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*Basel 3, Pillar 2: the role of banks' internal governance
and control function*

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Abstract (*)

The analysis of the financial crisis has revealed not only major market and regulatory failures, but also shortcomings in supervisory approaches and in banks' systems of internal and external controls. These failures and shortcomings played a significant role in the origin and evolution of the crisis. In some important cases, the crisis revealed that banks' internal governance, and their internal control functions in particular, were ineffective or even unsuitable when faced with the demands of overseeing the growing levels of risk undertaken by intermediaries, and especially the interrelations between these exposures. So what are the implications of the crisis, the regulatory innovations now being implemented, and the changes in supervisory policies and practices, for banks' internal control systems? Given the role of internal control functions in risk-based supervision, what is the exact relationship between supervisor and supervised as defined by Basel 3, Pillar 2, with regard to ICAAP and SREP? One important lesson to emerge from recent experience is the need to encourage a new culture amongst banks, ensuring that they appreciate the key role of internal controls as a tool for managing and monitoring risk.

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Introduction

The aim of this paper is to provide a detailed investigation of banks' internal control functions in the light of the crisis and the subsequent regulatory and supervisory measures, first and foremost Basel 3.

The first step will be to survey internal governance and control functions within the regulatory and supervisory context at the international level. This will be followed by an investigation of the main regulatory failings and supervisory

shortcomings which played a key role in the origin and evolution of the crisis, to identify the extent to which banks' internal control functions can be blamed for the events which unfolded. It will be seen that in some cases the quality of these control functions, and the supervisory procedures adopted, made the crucial difference in terms of the impact of the crisis.

The next topic to be examined will be the changes now being made at the international level to both regulation and the supervisory function, with specific reference to Europe. These changes are the outcome of the failures and shortcomings that emerged during the crisis. Within the framework being formed by Basel 3, points will be identified for comment and evaluation concerning the implications for internal governance, in the context of the risk-based approach and Pillar 2. Attention will be focused in particular on the role of internal control functions in overseeing banks' risk exposure, since it was these functions' inability to monitor the ever-increasing risks undertaken, and their failure to consider or even understand the interrelations between them and thus their combined weight in a firm-wide perspective, that prevented them from providing effective protection against excessive levels of risk.

1. The Regulatory and Supervisory Context

To assess the potential effects of the crisis and the resulting regulatory measures on financial intermediaries' internal control functions, we first need to place these systems in their context within the regulatory and supervisory framework of the last few years.

The regulatory framework and the way in which supervisory controls are performed affect intermediaries from various points of view. First of all, they may affect strategic decision-making, the definition of operating and business lines, the risk-return combinations of the various areas of business and thus the degree of risk undertaken overall. Differences in the regulations in different national contexts tend to lead to regulatory competition, with forum shopping, as intermediaries choose to locate specific areas of business in countries with more permissive regulations and/or supervisory procedures than their countries of origin. Similarly, these factors may influence the chosen governance structure, the risk management system and last but not least the system of internal controls. They also impact on the compliance costs intermediaries incur to conform to the new regulations.

Outlining the key features of regulation and supervision at the international level, and in the European Union in particular, will enable us to describe the general framework within which the internal control system can then be placed.

Prudential regulation is based on the assumption that intermediaries are able to develop their own business and risk assumption strategies with the aid of sufficient capital resources, so called *financial mitigation*, an effective risk

management system and suitable organisational measures, *operational mitigation*. Over the years, there has been a gradual shift from a prescriptive regulatory approach to a principle-based approach: the regulations lay down general principles, objectives and minimal requirements and may also provide guidelines for application and define best practices. Intermediaries are free to define their own management models and choose their own organisational solutions and the procedures used for risk assumption and management, within the relevant regulatory framework. This also applies to the regulations on capital adequacy in relation to risk set out in the Basel Accord. This approach was reinforced by the transition from Basel 1 to Basel 2: regulatory measures on capital adequacy abandoned a prescriptive, one-size-fits-all approach in favour of an approach which assigned an active role to the intermediaries, who, within the guiding principles set out in the Accord, are now able to choose to adopt not only the standard method but also their own internal risk assessment models: in the case of credit risk, these are IRB – Internal Rating Based – models. For the insurance industry, the approach adopted in Solvency 2 introduced the same changes compared to that of Solvency 1.

The Markets in Financial Instruments Directive - MiFID adopts a similar approach with regard to the regulation of ethics and transparency. Here again, it is up to the intermediaries, within the context of the relevant regulatory principles, to define management and organisational models for the control of the risks relative to their securities business, especially the risk of conflict of interest, in order to protect the client, usually the weaker party.

Under both types of regulation, a criterion is applied that the costs for the intermediaries concerned must be as low as possible in proportion to their operational and dimensional complexity. Therefore, the costs of compliance vary depending on the strategies adopted by the intermediaries both for the possible adoption of internal risk rating models and with regard to the organisational structures created.

The cost of regulation became a hot topic during the late Nineties, when the European Union introduced a large body of regulatory measures. The aim of achieving better regulation led to the development of evidence-based regulation, involving Regulatory Impact Assessment (RIA) to assess the costs and benefits of the regulatory measure under consideration, the possible options and its effects on the various stakeholders: the financial industry to be regulated, savers and the economic system overall. RIA is carried out through consultations with the stakeholders affected by the specific regulations concerned, and thus also with the intermediaries. The economic consequences of the proposed regulation and any options are assessed by means of cost-benefit analysis (CBA), which must also assess the costs of compliance for the target intermediaries. This process, also intended to intensify the dialogue between supervisors and supervised and thus strengthen the accountability of the supervisory body, is extremely problematical, especially with regard to the method adopted for the CBA, but the appropriate procedures have now been more or less identified and considerable progress has been made during the last few years. The activities in

this area of supervisory authorities, such as the Bank of Italy, are particularly important (Cannata et al. 2010)

The supervisory approach adopted is defined as risk-based and organisation-based. The aim of the control procedures is to ensure that the intermediary is managed on a safe and sound basis: the focus is on the risks undertaken on the one hand, and on the adequacy of its capital structure, internal controls, and organisation for dealing with them on the other. The intermediaries' independence in the management of their business also implies that they are responsible for managing their risks, and is counter-balanced by the supervisory authorities' verification that the level of risk undertaken is consistent with the adequacy and efficacy of the internal risk buffers: capital adequacy, organisational processes and internal control system. The principle-based regulatory approach does not provide intermediaries with the certainty that the organisational and procedural measures adopted will be considered adequate by the supervisory authorities. Assistance in this area is provided by the guidelines supplied to the intermediaries by the authorities.

In this regulatory and supervisory approach, the effective operation of the internal control system is essential in guaranteeing safe and sound management, especially when the attention given to risk assessment may wane under pressure from competitive and performance considerations (Tarantola 2007). The quantitative prerequisites for capital adequacy under prudential risk management regulation frameworks must therefore be supported by efficient, effective internal control systems. These systems and the relative organisational solutions are developed independently by the intermediaries and are thus subject to assessment by the supervisory bodies.

The risk-based approach has come to the fore in the roles assigned to the intermediaries and the supervisory authorities respectively under Pillar 2 of the Basel Accord, within the supervisory review process. The former must assess their own capital adequacy through the Internal Capital Adequacy Assessment Process (ICAAP). The aim of this process is to ensure that risks are properly identified, assessed and monitored, that levels of capital adequate to the risk profiles undertaken (including in relation to risks not specifically envisaged by Pillar 1) are maintained, and that strict risk management systems are used and kept up-to-date. Responsibility for defining and implementing the ICAAP lies with the intermediary's top management, within the context of its internal governance, whose main obligations are to define the business objectives and appetite for risk, to establish the organisational structure, to assign roles and responsibilities and establish the structure of information flows and reporting, and to decide how the internal control system is to be organised¹. The supervisory authorities are

¹ "Internal Governance is codified in Article 22 & annex V of the CRD. Internal governance aims at ensuring that an institution's management body (both the supervisory and management function) is explicitly and transparently responsible for its business strategy, organisation and internal control. Internal governance is the responsibility of the management body (both the supervisory and management function). It is concerned mainly with setting the institution's business objectives and its appetite for risk, how the business of the institution is organised, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey, and how

required to perform the Supervisory Review and Evaluation Process (SREP), intended to verify and assess the ICAAP and the quality and soundness of the internal government process within which it is performed: efficient, effective internal control systems are therefore essential for the ICAAP. The assessments conducted by the supervisory authority are intended to evaluate any risks arising from the inadequacy of intermediaries' general governance, organisational and control systems, focusing on the ownership structure and management and control bodies, the corporate organisational structure, and the control functions (internal audit, risk management and compliance function).

Pillar 2 therefore assigns clearly defined, separate tasks to the supervised intermediaries and supervisory bodies, but the dialogue and interaction between the two sides is a key factor in the performance of the SREP. This interactive relationship should cover all aspects of risk assumption and internal governance, including internal control systems (CEBS 2006). The principle of proportionality to the nature, scale, complexity and systemic relevance of the supervised intermediary is applied to this dialogue.

2. The role of internal control systems

As we have just seen, internal control systems are a fundamental factor in safe and sound management in the banking industry. Their role operates on several levels: as a corporate management tool, as an aid in risk-based supervision as described above, and finally as a general mechanism for the defence and protection of stakeholders.

From the operational point of view, an effective, efficient internal control system is an aid to the achievement of long-term management and profitability targets and in ensuring reliable financial and management reporting. The internal control system is also of assistance in verifying operations' compliance with external standards and regulations, as well as with internal policies, rules and procedures (BCBS 1998).

We have already discussed the importance assigned to the internal control systems (ICS) by the supervisory authorities and the degree of attention they devote to the assessment of these systems, especially in relation to SREP and verification of the ICAAP under Pillar 2 of the Basel Accord. Guidelines for an effective internal control system are provided on several levels within the context of the principles of effective supervision. The main international framework of reference in this area is supplied by the Basel Committee on Banking Supervision (Table 1).

internal control (including risk control, compliance, and internal audit) is organised". (CEBS 2006, p.5)

Table 1, *Core Principles for Effective Banking Supervision* –
Basel Committee in Banking Supervision, October 2006

Principle 7 – Risk management process:

Supervisors must be satisfied that banks and banking groups have in place a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control or mitigate all material risks and to assess their overall capital adequacy in relation to their risk profile. These processes should be commensurate with the size and complexity of the institution.

Principle 17 – Internal control and audit:

Supervisors must be satisfied that banks have in place internal controls that are adequate for the size and complexity of their business. These should include clear arrangements for delegating authority and responsibility; separation of the functions that involve committing the bank, paying away its funds, and accounting for its assets and liabilities; reconciliation of these processes; safeguarding the bank's assets; and appropriate independent internal audit and compliance functions to test adherence to these controls as well as applicable laws and regulations.

Not only are internal controls of assistance in achieving effective supervision, but, as with any other kind of firm, they also offer stakeholders protection against financial crises and scandals, as pointed out by the European Commission in relation to the collapse of Parmalat (Conti, 2009). They are in fact the first line of defence for the various stakeholders, coming into effect before auditing, regulatory and supervisory activities and, the final resort, action by the law enforcement agencies. In view of the specific nature of their activities and the possible systemic contagion if any one institution should get into financial difficulties, in the case of banking sector, inadequate risk management by intermediaries may have very serious repercussions on the individual institution's reputation and ability to inspire confidence, and on the entire financial system.

It is thus essential for internal control systems to be appropriate to the new strategies adopted by intermediaries, while continuing to be proportional to the business's scale and degree of complexity as the relative principle requires. Special attention must be paid to integrated risk assessment and especially to the new products developed as part of the ongoing financial innovation process, which can be highly complex and opaque. The failure to implement adequate controls was a key factor in the financial crises which hit several intermediaries. Conversely, in some significant cases an appropriate ICS and more effective

supervision made the impact of the general financial crisis much less devastating (Tarantola, 2008; Senior Supervisors Group 2008, 2009).

3. The crisis: failures of the control and monitoring chain

The crisis arose in a complex international financial context, involving integrated, globalised markets, within which intermediaries had taken on ever-increasing risks and clearly failed to grasp their scale and the interrelations between them. With varying degrees of blame, this underestimation of risks and incapacity to implement an integrated approach to their assessment occurred throughout the entire control and monitoring chain: the regulators, the supervisory bodies, the rating agencies and the intermediaries themselves all proved incapable of adequately understanding, measuring and managing this entangled mass of risks. At the root of this situation was a process of financial innovation, initially beneficial but subsequently out of control in many respects, which allowed the transition from the traditional originate-to-hold to the new originate-to-distribute (OTD) model (Gualandri et. al, 2009). The resulting profound change in banks' mode of operation involved the creation on the one hand of inadequately regulated and supervised vehicles/intermediaries and on the other of complex, opaque financial instruments, which to make matters worse were also traded on the unregulated, low-liquidity OTC markets.

At the same time, by dismantling the barriers between commercial and investment banking, the deregulation in countries such as the USA allowed the biggest banks to extend their areas of operation. The rise in competition and the consolidation process, especially in Europe, led to the development of cross-border and cross-sector financial conglomerates. This increase in operational complexity, the relative implications for governance and the assumption of rising levels of risk by the major international banks and conglomerates were not matched by an appropriate evolution in either internal or external control mechanisms.

At the international level, the high level of risks undertaken and the growth in their interrelation were the areas in which the most obvious market failures were reported, and this discredited the idea that the market was capable, on its own, of setting itself better rules. With regard to these aspects, failures or at least shortcomings emerged in all the first three lines of defence described above: regulation, supervisory activity and internal and external control systems. In many cases, within the chain of controls it was the internal control systems that played the key role in determining the gravity of the crisis's impact. Specifically, weaknesses were revealed in corporate governance and internal control procedures and difficulties emerged in identifying and analysing risks at an

integrated, firm-wide level, and in assessing the interrelations between them². There were also weaknesses in the risk rating methods adopted and a failure to modify internal controls to ensure their adequacy to the intermediaries' new strategies. Basically, in many cases, internal control systems failed to fulfil one of their main purposes: that of helping to ensure the safe and sound management of the bank.

It is worth looking in greater depth at the case of the European Union, where supervision is still carried out at the national level, although regulation is becoming increasingly uniform (but with some significant differences), financial markets are strongly integrated and, for the euro area states, there is also a shared monetary policy. The fragmentation of supervisory regimes, the difference in the approaches, practices and quality of controls and the failure to share important information flows proved to be critical factors, especially when it came to assessing the situation of the cross-border groups and thus dealing with the crises that hit some of them and the relative systemic implications. The Colleges of Supervisors (CoS), not compulsory at the time, had only just started operation and were without any real power, even with regard to information.

4. Beyond the crisis: regulation, supervision and internal controls

We are currently witnessing the rethinking and rewriting of the rules governing financial intermediation. We need to bear in mind the fact that since we left the acute phase of the crisis behind us it has not always proved possible to maintain the strict approach envisaged when it was at its peak. With regard to some factors, the aim of protecting national financial industries and protecting each state's leading domestic banks has tended to prevail. The financial lobbies have made their influence felt, and purely political considerations have also come into play.

² The studies performed by the Senior Supervisors Group, SSG, which currently comprises the supervisory authorities of Canada, France, Germany, Italy, Japan, the Netherlands, Spain, Switzerland, the United Kingdom and the United States, are particularly interesting. The first survey, published on 6 March 2008, was entitled *Observations on Risk Management Practices during the Recent Market Turbulence*. It sets out to assess the efficacy of risk management practices during the previous period of stress in order to obtain guidance for possible changes in supervisory measures. The second report, dated 21 October 2009, relates to the lessons banks have learnt from the 2008 crisis with regard to risk management and identifies the main critical areas: *Risk Management Lessons from the Global Banking Crisis of 2008*.

The various steps taken at the international level have pursued two aims: on the one hand to reinforce the existing regulations to deal with the failures which emerged, and on the other to extend the regulatory framework to include those areas or rather aspects of banking operations which were found to have been partially or totally excluded, and which played a major role amongst the origins of the crisis.

The principle underlying the measures taken at the international level emerges from these comments by Mario Draghi (2009), Governor of the Bank of Italy, Chairman of the Financial Stability Board, and newly-appointed President of the ECB (scheduled to take charge in November 2011): *“The key message is straightforward: we need major changes. We need to build a system which is less leveraged, where capital and liquidity buffers are much stronger, where all institutions or infrastructure capable of posing significant risk are subject to appropriate oversight and safeguards, and where no institution is too big to fail. And we need a systematic effort to reverse the misalignments in incentives that came to characterize part of financial system”*. The Basel Committee has started work on a package of reforms to deal with the regulatory gaps and failures which emerged during the crisis with the aim of creating a “more resilient banking sector”, to ensure that the international banking system is better prepared to deal with both financial and economic shocks, and thus reduce the risk that these shocks may negatively impact on the real economy (BCBS December 2010 a).

The core of the regulatory activity is the reform and extension of Basel 2. With Basel 3, the three-pillar structure is retained, as is the basic philosophy of principle-based prudential regulation and risk-based supervision. Major criticisms have been directed at these approaches and the two main underlying theoretical assumptions: that the markets concerned are complete, and efficient and that individual banks’ top management can safely be entrusted with the primary responsibility for managing risks (FSA 2009, Masera 2010). As a consequence, the reintroduction of structural rules has been envisaged, with the design of the financial system’s morphology complemented with a few very simple prudential measures; in this scenario, supervisors would be granted less discretion and provided with clearer general rules (Tonveronachi 2010). The debate on this subject is important and complex, but far beyond the scope of this paper. Therefore, below we will concentrate on current regulatory activity and supervisory reforms, and the reinforcement of ICS in this context.

The main changes in Basel 3 concern Pillar 1, with the reinforcement of the capital adequacy coefficients applied for the coverage of risk, implemented by introducing a definition of capital which favours high-quality components, the introduction of a limit on financial leverage and of measures to promote the build up of capital that can be drawn down in periods of stress, and the provision of specific global regulatory standards on bank liquidity (BCBS, 2010 a).

However, the innovations do not only affect Pillar 1. There are also measures modifying Pillars 2 and 3, in the former case to improve banks’ governance and risk management and in the latter to reinforce their transparency and disclosure of information (BCBS 2009). Important guidelines concerning the reinforcement

of corporate governance emerge from the principles published by the BCBS (2010 b). The focus for Pillar 2 is on strengthening the standards of the Supervisory Review Process. The aim is to reinforce the ICAAP to enable banks to better identify and manage risks in a firm-wide perspective in response to the continual process of financial innovation still being witnessed, and thus put them in a position to fully assess their capital adequacy. It is then the responsibility of the supervisory authorities to assess, by means of the SREP, whether the ICAAP carried out by a given intermediary is capable of overcoming the limitations revealed by the recent crisis.

The number of standards and regulations now being issued or in the pipeline is considerable. In the case of Italy, banks' compliance with the new standards may be simplified by the ongoing procedures being carried out by the Bank of Italy, involving public consultations and the formation of advisory panels on the texts of the planned regulations (Enria 2010). The analysis of the impact of the regulations and the assessment of the costs and benefits of the measures currently under development will also help to establish a more constructive relationship between supervisors and supervised.

With regard to supervisory activities, the main aim has been to encourage more effective, efficient supervision in different contexts, and increase the emphasis on international cooperation. More effective supervision implies *"the importance of supervisors developing a system-wide understanding of markets, products and their interconnectedness in stressed times and taking a more proactive approach when necessary."* (Caruana 2010). Moreover, the failure of the so called "light touch supervision" has suggested the adoption of a new supervisory approach: *"more intrusive and more systemic"* (Financial Services Authority- Turner Report), 2009, p. 88). The Basel Committee is revising its "Core Principles for Effective Banking Supervision" in the light of the Financial Stability Board recommendations and other recent inputs.

To overcome the problem of the fragmentation of supervision on a national basis, the EU has moved towards a Europe-wide approach, operational since 1 January 2011, with a structure based on macro-prudential supervision to be performed by the European Systemic Risk Board (ESRB) and micro-prudential or firm-specific supervision, entrusted to the European System of Financial Supervisors (ESFS). The time is not yet ripe to assess the quality of the policies adopted, which are the outcome of a compromise between the status quo ante and the possible radical alternative of completely pan-European supervision: we will have to wait until the European supervision system becomes fully operational before evaluating and verifying the structure's adequacy for overcoming the problems revealed by the crisis.

For our purposes, it will be useful to take a closer look at the objectives of the ESFS, which consists of three agencies established under EU law, the European Supervisory Authorities (ESAs) created by transforming the sectorial supervisory committees from level 3 of the Lamfalussy process, the duties and responsibilities of which they have taken over (table 2). Specifically, their tasks will be to coordinate the national supervisory bodies and CoS in relation to cross-

border groups and the exchange of information between the various organisations, to gather information (concerning stress tests, for example) and establish and manage joint databases to monitor risks to the financial system, and to develop common rules for supervisory bodies by drawing up rule books with binding standards to encourage the harmonisation of prudential regulation in the various member states.

Table 2 *The European Supervisory Authorities - ESA*

Banking industry:	EBA - European Banking Authority
Securities industry:	ESMA - European Securities Markets Authority
Insurance and pension fund industry	EIOPA – European Insurance and Occupational Pensions Authority

The rule books will be particularly important in overcoming differences in national approaches to supervision and supervisory practices. Obviously, their development will have to be monitored carefully to find out which aspects they cover and what type of approach they adopt, and whether they introduce changes to the relationship between the authorities and the intermediaries they supervise, and therefore to the working of SREP in Pillar 2 and to the evaluation of ICSs.

To conclude, a few comments on internal control systems. As we have already said, the strengthening of risk control structures definitely requires effective supervision, coordinated between the various states, especially within the EU. Effective supervision depends on turn on the quality of banks' internal governance, their ability to fully assess and manage the risks they undertake, and the efficacy of their internal control systems (BCBS, October 2010). These are therefore the aspects on which action must focus, and the CEBS guidelines on internal governance (2010) give them due weight.

The Basel Committee is revising its guidelines on internal control systems to reinforce them and ensure they are adequate to intermediaries' new strategies and the complexity of the risks they are undertaking. This reinforcement forms part of a much wider plan of action which starts from the weaknesses which have emerged in corporate governance and risk assumption strategies (OECD 2010). It is important to ensure that risk management systems manage to respond to the ongoing process of financial innovation, and that the methodological shortcomings which emerged in existing risk measurement systems are overcome. The crux of the matter continues to be the identification of risks, their correct assessment and the pinpointing of the interrelations between them within a firm-wide strategy.

The challenge now facing us is the implementation of Pillar 2 of the Basel Accord. Under Basel 3, the framework of capital adequacy coefficients in Pillar 1 is revised and toughened, but attention must also be paid to Pillar 2 and the

strengthening of all risk management mechanisms. The importance of the measures relating to the ICAAP lies not only in their technical and quantitative aspects, financial mitigation, but also in their implications for the quality and organisation of internal governance and controls, operational mitigation. These two factors come to the fore when the supervisory authorities perform their checks through the SREP and begin their dialogue with the specific institution, starting from its business strategies, the risks undertaken, and their consistency with the internal governance.

Conclusions

There are lessons to be learnt from the crisis across the board, but especially in risk management: implementation of the new rules is now underway, with application of the principle of proportionality. Reinforcement of risk management mechanisms is required of all banking systems even those, like the Italian system, which were less hard hit by the crisis than those of other states, due to both the strategic and management policies of the intermediaries themselves, which showed a lower appetite for risk and a firmer commitment to the model of the commercial bank funded by a high level of private saving, and the more thorough, prudent supervisory strategies implemented by the supervisory authority, as in the case of the Bank of Italy.

There are essentially three critical points for the reinforcement of internal risk control systems, with significant impact on Pillar 2 of Basel 3 with regard to both the ICAAP and the SREP.

The first point concerns the firm's top management and its responsibilities with regard to internal governance. It is the top management's task to define the intermediary's strategies and its appetite for risk, and to establish and oversee its risk management systems: "As we all know, the right *"tone at the top"* is essential to ensure effective governance" (Caruana 2010). Steps must be taken to ensure that this system is not incompatible with the strategies pursued and the risks undertaken, as has occurred in the past.

As far as the second point is concerned, the reinforcement of internal risk management mechanisms also involves cultural growth: top managements which underestimate the importance of investing in internal control systems do so because they fail to consider the possible knock-on effects in terms of non-compliance and reputational risks, with negative impacts on value creation, for which the intermediary's governance would obviously be responsible.

The third critical point relates to the crucial subject of risks, their complexity and the interrelations between them. In this case, as we have already seen, extremely important aspects not only of a technical and quantitative but also of a qualitative nature come into play. From the qualitative point of view, a real culture of risk awareness needs to be developed at the corporate level, based on an

understanding of the risks the intermediary is undertaking and how they are managed, keeping the risk tolerance threshold firmly in mind.

One interesting tool in this area is the “new product approval policy” (NPAP), (CEBS 2010, Principle 20), for application to strategic decision-making relating to the development of new markets, products and services and significant changes to existing ones. The NPAP should provide input for the decision-making process by assessing all the aspects requiring consideration before the intermediary decides to enter new markets, trade in new products, launch new services or make significant changes to existing products and services.

Last but not least, we must always remember that at present, banks are facing the challenge of returning to profitability levels high enough to enable them to increase their capital assets in response to the (gradual) introduction of Basel 3. Therefore, they are under pressure to keep costs, including management costs, down, while on the other they need to find sustainable portfolio risk-return combinations compatible with the capital resources available. Therefore, they need to pay the greatest possible attention to the delicate balance between risk and return, while at the same time investing in their internal control systems: “Getting the balance right between the business units and risk management is key.”(Caruana 2010)

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