

THE EVOLUTION OF CORPORATE GOVERNANCE OF ITALIAN LISTED BANKS: WHAT HAPPENED IN THE BOARDROOM?

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Introduction

There are several reasons why corporate governance of banks has become worldwide a central issue over the last two decades. Indeed the wave of privatizations, the increased international opening and competition, and the consolidation of financial industry driven by the intense M&A activity are among the main motivation. The current financial crisis has furthermore called the attention of policy-makers on the relevance of corporate governance in the financial services industry: the distortion of managerial incentives has possibly been among the main causes of the subprime crisis ⁽²⁾.

Italian corporate governance rules for listed banks have deeply changed during the recent years. This evolution has been sired by the introduction of new corporate governance rules for all listed companies as well as by the evolution of banking regulation. In particular, bank board rules have been the most affected by this combined influence.

The aim of this paper is to analyze the evolution of corporate governance of Italian listed banks, specifically focusing on boards: we will look at how bank board rules have changed and how board size, composition and operation have evolved during the last ten years, since the enactment of the Financial Markets Act ⁽³⁾.

The paper is organized as follows. Paragraph 1 briefly sketches the major findings of the economic literature on bank corporate governance; paragraph 2 presents some basic figures on the evolution of the Italian financial system and explains the increased importance

⁽¹⁾ Banca d'Italia. Usual disclaimer applies. The authors wish to thank Giovanni Turchetti for his useful assistance.

⁽²⁾ See, for instance, Gorton, (2008). As a matter of fact, the powerful influence of managerial compensation on the process of loan/mortgage extension seemed to have killed the prudential “due diligence” and introduced the practice of granting credit almost independently of the borrower’s financial conditions.

⁽³⁾ So called “Consolidated law on financial intermediation”, Legislative Decree n. 58/1998.

of bank corporate governance. Paragraph 3 presents a description of the evolution of Italian corporate governance rules and regulations. Paragraph 4 deals with an analysis of the latest supervisory regulations, specifically highlighting changes affecting boards; paragraph 5 provides some empirical evidence on the structure and operation of listed bank boards. Paragraph 6 summarizes the main conclusions of the paper.

1. Corporate governance of (listed) banks: common problems and specific issues

Listed banks corporate governance must reflect general corporate governance regulations that apply to all listed firms, irrespective of their line of business, and in addition take into account the clear strong public impact of bank activities associated to their peculiar and unique economic functions.

The general corporate governance theory suggests different solutions to a “nexus” of problems: separation of ownership and control; informational asymmetries between managers, shareholders and debtholders; collective action problems among shareholders as well as among creditors; rational apathy of small shareholders; misaligned incentives among different classes of stakeholders, due to different time-horizons, risk appetite and financial constraints. Remedies rely, depending on the case, on the controlling shareholders monitoring incentives, on minority shareholders voice and exit, on independent directors, on the disciplining effect of hostile takeover bids, on contractual schemes (e.g. remunerations) aimed at aligning managers and shareholders incentives, on the control exerted by statutory auditors, rating agencies and other gatekeepers, on the definition of managers fiduciary duties, on the threat of class-action suits and other private enforcement mechanism.

Banks “uniqueness” has been stressed by an extensive literature ⁽⁴⁾. Their central role in performing monetary and credit functions, the moral hazard associated with the presence of safety nets, in addition to the vulnerability and opaqueness of their balance sheet, justify the regulatory and supervisory scheme traditionally addressed to them. From a corporate governance standpoint, banks uniqueness causes more severe agency problems, informational asymmetries and moral hazard than in non-banking firms. In particular their high debt-to-

⁽⁴⁾ In addition to the unique role of banks in performing maturity and liquidity intermediation, banks are the most important external disciplinary factor of firms financial behaviour by tuning creditworthiness to the level of total debt of borrowers. See Allen, Santomero (1998); Diamond, Dybvig (1983); Diamond (1984); Caprio, Levine (2002); Padoa-Schioppa (1999).

equity ratio, the opaqueness of their balance sheet, the presence of safety nets makes difficult or reduces the monitoring incentives of minority shareholders and creditors; at the same time these factors increase the risk propensity of controlling shareholders and decrease transparency and accountability of management remuneration schemes.

Banks corporate governance has been explored only by a few studies ⁽⁵⁾. Despite acknowledging the peculiar needs arising from the crucial role played by banks in the economic system, this literature does not develop a corporate governance scheme for banks tuned to their specific public role, intrinsically different from that of other firms.

This output might be explained in two ways. First, prudential regulations applied to banks already partially mitigate the more severe agency, information asymmetry and moral hazard problems that banks face. Minimum capital requirements (Pillar 1 of Basel 2) lower risk propensity and encourages shareholders monitoring; controls over banks activity tend to lessen managers discretion; transparency imposed by the third pillar of Basel 2 tries to reduce banks opacity. Second, banks peculiarities do not automatically suggest a specific corporate governance scheme because the problems to be solved are not very different from the ones of non-banking firms; only the respective weights differ. Rather than working out a corporate governance pattern for banks different from that of other firms, it is necessary to tune and adapt the available tools in order to take into account the specificity of banks role.

This is the rationale that seems to emerge from rules and international best practices concerning the corporate governance of banks ⁽⁶⁾. Indeed, in the case of banks corporate governance is extremely important in order to pursue the business goals under safe and sound management conditions; corporate governance is therefore of primary concern also for bank supervisory authorities. The specific nature of banking activity, and the dire consequences that a banking crisis may cause to the economic system, do not immediately suggest a governance pattern different from that of the other businesses. However, they do strongly suggest to pay greater attention to management and control systems and therefore to the role

⁽⁵⁾ Adams, Mehran (2003); Macey, O'Hara (2003); Levine (2004); Polo (2007); Ciancanelli, Gonzales (2000); Alexander (2006); Heremans (2007); Laeven, Levine (2008); Ungureanu (2008).

⁽⁶⁾ Cfr., in particular, BIS: *Framework for internal control systems in banking organisations* (1998); *Enhancing Corporate governance in banking organisations* (2006); *Fundamental principles for an effective banking supervision* (2006). Other points of reference on governance and internal controls are included in the guidelines worked out by the Committee of European Banking Supervisors (CEBS) on a wide range of topics; see, for example, *Guidelines on the implementation, validation and assessment of Advanced Measurement (AMA) and Internal Ratings Based (IRB) Approaches* (2006), and *Guidelines on the Application of the Supervisory Review Process under Pillar 2* (2006).

of the board, and to the real balance of power between the board and the CEO. While the latter has the monopoly of information, the board bears the main responsibility of strategic decisions and has the power to take measures and safeguards in order to guaranty effective risk management, rational resource allocation, and management protection from improper external interferences. The achievement of these goals requires clear distinction between supervisory/control and managerial functions; sharp and consistent definition of roles and responsibilities at every level of the organization; qualitative and quantitative composition of boards to assure their proper functionality; information flows for a reliable and effective management; close interconnection between board, top management and internal control systems; fair remuneration schemes.

2. The evolution of the Italian banking system: some figures

The Italian banking system experienced deep changes over the last twenty years. The most relevant are: privatisation; increased recourse to market funding via stock exchanges; a wider international position; consolidation of the financial sector, followed by the growth in size of financial intermediaries; a greater organizational complexity deriving from an expansion into new geographical areas and business sectors; an increase in competition, spurred by the internationalisation of financial industry and – in the case of Europe – the harmonization of national legislations.

In Italy, State ownership of (listed) banks declined from 36.8% in 1990 to nil in 2007; foreign investors share increased from 1.8% to 6.1%; market share shifted from 38.7% to 68.2%. Since 1998 banks' ownership of other listed banks decreased from 11.3% to 3.5%, showing a deep restructuring of Italian banking groups (see Table 1).

Table 1 – Evolution of ownership structure of Italian listed banks

	1990	1998	2007
Insurance companies	0.6 %	3.2 %	2.1 %
Banks	5.8 %	11.3 %	3.5 %
Foreign investors	1.8 %	8.5 %	6.1 %
Foundations	11.1 %	17.4 %	13.8 %
Italian institutional investors	0.5 %	0.1 %	0.0 %
Corporations	2.1 %	0.9 %	4.2 %
State	36.8 %	1.0 %	0.0 %
Individuals	2.6 %	1.4 %	2.0 %
Total	61.3 %	43.6 %	31.8 %
Market	38.7 %	56.4 %	68.2 %

Source: Bianchi et al (2008), The evolution of Italian corporate governance in the last 15 years.

Between 1998 and 2007 the number of Italian banks listed on the stock exchange has decreased from 44 to 27, mainly as a result of the process of consolidation or restructuring undertaken by some of the major banking groups (Table 2).

Table 2 – Number of Italian listed banks

Year	All banks	By size (1)			By type	
		Small	Medium	Large	Holding companies	Other (2)
1998	44	15	15	14	25	19
1999	47	16	16	15	29	18
2000	45	15	15	15	30	15
2001	42	14	14	14	28	14
2002	35	12	12	11	27	8
2003	33	11	11	11	27	6
2004	34	12	11	11	28	6
2005	32	11	11	10	27	5
2006	28	10	9	9	23	5
2007	27	9	9	9	22	5

Source: Consob and Italian Stock Exchange.

(1) Distribution by total assets. Small: 1st 33rd percentile; Medium: 2nd 33rd percentile; Large: 3rd 33rd percentile. - (2) Individual banks not belonging to banking groups or non-holding-companies banks belonging to banking groups.

While in 1998 19 out of the 44 listed banks were individual institutions, i.e. banks not belonging to banking groups (or non-holding-company banks belonging to banking groups),

at the end of the period such banks were only 5 out of 27. As a consequence, most of the banks currently listed on the stock exchange are bank holding companies, with a banking group structure often quite complex.

Even if the number of listed banks has declined over the last decade, the share of the Italian banking system's total assets belonging to them has remained high and substantially unchanged; indeed the share was 73 percent at the beginning of the period and 70 percent at the end.⁽⁷⁾

As a consequence of the consolidation process, also the average size of listed banks, measured by total assets, has significantly increased during the decade. Average total assets have more than doubled for bank holding companies and increased by about 20 percent for individual banks (Table 3). For all listed banks average total assets have tripled, or even more for larger banks. Listed banks, therefore, have become larger and more complex, and their organizational structure has evolved accordingly.

Table 3 – Italian listed banks: Size
(average total assets; index numbers, 1998=100)

Year	All banks	By size (1)			By type	
		Small	Medium	Large	Holding companies	Other (2)
1998	100.0	100.0	100.0	100.0	100.0	100.0
1999	105.7	81.9	107.7	105.8	98.5	106.5
2000	122.9	84.8	109.9	120.4	107.5	122.3
2001	136.5	101.8	137.9	131.5	121.4	108.5
2002	170.2	112.4	180.4	172.5	135.7	86.2
2003	170.1	134.2	199.3	160.3	128.4	92.4
2004	174.4	150.8	214.1	168.3	131.0	90.3
2005	233.5	159.2	194.1	245.2	171.7	119.1
2006	233.6	129.4	152.3	246.2	176.3	109.2
2007	304.1	124.1	147.1	316.2	232.0	118.8

Source: Consob, Italian Stock Exchange and Bank of Italy data.

(1) Distribution by total assets. Small: 1st 33rd percentile; Medium: 2nd 33rd percentile; Large: 3rd 33rd percentile. - (2) Individual banks not belonging to banking groups or non-holding-companies banks belonging to banking groups.

One of the consequences of the consolidation process in the more recent years has been the exponential increase in internationalization of the largest Italian banking groups.

⁽⁷⁾ The share reached a maximum of 83 percent in 2000-2001 and a minimum of 62 percent in 2006.

On average, the share of the listed groups' assets belonging to foreign branches or subsidiaries ("foreign assets") has almost doubled during the decade, from 16.6 to 31.6 percent.⁽⁸⁾ Today for some of the largest banking groups foreign assets are even larger than domestic assets.

These factors, as in other industrialised countries, have enhanced the importance of bank governance. Good corporate governance is essential: on the one hand, it's a key to greater management efficiency and, more generally, to greater performance. Further, the quality of corporate governance influences firms accountability, i.e.: the size of mandate granted to their governing bodies and the effectiveness of controls imposed upon them. Both performance and accountability are key factors for companies in order to attract investors; in the case of banks they are also fundamental prerequisites of a safe and sound management.

This link between corporate governance, market discipline and bank stability is nowadays crucial also in the supervisory framework outlined by the 'New Basel Accord' (the so-called Basel 2) and by the related European legislation and national implementation provisions⁽⁹⁾.

After a long transition period from the "structural" to the "prudential" supervisory system, the New Basel Accord attaches to organizational factors a relevance comparable to capital requirements⁽¹⁰⁾, and introduces specific disclosure obligations towards the market.

Against the greater autonomy granted to banks in setting out the risk management and control systems and the total level of capital to cope with it, governance and organisational structure quality becomes essential both for banks themselves (within the Internal Capital Adequacy Assessment Process, ICAAP), and in the evaluation process of supervisory

⁽⁸⁾ The average share of foreign assets reached a minimum of 9.7 percent in 2003 and a maximum of 36.6 percent in 2006.

⁽⁹⁾ See *International Convergence of Capital Measurement and Capital Standards: a Revised Framework*, Basel Committee on Banking Supervision, June 2004, supplemented in November 2005 with the new regulations on the trading book, the counterparty credit risk and the treatment of collateralised transactions. For the European Union countries the prudential regulation of banks and investment companies, drawn from the New Basel Agreement, has been incorporated in directives No. 2006/48/EC and 2006/49/EC. The transposition into Italian law has been carried at the end of 2006 (Decree law No. 297 of 27 December 2006; decree of the Minister for the Economy and Finance No. 933 of 27 December 2006; Bank of Italy Circular No. 263 of 27 December 2006, *New regulations for the prudential supervision of banks*).

⁽¹⁰⁾ See article 22 of Directive 2006/48/EC, according to which each bank must have 'robust governance arrangements, which include a clear organisational structure with well defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks it is or might be exposed to, and adequate internal control mechanisms, including sound administrative and accounting procedures'.

authorities (the Supervisory Review and Evaluation Process, SREP) ⁽¹¹⁾ as well as for the trust given to the market monitoring function (3rd Pillar).

With regard to governance, it's the board that plays a crucial role; its primary task is to set up and assess adequate internal systems in order to control and manage all the risks to which the intermediary may be exposed ⁽¹²⁾. A proper and clear distribution of powers, functions and tasks among corporate bodies – primarily in the area of risk management and control – and an organisational structure suitable to the complexity of the activity are the two elements playing a major role in setting the total capital requirement.

Along the same vein, the regulation concerning investment activities and services - the MiFID Directive ⁽¹³⁾ - emphasizes the role of 'organisational requirements' as a mean to prevent and manage conflicts of interest between banks and their customers.

3. Governance of Italian banks between commercial and banking law

3.1 Alike other listed companies, Italian banks have benefited from the improvements in corporate governance regulation. Over the last decade, several initiatives have been carried out worldwide to ameliorate corporate governance rules ⁽¹⁴⁾. In Italy, modernization started with the Financial Markets Law (1998) ⁽¹⁵⁾ and has gone on with the Company law Reform (2003), the Savings Act (2005), the implementation of the European Directives on takeover bids (2007), prospectuses (2007), transparency (2007), market abuse (2005) and corporate governance statement (2008), the enactment of the listed companies' corporate governance code (1999, 2002, 2006).

Like for the banking sector, the pattern emerging from these regulatory changes – affecting all listed firms - reveals a balance between regulation and market discipline. While

⁽¹¹⁾ See *New regulations for the prudential supervision of banks*, Title I, Chapter 1, Part 4 and, on the significance of the governance structure within the process of prudential control, the document *Guidelines on the Application of the Supervisory Review Process*, February 2006, drawn up by the Committee of European Banking Supervisors (CEBS).

⁽¹²⁾ *New regulations for the prudential supervision of banks*, Title I, Part 4.

⁽¹³⁾ Directive 2004/39/EC.

⁽¹⁴⁾ See, for instance, the corporate governance standards issued by the OECD and periodically updated; the work done on this issue by the International Monetary Fund and the World Bank; the measures contained in the Action plan on company law and audit issued by the European Commission. On a national level, corporate governance and company law reforms are under way or already enacted in all the major countries

⁽¹⁵⁾ Legislative Decree 58/98.

private ordering is expanded (leaving more room for firms to choose their governance structure), mandatory rules are introduced, basically aimed at improving (minority) shareholders protection, both directly – through the strengthening of their voice and exit rights – as well as through the reform of boards regulation (*collegio sindacale* included) and the provision of minority representation within these bodies. Market discipline is reinforced: stricter disclosure requirements on firms economic and financial conditions, on their ownership structures, on governance practices actually adopted by each company are introduced; more stringent regulation for some gatekeepers, such as external auditing companies is conceived.

Efficiencies and weaknesses of such a regulatory scheme have been thoroughly highlighted by an extensive literature; however, if one wants to draw a general principle, a distinctive sign of those reforms, it is undeniable that they have powerfully contributed to align - and in some cases to anticipate - the set of regulations applicable to the Italian listed companies (and thus also to the listed banks) with those of the main countries.

3.2. Where banking regulation traditionally shows distinctive features in comparison with that of the other firms is on the board and, more generally, on the overall management and control system. The reason why banking regulation has always focused on this issue is because the efficiency of banks' internal governance mechanics is crucial for pursuing regulatory goals. The link is obvious: both macroeconomic (stability, efficiency and competitiveness of the financial system) and microeconomic (safe and sound management of banks) goals of banking regulation can be effectively pursued only when management and control bodies of the banks are able to detect, manage and control risks.

Banks boards efficiency is relevant also from a more theoretical standpoint. In a typical firm, due to the profit asymmetry between shares and debt, owners are more risk takers than debtholders. Managers risk appetite depends on their compensation structure. Given that banks are in the business of risk trading and have a high debt-to-equity ratio, and that depositors do not have the technical competence to monitor these risks (and in addition, being protected by deposit insurance schemes, have little incentive to do so) banks owners have more opportunities and incentive to engage in excessive risk taking, at the expense of debt-holders. Keeping managers' risk appetite low is, therefore, crucial for banks. The introduction of implicit and explicit safety net introduces another player in banks

management, the taxpayer. This explains why banking regulation have intervened to insulate managers from owners pressure towards more risk taking, also by putting more power in the hands of management at the cost of increasing the relevance of the monitoring role of banks board and the need for efficient not risk-encouraging managers remuneration schemes.

But what should banks board optimal structure be in order to effectively fulfil such needs?

Economic literature does not provide definitive answers to this question. First, it does not address specifically the issue of banks board, except in few cases. Second, it suggests that trade-offs are inherent to board structure decisions, and thus there is no specific board structure optimal for all firms (¹⁶). Since boards have a double role of monitoring and advising the CEO and managers, the optimal structure depends on the relative importance and costs of these two tasks. If advising CEO is more important than monitoring, than a unitary (sole) board system might be preferable since it eases the sharing of information and the communication process; on the contrary, if monitoring tasks play a more relevant role, as in the case of banks, than a dual board system might be more efficient: by ensuring the clear separation of the board's two roles, it allows for a more effective monitoring by outside directors.

With reference to board size, conventional wisdom supports the idea that small boards might be better, since this may reduce communication and coordination costs among members, therefore being more effective. However, recent empirical works show that board size is related to firms' complexity: since both monitoring and advising functions are more relevant for more complex firms, these firms should benefit from bringing in outsiders and thus resulting in larger and more independent boards. Although monitoring costs naturally increases with firm's complexity the benefit of effective monitoring should outweigh the costs on balance.

As regards board composition, trade-offs typically refer to the fact that while outside directors increase the quality of monitoring, they may lack of sufficient knowledge on firm-specific information, leading to sub-optimal decisions. The optimal proportion of inside and

(¹⁶) See, for more recent literature: Adams, Ferreira (2007); Adams, Mehran (2008); Belkhir (2008); Coles, Daniel, Naveen (2008); Harris, Raviv (2006), Hermalin, Weisbach (2003); Lehn, Patro, Zhao (2008); Linck, Netter, Yang (2008); Raheja (2005).

outside directors depends, therefore, again on the relative importance of monitoring and advising needs: if the former are greater, than having more outsider director is beneficial.

Put differently, although no board structure appears to be superior in all situations (ie: there is no “one-size-fits-all”), empirical evidence shows that some firm or industry-specific factors may play a significant role in shaping the “optimal” board structure. Larger, more diversified firms, or firms with a high debt-to equity-ratio (such as banks) may derive greater value from having larger board; firms where monitoring needs are higher (such as banks) may be better off having a greater proportion of outsiders.

Boards and managers remuneration schemes also play a relevant role. While managers are typically more risk averse than owners if they receive a fixed compensation, performance-based remuneration schemes change their attitude towards risk. If ill-designed, both equity-based compensation and other performance-related remuneration might be detrimental; banks’ opaqueness and managers’ ability to influence outcomes make it easier for them to design compensation packages that allow them to benefit at the expense of the long-run health of the bank.

Along these lines, Italian banking regulation has always put great emphasis on banks’ boards. Specific rules and principles date back to the end of the Nineties. At that time board’s autonomy vis-à-vis both owners and managers was stressed, and boards were formally given the ultimate responsibility for the management of the bank; detailed provisions were put in place to ensure a clear distinction of tasks and an efficient balance of powers between the board and the CEO (and/or the executive committee); the task of ensuring adequate internal control systems was given to the control body (ie: the *collegio sindacale*); a comprehensive group approach, based on managing and co-ordination powers given to the parent company, was adopted (¹⁷).

Many of these rules were then applied to non-banks as well. Some of the major innovations introduced for all firms boards by the Financial Markets law, the Company law Reform, and the Savings Act indeed go exactly in the same direction (¹⁸). Some others innovations, on the contrary, were new for banks too.

(¹⁷) See Bank of Italy Supervisory Instructions for Banks (1999), Title IV, Chapter 11 available at www.bancaditalia.it

(¹⁸) Compare, for instance, Bank of Italy Supervisory Instructions for Banks, Title IV, Chapter 11, Sect. 1.1 and 4 with new articles 2380, 2381, 2403 of the civil code introduced in 2003.

The pattern emerging from these regulatory changes – affecting all listed firms boards – reveals, again, a balance between public intervention and private ordering.

Mandatory rules were introduced primarily to ensure a more effective protection of minorities: boards with more than seven members should have at least one independent director; at least one director and one member of the control body (the *collegio sindacale*) should be appointed by minority shareholders; stricter independence requirements were set for the members of the *collegio sindacale*. At the same time, more room was left to private ordering, the most relevant example being the possibility for each firm to choose its own board structure among three different one: ie the traditional one, the two-tier (German) and the one-tier (Anglo-Saxon) ones.

4. The new supervisory provisions on banks' corporate governance

The growing importance of good banks governance and the changes occurred in both company law and banking regulation are echoed in the *Supervisory provisions concerning banks' organisation and corporate governance* issued by the Bank of Italy in March 2008⁽¹⁹⁾. Consistently with guidelines and principles developed at international level, (Basel, CEBS) banking regulation focuses mainly on 'internal governance', in particular on duties and powers of boards, on their composition, on information flows, on remuneration schemes.

As previously noted, existing literature on corporate governance suggests that no board structure appears to be superior in all situations, although some firm or industry-specific factors might be relevant. Supervisory regulation shares this view and does not require the adoption of a single board model, suitable for any intermediary whatever the context. The rationale is that each bank ought to identify and adopt its own corporate governance arrangements, provided that some fundamental principles are respected; echoing existing literature, banks choices must be consistent with their peculiarities in terms of strategies, dimensions, complexity, ownership and organizational structure⁽²⁰⁾. This greater autonomy is balanced with a higher degree of responsibility: banks have the burden of proving the fairness of their corporate governance schemes, and illustrate in an *ad hoc*

(19) Supervisory Provisions Concerning Banks' Organization and Corporate Governance, March 2008, available at www.bancaditalia.it

(20) See Supervisory Provisions Concerning Banks' Organization and Corporate Governance, par.1.

‘corporate governance project’ the reasons why their choices are more likely to ensure efficient management and effective controls.

As to the board size, banking regulation acknowledges the existence of various trade-offs. Therefore, it does not identify an optimal board size, but – rather – it requires that board size decisions be taken considering the need of having a proportionate mix of skills, fit for the intermediary’s complexity and, at the same time, to avoid cramped bodies, which are likely to diminish the incentive of each member to be diligent and impede the proper functioning of the board.

An efficient corporate governance scheme undoubtedly involves a clear distinction and organization of supervision/control and management tasks, together with their effective implementation. In banks such a general principle is further detailed in order to ensure, on the one hand, management autonomy and efficiency and, on the other, monitoring (supervision and control) effectiveness.

Greater autonomy of the management function is, as previously said, a distinctive feature of banking regulation. The supervisory provisions of 2008 reassert such approach and establish rules and principles aiming at ensuring a clear definition of management function and of its mandate, so as to guarantee suitable levels of autonomy and responsibility. In particular, provisions strive to avoid an excessive fragmentation of the management function, allowing a larger sub-division (managing director, executive committee, general manager) only in bigger and more complex banks. They require that the contents of the functions delegated to board members be spelled out in an analytical, precise and punctual way. Moreover, in the two-tier model where the relation between the supervisory and managerial functions is more complex since it involves two separate bodies (supervisory and management boards), the autonomy of the managerial function is sheltered via ad hoc protective and corrective measures ⁽²¹⁾.

The other concurrent need is to safeguard an effective monitoring action on management, so to avoid choices and behaviours potentially detrimental to the plurality of interests inside and outside the bank (shareholders, account holders, customers, efficient resource allocation, overall stability etc.). As underlined in existing literature, strengthening

⁽²¹⁾ See Supervisory Provisions Concerning Banks’ Organization and Corporate Governance, par. 2.1. point f) and 2.2 point j), and, in particular, provisions requiring banks to limit supervisory board’s tasks to actually strategic decisions and limiting participation to the meetings of the management board only to independent directors serving in the internal control committee.

of the board's monitoring role is strictly connected to the peculiarities of the banking activity. Supervisory provisions act on several fronts in order to accomplish this goal. First, they expand the number of items that the board cannot delegate to the CEO or to other executives⁽²²⁾. Second, they act on the board composition: the presence of non-executive and independent members, highly professional and therefore in a position to engage in discussion with the executives, must be ensured within the board. Third, special internal committees, provided with advisory, inquiry and proposal powers in matters where risks of conflict of interests are higher (e.g. controls, appointments, remuneration), must be established in case of bigger and more complex banks. Further, an adequate representation within the board of the various components of the shareholder base (institutional investors, qualified minorities etc.) must be ensured, as a prerequisite for a positive internal dialogue. Finally, provisions stress the role *super partes* of the chairman of the board who, in the best interest of owners, should smooth possible conflicts between executive and non-executive directors.

Consistently with the approach adopted in the regulation of 1999, the independence and effectiveness of control functions are reinforced. The new provisions require that the supervisory board (in the two-tier model) and the management control committee (in the one-tier model) be charged with extra tasks and powers, and provide for the adoption of precisely spelt measures aimed at preserving the impartiality of persons performing control functions⁽²³⁾ both inside the board and within the internal control systems⁽²⁴⁾.

Banking regulation prescribes rules on the crucial issue of managers incentives and remuneration. Suitable policies are essential to ensure a highly professional personnel and promote company objectives. However, public interest impose to limit excessive risk taking;

⁽²²⁾ See Supervisory Provisions Concerning Banks' Organization and Corporate Governance, par. 2.1. point a) and b).

⁽²³⁾ With reference to the two-tier model, the supervisory provisions aim at "closing" some asymmetries in comparison with the *collegio sindacale*, requiring the attribution to the supervisory board of additional tasks and powers (inspection and control, request of information to the members of the management board, attendance at the meetings of the management board). From an organisational point of view, a special committee, entirely composed by independent members is required to be set up within the supervisory board. For the one-tier model also, supervisory regulations tend to expand the tasks and to strengthen the independence of the management control committee (it is required, for instance, that the appointment of its members be left to shareholders meetings and not to the board itself). Furthermore, for both the one-tier and the two-tier model removal of board members charged with control functions be extensively motivated. Finally, independence of such persons is protected by the prohibition (applicable to all three models) to take up office in bodies different from the control ones in other companies, within the perimeter relevant to supervisory purposes.

⁽²⁴⁾ See, for example par. 2.2 requiring that internal control offices be appointed by the whole board rather than by the chief executive officer.

this is especially true in banks where, as highlighted by the literature, moral hazard risk is higher than in non-banks. Evidence from the subprime crisis show that distortion of managerial incentives caused by ill-designed remuneration packages might have been at the heart of the problem. This issue has therefore become crucial, and is calling for greater attention of policy-makers both from a general prospective and within national rescue packages for the financial sector ⁽²⁵⁾.

Italian supervisory rules specifically address both concerns emerging from the existing literature, namely that shareholders should have adequate control remuneration, and that remuneration schemes should provide the right incentives. The rules specify the following: i) shareholders meeting must be involved in setting ex ante remuneration policies and equity-based compensation plans; ii) Shareholders must be provided with ex post information on the practical implementation of remuneration policies; iii) large banks must set up a remuneration committee within the board, composed by a majority of independent directors, to provide advice and make proposals on directors remuneration and perform advisory tasks in relation to determining the criteria for managers remuneration; iv) remuneration policies and compensation schemes must be consistent with prudent risk management and the company's long-term objectives and must ensure an appropriate balance between their fixed and variable components. The variable component must further ensure an equilibrium between short-term and long-term performance and its consistency with the bank's actual and lasting results; and performance-related compensation must be risk-weighted; v) equity-based compensation or bonuses linked to performance are limited or prohibited for members of control bodies, non-executive directors (especially members of board committees such as the audit committee) and managers in charge of internal control.

5. The board of directors of Italian listed banks

As reported above, over the last decade the Italian banking system has significantly changed. Banking groups reorganized; the average size of Italian listed banks has increased; their degree of internationalization has expanded. At the same time, also the legal framework has changed.

⁽²⁵⁾ See, for instance, Declaration of the Summit on Financial Markets and the World Economy, Nov. 2008, points 10 and 16; European Council Conclusions on Executive Pay, Oct. 2008; Financial Stability Forum (2008a) (2008b), point II.19.

How have these changes affected the board ? This paragraph is devoted to provide some empirical evidence on the structure, composition and operation of Italian listed banks boards.

5.1. Board size and composition

5.1.1. Board size

The average number of board directors of Italian listed banks (weighted by their respective total assets) has *significantly increased* over the decade. It was 15.9 at the beginning of the period and reached 23.8 in 2007 (Table 4) ⁽²⁶⁾.

Table 4 – Italian listed banks: Number of board directors
(total-asset weighted average)

Year	All banks	By size (1)			By type	
		Small	Medium	Large	Holding companies	Other (2)
1998	15.9	12.4	15.0	16.2	16.3	13.0
1999	17.2	13.3	15.2	17.5	17.7	12.2
2000	17.6	13.5	14.0	18.1	18.0	12.7
2001	18.1	12.5	15.1	18.6	18.6	10.7
2002	19.0	11.0	17.4	19.4	19.1	13.3
2003	18.6	10.5	17.5	18.9	18.7	13.4
2004	18.3	11.3	17.4	18.6	18.4	13.6
2005	19.6	10.4	16.9	20.1	19.7	13.4
2006	23.0	11.6	14.6	23.9	23.2	14.5
2007	23.8	11.6	14.8	24.5	24.0	14.5

Source: Consob, Italian Stock Exchange and Bank of Italy data.

(1) Distribution by total assets. Small: 1st 33rd percentile; Medium: 2nd 33rd percentile; Large: 3rd 33rd percentile. - (2) Individual banks not belonging to banking groups or non-holding-companies banks belonging to banking groups.

As shown in Table 4, the average number of board directors has significantly increased for bank holding companies (from 16.3 to 24.0) and for large banks (from 16.2 to 24.5), while it has increased only slightly for individual banks (from 13.0 to 14.5) and decreased to some extent for small and medium banks (from 12.4 to 11.6 and from 15.0 to 14.8, respectively) (see also Charts 1 and 2 in the Annex).

⁽²⁶⁾ For the banks that have adopted in 2006 and 2007 the new “two-tier” board structure (with a supervisory board and a management board) the total number of board directors has been obtained by summing up the number of directors in each of the two boards.

These results are consistent with the findings of previous empirical research suggesting that board size depends on firm's complexity (measured as firm's size and debt-to-equity ratios) and on organizational structure (groups vs. individual firms) ⁽²⁷⁾. However, keeping in mind the trade-off suggested by the economic literature between board size and coordination costs among its members, one could question whether boards having such a high number of directors are really able to operate efficiently.

5.1.2. Board composition: executives vs. non-executives and the role of independent directors

The average number of *executive directors* in the board has also *increased*. ⁽²⁸⁾ Between 2000 (the first year for which reliable public data on executive directors are available) and 2007 the average number of listed banks' executive directors, weighted by their respective total assets, has increased from 6.3 to 9.1 (Table 5).

The average number of executives has increased for both bank holding companies (from 6.4 to 9.1) and individual banks (from 4.1 to 6.4). On the other hand, the significant increase for large banks (from 6.3 to 9.3) has been accompanied by a slight increase for small banks (from 4.0 to 4.2) and a minor decrease for medium banks (from 6.6 to 6.3) (see also Charts 3 and 4 in the Annex).

The joint dynamics of the total number of directors and the number of executives has been such that the average share of executive directors in the boards of Italian listed banks has slightly increased over the period 2000-2007, from 35.8 to 38.2 percent (Table 6). Consequently, the average share of non-executive directors has slightly decreased, from 64.2 to 61.8 percent.

⁽²⁷⁾ See for example, Adams, Mehran (2008); Linck et al. (2008); Coles, Daniel, Naveen (2007).

⁽²⁸⁾ The definition of executive directors refers according to the following criteria:

- a) for banks adopting the traditional board structure (only one board of directors), an executive director is the managing director (CEO) and a director belonging to the executive committee;
- b) for banks adopting the new "two-tier" board structure (a supervisory board and a management board), the executive directors are all the directors belonging to the management board.

Table 5 – Italian listed banks: Number of executive directors
(total-asset weighted average)

Year	All banks	By size (1)			By type	
		Small	Medium	Large	Holding companies	Other (2)
1998						
1999						
2000	6.3	4.0	6.6	6.3	6.4	4.1
2001	6.0	4.1	7.4	5.9	6.1	3.9
2002	7.4	3.8	6.9	7.5	7.4	5.4
2003	7.4	3.4	7.3	7.6	7.5	6.4
2004	6.9	3.9	7.2	6.9	6.9	6.4
2005	8.4	4.7	7.1	8.6	8.4	6.5
2006	8.8	4.8	6.1	9.0	8.8	6.5
2007	9.1	4.2	6.3	9.3	9.1	6.4

Source: Consob, Italian Stock Exchange and Bank of Italy data.

(1) Distribution by total assets. Small: 1st 33rd percentile; Medium: 2nd 33rd percentile; Large: 3rd 33rd percentile. - (2) Individual banks not belonging to banking groups or non-holding-companies banks belonging to banking groups.

Table 6 – Italian listed banks: Share of executive directors
(total-asset weighted average; percent)

Year	All banks	By size (1)			By type	
		Small	Medium	Large	Holding companies	Other (2)
1998						
1999						
2000	35.8	29.6	47.1	34.8	35.6	32.3
2001	33.1	32.8	49.0	31.7	32.8	36.4
2002	38.9	34.5	39.7	38.7	38.7	40.6
2003	39.8	32.4	41.7	40.2	40.1	47.8
2004	37.7	34.5	41.4	37.1	37.5	47.1
2005	42.9	45.2	42.0	42.8	42.6	48.5
2006	38.3	41.4	41.8	37.7	37.9	44.8
2007	38.2	36.2	42.6	38.0	37.9	44.1

Source: Consob, Italian Stock Exchange and Bank of Italy data.

(1) Distribution by total assets. Small: 1st 33rd percentile; Medium: 2nd 33rd percentile; Large: 3rd 33rd percentile. - (2) Individual banks not belonging to banking groups or non-holding-companies banks belonging to banking groups.

It is interesting to note that the increase in the share of executives in individual banks (from 32.3 to 44.1 percent) has been quite significant if compared with the increase in bank holding companies (from 35.6 to 37.9 percent). As for the banks size, the increase in the executives share for small (from 29.6 to 36.2 percent) and large banks (from 34.8 to 38.0

percent) has been accompanied by a decrease in case of medium banks (from 47.1 to 42.6 percent) (see also Charts 5 and 6 in the Annex).

According to the information collected by Assonime with reference to listed companies' compliance with the Italian corporate governance code, the *(simple) average number of independent directors, as well as their (simple) average share in the board have also decreased* over the period 2003-2006 (respectively, the first and the last available year) from 10.2 to 8.1 and from 67.5% to 51.3% respectively (see Table 8). The evolution is however different according to banks size (see Table 7). While medium and large banks show a decrease in the share of independent directors in the board (respectively, from 78.9 to 50.5 percent and from 66.9 to 52.5 percent), the share has actually increased for small banks (from 37.5 to 47.5 percent).

Even if this last evidence is not directly comparable with that on executive directors (the data sets on executives and independent directors are indeed different both in their time-horizon and in the type of data collected), and taking into account that the decrease of independent directors might also be due to new and more stringent independent requirements being issued in 2006, the evidence provided in this paragraph raises some concerns.

Table 7 – Listed banks: Share of independent directors by size
(*simple average; %*)

Year	All banks	By size (1)		
		Small	Medium	Large
2003	67.5	37.5	78.9	66.9
2006	51.3	47.5	50.5	52.5

Source: Consob, Italian Stock Exchange, Assonime and Bank of Italy data.

(1) Distribution by total assets. Small: 1st 33rd percentile; Medium: 2nd 33rd percentile; Large: 3rd 33rd percentile.

Banks seems to have react to the evolution of their operational environment and their higher complexity by increasing the relative role of executive directors, and decreasing the relative (monitoring) role of independent directors. This evidence must be carefully assessed against the existing economic literature suggesting that more complex firms should benefit from a greater proportion of outside directors, and that industry-specific factors, such as those

affecting banks, should call for reinforcing the board monitoring role. Furthermore, one could question whether the higher share of executive directors still ensures a proper balance of powers within the board, where better informed executive directors might prevail over less informed non executives.

5.3 The comparison between listed banks and all Italian listed companies

5.3.1 Board size and composition

Some useful information can be derived by comparing the features of the banks' board of directors with those of all Italian listed companies' (see Table 8). Such a comparison has been actually carried out for the period 2003-2006 using the empirical evidence collected by Assonime with reference to the listed companies' compliance with the Italian Corporate Governance Code.

Table 8 – Board of directors: Banks vs All listed companies
(simple average)

Year	Number of board directors		Number of executive directors		Number of independent directors (1)	
	Banks	All listed companies	Banks	All listed companies	Banks (2)	All listed companies
2003	15.1	10.1	5.8	2.6	10.2	4.5
2004	15.0	10.3	5.8	2.5	9.3	4.6
2005	15.0	10.3	6.3	2.5	9.3	4.4
2006	15.8	10.0	6.0	2.8	8.1	4.0

Year	Share of executive directors (%)		Share of non-executive directors (%)		Share of independent directors (%) (1)	
	Banks	All listed companies	Banks	All listed companies	Banks (2)	All listed companies
2003	38.4	29.5	61.6	70.5	67.5	41.4
2004	38.7	27.8	61.3	72.2	67.5	41.7
2005	42.0	28.3	58.0	71.7	62.0	40.4
2006	38.0	32.2	62.0	67.8	51.3	38.7

Source: Consob, Italian Stock Exchange and Assonime.

(1) The definition of "independence" is according to the Italian Corporate Governance Code for listed companies. - (2) The figures for 2004 and 2005 refer to the sum of banks and insurance companies, while the figures for 2003 and 2006 refer to banks only.

In 2006 (the most recent available year for the comparison) listed banks had an average number of board directors (15.8) higher than the average for all listed companies (10.0) (Table 8). Also the average number of executive directors (6.0) was higher than the average for all listed companies (2.8).

As a consequence, in 2006 listed banks had in their boards a share of executive directors (38.0 percent) larger than the corresponding average share for all listed companies (32.2 percent). Therefore, the share of non-executive directors was smaller for banks (62.0 percent) than for all listed companies (67.8 percent).

However, the average share of independent directors in the banks' boards has, during the whole time period, always been larger than the corresponding average share for all listed companies (67.5 vs. 41.4 percent in 2003; 51.3% vs. 38.7 percent in 2006); this means that among the non-executive directors the number of those who meet the requirements to be qualified as "independent" is higher for banks than for all listed companies. The decrease of independent directors' share within the board – which might be also due, as already mentioned, to a different and more stringent definition of "independence" adopted by the Italian Corporate Governance Code in 2006 – has however been greater for banks.

5.3.2. Board operation

Some additional comparative information can also be analyzed with regard to the annual number of meetings of the board of directors and the board of auditors, as well as with reference to the rate of directors' and auditors' participation to the meetings.

In 2006 the average number of meetings of the board of directors was higher for banks (15.2) than for all listed companies (9.7); similarly, the average rate of directors' participation to the meetings was larger for banks (94.9 percent) than for all listed companies (88.1 percent) (Table 9).

For listed banks the average number of meetings of the board of directors has not changed substantially, while the average rate of participation to the meetings has significantly increased with respect to 2003. For all listed companies the two figures have not changed substantially.

Table 9 – Board meetings: Banks vs All listed companies
(simple average)

Year	Number of board meetings		Directors' participation to board meetings (%)	
	Banks (1)	All listed companies	Banks (1)	All listed companies
2003	15.1	9.4	85.4	n.a.
2004	12.9	9.7	85.5	87.4
2005	13.3	9.8	84.6	86.9
2006	15.2	9.7	94.9	88.1

Year	Number of meetings of the board of auditors		Auditors' participation to meetings (%)	
	Banks (1)	All listed companies	Banks (2)	All listed companies
2003	23.9	11.1	n.a.	n.a.
2004	21.4	11.4	92.6	93.8
2005	18.8	10.3	93.9	94.7
2006	20.9	10.1	94.1	95.2

Source: Consob, Italian Stock Exchange and Assonime.

(1) The figures for 2004 and 2005 refer to the sum of banks and insurance companies, while the figures for 2003 and 2006 refer to banks only. - (2) All figures refer to the sum of banks and insurance companies.

As for the meetings of the board of auditors, the average number of meetings has, during the whole time period, always been much higher for banks than for all listed companies (23.9 vs. 11.1 in 2003; 20.9 vs. 10.1 in 2006), even though a slight decrease emerges for both banks and non-banks. Moreover, in 2006 the number of auditors' meetings for banks was significantly higher than the number of directors' meetings (20.9 vs 15.2), while for all listed companies the two numbers were not substantially different (10.1 vs 9.7).

In 2006 no significant difference seemed to exist between auditors' rate of participation to meeting for listed banks (94.1 percent) and all listed companies (95.2 percent).

6. Conclusions

Over the last decade the Italian banking system has undergone significant changes. Banks' ownership structure has been deeply modified and banking groups have been

reorganized. The average size of Italian listed banks has increased, as well as their degree of internationalization. These developments have clearly increased banks managerial responsibilities. These factors, common to other industrialised countries, have indeed enhanced the importance of a sound corporate governance for banks as a defence against excessive risk-taking. At the same time, the wave of structural deregulation affecting banking law has entailed greater reliance on banks governance and internal control systems, and good corporate governance has now become a crucial element within the banking supervisory framework.

From a regulatory prospective, the evolution of corporate governance rules for listed banks may be sketched – in Italy – as the result of deep changes that have occurred, since the late Nineties, both in company law and in banking regulation. Rules on banks boards, the efficiency of which is paramount in banking supervision, have been modified basically along three lines: ensure management autonomy and efficiency; enhance the effectiveness of monitoring; leave more room for banks to choose their own board structure.

How did banks react to these overall changes? Did banks' reorganization and increased complexity affect their board structure? The empirical evidence provided in this paper suggests a positive answer. Board size has significantly increased for bank holding companies and for large banks, where the average number of board directors is around 24. The share of executives has also increased, while that of NEDs qualifying as independent has decreased. Frequency of board meetings (and of the *collegio sindacale*) has remained stable, but a higher degree of directors participation may be detected. Compared to non banks, banks boards are significantly larger, with a greater proportion of independent directors; board meetings are more frequent and directors participation higher. Meetings of the control body (*collegio sindacale*) are twice as frequent.

These results are consistent with previous studies in governance, showing a relation between firms complexity and board size and composition, and suggesting that more complex firms (i.e.: larger, more diversified or with a higher debt-to-equity ratio, such as banks) should benefit from larger and more independent boards. While this accounts for the strong differences found between banks and non-banks boards, the evolutionary pattern of banks boards raises some concerns. Keeping in mind the trade-off suggested by the economic literature between board size and coordination costs among its members, one could question whether such large boards are really able to operate efficiently, and whether the higher share

of executive directors still ensures a balance of powers within the board. The danger that the clearly better informed executive directors dictate board decisions is evident. This raise of “kangaroo boards” might be further enhanced by the decline in the share of independent directors.

The need for effective monitoring over management decisions is amplified by the recent government bill (decree law n. 185 issued on Nov. 28th) that allows, in compliance with the European Directive on acquisitions in the financial sector, non financial firms to fully control banks (with the risk of becoming preferred related parties in bank transactions). While under Italian law this danger has traditionally been limited by a direct veto on the acquisition of banks by non financial firms, this innovation will further increase the need of proper corporate governance mechanism in order to avoid perverse incentives and an inefficient process of allocation of resources.

Moving to a more general and forward-looking perspective, banks corporate governance is expectedly going to become a central issue over the next years. Analyses of the recent crisis put their blame on perverse management incentives due to ill-designed remuneration schemes. Safety nets have been stretched to an unprecedented extent and the danger of moral hazard greatly increased.

The current worldwide framework for prudential regulation is under revision. Different views are currently being expressed. The Basel Committee is devoting substantial effort to revise and improve the way in which capital requirements are defined and computed in the Basel II framework, especially for the trading book. As a result of the refinement process, the importance that Basel II assigns to banks corporate governance and internal control systems will not change; they will likely become even more relevant, both from a micro- and from a macro-prudential perspective.

Therefore, a more precise and risk-effective design of corporate governance by banks, as well as a strict enforcement of corporate governance rules by bank supervisors, will certainly be needed.

Chart 1 - Number of board directors by size (total-asset weighted average)

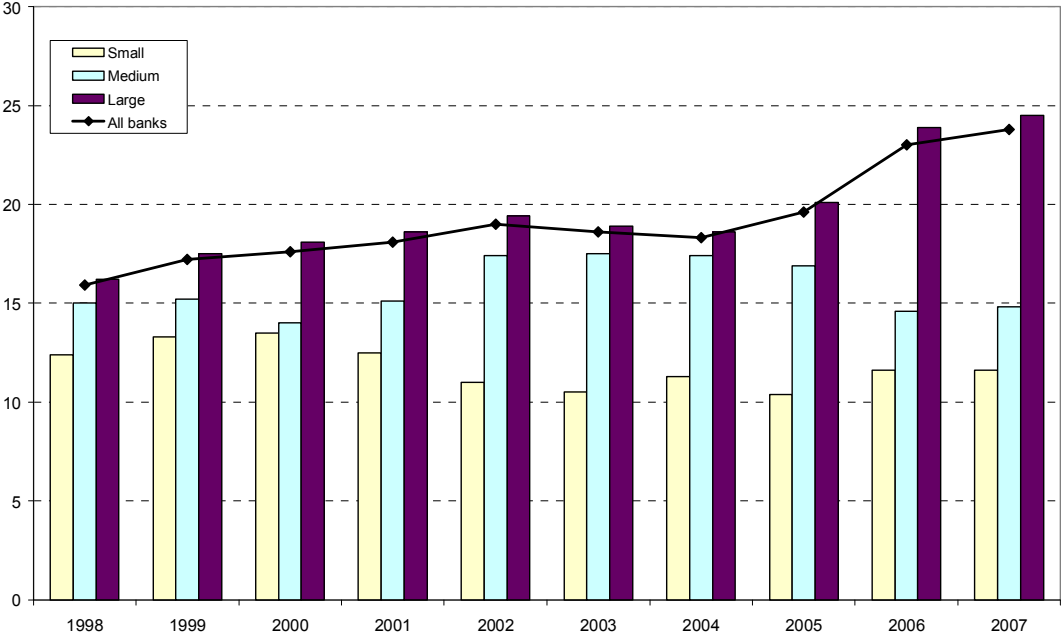


Chart 2 - Number of board directors by type (total-asset weighted average)

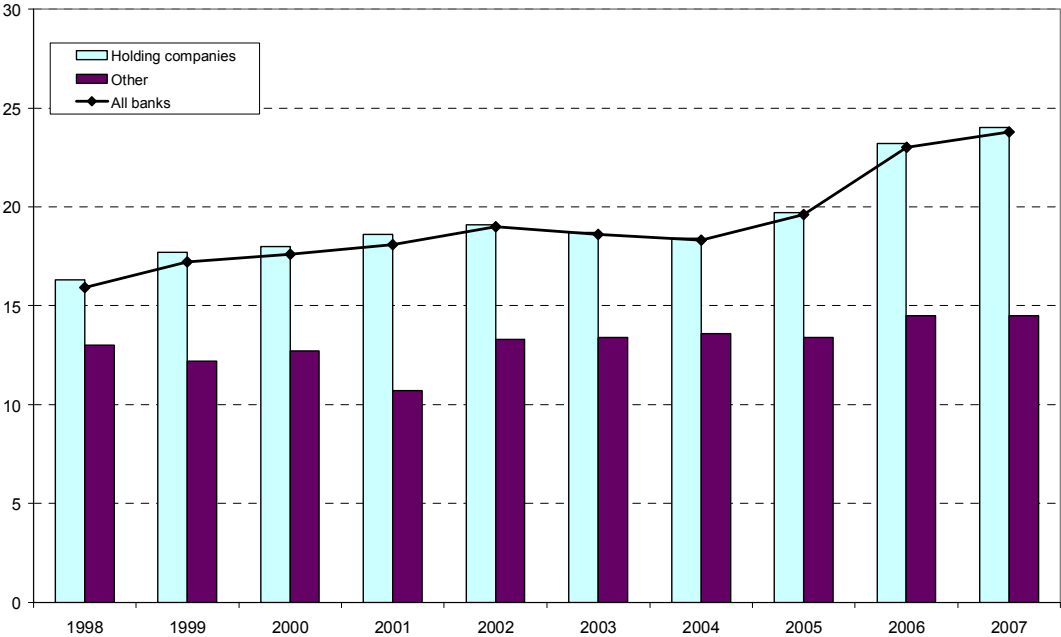


Chart 3 - Number of executive directors by size (total-asset weighted average)

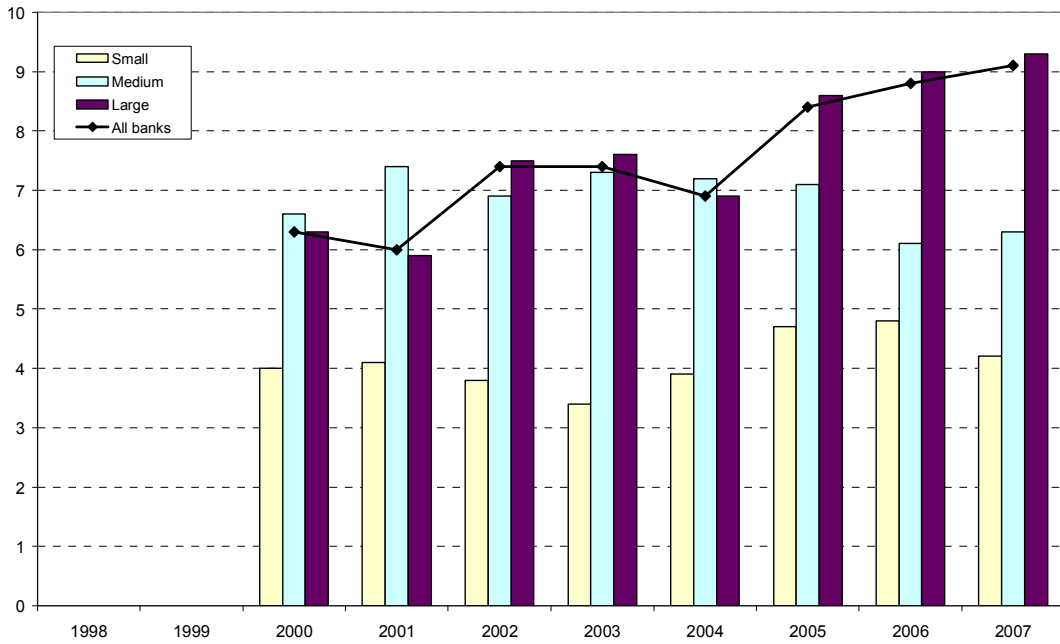


Chart 4 - Number of executive directors by type (total-asset weighted average)

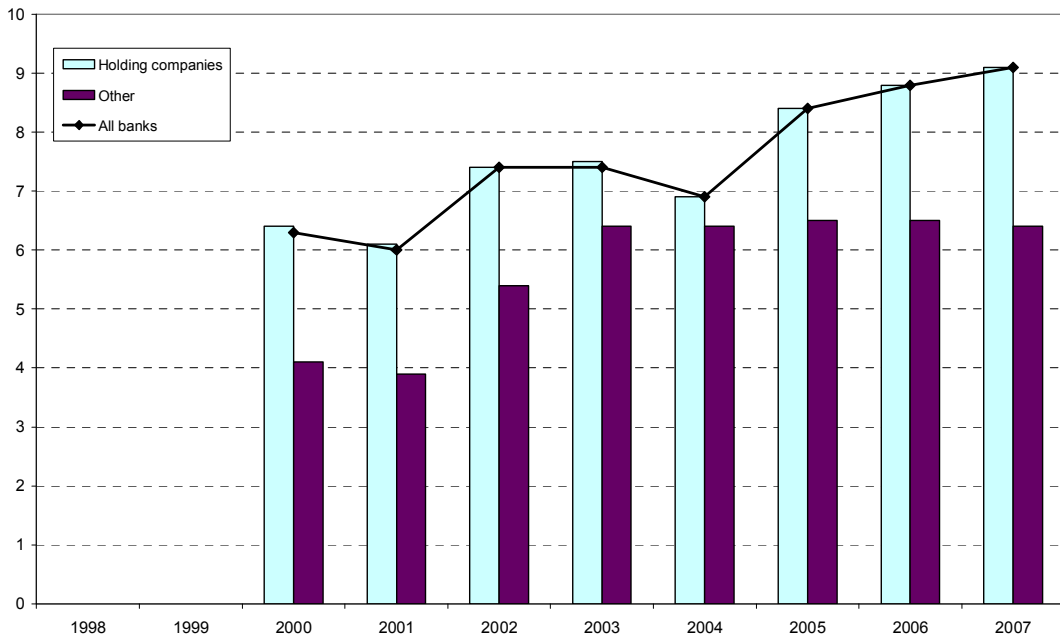


Chart 5 - Share of executive directors by size (total-asset weighted average; percent)

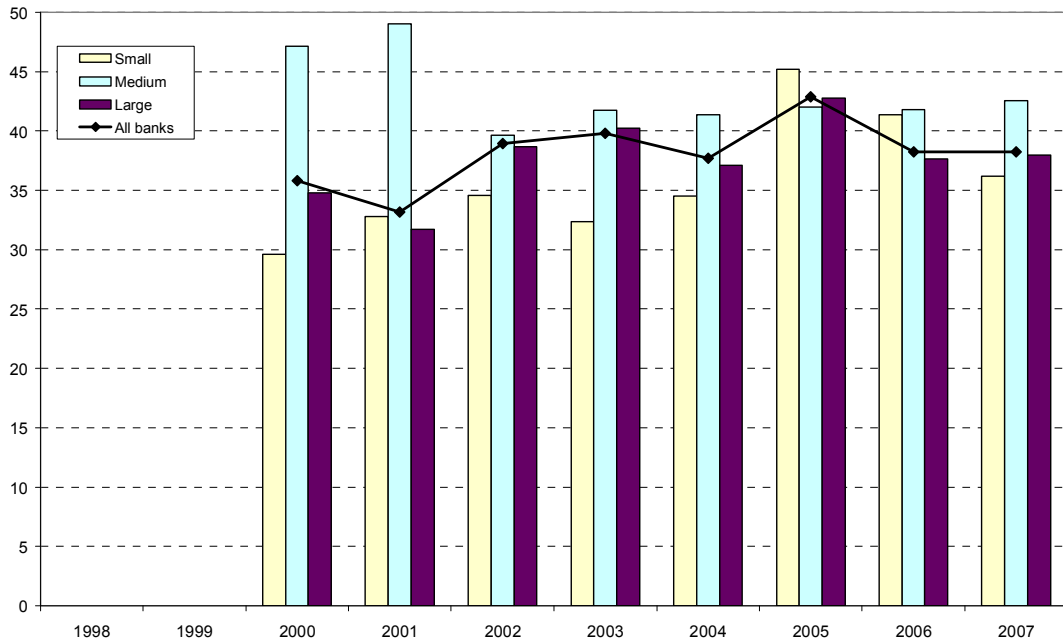
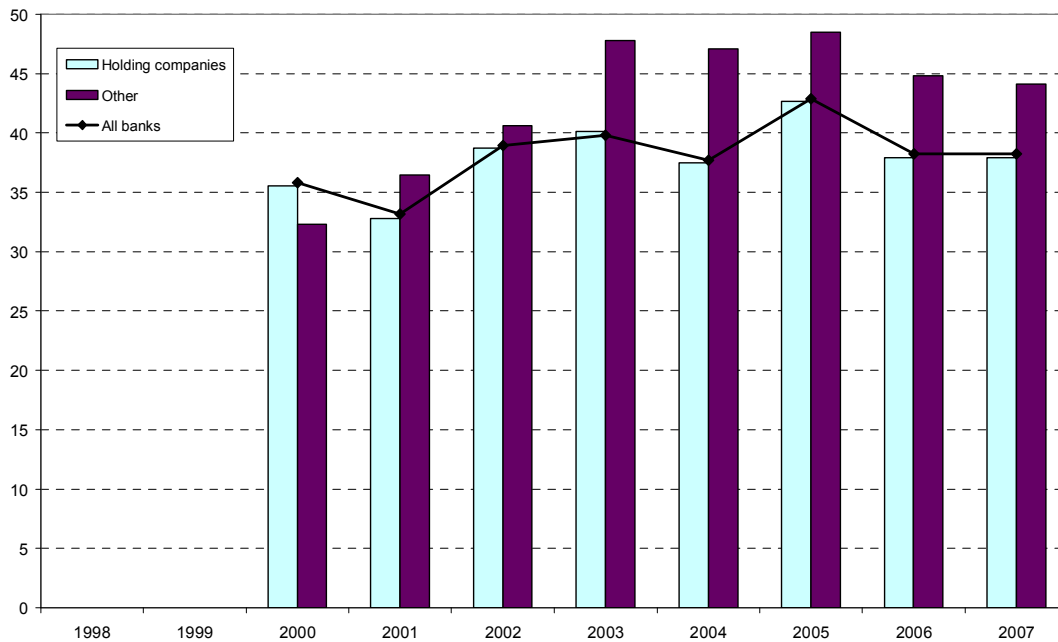


Chart 6 - Share of executive directors by type (total-asset weighted average; percent)



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