams, on a periodic basis, perform (or assist in) some inspections traditionally done by the branches depending on the criticality of the inspection theme or the entity being inspected. This approach can further strengthen oversight over the branches' supervision activities and foster harmonization of supervisory practices.

¹³ In addition, targeted AML/CFT inspections are added to the plan depending on the needs expressed by the AML/CFT function and the resources available for such inspections.

¹⁴ The establishment of the two cooperative groups as well as the transfer of the supervision of 18 LSIs from the branches to the Banking Supervision 2 Directorate will reduce significantly the number of banks supervised by the branches. The authorities have indicated that an assessment of the need to amend the planning process is underway in the light of the recent reform of the Supervision Department.

¹⁵ The authorities have indicated that the centralized division responsible for the coordination of the branches' activities has been recently reinforced in order to enhance harmonization of practices and processes among branches in line with the reorganization of the Bdl branch network supervision.

40. The Bdl conducts various types of onsite inspections. Bdl's inspections range from full-scope inspections (particularly for small or decentralized institutions) to targeted inspections (particularly for higher priority LSIs). The Bdl also performs follow-up inspections to monitor the progress in implementing corrective measures. It also conducts other types of inspections such as thematic inspections or compliance inspections (focused on compliance with AML/CFT requirements or consumer protection issues).

41. While the Bdl has recently increased its targeted inspections, the use of thematic inspections and the performance of deep dives have been limited. The Bdl has conducted only two thematic inspections over the last three years, one focused on consumer protection and AML/CFT and the other focused on credit risk and IT systems for cooperative banks in preparation for the establishment of the CBG. Table 6 shows the distribution of onsite inspection over the last four years.¹⁶ The level of targeted inspections focused on the Bdl's key supervisory priorities (governance, credit risk, and business models) has been very low until 2018. A higher use of thematic reviews and the performance of more targeted inspections and deep dives on the main supervisory priorities and LSI weaknesses could enhance the Bdl's inspection mix and enable it to better deal and benchmark common weaknesses and gaps in the banking sector.

Table 6. Italy: Onsite Inspections Performed / Planned by the Bdl over LSIs

| Year | 2015 | 2016 | 2017 | 2018 | Planned 2019 |
|------------------------------------|------------|-----------|-----------|-----------|-----------------|
| Number of inspections | 105 | 95 | 72 | 74 | 46 |
| - Full scope | 92 | 74 | 58 | 24 | 19 |
| - Targeted, Thematic, and other | 13 | 21 | 14 | 50 | 27 |
| <i>Of which focused on:</i> | | | | | |
| ▪ Credit Risk | 2 | 6 | 1 | 30 | - |
| ▪ Governance | 2 | 4 | - | 3 | 2 |
| ▪ Operational Risk | 3 | - | 2 | 4 | 2 |
| ▪ Consumer Protection | 5 | 6 | 3 | - | 2 |
| ▪ AML/CFT | - | - | 6 | 7 | 7 |
| ▪ Business Model and Profitability | - | - | 1 | - | 6 |
| ▪ Others | 1 | 5 | 1 | 6 | 8 |

Source: Banca d'Italia.

42. While the Bdl has well established onsite inspection processes, some practices can be streamlined to enhance the efficiency of onsite inspections. Onsite supervision visits are planned, and their findings are followed-up in coordination with the off-site supervision function. Pre-inspection notes are prepared before the start of inspections where onsite and offsite analysts work together to define the scope of the inspections and its main areas of focus. However, the Bdl teams still perform all inspections on a surprise basis which do not allow an ex-ante interaction with

¹⁶ The significant increase in inspections focused on credit risk in 2018 is mainly due to the thematic credit risk inspections performed on BCCs in the preparation for their integration into the established CBGs.

inspected institutions. Such interaction could enable a better preparation ahead of inspection missions and a more efficient use of inspection time. The inspection findings are well summarized in the inspection report that is presented by the head of the mission to the management and supervisory bodies of the bank. When deemed necessary, a post-inspection letter is communicated to the bank outlining the recommendations or the measures that the bank needs to take to address the findings. The offsite supervisors follow-up on the bank's implementation of the remedial measures. While the inspection report should be sent to the bank within 90 days of the finalization of the inspection, a review of the current practices reveals some cases where the communication of the inspection findings was longer. While this could be mainly attributed to the extensive quality review process in addition to post-mission processes and actions,¹⁷ more streamlining is possible to ensure that inspection findings are communicated, and remedial actions are set on a timely basis.

43. The Bdl has signed an MoU and established cooperation mechanisms with other domestic supervisory agencies, including CONSOB. The TUF requires the Bdl and CONSOB to sign a protocol of understanding to coordinate their supervisory duties and exchange information on irregularities. This protocol was signed in 2007 and was later complemented by various cooperation agreements on specific aspects. In June 2018, the Bdl and CONSOB signed a master agreement to strengthen their cooperation and collaboration. Two committees were established to facilitate coordination. The first is a high-level strategic committee that met twice in 2018 discussing general supervisory issues with no specific agenda. The second is a technical committee that has a lower level composition. It met three times in 2018 and discussed various supervisory issues on LSIs and the credit cooperative reform.

44. A more operational cooperation with CONSOB and a better integration of the inputs received from such cooperation could enhance the Bdl's supervisory processes. While there are cooperation agreements and mechanisms with CONSOB, the cooperation could be enhanced, at the operational level, to ensure more frequent discussion and monitoring of bank-specific issues and concerns. In addition, the supervisory process should ensure that the inputs received from such cooperation with CONSOB are adequately incorporated in the Bdl's risk assessment of banks and supervisory activities. These enhancements could leverage on the recent revision of the general MoU and the ongoing work on the other agreements with CONSOB.

45. While the Bdl's cooperation with CONSOB could also cover the oversight of external auditors, the Bdl should be given more powers related to banks' external auditors. In fact, the Bdl does not have the power to reject or rescind the appointment of banks' external auditors. As an interim measure to make up for this gap, the cooperation with CONSOB on this aspect could be useful. Such enhanced cooperation could allow the Bdl to get more information about CONSOB's assessment and views of banks' external auditors, which would be useful for the Bdl in determining the extent of reliance on the work of the respective external auditors. In addition, this cooperation

¹⁷ These include: the decision needed to start a sanctioning procedure, which is taken by a specific group composed of the representatives of the directorates responsible for off-site supervision, sanctioning procedures, legal advisory; the decision related to the supervisory corrective actions in case of problematic banks; and the time needed to call a dedicated meeting of the bank's BoD for the presentation of the inspection report.

could enable the Bdl to give CONSOB feedback about any gaps related to a bank's external auditor's work, which would help in taking actions against that external auditor by CONSOB. However, a more effective and legally robust solution would entail granting the Bdl powers to reject or rescind banks' external auditors or to request such rejection or rescindment from CONSOB.

46. On the other hand, the cooperation between the Bdl and banks' external auditors is still very general and does not rise to an operational level to discuss bank-specific issues. The Bdl meets, at least twice a year, with the representatives of the Italian external auditors' association (Assirevi) to discuss the current accounting issues and their prudential implications and to ensure the consistent application of the accounting and disclosure standards in banks' financial statements. However, the Bdl does not meet with external auditors to discuss bank-specific issues and concerns. This could be a useful tool to better inform the Bdl's about banks' risks and weaknesses. This is currently not permitted by the TUB due to professional secrecy requirements, but the authorities are currently working on addressing this constraint.

Recommendations

47. The Bdl has a well-balanced supervisory approach and risk-based processes, which can be enhanced as follows:

- The Bdl should continue its efforts (building on the recent reorganization of the banking supervision department) to further oversee the supervisory activities of Bdl's branches to ensure maximum harmonization of supervisory processes and practices across all Bdl's locations.
- The Bdl should perform more frequent deep dives and increased thematic and targeted inspections, particularly on key LSI weaknesses, including bank governance, credit risk, and business models.
- The Bdl should review its routine inspection processes to allow a prior notification to banks about inspection missions¹⁸ and look into ways to streamline / reduce inspection durations and the time spent to communicate supervisory findings, while ensuring a high quality of its work.
- The supervisory authorities should consider the need to review the current supervisory risk assessment methodology to better cater for the risks and activities of LSIs with specialized business models.

¹⁸ This should not preclude the Bdl from conducting surprise inspections where this is deemed more appropriate or in exceptional cases.

48. The Bdl can further enhance its coordination with CONSOB and banks' external auditors. The following steps are recommended:

- The Bdl should enhance the interaction with CONSOB to ensure more frequent discussion of bank-specific risks and issues, and also to share information and views about the work of banks' external auditors (building on the recent revision of the MoUs).
- The Bdl should be granted powers to reject or rescind banks' external auditors or to request such rejection or rescindment from CONSOB.
- The Bdl should better integrate the input received from CONSOB in its assessment of banks' risks.
- The Italian authorities should amend the TUB to allow the Bdl to discuss more granular bank-specific issues and concerns with banks' external auditors.

C. Corrective Actions and Sanctions

49. The corrective and sanctioning powers of Bdl have been significantly enhanced following the transposition of the CRD IV in the national legal framework. This has helped address many deficiencies found in the BCP assessment during the previous FSAP. Some of the main improvements are the following:

- The ability to sanction not only natural persons but supervised entities as well.
- The application of both pecuniary and non-pecuniary measures compared with the ability to apply only pecuniary measures previously.
- The increase in pecuniary penalties that can be applied to supervised entities from Euro 30,000 up to ten percent of the entity's total annual turnover, and for natural persons from Euro 5,000 up to five million. As alternative to fines, the Bdl can impose cease and desist orders on supervised entities or a temporary ban from exercising managerial functions in supervised entities for up to three years.
- The power to remove one or more board members of banks (including the general director) or the collective removal of a bank's board members.

50. The Bdl can impose or require the supervised entity, whether it is an LSI or companies belonging to LSI banking groups, to take a series of corrective measures to ensure the sound and prudent management of the entity or the group. These measures include stricter prudential measures (including capital add-ons), ban on conducting specific operations, restrictions on dividend payment and remuneration, as well as the removal of one or more members of the management or control bodies of an institution. In addition, the Bdl can apply early intervention measures in case of current or prospective infringement of prudential requirements. These can

include the activation of one or more arrangements of a bank's recovery plan, debt restructuring, or implementing changes to the business models or legal / operational structure.

51. The Bdl can apply more severe corrective measures but the power to withdraw a banking license remains, at least in theory and in some cases, limited. The Bdl has the power to appoint temporary or special administrators and an oversight committee to replace the management or control body of the supervised entity. The appointment of special administrators is for one year, but their term can be renewed, if needed. The power to withdraw banking licenses is vested exclusively in the ECB for SIs as well as LSIs. The ECB can exercise this right if: (i) the conditions for granting the banking license are no longer fulfilled; (ii) the banking license was obtained through false statements; (iii) the bank has not made use of the license within 6 months; or (iv) the bank has been put into a liquidation procedure (compulsory administrative liquidation) upon the Bdl proposal. There is a limitation to Bdl's powers in this latter case since article 80 of the TUB empowers the MEF, based on a proposal from the Bdl, to issue a decree ordering the compulsory administrative liquidation of a bank.

52. The Bdl's guide to supervisory activities (Circular 269) provides criteria and procedures for preventive and corrective actions that the Bdl supervisors apply with flexibility and judgment depending on each case. Usually, the imposition of corrective measures is the result of negative SREP results (score of 3 or 4), critical onsite inspection findings, or other situations where the bank is in a deteriorating condition that reaches or is likely to reach levels that may require early intervention measures, mainly in relation to capital, liquidity, credit quality and profitability. There is an increased interaction with the ECB for problematic bank situations. For this purpose, a financial deterioration reporting was set by the ECB whereby institutions that breach a fixed set of thresholds based on key solvency and performance indicators are being followed up and discussed more closely with the ECB.

53. The Bdl can address weaknesses and problems in banks by using a mix of both moral suasion and formal corrective actions. The first course of action is to have an informal dialogue with the credit institution to address the problems and use of strong moral suasion in order to push the bank to autonomously address its weaknesses in a prompt and efficient way. The second is to take formal corrective supervisory measures which are decided upon by the Bdl governing board although very few measures, involving a low degree of discretion, may be delegated to lower levels. There is also consultation with the ECB on the courses of action to adopt for problem banks, particularly those that are reported as "in financial deterioration" based on the ECB triggers. This also happens in the context of ex-ante notifications by NCAs on material supervisory procedures and draft decisions regarding HP LSIs, in line with the SSM framework regulation and the supervisory manual.

54. The Bdl's approach to weak and problem banks has been relying on exploring all the possible moral suasion efforts and other informal supervisory measures to address the situation before proceeding into stronger interventions. The Bdl has also resorted to stronger corrective measures in selected cases but the escalation of these measures takes some time, since the Bdl evaluates the implications associated with taking and escalating corrective measures

particularly in the current context where contagion and reputational risks are very high. The Bdl's preference to date was to resort to market solutions (such as mergers, new shareholders, etc.) to address the situation of banks with persistent weaknesses. Going forward, with the bolstering of the banking system in recent years, the Bdl's approach to problem banks should consider more decisive and timelier escalation of corrective measures to address banks with structural weaknesses and persistent deterioration (e.g., in relation to capital levels, operational efficiency, governance) so that weaknesses do not persist or even become exacerbated if not dealt with in a timely manner.

Recommendations

55. While the Bdl has broad powers and thorough approaches to deal with banks' problems and weaknesses, further enhancements are needed to raise the effectiveness and timeliness of those corrective measures. These enhancements are related to Bdl's powers and corrective action processes and practices. In particular, the following improvements can be made:

- Amend the banking law to shift the power of putting banks under compulsory administrative liquidation from the MEF to the supervisory authorities, subject to a proper consultation process with the MEF.
- Increase the Bdl's use of formal corrective measures and timely escalate these measures to more effectively address problem LSIs with persistently deteriorating conditions.

D. Capital Adequacy

56. Capital requirements are based on the EU prudential framework. The requirements established by the CRR for calculating capital requirements, the qualifying components of capital, and the deductions from own funds apply equally to the LSI sector. Since 2015, the Bdl formulates a formal capital decision for each LSI indicating: (i) the Total SREP Capital Requirements (TSCR) ratio that includes Pillar 1 (P1) and Pillar 2 Requirements (P2R) and has to be met at all times; (ii) the Overall Capital Ratio (OCR), that includes P1, P2R and the capital conservation buffer;¹⁹ and (iii) in case needed a Total Capital Demand, that is equal to the sum of OCR and Pillar 2 Guidance (P2G), where the latter is a non-legally binding requirement which, if not met, does not entail specific intervention measures.

57. The compliance of the EU legislation with the Basel capital framework has been assessed as "materially non-compliant" by the Basel Committee under its RCAP in 2014. The EU framework was found "compliant" in terms of scope of application, transitional arrangements, capital buffers, internal models approach for market risk, operational risk, supervisory review process and disclosure requirements. It was rated "largely compliant" for definition of capital, standardized approach for credit risk, securitization framework, and the standardized approach for market risk. But deviations were observed as explained below. A "materially non-compliant" rating was assigned

¹⁹ OCR is relevant for the calculation of maximum distributable amount and, if it is not met, a capital conservation plan has to be submitted by banks.

for the IRB approach for credit risk and a “non-compliant” rating was assigned for the counterparty credit risk framework (calculation of the CVA capital charge).

58. While some deviations highlighted in the Basel RCAP may be less material for Italian LSIs, others are quite relevant. Some material deviations found in the IRB approach to credit risk is not relevant to Italian LSIs since—apart in one case—they all apply the standardized approach. However, other deviations could also be very relevant for Italian LSIs such as the concessionary risk weight extended to SME exposures,²⁰ the treatment of residential mortgage loans, and the concessions from the CET1 criteria for mutually-owned institutions that go beyond the permissible flexibility under the Basel standard.

59. The Bdl applies pillar 2 capital add-ons as part of the SREP capital decision process. The frequency of capital decisions depends on the prioritization level of each institution (at least every year for high priority; two years for medium priority; three years for low priority). The starting point for the capital decision is the capital needs provided by each institution’s ICAAP. If these estimates are not deemed reliable, they are replaced by supervisory proxies.

60. The determination of the P2R add-on is also related to the overall SREP score of the institution. Circular 269 describes the methodology for the determination of the P2R add-on. The starting point for quantifying P2R is to challenge the ICAAP reports through supervisory proxies. In addition, supervisory discretion is applied depending on the overall risk profile of the institution. . The composition of P2R is usually consistent with P1 requirements,²¹ but the Bdl can require that P2R be composed solely of CET1 depending on the situation of the institution.

61. The use of supervisory proxies which involve thorough supervisory judgement in applying P2R could be enhanced by introducing more guidance and consistency checks in the application of these proxies. The Bdl supervisors have a detailed process for reviewing banks’ ICAAPs and comparing them with their own supervisory tools and proxies to determine P2R. However, supervisory proxies involve a range of add-ons that are applied based on an extensive use of supervisory judgment. While this is a sound approach, the choice of the proper add-on could be subject to additional criteria and ex-ante checks to ensure better consistency and horizontal benchmarking in applying P2R across LSIs. It is also important to ensure that P2R is calculated in a way that takes into account a forward-looking perspective of banks’ situations, including governance, business model, and asset quality.

²⁰ Based on the CRR, capital requirements for credit risk on exposures to SMEs, both in the EU and abroad, are multiplied by a factor of 0.7619. This provision, applicable to SME exposures under both the Standardized and IRB approach, was considered as a material deviation from the Basel standard according to the 2014 RCAP. Based on the authorities’ figures, the capital relief (in terms of CET1) stemming from the application of the SME factor amounts to 40 basis points based on SME exposures reported by Italian banking groups as of December 2017.

²¹ 56 percent CET1, 75 percent T1, and 100 percent TCR.

Recommendations

62. The Bdl should:

- regularly monitor the effect of the deviations in the EU capital framework from the Basel standards on LSIs' capital ratios and positions. In line with the 2018 Euro Area FSAP recommendations, the EU authorities should also work on conforming the capital adequacy requirements of the CRR and CRD IV to the Basel standards.
- The Bdl supervisors should ensure that the application of P2R in banks' capital decisions are subject to thorough criteria as well as various benchmarking and checks to promote more consistency in the application of supervisory judgment.

E. Credit Risk, Problem Assets and Provisioning²²

63. The regulations issued by the Bdl include thorough requirements about credit risk management policies and processes. Circular 285 requires banks and banking groups to comply with specific requirements on the measurement, monitoring, management, and reporting of credit risk. These requirements establish the tasks and responsibilities of the banks' governing bodies in defining and approving the banks' risk appetite and profile, determining credit and counterparty risk strategy and policies, and managing these risks. They also require banks' risk management functions to monitor and control banks' credit risk exposures and ensure that they remain within the risk policies and the operating limits set out by the banks' board of directors.

64. Supervision of credit risk continues to be one of the key supervisory priorities of the Bdl. The Bdl has recently increased its onsite inspections targeted over credit risk, in addition to the full scope inspections where credit risk is also a main focus. In addition to assessing banks' credit risk management and compliance with the related regulations and guidelines, the Bdl's inspectors perform quantitative assessment to assess the credit risk profile of the bank. In this regard, the Bdl inspectors assess a sample of the bank's credit portfolio to check if a bank's classification and valuation are in line with the applicable requirements and submit to the bank a list of loans containing the revised classification assessment and provision adjustment, which the bank usually takes on board. Offsite supervisors also monitor closely the credit risk indicators of banks in the context of the SREP process. They are supported by a wide set of information processed with specific IT tools as well as granular data through the Central Credit Register, which allows for cross comparisons between banks' valuations. Specific reviews are performed when needed to do some preliminary assessment of NPL classification and provisioning issues, which are then discussed with banks to identify the appropriate course of action.

²² For more details about the findings and recommendations on the treatment and management of NPLs in this section, see also the Italy 2019 FSAP Technical Note on "Tackling Non-performing Assets".

65. The Bdl teams have been also thoroughly engaged in the IFRS 9 implementation process by Italian banks and LSIs. The Bdl held meetings with banks, audit firms, and CONSOB to monitor the process of IFRS 9 implementation. The Bdl supervisors have been also actively participating in initiatives carried out by the SSM and the EBA in the context of IFRS 9 implementation. The Bdl has also extended the EBA and SSM exercises to an additional sample of LSIs in the first half of 2017. The Bdl has been collecting data in 2018 on the actual impact of IFRS 9 on the entire Italian banking system. Preliminary Bdl estimates in 2018 showed an average reduction of 131 bps in the CET1 ratio (without considering the impact of the transitional arrangements provided in the EU regulation).

66. The regulations and requirements covering loan classification and provisioning generally follow EU regulations or the Bdl's own regulations and circulars. Bdl circular 285 sets in general terms the obligations of banks' boards in determining criteria for the classification, measurement and management of non-performing exposures (NPEs). It sets general criteria for determining the recovery value of NPEs and clarifies the responsibility of the bank's risk control function in overseeing the whole process. The definition of (NPEs is based on the EBA ITS on Supervisory Reporting (Implementing Regulation EU No 680/2014) and on the Article 178 of the CRR. The Bdl has also implemented in March 2019 the EBA guidelines on credit institutions' credit risk management practices and accounting for expected credit losses in the national regulatory framework.

67. In an effort to push banks further to reduce their high stock of NPLs, the Bdl has issued in January 2018 a guidance on the management of NPLs for LSIs in Italy. The Bdl guidance extended to Italian LSIs some of the supervisory expectations set out in the SSM NPL Guidance for SIs.²³ The guidance urges banks to adopt a formal strategy for optimizing NPL management by maximizing the current value of recoveries. It also asks banks to develop short and medium to long-term operational plans (of roughly 1 and 3/5 years) for managing NPLs, setting out the targets for closing out positions and the actions to attain them. The guidance also included guidelines on the governance and operational arrangements for NPL management, treatment of forbearance measures, criteria for loan classification, value adjustments and write-offs, and the valuation of real estate collateral.

68. The Bdl has reviewed the NPL strategies submitted by high NPL LSIs. The Bdl has established a dedicated task force to assess and review these plans for reliability and ambitiousness. Based on these plans, the NPL ratio for a sample of 47 LSIs is expected to decrease from 16.3 percent in June 2018 to 9.7 percent in December 2021. While the Bdl found the targets set in the NPL strategies overall relevant, it requested some banks to amend the plans. The second round of the plan updates was scheduled for March 2019 and an annual update will take place going forward.

²³ In particular, chapter 5 and 6 of the Bdl Guidelines for NPL management for Italian LSIs report the main indications of the corresponding chapters (5 and 6) of the SSM Guidance, requiring banks to refer to the SSM Guidance for details.

69. Additional powers should be granted to the Bdl in relation to loan classification and provisioning requirements. The Bdl does not have the power to require banks to adjust their classifications of individual assets or increase provisioning levels in line with the requirements of BCP (essential criterion 7 of CP 18). The Bdl has indicated that banks usually take onboard the findings related to loan classification and provisioning in the course of the review of loan files performed by the Bdl's inspectors and supervisors. If banks do not comply, the Bdl may impose a pillar 2 capital add-on.

70. The NPL guidelines issued by Bdl represent a step in the right direction to promote more active NPL management by Italian LSIs, but they are not detailed enough particularly in relation to forbearance measures and processes. The Bdl guidance on the management of NPLs by LSIs is concise. It urges banks to assess the financial situation of debtors when forbearance measures are being considered, adopt forbearance policies that identify the best solutions, and monitor the effectiveness of forbearance measures. While the Bdl's guidelines include references to the related SSM guidance for operational details, incorporating prescriptive expectations in the Bdl guidelines would ensure a more consistent approach by banks and supervisory teams, particularly in relation to forbearance, collateral valuation, and impairment triggers. It would also be useful to enhance the Bdl's guidance on the management of NPLs by including more details on the indications for the viability and the timeline of forbearance measures and the main elements of a sound forbearance process, as outlined in the EBA guidelines on the management of non-performing and forborne exposure issued in October 2018.

Recommendations

71. The Bdl should further enhance its regulations and guidelines, particularly in relation to the treatment and management of problem assets. In this regard, the following recommendations are proposed:

- The Bdl should further align its NPL guidelines to the EBA guidelines on the management of non-performing and forborne exposure, with a view to outlining more detailed criteria and indications about: sound forbearance measures and processes, NPE recognition (including indications on classifying exposures as unlikely-to-pay (UTP), treating forborne exposures both in performing and non-performing status, and reclassification of NPEs), and NPE impairment and write-offs.
- The Bdl should be given the right to require banks to adjust their asset classification and increase provisioning levels.²⁴

²⁴ The EU has agreed new rules on calendar-based provisioning in April 2019. These rules set minimum loss coverage levels for banks' secured and unsecured NPLs depending on the time lapse since their classification as non-performing and the type of the collateral. The rules are effective for all new loans issued after the publication of the new requirements which will set out mandatory requirements (pillar 1 requirements) for all EU banks (both SIs and LSIs).

72. The Bdl supervisory teams should continue and increase their supervisory activities focused on credit risk and problem assets by:

- Performing more targeted inspections and deep dives into banks' credit risk management practices, particularly focusing on the adequacy of bank asset classification and provisioning, and the viability and prudence of banks' forbearance practices.
- Continue monitoring the implementation of banks' NPL plans (through a regular follow-up during the year) and further scrutinizing banks' NPL plans for reliability and ambitiousness.

F. Concentration Risk and Related Parties

73. The regulations on the management of concentration risk consist of the applicable EU regulations and directives and the EBA guidelines as well as the Bdl circular 285. The requirements for concentration risk resulting from exposures to individual counterparties or groups of connected counterparties are set in the CRR. However, other types of concentration risks, e.g., in economic sectors and geographic regions, are included in the Bdl circular 285, based on the provisions in the CRD IV and the EBA related guidelines.

74. The Bdl regulations include few requirements on how banks should establish policies and manage concentration risk. The circular requires banks to have internal control systems that ensure the management and control of concentration risks through exposure to: (i) single counterparties and groups of counterparties; (ii) counterparties in the same industry, economic sector, or geographic region; and (iii) counterparties whose financial performance depends on the same business or exposures having common credit risk mitigation techniques. The Bdl does not have explicit provisions requiring a bank's risk management policies and processes to establish thresholds for acceptable concentrations of risk reflecting the bank's risk profile, risk appetite, and its capital strength. The Bdl circular contains instead general provisions on the need for banks to establish risk management policies and risk tolerance thresholds.

75. The Bdl supervisors examine banks' concentration risk policies and exposures. The Bdl receives data on concentrated risk exposures from both SIs and LSIs which allow it to monitor and track various forms of concentration risk exposures in banks' portfolios. In addition, the Bdl onsite inspectors examine banks' concentration risk policies and exposures as part of their targeted and full scope inspections in banks. In addition, a thorough assessment of banks' concentration risk is made as part of the SREP based on a review of the banks' ICAAP reports. However, the Bdl supervisors still look at concentration risk as a subset of credit risk without examining other types of concentration risk.

76. The limits on exposures to single or groups of connected counterparties for LSIs are based on the CRR provisions, which are broadly but not exactly aligned with the Basel large exposure standard. As outlined in the 2018 Euro Area FSAP, some exceptions under article 400 (1) of the CRR seem to go beyond the Basel framework, such as the treatment of some off-balance

sheet contingent facilities and the definition of eligible capital.²⁵ The deviation in the definition of eligible capital may be less material for Italian LSIs that rely more on Tier 1 capital. In addition, the exemptions under national discretions provided by Article 400 (2) of the CRR may not be compliant with the Basel regime. It is worth noting that Italy has adopted those discretions allowed in article 400 (2) and the discretions under article 493 of the CRR.²⁶

77. While there is no EU-wide framework regulating related party transactions and exposures, Italy has made significant progress in this aspect since the previous Italy FSAP. The regulatory framework governing related parties is not new. It entered into effect just before the previous FSAP but there was no sufficient evidence back then to assess its effective implementation in practice. While this framework represents a major improvement from the old framework that existed in 2011, there are still few gaps where the framework could be enhanced.

78. The Bdl circular 263 establishes a thorough definition of a banks' related parties. The related parties are divided into four categories: (i) officers performing administrative, management and monitoring functions in a bank; (ii) participants holding at least ten percent of the bank or who can exercise control, joint control, or significant influence over the bank; (iii) persons, other than participants, empowered to appoint members of the bank's management or supervisory board on the basis of any concluded agreements; and (iv) companies or firms on which a bank or its subsidiary exerts control or significant influence. The regulation also defines a set of connected persons to the related party.²⁷ Any related party and its connected persons must be considered a single entity. The Bdl is also empowered to identify additional related parties beyond the definition on a case by case basis. While the definition is quite extensive, it does not appear to include the directors, senior management and key staff of a bank's affiliated companies, as required under the definition established by CP 20 EC 1. In addition, the definition may need to be reviewed in light of the reform of the BCC sector (either in the form of CBGs or IPS) to ensure that it continues to properly capture all related parties across the group.

79. The Bdl circular requires banks to implement thorough procedures to avoid conflict of interest in related party transactions. These procedures empower the bank's independent directors to oversee related party transactions. The procedure introduced additional elements such as special disclosures and reporting obligations to shareholders and to the body in charge of the

²⁵ Based on Article 3 (71) of the CRR, eligible capital includes "Tier 2 Capital ... equal to or less than one third of Tier 1 capital" in addition to Tier 1 capital, which is the only eligible capital under the Basel standard.

²⁶ After the entry into force of the CRR in 2013, Italy has exercised the relevant national discretions under article 493 (3). According to the article, the Member States are allowed to exempt one or more exposures from the large exposure limit for a transitional period ending in 2028. Specifically, Italy opted for the exemption of only seven type of exposures out of the eleven allowed under the CRR. However, in 2018, following the decision to implement the Guideline (EU) 2017/697 on the exercise of options and discretions available in Union law, the Bdl exercised—under article 400(2)—the discretions for the remaining four types of exposures.

²⁷ Connected persons include: (a) companies and other firms, also established as non-corporate entities, controlled by any related party; (b) entities that control any related party among those listed under the second and third categories of the definition provided above, as well as entities subject, directly or indirectly, to joint control with the same related party; and (c) close relatives of any related party—meaning first and second degree relatives.

control function, and implementation of internal policies on conflict of interests. Independent directors are involved in each transaction at both the preliminary stage and in the deliberative process, but their role is to issue a non-binding advice. The TUB also provides that shareholders and board members shall not take part in deliberations in which they have a conflict of interest.

80. Prudential limits have been established on individual related parties but not on all related party exposures. The TUB provides the Bdl with the power to set general conditions and limits in the case of transactions with related parties and to establish specific conditions and limits when it identifies conflicts of interest in transactions with related parties. The limits differ depending on whether the related party is financial or non-financial. Exposures to each non-financial related party and its respective connected persons are limited to five percent of equity for banks' officers and shareholders with significant influence or control powers, 7.5 percent for other shareholders, and 15 percent in all other cases. For exposures to other related parties (financial), the limit varies from five percent to 20 percent of equity on each related party and its respective connected persons. Those limits are applied at the consolidated level for banking groups. However, there is no limit applied for all the related parties of a bank. In addition, for banks that are part of a banking group, they can have, on a standalone basis, a higher 20 percent limit toward a single group of related parties irrespective of their financial or non-financial nature. Furthermore, the Bdl regulation requires banks to adopt internal controls and policies to define their risk appetite regarding exposures to related parties, also in terms of the maximum amount of all related party lending deemed acceptable in relation to their own funds. Finally, the Bdl has the power to impose more stringent prudential limits (including at aggregate level), and other conditions, on a case-by-case basis.

81. The Bdl data and assessment show a reduction in related party exposures. An ex-post assessment was performed by the Bdl focusing, among others, on the: (i) the evolution of the size and characteristics of the exposures to related parties since 2013; (ii) the respect of prudential limits; and (iii) the frequency and the characteristics of the material related party transactions. The evaluation showed that the share of related party exposures to total risk-weighted assets has decreased from 2.1 percent in March 2013 to 1.3 percent in December 2016 and that the number of exposures exceeding the prudential limit has decreased from 60 to 7. The assessment also showed that the material related transactions were concluded at market conditions in 89 percent of the cases (99 percent by size).

Recommendations

82. The Bdl and the EU regulatory requirements should be further aligned with Basel core principles and standards, and supervisory practices should entail a broader concept of concentration risk. In particular, the following actions are recommended:

- The Bdl should issue more thorough requirements in relation to concentration risk policies and management by banks.

- The EU should amend the rules on large exposures to ensure a closer alignment with the Basel standard, in line with the recommendation made in the Euro Area BCP DAR.
- The Bdl supervisors should take into account the potential impact of the deviations from the Basel regime in their bank risk assessment and closely monitor the risk concentration that these deviations may incentivize
- The Bdl supervisory approach and requirements should incorporate all dimensions of concentration risks rather than only those linked to credit risk.

83. The Bdl should further enhance its regulation and prudential framework on related party exposures and align it with international standards. The following recommendations are made:

- The Bdl should introduce an aggregate prudential limit for all related party exposures that is at least as strict as the single large exposure limit (25 percent of banks' equity).
- The Bdl should review the definition of related parties and their connected persons to include the directors, senior management and key staff of a bank's affiliated companies, as required under Basel Core Principles (CP 20 EC 1).
- The Bdl should revise the higher related party exposure limit allowed for banks that are part of a banking group and subject the standalone position of these banks to the same limits applied for the consolidated position of banking groups.

G. Liquidity Risk

84. Italian LSIs are subject to the EU LCR regulation which establishes the LCR as a minimum pillar 1 requirement. The EU LCR framework was subject to a RCAP review by the BCBS in 2017, which found the EU LCR framework overall largely compliant with the Basel LCR standard, but with some deviations, especially in the definition of HQLA. The treatment of certain inflows is also less stringent than under Basel LCR standard while it is the opposite for some outflows. The Bdl has exercised the options and discretions available in the CRR. As per the current EU framework, Italian banks are not currently subject to a binding net stable funding ratio (NSFR).²⁸

85. The Bdl regulations include very thorough liquidity risk management requirements that are usually assessed in the context of the SREP process and the ILAAP requirements. Italy has transposed the liquidity qualitative requirements listed in Article 86 of CRD IV in the Bdl circular 285. As such, banks are required to formalize their policies for the governance of liquidity risk and implement an effective process for its management. They are also requested to set their liquidity risk tolerance level and identify and measure liquidity risk on a forward-looking basis. Banks are also

²⁸ This is based on the applicable framework at the time of the mission. It is worth to note that the European Council approved the reformed banking package in June 2019, including CRR2 and CRD V. As per this package which became applicable on June 28, 2019, the NSFR becomes a binding requirement.

required to define a contingency funding and recovery plan (CFRP) to address extreme negative funding conditions and identify the necessary remedial actions in case of liquidity strains.

86. Supervision of banks' liquidity risk is performed by both offsite and onsite teams in the context of SREP. The ongoing evaluation of banks' liquidity risk profile is based on a specific methodology defined in the Bdl supervisory guide while the assessment is performed in accordance with the SSM LSI SREP Methodology for HP LSIs, and with Bdl supervisory guide, for non-HP LSIs. Based on the Bdl methodology, the final score attributed to the liquidity risk profile results from the combination of a quantitative analysis and of a qualitative assessment. This entails analyzing the bank's risk exposure by using the LCR and an indicator of the stability of funding which proxies the NSFR of the Basel Committee. These indicators are complemented by additional data on funding gap, asset encumbrance, and funding structure. Then a qualitative assessment of the bank's liquidity risk management framework is performed. A liquidity risk score is calculated after combining the qualitative and the quantitative assessment, based on which supervisory actions are determined. From an onsite perspective, banks' liquidity is usually assessed during full-scope missions to ensure that the liquidity risk framework is fully integrated within the risk management process and covers all the elements required by the regulation.

87. In addition, a subset of Italian LSIs is required to report more frequent information on their liquidity positions and sources which are monitored and assessed by Bdl supervisors.

Since the global financial crisis in 2007, the Bdl has requested all large and medium-sized banking groups and a selected number of small banks to report their counterbalancing capacity with a weekly frequency together with projected contractual maturities over a three-month period (monitoring frequency can be increased to daily at times of systemic or idiosyncratic stress) and detailed information about their central bank eligible assets (composition, level of encumbrance).²⁹ Data are discussed on a weekly basis with the bank; more frequent contacts are held if necessary. Starting from May 2016, the Bdl also receives on a fortnightly basis further information for the most relevant Italian LSIs regarding their estimates about additional sources of liquidity, funding composition, deposit concentration, and the interbank position. These data may result in informal requirements for institutions.

88. The recent implementation of ILAAP requirements allows a more thorough assessment of banks' liquidity risk management and exposures but more is needed to enhance this exercise and make it more useful for supervisory purposes. Since end-June 2018, Italian LSIs have started submitting their first ILAAP report in line with the EBA guidelines and the Bdl regulation. The first-time assessment has focused on the extent to which banks have complied with the supervisory requirements. The experience with ILAAP reports is still nascent. Future supervisory activities should focus on how to enhance the quality and completeness of the ILAAP reports submitted by LSIs and how to enhance its use and integrate it further in the supervisory process.

²⁹ The counterbalancing capacity is defined around the concept of central bank eligibility; the cumulated cash flow that constitutes the equivalent of the LCR denominator assumes a complete freeze of wholesale markets but does not employ standardized assumptions for retail funding run-off.

Recommendations

89. While the regulatory framework and supervisory process for liquidity risk is thorough, more efforts and work need to be done, particularly as outlined below:

- The Bdl should continue enhancing its assessment of LSIs' liquidity positions and risk management by requiring banks to further enhance their ILAAP reports to use them as a reliable basis for liquidity risk assessment.
- The EU framework should conform the LCR rules to the Basel standard, as recommended by the 2018 Euro Area FSAP.

H. Operational Risk

90. While the Bdl regulations include thorough requirements on banks' business continuity and information systems, the general requirements on operational risk management are rather thin. The circular 285 establishes thorough requirements on the overall risk management and the role of the management body in its supervisory function to define the risk tolerance threshold, the risk appetite framework and the risk governance policies. The circular includes an annex, a part of which is dedicated to operational risk. This annex mentions that the provisions on the governance and management of operational risk are set out in Part three, Title III of the CRR. However, the CRR includes some qualitative aspects to operational risk depending on the approach used by banks to compute the operational risk capital charge. The CRR does not include detailed operational risk management requirements for banks adopting the basic indicator approach to operational risk, which is the case for most Italian LSIs. Based on that and taking into account the developments in the international and EU regulatory framework, it would be useful to further enhance the circular 285 by including more thorough requirements in relation to the overall management of operational risk.

91. The Bdl regulatory requirements include thorough requirement on banks' business continuity plans and information systems. The Bdl has developed its supervisory manual related to business continuity and disaster recovery in line with the 2017 EBA guidelines on the assessment of information and communication technology (ICT) risk. In addition, the Bdl circular 285 requires banks to develop plans that contain the principles, objectives and description of the procedures for managing the business continuity of critical business processes. The circular defines the main or minimum elements of banks' business continuity plan and sets related reporting requirements to the Bdl. The Bdl regulations also lay out the minimum requirements for a bank's outsourcing policy and require that the bank's outsourced activities be consistent with the banks' policy.

92. The Bdl offsite and onsite supervisory teams assess various elements of banks' operational risk management frameworks. The assessment of operational risk is done in the context of the SREP. From the offsite perspective, it is based on various documents required from banks such as the annual reports on internal controls, risk management and outsourced functions, annual ICAAP reports, and the quarterly banks' internal control function reports (Tableau de Bord).

Based on the banks' business model and the level of their exposure, supervisory interventions can be made. The onsite assessment of operational and IT risks is primarily made through the full-scope inspections since the Bdl has not done recently targeted or thematic inspections focused on operational and IT risk. The Bdl supervisory teams assess ICT issues by focusing on the governance of the ICT function, ICT risk management structure, and ICT risk control. The Bdl teams also verify whether the ICT outsourcing arrangements made by the bank are in line with the bank's strategy and risk tolerance.

93. The Bdl resources on IT and cyber risk are very limited relative to the breadth of activities that those teams are involved in. The small team of IT supervisors are involved in policy development on ICT. They are also involved in onsite inspections for SIs as part of the SSM and for LSIs. In addition, they are involved in international activities on IT and cyber risk. The Bdl supervisory team sometimes gets additional resources from the Bdl IT department. The authorities indicated that the Bdl IT department possesses significant IT skills and their utilization in inspection contributed in a highly valuable way to the effectiveness of the investigations. However, these resources are not always available and may not always possess the proper mix of skills usually required from IT supervisors.

94. While a large number of Italian LSIs have outsourced their IT functions to a small number of firms and providers, the Bdl has not done thematic or targeted IT inspection for those providers. Given this concentration in IT outsourcing activities, inspections over the few IT providers is essential to check the ICT systems and security of those firms and ensure they do not pose significant risks to the LSI sector. The Bdl has the power to inspect these firms. Such inspections would also allow the Bdl to better streamline the use of its resources.

Recommendations

95. The Bdl regulatory framework and supervisory process for operational risk is broadly adequate. However, there are a number of areas that warrant further improvements:

- The Bdl should enhance its regulations on operational risk management by including more detailed requirements.
- The Bdl is advised to increase its supervisory capacity in relation to IT and cyber risk.
- Given that many of the LSIs outsource their IT systems and services to few firms, it would be useful if the Bdl performs inspections over these firms to ensure they are subject to minimum IT security requirements, in line with recently adopted inspection plans.

I. Financial Integrity

96. The AML legal framework has been extensively amended in 2017 to transpose the fourth AML directive. The Italian AML legal framework (AML Law) is set out in legislative decree no. 231/2007. It was amended in May 2017 by legislative decree no. 90, transposing the Directive (EU) 2015/849. The Decree has confirmed the power of the Bdl to adopt implementing regulations

regarding customer due diligence (CDD) requirements, record keeping obligations and internal controls. In order to verify the adequacy of the AML organizational and procedural arrangements set up by banks and their overall compliance with AML obligations, the Bdl has the power to request documents, acts and any other useful information from banks, and to carry out inspections. On March 26, 2019, the Bank of Italy published the provisions on organization, procedures and controls aimed at preventing the use of supervised entities for ML/TF purposes.

97. Unità di Informazione Finanze (UIF) is Italy's Financial Intelligence Unit, established within the Bdl as an autonomous and operationally independent unit since January 2008.³⁰

The UIF carries out controls, also through inspections, to ascertain compliance with the AML provisions in relation to suspicious transaction reporting and omitted reporting, as well as communications to UIF provided by the AML Law, also relying upon collaboration with the Currency Police Special Unit of Guardia di Finanza. The UIF exercises the key functions of receiving and analyzing suspicious transaction reports (STRs) received from all obliged entities (banks, financial intermediaries, professionals, non-financial operators). The UIF conducts general inspections on subject entities to check about the adequacy of the procedures for identifying and reporting STRs.

98. Cooperation between the Bdl supervisory function and UIF is mandated by the AML law and facilitated by a Memorandum of Understanding (MoU). The AML Law (article 12, para. 1) requires all the competent authorities (including supervisory authorities and the UIF), relevant administrations and bodies, the Judicial Authority and investigating bodies to jointly cooperate to identify circumstances that can help prevent the use of the financial and economic system for money laundering or terrorist financing purposes. In that aim, the Bdl and UIF have signed an MoU in 2009 detailing the information sharing and cooperation arrangement. Based on this MoU, the Bdl reports to the UIF suspicious transactions and other relevant findings as a result of its supervisory activities. Based on the discussions with both the Bdl and the UIF, cooperation and information sharing seem to work smoothly in line with the signed MoU.

99. The Bdl regulation on AML internal controls include thorough requirements and provisions pertaining to banks' AML/CFT policies and processes. The Bdl regulation requires banks to have well documented CDD processes that are communicated to all staff and fully integrated into the banks' overall risk management. A dedicated AML function should be created and integrated within the corporate control. In addition, the Bdl has invited banks, since 2015, to conduct a self-assessment exercise to identify and assess their ML/TF risks and evaluate their internal AML structure and safeguards. The AML law establishes also requirements in relation to determining politically exposed persons (PEP), getting the necessary authorizations for dealing with PEPs and monitoring the relationship with them. The Bdl requires credit institutions to establish

³⁰ The 2019 FATF Plenary concluded that Italy has made progress since its 2016 mutual evaluation report. The FATF Plenary agreed to re-rate 15 recommendations to reflect the country's current level of technical compliance, while progress was noted for three recommendations. The FATF follow-up report sets out the actions taken by Italy to strengthen the effectiveness of its measures to combat money laundering and the financing of terrorism and proliferation.

enhanced CDD procedures with respect to correspondent accounts only with non-EU respondent institutions.

100. The supervision of AML/CFT is performed by the Bdl Consumer protection and AML directorate. For offsite supervision, the Bdl has developed in 2016, in collaboration with the UIF, a new risk-based AML/CFT assessment model for the banking sector. This system allows Bdl supervisors to conduct an AML/CFT risk assessment of the supervised entities and guide supervisory activities and interventions. This model is based on existing databases, collecting data and information stemming from supervisory reporting, as well as AML compliance findings of the supervised entities. It evaluates the adequacy of banks' AML/CFT safeguards and produces a final score using a combined qualitative-quantitative approach.

101. The inspections of banks' AML/CFT frameworks and risks is performed during full scope inspections or via targeted AML/CFT inspections if required by the competent off-site supervisory units. Banks are sampled on the basis of size, date of previous inspection and off-site overall risk assessment. The analysis of AML/CFT profile is based on a methodology (included in the Guide circ. 269 Part III) which is focused on the adequacy of organizational structure, procedures and internal controls of the bank. Inspections also aim at verifying compliance with the regulatory provisions. In the past three years, the Bdl carried out 146 full scope inspections on LSIs and 23 targeted AML/CFT inspections, out of which 12 SIs and 11 LSIs. The number of inspections has been decreasing over the last three years but the Bdl attributes this trend to the consolidation process of Italian LSIs on one hand, and to the increase in the number of inspections on other financial intermediaries, on the other hand. Nevertheless, these inspections had led to a significant number of findings and the Bdl was able to apply sanctions or corrective measures over concerned institutions.

102. While the Bdl has enhanced its regulations and supervisory practices on AML/CFT, further efforts are needed to better use its supervisory resources and incorporate AML/CFT findings in banks' risk assessment. The Bdl sanctions have been increased following the transposition of the fourth EU AML directive. In addition, the Bdl has adopted a risk-based model to the assessment and follow-up of AML/CFT issues. However, supervisors in Bdl's branches still perform onsite assessments of AML/CFT practices in banks' branches. The Bdl believes that this approach allows it to have a better assessment of AML/CFT risks from a practical perspective. However, these inspections are performed by the branches and are in part covered by overall Bdl inspection plan. While these inspections are selected using risk indicators (e.g., anomalies on the use of cash, anomalies in suspicious transaction reporting, etc.), this approach to inspection of banks' branches do not seem to be fully in line with the move of the Bdl to a risk-based approach to AML/CFT supervision, which should be based on the overall ML/TF risk assessment of the supervised entity. It would be better if these supervisory resources could be allocated to increasing the number of targeted AML/CFT inspections or to the overall inspection resources and activities that the Bdl performs. In addition, the work and the findings of the AML/CFT directorate are still not well integrated in the overall supervisory process. Therefore, the Bdl should consider ways to further take into account its AML/CFT findings in its supervisory assessment of banks, in the context of the SREP process.

Recommendations

103. While the legal and regulatory framework for AML/CFT and the related supervisory tools have witnessed progress in the last period, the Bdl can still do more to enhance the effectiveness and integration of its AML supervision. In this regard, the Bdl should consider:

- Revisiting its approach to AML/CFT inspections in banks' branches and using these resources in doing more targeted AML/CFT reviews or more prudential inspections over banks.
- Better integrating the AML/CFT supervisory work and findings in the supervisory process and in the overall risk assessment of banks.

BANK GOVERNANCE

A. Key Actions and Reforms to Enhance Banks' Governance

104. The authorities have passed a series of reforms and regulatory actions in the last years to enhance the governance of Italian banks. These reforms aimed at enacting changes in banks that have special ownership structure, like banks that have significant or major ownership by foundations, or those that have particular legal forms, such as BCCs or popolari Banks. Some of these reforms are ongoing and have been challenging to execute. While it is still too early to assess their impact, these reforms have already created some positive changes in the current banking environment. In addition, the Bdl regulations on bank governance have been significantly enhanced and raised the bar for banks' governance practices. However, the implementation of these reforms and regulations need to be closely monitored and assessed by the authorities to ensure that they are achieving their objective of strengthening banks' governance and capital positions.

105. Historically, banking foundations were key shareholders of Italian banks. They have been a distinctive feature of the Italian banking system and played a critical role in bank privatization in the 1990s.³¹ Following that, they became stable long-term shareholders of banks, in many cases spurring them to expand and modernize. Foundations supported the recapitalization efforts of banks after the GFC. But at the same time, foundations had a peculiar governance structure, weak internal accountability, and little oversight (especially after a 2003 Constitutional Court decision that curtailed the authority of the MEF to supervise them). They do not follow uniform accounting rules, and the appointment of their governing bodies is not always transparent.

106. New features for foundations' investments in entities, including banks, were set in 2015. A protocol agreement was signed in April 2015 between the Association of Banking Foundations and Savings Banks (ACRI), that represents 85 associated members, and the MEF that is

³¹ Banking foundations (fondazioni) were created in the 1990s during the process of bank privatization, when several state-owned banks were transformed into joint stock companies with the shares transferred to non-profit, typically locally-based foundations, private legal entities intended to pursue public interest or socially-oriented activities.

responsible for supervising the foundations. Based on the protocol, the foundations committed to take measures with the main aim to diversify their portfolio, limit their risks and improve their asset management strategy, and enhance some governance aspects.³² A particular aspect of this protocol is the provision that foundations should reduce their direct or indirect exposure to a single person or entity to 33 percent of their assets by 2020. This means that foundations that have a concentrated ownership in banks, for example, have to reduce their stake to be within the limits set in the protocol agreement.

107. While the role of foundations has been decreasing over the years, they still have significant shareholdings in 11 banks. Table 7 shows the distribution of the number of foundations by their ownership levels in their spun-off banks. Most of the foundations have now minority shares in banks. However, about six foundations still have control ownership. This decrease may be due on one hand to the protocol signed with the MEF and also to the move or need of some banks to increase capital which has diluted the shares owned by foundations. Based on ACRI figures, foundations now invest around 26.5 percent of their total assets in banks, which is below the 33 percent limit stipulated in the protocol agreement with the MEF. However, according to the MEF, there remains about ten foundations that are above the threshold, knowing that the deadline is in April 2020.

108. The reform of the foundations is in line with the recommendations made in the context of the previous Italy FSAP. The previous FSAP recommended that the legal framework of the foundations be revised to ensure minimum standards of transparency and financial reporting, diversified investments and caps on leverage, stronger corporate governance arrangements (such as term limit for foundation members and a cooling-off period between a political office and foundation position), and robust oversight by the MEF or a new entity over the foundation with adequate sanctioning powers. The provisions of the protocol agreement would respond to most of these recommendations, if properly implemented. However, the key remaining issue is the extent to which the MEF can enforce a protocol agreement that is based on the will of the two parties to implement it. While the MEF receives reports from foundations and monitors the progress in the implementation of the protocol, the lack of enforcement powers does not allow for proper incentives to timely implement the reform.

109. The reform of the popolari banks was also a main tool to strengthen the position of these banks (see Box 1 for the main features of this reform). The caps on ownership and the restriction on voting rights (one head one vote) weakened the governance mechanisms of the large popolari banks and impacted their ability to attract outside capital, particularly in times of stress when capital is most needed. The conversion of the largest popolari banks (i.e., with total assets of more than Euro 8 billion) into joint stock companies has eased the governance challenges faced by

³² The protocol included some provisions to improve the governance of foundations. This includes reviewing the compensation paid to the board members and senior management, establishing term limits on the mandates of the foundations' board members, setting competence and professional experience requirements for the management bodies, establishing some incompatibility requirements such as the need to have a cooling-off period of one year between the assumption of position in a foundation and political appointments or taking a position in the bank that belongs to the foundation.

these banks and allowed them to tap financial markets to raise capital in a much easier way or to carry out mergers that would have been difficult to execute.

Table 7. Italy: Distribution of the Number of Foundations by Ownership Level in Their Banks

| | 2015 | 2016 | 2017 | 2018 |
|--|-----------|-----------|-----------|------------|
| - Foundations that have no shareholdings in their spun-off banks | 31 | 34 | 35 | 38 |
| - Foundations that have shareholdings <50 percent | 47 | 46 | 47 | 43 |
| <i>Of which:</i> | | | | |
| <i>Shareholdings less than 5 percent</i> | 27 | 30 | 34 | 33 |
| <i>Shareholdings between 5 and 20 percent</i> | 10 | 8 | 5 | 5 |
| <i>Shareholdings between 20 and 50 percent</i> | 10 | 8 | 8 | 5 |
| - Foundations that have shareholdings > 50 percent | 10 | 8 | 6 | 6 |
| Total Number of Foundations | 88 | 88 | 88 | 87* |

(*) The decrease in the number is due to a merger between a large and a small foundation in Northern Italy.

Source: ACRI Annual Reports and Data.

110. The transformation of the BCC sector into CBGs is also another positive development that could address the current difficult situation of the sector (see Box 2 for the main features of this reform). Given their small and very local nature, the BCCs have been facing profitability issues that impacted the viability and business model of many of them. This has led to a significant consolidation of the BCC sector over the last few years (see Table 2). In addition, the caps on ownership and the restriction on voting rights also raised many governance challenges that added to their problems. The group structure would allow the BCCs to raise their efficiency levels. The cross-guarantee scheme could also act as a mechanism to allow the weakest BCCs to take timely action to change or enhance their business models or to face corrective actions by the parent.

111. In addition to the above reforms, the Bdl has upgraded banks' governance requirements and aligned them further with international standards and best practices. The Bdl circular 285 was significantly upgraded in 2014 on governance-related aspects. The requirements focused on the clear allocation of tasks between the management and supervisory bodies, the balance of powers between executive and non-executive directors, the composition of the supervisory and management bodies, and the integrity and effectiveness of internal controls. Some proportionality aspects were also introduced to cater for different bank sizes and sophistication. Strict rules were included on the separation between the role of the chairperson and the CEO, the size of the board, and a minimum percentage (25 percent) of independent directors. For larger banks, three major board-level committees (remuneration, risk, and nomination) must be established and composed of non-executive directors, the majority of whom should be independent. A legislative ban was also introduced for interlocking directorships across financial sector entities.

B. Remaining Challenges and Priorities Ahead

112. A key challenge to enhancing bank governance in Italy is the current limited requirements for the fitness and propriety of banks' major shareholders and corporate officers. As outlined earlier in this note, the power to set these fit and proper criteria rests with the MEF according to the TUB. The current criteria for corporate officers are based on a 1998 decree³³ that sets narrow requirements in relation to professional and integrity requirements. With the current decree, supervisors face challenges in enforcing reputation, time commitment, experience, and conflict of interest issues. There is another decree³⁴ for the suitability of major shareholders but the requirements are also very few, mainly related to conviction of the person, without much discussion of reputation or other integrity issues.

113. The MEF has prepared a draft decree for the fit and proper requirements of corporate officers that has been in discussion for years but has not been issued yet. The draft decree was issued for public consultation back in September 2017. The last available version of the draft decree establishes thorough fit and proper criteria for banks' corporate officers. It establishes integrity, good repute, professional experience and competence criteria, independence requirements, time availability and limits on multiple positions. Based on the discussion with the MEF at the time of the mission, it seemed that the draft decree still had a fairly long process before being issued. It is therefore essential to accelerate the process of issuing this draft decree.

114. In addition, the authorities should consider granting the Bdl the power to set fit and proper criteria for banks' shareholders and corporate officers. The rationale for granting the MEF the powers to set these fit and proper criteria was because these are issues that can impact the personal rights of people, which could be sensitive and needs to be handled by the MEF, with the advice of the Council of State. However, these criteria have a clear prudential dimension which fall under the mandate of the Bdl. In addition, the current two decrees for banks' shareholders and corporate officers are more than 20 years old and the current process to amend one of them has been taking many years now and is not expected to be completed soon. Therefore, subjecting the setting of these criteria to a political process can hinder the ability of the Bdl to timely introduce needed changes, which could have implications for financial sector stability. Granting this power to the Bdl, with a possible consideration of a consultation process about significant changes in the regulations with the MEF and the Council of State if needed, could be a better option to ensure that the banking sector governance is continuously and timely enhanced in line with international standards.

115. While the Bdl requirements on bank governance were upgraded, the topic remains on the list of key supervisory priorities, which signals the need for more pointed activities. Despite the governance reforms, many LSIs still face governance weaknesses (including in relation to board composition, qualifications and suitability of the significant shareholders and board members,

³³ Ministerial Decree 161 of March 18, 1998.

³⁴ Ministerial Decree 144 of 1998.

and risk culture). This indicates the need to better enforce the governance requirements and be ready to take stronger measures in case of persistently poor governance practices. A more focused and an increased level of supervisory activities on governance may help in better informing supervisory actions. These activities could translate into more targeted inspections or thematic reviews on the governance of the LSI sector going forward.

116. The reform of the popolari banks should be fully implemented and additional supervisory actions or reforms should be explored to address weaknesses in the remaining popolari sector. The reform of the large popolari banks has been largely completed: eight of the ten popolari banks above the size threshold (total assets above Euro 8 billion) converted into JSC while, for the remaining two, a legal review by the European court of Justice is pending. In case the outcome of such review is in favor of the reform, the implementation of the reform should be completed quickly. Additional actions need to be envisaged in relation to the remaining popolari banks (i.e., the popolari banks with total assets of less than Euro 8 billion), particularly those in a weak situation. The move by some of them to pool their efforts and create synergies should be encouraged. This could be ultimately through the creation of some form of joint arrangement, such as an IPS, to benefit from mutual services or platforms and ultimately some joint liquidity support. This would help smaller popolari banks address business model weaknesses and reduce their NPLs, among other issues. However, this should be accompanied by a closer supervisory scrutiny of weak popolari banks and stronger supervisory measures for those with governance or other structural problems.

117. The reform of the BCCs through their transformation into CBGs is an innovative way to address their weaknesses, but the successful implementation of this reform could face several challenges. First, the CBGs show some specificities in their governance structure since BCCs participate in the parent and are represented in the parent's board on one hand and they are subjected to the parent's steering and coordination power on the other hand. While there are specific checks and balances to address conflicts resulting from this situation, implementation might prove to be difficult. Another challenge is related to the central role played by the parent and the high reliance on the parent to steer the whole group, which would require a capability of the parent to quickly gain effectiveness in its new function (which also involves a change in the mindset). In addition, any weaknesses or problems at the parent level or a lack in its ability to steer the group may impact all the BCCs in the group and could create more severe implications. Finally, the execution process is challenging, particularly the integration of IT systems and processes, the convergence into common standards and practices, and the centralization of risk management and internal control systems.

118. Given these challenges, a close supervision should be performed over the new CBGs, particularly in their first years of operations. The supervisory themes should be focused on the above-mentioned challenges to ensure that the reform is working as intended. Particular importance should be given to the governance of the parent and its ability to steer the affiliated BCCs, assess their risks, and take corrective actions vis-à-vis risky or weak BCCs. In addition, the early warning systems of the BCCs should be regularly reviewed to assess their relevance and reliability. In

this respect, it may be useful to consider the merits of performing a specific set of individual-level supervisory controls on the BCCs (at least in the first years), which could also help in assessing the adequacy of the early warning system at the parent level.

Recommendations

119. Based on the above, the implementation of the governance reforms needs to be continued and accompanied by thorough supervisory activities to ensure timely action in case of implementation problems. The following actions are recommended:

- The MEF should continue monitoring the compliance with the protocol agreement with ACRI and enforce its effective implementation by foundations.
- The MEF should quickly issue the draft decree on the fitness and propriety of banks' corporate officers and review the decree on the suitability requirements of major shareholders. In addition, the Bdl should be granted the power to issue such requirements given their prudential nature.
- The reform of the large popolari banks should continue and Italian authorities should continue to explore ways to address problems and push for solutions for the smaller popolari banks, as outlined earlier in this note.
- The supervisory authorities (ECB, Bdl) should closely supervise the new CBGs during their first years of operations to ensure that the challenges associated with the reform are successfully overcome.
- The Bdl should increase its focused supervisory activities on bank governance, such as performing more targeted inspections or thematic reviews, and take timely and adequate measures in case of persistent governance weaknesses.