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Supervisory Bodies in the Italian Banking System

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Abstract: This article concerns the role of financial supervisory bodies in the Italian banking system, and the responsibility they must share in the recent Italian banking crisis. It first gives a theoretical explanation of the purpose of financial supervision, and various structural models by which supervision can be implemented. The article then discusses the structure of financial supervision in Italy specifically, and how responsibility is divided between Banca D'Italia and CONSOB. The roles of these bodies have evolved over time due to developments in financial markets, political changes, and the involvement of the EU. Finally, the article analyses how Banca D'Italia and CONSOB failed in their supervisory roles, and the way these failures were a cause of the Italian banking crisis, making reference to specific banks including Banca Monte dei Paschi di Siena (MPS), Banca Populare di Vicenza (BPVi) and Veneto Banca.

The Purpose of Supervisory Bodies

Financial supervision refers to supervision of banks, insurance companies, and securities traded on the financial market by public bodies. It implies both the oversight of the institutions engaging in financial activities, and the transactions these institutions engage in. Legal theorists describe financial supervision as belonging to 'public order'[1]. As such, public bodies enforce the regulations supervisory bodies enact, violations are penalized via criminal or civil sanctions, and incompatible contract clauses are declared null and void.

The overarching aim of financial supervision is to ensure the overall stability of the financial system, which might be described as a 'public good'. Maintaining the stability of the financial system facilitates the building up of public confidence, a necessary feature of any functioning financial system. Financial stability cannot be achieved by markets alone. Financial crises are proof of this fact.

The mark of a successful regime of financial supervision, then, is a stable financial system which is unaffected by major scandals and crises. Financial crises and scandals signify not only the culpability of financial institutions, but also a failure in the effective function of supervisory bodies.

A Typology of Supervisory Functions

As part of the overarching goal of ensuring the stability of financial systems, supervisory bodies perform three main functions.

Prudential supervision

Prudential supervision is the most essential form of financial supervision. The aim of prudential supervision is to safeguard the solvency of financial institutions, and therein their ability to honor their promises to depositors or policy holders. It is necessary in order to counteract deleterious incentives on the part of financial institutions, created by the existence of government 'safety-nets' which protect depositors and policyholders. Government safety-nets, which prevent financial institutions from failing, are crucial in that they prevent bank runs and protect depositors. However, safety-nets also have the undesirable consequences of creating moral hazard on the part of intermediaries, leading to an adverse selection problem.

The moral hazard problem occurs because depositors know they will not suffer losses if banks fail, given the existence of a government safety-net[2]. As such, they are dis-incentivized from imposing market-discipline on banks by withdrawing their money when they become aware that a particular bank is taking on too much risk. Consequently, banks which are protected by a government safety-net are incentivized to take on greater risk. The moral hazard problem is particularly prevalent in big banks, which are sometimes referred to as 'too big to fail'. Governments are particularly reluctant to allow big banks to fail and cause depositors and shareholders losses because this can have wide ranging detrimental effects on the economy.

The adverse selection problem occurs because the individuals who are most likely to carry out risky transactions, which might cause bank failure are most likely to take advantage of government safety-nets[3]. Risk-loving individuals are, as a result, more likely to enter the banking industry in order to engage in risky activities.

Prudential supervision corrects the moral hazard and adverse selection problems by monitoring and imposing limits on the amount of risk financial institutions can take on. Prudential instruments are complex and applied to each firm as a whole, including its branches and subsidiaries.

Basel III, the latest set of guidelines in a series of recommendations on banking laws and regulations issued by the Basel Committee on Banking Supervision (BSBS), sets out an international framework for what prudential supervision entails. The accord suggests that supervisory bodies require financial institutions to maintain enough cash reserves to cover risks incurred by operations[4]. Banks holding riskier assets should be required to have more capital on hand than those who maintain safer portfolios. Companies are mandated to publish the details of risky investments and also their risk management practices.

Conduct of business supervision

Conduct of business supervision aims to ensure that dealings in markets, and in individual contracts with investors are honest and fair. This usually entails requiring disclosures about proposed products and transactions, prescribing protective contract clauses, and by imposing specific conduct. Supervisory bodies police behavior that is likely to be detrimental to investors and the functioning of the markets. Rules on conflicts of interests, in particular, tend to receive a large amount of attention.

Increasing integration of financial markets, and the blurring of lines between banking, insurance, and securities have driven developments in conduct of business supervision. These developments have encouraged supervisory bodies to impose increasingly specific conduct on financial institutions[5].

Oversight function of central banks

In addition to the two other types of supervisory functions, central banks have a further, more general role in oversight. Central banks aim to safeguard the smooth functioning of payment systems, and regulate other factors which ensure overall financial stability[6]. This typically entails the oversight of payments and securities settlement systems.

The three types of financial supervision are often applied to a single entity, such as a large, listed bank[7]. A large listed bank will be subject to prudential rules, and may also raise systemic concerns relevant to the oversight function of central banks. As a listed company, a large listed bank will be bound to disclose all relevant information to the markets, and is subject to supervision by bodies responsible for oversight of conduct of business.

Patterns of Supervisory Design in Europe

The supervisory functions described above are carried out between various government entities. A number of different organizational schemes exist which delegate these functions between different bodies. The organization of supervisory bodies is very important, because it can have a significant effect on the effectiveness of financial supervision. As Eddy Wymersch, former Chairman of the Supervisory Board of the Banking, Finance and Insurance Commission, notes, there exists an ongoing 'search [in Europe] for an adequate format for the regulation and supervision of financial activity' which has been made more urgent by market developments[8].

Three main patterns of supervisory design exist in Europe, the first two of which are most common. A number of countries have organizational models, which are intermediate between two of the main organizational patterns[9].

1. An 'institutional' scheme, wherein the main line of business of each firm determines the supervisory regime which is applied to it.

2. A 'functional' scheme, wherein similar activities developed by firms are subject to the same type of supervision, irrespective of the legal status of the firms.

3. An 'integrated' or 'single supervisor' scheme, wherein all supervisory functions are concentrated in the hands of a single entity

Supervisory Design in Italy

Italy has adopted an 'institutional' approach to supervision, though it also borrows elements from the 'functional' approach.

An institutional scheme of supervision entails that the main business line of a financial services firm determines its classification, and its scope of authorized activities. If a firm intends to undertake banking business, it will have to be registered as a bank, and its activity is confined to 'banking'. The definition of 'banking', it should be noted, is almost always very wide in scope, encompassing almost all financial services except insurance[10].

In Italy, banking supervision is exercised by the Banca D'Italia (BI), while the Istituto di Vigilanza sulle Assicurazioni Private (ISVAP) is in charge of insurance supervision. The Commissione Nazionale per le Società e la Borsa (CONSOB) undertakes supervision of the securities market. However, the model borrows elements from the functional approach, as some subjects have been divided between the Banco D'Italia and CONSOB. In the securities sector, Banca d'Italia carries out the prudential supervision of financial intermediaries, while CONSOB undertakes conduct of business supervision.

While the institutional scheme has the advantages of fostering specialization and expertise, it 'is increasingly discussed and even criticized as a consequence of market evolutions' as Eddy Wymersch notes[11]. Increasingly, different lines of business (banking, insurance and securities services including asset management, specialised investment banking etc.) are becoming blurred, particularly when carried out by larger financial services groups. Some commentators suggest the institutional model lags behind market developments, and risks supervisory bodies overlooking certain detrimental transactions and business practices, which financial institutions might engage in[12].

Supervisory Role of Banco D'Italia

The BI's function is to undertake prudential supervision and conduct of business of banks, as well as prudential supervision of firms in the securities sector. Of course, the BI also carries out a wide-ranging oversight function as a central bank. The bank's powers with respect to financial supervision include:

- Issuing secondary legislation
- Acting to protect the transparency of the contractual conditions for banking and financial operations
- Carrying out documentary controls on intermediaries, which entails collection, processing and analysis of statistical, accounting and administrative data

- Conducting on-site examinations, through which regulators check the accuracy of data given to them by intermediaries and study the operations of intermediaries in more detail
- Fostering conduct on the part of intermediaries marked not only by compliance with laws but also by a substantive improvement in relations with customers
- Adopting ad-hoc corrective measures when serious problems are detected in intermediaries' financial situations

In sum, the BI imposes and enforces rules, most of which are prudential in nature and directed at ensuring that intermediaries have adequate capital, while 'respecting the entrepreneurial nature of the persons subject to supervision, who are free to choose their strategies, organizational models and investment policies', as materials published by the BI note[13].

Evolution of the supervisory role of the Banco D'Italia

Until the 2000s, the supervisory role of the BI went unchallenged, in relative terms. During the 1980s and 1990s, the Italian banking system was not subject to a major scandal with the exception of the bankruptcy of Banco Ambrosiano in 1981[14]. In 2005, however, two scandals, both involving foreign takeovers of Italian banks, changed the perception of the BI and its effectiveness in performing its supervisory role.

The first was the attempted takeover of Banco Nationale del Lavoro by Banco Bilbao Vizcaya Argentaria, a Spanish group, the second the attempted takeover of Banca Antonveneta by ABN Amro, a Dutch bank. The governor of BI at the time, Antonio Fazio, attempted to block these foreign bids. Meanwhile, he encouraged and facilitated counter bids by two Italian banks, Banca Popolare di Lodi, and Unipol. Both ABN Amro and Banco Bilbao Vizcaya Argentaria sent complaints to the European commission in response to Fazio's obstruction, as the commission had approved the deals, finding they were in compliance with European banking competition law.

Fazio's actions, in fact, were part of a deliberate policy of protecting the *italianita' delle banche* — the Italian ownership of banks operating in Italy[15]. Reacting to attempts of foreign banks to enter the Italian market in the 2000s, Fazio and high-level management of the BI opposed acquisitions of Italian banks by foreign banks on a consistent basis. Fazio never approved a foreign takeover of an Italian bank during his tenure. The BI claimed that these policies were an attempt to allow Italian banks to adjust to globalization and become more competitive internationally, but some commentators suggest the BI was engaging in a form of 'protectionism'[16].

Fazio's actions were heavily criticized both domestically, and by EU bodies and member states, resulting in his resignation in autumn of 2005. Responding to pressure from EU member states, the BI underwent reforms, which removed the power of the BI to regulate competition policy. This power was transferred to the Competition Authority. The BI's extensive supervisory powers were curtailed only by a small measure, however. The BI retained the power to evaluate and approve acquisitions and mergers based on prudential guidelines.

Fazio's successor, Mario Draghi, former managing director of Goldman Sachs, implemented a spate of further reforms aimed at increasing the 'openness, accountability, and efficiency' of the BI, as Kenneth Dyson and Martin Marcussen note. Draghi hoped to modernize the Italian banking sector, predominantly by encouraging mergers, and allowing foreign takeovers[17]. Draghi also reformed the Bank's structure and use of resources, aiming to increase efficiency, but also to encourage greater accountability and transparency. Though Draghi's reforms were welcome, they may also have had unintended detrimental effects. Unfortunately, the BI has not recovered its credibility in relation to its supervisory function since the events of 2005.

The European Banking Union and the Single Supervisory Mechanism

The European banking union was established in 2012 in response to the 2008 financial crisis and the subsequent sovereign debt crisis, with the purpose of '[creating] a safer financial sector for the single market'[18]. The European banking union integrates European banks more closely by establishing the 'Single Supervisory Mechanism' (SSM), which is applicable to 'significant' banks within EU countries, and the 'Single Resolution Mechanism' (SRM), which created a new standard for the resolution of failing banks supervised by the ECB.

Since the time at which the SSM went into force in November 2014, the responsibility for banking supervision of the largest European banks (of which there are currently 124) was transferred to the ECB. Through the SSM, the ECB, working jointly with national authorities, is able to enforce a single set of prudential rules on applicable banks. The large banks which are currently supervised by the SSM in Italy are Banca Carige, Montei di Paschi, Banco BPM, BPER Banca, Banca Popolare di Sondria, Banca Popolare di Vicenza, Barclays Bank plc., Credito Emiliano Holding, ICCREA Banca, Intesa Sanpaolo, Mediobanca, Unicredit, Unione di Banche Italiane Società per Azioni and Veneto Banca. The ECB now enjoys much of the same regulatory powers over these banks as the BI formerly did, with powers to conduct supervisory reviews, on-site inspections and investigations, grant or withdraw banking licenses, assess banks' acquisition and disposal of qualifying holdings, ensure compliance with EU prudential rules and set higher capital requirements in order to counteract financial risks[19]. The BI retains prudential supervisory powers over banks that do not meet the capital requirements to be included in the SSM's framework, in addition to the other elements of its supervisory role beyond prudential regulation of banks.

Given that the SSM has been in effect for less than three years, it is difficult to assess its influence on the effectiveness of financial supervision within the EU. Within Italy, signs suggest that the ECB is somewhat stricter and more thorough in its supervision than the BI has been in recent years given the ECB's use of stringent stress tests and other methods.

Supervisory Role of CONSOB

The Commissione Nazionale per le Società e la Borsa (CONSOB) is the public authority responsible for regulating the Italian financial markets. As materials published by CONSOB note, the purpose of its supervisory role is to 'protect investors and the efficiency, transparency and development of the market'[20]. As such, its supervisory powers are limited to conduct of business supervision in the securities sector. CONSOB's powers include:

- Regulating the provision of investment services and activities by intermediaries, the reporting obligations of companies listed on regulated markets and appeals for public investment
- Monitoring market management companies and the transparency and orderly performance of negotiations, as well as the transparency and correct nature of the conduct of intermediaries and financial advisors
- Sanctioning the entities which it monitors
- Checking the information disclosed to the market by entities launching appeals for public investment and information contained in the accounting documents of listed companies
- Detecting and punishing violations of regulations on insider trading and market abuse
- Communicating with operators and investors in order to foster a more effective service and to develop the financial awareness of investors
- Cooperating with the other domestic and international authorities appointed to organize and operate financial markets (such as the BI)

In sum, the role of the CONSOB is to supervise conduct of business, ensuring that dealings and transactions within the financial markets are honest and lawful.

Supervisory Bodies' Responsibility in the Italian Banking Crisis

The ongoing crisis in the Italian banking system is primarily the result of two factors, as Angelo Baglioni, professor of political economy at the Università Cattolica di Milano, notes[21]. First, a debilitating recession, which resulted in many borrowers becoming insolvent. Second, the mismanagement of certain banks, such as Banca Monte dei Paschi di Siena (MPS), which suffered as a result of unsound and even illegal practices. Given that the function of financial supervision is to protect the stability of the financial system by preventing crises and scandals, Italian banks themselves are not the only parties culpable for the second cause of the crisis. The BI and CONSOB, which govern banks, also must held be responsible. A number of specific cases of negligence on the part of supervisory bodies in Italy point to a wider pattern of neglect, which has played a part in allowing the crisis to occur.

Supervisory Bodies and MPS

One of the most significant factors in precipitating the downfall of MPS was the bank's risky acquisition of Banco Antonveneta in 2007. The deal was a huge drain on liquidity at MPS, costing 10 billion euros for the initial acquisition and a further 7 billion euros to repay loans to Santander. The ill-fated deal appeared to have been carried out with little due-diligence, and was predated by a period of questionable business practices by MPS's management which seemed to be aimed at disguising MPS's risk.

As part of its role in prudential supervision, the BI has the power to assess mergers based on their risk, and to green light or block them based on its judgments. When MPS began the process of its acquisition of Antonveneta in November 2007, the BI should have rigorously investigated the deal. Its assessment should have led the regulator to the conclusion that the merger be blocked, preventing a devastating mistake in MPS's history.

The failure of the BI to block the deal was particularly egregious given that the deal was *prima facie* unwise and reckless. Banco Santander had only bought Antonveneta a few months before MPS attempted to purchase it for a price, which was 39% higher than what Banco Santander had paid. There seemed to be no justification for the increase in the value of Antonveneta. John Andrew, an investment banker based in Milan who was involved in the birth of Antonveneta in 1996, commented that the deal 'on the surface looked crazy' and that the figures involved in the deal were 'huge, absolutely astonishing, with no mitigating factors for the purchase'[22].

Two crucial elements of the deal seem to have been overlooked by the BI during its approval process. First, the lack of due diligence on the part of MPS. The Antonveneta deal was impulsive and seemed to have been carried out without adequate research. In fact, a report by an Committee of Inquiry for the Regional Council of Tuscany released in 2016 concluded that the sale rested on a lack of due diligence of Antonveneta's accounts on the part of MPS. The seller, Banco Santander, was looking specifically for a buyer who would purchase Antonveneta without 'preventative due diligence'. As John Andrew commented, the BI should have thoroughly investigated questions related to MPS's due diligence process such as: 'What procedures did MPS follow? Who were its advisers and who was paying them? What structure was put in place to consider the deal? Who was involved at MPS? How often did they meet? What matters were discussed? What safeguards were established? Where are the records of meetings?'[23]

The second crucial element of the deal overlooked by the BI was a degree of uncertainty about how MPS would finance the acquisition. A document released by the BI in 2013 admits that questions about MPS's capital solidity arose during the considerations of whether to approve the acquisition of Antonveneta[24]. Clearly, these concerns were not investigated with enough rigor. It later was revealed that MPS engaged in three illegal operations to raise funds to finance the Antonveneta deal. As these operations involved securities, they were under the remit of CONSOB. A more thorough investigation by the BI, however, might have revealed concerns about the capital strength of MPS.

A document released in 2013 outlining the BI's oversight of MPS suggests that the BI's supervision of MPS was too little, too late. It states that the BI scrutinised MPS with 'continuous' and 'growing intensity' since the time that MPS acquired Antonveneta[25]. According to the document, the Bank of Italy's scrutiny of MPS grew more rigorous during the second half of 2009 and 2010. Inspectors were sent to

MPS's headquarters and officers, as part of an attempt to evaluate MPS's liquidity, after MPS engaged in a number of structured finance deals in 2008 and 2009, which burdened the bank with debt. The crucial fact is that thorough investigations of MPS began two years after the Antonveneta acquisition. It is not unreasonable to suggest that Mario Draghi's policy of encouraging mergers may have resulted in a less than satisfactory assessment of whether to green light the Antonveneta acquisition. The BI's sluggish supervision of MPS did not go unnoticed in Italy. Giulio Tremonti, a former finance minister, testified before a special session of parliament in Rome in 2013 that "For two or three years [following the Antonveneta acquisition] almost nothing was done" by the BI[26].

Supervisory Bodies and the Veneto Banks

One of the regions of Italy which has most suffered as a result of the Italian banking crisis is Veneto, a rich industrial area. Two banks in the Veneto region — Banca Populare di Vicenza (BPVi) and the smaller Veneto Banca have suffered deeply from bad loans and weak capital. Both were effectively bailed out by the state in 2016, when they were taken over by Atlante, the government-sponsored private equity fund. As of June of this year, both banks were classified as 'failing or likely to fail' by the ECB on the basis of their lack of capital[27]. Currently, both banks are in the process of being wound up under insolvency proceedings.

The demise of BPVi and Veneto Banca were precipitated by poor management. Both banks took on a glut of bad loans, the worst of them being non-performing loans. Fundamentally, this was due to the fact that loans were frequently made on the basis of personal relationships and trust between officials at the bank and loanees, instead of objective financial assessments[28]. Both Veneto Banca and BPVi were very closely attached to the local community and local government within Veneto, particularly due to the fact that they were unlisted, mutual banks, referred to as 'populari'. As populari, the two banks had a one-shareholder-one-vote governance structure. Local shareholders had a strong influence over the operations of the banks. The shares of both banks were sold in 'private markets', wherein share prices were determined by the bank's management in tandem with auditors, and approved by shareholder's annually[29]. During the years in which the banks performed well, shareholders were rewarded with strong returns as a result of the annual revaluations process, as well as 'kissing shares' — extra shares offered to shareholders[30].

The harmful relationship between the Veneto banks and the local region resulted in a situation at both banks in which loans greatly outstripped capital and deposits. In 2015, BPVi's loans outstripped the bank's capital and deposits by 30% according to estimates, while Veneto Banca's liquidity position was deemed 'critical' by the ECB[31]. The seemingly miraculous economic growth of the Veneto region, which both banks helped to fuel had been stymied by Italy's sovereign debt crisis that devastated the region's industries. Unable to attract investment, the Veneto banks became embroiled in crisis.

Commentators suggest the Bank of Italy and CONSOB are highly culpable in the failure of BPVi and Veneto Banca. Both regulators failed to act, allowing the crises within both banks to mount until Atlante stepped in.

The BI's failure to regulate the banks' behaviour is particularly egregious given that the tenuous position of both BPVi and Veneto Banca was widely known among the financial elite of Italy, according to the former Chief Executive of one of Italy's largest banks[32]. Once supervision of BPVi was taken over by the ECB under the rules of the Single Supervisory Mechanism, European regulators quickly identified irregularities and concerning business practices. A 2014 stress test of European 'significant' banks by the ECB, which was bemoaned as too stringent by officials at the BI, found that BPVi needed to raise capital[33]. In 2015, the ECB identified a 'loan-sharing' scheme, which occurred on at least two occasions in 2013 and 2014 at BPVi, wherein loans had been granted to customers to buy into two share issues[34]. The fact that the ECB swiftly identified irregularities at BPVi within months of beginning to supervise the bank suggests that Italian regulators, which seem to have failed to identify the problems, were far too lax in their supervision. Former Deputy Economy Minister Enrico Zanetti commented on the issue that 'if improper actions over share (sales) can take place for years, it means they don't work[35].' Zanetti suggested that 'more active controls that go beyond the object of… supervision' such as local information gathering or interviews of customers are required in order to gather sufficient information about the business practices of Italian banks[36].

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