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by Elisabetta Gualandri, Enzo Mangone and Aldo Stanziale

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CEFIN - Centro Studi di Banca e Finanza
Dipartimento di Economia Aziendale - Università di Modena e Reggio Emilia
Viale Jacopo Berengario 51, 41100 MODENA (Italy)
tel. 39-059.2056711 (Centralino) fax 059 205 6927

Internal Corporate Governance and the Financial Crisis: Lessons for Banks, Regulators and Supervisors (*)

Elisabetta Gualandri (**), Enzo Mangone (***) and Aldo Stanziale (***)

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(**) Università di Modena e Reggio Emilia and CEFIN – Centro Studi Banca e Finanza.
(***) Bank of Italy, Supervisory Regulation and Polices department, Rome. The views expressed are those of the authors and should not be taken to reflect those of the Bank of Italy.

elisabetta.gualandri@unimore.it
enzo.mangone@bancaditalia.it
aldo.stanziale@bancaditalia.it

Abstract

This paper aims to highlight the importance of banks' Internal Corporate Governance (ICG), viewed as an operational mitigation instrument, in a context where banks enjoy a high degree of organisational flexibility due to principle-based regulatory and risk-based supervisory approaches. The recent crisis has shown, on the one hand, that financial mitigations (i.e. capital requirements) are, *per se*, not sufficient to ensure the stability of the banks (which underpins the soundness of the entire financial system) and, on the other hand, the failure of the light-touch supervisory approach. The main research question is whether the improvement of ICG, involving proper protection for stakeholders and the switch to a more intrusive supervisory model, will be able to offset the failures of market discipline revealed by the crisis and, together with Basel 3's reinforced capital adequacy regime, strengthen the resilience of the financial system, without the reintroduction of structural reforms. In the European Union, the new European Systemic Risk Board (ESRB) and, above all, the three new European Supervisory Authorities (ESAs) will play a crucial role in this process.

Key words: Banks' Internal Corporate Governance, Financial Crisis, Operational mitigation, Supervisory approaches, European Supervisory Authorities.

JEL classification: G01, G21, G28, G34, G38, M4, M42

Introduction

This paper aims to highlight the importance of banks' Internal Corporate Governance (ICG), viewed as an operational mitigation instrument, in a context where banks enjoy a high degree of organisational flexibility due to principle-based regulatory and risk-based supervisory approaches. The recent crisis has shown, on the one hand, that financial mitigations (i.e. capital requirements) are, *per se*, not sufficient to ensure the stability of the banks (which underpins the soundness of the entire financial system) and, on the other hand, the failure of the light-touch supervisory approach. The main research question is whether the enhancement of ICG, involving proper protection for stakeholders and the switch to a more intrusive supervisory model, will be able to offset the failures of market discipline revealed by the crisis and, together with Basel 3's reinforced capital adequacy regime, strengthen the resilience of the financial system, without the reintroduction of structural reforms. In the European Union, the new European Systemic Risk Board (ESRB) and, above all, the three new European Supervisory Authorities (ESAs) will play a crucial role in this process.

The paper is divided into six sections. The first describes the regulatory and supervisory framework for banks and the role of Internal Corporate Governance at the beginning of the crisis. To this end it is of key importance to highlight the specific features of banks' ICG vis-à-vis non financial firms. The main point is that a principle-based regulatory approach needs, on one side, to be counterbalanced by effective ICG and, on the other, to be backed up by a suitable supervisory model intended to ensure compliance with regulatory principles.

In the second section, the main failures and shortcomings of banks' ICG, as revealed by the crisis, are studied in depth. The most serious weaknesses emerge in banks' boards, risk management and internal control system frameworks.

The third section critically analyses the changes now being made to regulation at the international level with the aim of dealing with the failures that emerged in banks' ICG.

The fourth section highlights some major shortcomings of the new principles issued by the international regulators.

The fifth section is dedicated to the present and future role of supervision in controlling the adequacy of ICG as a buffer/protection against the risks taken by banks. The focus is on the working/functioning of the new European supervisory architecture and the consequences of the new system from two main points of view: on the one hand, the national authorities' role in the implementation and endorsement of EU regulations in general and EU ICG regulation in particular; on the other hand, the degree of intrusiveness of the supervisory models that need to be imposed across the Union to ensure that regulation is really enforced.

The sixth section concludes and identifies possible areas of research in this field.

1. The pre-crisis regulatory framework: the role of banks' Internal Corporate Governance and the supervisory approaches

The financial crisis revealed failures and shortcomings in banks' risk assessment framework, not only in "financial mitigation" (capital adequacy and liquidity regimes), but also in so-called "operational mitigation" (Bank of England - FSA, 2011, p. 9), based on the proper functioning of corporate governance, risk management and internal controls, together known as Internal Corporate Governance - ICG.

"*Internal governance is a limited but crucial component of corporate governance, focusing on the internal structure and organisation of an institution*" (EBA 2011, p. 9). Risk management and Internal control systems are thus part of internal governance. Internal controls usually include three functions: internal audit, compliance and risk control, while risk management refers to all the policies, procedures and strategies adopted to identify, measure, assess, monitor, mitigate and report risks arising in connection with banks' activities and business. In spite of this difference, it has to be pointed out that, in practice, the objectives and scopes of internal control systems and risk management tend to overlap (BCBS 2010 b, p. 16). In this paper corporate governance is described as the set of relationships between an institution, its management, its shareholders and other stakeholders: special emphasis will be paid to internal governance.

Before focusing on these failures and the proposed regulatory solutions, it is important both to point out the specific features of banks' corporate governance and to describe the regulatory and supervisory approaches under which operational mitigation had been developing before the crisis.

There are three main reasons why banks' corporate governance is different from the corporate governance of non-financial companies: (i) the huge number of stakeholders (*in primis* depositors, deposit protection schemes and tax payers); (ii) the high leverage; (iii) the opaqueness and complexity of banks' activities and business models. In particular, due to the specific services banks provide, such as maturity transformations and liquidity supply, they have a public role crucial for the economy, meaning that in case of insolvency there are huge negative externalities affecting the financial and economic system as a whole, which do not only fall on shareholders but must be borne by governments and, in the final analysis, by taxpayers (Macey, O'Hare, 2003; Meheran et al. 2011, Hopt 2011). These specific features are the reasons why banks' ICG is so important for regulators and supervisors.

The financial crisis broke out and developed within a regulatory framework based on the prudential regulatory approach still in force. In this context, banks' risk-taking is supposed to be offset by two main pillars: the first is the capital adequacy regime, i.e. financial mitigation; the second consists of effective risk management systems and suitable organisational measures, i.e. operational mitigation.

The present regulatory framework has developed over the last two decades, with a gradual shift from a prescriptive regulatory approach to a principle-based approach: regulations lay down general principles, objectives and minimal requirements and may also provide guidelines for application and define best practices. Banks are free to define their own management models and choose their own organisational solutions and the procedures used for risk-taking and management, within the relevant regulatory framework. The banks' independence in managing their business is counterbalanced, firstly, by effective ICG and, secondly, by the supervisory authorities' ability to assess that the level of risk undertaken is consistent with internal capital, risk management and, broadly, sound ICG. The supervisory approach adopted is defined as risk-based and organisation-based and the aim of the control procedures is to ensure that firms' strategies are sound and able to contain risk-taking activities.

Therefore, under this regulatory and supervisory approach proper ICG is essential in guaranteeing safe and sound management, especially when the pressure from competitive and performance considerations may lower the attention given to risk assessment, (Tarantola 2008, p. 6), as actually happened in the period before the crisis. As a consequence, the quantitative requirements for capital adequacy under prudential risk management regulation frameworks (Pillar 1) must be supported by efficient, effective, sound operational mitigation (Gualandri 2011).

However, the crisis has shown that ICG mainly served the interests of shareholders, disregarding the positions of the other stakeholders and thus was not able to carry out its function of counterbalancing banks' greater freedom under the risk-based regulatory approach. In this context, the idea that it is the duty of corporate governance to pursue the maximization of shareholder value was commonly shared before the crisis, as the executive and board compensation schemes showed (Meheran et al. 2011, Hopt 2011). Shareholders were able to control and influence banks' boards while owning, on average, just 10% of their assets; they enjoyed an almost unlimited upside with only limited downside, and therefore they pushed for risk-taking activities. By disregarding the peculiarities of banks' ICG, this idea of shareholder-oriented ICG weakened its role of operational mitigation within the new regulatory framework. Furthermore, the fragmentation of supervision and the differences in supervisory approaches worsened the situation, as the case of the European Union reveals (FSA 2009, p. 87).

Indeed, at the national level the pre-crisis supervisory approaches were quite different, and some jurisdictions actually lacked the necessary tools to ensure/assess that banks were managed on a safe and sound basis. In some cases the approach was defined "light-touch supervision" and was based on two main implicit assumptions (at times the dominant philosophy), which the crisis proved to be wrong (FSA 2009, p. 87, Masera 2010):

(i) the working of complete and efficient markets. Markets were in general considered self-correcting, and market failures had become irrelevant. Market discipline was considered a more effective tool than regulation or supervisory oversight for ensuring that firms' strategies were sound and risks contained;

(ii) since intermediaries had developed very powerful risk management control techniques, top managers were considered to be better placed to assess business model risk than bank regulators, provided appropriate systems, procedures and skilled people were in place. Therefore, the senior management and boards of the individual firms could be relied on to make appropriate decisions about the balance between risk and return, with the primary responsibility for managing risks.

The supervisors' reliance on market discipline was so intense as to lead the former US Fed chairman A. Greenspan (Greenspan 2007) to argue that "*Hands-on supervision and regulation … is being swamped by the volume and complexity of twenty-first century finance … Public-sector surveillance is no longer up to the task … We have no sensible choice other than to let markets work*".

However, the aftermath of the crisis has shown that the market alone was not able to give the right incentives to managers who, without intrusive supervision, too easily bypassed the check and balance architecture based on ICG. Banks reached a size and a degree of complexity so impressive as to be perceived by investors and depositors as implicitly supported by Governments; in these conditions investors and depositors had no incentive to monitor banks' risk taking, weakening market discipline and increasing the misalignment between the interests of bank managers and bank stakeholders.

Therefore, one of the most important lessons from the crisis is that ICG needs to be reshaped, partly by giving greater weight to the stakeholders' perspective. At the same time, so-called "light-touch supervision" failed to spot emerging issues or identify the overall risks of the business models banks adopted. An in-depth analysis of these failures in the UK has been provided by the Turner Report, which suggests the adoption of a new, "more intrusive and more systemic" supervisory approach (Financial Services Authority, 2009, p. 88). In the pre-crisis context of light supervision, efficient ICG was not guaranteed, so one of the main pillars thought to counterbalance banks' increasing organisational and business freedom failed.

In other countries, where more intrusive supervision was implemented, those operational mitigation mechanisms were more efficient and, in turn, banks were able to better afford and react to the crisis.

Since the banking and financial services delivered by banks are of public interest, due to their essential role in assisting the flow of funds from depositors to enterprises, ICG has to serve not only shareholders' interests but also those of the other stakeholders. Furthermore, the role of ICG was reinforced even more by the new risk-based regulatory framework, according to which ICG was intended to provide an important counterbalance to the increased freedom granted to banks. However, the crisis has shown that something went wrong: ICG mainly cared about managers and shareholders, disregarding its more comprehensive role.

In this context, on the one hand, regulatory principles on ICG have been revised, also strengthening the attention to the interests of the other stakeholders and, on the other hand, measures have been taken to adopt a more intrusive supervisory approach.

The question inevitably arises as to whether these reforms are enough to make the financial system more resilient. To this end two major issues need to be dealt with.

The first relates to whether the new ICG principles and broader Basel 3 framework should be supported by the introduction of structural reforms such as those under discussion in the UK on the separation between the investment banking and the retail/commercial banking through the so-called ring-fencing (ICB 2011, p. 35).

The second is linked to the interconnectedness of financial systems, which requires all regulators to adopt a uniform approach to more intrusive supervision. This issue is particularly important for the success of the new European supervisory architecture.

These two issues will be further analysed in the final section, after an investigation of the major failures in this field highlighted by the crisis and the reaction of the regulatory authorities.

2. Corporate governance, risk management and internal control systems: weaknesses highlighted by the financial crisis

Corporate governance, risk management and internal control systems, as defined in section 1 under the label "ICG", played a key role in the development and spread of the financial crisis. Although ICG cannot be deemed the main cause of the financial crisis, it has been argued, quite rightly, that "*poor corporate governance can contribute to bank failures, which can in turn pose significant public costs and consequences due to their potential impact on any applicable deposit insurance and the possibility of broader macroeconomic implications, such as contagion risk and impact on payment systems*", which is exactly what happened during the current financial crisis; moreover, "*poor corporate governance can lead markets to lose confidence in the ability of a bank to proper manage its assets and liabilities, including deposits, which could in turn trigger a bank run or liquidity crisis*" (BCBS 2010 b, p. 5). For those reasons corporate governance issues were called into question in the aftermath of the crisis.

This section aims to provide an overview of the main weaknesses which have become apparent in the structuring of financial intermediaries' ICG during the current financial turmoil. The section will be divided into four subsections: the first will address the issues related to the role of non-executive directors, the composition of the management body and the shortcomings of the information system; the second and the third sections will inquire into the weaknesses of risk management, considering organisational problems and technical limits respectively; the fourth will analyse the role played by supervisors.

2.1 Management body issues

First of all, an examination of the role of banks' boards during the crisis quickly reveals that a fairly large number of shortcomings arose out of the composition, structure and duties of boards general.

One of the main problems laid bare by the crisis was the role of non-executive directors (European Commission 2010 b, p. 6). In the majority of cases, these directors did not actively carry out their duty to oversee and monitor the banks' executives and, above all, one of the reasons why they spent so little time performing their tasks lay with the multiple mandates they typically collected from different institutions. Moreover, non-executive directors did not have in-depth knowledge of the working of the financial system and lacked the skills needed to adequately monitor the activities of the executive board members and senior managers.

The second problem was the composition of the boards. It has been argued that diversity benefits corporate governance both in terms of efficiency and better monitoring. "*Diversity, not just of gender but also of race and social background, and the presence of employee representatives, broadens the debate within the boards and helps to avoid the danger of narrow group think*" (European Commission 2010 b, p. 8). The lack of diversity in boards' composition, particularly with reference to non-executive directors, seems to have contributed, to a certain extent, to reducing the effectiveness of their monitoring activity.

Several studies (Hopt 2011) have been carried out to inquire into the relationship between the amount of risk taken and the main features of the bank's board, such as its composition, size, experience and so on. Many of these studies have actually demonstrated a negative correlation, for example, between risk and the percentage of independent directors on the board or between risk and board size (Minton et al. 2010), confirming the potential role of the management body in containing the amount of risk taken by banks.

Moreover, banks' boards were also prevented from fully fulfilling their duties of conscientiously supervising and directing the senior management by the lack of an efficient information system.

The information flow within banks was a key factor (SSG 2008, p. 13). On too many occasions, business areas were organised in such a way as to make a continuous information flow among and between them difficult. The "silo" structure was a common way of organising business units: structuring departments along rigid vertical reporting lines caused fragmentation of the information system, preventing the board from getting the "whole picture" of the business.

Several other drawbacks were highlighted by the crisis, such as the resistance of managers and staff to receiving input and feedback from other departments and the excessive avoidance of the disclosure of important information. Information available to certain areas and useful for decision-making in others was not circulated due to a lack of coordination, for which directors and senior management were mainly to blame. They were not able, in the final analysis, to guarantee the efficiency of the corporate structure. Poor information flow was common in the interaction between risk management and directors and between risk management and business line management. Moreover, risk management lacked an integrated approach to market and credit risks and failed to properly interact with accounting and financial control functions (BCBS 2009 a, p. 15).

2.2 Risk management: organisational issues

However, the main failure of banks' boards was linked to risk governance (OECD 2010, p. 13). Basically, directors took an amount of risk much higher than the level that banks were able to afford exceeding the threshold of absolute risk that banks were *a priori* open to take (so-called risk appetite) and, consequently, the actual limits within their risk appetite that banks were pursuing (so-called risk tolerance). Sometimes directors failed to set clear guidelines to define the risk tolerance/appetite of their own banks (for the sake of simplicity in this paper we will refer interchangeably to risk appetite and risk tolerance, following the EBA approach, see EBA 2011, p. 11).

In other cases, directors were completely unable to fully understand the risk embedded in complex-structured, opaque financial products. Furthermore, they failed to correctly assess institutions' aggregate exposure to risks, underestimating the amount of risk arising from their business areas. When risks were detected, directors were not able to recognize their systemic nature, and failed to report them promptly to the supervisory authorities (European Commission 2010 b, p. 15).

A clear lack of involvement of the board in the determination of risk strategy and the structuring of the risk management function has also been noted (Brogi 2010, p. 294). Responsibilities in identifying risks were not clearly assigned. Reporting lines and escalation procedures from the internal audit and risk management were missing or not adequately detailed; as has been pointed out: "*in some cases, hierarchical structures tended to serve as filters when information was sent up the management chain, leading to delays or distortion in sharing important data with senior management*" (SSG 2008, p. 9).

To expand the business or to protect the firm's market position, senior management encouraged increasing exposure to risk far beyond the level that could have been deemed appropriate by internal control system structures. To prevent the rejection of transactions by risk managers, traders and operational staff either did not duly inform risk managers about the building and marketing of new products, or the undertaking of new business in new markets, or the information submitted was incomplete and usually risks were not duly highlighted. This practice was made possible by the failure of the management body to set standardized procedures to clearly define the role of risk managers and internal controllers in the development of new products or new lines of business which would trigger new types of risks (SSG 2008, p. 7).

Another important weakness was the approach to the management of risks. In many cases, directors refused to manage risks and to implement policies intended to deal with the rapid growth in risk-taking. They were insufficiently trained in the implementation of risk management strategies oriented towards a firm-wide approach (European Commission 2010 b, p. 9, OECD 2010, p. 13).

Also crucial, in light of the effectiveness of risk management goals, was risk managers' lack not only of independence but also, and above all, of authority (Mottura 2008, p. 26). It was clear that risk managers were not provided with enough powers to stop the operational and trade functions taking aggressive managerial decisions aimed at short-term profits and implying huge risks for the institution (SSG 2009, p. 3-4).

The boards of directors of many banks were not able to allocate an amount of resources to internal control and risk management functions consistent with their risk tolerance/appetite. In other words there was a clear mismatch between the risk tolerance/appetite shown by aggressive managerial decisions and the resources and powers assigned to these functions. This mismatch was aggravated by compensation and remuneration schemes, too often oriented to short-term profits and disregarding the need for a rate of growth sustainable in the long term (SSG 2009, p. 3-4).

2.3 Risk management: technical issues

Other serious problems highlighted by the crisis were more directly connected with the risk management function. Although some of these problems overlap those mentioned above and are linked to boards' responsibilities, it seems helpful to further analyse them from a different standpoint: the technical deficiencies of the risk management function.

The De Larosiere report (European Commission 2009, p. 8) was the first one to try to identify the main failures of the risk management function. According to the report, risk management functions overestimated banks' ability to manage risks and, consequently, the amount of capital held was below the necessary threshold for the actual amount of risk taken. Risk assessment failure was due to several reasons, summarised as follows.

- The interaction and concentration between market, credit and liquidity risks were not correctly detected. In other words, by heavily relying only on the traditional concentration measures such as correlation between market, credit and liquidity risks, other more subtle and situation-specific key factors such as interaction between trading and banking book, exposure to similar collateral types, funding source, exposure to same industry or counterparty, etc. were disregarded (BCBS 2009 a, p. 15).

- The overall leverage of institutions was not verified. Due to a focus only on risk-weighted assets in setting capital requirements, banks' overall leverage ratio was completely ignored. Nonetheless, leverage was crucial: during the crisis the market forced banks to decrease their leverage, triggering the discounting of assets and thus aggravating losses and reduction in capital.

- The degree of complexity of structured financial products was so high as to make risk assessment very challenging even for sophisticated risk management models; moreover risk managers blindly trusted in rating agencies (Masera 2009, p. 4).

- Risk management models did not give the correct weight to tail events (low probability, high impact) and their systemic effect was overlooked, stress tests were carried out under over-accommodating or even wrong assumptions.

- Banks switched from an *originate-to-hold* (OtH) model to an *originate-to-distribute* (OtD) model by using the so-called shadow banking system to break out risks. Many times, however, the relationships between entities were closer than appeared to risk managers, so that risks formally seemed to be spread out, but were actually simply hidden in some part of the shadow system and, in the end, taken by the same institutions who were seeking to transfer them to the market. In addition, risk managers failed to identify reputational risk deriving from off balance sheet vehicles. Banks were obliged to supply financial support to entities to preserve their reputations.

- The risk management function was not able to correctly set procedures to verify the methods used to price fair-valued instruments as liquidity dried up and market prices lost significance (BCBS 2008, p. 4, BCBS 2009 b, p. 5).

- OTC derivatives were thought to be suitable instruments for the transfer of risks; however, they proved unable to transfer risks when the counterparties were in trouble and thus could not meet their obligations (Sjostrom 2009, p. 943).

- The *originate-to-distribute* model gave strong incentives to risk managers to underestimate credit risk. Since they knew that risks would be transferred to third parties, borrower screening and monitoring activities were carried out with less severity.

Last but not least, liquidity risk was totally ignored: maturity transformation was carried out with an excessive reliance on the liquidity available on wholesale funding markets. Moreover, banks failed to correctly assess the impact of liquidity on institutions' solvency: once the liquidity dried up, institutions were forced to sell off their assets at a big discount, undermining their solvency and increasing their default risk (e.g. Northern Rock).

As already mentioned, the ineffectiveness of the risk management function was worsened by the inadequacy of IT infrastructures. The rapid growth of structured financial product complexity was not followed by any increase in allocation of financial and human resources to build a more robust infrastructure system.

2.4 Role of supervisors

The aftermath of the crisis clearly showed that supervisors were seriously to blame. Financial system oversight was carried out in a context where resources and skills were not adequate to the complexity and opaqueness of the players and products supervisors had to deal with. Moreover, and most important, the degree of flexibility given to national regulators and supervisors was too high, causing regulatory competition and supervisory capture (Tonveronachi 2010, p. 366). The light-touch approach adopted by some supervisors led to the creation of systemic risk (FSA 2009, p. 88) that, in the end, had an impact even on countries where a stricter approach was preferred, due to the high degree of interconnection between markets, and also affected the global real economy.

Supervisors also fell seriously short in the verification of corporate governance and risk management functions. It has been correctly noted (European Commission 2010 b, p. 30) that: "*The financial crisis highlighted a poor enforcement of existing rules and regulations on corporate governance and inadequate supervisory control of governance practices in financial institutions. In many cases, supervisors did not monitor whether risk management frameworks and internal organisation were well-adapted to changes of business model and financial innovation. They also failed to ensure appropriate expertise of boards and to apply "fit and proper" tests, focusing essentially on probity tests*".

And furthermore: "*Supervisors were too much focused on formal compliance by financial institutions rather than on the proper functioning of the boards and on effective implementation by financial institutions of sound corporate governance principles. In a number of cases supervisors did not or could not take account of existing guidelines for corporate governance of banks insurance which are intended, inter alia, to guide supervisors, in the lightly regulated non-banks sector. The governance of supervisors themselves has not been adequately debated, especially taking into account that supervisors' jurisdiction and areas of competence are increasingly failing to align with the* *actual operations of financial firms, creating, at the minimum, complexity in risk management and regulatory compliance*".

Indeed, those issues were so important that even before the crisis in 2007, the IMF (2009) conducted a comprehensive survey of governance practices at financial regulatory and supervisory agencies. More recently proposals have been put forward by academics (Dermine 2011) for measuring supervisors' performance. It is hoped that peer reviews may facilitate the spread of best practices among supervisors.

3. The reaction of international regulators and supervisors to corporate governance issues

This section aims to provide a critical analysis of the main measures taken by international regulators to ensure suitable, effective corporate governance principles. These measures mainly derive from a stakeholder-based approach, as opposed to a shareholder-based approach. The approach followed by the new regulation is due to the failure that emerged with the crisis in the latter approach, mainly adopted by the Anglo-Saxon systems. The key question is whether those measures are able to properly protect stakeholders, preventing them from bearing the costs of future crises, while at the same time managing not to hurt economic growth and risk taking. To avoid these possibilities, a dual governance system for banks has also been proposed, where the governance of banks would follow a shareholder approach while supervisory authorities would operate with the stability of the banking system as their top priority, without devolving regulatory responsibility to banks' boards (Dermine 2011).

As far as the ICG issue is concerned, several initiatives have been taken at the international level in response to banks' ICG weaknesses.

Corporate governance and risk management principles have been issued by the Basel Committee on Banking Supervision (BCBS 2010 b) and the European Banking Authority (EBA 2011, CEBS 2010 a); in addition, the European Commission has issued two green papers, one on corporate governance in financial institution and remuneration policies and another on the EU corporate governance framework (European Commission 2010 a, b).

Regulators have focused their attention on corporate structure and organisation; management body; risk management; internal control; system and continuity; and transparency. In the subsections which follow, the principles issued for each of the abovementioned topics will be summarized and commented on.

3.1 Corporate structure and organisation

The main failures of ICG addressed in this area regard the opacity and complexity of structures, particularly in groups, which prevented efficient, effective risk control and management.

Pursuant to EBA principle on corporate structure and organisation (EBA 2011, p. 16), a bank's structure and reporting lines should be clear and transparent, to ensure the proper oversight and management of risks. At the same time, changes in corporate structure and organisation due to mergers, acquisitions, restructures and so on and so forth should imply proper adjustments aimed at safeguarding the transparency of the bank as a whole.

Should a bank be organised as a group, sound internal governance should be ensured across all subsidiaries, so as to allow effective monitoring and assessment of all the risks at both group and single entity levels. On the one side, the management body has to set appropriate internal governance policies for the entire group and provide subsidiaries with enough resources (human, technological and organisational) for their correct implementation. Special attention has to be devoted to reporting lines when the perimeters of business lines do not perfectly overlap with the boundaries of legal entities. On the other side, subsidiaries' management bodies must fulfil their own responsibilities for their entities' internal governance and verify that the parent company's policies ensure its compliance with all relevant regulations. The inclusion of directors independent of the parent company in subsidiaries' management bodies is advisable.

Furthermore, the management body should have a deep knowledge of the bank's structure (including "*group-specific operational risks, intra-group exposure and how the group's funding, capital and risk profiles could be affected under normal and adverse circumstances*" (CEBS 2010 a, p. 9)) and verify its appropriateness in relation to its business strategies and risk profile, avoiding unduly complex architecture since complexity often brings unjustified risks. To keep it up to date with the group's structure, the management body needs to be promptly provided with information on subsidiaries; conversely, the management body has to ensure that information on overall group risk profile, policies, and strategies is provided to controlled entities; information, where needed, should also be exchanged among the group's entities. Information should be recorded and made available to the management body, control functions and supervisors: so-called "*know your structure*" principle.

Finally, to preserve the transparency of the group's structures and activities, special attention has to be paid to (i) activities carried out in jurisdictions that do not comply with international banking standards; (ii) the setting up of opaque structures as special purpose vehicles and trustees. In this case there are specific legal, reputational and financial risks that need to be carefully considered. Specific procedures should be introduced to approve structures and activities of this kind. In these cases, of course, information flow is crucial.

3.2 Management body

In the case of management body, several principles have been adopted to address failures in quite different areas: responsibilities, functions, composition, organisation and so on.

Firstly, international regulators have listed the main responsibilities of management bodies as described in Box 1 (EBA 2011, p. 21).

BOX 1- Management body duties

The management body should set and oversee:

(i) the overall business strategy of the institution within the applicable legal and regulatory framework taking into account the institution's long-term financial interests and solvency;
(ii) the overall risk strategy and policy of the institution, including its risk tolerance/appetite and its risk management framework;
(iii) the amounts, types and distribution of both internal capital and own funds adequate to cover the risks of the institution;
(iv) a robust and transparent organisational structure with effective communication and reporting channels;
(v) a policy on the nomination and succession of individuals with key functions in the institution;
(vi) a remuneration framework that is in line with the risk strategies of the institution;
(vii) the governance principles and corporate values of the institution, including through a code of conduct or comparable document;
(viii) an adequate and effective internal control framework, that includes well-functioning Risk Control, Compliance and Internal Audit functions as well as an appropriate financial reporting and accounting framework.

Secondly, a bank's management body, regardless of the way it is organised, should have two functions: management and supervisory functions. The former should be responsible for the day to day business and the development and implementation of business strategies and risk policies; the latter should monitor and advise it as well as evaluate the developments of the business and risks. Close coordination between the two functions, and intensive information exchange, are crucial.

Thirdly, a cluster of principles have been issued covering boards' composition and the main characteristics directors should have (European Commission 2010 a, p. 11.). Boards' size should be consistent with the dimensions and complexity of the banks concerned and there should be a clear procedure for the selection, appointment and replacement of directors, who should be highly skilled in order to successfully carry out their duties. They should also be able to understand business for which they are not directly responsible. Directors should be actively involved in the management and supervision of the institution; they should act independently and commit themselves for a long enough time for the effective fulfilment of their duties, and for the same reason they should not accept too many mandates or engage in time-consuming professional activities. Furthermore, a minimum expected time commitment should be indicated in a written document. Directors should be professionals with different backgrounds. A minimum number of non-executive directors will be advisable to enhance independence. It is then crucial to set a specific policy to prevent and properly manage conflicts of interest and transactions with related parties. To promote and spread knowledge and skills among directors, training programmes should be activated at least in the fields of the institution's risk management tools and models, new developments, changes within the organisation, complex products or markets and mergers (OECD 2010, p. 17).

Fourthly, to ensure sound internal corporate governance practices for the bank overall it is important that the management body itself should be well organised. Not only are the regularity of the meetings, the clarity of the minutes and the role of the chair important, but the organisation of the board through committees is also paramount. The establishment of an audit committee and a risk committee is recommended in particular (BCBS 2010 b, p. 12). The former should be chaired by an independent director without executive functions and with "*specialist knowledge and experience in the application of accounting principles and internal control process*" (EBA 2011, p. 29); the audit committee should "*oversee the institution's internal and external auditors; recommend for approval by the management body the appointment, compensation and dismissal of the external auditors; review and approve the audit scope and frequency; review audit reports; and check that the management body in its management function takes necessary corrective actions in a timely manner to address control weaknesses, non compliance with laws, regulations and policies, and other problems identified by the auditors. In addition, the audit committee should oversee the establishment of accounting policies by the institution*" (EBA 2011, p. 28). The latter should recommend the appropriate risk tolerance/appetite and risk strategy to the board and monitor its effective implementation. In order to pursue its goals, the risk committee should regularly exchange information with the risk control functions and Chief Risk Officer. It should be able to call on external expert advice, above all in connection with transactions that may heavily impact on the institution risk profile.

A remuneration committee should also be created, given the crucial importance of remuneration incentives on managers' attitude to risk-taking. In this respect, guidelines and specific regulations have been adopted on the governance of remuneration policy. These require the involvement of the control function and an active role for the remuneration committee, whose members should be qualified and independent, ensuring that remuneration policy is in line with the institution's risk profile and preventing conflicts of interest. Remuneration should be consistent with the institution's risk tolerance/appetite and business strategy, discouraging excessive risk-taking. Specific arrangements need to be made when the remuneration of staff whose work may impact on the institution's overall risk profile is agreed. Remuneration of the control function should not be linked to business line performance but to specific objectives. Moreover, when a proportion of remuneration depends on performance, non-financial factors have to be taken into account and the variable part of the remuneration (i.e. bonus) should be adjusted in response to risk and cost of capital. The timing of bonus payments should reflect the institution's long-term objectives. Performance-related remuneration should be based not only on individual but also on collective performance.

Fifthly, another important principle has been issued to ensure the sound functioning of internal governance. Management bodies have been advised to set up "*internal alert procedures*" (EBA 2011, p. 30) aimed at allowing staff to bring issues concerning the internal governance of the institution to the attention of the board or, where appropriate, to the supervisor, bypassing the regular reporting lines.

Finally, a set of principles have been issued (EBA 2011, p. 29) with reference to: (i) Corporate values and code of conduct (to reduce operational risk, a code of conduct aimed at encouraging professional and responsible behaviour together with high ethical standards should be set up and implemented throughout the institution); (ii) Conflict of interest at institutional level ("*The management body should establish, implement and maintain effective policies to identify actual and potential* *conflicts of interest so they can be prevented. If conflicts of interest cannot be prevented, they should be appropriately managed*"); (iii) Outsourcing ("*The management body should approve and regularly review the outsourcing policy of an institution*").

3.3 Risk management

Banks have to deal with risks; risk-taking is one of the activities that economically justify the existence of financial intermediation (OECD 2010, p. 13). The management of risks is, thus, one of the most important tasks that a bank has to fulfil. However, the recent financial crisis has clearly showed that risk management failures made a huge contribution to the spread and intensity of the crisis. To make risk management more resilient when faced with market turbulence, regulators have issued several principles and guidelines aimed at strengthening its effectiveness.

To have effective risk management, in the view of regulators, it is crucial to build a proper "risk culture" inside the institution by means of proper policies and staff training. Staff should have a different approach to risk management, which should not be viewed as just a matter assigned to risk managers but rather an issue of common concern. Each employee and business unit staff above all, should be able to fully understand which risks are associated with the tasks they perform and verify consistency with the institution's risk tolerance/appetite. Furthermore, the bank should adopt a firm-wide integrated approach to risk, considering all the types of risk arising out of the entire institution (so focusing not only to credit, market, liquidity and operational risks but also concentration, reputational, compliance and strategic risks). In addition, the risk management framework should provide the institution with proper information about risks in order to allow suitable decisions to be taken. Risks have to be monitored and assessed in every part of the institution, by both business lines and the risk function, using the same terminology and approach. Finally, the risk management framework should be reviewed and reassessed regularly to verify its compatibility with the institution's risk profile. The review process should be carried out considering information from Risk Control function and Risk committee and taking into account "*balance sheet and revenue growth, increasing complexity of the institution's business, risk profile and operating structure, geographic expansion, mergers and acquisitions and the introduction of new products or business lines*" (EBA 2011, p. 33).

Turning to the operational aspect, it has been stressed (EBA 2011, p. 34, BCBS 2010 b, p. 19) that the risk management framework should issue guidance on implementation of its strategies and set internal limits to operations in a way that reflects the institution's risk profile, financial solidity and strategies. Limits must be respected and any violation should be duly referred to the management body and followed up.

Both forward-looking and backward-looking tools should be developed to identify and assess risks. The former (namely, scenario analysis and stress tests) should identify potential risk exposures under adverse circumstances, while the latter should verify that the actual risk profile is in line with the institution's risk tolerance. Risks should be evaluated adopting a firm-wide integrated approach. External risk assessments may be helpful, but institution risk managers should not over-rely on such assessments as they may be misleading. In addition, managers have to bear in mind that, in the final analysis, the responsibility for risk identification and assessment cannot be outsourced. They need to use their judgment and understand the limits of merely quantitative approaches such as metrics and models, which are certainly very important but not self-sufficient: a qualitative approach is needed to support models and check the plausibility of the assumptions used. Furthermore, to be effective a risk management framework needs an efficient communication system: risk strategies have to be duly communicated across the institution. Risk reports should be transparent and easily understandable.

One crucial factor for a sound risk management system is the reliable valuation of assets (BCBS 2008, p. 4, BCBS 2009 b, p. 5). Therefore, banks must develop specific valuation procedures, especially for assets that are difficult to value (e.g. illiquid or complex financial instruments). The crisis revealed the lack of appropriate internal valuation methods for the assessment of instruments whose market prices lost significance as liquidity vanished.

Finally, a proper new product approval policy ("NPAP") (BCBS 2010 b, p. 21) should be set up and approved by the management body to clearly identify the main concerns to be considered when an institution decides to enter new markets, deal in new products and so on. Issues to be addressed include "*regulatory compliance, pricing models, impacts on risk profile, capital adequacy and profitability, availability of adequate front, back and middle office resources and adequate internal tools and expertise to understand and monitor the associated risks. The decision to launch a new activity should clearly state the business unit and individuals responsible for it. A new activity should not be undertaken until adequate resources to understand and manage the associated risks are available*". The control functions also need to be involved in the procedure, as has been clearly stated: "*The Risk Control function should be involved in approving new products or significant changes to existing products. Its input should include a full and objective assessment of risks arising from new activities under a variety of scenarios, of any potential shortcomings in the institution's risk management and internal control frameworks, and of the ability of the institution to manage any new risks effectively. The Risk Control function should also have a clear overview of the roll-out of new product (or significant changes to existing products) across different business lines and portfolios and the power to require that changes to existing products go through the formal NPAP process*" (EBA 2011, p. 37).

3.4 Internal Control

An important element of the internal governance of a bank is the internal control framework. In this regard, regulators have issued several principles intended to identify the main tasks and proper structure: the main failures addressed regard the efficiency, effectiveness and independence of the control function.

The internal control framework should ensure "*effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported, both internally and externally, and compliance with laws, regulations, supervisors requirements and the institution's internal rules and decisions*" (CEBS 2010 a, p. 31). To fulfil its mandate, the internal control framework should be enforced across the entire institution and it should have sufficient authority to ensure its effectiveness (European Commission 2010 a, p. 13).

The internal control framework should be structured in such a way that all areas of the institution are involved. To achieve this, it is recommended that business lines bear the main responsibility for internal control policies and procedures, which then need to be verified by independent control functions established at a proper level of the hierarchy and reporting directly to the board. These control functions must comprise, at least, the Risk Control function, the Compliance function and the Internal Audit function (BCBS 2010 b, p. 18).

To operate effectively, control functions need to be independent and provided with qualified staff and resources. From a regulatory standpoint, a function may be considered independent if: (i) its staff do not perform any tasks that fall within the scope of the activities the control function is intended to monitor and control; (ii) it is organisationally separate from the activities it is assigned to monitor and control; (iii) the head of the control function is subordinate to a person who has no responsibility for managing the activities the control function monitors and controls. The head of the control function should generally report directly to the management body and any relevant committees and should regularly attend their meetings; and (iv) the remuneration of the control function's staff should not be linked to the performance of the activities the control function monitors and controls, and not be otherwise likely to compromise their objectivity.

Control functions should report the main shortcomings identified directly to the board and address recommendations. (For more details on control functions, please see Box 2 here below).

BOX 2 - Control functions

Risk control function (RCF) and Chief Risk Officer (CRO)

The RCF has two important roles: on the one hand, to verify that business units identify, measure and monitor all the relevant risks they are bearing; on the other, to provide the board with a firm-wide integrated risk overview.

The RCF has to actively participate in the definition of the institution's risk appetite by providing the board with all risk-relevant information. The RCF has then to verify that the limits imposed on the business units are in line with the institution's risk tolerance.

Special emphasis is placed on the RCF with reference to the identification and assessment of risks connected to (i) transactions with related parties; (ii) the complexity of the institution's legal structure and (iii) material changes and exceptional transactions (such as mergers, acquisitions, sale or purchase of new entities and so on) due to the fact that these risks are not easily defined but may have a heavy impact on the institution's overall risk exposure.

It is also worth mentioning that the RCF should oversee the business units' compliance with the institution's risk tolerance and strategies. Any breach thereof should be assessed and the relevant business unit should be informed and possible remedies recommended. The RCF should then make sure that its recommendations are implemented and, if appropriate, report to the board or the risk committee.

One of the most important innovations regulators have introduced is the position of the CRO. The CRO should be responsible for the RCF and should play a key role in the setting of the risk strategy and communication with the management body and risk committee. The CRO should have in-depth expertise and, above all, a high degree of independence and authority even from the CEO, enabling him to question decisions that may negatively impact on the institution's risk profile. The CRO appointment and removal procedure should be clearly stated and subject to the approval of the management body in its supervisory function. The CRO may also have the right of veto over operational decisions (in this case the risk policy should specify the CRO's powers and their limits and the escalation or appeal procedures).

Compliance function

A dedicated function should be set up to oversee compliance risk, defined as "*the current or prospective risk to earnings and capital arising from violations or non-compliance with laws, rules, regulations, agreements, prescribed practices or ethical standards*" (EBA 2011, p. 43). A Compliance Officer should be in charge of this function. The Compliance function should verify that all the relevant laws, regulations and supervisory requirements are observed; moreover it should assess the impact of changes in the legal environment and the compliance of the institution's new products and businesses with laws and regulations.

Internal Audit function (IAF)

The IAF should ensure that the internal control framework is efficient and successfully pursues its goals. To this regard, the IAF also has to oversee the RCF and the Compliance function, verifying that those functions comply with their policies and procedures. The IAF reports directly to the board and has to be independent, with no involvement in operational issues (such as the selection of risk management models). IAF staff should comply with national and international professional standards

3.5 Systems and continuity

Regarding information systems and business continuity, two main principles have been issued. The first, on information systems and communication states that "*an institution should have effective and reliable information and communication systems covering all its significant activities*" (CEBS 2010 a, p. 39. European Commission 2010 a, p. 13). It is important that such a system is flexible enough to allow the aggregation and disaggregation of information to give a clear picture of the business and risk trends; it is crucial, in particular, that the management reporting system should also be concise, easy to understand and informative. The second principle, on business continuity management, says that "*an institution should establish a sound business continuity management to ensure its ability to operate on an on-going basis and limit losses in the event of severe business disruption*" (CEBS 2010 a, p. 40).

3.6 Transparency

On this topic, regulators have stressed the importance of making all employees aware of the policies and procedures in force and relevant to their duties and responsibilities.

Transparency is deemed to be crucial not only at the institution level but also, and most important, in relation to the other external stakeholders (BCBS 2010 b, p. 29). To this extent, regulators have issued the minimum set of information that an institution needs to disclose (CEBS 2010 a, p. 42):

(i) its governance structures and policies, including its objectives, organisational structure, internal governance arrangements, structure and organisation of the management body, including attendances, and the incentive and remuneration structure of the institution;
(ii) the nature, extent, purpose and economic substance of transactions with affiliates and related parties and an explanation of how they could influence the entire organisation;
(iii) how its business and risk strategy is set (including the involvement of the management body) and foreseeable risk factors;
(iv) its internal control framework and how its control functions are organised, the major tasks they perform, how their performance is monitored by the management body and any planned material changes to these functions;
(v) material information about its financial and operating results.

4. Is regulation enough?

Although the above-mentioned principles are common sense and thus broadly acceptable, it may be argued that they are not, on their own, sufficient to solve all the weaknesses in ICG highlighted by the crisis or to effectively address the issue of the protection of stakeholders' interests: in this field further analysis is clearly needed, including the in-depth study of ICG practices (Meheran et al. 2011, Ahrens et al. 2011).

Let us consider the board's responsibility for deciding the institution's the risk tolerance/risk appetite. How can an institution's risk tolerance be defined? Is it possible to quantify risk tolerance/appetite? How can it be measured? What guidelines can be used to set the amount of risk taken? And, furthermore, how can the optimal amount of risk-taking desirable for stakeholders be set?

In recent years several studies of financial markets' appetite have been published (Uhlenbrock 2009), while studies on the setting of banks' risk tolerance/appetite are still in the early stages. This field of research will be of paramount importance as the SSG has stressed. In the concluding comments of the "*Observations on Developments in Risk Appetite Frameworks and IT Infrastructure*" (SSG 2010, p. 14), the SSG has argued that although progress has been made more steps forward need to be taken to strengthen risk tolerance/appetite frameworks and, thus, to enhance strategic planning and decision making.

Without a doubt, the introduction of guidelines on risk tolerance/appetite will encourage new research both by banks and academics in this field.

Questions may be also raised with reference to boards' composition. It has been stated that boards should contain a certain number of non-executive and independent directors, but at the same time, directors should have a solid financial background, experience and skills. It is obvious that only deep involvement in business allows them to acquire skills and experience. It seems that there is a trade-off between independence and expertise. The degree of board engagement also comes into play (Meheran et al. 2011).

Turning to transparency issues, the disclosure of a list of information may not be sufficient to make stakeholders really aware of their banks' risk profiles. Banks' stakeholders are of different types and backgrounds (we need only consider the difference between a depositor, a bondholder, an OTC derivative counterparty or a counterparty in the wholesale funding market) and, above all, depositors do not have the right skills to really understand how much risk their bank is going to take. In addition, stakeholders have no incentive to monitor banks' activities, because they are perceived to enjoy state support.

It seems clear that rules and principles, even if detailed and well drawn up, may always present shortfalls on the slippery ground of ICG, making the role of supervisors even more crucial.

The importance of ICG in banks, deriving from the sensitive nature of banking and financial services in the light of their intrinsic public interest, has already been mentioned. The financial turmoil has led to calls for greater protection for stakeholders, since market discipline alone is clearly not sufficient and light-touch supervision has proved inadequate. International regulators have produced detailed principles and regulations to enhance ICG, but this is still not sufficient if supervisors do not carry out their duties properly. In the following section we will investigate the case of the new European supervisory architecture, to highlight the challenges facing the new bodies in this field.

5. The role of national supervisors in light of the new European Financial Supervision framework

The first section of this paper highlighted the principle-based approach adopted to regulate the financial industry. Regulators state the main objectives and driving principles of the regulation, then supervisors translate these broad measures in concrete, effective operative measures (prudential risk-based regulation); institutions exercise their organisational freedom within the principles set by the regulators as specified by the supervisors and, finally, the supervisors check that what institutions have done is compliant with what they should have done according to the regulations.

Within this regulatory framework, the banks enjoy a certain degree of freedom in deciding their structure and organisation. Banks are thus responsible for deciding their risk tolerance/appetite and business strategies.

In this context of high flexibility, it emerged that those institutions with efficient internal corporate governance and a solid architecture of internal controls were better able to manage the different types of risks triggered by the crisis.

In other words, efficient internal governance is the counterbalance to the higher degree of bank freedom deriving from prudential principle-based regulation.

The importance of sound internal governance is due to the fact that, with regard to risks, capital requirements by themselves are not sufficient to ensure the stability of the institution (Tarantola 2008, p. 5). This is true not only with reference to non measurable risks (such as reputational risk) for which, by definition, capital adequacy cannot reasonably be assessed. The organisational structure is also crucial for measurable risks: indeed, (i) the amount of capital allocated to cover these risks is calculated using models and assumptions, and recent experience has shown that models may fail; (ii) it is impossible to assess tail events without using a high degree of discretion.

In light of the above, a principle-based approach cannot make the financial system stable and safe without giving due weight to the issue of corporate governance and internal control systems.

In this regard, a key role is played by national supervisors and, more and more, by international authorities. Supervisors have the role of adopting and implementing the principles and guidelines discussed in the previous section properly, to ensure the effectiveness of these operational mitigations. In addition, the action of supervisors is needed to ensure that ICG is efficient and aims to guarantee the protection of all the stakeholders involved, not only at the individual level, but also at the level of the entire financial system. It has already been noted that the weakness of market discipline calls for more intrusive supervision.

A sound prudential supervisory system and a properly designed regulatory framework may strike the right balance between the market freedom needed to foster innovation and strict structural controls intended to prevent future crises.

The action of supervisors in this field is crucial, and their coordinated action is also increasingly important in a context characterised by highly integrated markets. The recent crisis has shown how, even under a common set of rules (as in the European Union), the different supervisory approaches and the high degree of discretion left to national supervisors may lead to different results.

In some countries where a "light-touch supervision" approach was preferred, banks suffered huge losses, requiring bailing out with taxpayers' money.

In other countries, in contrast, the rigorous approach of the supervisory authorities based on wide-ranging supervision (preventing the development of a shadow banking system), close control over the process of financial innovation and intensive on-site and inspection-based supervision allowed the construction of a more resilient financial system better able to handle the crisis.

However, even the countries enjoying fairly intrusive supervision were finally dragged into the loop of the crisis due to two main reasons: on the one hand, the high degree of integration and interconnection of the financial markets caused the involvement of institutions of different jurisdictions; on the other hand, the impact of the financial crisis on the real global economy of course affected even those countries where financial risks had been properly managed thanks to the action of national financial system watchdogs.

In this respect, it is very important that integrated markets are not only regulated in the same way but also overseen in a uniform manner, as has been argued "*suitable rules alone are not enough to ensure good supervision: without strong operating practices, without stringent and efficacious action, crises will not be averted. This has been made abundantly clear by the dramatic recent experiences*" (Draghi 2011, p. 17).

The new architecture of European financial supervision is intended to reduce the differences among countries.

In the new pan-European framework a new body (the European Systemic Risk Board - ESRB) and three new authorities (European Banking Authority - EBA, European Securities and Markets Authority - ESMA, European Insurance and Occupational Pensions Authority - EIOPA, together the European Supervisory Authorities - ESAs) have been set up with different tasks and responsibilities. The ESRB and the three ESAs, together with the national supervisors, will form the European System of Financial Supervisors - ESFS.

The ESRB is responsible for the macro-prudential oversight of the European Union, analysing the inter-linkages between developments in the broader macroeconomic environment and the financial system (Box 3).

Even more important, for our purposes, is the role played by the ESAs and, in particular by the EBA. These new authorities are intended to be responsible for the micro-prudential oversight of the European Union financial system.

As we have noted above, the main shortcoming highlighted by the crisis lays in the differences among supervisory models across Europe, hampering appropriate coordination and an effective flow of information among supervisors. Moreover, these different approaches may have been one of the reasons behind the variation in the robustness of institutions among jurisdictions.

The new European supervisory framework may be able to tackle those problems: the ESAs will enact technical standards (also, if appropriate, in the form of a single rulebook) directly applicable to all jurisdictions and, to fully pursue its goals, should also impose the degree of strictness that supervisors have to apply with no room for national discretion. So that, in theory, all financial institutions, right across Europe, will be subject not only to the same rules but also to the same degree of intrusiveness of supervision.

In this new regulatory and supervisory environment, it is clear that most of the decisions about prudential regulation will be taken at the European level and the national authorities will have less freedom in exercising supervisory powers. The huge risk is that less rigorous approaches could prevail at the European level, undermining the effectiveness of supervision even in those countries where supervisors previously used their discretion to be stricter and build more resilient institutions.

This concern has been effectively raised also by one Author (Tonveronachi 2010, p. 373), who states that in the event of a single European financial market, the outcome will be an increase in rules with a reduction in discretion. If, on the other hand, routine supervision remains at the national level, the areas subject to national supervision will continue to show major discrepancies. It is also difficult to forecast whether future regulatory activity will involve real restructuring or just cosmetic measures - with the latter more probable due to the influence of the banking sector itself and some member states, as well as the incorporation of international standards.

In order to prevent future crises it is crucial for the ESAs and for the ESFS as a whole to adopt and impose those supervisory models that proved most successful during the recent financial turmoil; moreover, the financial industry has to understand that it will be the first beneficiary of a more resilient financial system, since this is the only way to ensure long-term profitability.

BOX 3 – Duties and powers of the ESRB and ESAs

Pursuant to whereas no. 10 of Parliament and Council Regulation 1092/2010 establishing the ESRB, the ESRB is required to “monitor and assess systemic risk in normal times for the purpose of mitigating the exposure of the system to the risk of failure of systemic components and enhancing the financial system’s resilience to shocks. In that respect, the ESRB should contribute to ensuring financial stability and mitigating the negative impacts on the internal market and the real economy. In order to accomplish its objectives, the ESRB should analyse all the relevant information”.

To fulfil its mandate, the ESRB can address warnings and recommendations to the ESAs, the European Institutions, States and national supervisors. Although warnings and recommendations are not binding, an “act or explain” mechanism is provided for by the regulation. In addition, pursuant to article 17 of the Regulation, if a recommendation has not been followed or acceptable justification of non compliance has not been provided, the ESRB has the power to inform the Council, escalating the issue to the political level.

The main functions of the ESAs are clearly stated in whereas no. 11 of Parliament and Council Regulation 1093/2010 establishing the EBA. According to this provision, the ESAs are required to: (i) ensure a high, effective and consistent level of regulation and supervision; (ii) protect public values such as the stability of the financial system, the transparency of markets and financial products, and the protection of depositors and investors; (iii) prevent regulatory arbitrage and guarantee a level playing field, and strengthen international supervisory coordination, for the benefit of the economy at large, including financial institutions and other stakeholders, consumers and employees; (iv) promote supervisory convergence and provide advice to the Union institutions in the areas of banking, payments, e-money regulation and supervision, and related corporate governance, auditing and financial reporting issues; (v) be entrusted with certain responsibilities for existing and new financial activities.

Several powers are assigned to the ESAs to enable them to carry out their duties; of these powers, the most important and the most relevant for our purposes are: (i) the power to issue draft harmonised technical standards in financial services, also through a single rulebook, in order to ensure a level playing field and adequate protection of depositors, investors and consumers; (ii) the power to settle disagreements in cross-border situations among national supervisors with binding effect; (iii) the power to adopt measures and actions against single institutions when the national supervisors fail to comply with ESA decisions.

With reference to point *sub* (i), it is worth to mention that draft technical standards issued by ESAs, in order to become binding, need to be formally adopted by the Commission. In fact, pursuant to article 290 of the Treaty on the functioning of the European Union (TFEU) legislative acts may be specified through non legislative acts (as technical standards are) only if there is a duly detailed delegation in the former. The only Institution that can be delegated is the Commission. Nonetheless, whereas no. 23 of Regulation 1093/2010 clearly states that ESA technical standards should be amended by the Commission only in extraordinary circumstances: “*The Commission should endorse those draft regulatory technical standards by means of delegated acts pursuant to Article 290 TFEU in order to give them binding legal effect. They should be subject to amendment only in very restricted and extraordinary circumstances, since the Authority (ESA) is the actor in close contact with and knowing best the daily functioning of financial markets. Draft regulatory technical standards would be subject to amendment if they were incompatible with Union law, did not respect the principle of proportionality or ran counter to the fundamental principles of the internal market for financial services as reflected in the acquis of Union financial services legislation. The Commission should not change the content of the draft regulatory technical standards prepared by the Authority (ESA) without prior coordination with the Authority (ESA). To ensure a smooth and expeditious adoption process for those standards, the Commission’s decision to endorse draft regulatory technical standards should be subject to a time limit*”.

The questions that need to be asked at this point are: is it worthwhile to set binding technical standards with reference to internal governance, or is the discretion left to national authorities by the current EBA principles sufficient to ensure its effectiveness? And is it reasonable also to set binding standards for organisational issues?

We have highlighted the importance of organisational issues, such as internal corporate governance, considered here as operational mitigation, on several occasions. Banks' entrepreneurial freedom must go hand in hand with a proper system of checks and balances. However, internal governance issues cannot be solved by simply enacting rules or sound principles: indeed, as the previous section clearly demonstrates, the principles adopted are quite broad and really, in the final analysis, simply common sense: to put it more plainly, there is nothing new on the table.

Rules, principles and guidelines alone are unable, as Draghi (2011, p. 17) has said, to ensure effective supervision and this is true above all with reference to internal corporate governance, a matter that is not easily manageable through strict rules because of its elusive nature.

In this respect, clear principles and rules are, of course, a good starting point but the role of the supervisor is even more crucial in really improving internal corporate governance. Only with strict on-site and off-site supervision is it possible to verify that banks are complying with their internal governance obligations and are pursuing the interest of all the stakeholders involved.

It is now possible to answer the questions posed above as follows: setting common rules and decreasing the national discretion, provided that a rigorous approach is followed at the EU level, is desirable in internal corporate governance issues, as elsewhere: the more precisely framed the rules, the better - the current principles are too general and do not add much to the current framework. However, rules alone are not sufficient to promote sound governance since organisational principles are by their very nature flexible; therefore, a stringent supervision is needed to verify whether banks implement these principles correctly.

The challenge for the new ESAs is not only to draft sound, effective rules but also to impose a tough supervisory approach of this kind right across the European Union.

6. Conclusions

This paper has analysed the role banks’ Internal Corporate Governace, seen as a means to the operational mitigation of the growing flexibility and freedom given to banks by a prudential principle-based regulation framework and a risk based-organisational based supervisory approach.

We have focused on the important role played by banks’ ICG during the crisis: those institutions with strong ICG were able to better identify risks and were not too seriously damaged by the crisis. The reinforcement of ICG – which, as already stated, in our opinion should follow the stakeholders’ welfare approach - must go hand in hand with the development of a more intrusive supervisory approach, to cope with market failures and safeguard the core principles of the current prudential regulatory framework. However, if this model is to work, more research is needed in different fields, for example: the definition and measurement of risk tolerance in banks; the impact of board composition on risk assumption and performance; and the development of NPAP policies. Finally, more in-depth study of corporate governance practices is needed.

A key question in the future debate is whether the approach we have described in this paper will be enough to overcome the shortcomings highlighted by the crisis or whether there will be still room for the reintroduction of structural reforms such as those under discussion in the UK on the separation between the investment banking and the retail/commercial banking through the so called ring-fencing (ICB 2011, p. 35).

A second point we have focused on in the paper is the argument that the successful enforcement of sound ICG requires not only the effective operation of uniform rules and principles across Europe, but also a deeply harmonized approach, which must reject light-touch supervision in favour of more intrusive, more systemic supervision. This is true in general but still needs to be emphasised with reference to ICG. Indeed, due to the intrinsic principle-based nature of ICG regulation, the proper performance of and compliance with organisational obligations will be less likely if appropriate intrusive supervision is not performed. Furthermore, the failure of market discipline has shown that only suitably intrusive supervision has any chance of preventing a serious misalignment between the interests of shareholders and managers and those of the other stakeholders. Otherwise, it may prove impossible to guarantee the soundness of the financial system without more structural reforms, of the kind recently recommend in the UK, which, and this is no coincidence, was one of the strongest promoters of the so-called “light-touch approach”.

Under the new architecture of European supervision, the main challenge for the ESFS as a whole and for the ESAs in particular, will be not only to issue precise, proper technical standards aimed at detailing EU law, but also and most important to enforce supervisory practice across all the member states, with a high but still fair degree of intrusiveness.

In the final analysis, “*national interests must not prevail, otherwise the credibility of the reform and financial stability itself will be undermined. Intermediaries cannot call for shared rules to ensure a level playing field and at the same time seek competitive advantages through their less strict application at national level*” (Draghi 2011, p. 7).

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