

SUPERVISORY PROVISIONS CONCERNING BANKS' ORGANIZATION AND CORPORATE GOVERNANCE*

Introduction

1. For all companies, efficient organizational and corporate governance structures are an essential prerequisite for the pursuit of the company's objectives.

For banks they take on special importance because of the characteristics that distinguish banking and the public interests that are given specific consideration in legislation. Banks' organizational and corporate governance structures must not only respond to the corporate interest but also ensure conditions of sound and prudent management, the essential objective of regulation and supervisory controls.

With a decree signed on 5 August 2004 (published in the *Gazzetta Ufficiale* no. 200 of 26 August 2004), the Minister for the Economy, as chairman of the Interministerial Committee for Credit and Savings, acting on a proposal from the Bank of Italy, pursuant to Articles 53, 67, 107 and 114-*quater* of the Consolidated Law on Banking, issued general criteria and guidelines concerning the organization and corporate governance of banks, financial intermediaries entered in the special register referred to in Article 107 of the Consolidated Law on Banking, and electronic money institutions. With the present provisions the Bank of Italy implements that decree as regards banks and parent companies of banking groups, indicating the essential features of corporate governance for purposes of sound and prudent management.

This regulatory measure is based on the innovations introduced by the reform of company law and the coordination of it with the Consolidated Law on Banking. More specifically, it derives from the possibility granted banks to adopt different board models (the one-tier, the two-tier and the traditional model) and the use made of it in the banking sector. It takes into account the most recent developments in the legislative framework for corporate organization and governance, stemming from the implementation of the law for the protection of savings (Law 262/2005)¹ and the transposition of the new prudential rules for banks,² as well as the relevant principles and guidelines developed at national and international level.³

These provisions, which govern the role and functioning of the management and control bodies and the relationship of these bodies with the company's structure, are an integral part of a broader regulatory

* The Italian text alone is authentic.

¹ Reference is made, in particular, to the amendments to the Consolidated Law on Finance aimed at strengthening the effectiveness of controls and the protection of minority shareholders in listed companies.

² See Bank of Italy Circular 263 of 27 December 2006, especially the provisions of Title I, Chapter 1, Part 4, on "Risk management and control. The role of governing bodies".

³ Reference is made, in particular, to: "Corporate Governance Code", Corporate Governance Committee of Borsa Italiana S.p.A., 2006; "OECD Principles of Corporate Governance", OECD, April 2004; and "Enhancing corporate governance for banking organisations", Basel Committee for Banking Supervision, February 2006.

system bearing on other important aspects of corporate organization and governance: controls on banks' ownership and control structure and amendments to the bylaws, internal control systems, risk management, requirements for corporate officers, conflicts of interest, requirements for disclosure to investors and the market, and special rules established for listed companies and for investment services and activities.⁴

These provisions apply to banks and parent companies of banking groups. The latter are responsible, in particular, through their activity of direction and coordination, for ensuring the overall consistency of the group's governance structure, having regard above all to the need to establish adequate procedures for effective interaction between the governing bodies, units and functions of the different components of the group, especially those having control tasks.

2. In line with "better regulation" standards, these supervisory provisions are divided into general principles and implementing guidelines. By means of general rules, the former lay down the regulatory objectives, leaving it up to intermediaries to determine the best ways to achieve them, according to the proportionality principle.⁵ The implementing guidelines facilitate application of the general rules to some specific aspects without exhausting their prescriptive content. They are calibrated to the organizational and operating characteristics of the various types of bank. With a view to strengthening the minimum standards of banks' corporate organization and governance, the principles indicated concern: clear distinction of roles and responsibilities, appropriate checks and balances, balanced composition of governing bodies, effectiveness of controls, monitoring of all company risks and adequacy of information flows.

The governing bodies of a bank play a central role in determining, on the basis of careful assessment of the company's specific characteristics, corporate governance arrangements likely to ensure the pursuit of those objectives.

The Bank of Italy will consider complete and substantial compliance with these provisions in evaluating the adequacy of organizational and corporate governance arrangements. The provisions also constitute criteria for ascertaining the conformity of banks' bylaws with the principle of sound and prudent management, pursuant to Article 56 of the Consolidated Law on Banking.

3. These provisions do not generally refer to the various corporate bodies by name, as terms may vary with the board model chosen, but to the "strategic supervision", "management" and "control" functions, which need to be concretely assigned to the governing bodies or to their members in accordance with the Civil Code and supervisory regulations.

This approach serves to specify, among the powers and duties of the corporate bodies in the different board models, those that in every model are important for purposes of banking supervision. The strategic supervision function refers to the determination of the strategic guidelines and objectives of the bank and checking on their attainment; the management function consists in conducting business operations in order to execute those strategies; the control function consists in monitoring the regularity of operations and checking the adequacy of the bank's organization and accounting arrangements.

Given the diversity of board models and depending on the choices made in individual banks' bylaws, it is possible for more than one function to be performed by the same body or for more than one body to

⁴ For the latter, see the Bank of Italy-Consob joint regulation of 29 October 2007 on the organization and procedures of intermediaries, adopted pursuant to Article 6.2-*bis*, of the Consolidated Law on Finance.

⁵ This approach makes it possible, in applying these rules, to justify corporate governance choices as a function of the bank's size, organization and business characteristics. Other relevant factors in this regard may be a bank's stock exchange listing or membership of an international group.

share the same function. For example, since the strategic supervision function and the management function both bear on the operation of the company, they can be vested in the same governing body, typically the board of directors. In the two-tier model the supervisory board and the management board can concurrently perform strategic supervision where the bylaws empower the supervisory board to make decisions on strategic operations and business and financial plans (Civil Code, Article 2409-*terdecies*, first paragraph, point *f-bis*). In this case, however, for purposes of banking supervision the strategic supervision function will be considered to be assigned to the supervisory board.

In this perspective, the expression “body charged with the strategic supervision function” is to be understood as referring to the governing body in which are concentrated tasks of setting and/or overseeing the overall business strategy of the bank (for example, by means of examination of and decision on the company’s business or financial plans or its strategic transactions).⁶ The expression “body charged with the management function” is to be understood as referring to the governing body or the members thereof that have or have been delegated powers for current business operations, that is to say implementation of the policies decided in the exercise of the strategic supervision function. The general manager heads the internal structure and as such takes part in the management function. The board of auditors (*collegio sindacale*), supervisory board and management control committee are, in the different models, the bodies charged with the control function.

1. Board model and corporate governance project

General principles

In theory, there is no automatic correspondence between the characteristics of each board model and the structural and operational characteristics of each bank.

Banks will have to exercise their right to choose from among the three board models on the basis of a thorough self-evaluation enabling them to identify the model that in practice is most likely to ensure efficiency of operations and effectiveness of controls, while taking into account the costs associated with the adoption and functioning of the system selected.

In particular, banks will take the following elements into account: the ownership structure and the extent of recourse to the equity capital market; the size and complexity of operations; the medium and long-term strategic objectives; and the organizational structure of any group to which they belong.

The one-tier and two-tier models may also answer the needs of banks that operate to a significant extent on the international markets where those models are better known or that belong to groups in which those board models are prevalent.

The choice can also be affected by extraordinary factors or events that constitute moments of discontinuity in the life of the company (for example, mergers, changes in corporate control), without prejudice to the need for the model adopted to be consistent with the company’s long-term strategies.

Smaller banks may find it advantageous to use model bylaws and organizational practices developed with the assistance of their respective trade associations and evaluated by the Bank of Italy.

⁶ In line with this approach, Circular 263/2006 assigns to a single body, the one charged with strategic supervision, the function of setting the bank’s risk management and control policy and checking its implementation by the body charged with management.

The reasons underlying the choice of board model, which it is up to the shareholders' meeting to make, must be described as part of a more general corporate governance project representing the bylaws and internal organization; the project must be approved by the body charged with the strategic supervision function, with the favourable opinion of the body charged with the control function.

In the case of banking groups, the corporate governance project drafted by the parent company must illustrate the choices made to guarantee, at consolidated as well as individual level, effective and efficient management and control systems, and describe the organizational arrangements adopted for this purpose by the subsidiaries.

Implementing guidelines

The corporate governance project must:

- a) illustrate the reasons why the model chosen is more likely to ensure efficient management and effective controls;
- b) describe the specific choices concerning: the organizational structure (tasks, powers and composition of the governing bodies; delegated powers; accounting control system; incentive and remuneration schemes; information flows); shareholder rights (as regards withdrawal, quorums for shareholders' meetings to vote on resolutions and for challenging shareholder or board resolutions, proxy voting, etc.); the financial structure (classes of shares and limits on their transfer, other equity-like securities, segregated assets, etc.); procedures for handling conflicts of interest (for example, related-party transactions, obligations of corporate officers, etc.);
- c) in the case of parent companies, give an adequate description and explanation of the procedures for interaction between the corporate bodies and functions of the different components, with special attention to matters relating to the system of controls (powers of the governing bodies, information flows, risk management, etc.).⁷ Banks belonging to a group are not required to draw up the corporate governance project where the choices and explanations of its organizational arrangements are fully described in the parent company's project;
- d) be drawn up and sent to the Bank of Italy during the setting up of the bank at the same time as the application for authorization and, on the occasion of changes to the board model, together with the request for verification of the relevant amendment to the bylaws;
- e) be drawn up by all banks by 30 June 2009, updated whenever there are significant organizational changes, and be submitted to the Bank of Italy upon request;⁸
- f) mutual banks (*banche di credito cooperativo*) that adopt the standard bylaws prepared by their trade association and evaluated by the Bank of Italy are not required to prepare the corporate governance project.

2. Tasks and powers of the governing bodies

⁷ Reference is made, for example, to the possibility for a company's control bodies to request news and exchange information concerning subsidiaries, including by addressing such requests directly to the latter's governing bodies (see Articles 2403-*bis* and Article 2409-*quaterdecies* of the Civil Code and Article 151 et seq. of the Consolidated Law on Finance).

⁸ Banks must consider the possibility of making all or part of their corporate governance project public.

Tasks and powers of management and control must be divided in a clear and balanced manner between and within the governing bodies, avoiding concentration of power such as to impede a proper internal dialogue.

The configuration of the governing bodies must be compliant, in both form and substance, with the regulatory requirements for the various board models and avoid constituting structures (e.g. inter-body committees) with powers that could limit the prerogatives of the governing bodies.

2.1 Bodies charged with the strategic supervision and management functions

General principles

An efficient corporate governance system, based on the principle of checks and balances, requires that, where the strategic supervision and management functions are assigned to different bodies, the tasks and responsibilities of the two bodies must be clearly identified and separate, with the one responsible for deciding on the bank's strategic policies and continuously verifying their implementation and the other responsible for the company's management. There is an analogous need for a clear separation of roles with regard to the members of the body to which both functions are assigned.⁹ This separation of roles does not diminish the collegial nature of the body or the involvement of all its members in the performance of the activity, but allows a more precise configuration of the moments (of strategic supervision and management) through which the body performs its tasks. In smaller banks whose operations are not especially complex, it is possible for the above-mentioned separation not to exist, considering, among other things, the contribution made by the general manager in performing the tasks of management.

The chairman of the board of directors plays an important role in promoting internal dialogue and ensuring checks and balances, consistently with the tasks assigned to him by the Civil Code as regards the organization of the board's activity and the circulation of information.¹⁰

An analogous role of promoting dialogue with the management function must be played in the two-tier model by the chairman of the body assigned to the strategic supervision function. When this function is assigned to the supervisory board, its chairman must maintain equidistance between the various functions in order to ensure objective, impartial liaison between them.

Implementing guidelines

- a) Delegated powers within the body charged with the management function must be specified in detail and be clear and precise, including as regards the indication of quantity or value limits and how they are to be

⁹ The new provisions of the Civil Code clearly identify the tasks and responsibilities of the members of the board of directors, distinguishing between directors with delegated powers and non-executive directors. In effect, the Code distinguishes between tasks of "attending to" the adequacy of the organizational, managerial and accounting structure, performed by the bodies with delegated powers, and tasks of "evaluating" that structure and, in general, the performance of operations, carried out by the board of directors. This arrangement enhances the value of the supervision that must be performed by the board of directors as a whole on the bank's current business operations, which are entrusted to those having executive functions (Article 2381 of the Civil Code).

¹⁰ See Article 2381, first paragraph, of the Civil Code, referred to by Article 2409-*noviesdecies* for the one-tier model.

exercised. This is also to allow the collegial body to verify exactly whether they have been correctly used and to exercise its powers of direction and revocation.

- b) In addition to the tasks that by law cannot be delegated, the following may not be delegated: decisions concerning strategic policies and transactions and business and financial plans; the appointment of the general manager; the acquisition and disposal of major holdings; the approval and amendment of major internal rules and regulations; the establishment of board committees; and the appointment of the head of the internal audit and compliance functions. In the case of parent companies of groups, transactions involving non-material changes in the composition of the group may be delegated.
- c) When, with the aim of achieving consistency in the management of the company, major operational powers are delegated to a single managing director, it is necessary to maintain a correct and constructive internal dialogue; to this end, even when the power to propose resolutions to be voted by the board is assigned on an ordinary basis to that director, other board members must also be ensured the right to formulate proposals, and special attention and diligence must be exercised to ensure that the board receives complete and timely information.
- d) The simultaneous presence of an executive committee and a managing director or of more than one managing director is justified only in particularly complex banks in terms of size or operational structure and requires a clear division of powers and responsibilities. In less complex banks the appointment of both a general manager and a managing director should be avoided. The presence of more than one general manager is permitted in exceptional cases to meet the need for an extensive executive structure (in relation to the bank's size, cross-border activity or operational complexity), provided the duties of each general manager are clearly specified and consistency in the management of the company is guaranteed.
- e) The chairman of the board of directors promotes the effective functioning of the system of corporate governance and ensures the balance of powers vis-à-vis the managing director and the other executive directors; he is the interlocutor for the internal control bodies and internal committees. In order to perform his function effectively, the chairman must have a non-executive role and not be involved de facto in the current business of the company, except for the possibility of standing in for executive directors in exceptional circumstances. These provisions also apply to the chairman of the management board when the supervisory board does not perform the strategic supervision function.
- f) The assignment of strategic supervision tasks to the supervisory board must not cause the latter to interfere in the management of the company, in order not to distort its control function and curb the autonomy of the management body. Insofar as the Civil Code permits, the bank's bylaws must: i) clearly identify the scope of the matters assigned to the supervisory board; ii) restrict such matters exclusively to transactions that are really "strategic" and exclude the broadening of the range of such transactions; iii) distinguish the nature and content of the decision-making authority granted to the supervisory board with respect to the powers of the management board, without prejudice to the latter's power to make proposals; iv) identify the fundamental strategic transactions (for example, mergers, major acquisitions) for which the supervisory board may submit an opinion to the management board for the preparation of

the related proposal; and v) assign the task of designating the executive directors of group companies to the management board of the parent company with a view to ensuring consistency in the management of the group.

- g) Taking account of the provisions of the Civil Code concerning the interests of directors in the traditional and one-tier board models (Articles 2391 and 2409-*noviesdecies*, first paragraph, of the Civil Code), in the event of the supervisory board being assigned the strategic supervision function, banks must adopt bylaws ensuring adequate transparency and substantial fairness in the taking of decisions concerning transactions in which members of the supervisory board have interests, either directly or on behalf of third parties.¹¹ In such circumstances members of the supervisory board must disclose their interests and specify the latter's nature, terms, origin and extent. The resolution adopted must also adequately explain the reasons for the transaction and the benefit for the company.

2.2 Body charged with the control function

General principles

The control body oversees compliance with laws, regulations and the bylaws, proper management and the adequacy of the bank's organizational and accounting structures.

The law entrusts the control function to the board of auditors (*collegio sindacale*) in the traditional system, to the supervisory board in the two-tier system, and to the management control committee (Article 2409-*octiesdecies* of the Civil Code) in the one-tier system.

In view of the importance of the above-mentioned tasks, the Consolidated Law on Banking (Article 52) provides for a functional link with the supervisory authority: the control body must inform the Bank of Italy without delay of every act or fact it comes to know of that may constitute an irregularity in the management of banks or a violation of the provisions governing banking. To this end, banks' bylaws, regardless of the board model adopted, must grant the control body the relevant tasks and powers.

The control body is responsible for overseeing the working of the overall system of internal controls. Considering the variety of corporate functions and structures having control tasks and responsibilities,¹² the control body is required to verify the effectiveness of all the structures and functions involved in the control system and their coordination and to promote action to correct any shortcomings and irregularities found.

The control body uses the company's internal control structures and functions to perform the necessary checks and tests and receives appropriate flows of information from them of a periodic nature or

¹¹ This is without prejudice to the application of the Consolidated Law on Banking concerning the obligations of banks' directors and exposures to related parties (Articles 136 and 53).

¹² E.g. second-level control functions (risk management and compliance); third-level control functions (internal audit); and the supervisory panel set up under Legislative Decree 231/2001, where applicable.

regarding specific corporate situations or developments. In view of this close link, it is desirable that the control body be called upon to give its opinion in decisions concerning the appointment of the heads of internal control functions (especially internal audit and compliance functions) and the specification of the essential elements of the architecture of the control system (powers, responsibilities, resources, information flows, and the handling of conflicts of interest).

The control body oversees the adequacy of the risk management and control system. To this end it must have an appropriate knowledge of the systems used by the intermediary, how they actually work, and their ability to cover every aspect of the company's operations. Special attention must be paid to the systems for determining capital requirements, with respect to both organizational and quantitative aspects. In view of the importance of the risks not expressly covered by the prudential regulation of the "first pillar" (such as reputational and strategic risk), the control body is also required to ensure that the internal capital adequacy assessment process (ICAAP) is appropriate and meets the regulatory standards.

As part of the controls on proper management, the control body is concerned with the causes of and remedies for operational irregularities, anomalous developments, and shortcomings in organizational and accounting structures. Special attention must be paid to compliance with the rules on conflicts of interest.¹³

In determining the frequency, scale and scope of the controls to be carried out and in assessing the irregularities found, the control body must take account of both the potential losses for the intermediary and the harm to its reputation and the confidence of the public.

Controls must extend across the entire company and include checks on systems and procedures (information systems and administrative and accounting mechanisms, etc.), lines of business (credit and finance, etc.), and operations (introduction of new products, entry into new lines of business or geographical areas, business continuity, outsourcing, etc.).

The bodies charged with the control function in the parent company are also required to verify the proper performance by the parent company of strategic and operational oversight of the companies belonging to the group.

When the one-tier or two-tier board model has been adopted, it becomes especially important to ensure the efficiency and effectiveness of the functions performed by the control body. Pursuant to Article 52 of the Consolidated Law on Banking referred to above, banks' bylaws must assign the control body tasks and powers that will allow it to fulfil its obligation to inform the Bank of Italy of irregularities in the management of banks or violations of the law.

In the one-tier and two-tier board models banks must take appropriate steps in their bylaws, rules and organizational arrangements to prevent adverse effects on the effectiveness of controls due to the presence of management and control functions in the same body. In the two-tier model, where the strategic supervision

¹³ Reference is made here both to Articles 2391 and 2391-*bis* of the Civil Code and to the bank-specific provisions concerned with exposures to related parties and obligations of banks' directors (Articles 53 and 136 of the Consolidated Law on Banking). Also important in this respect are the provisions of the Consolidated Law on Finance governing conflicts of interest in the supply of investment services (Article 6.2-*bis*).

function is assigned to the supervisory board or the latter has a large number of members, the above-mentioned objectives must be ensured through the creation of a special committee (internal control committee), a point of reference for the corporate internal control functions and units.

Where the one-tier or two-tier board model has been adopted, the terms of office of the members of the control body must have appropriate stability in order to guarantee the continuity of control activity.

In banks that are obliged by law or have chosen in their bylaws¹⁴ to entrust the audit of their accounts to an external auditor, the control body, which is principally required to verify proper management, must retain tasks connected with the appropriateness and functionality of the accounting system, including the related information systems, in order to ensure a true and fair view of the company's activities. External auditors are also subject to the obligation to inform the Bank of Italy referred to in Article 52.2 of the Consolidated Law on Banking.

Implementing guidelines

For all the board models:

- a) in performing its tasks the control body avails of the information flows coming from the internal control functions and structures; the heads of the internal audit and compliance functions must also send their reports directly to the control body;
- b) the control body of the parent company must operate in close coordination with the control bodies of its subsidiaries;
- c) without prejudice to the obligation to inform the Bank of Italy, the control body must notify the bodies with strategic supervision and management functions of any shortcomings and irregularities found, request the adoption of appropriate corrective measures and subsequently verify their effectiveness;
- d) the control body must periodically verify its adequacy in terms of powers, functioning and composition, taking into account the scale, complexity and activities of the intermediary (see Section 3);
- e) the members of control bodies may not serve in other bodies than control bodies¹⁵ in other companies of the group or financial conglomerate or companies in which the bank directly or indirectly holds a strategic shareholding;¹⁶
- f) the choice of external auditor must be made after carefully assessing its professionalism and experience, so as to ensure they are proportionate to the size and complexity of the bank's operations;

¹⁴ For mutual banks see Article 52.2-*bis* of the Consolidated Law on Banking, which states that the task of checking the accounts may be assigned to the board of auditors.

¹⁵ The prohibition includes serving on management control committees.

¹⁶ For this purpose "strategic shareholding" means a holding equal to at least 10 per cent of the share capital or voting rights in the ordinary shareholders' meeting of the investee company and 5 per cent of the consolidated regulatory capital of the banking group (or of the solo capital in the case of banks that do not belong to a banking group).

- g) adequate forms of ongoing coordination must be provided between the control body and the external auditor.

The bylaws of banks that adopt the two-tier board model must lay down that:

- h) pursuant to Article 52 of the Consolidated Law on Banking, the supervisory board may carry out inspections and make checks at any time. The powers of inspection are to be exercised so as to ensure the efficient performance of the bank's operations; in particular, where the supervisory board has more than six members, the bylaws shall provide for such powers to be exercised by a board committee (the internal control committee; see Section 3);¹⁷
- i) the members of the supervisory board may ask the members of the management board for information on the performance of the company's business or particular transactions, establishing procedures for the exercise of such prerogative that are not likely to hinder the company's operations;
- j) at least one member of the supervisory board must participate in the meetings of the management board. Such participation, which is strictly related to the performance of the control functions, is to be reserved exclusively to members of the internal control committee or, in its absence, to the persons best suited to perform such function according to the required standards of professionalism and independence;
- k) removal of members of the supervisory board or of the internal control committee, if established, must be duly motivated.¹⁸

The bylaws of banks that adopt the one-tier board model must:

- l) expressly entrust the management control committee with the task of overseeing compliance with the law, regulations and the bylaws, pursuant to Article 52 of the Consolidated Law on Banking;
- m) provide for the management control committee to carry out inspections and make checks at any time;
- n) assign the task of appointing and removing members of the management control committee to the shareholders' meeting pursuant to Article 2409-*octiesdecies* of the Civil Code; removals must be duly motivated.

3. *Composition of governing bodies*

General principles

The composition of the governing bodies is crucial to the effective performance of the duties entrusted to them by law, supervisory regulations and the bylaws. The division of duties and responsibilities

¹⁷ This solution is an organizational arrangement by means of which to increase the effectiveness of the control function, responsibility for which nonetheless rests with the supervisory board as a whole. It does not exclude that the supervisory board may decide to have inspections carried out by the committee.

¹⁸ Substitution of members of the internal control committee by the supervisory board must also be motivated.

within governing bodies must be consistent with the roles assigned to them within the board model that has been chosen.

The number of members of the governing bodies must be adequate to the bank's size and organizational complexity in order to ensure effective oversight of all its operations as concerns management and control. The bodies must not be too large: an excessive number of members is likely to diminish the incentive of each to be diligent in carrying out assignments and impede the proper functioning of the body.

In terms of qualifications, the members of the governing bodies must have experience adequate to the size and operational complexity of the bank, without prejudice to the requirements laid down by Article 26 of the Consolidated Law on Banking, and they must devote sufficient time and resources to discharging their duties.

The presence of a sufficient number of non-executive members¹⁹ with well-defined roles and duties who effectively serve as counterweight to the executive members and the management of the bank helps to foster dialogue within the body to which they belong, especially where a single body exercises different functions (strategic supervision and management).

The body charged with the strategic supervision function must include independent members who monitor, with independence of judgment, the management of the bank, and help to ensure that this is in the interest of the bank and consistent with the objectives of sound and prudent management.²⁰ In large and operationally complex companies, the establishment – within the body charged with the strategic supervision function – of special committees containing independent members (charged with examining, advising and proposing) facilitates decision-making, especially in sectors of activity where conflicts of interest are most likely to arise.

In general, in order to ensure a coherent governance structure, the tasks of the committees and their composition must mirror those of the body within which they are established. Their overall organization must not entail any overlapping of responsibilities or impede decision-making processes; their activities must be set out in formal terms.

The procedures for the appointment and removal of governing bodies must be transparent and laid down in the bylaws. They must guarantee adequate representation within the governing bodies of the various components of the shareholder base (institutional investors, qualified minorities). Especially when this base

¹⁹ In line with the Civil Code, “non-executive members” means those who are not members of the executive committee, do not have special mandates and do not perform, even merely *de facto*, functions relating to the current business of the company.

²⁰ The provision gives a supervisory indication of the importance of independent members; detailed rules are to be issued by the Minister for the Economy and Finance pursuant to Article 26 of the Consolidated Law on Banking. Listed companies are subject to Articles 147-*ter*, paragraph 4, and 147-*quater* of the Consolidated Law on Finance, which require that the number of independent members on the board of directors and the management board be in relation to the total number of members. In general, for the two-tier and one-tier models of corporate governance, see Articles 2409-*duodecies*, tenth paragraph, and 2409-*septiesdecies*, second paragraph, of the Civil Code. The composition of governing bodies of listed companies is also subject to Articles 147-*ter* and 148 of the Consolidated Law on Finance and the related implementing regulations, which govern the appointment of members representing minority shareholders.

is widely distributed (as, for example, in the case of cooperative banks – *banche popolari*) mechanisms must be put in place to facilitate the broad participation of shareholders in the general meeting.

Implementing guidelines

- a) The qualifications of board members to perform their functions, in terms of experience, availability of time and, where required, independence, are subject to the judgment of the body to which they belong, which must verify such qualifications and their continuation in time.
- b) Without prejudice to the obligations laid down by the rules for listed banks,²¹ on the occasion of the appointment of board members and continuing over time, the number of similar positions held must be verified and evaluated, with special attention to those requiring greater involvement in the current business of the company. The limits to the holding of multiple positions must be the subject of specific provisions of company bylaws or rules.
- c) Assigning the function of strategic supervision to the supervisory board is consistent with the management board having a small number of mainly executive members.²² If the supervisory board has only control duties, the management board must include an adequate number of non-executive members.
- d) The non-executive members must:
 - acquire from the management, the internal audit function and the other internal control functions, by means of the internal committees, information on the organization and management of the company;
 - not be involved, even de facto, in the current business of the company and must avoid conflicts of interest;
 - be actively engaged in performing the duties assigned to them, including in terms of allocation of time;
 - take part in the appointment and removal of the persons responsible for the internal control and risk management functions (in particular, internal audit and compliance).
- e) The body charged with the strategic supervision function must include a number of independent members commensurate with the size of the body and the business of the bank.²³ They must have the professional experience and authority needed to guarantee a high level of discussion within the body to which they belong and to contribute significantly to shaping the body's decisions.
- f) In large and operationally complex companies, within the body charged with the strategic supervision function:

²¹ See Article 148-*bis* of the Consolidated Law on Finance and its implementing provisions imposing limits on the holding of multiple positions. In general, see also Articles 2400, fourth paragraph, and 2409-*quaterdecies*, first paragraph, of the Civil Code.

²² Without prejudice to Article 147-*quater* of the Consolidated Law on Finance.

²³ See footnote 20.

- special committees must be established (e.g. internal control, remuneration and appointment committees) for matters where the potential for conflicts of interest is greatest;
 - the composition, mandate, powers (of examining, advising and proposing), available resources and internal rules of the committees must be clearly specified; the formation of the committees must not entail a limitation of the decision-making powers and responsibility of the governing bodies within which they are constituted;
 - the number of members of these committees, ordinarily ranging from 3 to 5, must be commensurate with their duties, and they must include independent members.
- g) In the two-tier model, the internal control committee, which is required where the supervisory board is charged with the strategic supervision function or where it is of broad membership, must be composed of persons with proper professional qualifications and they must all be independent. The chairman of the supervisory board, when the latter performs the strategic supervision function, in order to remain equally detached from the various functions, may not be a member of the internal control committee.
- h) In the one-tier model, in order to ensure effective controls, the management control committee must have at least three members.
- i) The composition of the bodies and the appointment and removal of their members must be regulated in the bylaws in a clear and transparent manner, with no reference to agreements, structures or persons external to the company. The renewal of the governing bodies must not be made excessively difficult.

4. Compensation and incentive mechanisms

General principles

Appropriate remuneration and incentive mechanisms for banks' directors and managers can enhance the competitiveness and governance of their businesses. Compensation, in particular that of persons with key roles within the corporate structure, should attract and retain persons with skills and experience meeting banks' needs.

At the same time, remuneration schemes must not conflict with a bank's prudent risk management policies or its long-term strategy. In particular, equity-based incentives (e.g. stock options) or performance-linked pay must take account of the risk borne by banks and be structured so as to avoid generating incentives that conflict with their long-term interests.

Implementing guidelines

- a) The bylaws shall provide that the shareholders' meeting, besides establishing the remuneration of members of the bodies it has appointed, approve: (i) the remuneration policies²⁴ for directors, employees and external collaborators, and (ii) equity-based compensation schemes (e.g. stock options).²⁵ The approval of remuneration policies and compensation schemes must evidence their conformity with prudent risk management and the company's long-term objectives; they must also ensure an appropriate balance between the fixed and variable components, including in the case of the latter, risk-weighting systems and mechanisms designed to ensure that compensation is linked to effective and lasting results.²⁶ The shareholders' meeting must be provided with adequate information on the implementation of remuneration policies.
- b) In large and operationally complex companies the body²⁷ that determines the remuneration of directors charged with special tasks is required to have a committee, a majority of whose members must be independent, to provide advice and make proposals on directors' remuneration and perform advisory tasks in relation to determining the criteria for managers' remuneration. Remuneration for special tasks performed by members of the supervisory board is fixed by the shareholders' meeting.²⁸
- c) Members of the body charged with the control function should be excluded from equity-based compensation or bonuses linked to corporate performance. Non-executive directors should normally be excluded from incentive-based mechanisms, which in any case should represent only a small proportion of their total remuneration and be established in strict observance of all the precautions set out in point (a).
- d) The remuneration of persons responsible for the internal control function²⁹ and of the manager responsible for preparing the financial statements must be commensurate with their considerable responsibilities and commitment. Incentive-based mechanisms must be consistent with the assigned tasks: bonuses linked to corporate results should be excluded except for valid and justifiable reasons and

²⁴ In accordance with the Commission Recommendation of 14 December 2004 (2004/913/EC), the statement of remuneration policy must include the reasons and criteria on which remuneration is based and give details of the relative importance of the fixed and variable components (including performance-linked bonuses and equity-based remuneration) and of the compensation paid in connection with the termination of service.

²⁵ With regard to the provisions of the Civil Code and the Consolidated Law on Finance, under the two-tier system the supervisory board is responsible: (i) for approving remuneration policies for employees and external collaborators and (ii) exclusively in the case of banks that are not listed (and do not issue financial instruments widely distributed among the public under the terms of Article 116 of the Consolidated Law on Finance), for approving equity-based compensation schemes for employees and external collaborators.

²⁶ For example, in the case of stock options, appropriate vesting periods and holding periods may be established to ensure that economic benefits are granted gradually; in the case of bonuses, parameters may be based on financial results achieved over a number of years.

²⁷ The board of directors, pursuant to Article 2389, third paragraph, of the Civil Code, cited in connection with the one-tier model in Article 2409-*noviesdecies*, first paragraph, of the Civil Code, or the supervisory board, pursuant to Article 2409-*terdecies*, first paragraph, point (a) of the Civil Code.

²⁸ See Article 2364-*bis*, first paragraph, point (2) and Article 2402 of the Civil Code which apply to the supervisory board in accordance with Article 2409-*quaterdecies*, paragraph 1, of the Civil Code.

²⁹ For example the heads of the internal audit, compliance and risk management functions.

particular care should be taken to observe the precautions set out in letter (a) regarding equity-based compensation.

- e) The body charged with the strategic supervision function must also be involved in designing the system of incentives and remuneration for persons holding top positions in the bank's organizational and operational structure. This body must satisfy itself that the system takes due account of risk limitation policies and is consistent with the bank's long-term objectives, corporate culture and corporate governance and internal control arrangements. The parameters for setting the amount of remuneration must be clearly specified and objective and must permit immediate evaluation. Further, the ratio of the incentive-based component to total remuneration must be defined and carefully evaluated to prevent the former from giving rise to conflicts of interest.

5. Information flows

General principles

The circulation of information among and within governing bodies is a sine qua non for the attainment of the objectives of efficient management and effective controls. Banks must pay special attention to the forms of communication and the exchange of complete, timely and accurate information between the bodies charged with the functions of strategic supervision, management and control, in respect of the powers and duties of each, as well as within each body. Organizational safeguards must be put in place to avert the risk of improper disclosure of confidential information.

Well-designed information flows (i.e. appropriate and consistent with the importance and complexity of the information itself) are also necessary to permit the various levels of responsibility within the organization to function properly.

These needs are consistent with the Civil Code provisions in the matter of: the exclusive responsibility of the directors for the running of the company; the duty to "act in an informed manner"; regular reporting to the board by bodies with delegated powers; and the right of directors to receive information on company operations from the delegated bodies.

Implementing guidelines

Specific regulations must govern at least the following matters:

- a) the time limits, form and content of the documentation to be transmitted to the individual members of the bodies for their decisions on the items on the agenda; the regulations must also specify the tasks and duties of the chairmen of the various bodies as regards: the setting of the agenda; information to be sent in advance to members of the bodies on the items on the agenda; documentation and minutes on the

decision-making process; ex-post availability of the documentation; and communication of decisions to the supervisory authority when the law so provides;

- b) the specification of the persons required to send information to the governing bodies on a regular basis, establishing in particular that the persons responsible for control functions within the bank must report directly to the control, management, and strategic supervision bodies;
- c) the minimum content of information flows, including the level and trend in the bank's exposure to all the main types of risk (credit, market, operational, reputational, etc.), any overshoots with respect to the policies approved by the body charged with strategic supervision, and types of innovative transactions and their risks.

* * *

Adaptation to these supervisory provisions can be gradual. The corporate governance arrangements adopted by banks and banking groups must ensure full, substantial compliance with these provisions by 30 June 2009.

As from the date of these provisions, the Bank of Italy will take them into account in judging the conformity of bylaw amendments and of the bylaws of newly constituted banks with sound and prudent management. In their compensation and incentive schemes, banks must comply with the standards set forth in Section 4.

Rome, 4 March 2008

THE GOVERNOR
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