

# LAW AND ECONOMICS YEARLY REVIEW

ISSUES ON FINANCIAL  
MARKET  
REGULATION,  
BUSINESS  
DEVELOPMENT AND  
GOVERNMENT'S  
POLICIES ON  
GLOBALIZATION

*Editors*

F. CAPRIGLIONE – R.M. LASTRA – R. MCCORMICK  
C. PAULUS – L. REICHLIN – M. SAKURAMOTO



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# LAW AND ECONOMICS YEARLY REVIEW

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## *Mission*

The “Law and Economics Yearly Review” is an academic journal to promote a legal and economic debate. It is published twice annually (Part I and Part II), by the Fondazione Gerardo Capriglione Onlus (an organization aimed to promote and develop the research activity on financial regulation) in association with Queen Mary University of London. The journal faces questions about development issues and other several matters related to the international context, originated by globalization. Delays in political actions, limits of certain Government’s policies, business development constraints and the “sovereign debt crisis” are some aims of our studies. The global financial and economic crisis is analysed in its controversial perspectives; the same approach qualifies the research of possible remedies to override this period of progressive capitalism’s turbulences and to promote a sustainable retrieval.

## *Address*

Fondazione Gerardo Capriglione Onlus  
c/o Centre for Commercial Law Studies  
Queen Mary, University of London  
67-69 Lincoln’s Inn Fields  
London, WC2A 3JB  
United Kingdom

## *Main Contact*

Fondazione G. Capriglione Onlus - [fondazionecapriglione@luiss.it](mailto:fondazionecapriglione@luiss.it)

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*Marco Sepe*

## PRESENTATION

1. Continuing on a path of in-depth study and of analysis of certain significant issues of “Law and economics”, the Review faces, in its third year, questions concerning the identification of the tools and models suitable to increase the process of economic growth to which the entrepreneurial activity of market operators is aimed at.

Therefore, the different organizational techniques and disciplinary tools adopted by States to ensure conditions of stability within the economic and financial sector must be taken into consideration. In fact, it’s widely acknowledged that we must refer to the mechanisms of corporate governance to correctly understand the social-political context in which these are placed; which is why the analysis of tools, methods and of the organizational structure, as well as the related regulatory framework allows us to identify the elements according to which the company determines and pursues its objectives.

However, it is well known that the profiles that characterize the business reality – albeit with differentiations due to the change of times and of the context we are referring to – since time gone by guide the legal and economic doctrine in the identification of optimal “structural forms” and “corporate governance”. In particular, the convergence towards studies that allow focusing on the technical profiles of the combination cognition/execution, placed at the base of the efficiency of whichever enterprise is noticeable at an epistemological level.

The study (faced in this first issue of the Review) intends to focus, specifically, on the legal criteria of the governance of banking bodies, analysing its configuration from different angles. In this way, it is possible to highlight the centrality attributed to “corporate governance” in the definition of management policies for the credit intermediaries and, more in general, in the acquisition of behavioural guidelines for a fair and balanced exercise of the activity pursued by them.

Hence the definition of the crucial role that financial actors play in the process of economic development. The analysis shows, in fact, that they, together with other forces involved in the entrepreneurial system, help in the search for effective and shared solutions to the countless problems of corporate governance. This relevance is not diminished by the awareness that banking companies involve public interests that the legislator in some countries considered worthy of protection even at constitutional level.

We are facing a problem that appears, by itself, worthy of attention and study; it denotes specific relevance in the present historical moment, where there is regard for the numerous negative implications of the recent “financial and sovereign debt crisis”, which – as it’s known - has raged since 2007, slowing down the development of some industrialized countries and engaging, at times, dangerous recessions.

Hence the goal of the research to provide useful information to readers in relation to the “ways”, expressed by the regulation, to overcome the limits of the “management machine” found in some western financial systems, whose regulation proved itself to be unable to face the challenge of times; information

that may support the creation of new normative structures to prevent that, in future, situations of economic and financial instability, sadly similar to those experienced in recent times, repeat themselves.

2. Particular attention, in the outlined context, should be drawn to the evaluation of the European entrepreneurial system and, especially, to the governance of the components of the financial system. This, due to the fact that in this area there are countries in which the “crisis” has affected them in a very significant way, making it necessary to adopt measures which – in causing deep institutional changes to the systems in question – appear destined to innovate the same management mechanisms of the banks.

Hence the need to orientate the study not only towards the analysis of the remedies adopted by the Member States of the EU (independently or in accordance with specific guidelines adopted by the EU), but also towards the evaluation of the extent of innovations in the changes made (as a consequence to the pathological events mentioned above) to the old system that regulated financial activities and markets. So that, for a complete evaluation of the economic reality of European countries we must examine on the one hand the disciplinary system introduced by them to face the crisis, on the other hand the rules laid down by the competent authorities of the Union following a risk prevention logic for the system.

It appears evident, therefore, how the acknowledgment of the adequacy of the new model of banking governance, towards which the disciplinary measures taken by the heads of the Union seem to be oriented, is related to the

change taking place in the process of Europeanization. Indeed, the reference to the events of recent years shows that the recovery of the entrepreneurial skills of the banking industry will be ensured by more punctual forms of harmonization, that make uniform the disciplinary regime in force in subjecta materia. Moreover, this moving from the rules of corporate governance, primary factor for the efficiency and fairness of the agere, and, therefore, essential prerequisite for any possibility of regrowth. Obviously some undeniable achievements made in Europe stand still, such as the irreversibility of the Euro and the generalized convincement in relation of the need to pursue the path of economic integration, as well as the opportunity to overcome the individualism of some countries (anticipating more cohesive forms of union between states that, for more than half a century, have decided to share a common fate).

In this context, the expectation of a banking activity able to initiate and consolidate the economic recovery (overcoming the stalemate that some countries, like Italy, have reached) is indirectly related to the incidence that the recent institutional changes made in the EU (e.g. UBE and SSM) will be able to complete on the organizational structures of banking intermediaries. More generally, the issue in question – reconnecting to the introduction of criteria for a better harmonization among the members of the financial sector and, therefore, to the implementation of more intense forms of competition between them – will have to take into account the role played by the governing bodies of this system (and first of all of the ECB) in promoting more cohesive forms of participation of banks in the production process.

3. The brief considerations above highlight the many reasons that may push us to dwell on the issue to be analysed. The economic events of the recent years have accelerated the implementation of reforms that ensure increasing levels of system stability: among these, the revision of the governance forms of the entities that operate in markets assumes primary importance.

The improvement of the structures, administrative procedures and disclosure duties for banks identifies the natural completion of a regulatory supervision, which aims to development objectives. Identifying the elements of a corporate governance able to determine conditions of greater balance in economic processes is the goal to be pursued in order to meet the challenge of a change required by the complexity of the “business” practicable in the presence of an “advanced finance” (which gives new aspect to the action carried out by credit institutions), as well as by the need to put this crisis (which has had a profound effect on the socio-economic reality of many countries) “behind our backs”.

**Francesco Capriglione**

*Editor-in-Chief*

# GOVERNANCE OF BANKS IN AN ERA OF REGULATORY CHANGE AND DECLINING PUBLIC CONFIDENCE

Roger McCormick - Andrea Minto\*

**ABSTRACT:** *Corporate governance reforms have become more intrusive for banks than might be thought appropriate for “ordinary corporates”. “Heavier” regulation in this area is justified by the public interest at stake in bank activity and the risk to the public interest if a bank is allowed to fail (and the cost to the public of saving a bank from failure). The public interest (and the interest of all stakeholders) also has implications for the scope of the duty of care of bank directors.*

*Conventional concepts of corporate governance address traditional risk areas in banking activity as well as tensions such as the “agency problem” and the need for oversight by directors of senior management. However, a new set*

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\* Roger McCormick is a Visiting Professor at London School of Economics and Political Science and the Managing Director of CCP Research Foundation CIC, a social enterprise vehicle that supports and undertakes research in topics related to conduct culture and people in large organizations.

Andrea Minto is Post-doctoral Fellow and Adjunct Professor of Banking and Financial Market Law at Ca’ Foscari University of Venice. Although this paper is the result of a joint reflection of the Authors, Roger McCormick is primarily responsible for paragraphs 1 and 6, whereas Andrea Minto is primarily responsible for paragraphs 2, 3, 4 and 5. The paragraphs credited to Andrea Minto reproduce, with some additions, the Presentation regarding “Current risk issues and the challenges of financial undertakings’ internal governance”, held at the University of Southern Denmark on 19 May 2014.

The author would like to thank the Research Group in “Regulating Financial Business and Services” for the suggestions arising from the debate.

*of issues related to public trust has been triggered by the LIBOR scandal and most banks, and many commentators, profess a desire to “restore public trust” and address acknowledged shortcomings in their approach to ethical questions and the soundness of their corporate culture. A related, but different, set of challenges arises as a result.*

**SUMMARY:** 1. Introduction. – 2. The internal governance concept: an overview. – 3. Nature of the firm, risk management and agency issues: new strategies in regulating the governance of banks. – 4. The “organisational duty” and the upward trajectory of the directors’ duty of care and diligence. – 5. Matching board composition to business risks. – 6. Concluding remarks.

1. Six years after the collapse of Lehmans and the onset of the worst financial crisis of the post-war era, there appears, still, to be an ongoing crisis of public trust in relation to how our banks are running. If we take the United Kingdom as an example, we have, in 2014, heard calls for banks to “professionalize” themselves<sup>1</sup>, for bankers to be required to swear solemn oaths as to their honesty and behaviour<sup>2</sup> and for businesses generally (but especially banks) to enter into a “covenant” with the communities they serve. It is fair to say that public confidence in banks remains low.

The idea for the “covenant” was put forward in August 2014 by Lord Digby Jones (former UK government minister and former Director-General of the Confederation of British Industry) when he asserted that “ ...as we come

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<sup>1</sup> See the various publications of the UK's Banking Standards Review.

<sup>2</sup> See the July 2014 publication, “*Virtuous Banking*” by the Res Publica “Think Tank”.

out of one of the worst financial crises this country has ever experienced, trust in business is pretty much at rock bottom". Such sentiments have, in recent times, often been expressed in relation to the banking sector (but have also been heard in relation to the energy sector and various parts of the public sector (such as the police and health services)). The desire (and expressed need) to "restore public trust" has become something of a mantra, repeated with ever-increasing frequency in an expanding range of contexts. But where we hear the mantra most frequently is in the context of banking, from the mouths of bank CEOs and Chairmen. The Chairman of the UK bankers' trade organization, the British Banking Authority, said recently: "Restoring trust and confidence is the banking industry's number one priority".

This outbreak of "restore trust" chest-beating was triggered by the LIBOR scandal, which broke in the summer of 2012. That scandal has proved to be something of a watershed. Before it, the crisis had told us that bankers were by no means as smart as we had thought they were: their risk-taking was out of control to the point of recklessness. But after LIBOR we learnt something else. The industry was not only reckless in its habits, parts of it, perhaps large parts of it, had become downright dishonest. The "culture" had been corrupted. The scandal quickly led, in the UK, to the formation of the Parliamentary Commission on Banking Standards (which, ultimately, begat the Banking Standards Review, referred to above) which held a series of searching interviews with senior bankers and published various reports on the theme of ethics and morality in banking. The ethics/culture refrain has been widely taken

up. But where does this leave the somewhat narrower, more technical, field of corporate governance?

On 12th September 2012, Sir David Walker (who in 2009 had authored a government-sponsored review of bank governance<sup>3</sup> and is currently the Chairman of Barclays) gave evidence to the Parliamentary Commission. He acknowledged that standards in banking were low (but also pointed out that there had been other times in recent history when they had been low). But one of the most telling remarks he made was, in referring to his bank governance review, that he was “struck” that he “did not talk much about culture or reputation” in that document. The biggest issues in 2009 had been (he said) concerned with the “survival of banks” and associated risk issues. Those issues (essentially concerned with financial stability) “overshadowed” the questions of culture and reputational risk that the LIBOR scandal had brought to the fore (which Sir David acknowledged were “very serious”). This, very simple but very telling, analysis by a senior, eminent banker of how public attention shifted, in 2012, from “classic” governance issues (i.e. focused mainly on risk management and responsibility for it) to the “morality/ethics/culture” agenda demonstrates very neatly an important aspect of the relationship between what we know as “corporate governance” and corporate culture. In the context of banking, it is no longer sufficient for policy makers to allow focus on the former (important though it is) to exclude attention to the latter, which presents related, but different, challenges. Whilst, in the context of banking, corporate governance may be more concerned with sound management of risks such as credit risk and

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<sup>3</sup> See “*A review of corporate governance in UK banks and other financial entities*”, November 2009.

other risks traditionally associated with market activity, corporate culture is more concerned with reputational risk and the bank's own sense of what is acceptable (and unacceptable) behaviour. The "crisis of trust", which is directly linked to corporate culture, relates, in simple terms, to how banks are run and, in particular, whether they are run honestly and respectably by people who feel they have some obligation to the society in which they operate that overrides the short-term desire to maximize profit.

Apart from the LIBOR scandal itself, it is worthwhile reflecting on some further examples of bad bank behaviour or culture that have led to the trust crisis. In his evidence to the Parliamentary Commission, Sir David referred to three "strands" that were relevant. The first was the widespread practice (fed by a "commission culture") of mis-selling financial products to consumers (notably, payment protection insurance). The second was the desire of many banks, in the pre-crisis "go-go" atmosphere, to increase market share regardless of price and risk considerations. Thirdly, the huge strides made in technological developments, with expectations of (for example) of rapid responses to complex issues and questions (and the attractions of making quick returns) tended to prioritize ingenuity over integrity. Of course, in the time that has elapsed since Sir David was giving his evidence we have learned of other actual or potential scandals with "LIBOR overtones" in relation to the foreign exchange market and other "benchmark" rates such as Euribor.

And so the "culture" declined. But culture is a tricky, and very vague concept. If banks are trying to restore the situation, it is important that we find ways of testing their success. Fine words alone are not enough. The Conduct

Costs Project<sup>4</sup> offers one approach. If banks are successful in their efforts to improve their conduct, then the cost of poor conduct, as demonstrated by regulatory fines and compensation payments (for example) should start to go down. However, we cannot know if this is the case if we do not keep a log of such costs. That is what the Conduct Costs Project (amongst other things) seeks to do. The Project's findings for ten major international banks for the five year period ending 2013 showed an aggregate conduct cost total of just under £160bn. There is no reason to suppose that the figures for the period ending 2014 will show much improvement. That is a huge figure, so there is evidently some way to go. Banks understandably point out that many of these costs relate to what they now call "legacy issues" but it is perhaps a little too soon to be confident that they really are "legacy" and that the underlying problems have been solved. Other suggested approaches (seeking more "positive metrics") can be found in the Banking Standards Review Report. It remains to be seen whether or not any of these proposals will mature into something more "concrete".

The Conduct Costs Project has already had some influence. In August 2014, the European Banking Authority announced that it would, for the first

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<sup>4</sup> Formerly, the LSE Conduct Costs Project at [blogs.lse.ac.uk](http://blogs.lse.ac.uk). This project is now transferred to the CCP Research Foundation CIC. Apart from the totals, the project provides data on a bank-by bank basis and also breaks down the various "heads of problem" (e.g. mis-selling, AML issues, US sanctions problems etc.).

time, be publishing bank conduct cost data when it published the results of its latest bank stress tests<sup>5</sup>.

If the “trust crisis” is easy enough to identify, finding a solution to it is rather more difficult. The Conduct Costs Project represents a civil society response. Each bank is developing its own response. There does not yet seem to be a cross-industry response but that may develop as the Banking Standards Review progresses its work. What seems to be clear, however, is that, as regards culture, we seem to have reached the limit of what conventional regulation can achieve. We can regulate for corporate governance, for the formation of organizational and reporting requirements and for appropriate risk management. (In short, we can regulate for adequate corporate governance). To regulate for “honest behaviour” and “better culture”, however, would seem to be fatuous. A dishonest man will likely be dishonest whatever the law may say. What we can do is work more diligently on the “grey areas” that still exist as to what is or is not acceptable behaviour and we should, it is suggested, encourage banks to do this in consultation with each other on a cross-industry basis.

Although the trust crisis currently preoccupies banks and industry commentators (at least in the UK), the reform process for “traditional” corporate governance rolls on, gathering momentum in the process. The realization that “banks are different” has given added impetus to the need for a

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<sup>5</sup> In June 2014, Roger McCormick (as Director of the Conduct Costs Project) had given the keynote speech (on the importance of conduct cost reporting and conduct risk management) at the Consumer Protection Day organised in London by the European Banking Authority and other European Supervisory Agencies.

fresh look at what sound corporate governance means in the context of banks and an assessment of how, and to what extent, the rules that apply to ordinary corporates should be amended and amplified in the case of banks. The most important lesson we have learned from the Crisis is that when banks go wrong it is not only shareholders who may suffer. This justifies a much more rigorous approach to such rules as may apply in the bank corporate governance area. The issues that such changes give rise to are considered in the sections that follow.

2. As described in the foregoing section, questions about the corporate governance of banks have become closely associated with issues related to “restoring public confidence” or “public trust”<sup>6</sup>. Indeed, the CEOs and Chairmen of many major banks have, particularly since the unfolding of the LIBOR scandal, reminded us at regular intervals that they see the restoration of public trust in their bank as a central part of their mission. The scandals that have emerged following the 2007-2008 Crisis have provoked much reflection on the role and degree of intervention by regulators, substantially shifting from what was perceived to be a “light-touch” towards a heavier approach<sup>7</sup>. Prominent items

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<sup>6</sup> It is quite expressive the *incipit* of the EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011: «Trust in the reliability of the banking system is crucial for its proper functioning and a prerequisite if it is to contribute to the economy as a whole. Consequently, effective internal governance arrangements are fundamental if institutions, individually, and the banking system, are to operate well». On the need of restoring the lost trust due to the mismanagement, see also the UK Banking Standard Review Report, May 2014.

<sup>7</sup> See WEBER - REY, *Effects of the Better Regulation Approach on European Company Law and Corporate Governance*, in *European Company and Financial Law Review*, 2007, pp. 393 - 394; DALLA

on regulatory agendas are the improvement of both banks' corporate governance systems and the authorities' supervision of them.

Alongside changes to substantive laws and regulation, regulators and policy makers have been reconsidering what can and should be expected of "corporate governance" in the context of banking. There has been a realisation that traditional concepts and associated rules and organizational structures related to "corporate governance" and the classical "agency theory" underpinning the law relating to corporate management and responsibility to shareholders do not really deliver what society expects from financial institutions that depend on substantial direct and indirect support from the taxpayer and that, consequently, owe duties to stakeholders that would not generally apply in a non-financial context (i.e. to an "ordinary" corporate entity)<sup>8</sup>.

Redefining the boundaries of what "corporate governance" actually means in the context of banks involves not only a fresh look at its content, which has become blurred over time<sup>9</sup>. It also requires a review of the way a corporation is governed that re-examines the traditional agency scheme mostly focused on the tension between shareholders and management interests. The

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PELLEGRINA - MASCIANDARO, *Good Bye Light Touch? Macroeconomic Resilience, Banking Regulation and Institution*, in *Journal of Risk Governance and Control*, vol.3, n. 1, 2013, p. 18.

<sup>8</sup> Commenting the recent regulatory changes, it has also been proposed a modification to the corporate governance of system financial firms as to take into account their peculiarities. See ARMOUR - GORDON, *Systemic Harms and Shareholder Value*, in *ECGI Law Working Paper*, 2013, n. 222, p. 5; ROE, *Structural Corporate Degradation Due to Too-Big-Too-Fail Finance*, in *ECGI Law Working Paper*, 2014, n. 253.

<sup>9</sup> See BELCREDI - ENRIQUES, *The European Corporate Governance Framework: Issues and Perspectives*, in *ECGI Law Working Paper*, 2013, n. 214.

legal strategies conceived in the pre-Crisis era to address the agency issues between shareholder interests and management no longer seem adequate as an effective and concrete response also to the issues that the Crisis has raised<sup>10</sup>.

Even though, in the aftermath of the Crisis, there have been controversial opinions about corporate governance issues<sup>11</sup>, there is much common ground that malfunctioning of the management body has been a key contributory factor to the problems that have been experienced.

The main weakness revealed by the bank collapses was the lack of oversight by the failed bank's management body (i.e. the board of directors), which did not properly perform either its management or its supervisory

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<sup>10</sup> As regard the increasing attention on organizational mechanisms that were often ignored by the corporate governance models, see MCCAHERY - VERMEULEN, *Understanding the Board of Directors after the Financial Crisis*, in *ECGI Law Working Paper*, 2013, n. 229, p. 11.

<sup>11</sup> See, e.g., AKHIGBE – MARTIN, *Influence of Disclosure and Governance on Risk of U.S. Financial Services Firms Following Sarbanes-Oxley*, in *Journal of Banking and Finance*, 2008, p. 2124; KIRKPATRICK, *The Corporate Governance Lessons from the Financial Crisis*, in *Financial Market Trends*, OECD, 2009, n. 1, p. 1; MÜLBERT - CITLAU, *The Uncertain Role of Banks' Corporate Governance in Systemic Risk Regulation*, in *ECGI Law Working Paper*, 2011, n. 179; PATHAN, *Strong boards, CEO power and bank risk-taking*, in *Journal of Banking and Finance*, 2009, p. 1340; BELTRATTI - STULTZ, *Why Did Some Banks Perform Better during the Credit Crisis? A Cross-Country Study of the Impact of Governance and Regulation*, in *ECGI Finance Working Paper*, 2009, n. 254; ERKENS – HUNG - MATOS, *Corporate Governance in the 2007–2008 Financial Crisis: Evidence from Financial Institutions Worldwide*, in *ECGI Finance Working Paper*, 2009, n. 249; CLAESSENS – DELL'ARICCIA – IGAN - LAEVEN, *Lessons and Policy Implications from the Global Financial Crisis*, IMF Working Paper, 2010, n. 44; AHRENS – SCHWEICKERT - ZENKER, *Varieties of capitalism, governance and government spending: A cross-section analysis*, in *Kiel Working Papers*, 2011, n. 1726; BERGER – IMBIEROWICZ - RAUCH, *The role of corporate governance in bank failures during the recent financial crisis*, in *European Banking Center Discussion Paper*, 2012, n. 23; BECHT – BOLTON – RÖELL, *Why bank governance is different?*, in *Oxford Review of Economic Policy*, 2012, p. 437; HOPT, *Corporate governance of Banks and Other Financial Institutions After the Financial Crisis*, in *Journal of Corporate Law Studies*, 2013, p. 219.

function<sup>12</sup>. The failure of bank boards to supervise the business appropriately was largely due to difficulties at senior level in grasping the complexity of the business and the risks involved, and the related failure to identify and constrain excessive risk-taking<sup>13</sup>. The need to identify, and keep to, a predetermined threshold of risk tolerance (or “appetite”) is at the heart of the decision-making process and to the relationship between the board of directors and senior executives<sup>14</sup>. The resulting allocation of powers entails the separation of tasks between senior management and the board of directors: the execution of business decisions is the province of the former, while the determination of the strategic plans and the monitoring of management performance in the context of those strategies, is the province of the latter<sup>15</sup>.

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<sup>12</sup> We refer interchangeably to the supervisory function and to the monitoring one, even if the former is actually broader than the latter as it oversees the management function and provides advice to it. Its oversight role consists in providing constructive challenge when developing the strategy of an institution; monitoring of the performance of the management function and the realization of agreed goals and objectives; and ensuring the integrity of the financial information and effective risk management and internal controls (see the definition provided by the European Banking Authority, *Guidelines on Internal Governance*, London, September 2011).

<sup>13</sup> Focusing on the risk management role of the board of directors WYMEERSCH, *Risk in Financial Institutions – is it managed?*, in *FLI Working Paper*, 2012, n. 4.

<sup>14</sup> See ADAMS – HERMALIN - WEISBACH, *The role of board of directors in corporate governance: a conceptual framework and survey*, in *Journal of Economic Literature*, 2010, 48, pp. 58 ff.

<sup>15</sup> Obviously, the separation of powers and tasks strictly depends on whether the company has adopted the one-tier or two-tier board structure: for an overview, see WILLIAMSON, *Corporate Board of Directors: in Theory and in Practice*, in *Journal of Law, Economics & Organization*, 2008, 24, pp. 247 ff.; ARMOUR – HANSMANN - KRAAKMAN, *What is Corporate Law?*, in KRAAKMAN et al. (eds.), *The Anatomy of Corporate Law. A comparative and Functional Approach*, Oxford University Press, 2009, pp. 12 ff.

Focusing on the monitoring function of the board of directors, various international bodies<sup>16</sup> have paid increasing attention to the concept of “internal governance”. This has led to a marked focus on specific issues in the corporate governance area, for example, the arrangements within a bank for the sound management of risk. The definition of internal governance was initially covered by article 22 of the Directive 2006/48/EC, which provided «that every credit institution has robust governance arrangements, which include a clear organizational 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, adequate internal control mechanisms, including sound administrative and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management».

In the wake of a growing interest around this topic, the European Banking Authority has shed light on internal governance requirements through *ad hoc* guidelines, arguing that internal governance is closely related to, but different from, corporate governance. The former should be considered as a limited but crucial component of corporate governance, focusing on the internal structure and organization of an institution and especially the delegation of powers to

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<sup>16</sup> See BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for enhancing corporate governance*, October 2010; ORGANIZATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT, *Corporate governance and the financial crisis - Conclusions and emerging good practices to enhance implementation of the Principles*, February 2010; EUROPEAN COMMISSION, *Green Paper on Corporate governance in financial institutions and remuneration policies*, June 2010.

senior management and to the corresponding monitoring function for which the board is responsible.

Directive 2013/36/EU (the Fourth Capital Requirement Directive, hereinafter “CRD IV”), which repealed Directive 2006/48/EC (referred to above), has further developed the regulatory framework in this area in accordance with the European Banking Authority guidelines.

As is well-known, corporate governance measures traditionally stem less from provisions in laws or regulations, which often adopt a high-profile generic formulation, and more from agreed documents and contracts, such as corporate governance codes which may be transposed into appropriate provisions in the articles of association<sup>17</sup>. The last round of changes to European banking law, consisting mainly of CRD IV – and Directive 2014/65/EU as well, but actually with reference to markets in financial instruments and to investment firms (known as “MiFID II”) – marked a regulatory *revirement*, steering away from the previous general provisions on risk management and internal control towards a proliferation of more detailed rulemaking, with new mandatory and regulatory determined measures and several specific activity related requirements<sup>18</sup>.

Thus, the outcome of the ongoing reform process concerning the regulation of corporate governance is a framework with the objective, on the one hand, to emphasize specific areas – such as internal governance –and, on the other hand, to provide more detailed prescriptive provisions than in the

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<sup>17</sup> See ARMOUR - RINGE, *European Company Law 1999-2010: Renaissance and Crisis*, in *Common Market Law Review*, 2011, 48, pp. 125 ff.

<sup>18</sup> On these themes, see VAN DER ELST, *The Risk Management Duties of the Board of Directors*, in *Financial Law Institute Working Paper*, Gent University, 2013, 12.

past, resulting, it is hoped, in a more rigorous risk and management regime than resulted from the broad adoption of the “better regulation” technique<sup>19</sup>.

In light of the weaknesses in the way financial firms were run, the majority of the recent developments on corporate governance of banks are predominantly focused on improving the working of the management body and on the internal organizational measures that could serve this purpose. It appears that the most recent reforms are concerned less with working out *directly* the classic agency problems between shareholders and managers and more at concerns that are due to the special nature of financial business, since the *risks* involved in running that kind of business are what shape the conduct expected.

What do we mean by “special nature of financial business”? It has often been observed that “banks are different” and, in this context, it is the peculiar risks that financial institutions have to manage and, at the same time, the public interest in successful management of such risks that makes financial business “special”<sup>20</sup>. As recent events have painfully showed, many and multi-faceted

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<sup>19</sup> See Recital 53 of CRD IV, stating that «the very general provisions on governance of institutions and the non-binding nature of a substantial part of the corporate governance framework, based essentially on voluntary codes of conduct, did not sufficiently facilitate the effective implementation of sound corporate governance practices by institutions».

<sup>20</sup> Banks are different from other firms for several reasons that matter from a corporate governance perspective: see, e.g., MACEY - O'HARA, *The Corporate Governance of Banks*, in *Economic Policy Review*, 2003, 9, pp. 91 ff.; ADAMS - MEHERAN, *Is Corporate Governance Different for Bank Holding Companies?*, in *Economic Policy Review*, 2003, 9, pp. 123 ff.; COCRIS - UNGUREANU, *Why are Banks Special? An Approach from the Corporate Governance Perspective*, in *ALI Cuza University of Iasi, Economic Series*, 2007, 55; MÜLBERT, *Corporate Governance of Banks after the Financial Crisis — Theory, Evidence, Reforms*, in *ECGI Law Working Paper*, 2009, n. 130; FERRARINI – UNGUREANU,

banking risks involve not just shareholders' interests but also the interests of a wide range of stakeholders, such as creditors, "taxpayers" and the financial system as a whole<sup>21</sup>.

A key driver of the reform of corporate governance of banks is therefore the need to consider the wider range of consequences may result from a financial institution's failure and how this affects the directors' duty of care and the duty to establish an effective oversight system<sup>22</sup>. It is no longer tenable to argue that bank's directors owe only duties to shareholders<sup>23</sup>. In reality, they

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*Economics, politics, and the international Principles for Sound Compensation Practices: An analysis of executive pay at European banks*, in *Vanderbilt Law Review*, 2011, 64, pp. 431 ff. Accordingly to BELCREDI - ENRIQUES, *The European Corporate Governance Framework: Issues and Perspectives*, in *ECGI Law Working Paper*, 2013, n. 214, pp. 11 ff., there are substantially three key factors. First, banks are more leveraged than other firms, with the consequence that the conflict between shareholders and fixed claimants, which is present in all corporations, is more acute for banks. Second, banks' liabilities are largely issued as demand deposits, while their assets, such as loans, have longer maturities. Third, despite contributing to the prevention of bank runs, deposit insurance generates moral hazard by incentivizing shareholders and managers of insured institutions to engage in excessive risk-taking.

<sup>21</sup> See BECHT – BOLTON - RÖELL, *Why Bank Governance Is Different*, in *Oxford Review of Economic Policy*, 2011, 27, pp. 444 ff.; HOPT, *Comparative Corporate Governance: The State of the Art and International Regulation*, in *American Journal of Comparative Law*, 2011, 59, pp. 28 ff.

<sup>22</sup> See JOHNSON, *Addressing Gaps in the Dodd-Frank Act: Directors' Risk Management Oversight Obligations*, in *Seton Hall Public Law Research Paper*, 2011, n. 3; MILLER, *Oversight Liability for Risk Management Failures at Financial Firms*, in *Southern California Law Review*, Vol. 84, 2011, 47.

<sup>23</sup> It has been argued that in the long run the corporate actions might maximize both shareholder wealth and enterprise value: HOPT – LEYENS, *Boards Models in Europe – Recent Developments of Internal Corporate Governance Structure in Germany, United Kingdom, France and Italy*, in *European Company and Financial Law Review*, 2004, 1, pp. 134 ff.; TUSCHKE - LUBER, *Corporate Governance in Germany: Converging towards Shareholders Value-Oriented or not so Much?*, in RASHEED - YOSHIKAWA, (eds.), *The Convergence of Corporate Governance – Premise and Prospects*, New York, 2012, pp. 75 ff.; MERKT, *Internal and External Corporate Governance*, in FLECKNER - HOPT (eds.), *Comparative Corporate Governance: A Functional and International Analysis*, Cambridge University

have a broader responsibility than directors of non-bank corporates and internal governance serves exactly the purpose of helping them discharge that responsibility.

3. The European Commission has recently stated that «financial institutions' internal governance cannot be reduced to a simple problem of conflicts of interest between shareholders and the management» and thus governance rules «must be adapted to take account of the *specific nature of these companies*», in pursuit of the goal of enhancing the internal organizational measures<sup>24</sup>.

Since the risk issues are seriously considered by policymakers<sup>25</sup>, the peculiarity of banking activity is at the center of the regulatory setting. It is significant that CRD IV requires member States to «introduce principles and standards to ensure effective oversight by the management body, promote a sound risk culture at all levels of credit institutions and investment firms and enable competent authorities to monitor the adequacy of internal governance

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Press, 2013, pp. 521 ff.; DAVIES - HOPT, *Corporate Boards in Europe – Accountability and Convergence*, in *American Journal of Comparative Law*, 2013, 61, 301; FERRARINI - FILIPPELLI, *Independent directors and controlling shareholders around the world*, in *ECGI Law Working Paper*, 2014, n. 258, 13.

<sup>24</sup> See EUROPEAN COMMISSION, *Green Paper on Corporate governance in financial institutions and remuneration policies*, June 2010; see also OECD, *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles*, February 2010.

<sup>25</sup> See HOPT, *Better Governance of Financial Institutions*, in *ECGI Law Working Paper*, 2013, n. 207, 11, noticed that «in the Basel Committee's eight principles for good governance of banks in 2006, the word "risk" does not appear at all, while in the fourteen principles of 2010 it appears in nine of the fourteen principles».

arrangements. Those principles and standards should apply taking into account the *nature, scale and complexity of institutions' activities*» (Recital 54; the same concept also is expressed by Recital 5 of MIFID II).

Two fundamental issues arise. First, banking activity makes directors' duty of care greater than in other businesses: the onus of responsibility is necessarily higher and more difficult to discharge, given the range and complexity of activities of most banks<sup>26</sup>. In the case of banking business, common directors' duties need to be fulfilled in accordance to the enriched set of risks they have to face, all along the decision-making chain: if generally in making business decisions the directors must act on an informed basis, banks' directors are obliged to gather wider and more frequently compiled sets of information in order to be aware of all the exposures and risks the bank faces and so to safeguard the proper and prudent management of the institution<sup>27</sup>.

Secondly, the nature of banking business underpins the need for banking law to adopt a different approach or strategy from general corporate law to the extent the latter is not sufficient to protect all the public interest.

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<sup>26</sup> See ADAMS - FERREIRA, *Regulatory Pressure and Bank Directors' Incentives to Attend Board Meetings*, in *ECGI Finance Working Paper*, 2008, n. 203; HOPT, *Trusteeship and Conflicts of Interest in Corporate, Banking, and Agency Law: Toward Common Legal Principles for Intermediaries in the Modern Service-Oriented Society*, in Ferrarini, Hopt, Winter and Wymeersch, eds., *Reforming Company and Takeover Law in Europe*, Oxford, Oxford University Press, 2004, pp. 51 ff.

<sup>27</sup> In Italy, Cassazione February 5 2013, n. 2337, stated that bank directors have a greater duty of care than in non-financial firm as the diligence expected reflects the nature of banking activity. In discharging the duty to oversight, they must use all the organizational measures at their disposal, and in particular, non-executive directors cannot behave passively waiting to be informed by the executive ones, in particular because they can rely on the internal control system through which they could gather information about the action of the hired officers.

As a general principle, the decision-making process is supposed to reflect the nature of the undertaking's activity, as managers and directors' decisions determine the exposure to the risks arising from the specific business they are entrusted to govern. Accordingly, in banking institutions the complexities involved in identifying, assessing and monitoring the typical risks this kind of business faces set the bar very high for the conduct expected from those responsible for risk decisions: directors are required not only to pay more attention than in normal firms, as already mentioned, but also to be able to rely on well-defined organizational structures to assist with the decision-making process.

Thus, the complexity of banking business requires the implementation of a specific risk governance framework, which must satisfy the internal control needs, given that individual directors are realistically unable to handle all relevant issues by themselves without assistance that they can reasonably rely on.

Internal governance has caught policymakers' attention because it covers the set of internal rules, processes, procedures, structures and functions that are necessary to make the business work. It includes all standards and principles concerned with setting a firm's objectives, strategies, and risk tolerance and appetite, how its business is organized, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey.

In almost all jurisdictions, corporate law provides for directors to set up an internal structure, which is adequate to the nature and scale of the firm's activities, leaving to them the responsibility of working out the details of the

arrangement. Conversely, banking law predetermines *ex lege* the essentials the internal structure banks must establish, allowing less room for the directors' discretion in relation to such details, with much more prescriptive, and detailed, regulation<sup>28</sup>.

A prominent example of this more intrusive approach requirements is the imposition of an internal control system as the main binding component of internal governance: if it is true that all corporations – included but not limited to banks – have an internal code or order (the internal governance), it is not always the case that all firms should be equipped with a control system framework, since this is in the discretion of directors. Since it is impractical to provide for a “one-size-fits-all” internal governance structure, corporate law does not generally specify what is required to constitute the organizational framework but instead requires directors to define it. Corporate law merely identifies in general terms the goal directors must pursue in performing their organizational duty.

As the aim of this general approach is provide for a wide range of circumstances, it could be argued that it should also apply to banks. However, banking law does not “run the risk” of directors being unable to properly manage the business.

Banking law cannot afford to risk giving directors the level of discretion that might apply to non-bank businesses because, with banking, the public interest is at stake. For this reason, it provides in more detailed provisions what

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<sup>28</sup> On the relationship between the directors autonomy and the authority interference see also the next paragraph.

directors are required to do in order to establish the internal governance of the institution. The different approach that one finds in the case of banking law, as opposed to general corporate law does not mean the former derogates or is an exception to the latter. Banking law simply clarifies explicitly the content of a general principle, which in corporate law is addressed only implicitly.

In other words, one could say that, to some extent, financial law spells out what is generally a director's liability matter in order to protect market stability (or the public interest). Obviously, this does not imply that the regulator does the directors' job for them, but rather that it clarifies, into substantial rules, the specific application of a general principle in the case of banking business, making "visible" what is implicit in other contexts. Moreover, even if bank directors' duty to set up the internal governance appears quite restrictive, directors are nevertheless free to decide *how* to implement what the regulation requires, so as to preserve room for the inevitably differences within bank corporations and the consequent differing risk profiles that directors have to address.

Imposing the establishment of an internal control framework, banking regulation thus requires a mandatory organizational structure, which is chiefly preordained to improve the decision-making process, in line with the special functions and risks of banking, such as, e.g., credit, market, liquidity operational, concentration, reputational, compliance and strategic risk<sup>29</sup>.

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<sup>29</sup> See HAMALAINEN, *Mandatory Subordinated Debt and the Corporate Governance of Banks*, in *Corporate Governance: An International Review*, 2004, 1, pp. 93 ff.; LEVINE, *The Corporate Governance of Banks: A Concise Discussion of Concepts and Evidence*, in *World Bank Policy Research Working Paper*, 2004, n. 3404; MULLINEX, *The Corporate Governance of Banks*, in *Journal of*

Referring to EBA *Guidelines*, «the internal control framework of an institution should ensure effective and efficient operations, adequate control of risks, prudent conduct of business, reliability of financial and non-financial information reported, both internally and externally, and compliance with laws, regulations, supervisory requirements and the institution's internal rules and decisions. The internal control framework should cover the whole organization, including the activities of all business, support and control units. The internal control framework should be appropriate for an institution's business, with sound administrative and accounting procedures»<sup>30</sup>.

Besides procedures, rules and other organizational devices, the internal control system includes specific independent control functions, such as a Risk Control function, a Compliance function and an Internal Audit function<sup>31</sup>.

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*Financial Regulation and Compliance*, 2006, 14, 375; LAEVEN – LEVINE, *Bank Governance, Regulation and Risk Taking*, in *Journal of Financial Economics*, 2009, 93, pp. 259 ff.; UNGUREANU, *Banks: Regulation and Corporate Governance Framework*, in *Corporate Ownership & Control*, 2008, 2, 449 ff.; MÜLBERT, *Corporate Governance of Banks after the Financial Crisis — Theory, Evidence, Reforms*, in *ECGI Law Working Paper*, 2009, n. 130; ID., *Corporate Governance of Banks*, in *European Business Organization Law Review*, 2009, 10, pp. 411 ff.; BECHT, *The Governance of Financial Institutions in Crisis*, in Grundmann et al. eds., *Festschrift für Klaus J. Hopt*, Berlin, 2010, II, pp. 1615 ff.

<sup>30</sup> See EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011, 24.2.

<sup>31</sup> As known, the internal control system is structured on a “three-lines-of-defence model”: the primary responsibility for the identification, control, monitoring and mitigation of risk lies with operational areas across each business area; second line of defence is provided by Compliance Function and Risk Management Function; the last, third line of defence is the function performed by the Internal Audit which is responsible for providing independent review of the effectiveness of the whole risk management framework and adherence to processes in the first and second lines. The internal control functions should be independent of the business and support units they monitor and control as well as organizationally independent from each other, since they perform different functions (even if, pursuant to the proportional

In line with the general internal governance concept, internal control functions are specifically meant to support directly the management body and to help it be more aware of the level of risk exposure. An example is the reporting function required in cases where senior management undertakes greater risks than those anticipated planned in the strategy outlook<sup>32</sup>.

As a key responsibility, the management body has to set and oversee the business strategy of the institution. In doing so, the management body is required to define the overall risk strategy and policy of the institution, including its risk tolerance and appetite and its risk management framework in order to plan how to behave and react in a variety of risk scenarios<sup>33</sup>.

In addition, the management body should formalize the limits if the risks the bank is *a priori* prepared to take and the actual limits the institutions pursues, with a clear definition of what the strategic plans are (with the imposition of formalizing the business model) and which risks are implied by achieving them (obligation to implement a Risk appetite framework<sup>34</sup>).

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principle, in less complex or smaller institutions, the tasks of the Risk Control and Compliance function may be combined). See, e.g., LYONS, *Defending Our Stakeholders: Corporate Defence Management Explored*, in *The Business Continuity and Resiliency Journal*, 3, 2012.

<sup>32</sup> See FENG – LI - McVAY, *Internal control and management guidance*, in *Journal of Accounting and Economics*, 2009, 48, pp. 190 ff.

<sup>33</sup> See EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011, 8.2; BASEL COMMITTEE ON BANKING SUPERVISION, *The internal audit function in banks*, June 2012.

<sup>34</sup> In Italy, the national supervisory authority (Bank of Italy) want the board of directors to formalize the “Risk Appetite Framework” (RAF), which has to contain of some parameters about the risk profile as to conduct properly the business having them constantly monitored. This reference framework expresses the following items: *i*) the maximum risk level a bank institution is technically able to face (risk capacity); *ii*) the risk level is supposed to be taken by the bank to achieve the predetermined strategies (risk appetite); *iii*) the maximum deviance from risk appetite to assure bank stability under the threshold of risk capacity

Compliance and Risk control functions are involved in providing relevant independent information, analyses and expert judgment on risk exposures, and advice on proposals and risk decisions made by the management body and business or support units as to whether they are consistent with the institution's risk tolerance/appetite. In particular, they are also required to recommend improvements to the risk management framework and options to remedy breaches of risk policies, procedures and limits.

In light of the above, it is clear that the internal control system is intended primarily to enhance the way the board of directors fulfils its duties, as it serves the scope of assisting the analysis of the risks directors are prepared to accept as appropriate for the business whilst at the same time fulfilling their supervisory task. The current legislative strategies on bank corporate governance are in fact more focused on the business activity features and on the best way to govern risks than on the traditional agency issues between managers and shareholders.

Since the main topic of current regulatory policy is the improvement of the decision-making process, emphasis should be no longer put on the conflicts of interest between shareholders and management (i.e. the classical agency problem) but on the conflict of interests between the board of directors and executives.

The agency issues between the management body (both as whole and as regards its individual non-executive members) and senior management could

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(risk tolerance); *iv*) the risks actually taken (risk profile); *v*) the definition of operative boundaries consistent with the risks estimated (risk limits).

stem from the tendency of the latter to serve their own interests instead of the corporation's<sup>35</sup>. The relationship between the executive (who manages) and the non-executive (who monitors how the executive has worked) is becoming challenging – as in all agency situations in which agents delegate powers to principals<sup>36</sup> – due to the lack of information: «because evaluations and decisions are shaped by the information available to the decision maker, of the executives control the information the board receives, the board's monitoring and decision making functions often will be little more than nominal»<sup>37</sup>.

Accordingly, the internal control system plays a role in eliminating the information imbalances amongst directors and senior management. If we read together two statements by the European Banking Authority, one saying that «the control functions should be established at an adequate hierarchical level and report directly to the management body», and the other one underlying that, «in assessing the efficiency of Internal Control within an institution, the management body should be able to rely on the work of control functions, including the Risk Control function, the Compliance function and the Internal

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<sup>35</sup> See HOPT, *Better Governance of Financial Institutions*, in *ECGI Law Working Paper*, 2013, n. 207, 8.

<sup>36</sup> See JENSEN – MECKLING, *Theory of the Firm: Managerial Behaviour, Agency Costs and Ownership Structure*, in *Journal of Financial Economics*, 1976, 3, 5; FAMA – JENSON, *Separation of Ownership and Control*, in *Journal of Law and Economics*, 1983, pp. 301 ff.; ARROW, *The Economics of Agency*, in Pratt, Zeckhauser, eds., *Principals and Agents: The Structure of Business*, Harvard, 1985, pp. 37 ff.; DONALDSON - DAVIS, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, in *Australian Journal of Management*, 1991, 49 ff.; DEMSETZ, *The Economics of the Business Firms*, Cambridge, 1995, 15 ff.; HART, *Corporate Governance: some Theory and Implications*, in *The Economic Journal*, 1995, pp. 678 ff.

<sup>37</sup> See EISEMBERG, *The Board of Directors and Internal Control*, in *Cardozo Law Rev*, 1997, 19, 246; HILL, *Centro and the Monitoring Board - Legal Duties versus Aspirational Ideals in Corporate Governance*, in *UNSW Law Journal*, 2012, 35, pp. 341 ff.

Audit function»<sup>38</sup>, it is clear that internal control measures, and particularly control functions, are meant to stay close to the management board. It is up to the latter to gather the information and obtain the elements it needs, firstly to plan the business strategies and the risk appetite and, secondly, to assess and verify how the entrusted officers and managers are doing, in relation to the agreed risk tolerance.

Internal control is not simply a warning system, which purports to save the management board from higher risk, but a complex set of requirements that results in processes to identify, measure or assess, monitor, mitigate and report on risks. Hence, internal control is “good” as long as it restricts harmful operations, but it becomes “bad” when it restricts useful ones<sup>39</sup>. This point is important as it is strictly related to the strategic plans and business long-term strategies the board has adopted. In this sense, cumbersome internal control systems tend to stifle innovation since innovation is always risky, even if the outcome could be opportunities that increase firm value<sup>40</sup>.

In addition, the “nature” of the control activities performed by the internal functions reveals once again that they are conceived as a *staff* structure serving the management body. Unlike the role traditionally played by the Audit

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<sup>38</sup> See EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011, 24.5.

<sup>39</sup> See STULZ, *Governance, Risk Management, and Risk-Taking in Banks*, in *ECGI Finance Working Paper*, 2014, n. 427.

<sup>40</sup> See KAPLAN - ANNETTE, *Managing Risks: A New Framework*, in *Harvard Business Review*, 2012.

Committee<sup>41</sup>, the role of the internal control functions is principally to operate as a sort of advisor to the board, involving, for example, expressions of business judgment. Even if the final decision-maker is naturally the board of directors, internal control functions must pronounce on the merit of the business decision, as they possess the expertise required in order to deeply understand the risks undertaken<sup>42</sup>. This is why the head of the control functions should regularly attend board meetings.

In this regard, it has to be borne in mind that the internal control system, as a component of the internal governance measures, is a series of organizational mechanisms required to make the decision-making process run in an efficient and effective way. Consequently, the work of the internal control functions is mostly required to operate during the decision-making process (*ex ante* control) rather than at the time the decision has already been taken (*ex post* control)<sup>43</sup>. Therefore, internal control system aims at following step by step how business decisions are taken.

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<sup>41</sup> See KRISHNAN, *Audit Committee Quality and Internal Control: An Empirical Analysis*, in *The Accounting Review*, 2005, 80, 649 ff.; DOYLE – GE - McVAY, *Determinants of weaknesses in internal control over financial reporting*, in *Journal of Accounting and Economics*, 2007, 44, pp. 193 ff.

<sup>42</sup> For example, think about the Risk Control Function's role in strategy and decisions: the Risk Control Function (RCF) «shall be actively involved at an early stage in elaborating an institution's risk strategy and in all material risk management decisions. The RCF shall play a key role in ensuring the institution has effective risk management processes in place» (EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, September 2011, 26.1). «The RCF's involvement in the decision-making processes should ensure risk considerations are taken into account appropriately. However, accountability for the decisions taken should remain with the business and support units and ultimately the management body» (*Idem*, 26.5).

<sup>43</sup> For an analysis on the difference between *ex-ante* and *ex-post* control, see, e.g., PIË - RITSEMA, *Corporate strategy: Implementation and control*, in *European Management Journal*, 1993, 11, pp. 122

We should now turn to the theories underpinning bank governance. It can be argued that tensions naturally arise between non-executives and executive directors, reflecting the conflicts of interest between shareholders and managers. In the case of banks, such tensions and conflicts are made more complex by the additional public interest at stake in ensuring as far as possible that banks are managed responsibly.

4. As mentioned above, in pursuing the enhancement of the decision-making process, policymakers are increasingly interfering with internal corporate life of banks, mostly by setting up requirements for the organizational structure and by prescribing certain internal procedures<sup>44</sup>. An important strategy is redefining the organizational duty the board of directors has to perform, avoiding unfettered powers of decision.

Indeed, banking law grants less autonomy for implementing the internal organizational framework than corporate law generally does: while the latter usually provides the general duty of directors to set up the organizational

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ff.; LEWIS, *Cause, consequence and control: towards a theoretical and practical model of operational risk*, in *Journal of Operations Management*, 2003, 21, pp. 205 ff.; DEKKER, *Control of inter-organizational relationships: evidence on appropriation concerns and coordination requirements*, in *Accounting, Organizations and Society*, 2004, 29, pp. 27 ff.; BELINFANTI, *The Proxy Advisory and Corporate Governance Industry: The Case for Increased Oversight and Control*, in *Stan. J.L. Bus. & Fin.*, 2009, 14, pp. 384 ff.

<sup>44</sup> See HOPT, *Better Governance of Financial Institutions*, in *ECGI Law Working Paper*, 2013, n. 207, 8; BELCREDI - ENRIQUES, *The European Corporate Governance Framework: Issues and Perspectives*, in *ECGI Law Working Paper*, 2013, n. 214, 20.

structure with a great margin of discretion<sup>45</sup>, the former, on the contrary, defines the contents of internal governance.

Therefore, banks shall have «robust governance arrangements, which include a clear organizational structure with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks they are or might be exposed to, adequate internal control mechanisms, including sound administration and accounting procedures, and remuneration policies and practices that are consistent with and promote sound and effective risk management» (CRD IV, article 74 (1)). Accordingly, the management body «approves and periodically reviews the strategies and policies for taking up, managing, monitoring and mitigating the risks the institution is or might be exposed to, including those posed by the macroeconomic environment in which it operates in relation to the status of the business cycle» (CRD IV, article 76 (1)).

The fact that regulatory norms explain the minimum content of the internal governance of banks notwithstanding the discretion of directors does not make the organizational responsibility more lenient than it otherwise might be. It is important to underline that banking law actually “takes over” not the province that remains to directors but the role in explaining what are the implications of banking business in this area, without displacing the professional duties of directors.

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<sup>45</sup> For example, the article 2381 of the Italian Civil Code requires the directors to establish an organizational structure consistent with the nature and the dimension of the entrepreneurial activity,

Internal governance regulation policy aims at setting out *what* banks' organizational structure needs but not *how* to implement it. Thus, the regulations provide the structure to be applied in its essentials (using detailed prescriptions) without predetermining and imposing its implementation.

For example, banks are required to set up the internal control system, but the management body remains responsible for deciding how to put into practice the provisions under the trade-off costs/organization suitability to face the business risks. In other words, banks directors remain entitled of the power to set up the internal rules governing the corporation, even if they must abide by what banking law required being the organizational mechanisms and measure the same directors need to work properly.

Besides, it would be admittedly impossible to enact mandatory rules resulting in "one-size-fits-all" solutions, as it may lead to suboptimal outcomes<sup>46</sup>; moreover, it is necessary to preserve flexible margins to shape the structure in accordance to the specific risks to be faced<sup>47</sup>. An intrusive governance regulation is justified by the public interests at stake and hence policymaker are legitimated to enact a set of rules which quite often are more detailed than general rules applicable to "normal" firms.

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<sup>46</sup> A too intrusive regulation, in fact, could lead to a "box-ticking conformity" or "cosmetic compliance" phenomenon: LAUFER, *Corporate Liability, Risk Shifting and the Paradox of Compliance*, in *Vanderbilt Law Review*, 1999, 52, pp. 1343 ff.; KRAWIEC, *Cosmetic Compliance and the Failure of Negotiated Governance*, in *Washington University Law Quarterly*, 2003, 81, 487 ff. See also *A review of Corporate Governance in UK Banks and other Financial Industry Entities*, London, 2009 (the "Walker Review"), in which it is stated that «*Governance practices are, by their nature, organic dynamic and behavioural rather than akin to black letter regulation*».

<sup>47</sup> See McCACHERY - VERMEULEN, *Six Components of Corporate Governance That Cannot be Ignored*, in *Tilburg Law School Legal Studies Research Paper Series*, 2014, n. 8.

In addition, it has to be highlighted that financial regulation is focusing on internal governance because the directors' organizational duty is not an end to itself but actually it is instrumental to let the other fundamental directors' task to be properly performed, namely the monitoring one<sup>48</sup>. This legal strategy implies the intervention on the quality of decision-making process, which represents the measure of the way directors discharge their obligations<sup>49</sup>.

The recent amendments on internal organization of banks therefore seem to be intended to stress the greater accountability of directors in

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<sup>48</sup> See BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for enhancing corporate governance*, October 2010, Principle 32: «The board should also ensure that the bank's organizational structure facilitates effective decision making and good governance. This should include ensuring that lines of responsibility and accountability-- which define clearly the key responsibilities and authorities of the board itself, as well as of senior management and those responsible for the control functions-- are set and enforced throughout the organization».

<sup>49</sup> See PAN, *A Board's Duty to Monitor*, in *NY Law School Law Review*, 2009, pp. 718 ff.; HILL - MCDONNEL, *Fiduciary Duties: The Emerging Jurisprudence*, in HILL - MCDONNEL (eds.), *Handbook on The Economics of Corporate Law*, 2012, pp. 144 ff.; *Stone ex rel. AmSouth Bancorporation v. Ritter*, 911 A.2d 362, Del. 2006. See also *In re Caremark International Inc. Derivative Litigation*, 698 A.2d 959, Del. Ch. 1996; *South v. Baker*, C.A. No. 7294-VCL, Del. Ch. 2012.

A related important issue to be studied in the future is whether the *ex lege* imposition of a certain decision-making process affects the business judgment rule scope and, if yes, what are the consequences. As internal governance of bank regulation aims at improving the decision-making process minimizing the uncertainty and errors while directors are taking the business decision, the response to the question seem to be positive. Anyway, as already highlighted, «company boards are responsible for monitoring the effectiveness of internal control system but pleased against a legal obligation for boards to certify the effectiveness of internal control» (EUROPEAN CORPORATE GOVERNANCE FORUM, *Statement on Risk Management and Internal Control*, Brussels, 2006, par. 6), and . See also HANSEN, *The ALI Corporate Governance Project: of the Duty of Due Care and the Business Judgment Rule, a Commentary*, in *Business Lawyer*, 1986, n. 41, 1237 ff.; EISEMBERG, *Duty of Good Faith in Corporate Law*, in *Delaware Journal of Corporate Law*, 2006, 31, pp. 237 ff.; LANGEVOORT, *Internal Controls after Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems*, in *Journal of Corporate Law*, 2006, vol. 31, pp. 943 ff.

discharging their duty of care and diligence: they are indeed expected to fulfil correctly their functions, as they are equipped *ex lege* with the organizational framework necessary to face up inherent business risks. Internal governance measures thus entail a more careful and aware conduct, since directors must exploit the works internal control functions, for example, are doing to their benefit.

In particular, it could be argued that the main internal governance support to the board is instrumental to pursue the goal of an informed action also in the perspective to prevent moral-hazard behaviours and to solve agency problems arising between the board of directors and the top management. In this outlook, it has been specified that «the benefits of an internal control system would be measured by (and largely limited to) how well it helps monitor and control the behaviour of the firm's senior managers»<sup>50</sup>.

This consideration is based on the recent attention focused on the role of non-executive directors (NEDs), as NEDs tend to have less information within all directors: «the role of non-executive members of the management body within an institution should include constructively challenging the strategy of the institution and thereby contributing to its development, scrutinising the performance of management in achieving agreed objectives, satisfying themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible, scrutinising the design and implementation of the institution's remuneration policy and providing

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<sup>50</sup> See LANGEVOORT, *Internal Controls after Sarbanes-Oxley: Revisiting Corporate Law's "Duty of Care as Responsibility for Systems*, in *Journal of Corporate Law*, 2006, 31, p. 943.

objective views on resources, appointments and standards of conduct» (CRD IV, Recital 57).

In this sense, it is interesting to note, considering the broader view of the financial sector as a whole, that «management or supervisory body of the [insurance] undertaking has appropriate interaction with any committee it establishes as well as with senior management and with other key functions in the undertaking, proactively requesting information from them and challenging that information when necessary»<sup>51</sup>. In the same perspective, MIFID II obliges that «members of the management body shall have adequate access to information and documents which are needed to oversee and monitor management decision-making» (see art. 9 (3)).

Monitoring responsibilities are not deemed to go so far as to require the NEDs to overrule the specialist directors in their field<sup>52</sup>. Nevertheless, if the monitoring duties are company-specific, banks' NEDs need to obtain the specialized information needed to supervise the management, bearing in mind the high level of technical complexity that banking tends to involve.

To return to the initial arguments tackled in this work, since directors' responsibilities are necessarily related to nature of the business, the "special" duty of care provided in the banking sector could be considered as a sort of mirror-image of the banking specialty and, above all, of the kind of risks to be

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<sup>51</sup> See EUROPEAN INSURANCE AND OCCUPATIONAL PENSIONS AUTHORITY, *Guidelines on System of Governance*, 2013, Guideline 3.

<sup>52</sup> *Re Continental Assurance CO of London plc (in Liquidation)*, 2 BCLC 287, 2007. See BACHNER, *Wrongful Trading before the English High Court: Re Continental Assurance Company of London plc (Singer v. Beckett)*, in *European Business Organization Law Review*, 2004, p. 195.

managed. What policy-makers are seeking to create is a relationship between the financial sector's characteristics (in term of risks the financial institutions confront) and the directors' conduct (how they must perform their functions): the link is the internal governance, with particular reference to internal control system.

5. One of the most significant corporate weaknesses revealed by the financial crisis and related to the monitoring function performed by the management body was the fact that many board members were shown to be insufficiently qualified to know, understand, assess and handle the complexities and risks of banking activities<sup>53</sup>.

In light of the critical role played by the board in the governance of banks, regulators have spent much more attention to the appropriate composition of the board. The result is a set of rules within CRD IV intended to intervene both on the composition of the board and on the skills the board members are required to possess, always pursuing the principal aim of strengthening the monitoring role of the board<sup>54</sup>.

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<sup>53</sup> An “half-way” measure between the organizational requirements intended to improve the decision-making process and the board composition is the creation of internal specialized committees within the board of directors: it is particularly increasing the regulation interest around the risk committee. Members of the risk committee shall have appropriate knowledge, skills and expertise to fully understand and monitor the risk strategy and the risk appetite of the institution (see CRD IV, article 76 (3)).

<sup>54</sup> See, e.g., ENRIQUES - ZETZSCHE, *Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive*, in *ECGI Law Working Paper*, 2014, n. 249, 7.

Among other provisions on this matter, the Directive requires the board *as a whole* to reflect «broad range of experience» (art. 91 (1)) and to «possess adequate collective knowledge, skills and experience to be able to understand the institution's activities, including the main risks» (art. 91 (7)).

In addition, it is required that *individual* board members possess at all times «sufficient knowledge, skills and experience to perform their duties» (art. 91 (1)) and that they behave «with honesty, integrity and independence of mind to effectively assess and challenge the decisions of the senior management where necessary and to effectively oversee and monitor management and decision-making» (art. 91 (8)). In achieving this outcome, banks have also to «devote adequate human and financial resources to the induction and training of member of the management body» (art. 91 (7)) and to foster diversity within boards (art. 91 (10), (11)).

The idea that the diversity should guarantee better performance thanks to members with general business experience and a specific industry knowledge as well is actually a *leitmotiv* of almost all the corporate governance codes, which are intended to complement corporate laws generally focused on the formal requirements for director qualifications without providing any indication about board composition<sup>55</sup>. Just to give an example, the German Corporate governance code recommends that the supervisory board has «knowledge, ability and expert experience to properly complete its tasks»<sup>56</sup>.

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<sup>55</sup> See EUROPEAN COMMISSION, *Green Paper, The EU corporate governance framework*, April 2011

<sup>56</sup> See GOVERNMENT COMMISSION, *German Corporate Governance Code*, May 2012, Recommendation 4.2.1. In the same direction, see also, *e.g.*, ASSOCIATION FRANÇAISE DE LA GESTION FINANCIÈRE, *Recommendations on corporate governance*, March 2011; BORSA

Different from general corporate laws, financial regulation requires that individual members of the board should have the necessary skills and expertise.

Although it has been correctly questioned, the effectiveness and the governance benefit of the mandatory diversity requirement<sup>57</sup>, the pre-set combination of personal characteristics should not be considered and assessed by itself<sup>58</sup> but rather alongside the professional requirements the bank needs for its business objectives<sup>59</sup>.

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ITALIANA SPA, *Corporate Governance Code*, December 2011; COMISION NACIONAL DEL MERCADO DE VALORES, *Código Unificado de buen gobierno de las sociedades cotizadas*, JUBE 2013; FEDERAL MINISTRY OF FINANCE, *Austrian Corporate Governance Code*, July 2012.

<sup>57</sup> See in particular ENRIQUES - ZETZSCHE, *Quack Corporate Governance, Round III? Bank Board Regulation Under the New European Capital Requirement Directive*, in *ECGI Law Working Paper*, 2014, n. 249, pp. 8 - 11.

<sup>58</sup> Board diversity and its possible effects on board effectiveness, firm value and performance are still a controversial issue. See, e.g., CARTER – SIMKINS - SIMPSON, *Corporate Governance, Board Diversity, and Firm Value*, in *The Financial Review*, 2003, 38, pp. 33 ff.; ADAMS - FERREIRA, *Women in the Boardroom and their Impact on Governance and Performance*, in *Journal of Financial Economics*, 2009, 94, pp. 291 ff.; AHERN - DITTMAR, *The Changing Role of the Board: The Impact of Firm Valuation of Mandated Female Board Representation*, in *The Quarterly Journal of Economics*, 2012, 127, pp. 137 ff.

<sup>59</sup> For a thorough presentation of skill-mix approach, see SCHWIZER – FARINA - STEFANELLI, *Dimension, Structure And Skill Mix In European Boards: Are They Converging Towards A Common Model Of Corporate Governance?*, in *Corporate Ownership and Control Journal*, 2010, pp. 87 ff.; McCAHERY - VERMEULEN, *Understanding the Board of Directors after the Financial Crisis*, in *ECGI Law Working Paper*, 2013, n. 229. Within the behavioural corporate governance literature, see HUSE, *Renewing management and governance: new paradigms of governance?*, in *Journal of Management and Governance*, 2003, 7, pp. 211 ff.; DAILY – DALTON - CANNELLA, *Corporate governance: Decades of dialogue and data*, in *Academy of Management Review*, 2003, pp. 371 ff.; GABRIELSSON - HUSE, *Context, behaviour and evolution: Challenges in research on boards and governance*, in *International Studies of Management and Organization*, 2004, pp. 11 ff.; HUSE, *Accountability and creating accountability: A framework for exploring behavioural perspectives of corporate governance*, in *British*

As a matter of fact, the new provisions promote knowledge and diversity consistently with the special features of the financial firms, in terms of complexity and risks, as it is stated that the *adequate* knowledge is with reference of being able to understand the *institution's activity*. Therefore, the principle is that the board must be composed to provide for the appropriate skills and experience for managing the company and monitoring the top management<sup>60</sup>.

Recital 60 of CRD IV explains that «the lack of monitoring by management bodies of management decisions is partly due to the phenomenon of “groupthink”. This phenomenon is, *inter alia*, caused by a lack of diversity in the composition of management bodies». Actually, «more diverse management bodies should more effectively monitor management and therefore contribute to improved risk oversight and resilience of institutions. Therefore, diversity should be one of the criteria for the composition of management bodies». All the new provisions enacted on diversity are thus to be seen as a sort of backlash against the lack of oversight, as a more diverse board is expected to fulfil its monitor function better and more effectively. Therefore, board composition should be «sufficiently diverse as regards age, gender, geographical provenance and educational and professional background to present a variety of views and experiences».

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*Journal of Management*, 2005, pp. 65 ff.; EES – GABRIELSSON - HUSE, *Toward a behavioural theory of boards and corporate governance*, in *Corporate Governance: An International Review*, 2009, p. 307

<sup>60</sup> It should be emphasized that the European Banking Authority shall issue guidelines on the «notion of diversity to be taken into account for the selection» of board members (see CRD IV, article 91 (11)).

To achieve the correct functioning of the board, in particular with regard to the supervisory task it has to perform, the CRD IV endorses an appropriate balanced board *vis-à-vis* its qualification of the members: even before establishing the balance of powers between executives, non-executives and independent members, it is of utmost importance to assess the balance of knowledge, judgment and experience to properly and consistently respond to the specific circumstances of each bank and define members' own duties as executive, non-executive or independent<sup>61</sup>.

The same idea is at the base of the UK Corporate Governance Code, which requires a «balance of skills, experience, independence and knowledge of the company. The board must be sufficient in size to manage the business and board changes adequately and should include an appropriate combination of executives and non-executives directors (and, in particular, independent non-executives directors) such that no individual or small group of individuals can dominate the board's decision making»<sup>62</sup>.

The regulation trends concerning board composition have therefore to be interpreted in light of the increasing importance of the nature of the banking activity. In fact, the recent rules are exactly preordained to have boardrooms,

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<sup>61</sup> For instance, independent directors are used as a proxy for good monitoring by the board, but this monitoring depends on professional qualities and levels of engagement in board activities that are not necessarily captured by current definitions of independence: GORDON, *The rise of independent directors in the United States*, in *Stanford Law Review*, 2007, 59, pp. 1465 ff.; FERRARINI - UNGUREANU, *Economics, politics, and the international Principles for Sound Compensation Practices: An analysis of executive pay at European banks*, in *Vanderbilt Law Review*, 2011, 64, pp. 431 ff.; RINGE, *Independent Directors : After the Crisis*, in *European Business Organization Law Review*, 2013, 14, pp. 401 ff.

<sup>62</sup> See FINANCIAL REPORTING COUNCIL, *UK Corporate Governance Code*, London, Main Principle B.1.

which are fit for the risks to be assessed, thanks to a balanced set of skills and experience.

This is why the CRD IV requires to predetermine and formally identify which are the skills the bank needs to have: the problem is not the experience and professional qualifications of a director considered by themselves but these attributes in relation to the board as a whole and to what the decision making process needs to improve.

In the same direction, also the EBA has stated that «the management body should ensure that an institution has policies for selecting new members and re-appointing existing members. These policies should include the making of a description of the necessary competencies and skills to ensure sufficient expertise»<sup>63</sup>. In addition, «an institution should have a sound process in place to ensure that the management body members, individually and collectively, have sufficient qualifications»<sup>64</sup>.

In this perspective, the requirement of formalizing and filling in a document scheduling which are the most adequate profiles for the complexity of financial firms is a way to formalize a “professional plan” consistent with a long-term strategic plan. This is extremely important for the purpose of developing a more risk-sensitive decision making process. As a matter of fact “diversity-means-risk-reduction” insofar diversity is intended as the obligatory combination of qualities related to the complexity of the business activity.

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<sup>63</sup> See EBA, *Guidelines on Internal Governance*, September 2011, B.11.4.

<sup>64</sup> See EBA, *loc. ult. cit.*

The skills should be evidently improved in the future, «members of the management body shall be and remain qualified, including through training, for their positions. They shall have a clear understanding of the institution's governance arrangements and their role in them»<sup>65</sup>.

By focusing on the nature of the risks each bank has to face, the alignment of the board composition with the corporate strategies reduces the pressure on the short termism<sup>66</sup> and constrain consequently excessive risk taking by the board.

6. It can be seen from the above that banks are faced with an extensive new generation of corporate governance regulatory requirements. They are directly geared to what many may feel are the "lessons learned" from the Crisis. As with all such backward-looking reforms, they may be open to criticisms that they do little more than "shut the barn door after the horse has bolted" or are focused on "fighting the last war". However, it is hard to see how policy makers could ignore the salient failures in governance, revealed all too often in reckless risk taking, that came to light as a result of the Crisis. If that results in "intrusive" regulations that come close to telling businessmen (at least those who run banks) what we might have thought common sense would have told them already, then so be it. Perhaps it has to be done.

There are, however, two caveats. The first is that there is a danger that excessive prescription reinforces the tendency amongst bankers to act as

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<sup>65</sup> See EBA, *loc. ult. cit.*

<sup>66</sup> See VAN DER ELST, *Transparency of Directors' Attributes: Improving Proxy Materials in Europe*, in *Financial Law Institute Working Paper*, Gent University, 2013, p. 13.

though the “rule- book” is a comprehensive behaviour code and, as a result, take the view that anything that is not expressly forbidden is allowed and anything not expressly required can be ignored. The second is that the trust crisis is not addressed (and should not be expected to be addressed) by corporate governance reforms alone. Other approaches to behaviour and culture now need to be looked at as a matter of some urgency, not to displace corporate governance requirements but to sit alongside them. That is where the more interesting developments on “rules for running a bank” are likely to lie for the next few years. Assuming, of course, that the worst of the financial crisis is behind us!

# CORPORATE GOVERNANCE AND ISOMORPHIC LEGITIMACY IN THE BANKING SYSTEM: AN INSTITUTIONALIST PERSPECTIVE

Cindy Schipani – Ilaria Supino\*

**ABSTRACT:** *The main purpose of this paper is to clarify the relationship that links corporate governance issues to institution-based antecedents. Unlike the agency and the stakeholder theory, the institutionalist perspective does not fail to analyse a wide range of environmental elements that appear relevant to the topic of corporate governance. The starting point for this inquiry is to acknowledge that all organizations seek for legitimacy within a certain playing arena and that different types of external pressures push them to adaptively change their corporate governance system. Using isomorphic mechanisms as explanatory variables aims to stress the consistency of this investigating approach: the DiMaggio and Powell's framework has been exploited in order to explore the effect of institutional changes on corporate governance dynamics within the highly crucial field of the banking activities. Banks represent the archetypes of legitimacy-seeker organizations and, more than others, show the changeability of corporate governance practices in accordance to context-driven evolutions.*

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\* Cindy A. Schipani, Merwin H. Waterman Collegiate Professor of Business Administration and Professor of Business Law Ross School of Business at University of Michigan.

Ilaria Supino is Research Fellow at LUISS School of Business and Management.

Although the article is the result of joint observations of the two authors, the paragraph 1 has to be attributed to Cindy Schipani, while the paragraphs 2, 3, 4, 5, 6 have to be attributed to Ilaria Supino.

**SUMMARY:** 1. Introduction. - 2. Corporate governance and institutional domains: a theoretical background. - 3. Corporate governance, organizational legitimacy and isomorphic attitudes. - 4. Comparative corporate governance analysis and institutional heterogeneity. - 5. Institutional pressures and corporate governance changes within the banking sector. - 6. Concluding remarks.

1. It is not an overstatement to say that the global financial crisis of 2008 sent shockwaves throughout the world. Headlines in the financial press used terms such as crisis, grave, acropolis, tsunami, shambles, and even depression to describe the state of economic affairs.<sup>1</sup> The crisis in the financial industry is particularly troubling in light of the trust-based nature of banking transactions, the reputation capital of banks, and the significance of the banking sector to the worldwide economy. Many pundits have weighed in on the causes of the crisis.<sup>2</sup> In contrast, this paper examines the corporate governance of the banking sector through an institutionalist lens.

Historically, the academic literature has focused on corporate governance as a means to address the agency problem presented by the

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<sup>1</sup> See, e.g., *Crisis on Wall Street as Lehman Totters, Merrill is Sold, AIG Seeks to Raise Cash*, Wall Street Journal, Sept. 18, 2008, at A1; *Citing Grave Financial Threats, Officials Ready Massive Rescue*, Washington Post, Sept. 19, 2008, at A1; *Acropolis Now, Europe's Debt Crisis Spins out of Control*, The Economist, May 1<sup>st</sup> – 7<sup>th</sup>, 2010; *AIG struggles to survive financial tsunami*, Reuters, September 16, 2008; *Warren Buffet: U.S. in "Shambles" No Signs of Recovery Yet*, CNBC, June 24, 2009; *Global Economic Shock Worse Than Great Depression*, Huffington Post, May 8, 2009.

<sup>2</sup> See, e.g., FRIEDMAN, *What Caused the Financial Crisis*, University of Pennsylvania Press J., 2011; REINHART - ROGOFF, *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009; RAJAN, *How Hidden Fractures Still Threaten the World Economy*, Princeton University Press, 2010.

separation of ownership and control in the modern corporation.<sup>3</sup> As such, theories of corporate governance have focused on, according to Andrei Shleifer and Robert W. Vishny, the process «deal[ing] with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment».<sup>4</sup> Other scholars have pushed the analysis further, studying the relationship between corporate governance and major corporate events, such as mergers,<sup>5</sup> takeovers,<sup>6</sup> bankruptcies<sup>7</sup> as well as various changes in the legal environment such as tax law changes<sup>8</sup> and changes in state corporate law.<sup>9</sup> Most of these scholars focused primarily on the impact of the institutional environment on shareholder welfare. Additionally, Rafael La Porta and his colleagues took the analysis into another realm, considering whether there was a relationship between the size of a country's capital market and the protections a country offers stockholders.<sup>10</sup>

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<sup>3</sup> See, e.g., JENSEN - MECKLING, *Theory of the firm: Managerial behaviour, agency costs and ownership structure*, in *Journal of Financial Economics*, 3, 1976, pp. 305 - 360.

<sup>4</sup> See SHLEIFER - VISHNY, *A Survey of Corporate Governance*, in *Journal of Finance*, 52, 1997, pp. 737 - 783

<sup>5</sup> See LEWELLEN *et al.*, *Merger decisions and executive stock ownership in acquiring firms*, in *Journal of Accounting and Economics*, 7, 1995, p. 209 - 231.

<sup>6</sup> See SHIVDASANI, *Board composition, ownership structure, and hostile takeover*, in *Journal of Accounting and Economics*, 16, 1993, pp. 167 - 198.

<sup>7</sup> See DAILY, *The relationship between board composition and leadership structure and bankruptcy reorganization outcomes*, in *Journal of Management*, 21, 1995, pp. 1041-1056.

<sup>8</sup> See SCHOLLES - WOLFSON, *Taxes and Business Strategy: A Planning Approach*, 1992.

<sup>9</sup> See BRADLEY - SCHIPANI, *The relevance of the duty of care standard in corporate governance*, in *Iowa Law Review*, 75, 1989, pp. 1 - 74.

<sup>10</sup> See LA PORTA – LOPEZ DE SILANES – SHLEIFER - VISHNY, *Legal determinants of external finance*, in *Journal of Finance*, 52, 1997, pp. 1131-1150.

As the nature of work and the capital markets changed, so has the nature of scholarship in this area. For example, Michael Bradley and his colleagues grapple with the purpose of the corporation in contemporary society arguing that the question is broader than shareholder wealth and that it is important to think about the firm's role in society.<sup>11</sup> Furthermore, these authors contend that it is necessary for scholars to go beyond the governance relationships within the firm and to consider the evolution of the firm's institutional environment.

With this backdrop, this paper seeks to clarify the links between corporate governance and institutional theory by analysing how external attitudes and forces influence the internal makeup of a firm, specifically in the context of the banking sector. Indeed, corporate governance is concerned with allocating and investing resources efficiently. Concurrently, institutions affect corporate governance schemes and play a crucial role in influencing how corporations make these investments and distribute the gains to shareholders.

With this in mind, it becomes important to investigate the role environmental and social contexts play in corporate governance systems. Institutional theory can play an important role in discovering the elements that lead to differing corporate governance models across countries. Furthermore, corporations need organizational legitimacy for active shareholder support and thus tend to formulate their corporate governance schemes based upon achieving social acceptance.

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<sup>11</sup> See BRADLEY - SCHIPANI - SUNDARAM - WALSH, *The purposes and accountability of the corporation in contemporary society: Corporate Governance at a Crossroads*, in *Law and Contemporary Problems*, 62, 1999, pp. 9 - 86.

In this regard, this paper addresses three mechanisms, (1) coercive, (2) mimetic, and (3) normative, upon which institutions may impact legitimacy-seeking corporations. The coercive mechanism refers to the force that national institutions exert upon corporations through regulations. Moreover, once some corporations begin to follow regulations other firms mimic the behaviour to gain legitimacy. The normative mechanism references the educational background of players within the organization – because people with similar education approach corporate problems similarly, educational institutions undoubtedly influence corporate governance. This paper analyses these mechanisms taking into consideration the context of the banking sector.

Additionally, it is worthwhile noting that because institutional environments are often nationally distinct, corporate governance practices tend to be similar within countries while differing across countries. For example, in developed countries where formal institutions promulgate numerous laws and regulations, there is often strong corporate governance. Meanwhile, in emerging economies there are few formal institutions and laws regarding corporate behaviour with the result that corporate governance is shaped by informal institutions.

To address these issues, Part 1.2 below provides a theoretical background regarding corporate governance and institutional domains, followed in Part 1.3 with a discussion of corporate governance, organizational legitimacy and isomorphic attitudes. In Part 1.4 comparative corporate governance regimes and institutional heterogeneity are analysed. The next Part,

1.5, focuses on institutional pressures and corporate changes within the banking sector with concluding remarks following in Part 1.6.

2. Business-related research has progressively studied the institutional underpinnings of strategic behaviour to such an extent that institutional theory has become the chief tool for analysing managerial dynamics in both advanced and emerging economies. A particularly relevant aspect in this theoretical evolution lies in the field of *corporate governance* and in the organizational consequences that arise from its functioning.

According to Aoki,<sup>12</sup> for corporate governance we mean «a set of self-enforceable rules (formal or informal) that regulates the contingent action choices of the stakeholders (investors, workers, and managers) in the corporate organization domain». It encompasses the sphere of management concerning the attempt of balancing the interests of several stakeholders in a specific corporate entity. In the last decades, a large literature has focused its effort on investigating the role of institutional determinants in shaping corporate governance patterns worldwide and has tried to identify the extent to which environmental heterogeneity affects the definition of a firm's internal structure.

As we know, organizations move within a non-ergodic habitat in which systematic connections are not crystallized but tend to change in an unpredictable way while generating several uncertainties to be faced by enhancing institutional fitness. Firms have to control contingencies, i.e. exogenous variables such as innovation breakthroughs, regulation changeability

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<sup>12</sup> See AOKI, *Towards a comparative institutional analysis*. Cambridge, MA: MIT Press, 2001, p. 281.

or task uncertainty that systematically concur to condition firm's internal arrangements. Thus, in order to survive in such an evolutionary scenario, organizations should be able to manage contextual variability by using congruence and interaction.

Institutionalism provides corporate governance studies with proper instruments oriented to understand how *external* isomorphic attitudes may influence *internal* adaptive composition.

Generally speaking, the institutional theory sees organizations as leading players within a specific *social* arena where different actors are asked to survive by respecting norms, conventions, imperative enforcements, shared prescriptions, macro-level orderings and individual standards. In such a perspective, institutions are intended as exogenous entities embodying the cumulative learning that a society is able to endogenously generate and, consequently, firms should develop the peculiar ability of reaping *community-based* benefits. Such an approach tends to emphasise the influence of societal effects and cultural environment on the institutionalization of organizational practises: institutional commitments bring further constraints to the organization and to its decision-making capability.

Several authors investigate on how the institutional perspective may impact on organizational issues: Parson<sup>13</sup> qualifies institutions as normative structures designed to give legitimacy to market incumbents that *functionally*

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<sup>13</sup> See PARSONS, *Suggestions for a sociological approach to the theory of organizations*, in *Administrative Science Quarterly*, vol. 1, 1956, pp. 63 - 85; PARSONS, *Structure and Process in Modern Societies*. New York: Free Press, 1960.

seek for stability and order maintenance; Silverman<sup>14</sup> conceptualises institutional bodies as *meaning* systems that concur to unhinge the traditional (but reductive) view of organisations as mere results of technical sophistication; Scott<sup>15</sup> talks about institutions in terms of «multifaceted, durable social structures, made up of symbolic elements, social activities, and material resources» that have a high degree of resilience and must be internalized by organizations with a socialization process and then reproduced and externalized.

In the light of this, one can easily identify the point of contact between institution-based considerations and corporate governance issues. A system of corporate governance is concerned with the allocation of available resources among possible investments capable of generating a certain return for the company's stakeholders. Hence, it becomes crucial the role that domestic or foreign institutions play in influencing how corporations decide their investments or distribute their eventual gains. Since institutional configurations affect organizational infrastructures (e.g. corporate governance schemes), it is deemed necessary to appreciate the interconnected role of companies with a certain social environment.

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<sup>14</sup> See SILVERMAN, *The Theory of Organizations: A sociological Framework*. New York: Basic Books, 1971.

<sup>15</sup> Additionally, Scott (2001: p.48) states that '[institutions] are composed of cultural-cognitive, normative, and regulative elements that, together with associated activities and resources, provide stability and meaning to social life. Institutions are transmitted by various types of carriers, including symbolic systems, relational systems, routines, and artefacts. Institutions operate at different levels of jurisdiction, from the world system to localized interpersonal relationships. Institutions by definition connote stability but are subject to change processes, both incremental and discontinuous'.

Granovetter<sup>16</sup> asserts that organizations are *embedded* within social contexts and belong to a network that may give or not legitimacy to their businesses. Social relations and economic actions are mutually incorporated into each other, and institutional *relatedness* produces inter-organizational reciprocity, repetition and knowledge fertilization.

Groenwegen<sup>17</sup> states that only shifting the attention from an individualistic and atomised vision of organizations to an *environmental* interpretation of them is possible to better understand corporate governance codes and behaviours.

Similarly, Davis<sup>18</sup> argues that the new challenge for corporate governance research is «to provide a theoretical counter-weight to the deficiencies of the contractarian approach by investigating the institutional dynamics».

More in detail, Aguilera and Jackson<sup>19</sup> examine «how different *configurations* of institutions support different sorts of *interactions* among stakeholders in corporate governance»: they state that a country's property rights model, financial markets and inter-firm networks significantly shape the role of capital; evenly, the labour mechanism is influenced by the weight of domestic union organizations while the role of the management strictly

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<sup>16</sup> See GRANOVERTER, *The Impact of Social Structure on Economic Outcomes*. in *Journal of Economic Perspectives*, 19, 2005, pp. 33 - 50.

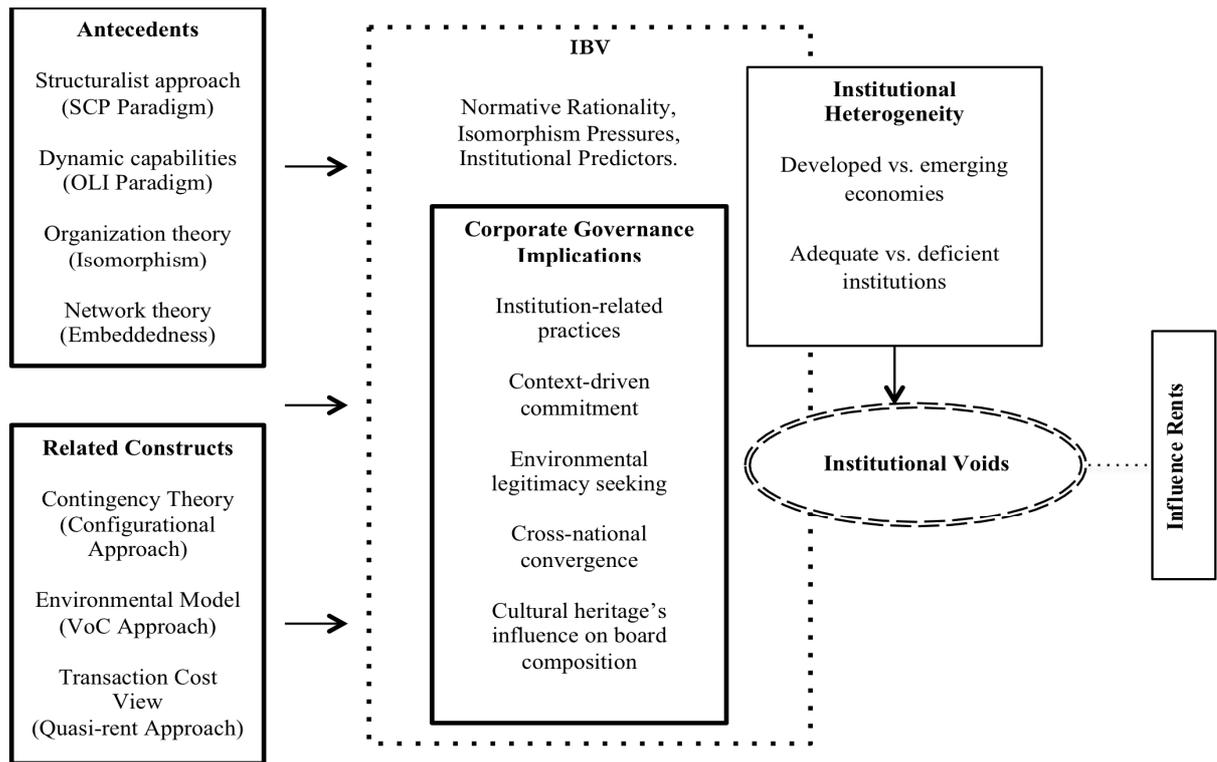
<sup>17</sup> See GROENEWEGEN, *Who should control the firm? Insights from new and original institutional economics*. in *Journal of Economic Issues*, 38(2), 2004, pp. 353 - 361.

<sup>18</sup> See DAVIS, *New directions in corporate governance*, in *Annual Review of Sociology*, 31(1), 2005, pp. 143 – 162.

<sup>19</sup>See AGUILERA - JACKSON, *The cross-national diversity of corporate governance: Dimensions and determinants*, in *Academy of Management Review*, 28, 2003, pp. 447 - 465.

depends upon the career paths viable within the national boundaries.

**Figure 1)** An institutional framework for corporate governance research



**Source:** our elaboration

Moreover, Doidge *et al.*<sup>20</sup> demonstrate that country-level characteristics, such as legal protections for minority investors or costs of accessing capital markets, tend to explain corporate governance practices better than firm-level features.

Hence, institutional tools may help in discovering the roots of cross-national differences in corporate governance models and thus in identifying the

<sup>20</sup> See DOIDGE – KAROLYI - STULTZ, *Why do countries matter so much for corporate governance?* NBER Working Paper n. 10726. Cambridge, MA: National Bureau of Economic Research, 2004.

key elements explaining this heterogeneity.

3. According to Powell and DiMaggio «organizations compete not just for resources and customers, but for political power and institutional legitimacy, for social as well as for economic fitness».<sup>21</sup> Companies fear social ostracism and are obligated to adopt conformity-based mechanisms. Those considerations are relevant for corporate governance research since legitimacy helps organizations in being *persistent* while corporate creditability represents one of the most desirable and appreciable features that stakeholders look for. Following that logic, Meyer and Rowan<sup>22</sup> argue that, being not legitimized, organizations risk to be viewed as irrational and redundant structures. DiMaggio<sup>23</sup> states that an active support from stakeholders might not be obtained without attaining organizational legitimacy.

There are three mechanisms of institutional-adaptive changing through which institutional effects are diffused among legitimacy-seeking organizations: coercive, mimetic and normative. The first type of mechanism I mentioned above, the *coercive* one, refers to constraining processes of reproduction requiring an organization to face pressures from political influence and legitimacy seeking. In this regard, it is quite obvious that national institutions

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<sup>21</sup> See DIMAGGIO - POWELL, *The iron cage revisited: Institutional isomorphism and collective rationality in organizational fields*, in *American Sociological Review*, 48(2), 1983, pp. 147 - 160.

<sup>22</sup> See MEYER - ROWAN, *Institutionalized organizations: Formal structure as myth and ceremony*, in POWELL - DIMAGGIO (eds.), *The new institutionalism in organizational analysis*, Chicago: University of Chicago Press, 1991, pp. 41 - 62.

<sup>23</sup> See DIMAGGIO, *Interest and agency in institutional theory*, in Zucker (eds.), *Institutional patterns and organizations*, Cambridge, MA: Ballinger, 1988, pp. 3 - 22.

(or, in general, external forces) contribute to the effectiveness of corporate governance practises since they tend to force organizations to be transparent and ethics-oriented. At the same time, when some organizations begin to follow corporate governance regulations, it happens that late adopters tend to mimic early adopters' behaviours in order to obtain legitimacy from the usage of widely diffused practises.<sup>24</sup> Of course, this evidence perfectly fits with DiMaggio and Powell's notion of *mimetic* isomorphism. Additionally, one can argue that also the *normative* mechanism exerts influence on corporate governance issues: in fact, since it deals with learning factors that stem from professionalization and educational background, it is quite plain that such an aspect may have a great impact on the composition and on the quality of a firm's management. Norms developed during the education are converted into routines once in the organization and people having the same educational heritage tend approach corporate problems in the same way. It is evident that all these elements, if combined, inevitably impact on corporate governance arrangements and effectiveness.

Consequently, Aguilera and Jackson notified that «where institutional environments are *nationally* distinct, isomorphic processes drive corporate governance practices to become more similar within countries and to differ across countries».<sup>25</sup> Thus, to understand the extent to which cross-national heterogeneity determines the convergence or discrepancy among global corporate governance praxis becomes an interesting (and, of course, necessary)

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<sup>24</sup> See ENRIONE – MAZZA - ZERBONI, *Institutionalizing Codes of Governance*, in *The American Behavioural Scientist*, 49(7), 2006, pp. 961 – 973.

<sup>25</sup> See AGUILERA - JACKSON, *op. cit.*

research exercise.

4. As widely acknowledged, each country tends to generate its own path-dependent institutions that constraint the character of organizational development for what concerns market openness, labour systems and access to capitals.

Dunning and Lundan<sup>26</sup> try to incorporate the institutional dimension into the OLI framework claiming that in addition to the traditional asset advantages it is opportune to mention also the so-called *institutional* advantages, i.e. a firm-specific «galaxy of internally generated and externally imposed incentives, regulations and norms, each of which may affect all areas of managerial decision-taking, the attitudes and behaviour of the firm's stakeholders, and of how each of these relates to the goals and aspirations of other economic and political actors in the wealth creating process». This means that cross-national institutional heterogeneity generates comparative institutional advantages stemming from different business configurations or varieties of capitalism.<sup>27</sup>

However, national institutions may be ineffective or malfunctioning<sup>28</sup> and produce *lacunas* that should not be considered as mere structural black holes:

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<sup>26</sup> See DUNNING - LUNDAN, *Institutions and the OLI paradigm of the multinational enterprise*, in *Asia Pacific Journal of Management*, 25, 2008, pp. 573- 593.

<sup>27</sup> According to the *varieties of capitalism* approach (Hall and Soskice, 2001), market economies can be distinguished into coordinated and liberal depending on the level of mutual interdependence between actors and institutions. In *coordinated* scenarios, models of production are institutionally embedded (e.g. Japan system) while *liberal* mechanisms may be configured as disembedded economies where weak ties and arm's length forms of coordination prevail.

<sup>28</sup> See AHUJA - NARAYANAN. *Explaining Influence Rents: The case for an Institution-Based View of Strategy*, in *Organization Science*, 22(6), 2011, pp. 1631- 1652.

contrariwise, they represent an opportunity to reap benefits from the institutional emptiness of specific markets.

Thus, «where institutional environments are *nationally* distinct, isomorphic processes drive corporate governance practices to become more similar within countries and to differ across countries».<sup>29</sup> For example, in developed countries,<sup>30</sup> the presence of self-enforcing formal institutions helps in creating a 'strong governance' environment by granting information disclosure and contractual protection. Conversely, emerging economies are characterized by unpredictable rules of law and weak institutional stability: this means that standard corporate governance mechanisms have relatively little institutional support.<sup>31</sup> Within developing countries, «relational ties, business groups, family connections, and government contacts»<sup>32</sup> seem to be the main influencers for corporate governance dynamics since informal arrangements play a dominant role in such scenarios.

Peng and Heath<sup>33</sup> underline the growing role that informal constraints wear in emerging markets where formal contingencies may be unclear. The convergence towards informal institutions in lieu of deficient formal infrastructures provides a shortcut for firms that, waiting for institutional

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<sup>29</sup> See AGUILERA - JACKSON, *op. cit.*

<sup>30</sup> In particular, those of the Anglo-American system.

<sup>31</sup> See SEGAL-HORN - FAULKNER, *Understanding Global Strategy*, Cengage Learning EMEA, 2010.

<sup>32</sup> See YOUNG *et al.*, *Corporate Governance in Emerging Economies: A Review of the Principal-principal Perspective*, in *Journal of Management Studies*, 45(1), 2008, pp. 196 – 220; PENG, *Outside directors and firm performance during institutional transitions*, in *Strategic Management Journal*, 25(5), 2004, pp. 453 - 471.

<sup>33</sup> See PENG - HEATH, *The growth of the firm in planned economies in transition: institutions, organizations, and strategic choices*, in *Academy of Management Review*, 21, 1996, pp. 492 - 528.

improvements to be formalized, succeed in this way to give economic continuity to their businesses. Shleifer and Vishny<sup>34</sup> identify in several features (i.e. the nature of legal protection for investors, the presence of large investors and the high concentration of ownership) the main corporate governance issues to be faced in developing areas. The most reasonable and viable response to such institutional fragility lies in a concentrated ownership in the hands of families and business groups. Following Steier<sup>35</sup>, in weak institutional scenarios, *family business structure* represents the principal mode of corporate governance combined with abiding state presence and financial industrial groupings.

Family-owned firms rely on mutual trust and this concurs to facilitate internal monitoring, look after managerial opportunism and lower agency costs. However, in these types of corporations «sibling rivalry, generational envy, non-merit-based compensation, and 'irrational' strategic decisions can destroy firm value in family businesses».<sup>36</sup>

In addition, *business groups* represent another omnipresent tract of corporate life in developing economies. In the absence of institutional tutelage, business group affiliation results particularly profitable within emerging realities since they avoid capital misallocation and permit horizontal product diversification where inadequate institutions would have prevented it. However this instable environment may isolate minority shareholders and determine

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<sup>34</sup> See VISHNY - SHLEIFER, *A Survey of Corporate Governance*, in *Journal of Finance*, 52(2), 1997, pp. 737 – 783.

<sup>35</sup> See STEIER, *Familial capitalism in global institutional contexts: Implications for corporate governance and entrepreneurship in East Asia*, in *Asia Pacific Journal of Management*, Springer, 26(3), 2009, pp. 513 - 535.

internal organizational conflicts.

5. Extending the institution-based view of business strategy to the banking industry means to understand why institutions really *do matter* in this important branch of the financial sector. Globalization, technological improvement, increased rivalry and new waves of regulation impact on the proper functioning of banks and result in different types of pressures that lead to the introduction of changes in corporate governance.

The DiMaggio and Powel framework we have mentioned above may be used as a theoretical tool for measuring the scope of institutional *influencers* among the governance schemes of financial intermediaries.

As the Table 1 shows, the first isomorphic pressure derives from *coercive* rules and regulative norms that push banks towards legally imposed practices and government-enforced managerial conducts. New regulations<sup>37</sup> may impose to the banking operators specific corporate governance standards and *best practices* to be compulsorily adopted. For instance, this regulatory intervention is typically oriented to provide indications concerning risk management processes, guidelines on remuneration policies, independence requirements for top management positions and disclosure obligations.

Secondly, one should take into account also *mimetic* pressures that are usually exerted on banks: in fact, as commonly argued, financial intermediaries operate in uncertain contexts and, in order to increase their social legitimacy,

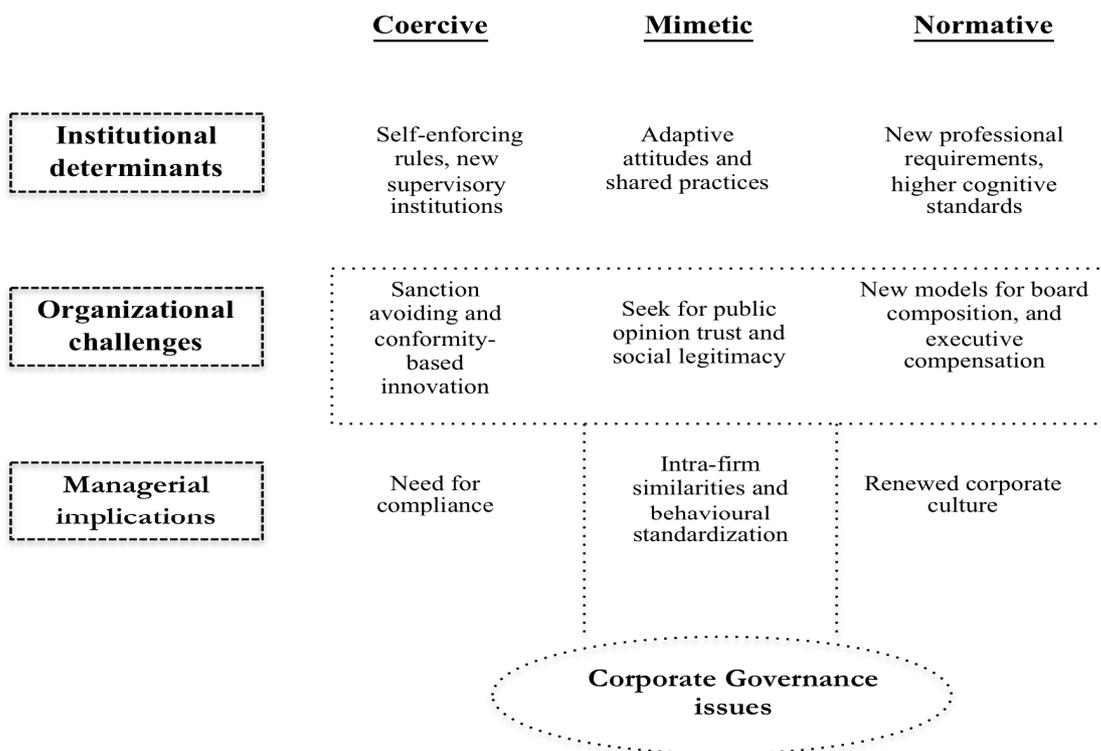
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<sup>37</sup> See for example, after the 2008 financial crisis, the Dodd-Frank Act and the Third Basel Accord.

model themselves on other successful banking institutions.

Consequently, banks undertake imitation to gain the favour of public opinion and to avoid experiencing a *crisis of confidence* on the part of their clients. Therefore, it is quite clear that mimicking legitimacy-based reference banks and following social-accepted practices imply to change corporate governance assumptions.

**Table 1:** Institutions, banks and corporate governance



**Source:** our elaboration

In this respect, some suggested corrections might be identified in: (a) greater attention to risk-taking activities, typically perceived by the general

audience with mistrust; (b) lower remuneration levels as signal of sobriety and integrity; (c) competence-based composition of the executive board as result of meritocracy and not of power-oriented logics of human sources selection.

Thirdly, changes in the *normative* pressures are progressively revising the notion of banker's professionalism. As we know the banking sector belongs to the macro-industry of the financial services, in which are traditionally recruited people having similar academic backgrounds and shared professional skills.

This trend is essentially due to some explanatory contingencies: on one hand, the recent and increasingly relevant content homogenization through finance courses and executive programs in elite universities encourages banks to hire qualified employers who possess standardized competences and approach problems in a similar fashion; on the other, highly ranked employers are usually engaged into professional networks and communities that permit them to share common ideas, consolidated policies, tested procedures and up-skilled knowledge.

It follows that all these elements may concur to promote a sort of *convergence* of corporate governance practices within the banking system in terms of talent hunting, top management team composition, commitment and accountability.

6. In the outlined conceptual framework, the nodal approach to corporate governance requires to admit that both strategic and organizational choices may depend upon external factors, on which firms do not exert any sort of influence. On the contrary, it is the environmental scenario that influences

corporate behaviour and generates pressures on it. Simultaneous institutional processes of change occur across the world and require to be 'absorbed' by organizations.

These changes may take the form of new rules, modes of competition, forms of innovation that gradually bring market incumbents to rethink their way of doing business. Herein, we tried to qualify the scope of the institutional phenomenon in the area of corporate governance: we saw that, in general, organizations reformulate the equation of their internal arrangements in order to obtain social acceptance. The art of managing stakeholders' interests in the view of conformity and legitimacy is primarily important in the financial industry, i.e. in a context where trust-based transactions and reputational capital play vital roles.

In conclusion, is now shared belief that the research stream of *comparative* corporate governance analysis is even more and more supported and integrated by the multi-dimensional features of the institutional pillars. The contribution of the institution-related arguments to corporate governance issues can be intended as a key to understand the last financial crisis (what we did wrong as *humans?*) and to improve not just our organizations but, above all, our way to manage them (how we will change our companies while changing *ourselves?*).

**BANKING GOVERNANCE**

**WITHIN COMPANY INTERESTS AND PRUDENTIAL REGULATION.**

**(EUROPEAN REGULATION AND SPECIFIC ITALIAN RULES)**

Francesco Capriglione\*

**ABSTRACT:** *This paper analyses banking governance by taking into account both company's interests and prudential regulation. The focus on European regulatory framework and Italian rules allows us to understand the peculiar role of financial intermediaries. This is the reason why this regulation is aimed to ensure the soundness of banks' activity and the transparency of their management policies. In particular, this research shows that the role of the board of directors and the board of auditors have been clarified by these rules, highlighting the importance of a consistent remuneration policy able to avoid risks. In conclusion, the analysis of the European and Italian legal framework does not dispel the doubt that, notwithstanding the new rules, politics – by interfering with internal corporate mechanisms – might continue to exert its influence over finance. On the other hand, we can argue that a good corporate governance could be a tool in order to overcome the difficulties of the third millennium.*

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\* Francesco Capriglione is Full Professor of Law and Economics and Dean of Law Faculty at Università degli Studi Guglielmo Marconi in Rome

Associate with those who will make  
a better man of you. Welcome those  
whom you yourself can improve.  
The process is mutual; for men learn  
while they teach.

Seneca The Younger, *Moral letters to Lucilius*.

**SUMMARY:** 1. Business reality and corporate governance. – 2. The peculiarity of banking governance. – 3 *continued:* its place in the market reality. – 4. Disciplinary complex contents: general view. – 5. *continued:* targets of the administration and control boards. – 6. *continued:* remuneration limitations in bank exponents. – 7. *continued:* risk prevention and monitoring systems. – 8. Banking governance under political influence. – 9. Conclusions.

1. Since time gone by, the juridical and economic discipline is orientated towards the identification of high quality organizational formats that would make it possible to unite business management to the pursuit of stakeholders' interests, above all, of shareholders.<sup>38</sup> In regarding to this matter, the importance of giving centrality to the mechanisms of corporate governance has been highlighted to allow a correct interpretation of the socio-political context in which these are placed; this has drawn particular attention to the analysis of

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<sup>38</sup> See VV. AA., *Corporate governance regimes. Convergence and diversity*, edited by McCahery – Moerland – Raajmakers - Renneboog, Oxford, 2002, and in particular the introduction to the volume by McCAHERY - RENNEBOOG, p.1; see also MACEY, *Corporate governance. Promises kept, promises broken*, Princeton, 2008, *passim*; CHEFFINS, *The history of corporate governance*, University of Cambridge, Working paper n. 54, December 2011, *passim*.

tools, methods and organizational structures, as well as the legal reference frame, elements upon which the company determines and pursues its targets.<sup>39</sup>

Naturally, the research perspective appears to be heterogeneous in relation to the peculiarity of the entities under observation and to the complexity of the situations experienced from time to time by companies. At the basis of this reality, we find not only the diverse features of the corporate governance models arising from the underlying legal and political background, but also the existing differences between common and civil law countries, that still persist despite the growing uniformity of existing disciplinary arrangements supported by the intense globalization process.

The existence of a network of “good” relations within company management, shareholders and other stakeholders – in giving content to the research on company corporate governance – represents the assumption of any verifications on the achievement of business performance.

Indeed, verifying the appropriateness of the activity of company boards (administration and control) constitutes an issue of common interest in comparison to the management guidelines (identified by the strategic guidance organism) and to the regulative reference framework. These are assessments that are summed up essentially in evaluations regarding the organizational form of the institution itself and, in particular, the presence of adequate balancing

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<sup>39</sup> See, among others, MARK, *Realms of choice: finance capitalism and corporate governance*, in *Columbia Law Review*, 1995, p. 973; CHEFFINS, *Does Law Matter?: The Separation of Ownership and Control in the United Kingdom*, ERSC Centre for Business Research, University of Cambridge, Working Paper No. 172, 2000.

elements within (e.g. between executive, non-executive and independent administrators); in addition, they require to take into consideration the functioning of regulations and inspections that aim to downsize the so-called private benefits of which managers or major shareholders can take the advantage of (penalizing, respectively, all other shareholders i.e. the minority ones).

These fundamental aspects of the business reality – albeit with the differences due the changes of times and context of reference – have guided the investigation in identifying optimal structural and corporate governance forms. More in particular, it detects the confluence, observable at epistemological level, towards studies, which allow focusing on the technical profiles of the combination of knowledge/ performance, based on the operation of any type of business. Therefore, the research has been oriented towards elements characterising the regulation system that disciplines the subject, analysing especially issues concerning risk control and management (keeping in mind the obvious consequences on the capital aspects of the institution). This results in a complex issue that, in some corporate typologies such as banking companies, acquires peculiar significance, being involved public interests to which – in some countries – the legislator attributes protection even at constitutional level.

2. Willing to focus on the subject of banking governance, we should immediately specify that the peculiarity of the disciplinary regime of the latter is based on the fact that financial intermediaries play a specific role in the

economic process, which is inevitably affected by their actions; from this follows the importance that the analysis of the technical forms adopted by these bodies has *in subiecta materia*.

Since a long time ago, economic theory has, in fact, demonstrated that the combination of *savings, investments* and *income* – pillars of a formula of productivity and growth successfully experimented since the English industrial revolution – takes advantage of the intermediary action that makes it possible to transfer resources from the savings collection centers to the savings investment centers, affecting the proper functioning of markets.<sup>40</sup> The possibility to achieve goals that, always, go beyond the business interests of the banks themselves and, often, beyond the interests of depositors and shareholders is remitted to bank activity.<sup>41</sup>

Therefore, the reasons why the structure of such institutions, at a regulatory level, appears to be characterized in function of a peculiar junction between “management” and “risk control” are quite evident; these reasons are relatable to the regulator’s intent to draw up an organizational scheme suitable, at a technical level, to ensure *stability* to these bodies. At the base of this disciplinary orientation, we find, obviously, the awareness of being in the presence of a business that is capable of reflecting on the overall prospects for

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<sup>40</sup> See, inter alia, ABEL - BERNANKE, *Macroeconomics*, 2005, pp. 130 ff.; SYLOS LABINI, *Torniamo ai classici*, Roma-Bari, 2005, pp. 35 ff.; EHNTS, *A Simple Model of a Currency Union with Endogenous Money and Saving-Investment Imbalances*, in *Berlin School of Economics and Law Working Paper No. 16*, 2012.

<sup>41</sup> See LEMMA, *Etica e professionalità bancaria*, Padova, 2013, pp. 129-130 where it is argued that “the intrinsic utility of the financial *agere*... goes beyond the individual profit of the banking company in favour of the more general, advantageous effects realized for the collectivity”.

the country's economic growth, also taking into account, the negative consequences arising from hypothetical situations of *mala gestio*.

It appears significant the observation that, following EU guidelines, public supervision is orientated towards the monitoring of bank risks ensuring their solvency.<sup>42</sup> In this regard, we detect some directives (nn.89/ 299/CEE e 89/647/CEE, in which the 1988 Basel Accord is transfused with some adjustments and n. 89/646/ CEE, so-called Second Council Directive) which mark the abandonment of the public intervention system based on structural measures. In this context, the business paradigm, at the base of the concept of "banking", has to require corporate governance arrangements closely related to the prudential setting that distinguish the supervision upon the members of the financial system.<sup>43</sup>

As a consequence, the disciplinary construction of the governance, not being able to abstract from the reference to the supervision purposes, must have regard to the realization of an operability carried out according to the principles of "safe and sound management" and preordered to the overall stability, to the efficiency and to the competitiveness of the financial system;<sup>44</sup>

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<sup>42</sup> See BRESCIA MORRA, *La disciplina dei controlli pubblici sulla finanza*, in VV. AA., *L'ordinamento finanziario italiano*, edited by Capriglione, Padova, 2010, Vol. I, pp. 303 ff.

<sup>43</sup> Regarding the Italian system see MINTO, *La governance bancaria tra autonomia privata ed eteronomia*, Padova, 2012, p. 14; and, previously, CERA, *Autonomia statutaria delle banche e vigilanza*, Milano, 2001, p. 10; FERRO LUZZI, *Lezioni di diritto bancario*, Torino, 2004, pp. 64 ff.

<sup>44</sup> See MOTTURA, *Modelli di governance e sana e prudente gestione*, report by the ADEIMF (Associazione Docenti Economia Intermediari Mercati Finanziari), Bergamo, January 2009.

This objective is expressively indicated by the Italian legislator in the art. 5, first paragraph, of the Consolidated Law on Banking, where the purposes of the supervisory action are set with a prior recall to principles that assure the "sound and safe management" of the sector incumbents, the competitive

it's bound, therefore, to meet the targets identified by the supervisory authorities while performing an effective control on the system.<sup>45</sup>

More specifically, it requires that the regulator – in the accomplishment of micro-economic purposes (related to the business specificity of entities inserted and operating in a market environment) – gives account of the intricate mutability which is common in the diverse circumstances typical of the banking field. Hence the peculiarity of the “public intervention”, increasingly focused on control forms based on the “cost-benefit” analysis and assessments of the quantitative impact, essential for a complete evaluation of the real condition in which the intermediaries are in;<sup>46</sup> the latter is a monitoring technique in addition to which, as a result of the recent financial crisis, we have macro-prudential interventions, qualified by an accurate doctrine “as a new approach... for adopting the more transformative remains open”.<sup>47</sup>

Therefore, in the regulations concerning this subject, the need to adapt the disciplinary principles valid for the generality of businesses to the peculiarity of the banks, according to a legal criteria that, based on the considerations set out above, induces not to limit the perimeter of the evaluations in merit of banking corporate governance to only the interests of shareholders. Referring

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freedom, the integrity (in terms of capital requirements) of the initiatives and the adoption of adequate organizational methods; see CAPRIGLIONE, *Commento sub art. 5 tub*, in VV. AA., *Commentario al testo unico delle leggi in materia bancaria e creditizia*, Padova, 2012, Vol. I, pp. 49 ff.

<sup>45</sup> See GOODHART, *The Organizational Structure of Banking Supervision*, in *FSI Occasional papers*, n. 1, 2000.

<sup>46</sup> See OECD, *Guiding Principles for Regulatory Quality and Performance*, 2005.

<sup>47</sup> See ANDENAS - H-Y CHIU, *The Foundations and Future of Financial Regulation*, Routledge, London and New York, 2014, *Introduction*, p. 14.

to a modern market environment – together with the effects of the all relations conducted within the corporate structure – allows, in fact, overcoming the vision of a type of governance linked to the position of the *sole* property holders and, therefore, shaped on the exercise of company control. Therefore, the necessity to exclude interpretations of business reality that would point out a limited functionality to the maximization of the share value, intended primarily as the discounted value of expected returns in the future.<sup>48</sup>

In addition, at an exegetical level it can't be ignored that the activity of banks, while reflecting the neutrality of the "business typology", as in the past it was pointed out by a prominent doctrine,<sup>49</sup> is orientated (in its concrete explanations) towards the achievement of public interests, as it has just been pointed out. In that way, we justify the departures from to the common rules and the downsizing of the statutory autonomy of these bodies, highlighted in literature,<sup>50</sup> while not changing the peculiarity of the relation between "activity and organization", at the base of business reality. At the same time, we understand the reason why the components of this relationship, in the market dynamics, assume a specificity related to organizational choices (which serve to achieve the company's profitability), or the presence of administrative controls underlying the protection of public interests that characterize the financial subject.

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<sup>48</sup> On the opportunity of reviewing the function of *governance* not only from an economic point of view, see AOKI, *Corporations in evolving diversity. Cognition, governance, and institutions*, New York, 2010, pp. 1 ff., where it is represented the comparison between the different paradigms of governance.

<sup>49</sup> See OPPO, *Realtà giuridica globale dell'impresa nell'ordinamento italiano*, in *Riv. dir. civ.*, 1976, I, pp. 591 ff.

<sup>50</sup> See CERA, *op. cit.*, p. 9

That said, it is clear how the banking governance articulation serves as essential requirement of company stability, in the terms described above. Indeed, the governing principles at the basis of our institutional forms of management and control are necessarily configured as related to the “system of organizational patterns”, imposed by the special regulations for granting the fairness of management and, more generally, the achievement of the overall equilibrium within the sector. In this sense it’s helpful especially the prediction of corporate rules (found primarily at European level) aimed at introducing effective measures to protect from risks, which – if not adequately monitored – can affect not only the objectivity and impartiality of the strategic-operative decisions taken by banks (e.g. the fulfilment of certain transactions, allocation of financial resources, grant funding, etc.),<sup>51</sup> but also the smooth functioning of the entire financial system.

It can be said, therefore, that the system of corporate governance in the banking sector is instrumental to the proper exercise of this type of financial activity. This system reflects itself upon the determination of strategic plans and business targets (to which relates the choice of particular organizational forms), as well as on the management of current operations. Indeed, the proper performance of the functions assigned by the disciplinary rules to the administrative bodies and of the control, are at the base of the ability to create value and generate income, becoming a primary factor in the realization of the core business of the banking company.

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<sup>51</sup> Embrace this view also the second consultation document of the Bank of Italy on “Risk and conflicts of interest of banks and banking groups in respect of related parties” May 2010, pp. 6 ff.

Thus, bank management becomes the primary evaluation factor to test the respect of the “safe and sound management”; it is necessary to refer to it while verifying the adoption of measures and behaviour guidelines adequate to ensure the stability and the sustainability of the business itself.

The responsibility of corporate bodies is, in fact, guarantee of a balanced execution of the duties and the powers assigned to them; it allows the banking company to fulfil the requirements set with the aim of ensuring the balance of public and private interests, that – as mentioned above – characterize the essence of such a type of financial institution.

It follows a first conclusion: the know-how of the persons that compose the corporate bodies, the independence of the individual exponents and of the credit institution (such as to save them from dangerous influences, even if unconscious), the dynamics of the flows of information, the transparency towards all stakeholders are – together – a significant part of the disciplinary content of the rules about the sector. In fact, these rules have their roots in the intent to preserve the observance of the managing criteria that would ensure the appropriateness of decision-making and operational processes, moving them away from those *laissez faire* attitudes that sometimes are left the internal structure of such entities. This in the belief – understandable especially in the light of the teachings deriving from the recent financial crisis – that the market is not always able to use in a positive way the freedom to it granted by the law and by supervisors.

3. On the basis of what has been argued above it is evident how the discipline of governance applicable to credit institutions should be seen as a sort of specification of the one designed for all businesses. The possibility of overlapping (and of justifiable reference to the general norms that connote the regulation in question) is mainly due to differences in “declination” and not of genre.<sup>52</sup> This, in a constant process that recognizes in the common legislation a “laboratory of structural rules”, intended to be applied to various types of businesses.

In addition, in defining the system of legal provisions under examination, it should be highlighted that, in the last five-year periods, different events have interacted on it, in some ways convergent in stressing the specificity of the models of organization and corporate governance of banks. This applies, in particular, to *globalization*, to the trend towards the *financialization* of economy and the *self-referentiality* of the market, as well as to the negative implications of the recent financial crisis.

It's known how the intense globalization process that has been affecting the planet for some decades, imposing the economic and financial activity to overcome national borders, has marked an opening towards the interconnection between numerous businesses, producing its effects, among other things, on the businesses' corporate governance (in particular of banks).<sup>53</sup>

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<sup>52</sup> See MASERA, *La Corporate Governance nelle banche*, Bologna, 2006.

<sup>53</sup> Among the many works that analyse globalization we mention REMBOUILLET, *La globalizzazione dell'economia*, Bologna, 1999; STIGLITZ, *La globalizzazione e i suoi oppositori*, Torino, 2002; ID., *La globalizzazione che funziona*, Torino, 2006; IRTI, *Le categorie giuridiche della globalizzazione*, in *Riv. dir. civ.*, 2003, 1, p. 625; GALGANO, *La globalizzazione nello specchio del diritto*, Bologna, 2005;

Therefore, appropriate transformations of the disciplinary framework of the banks became necessary, to allow them to support, through appropriate structural modifications, forms of development undocked from the former institutional localism typical for the “closed” economic systems (i.e. not striving towards a homogenization of rules and practices).

Then, comes into consideration the tendency (sometimes exasperated) to finance the economy – *i.e.* the activation of operational forms distant from any reference to the reality (being oriented to the pursuit of the benefits arising from a fluctuating variation in the prices of securities)<sup>54</sup> – and consequentially to the *self-referentiality* of the market.<sup>55</sup> Both followed by conditions of substantial *weakness* of the legal mechanisms applied in the financial sector, with obvious impact on the design of organizational structures and corporate banking intermediaries; the necessity to activate adequate organizational schemes that would restore confidence into the financial system, as well as in the intermediary function of banks and markets has become urgent.

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ESPOSITO, *Istituzioni economiche internazionali e governance globale*, Torino, 2009; CHITI, *Organizzazione europea ed organizzazione globale: elementi per una comparazione*, in *Riv. trim. dir. pubbl.*, 2009, pp. 359 ff; CAPRIGLIONE, *Euroscerosi e globalizzazione (contro un possibile ritorno all'euroscetticismo)*, in *Riv. trim. dir. econ.*, 2010, I, pp. 1 ff; DI GASPARE, *Teoria e critica della globalizzazione finanziaria*, Padova, 2012.

<sup>54</sup> The financialization indicates the “weight”, in relative terms, of the financial sector compared to the total commercial exchanges of a country. In particular, the financialization rate of the economy is given by the ratio between the totality of the financial instruments in circulation in a given period (shares, credits, etc..) and the gross product of a single country or of the world economy; this ratio is the basis of the relationship between the sphere of finance and that of production, defining the terms of the existing connection between them.

<sup>55</sup> See CAPRIGLIONE, *Ordine giuridico e processo economico nell'analisi di Law and Economics*, in *VV. AA., Elementi di diritto pubblico dell'economia*, edited by Pellegrini, Padova, 2012, p. 3.

Finally, it should be noted that additional requests for modifying the internal structures and corporate governance of credit institutions are a result of the difficulties caused to the business system by the financial turmoil since 2007. The subsequent crisis – in highlighting the inadequacies of organizational systems required by national regulations, which are characterized by significant differences between the different EU countries – has stressed, therefore, the need to overcome the obstacles to a prompt and efficient economic recovery.<sup>56</sup>

The result was a careful reflection on the “capability to resist” shown by the theoretical models and the systems of corporate governance practiced until now, put to the test by the factual reality;<sup>57</sup> it was accompanied by the adoption of disciplinary interventions designed to take into account the functional limitations of the previous models and the start of a process of changes non yet completed.

It is clear how the traumatic events of recent years have become, in this way, the catalyst element for the optimization of the governing mechanisms of banks. Therefore, the transposition (in the normative framework of the EU countries) of regulatory interventions disposed at European level has become a requirement for a re-establishment of adequate levels of business performance

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<sup>56</sup> See, especially, DRAGHI, *Intervento a margine del 15° Convegno aiaf - assiom - atic forex*, Milano, 21st February 2009, p. 17, where he stresses the need for governments, monetary and supervisory authorities, banks and all financial operators, to give priority to the rebuilding of the lost trust and to a crucial support “to exit the vortex of the crisis without losing sight of the side bank to achieve (?????)”. See also OECD, *Corporate Governance and the Financial Crisis: Key Findings and Main Messages* (June 2009), in [www.oecd.org](http://www.oecd.org), March 9, 2013.

<sup>57</sup> See, among others, CAPRIGLIONE, *Considerazioni a margine del libro «Saggi sulla metodologia della ricerca in economia»*, in *Economia italiana*, 2011, *passim*.

and an improvement of the forms of international cooperation, to which the efforts of several member countries seem to be devoted.

A framework within which, as it has been promptly underlined by the doctrine, the “regulators are attempting to challenge aspects of business that are contrary to the public interest”; hence, the need to identify the limit of what can be reached by doing finance “without overly interfering with the freedom to generate wealth”.<sup>58</sup>

4. What we have said above explains the interest of the European regulator for the definition of a unitary disciplinary system on banking governance, applicable to the EU credit institutions. This interest goes back in time, but it's become more important in the last five years as a result of the many crisis events mentioned;<sup>59</sup> hence the referring to broad legal criteria that associate – to the regulation of the forms of administration and control – the introduction of regulatory innovations concerning issues (ownership, related party relationships, etc.) connected with the pursuit of good corporate governance policies.

With the enactment of the 2006/46/EC directive, the European regulator – updating the legislation devoted to the creation of the internal banking market (2000/12/EC directive) – gives punctual suggestions in order to “adopt” appropriate risk measuring techniques (*considerando* n.38 and following) and

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<sup>58</sup> See ANDENAS - H-Y CHIU, *The Foundations and Future of Financial Regulation*, cit., p. 359.

<sup>59</sup> See in particular BAXTER *et al.*, *Enterprise Risk Management Program Quality: Determinants, Value Relevance, and the Financial Crisis*, (July 2012), in *ssrn.com*; BODNAR *et. al.*, *Managing Risk Management*, (March 2011), in *ssrn.com*.

provide for the adoption by the credit institutions of “strategies and processes in place for assessing and maintaining the adequacy of their internal capital” (*considerando* n. 53), while improving “the internal management organization” (*considerando* n.62).

To the general criteria above-mentioned is inspired the clear prevision of the art. 22 of the directive in question in which it’s left to the competent authorities of the member countries the task of imposing – to credit institutions – the adoption of “robust governance arrangements”, i.e. an organizational structure “with well-defined, transparent and consistent lines of responsibility, effective processes to identify, manage, monitor and report the risks”. It has been obtained, in this way, the definition of the legal criteria of a banking governance, which responds to the needs posed by the complexity of the financial *agere*; natural assumption of this organizational construction is the realization of “adequate internal control mechanisms, including sound administration and accounting procedures”, to which the Disposition in question refers.<sup>60</sup>

It must be pointed out, however, that the methods used by public authorities to intervene in different Countries appear differentiated, even if they converge towards the common goal of preventing intermediaries from being overwhelmed by the “market failures”. The *rescue* actions, carried out in

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<sup>60</sup> In line with these indications the Italian regulator has intervened, in 2008, with some significant measures designed to reorganize the relationship between administration and supervision, nonetheless to set ideal protections for risk prevention, see *Disposizioni di vigilanza in materia di organizzazione e governo societario della banche*, letter of instruction, n. 264010, 4 March 2008.

some countries in the form of nationalization,<sup>61</sup> are matched in other countries to the creation of public funds developed to purchase toxic assets of banks and financial companies (we are referring to the U.S. emergency legislation which provided the possibility for the Treasury to directly acquire shares of banks and financial companies).<sup>62</sup>

In Italy, the initiatives taken by the Government aim at containing, with measures applicable until the 31<sup>st</sup> of December 2009, the risk (faced by some banks) of running into default situations. This refers to the adoption of the L.D. October 9<sup>th</sup>, 2008, n.155, containing “urgent measures to ensure the stability of the banking system and the continuity of the provision of credit to businesses and consumers”, converted, with modifications, by the Law 4<sup>th</sup> December 2008, n.190, and complemented by other regulatory measures including the Law n.2 of 2009. This normative appears to be orientated towards containing the difficulties some credit institutions have faced because of the crisis that, at the time, was starting to show its negative effects. The absence of a coherent plan based on the action of the legislator (which is conditioned by a logic of absolute emergency) together with the introduction of rules that negatively impact on the levels of independence of the banks are at the basis of doubts about the effectiveness of such remedies; hence the critical evaluation of these, which turned into a substantial non-application of the laws mentioned above.

It can be said that in Italy the formation of the rules – carried out in a manner of consistent support to the evolution of processes before the crisis

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<sup>61</sup> It is the case, for example, of the *Northern Rock Bank* nationalized in Great Britain with the *Banking [Special Provisions] Act 2008*.

<sup>62</sup> See *Treasury Announces TARP Capital Purchase Program Description*, October 2008.

erupted – with the spreading of the financial turmoil, has been orientated towards a redesign of the mechanisms of “corporate governance”, proved to be inadequate in the presence of critical operative conditions. Hence the need of strict structural criteria at the base of corporate governance, whose characterizing features are identified mainly in a more intense internal dialogue between the bodies (government and control), in the introduction of the figure of the “independent director” and in the definition of special compensation policies.

Therefore, finds affirmation a disciplinary logic in which it is given proper importance to the need to ensure responsible behaviour, orientated towards risk prevention and towards the predisposition of protections that would permit the observation of prudential guidelines. Not by chance a member of the Supervisory Board, commenting the measure of secondary legislation on the subject adopted by the Bank of Italy in March 2008,<sup>63</sup> stressed that the latter dedicated “particular attention ... to tasks, powers and responsibilities of governing bodies, to the organizational structure (information flows, functions’ arrangements, compensation), to the system of internal controls”.<sup>64</sup>

The disciplinary intent to ensure conditions of “sound and safe management” explains the precise determination of the role and functioning of the organs of administration and supervision of credit institutions and, therefore, of the relationship between these exponents and their structure;

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<sup>63</sup> See *Disposizioni di vigilanza in materia di organizzazione e governo societario della banche*, cit.

<sup>64</sup> See TARANTOLA, *Il sistema dei controlli interni nella governance bancaria*, intervention at the “*Il sistema dei controlli aziendali: alla ricerca di una governance*” conference organized by DEXIA Crediop (Rome, 6th June 2008).

hence the functionalization of direction and coordination to achieve adequate arrangements of internal cooperation and, therefore, a overall harmony within the management team.

It should be highlighted, additionally, that the intention to overcome the limitations of the organizational model in which the banking governance had found expression in the past ended up. It results in propositions that if, on the one hand, provide greater functional cohesion among the corporate bodies (together with more significant forms of transparency and fairness), and on the other affect the levels of independence of these companies, sometimes determining their freedom in decision. On this point it is relevant the supervisory regulation which – in pointing out the main principles and guidelines relating to governance arrangements and to the control system – extends the scope of its intervention in the elaboration of “business strategies”.

Accordingly, stands a disciplinary system that, in bringing undeniable advantages to the stability of credit institutions, acts (in some ways resizing it) on the capacity of intervention of banks, requiring structural changes, impeding certain operational forms and indicating the remuneration ceilings of banking executives. This is the cost of a construction that is intended to clarify the real components of the management function, identifying the tasks, duties and responsibilities of those who perform it!

5. A balanced situation within corporate boundaries represents the company’s first “sub-goal” that the regulator identifies for the achievement of the purposes underlying the whole governance discipline. To ensure that, the

regulations – in prescribing a clear distribution of tasks and responsibilities – are intended to prevent that an excessive concentration of power in the hands of few subjects, on the one hand, and a plethoric form of the corporate bodies, on the other, compromise the proper and prompt decision making and, consequently, the correct functioning of the bank. Both situations, in fact, could act as a restriction to the internal dialogue, nonetheless to the delimitation of the prerogatives of the corporate bodies in specific organizational structures (e.g. Committees), as it is established by law.<sup>65</sup>

The Italian regulator has focused, therefore, on the one hand, on ensuring a complete correspondence between the performance of the strategic supervision functions and the management ones (and, therefore, the unity of the bodies to which they refer to), on the other on creating the conditions so that the control body can play its role effectively as the representative of the banking supervision (in line with the provisions in the art. 52 of the Consolidated Law on Banking). The provisions on the subject of “corporate governance”, issued by the Bank of Italy in 2008, leave no doubt about that, as can be inferred from the introduction to the legislative measure in question, where it’s stated that they regard “the need to establish appropriate methods of connection between the bodies, the structures and the business functions... especially those.... of control”.

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<sup>65</sup> The clear differentiation of tasks and responsibilities, in fact, appears oriented – as it has been carefully highlighted – to a smooth conduct of the «decisional processes, to avoid overlappings and competence conflicts, to promote and favour a corporate dialogue»; see TARANTOLA, *Il sistema dei controlli interni nella governance bancaria*, cit.

In the company organization, corporate governance appears only apparently separate from the control, whereas in reality they complement one another and contribute to the proper functioning of the banking business; the coordinated action of this combination concurs to grant the operability founded on the principles of efficiency, effectiveness and fairness. Indeed, if the “guidelines” outlined by the organ performing the strategic supervision function should direct the conduct of the activity towards (sustainable) growth targets, it’s also true that the detection of the administrative regularity of the operations (and more specifically, of the forms of credit provision) is left to the “effectiveness of the checks” arranged by the body with control function; to the latter, the above mentioned provisions of the Bank of Italy assign, also, the responsibility of monitoring the functionality of the overall “system of internal control” (i.e., on all the activities carried out by the appropriate corporate functions).

We’re looking at a structure in which the top management of the bank plays a central role in defining corporate governance arrangements, in the context of a precise identification of the peculiarity of each function (that are supposed to converge towards organizational and operative solutions, in which the goals are the objectives of the “safe and sound management” and of the stability of the whole financial system). Needless to say that – in accordance with the statutory regulation of the management and control model adopted – the strategic supervision and management function can be attributed to the unitary action of the same collegial body (the Board of Directors) or of the supervisory and management boards (as it happens in the dualistic model).

That said, it is evident how, underlying this system, there is a reference to a necessary relational harmony to be activated in the relationships within the administrative body (e.g. between the chairman and board members) and in those between directors and management board. In other words, the regulator links the efficiency of management to a decisional and operative context in which the functionality of the strategic supervision and management bodies results from the respect for the roles and the absence of prevarications. At the same time, considering the above mentioned purposes, the *management* is required to act independently of hegemonic pressures and, therefore, of managers' wishes; otherwise, the executive board would be prevented from properly performing its own disclosure activity (as a consequence, adequate and reliable reports run the risk of being moved out of the business management).

In view of that, the *favour* for a proactive internal dialogue becomes the prerequisite for a managerial approach in which the earning capacity of credit institutions is not improperly misled. Consequently, one should consider that the decision-making process won't be compromised by an unjustified lack of information/knowledge or distorted by technical evaluations, due to the indications of a management board only concerned about being available to support strategic guidelines that satisfy the top management.

This results in the need, deriving from the normative indications in question, to give a peculiar content to the relationship between the board members. Significantly, its essence is identified in the analytical methods of exercising the power of delegation, in the necessity to include in the bylaws the possibility to attribute specific powers to the general director – who stands at

the top of the internal structure (and, in such a position, participates to the management activity) – and, finally, in the specification of the duties of the chairman. Additionally, one should point out that the board of directors plays a vital role in achieving the goals mentioned so far, having to mandatorily promote the internal dialogue and to ensure the balance of powers, in accordance with the organizational tasks and with the circulation of information.<sup>66</sup>

As we have already mentioned, the framework of the new governance model has been enhanced by the strengthening of the role of the independent director, figure positioned within the corporate bodies. Admittedly, the presence of persons with these features – essentially aimed to give adequate importance to the rights of minority shareholders in relation to other stakeholders – should ensure a fair balance between the different powers of shareholders, avoiding forms of concentration or conflict situations.<sup>67</sup> Hence the overcoming of the typical limits of the forms of self-regulation to ensure “from the bottom” operative transparency and responsibility;<sup>68</sup> reconstructive

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<sup>66</sup> See in particular, par. 5 of the *Disposizioni in materia di organizzazione e governo societario, Documento di consultazione*, available on the Bank of Italy website.

<sup>67</sup> See ENRIQUES, *Codici di corporate governance, diritto societario e assetti proprietari: alcune considerazioni preliminari*, in *Banca impresa società*, 2003, pp. 97 ff.; MARCHETTI, *L'indipendenza degli amministratori*, in VV. AA., *La corporate governance e il risparmio gestito*, by Assogestioni, 2006, pp. 17 ff.; RORDORF, *Gli amministratori indipendenti*, in *Giur. Comm.*, 2007, I, pp. 145 ff.; FERRO LUZZI, *Indipendente... da chi? da che cosa?*, in *Riv. Soc.*, 2008, I, pp. 209 ff.

<sup>68</sup> See among others, TROIANO, *Etica degli affari, codici di condotta e tutela dei risparmiatori*, in VV. AA., *Finanza impresa e nuovo umanesimo*, by Capriglione, Bari, 2007, p. 163 ff.; CAPRIGLIONE, *Cultura della responsabilità ed etica della finanza*, by Conte, Bari, 2008, pp. 138 ff.

hypothesis to which should follow the possibility of a more efficient allocation of financial resources of banks and a desirable increase in trust by the investors.

We can claim, therefore, that the administrative body has taken an adequate characterization appropriate for the management of institutions whose subject consists in the exercise of a *restricted* activity, such as the banking one. Indeed, the contribution of different kinds of expertise (granted by the independence of some members of the Board) is considered by the regulator coherent to the adoption of a prudential logic; these variegated forms of professionalism, however, could give the expected contribution only if the action carried out by this body is orientated towards the achievement of business targets in a cohesive manner (i.e. in a context that respects the technical/decisional prerogatives that are at the basis of a free process of decision-making).

This is an organizational innovation intended to strengthen the transparency and operative fairness, as it can be translated in an increased sense of responsibility of corporate members, related to the distinction of roles; in addition, the disciplinary modification concerning the independent administrators, that avoids the overlapping of interests, with obvious positive repercussions at a management level. This significant normative orientation of the banking regulator has not stayed isolated, as it can be inferred from the art. 36 of the L.D. "Salva Italia" (L.D. 6<sup>th</sup> December 2011, n. 201), in which it's established the so called "interlocking prohibition";<sup>69</sup> and indeed, even if it is

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<sup>69</sup> It's the preclusion imposed by that rule to those who hold positions in management bodies, of supervision or of control and to the executives of companies or groups of companies that operate in the

aimed to introduce a general standard for the fairness of competition, prohibiting individual cross-shareholdings (at both banking and financial level) certainly bears a significant contribution to the clarification of the determinants of a governance (which is placed, for this reason, outside every form of relational opacity).

Particular attention should be then devoted to the legal provision concerning the functions delegated by the Italian regulator to the corporate control body. Without examining the specific tasks of the body itself in the different management models, it's appropriate to highlight the interest of the regulator for what regards its role; interest aimed at ensuring the compliance with the laws, regulations and statutory provisions, the proper administration and the adequacy of the organizational and accounting arrangements of the banks.

Significant is, therefore, the position of this body (e.g. the "board of statutory auditors" in the traditional system; the supervisory board in the two-tier system or the "management audit committee" in the one-tier model). Indeed, in reaffirming the function of contact with (?) the Bank of Italy (as the Consolidated Law on Banking states), as mentioned above, the regulator has given to it a broad sphere of action, being designated to verify the respect of the bylaws and the corporate law and the application of the dispositions regarding the sector.<sup>70</sup> Hence, it has a centrality in detecting the conformity of the *agere*

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banking, insurance and financial markets to hold similar positions in (or in groups of) competing companies.

<sup>70</sup> See ALBAMONTE – BASSO – CAPONE - MARANGONI, *La vigilanza sulle banche*, in VV. AA., *Diritto delle banche e degli intermediari finanziari*, by Galanti, Padova, 2008, p. 503; VELLA -

to the rules of the common and special discipline, as well as in verifying the structural settings of the institution. This is confirmed by its task of supervising the system of internal controls and the observance of the banking normative; task that – going beyond the attributions of the Civil Code regulations – includes inspections to the functionality of the protections granting the “sound and safe management”, with particular attention to procedures for the risk control and accounting system.<sup>71</sup>

Finally, it should be pointed out that the regulative system, which was defined by the Bank of Italy in 2008, has been recently reviewed, on the occasion of the transposition of the 2013/36/EU Directive (CRD IV).<sup>72</sup> The definitions contained in a special “consultation document”, formulated after

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PRISTIPINO, *Commento all’art. 52*, in VV. AA., *Testo unico bancario. Commentario*, by Porzio, Belli, Losappio, Rispoli Farina, Santoro, Milano, 2010, pp. 462 ff.

<sup>71</sup> See among others VALENSISE, *Il collegio sindacale nelle banche*, in AGE, n. 1/2004, pp. 159 ff.; BRESCIA MORRA, *I controlli sull’impresa bancaria*, in *L’impresa bancaria. L’organizzazione e il contratto*, Napoli, 2006, pp. 283 ff.; PORZIO, *Controlli interni e controlli esterni nell’esercizio dell’impresa bancaria a sistema dualistico*, in VV. AA., *Sistema dualistico e governance bancaria*, edited by Abbadessa e Cesarini, Torino, 2009, pp. 175 ff.; TROIANO, *Commento sub art. 52 tub*, in VV. AA. *Commentario a testo unico delle leggi in materia bancaria e creditizia*, by Capriglione, Padova, 2012, Vol. II, pp. 616 ff.

<sup>72</sup> The European regulator had previously intervened by issuing in 2011 (by the EBA) the “Guidelines” on internal governance; these have been transposed in our system with the Communication to the Bank of Italy in January 2012. The content of this Communication – in the reviewing process just recalled – has become essential part of the “Governance Dispositions” recently issued after the consultation phase to which they have been submitted (cf. next note); the respect of the EBA regulations has been considered lacking, despite the precise indications of the above mentioned Communication: for this reason, this Communication has been essentially transposed in the “Dispositions” which are at the basis of the recent disciplinary intervention.

some clarifications *in subjecta materia*,<sup>73</sup> have been implemented at the level of secondary legislation, making a significant addition to the disciplinary framework of corporate governance of credit institutions.<sup>74</sup>

We are in the presence of changes that – despite being functional “at the beginning of the application, from the 1<sup>st</sup> of January 2014, of the community legislation which later transposed into the EU legal system the reforms of the Basel Committee (Basel 3)?” – show a particularly wide scope, which goes beyond the contents of the directive “CRD IV”. They bring organizational and procedural rules “that have close connection with the subject in question”, as it’s regularly pointed out in the “introduction” to the rules themselves.

In this regard, it’s relevant, among other things, the prescription of a diversified composition of the board, even by professionalism and genre, of a significant presence of independent directors, of a careful analysis of the appointment processes of members of the board; additionally, there is a preliminary evaluation of the profiles required for the effective performance of the functions assigned to the same, and the establishment of committees composed of non-executive directors (mostly independent).<sup>75</sup> It is clear how there is a tendency towards a more organic body formation, subject to the

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<sup>73</sup> See the ‘Documento per la consultazione’ on «*Disposizioni di vigilanza in materia di organizzazione e governo societario delle banche*» of December 2013, available on the Bank of Italy website. Beforehand must see the *Nota di Chiarimenti* of February 2009, now incorporated in the above mentioned “Documento per la consultazione”, and the *Comunicazione* of January 2012 reported in note 9.

<sup>74</sup> See the update of the Circular letter n. 285 published on the 6th of May 2014. In particular, the “*Comunicato stampa*” of the Bank of Italy, in which are specified the general principles of the new regulative framework orientated towards reinforcing the governance arrangements of the Italian banks.

<sup>75</sup> See the Circular letter of the Bank of Italy n. 285 of the 17th of December 2013, and following updates, cit., Sez. VII, pp. 320 ff.

identification of the ways of involvement of the directors (to ensure the independence of their judgment) and preparation of training plans for individuals who hold key positions within the bank. In particular, the sector authority appears to be intentioned to ensure that the risks connected with shareholder relationships “like those resulting from transaction with counterparties closely linked to the banks... (are)... firmly guarded by corporate bodies”.<sup>76</sup>

There has been a disciplinary revision that – in emphasizing on systemic aspects until now rarely considered by law (and, therefore, not fully implemented by intermediaries) – relates to the many and varied profiles of banking, with regard to those who find certain peculiar rulings on the subject of shares to be hold and cooperative banks. The intent of the regulator is clearly straining to achieve, with effective measures, the purposes of banking and financial supervision “in full respect of the principles of transparency and proportionality of costs for the recipients of the rules” and in the conviction that “the availability of a set of clear and coherent prudential rules... constitutes .... a prerequisite for the success of the Single Supervisory Mechanism of which the Bank of Italy is part together with the ECB and other national competent authorities”.<sup>77</sup>

In that logic is justified the intervention of moral suasion indicated by the supervisory authority which has suggested the possibility of requiring a radical

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<sup>76</sup> See *Considerazioni finali della Relazione della Banca d'Italia per l'anno 2013*, p. 20.

<sup>77</sup> See the ‘*Documento per la consultazione*’ on «Disposizioni di vigilanza in materia di organizzazione e governo societario delle banche» of December 2013, cit. and now Circular letter of the Bank of Italy n. 285, December 17 2013, cit., *Premessa*, p. 12.

renewal of the “composition of the administrative bodies... to prevent the use of extraordinary measures”;<sup>78</sup> similar *ratio* may be due to the wish expressed by the control body to being attributed “to the Bank of Italy ...(the)... power to remove – when necessary and on the basis of founded evidence – the directors of a bank from their position”.<sup>79</sup>

There is no doubt that we are in the presence of rules aimed at supporting the process of internationalization of banking companies, and therefore, the transformation of their business model. As it’s evident from the contents of the regulations mentioned above, there is a greater involvement, than in the past, of corporate governance in the work of prevention and management of criticalities (resulting from the economic slowdown and tensions that exist in financial markets) that impact on the balance sheet of the banks; this indicates the direction of the disciplinary change, in which – as will be said following – it becomes prevalent the attention to the risks and analysis of the sustainability of the objectives to seek for.

6. Examining the disciplinary system concerning corporate governance, particular attention should be paid to the application of innovative compensation mechanisms, which are designed to “attract and keep into the business professional people who have the skills and capabilities tailored to the needs of the enterprise”.<sup>80</sup>

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<sup>78</sup> See *Considerazioni finali della Relazione della Banca d’Italia per l’anno 2013*, cit., loc. ult. cit.

<sup>79</sup> See *Considerazioni finali della Relazione della Banca d’Italia per l’anno 2013*, cit., loc. ult. cit.

<sup>80</sup> Referring to the indications of the Italian regulator and, in particular, to the clarifications contained in the mentioned “Disposizioni di Governance”, 4 March 2008, which – anticipating the disciplinary

Within the measures adequate to ensure business processes respectful of the financial regulation, the introduction of special dispositions concerning the definition of “compensation policies” is completely inspired to the objectives of sound and safe management, as well as to the proper management of risks and of the long-term bank strategies.<sup>81</sup> In fact, the compensation issue directly affects good corporate governance; this is because the lack of discipline of the remuneration forms can promote arbitrary determinations, as it is shown by some events of the past.

It is worth noting that, quite often, due to regulatory shortcomings on this point, in recent years, have occurred circumstances in which the incentives to increase business productivity has been given in situations completely undocked from the achievement of long-term goals. Not to mention, then, some limit cases in which the assignment of a *variable* part of the remuneration is not supported by the realization of effectively profitable transactions, but paid in the presence of an apparent growth of the business volume of the credit institution. It's clear how, in such a context, the greed of many bankers, who tend to practice unjustified risings of the operational volumes, has caused the acquisition (by intermediaries) of intolerable risks due to disbursements made without a previous, careful examination of the credit worthiness.

At European level, with the Directive 2010/76/EC, specific rules on the “compensation policies” have been introduced with regard to credit institutions

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standards of the European legislator – outline the principles on which the banks should develop sound and safe compensation policies.

<sup>81</sup> See VENTURI, *Le politiche di remunerazione nelle imprese finanziarie (dal contesto internazionale alle nuove regole europee)*, in *Riv. trim. dir. econ.*, 2010, I, pp. 291 ff.

and investments firms. As it can be inferred from this directive, the definition of clear principles of a sound remuneration policy discourages “excessive risk-taking by individuals or moral hazard” (*considerando* n.4) and aligns “the personal objectives of staff members with the long-term interests of the credit institution or investment firm concerned” (*considerando* n.7). Following is, therefore, the normative provision in the art.1, paragraph 3, letter a, in which among “governance arrangements” is included the adoption of “remuneration policies and practices that are consistent with and promote sound and effective risk management”.

It should be noted, therefore, the completion of this legislation which was possible thanks to the integrations brought by the guidelines first issued by the Committee of European Banking Regulators (CEBSR) and, later, endorsed by the EBA.

In line with this approach are, then, the rules adopted in the UK, in occasion of the transposition of the CRD IV directive, so that – as it has been promptly highlighted by the doctrine – today the UK regulator’s Remuneration Code ensures “the alignment of remuneration incentives with risk management”.<sup>82</sup> We also find a similar approach in the dispositions issued by the Bank of Italy, which – in confirming the previously applicable disciplinary criteria- “are characterized by a greater degree of detail on certain aspects, in accordance with the European and International setting”.<sup>83</sup> It results – in the

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<sup>82</sup> See ANDENAS - H-Y CHIU, *The Foundations and Future of Financial Regulation*, cit., p. 366.

<sup>83</sup> See *Disposizioni della Banca d’Italia in materia di politiche e prassi di remunerazione e incentivazione nelle banche e nei gruppi bancari*, measure adopted on the 30<sup>th</sup> of March 2011. This normative, apart from incorporating and widening the rules and the applicative principles already contained in the

occasion – in the adaption of the national regulatory framework, concluded with the modifications made to the joint BI-Consob regulation, in July 2012, for the introduction of rules on remuneration applicable to firms and to banks in the performance of investment activities and services.<sup>84</sup>

Recently, in Italy, a further step in the process of change of the regulation intended to make “more stringent controls and monitoring verifications on the respect of the legislation on remuneration” has been taken, as it is pointed out in a new “consultation document” in which the disciplinary profiles in question are subject to a careful study.<sup>85</sup> The regulator appears to be, therefore, determined to complete the interventions that, in recent times, had found expression in a number of recommendations addressed to all operators.<sup>86</sup>

The indications for this route provided by the Supervisory Banking Organism suggest – in accordance with what has already been affirmed at European level<sup>87</sup> – the strengthening of guarantees aimed at the creation of

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“Disposizioni” of March 2008 (see note 23), also transposed a Communication of October 2009, with which the international standards of the FSB were introduced into our system (see VENTURI, *op. cit.*).

<sup>84</sup> See *Regulation* of the 9th of May 2012 that modifies the Regulations of the 29th of October 2007, so called joint Bank of Italy and Consob regulation on the subject of organization and procedures for intermediaries. See in particular the new “Capo III-bis” of the regulation in question, concerning the “organizational-prudential requisites on the subject of policies and procedures of remuneration and incentive”.

<sup>85</sup> See the *Document* for the consultation on the subjects of “*Disposizioni della Banca d’Italia in materia di politiche e prassi di remunerazione e incentivazione nelle banche e nei gruppi bancari*” issued by the Bank of Italy in the December of 2013.

<sup>86</sup> See the *Communications* of the Bank of Italy of the 2nd of March 2012 and of the 13th of March 2013.

<sup>87</sup> See EBA, “*Survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices*”, April 2012; FSB, “*Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards. Progress report*”, June 2012 and August 2013.

correct incentive systems “to take account of all the risks, associated with the long-term results and coherent with the levels of capitalization and liquidity of intermediaries”.<sup>88</sup> Therefore, despite leaving the systemic structure and the fundamental principles of the existing disciplinary system unchanged, there are some changes to the normative, which accomplish the objective of correlating more strictly the remuneration policies to risk prevention.

The changes in question – in line with the requirements of the CRD IV Directive (articles 75 and from 92 to 95) – deals with a more complete clarification of the relationship between the fixed and the variable component of remuneration; If necessary, proceeding with the introduction of a ceiling (of 1 to 1), giving the shareholders’ meeting the power to approve a higher limit, as well as providing mechanisms of corrections to *ex post* risks.<sup>89</sup> Significant, in this regard, are the rules according to which “the variable component shall not exceed 100 % of the fixed component of the total remuneration for each individual” (article 94, directive in question); it’s clear that the European regulator tends to ensure the balance and the adequacy of the fixed and variable components of compensation in order to avoid the negative effects of a “fully flexible policy”.

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<sup>88</sup> See the *Document* for the consultation on the subject of “*Disposizioni della Banca d’Italia in materia di politiche e prassi di remunerazione e incentivazione nelle banche e nei gruppi bancari*” cit.

<sup>89</sup> The ability to attribute to the general meeting the power to raise the limit is granted by the CRD IV, which also identifies reinforced constitutional and deliberative quorums in comparison to those established in the Italian System by the civil code. To ensure the achievement of the prudential objectives underlying the introduction of the so-called *cap* (limit to variable/fixed ratio), the directive established that the shareholders’ meeting could raise it up to a maximum of 2:1 (e.g. such that the variable remuneration may not exceed 200% of the fixed one).

Related to the purpose of maintaining unchanged the capital levels of the credit institutions is also the provision of the European normative in which are defined the variable components of remunerations. In particular, the regulator is keen to stress that “the variable remuneration, including the deferred portion, is paid or vests only if it is sustainable according to the financial situation of the institution as a whole, and justified on the basis of” of the management (art. 94, paragraph 1, lett. *n*). In other words, important limits to the increase of remunerations (e.g. in cases where the banks do not comply with the specific capital requirements) are imposed through regulatory changes, relevant with regard to the intention underlying them, to avoid that particularly high variable compensations resolve in greater managerial weights or even in a factor of imbalance for the unjustified assumption of risk (as mentioned previously).

These are constraints that may give rise to doubts if the banking sector is required to proceed *tout court* to their introduction, to be carried out indiscriminately in the above-mentioned terms. This is even more true in the Italian case, which is characterized – as seen above for governance – for the introduction of additional rules to those identified in the CRD IV, however motivated by the need to remedy to some non-acceptable remuneration practices.<sup>90</sup>

In fact, in the presence of business situations characterized by a significant capitalization of the institution and by a proper *agere* of bankers –

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<sup>90</sup> See *Disposition on the subject of policies and practices of remuneration*, quote. See in particular the introduction box, in which are differentiated the regulations enacted for the transposition of the CRD IV (that is of minimum harmonization) and those of national enactment.

that is, in cases in which it seems that there can't be any doubts about the respect of the rules granting the "sound and safe management" – an excessive disciplinary strictness in the determination of remuneration may result, as previously said, in a form of constraint (or rather: limitation) of independence, unjustified by the need for prudential coherence... Once again come to mind Horace's words: "est inter Tanain quiddam socerunque Viselli: est modus in rebus"!

7. From another perspective, it should be highlighted the special attention paid by the European regulator to the connection between stability of the participants in the financial sector and the observance of the disposition preordained to the mapping and prevention of risks, to which the intermediaries are exposed in the conduct of their business activity. The composition of the corporate bodies and the distinction of the roles within the corporate structure – as previously said – respond, in fact to the need to realize efficient structures with regard to the "different types of control" to be practiced in ways coherent with the "risk profile" that characterizes the different banking entities.<sup>91</sup>

In reality, the introduction of particular relational techniques (intended to impact on significant governance profiles) aiming at overcoming the traditional weaknesses of banking management, attributable to different reasons, goes back in time. This applies, in particular, to realities characterized by insufficient internal reports, by conflicts of interest, by improper behaviour

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<sup>91</sup> See TARANTOLA, *Il sistema dei controlli interni nella governance bancaria*, cit.

of corporate bodies, due to internal conflicts or to forms of subjection of the executive.

Risk prevention becomes, therefore, the central moment of corporate governance, giving particular content to the connection between administration and control; indeed, the achievement of this objective is closely related to the coordination of the functions performed by these bodies. There is no doubt that the guidelines defined by the body of strategic supervision (in view of an activity oriented towards growth) must find a fair correspondence in the *agere* of banking institutions; hence the need to rely, without continuity solutions, on the prompt inspections carried out by the internal control bodies and, above all, by the statutory auditors.

Therefore, the definition of the risk monitoring apparatus performs a primary function of ensuring a proper assessment of the returns, linked to the company policy. In particular, such a system is put in charge of a prudent estimate of the adequacy of the selected option; task which impacts not only on the organizational and financial structure of intermediaries, but also on the interaction between management and control in re-conducting the production process towards unity.

To the present, also in response to the recommendations arising from the recent crisis, the need for a governance attentive to the provision of adequate information channels, such as to make a better understanding of possible risk situations, has increased. The analysis of such situations becomes necessary prerequisite for their prevention and, therefore, for ensuring stability to the banks. This is the strategic foundation on which must be based the assessments

oriented to the Asset Quality Review, i.e. an examination of the quality of the assets of European banks, which will be followed by a new exercise of “stress tests”, developed to evaluate the ability of the intermediaries to absorb possible shocks arising from market tensions and from the deteriorating of the context-related economic determinants.<sup>92</sup>

To this logic seems to be inspired the revision of the special regulative system implemented during the adoption in Italy of the mentioned CRD IV directive, of which has been said before. The extensive integration of secondary legislation in the field of “organization and corporate governance of banks”, here applied, underlines – among other things – the necessity to develop specific forms of connection between the evaluation and the internal supervision system.<sup>93</sup> In perspective, the link between the corporate rules and the pursuit of stability of them belonging to the banking sector seems orientated towards an always closer interaction; the observance of the first, in fact, is more and more related to the mapping, measurement and prevention of the risks to which they will be exposed in the course of their business activities.

It is worth recalling the centrality that Italian governance rules recognize to the composition and qualification of the boards of management and control in the administration of the company and, therefore, the importance given by the law to the specification of the “role of the business organisms”.<sup>94</sup> We are in the presence of measures that, learning from the crisis, are intended to

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<sup>92</sup> See EUROPEAN CENTRAL BANK, *Note – comprehensive assessment*, October 2013, p. 5

<sup>93</sup> See *Newsletter* of the Bank of Italy n. 285 of the 17<sup>th</sup> of December 2013, quote, p. 44

<sup>94</sup> See the *Press Release* of the Bank of Italy of the 7<sup>th</sup> of May 2014 quoted in the note n. 29.

overcome the weak point of operational management: risk control, which in large banks of systemic relevance has been a great destabilizing factor.

This impulse of implanting the disciplinary system can't be separated, however, from the significant contribution that, for the realization of complete forms of analysis for risk management, comes from some special functions (rectius: control centers), of which the banks must equip themselves especially in view of performing in an optimal way, the mentioned action of prevention. Thus, we can refer to internal audit systems oriented towards the overall qualitative assessment of risk exposure, the risk management function intended to measure them (in relation to the different operational forms) and, finally, the findings of non-conformity with traditional compliance regulation (that, among other things, deals with the risks of legal sanctions, financial losses and reputational risks for non-compliance with laws, regulation, codes of conduct).

8. The examination of the regulative system regarding banking corporate governance should not be subtracted from criticism regarding the failure of the Italian regulator on the subject of relationships that, still today, are entertained by many banking companies with the foundations subject to the law Ciampi-Carli (Legislative Decree. n. 153/1999). Up until this moment, have gone missing, in fact, valuable opportunities (in the transposition of EU legislation) to finally clarify the critical question of the relationship between politics and

finance, which still has dark sides, on which it would be appropriate to shine a light on without further delay, as I have already stressed.<sup>95</sup>

In determining the special rules, the legal instruments, used by the so-called banking foundations to test their shareholding relationship in the derived credit institutions, through the power of appointment of its members, have been left unaltered. At the same time, no modifications have been made to the regulatory regime of banking companies covered by the provisions of the Volonté amendment, which – as it's known – may, still, be legitimately controlled by the institutions of origin, therefore disregarding the general need to avoid that, in such a manner, forms of interaction between politics and finance may take place.

In other words, the regulation did not take any account of the fact that the primary target of the majority of foundations is the management of the credit institutions in which they hold shares; hence, the significant degree of influence exercised on them (in order to take for granted the income stream necessary for the realization of their institutional goals).

Conversely, the referring to the organizational structure of these banking institutions should have suggested them to reformulate the rules contained in their bylaws, with which the so-called *list vote* has been disciplined, introduced by the n.474 Law of 1974 and then made mandatory for the election of exponents of listed companies by the so-called "savings protection law" (n. 262 of 2005) in order to "allow the representation of minority shareholders on the

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<sup>95</sup> See CAPRIGLIONE, *Politica e finanza. Ruolo e prospettive delle fondazioni bancarie*, in *Riv. Trim. Dir. Ec.*, 2013, I, pp. 23 ff.

board of directors". Adequate changes to the legal criteria of the corporate structure, that, still, gives to the "majority list" (even if the majority is relative, i.e. the one that gets the most number of votes) the right to nominate almost all of the components of the administrative and control bodies, could have been foreseen.<sup>96</sup>

A coherent and uniform regulation of corporate governance could have brought ideal changes to avoid the continuation of a situation in which the circumstance of being a "public company" certainly plays in favour of the assumption of a substantial form of control by the foundations. From here, the finding of a participation of shareholders to the general meeting usually very limited, as well as a lack of interest from the new investors for an entity in which the possibility to actively enforce their share ownership results limited.

It would have been appropriate, perhaps, to clarify with the regard to the possibility to justify, on a formal level, the eligibility of *agreements* between banking foundations created for the sole purpose of presenting the "lists" for the election of corporate members; agreements which, according to the technical and juridical reconstruction of these offered by an important exponent of the *foundations'world*, constitute "coalitions... not aiming at the control of

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<sup>96</sup> See, as an example, the disposition of the art. 23 of the Statute of the Intesa Bank. "Art. 23: Election of the Supervisory Board. 23.2. - Voting".

For the election of the Supervisory Board the procedure follows. The components are selected proportionally from lists that have received votes; for this purpose, the votes obtained by each of the lists are divided by one, two, three, four and so on according to the number of members to be elected. The quotients obtained are assigned to the candidates on each list, in the order they are listed. The quotients like this attributed to the candidates of the different lists are disposed in a unique decreasing rank: are considered elected Members of the Supervisory Board those who have obtain the higher quotients".

the company, but simply at ensuring the formation of a structure of stable and effective government, and therefore destined to run out of their effects in a single stroke, i.e. at the time of election of the bank bodies (board of directors or supervisory board, depending on the model of management and control adopted)."<sup>97</sup>

From another perspective, is relevant the link, still in place and just mentioned above, between politics (in which find expression the instances that, even at a local level, express government guidelines) and the so-called foundations; this recalling, at least in memory, the not too distant events in which many banks depended on non-transparent schemes of money provision of public origin (from which derive malpractices that, hopefully, we all want to leave behind our backs).

Indeed, the purpose of the just mentioned regulation – aimed at ensuring financial coverage for the performance and the development of the activities of specific social valence – not in itself excludes the possibility (quite likely) that the action taken by the foundations are oriented to the support of interests considered determinant in the aggregation of political consensus, interests in the past supported by logical assistance. Conversely, the need to “operate... to reinforce the separation between the foundation and the bank” is still considered unavoidable by the sectorial authority, which has recently confirmed that the “transition from the top of one to the bodies of another” should be

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<sup>97</sup> See BENEZIA, *Le fondazioni bancarie di fronte alla crisi finanziaria: prime riflessioni*, intervention at the second *Conference of Economic, Banking and Financial Law*” organized by the Foundation “Angelo Colucci” and by the University of Macerata, Jesi, 2009, p. 29.

excluded, and prohibited a fortiori the “control to the cases in which it is exercised, de facto, also jointly with other shareholders”.<sup>98</sup>

That being so it’s evident that the introduction of appropriate rules to break the link between politics and finance constitutes a primary objective, towards which the legislator – in this moment of significant systemic changes – will have to direct its actions; this, being aware that, in any case, a return to forms of political control over banks, to be considered – as well as anachronistic – contrary to the logic of the market, driving factor for the growth of the Country, must be disregarded.

9. The regulation of banking governance – launched, in Italy, following the reform of corporate law at the beginning of this millennium – has received a significant boost from the European disciplinary guidelines and the demands of regulatory compliance stressed in the EU countries by the recent economic crisis. The specificity of financial matters, at the basis of the operations of credit institutions, has interacted on the model of “corporate governance” to these applicable; so that, the latter has taken on a peculiar characterization that differentiates it from the typical configuration required by law to similar subjective realities.

In particular, in order to ensure the objective of “sound and safe management”, the regulation is aimed to avoid imbalances related to the distinction of roles between the governing body and the control one. From here the clarification of tasks and responsibilities – in bringing clarity with regard to

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<sup>98</sup> See *Considerazioni finali della Relazione della Banca d’Italia per l’anno 2013*, cit., p. 19.

the prohibition of forms of abuse of power between the chairman and directors or between strategic supervision and management – constitutes the natural condition for taking management decisions based on suitable informational supports and not distant from adequate assessment processes. In this way is outlined a regulative context orientated towards the observance of prudential logic, in which the figure of the control body, that is in charge of the function of verifying the regularity of the action taking place (and therefore, the observance of the disciplinary system placed as safeguard of the proper management) assumes centrality.

For that concerning in particular the Italian legislation, the provision issued by the Bank of Italy, at first appeared orientated towards promoting forms of internal dialogue within the corporate bodies and fixing disciplinary instruments (including the regulation of compensation policies) that ensure profitable management and operational correctness. More recently, in occasion of the transposition of the CRD IV mentioned, aimed at the prevention of risks and at the strengthening of the capital of credit institutions, a new impulse has been given to the regulation that we study, reviewing banking governance and the legislation on the remuneration of members of credit institutions. Conversely, certain deficiencies that still remain in the regulative system in question should be reported; shortcomings due to the fact that the Italian legislature has not taken any regulatory measures can affect the “relationship between politics and finance” which still allows banking foundations to influence the management of many participant banks.

That said, the increased willingness of the regulator to correlate the organizational structure of credit institutions to the need for a proper risk consideration and prevention should be highlighted.

Corporate governance is increasingly permeated by the public interests, which distinguish the exercise of the financial asset; from here the attention given by the special regulations for the production of technical-organizational measures (risk management, internal audit and compliance) to ensure the compliance of managements to the legal standards to which the legislator refers to in that field.

The evolutionary path of regulation is likely to continue in line with the process of internationalization of financial systems and with the increase of the complexity of the markets.

A new proposal for a directive by the European Commission on corporate governance – orientated towards the strengthening of the commitment of shareholders (and giving them a “voice” on the subject of remuneration of directors of the largest companies in Europe) – makes us understand that the matter in question is still far from normative solutions with a definitive character.<sup>99</sup> What appears certain is that the experiences of recent years lead us to conclude that “good corporate governance”, which is also mentioned in a recent recommendation also from the Commission, is one of the appropriate

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<sup>99</sup> See EU Commission directive proposition of the 9th of April 2014 (IP/14/396)

measures to provide enterprises with a framework for effective operability and growth.<sup>100</sup>

This is a final thought that, of course, is applicable to any category of corporate entities and, therefore, also to banks and investment firms.

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<sup>100</sup> See *Recommendation on the quality of corporate governance reporting ('comply or explain principle')* of the 9th of April 2014, C(2014) 2165/2, *considerando* n. 2.

# AN OVERVIEW ABOUT THE NEW RULES REGARDING CORPORATE GOVERNANCE AND REMUNERATION POLICIES IN SPANISH BANKS

Ana Belén Campuzano - Rosa Calderazzi - Aurelio Gurrea  
Martínez\*

**ABSTRACT:** *The European Union is currently taking several steps in order to create the Banking Union. Among other measures, the European lawmaker has recently enacted the Regulation (EU) No 575/2013, which establishes uniform and directly applicable prudential requirements for credit institutions and investment firms. Likewise, it has also enacted the Directive 2013/36/EU, whose main objective is to coordinate national provisions concerning access to the activity of credit institutions and investment firms, the modalities for their governance, and their supervisory framework. In this context, and with the aim of adapting these new rules to local law, Spain has enacted the Royal-Decree 14/2013, focused on prudential requirements for credit institutions and investment firms, as well as a new Banking Law (Ley 10/2014), which provides –*

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\* Ana B. Campuzano is Professor of Business Law and Dean of the Faculty of Law at CEU San Pablo University (wrote the following paragraphs: III, III.1, III.2, III.3, III.4, III.5, IV, IV.1, IV.2, IV.3, IV.4, IV.5).

Rosa Calderazzi is Researcher of Business Law in University of Bari (wrote the following paragraphs: II, II.1, II.2).

Aurelio Gurrea Martínez is a Lecturer in Business Law at CEU San Pablo University (wrote the following paragraphs: III, III.1, III.2, III.3, III.4, III.5, IV, IV.1, IV.2, IV.3, IV.4, IV.5).

*among other aspects – new rules regarding corporate governance and remuneration policies. This note seeks to describe these new rules in Spanish Banking Law, as a first step to analyse in a future research the level of efficiency of these new rules by comparison with the measures implemented by other European countries.*

**SUMMARY:** I. Introduction. – II. The aims of the directive 2013/36/eu - 1. The role of the management body. - 2. The remuneration policy. - III. New rules regarding corporate governance in Spanish banks. - 1. An overview. - 2. Goals and requirements of corporate governance systems. - 3. The general viability plan. - 4. The board. - 5. The appointments committee. - IV. Remuneration policies in Spanish banks. - 1. Introduction. - 2. Principles of remuneration policies. - 3. Design and limits of the variable remuneration. - 4. Special rules for recipients of public money. - 5. Remuneration committee. - V. Conclusion. - VI. Bibliography

I. The global financial crisis has shown the importance of the interconnection between financial markets. The existence of global markets, the issuance of financial assets all over the world, and the interconnection between banks, provokes that a bank failure may disrupt the stability of the whole financial system. Thus, the regulation of financial institutions is no longer a local problem.

The first reaction in order to regulate global financial markets was taken in 2010, when the Basel Committee on Banking Supervision decided to implement new rules regarding capital requirement, stress testing and market liquidity risk. As a result of this new banking framework, the European Union

also amended the legislation regarding financial institutions. For this purpose, it was enacted the Regulation (EU) No 575/2013, which establishes uniform and directly applicable prudential requirements for credit institutions and investment firms. Likewise, it was enacted the Directive 2013/36/EU of 26 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms. The main objective of this Directive is to coordinate national provisions concerning access to the activity of credit institutions and investment firms, the modalities for their governance, and their supervisory framework.

This new legal framework in Europe not only is limited to adapt the new rules agreed by the Basel Committee, but it also advances in the creation of a uniform banking regulation. Thus, after the harmonization of banking laws, and the constitution of single mechanisms to supervise and resolve credit institutions, it will be possible to create a real banking union in the Eurozone.

In this context, and with the aim of adapting these new rules of financial regulation, Spain –as all its European fellows– is amending its banking laws. For this purpose, it was enacted the *Real Decreto-ley 14/2013, de 29 de noviembre, de medidas urgentes para la adaptación del derecho español a la normativa de la Unión Europea en materia de supervisión y solvencia de entidades financieras* (hereafter, the *Real Decreto 14/2013*). Likewise, at the end of July 2014 was also enacted the *Ley 10/2014, de 26 de junio, de ordenación, supervisión y solvencia de entidades de crédito* (hereafter, the Banking Act), which has two main purposes. First, it completes the *Real Decreto-ley 14/2013* in order to implement several aspects required by the Directive 2013/36/EU, related to the

supervision regime, capital requirements and sanctions for banks. Second, this Act also involves an internal compilation and harmonization of Spanish laws. Thus, the new Banking Law allows to create an useful and coherent body of banking laws, facilitating its application and interpretation.

Whereas the Regulation 575/2013, directly applicable in all State Members, establishes the main rules related to capital requirement, solvency and assumption of risks, these new rules –which partially implements the Directive 2013/36/EU– aims to regulate the legal framework of credit institutions. Namely, we will focus our analysis on the new rules regarding corporate governance and remuneration policies implemented in Spain in accordance with the European and International standards.

II. The Directive 2013/36/EU of 26 June 2013 (CRD 4, Capital Requirements Directive), which rectifies the Directive 2002/87/CE and repeals the Directives 2006/48/CE e 2006/49/CE, deals with the access to the activity of Credit Institutions and with the prudential supervision of Credit Institutions and Investment Firms.

The aim is to provide, together with the EU Regulation n. 575/2013, a discipline to access banking activities, a control framework and prudential norms for Credit Institutions and Investment Firms (as reported in the 2nd whereas of the Directive and in the 5th whereas of the Regulation).

This intervention fits within a wide phenomenon based on significant indications coming out, at international level, from the Principles for Enhancing Corporate Governance of the Basel Committee (2010), from the

Corporate Governance and the Financial Crisis: Key Findings and Main Messages of OECD (2009), and from the Thematic Review on Risk Governance - Peer Review Report of the Financial Stability Board (2013), and at European level, from the Guidelines on Internal Governance (2011) and the Guidelines on the suitability assessment of the members of the management body and key function holders (2013) of EBA.

Among the numerous interventions, the Directive intervenes on the bank governance outlines, aware of the existence of a close relation between the lack of a discipline in the bank corporate governance and the economic-financial crisis.

The emerging perspective from the Community Directive is that the pursuit of a balanced order of government together with an adequate management body may allow not only to withstand the crisis and to overcome it, but also to strengthen the trust of the market and of the investments.

In fact, in the bank, the presence of an effective organizer and a society government order gives importance to the peculiarities characterizing the same banking activities and the associated public interests.

Although wide are the reasons justifying the origin of the crisis, undoubtedly it is a bad working of the social body that affects the extent and the duration of the crisis itself. Boards of directors unable to hold a prognostic inquiry on potential risks, non-executive managers not well-informed and poorly careful as controllers, distortion of incentives have

triggered a lack of management and risk control and a poor informative flow towards intermediaries.

This is the reason why interventions on the access to the activity of Credit Institutions and on prudential supervision of Credit Institutions and Investment Firms should devote a number of provisions to the bank governance to assure a best protection against the risks related to the company management.

The Community decision to submit the bank system to an unitary supervision with rigorous and shared rules aims, on one side to pursue the result of strengthening the united market, on the other trying to set the operators on a more competitive level: in this context of global competition, it is unavoidable to have an adequate governance.

The Directive provisions, even though interfering with the rules of the national social law and irrespective of the different model used, aim to fix common objectives.

II. 1 The delicate but complex banking activity and the predominant role of the trust element make the care of the company board government of fundamental importance.

By assuming that a fair and qualified management of the bank governance represents the best signal for the market concerning the bank trust and ability in adequate saving protection, the Directive 2013/36 fixes some provisions on this specific point with a greater accuracy compared to

the general principles previously reported in the repealed art. 22 of the Directive 2006/48/UE.

In the 54th whereas, the Directive urges the Member States to avoid that poor company governments may cause harmful effects on the sound management of risk and to introduce provisions aimed to assure an effective supervision by the management body, to promote a sound risk culture at all levels of Credit Institutions and Investment Firms, and to allow the competent authority to monitor the adequacy of the internal apparatus of governance.

The Credit Institutions, besides to be provided of a valid governance organization from which a well-defined and transparent liability rises, must determine procedures to identify, manage and mark the risks, and provide adequate internal control systems together with efficient administrative, accountable and political proceedings of remuneration to assure a sound risk management, as reported in the art. 74.

Without forgetting the different models of management adopted by the Member States, the Directive fixes common roles to be carried out each for every State and with whatever selected structure: in particular, concerning the management activity which consists in the conduction of the social activity; the role of strategic supervision by which it is possible to determine the strategic addresses and company objectives and to prove their accomplishment; the role of control which consists in ascertaining the regularity of the administration activity and the adequacy of the bank organization and accountability.

In the case the monistic system is adopted, the board of directors will carry on management and strategic supervision tasks; in the case of dualistic model, the management body will be entrusted of the executive role, responsible for the ordinary management, while the council of surveillance (which has no executive role) entrusts a strategic supervisory role.

A special attention has to be paid to non-executive managers which have an important active role: in fact, although not carrying a personal managing role, they contribute with a productive and efficient manner by i) stimulating, in a constructive manner, the bank strategy processing, ii) checking the management results, iii) ascertaining the accuracy of financial information, the soundness and justification of financial controls and of risk managing systems, the analysis of the bank remuneration policy, iv) expressing opinions on resources, appointments and standards of conduct.

The bank board have all the proper duties and authorities of the company managers, of each company structure, although in the bank circuit, also the professional character and efficiency of the counsellors influence the grade of protection given to investors and clients.

The Directive also dwells upon the requirements of the management body components: first of all, it is noteworthy the need to limit the number of assignments for the managers working in different companies in order to avoid that components of the management body wouldn't be able to control the managing choices, the institution activity and risk exposure, and the deriving consequences of undertaken strategies, pointing to the need that each counsellor has to spend enough time for his assignment.

By contrast, concerning the components requirements, the partners are invited to choose the managers with open and transparent assignment procedures which should take into the account the essential knowledge and competence in order to guarantee a proper and prudent management of the institution; a further criterion to consider before forming the management body is the diversification of components according to age, sex, geographical origin and background, useful for a more efficient control of the management activity and to improve the risk supervision.

Just to guarantee the professional character of the components of the management body, the art. 91, par. 9 of the CRD IV provides that the banks “assign adequate human and financial resources to prepare and train” the components of the board of directors, by providing training projects to favour an up to date skill.

The Directive, in the articles 76, 88 and 95, requires – for the Institutions named “significant” according to their size, internal organization, nature, extension and complexity of activity – an obligatory establishment – within the management body, one committee for the appointments, one committee for the risk and one committee for the remuneration, which help the administration board in the case of special subjects distinguished for their strategic relevance and technical complexity and for the risk of conflict of interest.

Regarding the other banks (i.e. those with lower size and complexity), the CRD IV does not prescribe the institution of committees, however it does

not exclude the possibility to found them; indeed, all banks can provide different committees if it is required by valid requirements.

II. 2 The remuneration represents a topic of primary importance, both in the European and in the international circuits, based on the assumption that adequate mechanisms of managers remuneration and incentive and the management of the bank itself may favour the competitiveness and a good governance, whereas policies encouraging excessive risk assumption may compromise the sound and careful risk management of the Credit Institutions.

This topic is of particular relevance both at regulation and at supervisory level; therefore, numerous interventions took place: EBA, "Survey on the implementation of the CEBS Guidelines on Remuneration Policies and Practices", April 2012; FSB, "Implementing the FSB Principles for Sound Compensation Practices and their Implementation Standards. Progress report", June 2012 and August 2013; the methodologies processed by the Basel Committee for bank surveillance; the European Committee Recommendation for the remuneration in the financial sector; the Directives 2006/48 and 2010/76; the Guidelines issued by the Committee of European Banking Supervisors in accordance with the provisions included in CRD 3; in particular, the CRD 3 had indicated principles and specific criteria to which the banks should have followed to guarantee a right processing of the remuneration systems which had considered the risks of the degree of capitalization and the liquidity level of each intermediary; to manage the

potential conflict of interest; to assure a degree of transparency towards the market; to strengthen the control of the supervisory authority.

The Directive n. 36 aims to reach the goal of processing the remuneration systems which, by considering the long-term company strategies, may avoid ways of acting in breaking provisions or with an excessive propensity to risk for the bank and the whole system, in general.

For these reasons, it devotes wide spaces to the remuneration policy, providing the obligation – for the Credit Institutions – to arrange rules in the matter of remuneration, consistent with the effective management of risk.

To realize this objective, the Directive considers that the Institutions have to indicate transparent principles on the governance and on the remuneration policy: the selection will vary according to the different typology of the Institution, by considering its size, nature and complexity of the activity, although it will always have to consider the risk propensity (Risk Appetite Framework - "RAF"), the long term values and interests of the Credit Institution, and that it has to be appraised on long term results and on present and future risks related to the results.

Moreover, to avoid excessive risks, the remuneration should include a fixed part and a variable one: with regard to, the Directive introduces important novelties concerning the introduction of a maximum limit in the ratio between variable and fixed parts of the remuneration, with the evident purpose of avoiding that a predominant percentage of the variable payment may favor the assumption of excessive risks.

Periodically, the management body must reconsider the predisposed remuneration policy.

However, it is possible that the partners' assembly may approve a higher limit for the ratio between fixed and variable remuneration, although always within the range defined by the Directive; moreover, it is possible to arrange repairing mechanisms for the ex post risks linked to the achievement of the results, to which qualitative indicators related to the staff behaviour in the fulfilment of the employee relationship with bank have to be added.

In addition, a limit to variable remuneration is provided in the case the bank does not observe specific capital requirements: the property soundness becomes an indispensable condition for the payment of incentives.

Finally, ABE supervises the remuneration policies by gathering information from the national competent authority in order to compare the different remuneration procedures within the Union and co-operates with AESFEM to design the guidance for remuneration policies.

III. 1 A large part of the Spanish financial crisis was due to the problem of having inefficient corporate governance structures in saving banks (*cajas de ahorros*). Indeed, since these financial institutions were not corporations (but *foundations*), and therefore did not have shareholders, the directors of Spanish saving banks (i) were not monitored by any shareholders, (ii) were not subject to mechanisms for corporate control, and (iii) did not have a clear and effective system of fiduciary duties.

For this reason, even though the 2008 financial crisis demanded a reform of several aspects of corporate governance around the world, these changes seemed to be even more urgent in Spain. These changes have been focused on two main aspects: (i) first, the establishment of an efficient system of corporate governance; and (ii) second, the development of a remuneration policy best aligned with the interest of the financial institution in the long-term.

III. 2 All credit institutions are required to carry on their business in accordance with the standards of corporate governance established in the new Banking Act (BA), as well as other applicable laws (art. 28 BA). Among other procedures required to ensure an effective corporate governance system, all credit institutions are required to implement: (i) a clear organizational structure with a coherent, transparent and well-defined liability regime; (ii) effective procedures to identify, control and inform about the level of risk exposure; (iii) proper mechanisms for internal control, including accounting and administrative mechanisms; (iv) remuneration policies and practices which allow a proper and effective risk management (art. 29.1 BA). These systems of corporate governance will be both comprehensive and proportionate to the nature, scale and complexity of the risks inherent to the activities and business model of the entity.

Likewise, all credit institutions must have a website where they will both disclose all information related to corporate governance required by the Spanish Banking Law, and explain the level of compliance with these requirements. On the other hand, if a credit institution provides investment

services, it will also have to comply with the requirements established in article 70 ter.2 of the Spanish Securities Market Law (*Ley 24/1988, de 28 de julio, del Mercado de Valores*).

III. 3 As a part of the procedures established for an efficient corporate governance system, credit institutions are required to prepare and keep updated a General Viability Plan. This plan will provide those steps to take in order to restore the viability and stability of the entity in case of financial trouble.

This plan will be subject to the approval of the Bank of Spain, which may require any amendment of the content of the plan. Moreover, if the Bank of Spain concludes that the plan is not sufficient to fulfil its purpose, it will be able to impose some measures established in the article 24 of the Spanish Banking Resolution Act (*Ley 9/2012, de 14 de noviembre, de reestructuración y resolución de entidades de crédito*).

III. 4 The board of directors of credit institutions shall establish a system of governance with the aim of providing a sound and prudent management of the entity, including appropriate segregation of duties in the organization and the prevention of conflicts of interest. The board of directors will monitor the implementation of this system and will be responsible for it. For this purpose, they will have to monitor and evaluate on a regular basis the effectiveness of this system, and take appropriate steps in order to solve potential deficiencies (art. 29.2 BA).

Although the board of directors has a wide autonomy in the way they run the entity, they will not be allowed to delegate the following functions: (i) the surveillance, monitoring and periodic evaluation of the effectiveness of the corporate governance system and the adoption of appropriate measures to remedy their deficiencies (if any) ; (ii) to take responsibility for the administration and management of the entity, as well as the approval and monitoring the implementation of the strategic objectives, risk strategy and internal government of the entity; (iii) to ensure the integrity of the accounting and financial information system, including financial and operational control and compliance with applicable law; (iv) to oversee the process of disclosure and communications relating to the credit institution itself; (v) to ensure effective oversight of executive managers (art. 29.3 BA)

An important measure implemented by this new Banking Law is that the chairman of the board of directors cannot be at the same time the CEO of the entity, unless the entity justifies this decision, and the Bank of Spain authorizes this appointment (art. 29.4 BA).

III. 5 Another important provision required by this mandatory law is that all credit institutions will create an appointments committee formed by the members of the board of directors who do not perform executive functions. At least one-third of these members and, in any case, the chairman, must be independent directors (art. 31.1 BA). Some entities may be allowed by the Bank of Spain to create the appointments committee together with a remuneration committee, according to the size of the entity, its internal organization, and the

complexity of its business –this possibility is only available to small and non-complex credit institutions.

In any case, saving banks will establish both an appointments and a remuneration committee in accordance with their own legislation. However, these committees will exercise all powers and functions established in the Banking Act (art. 31.2 BA).

Likewise, the appointments committee shall follow a non-gender discrimination policy. For this purpose, it is required to establish several mechanisms to favour the gender with less representation in the board (art. 31.3 BA).

IV. 1 When credit institutions define and apply global remuneration policies, including salaries and pension benefits, and these remuneration policies affect people whose work may affect the risk management of the entity, it seems necessary to take some cautions. The new Banking Act provides several principles in order to minimize the perverse incentives faced by these people who manage the risk policy of the entity.

These principles will be taken into account according to the size, internal organization, nature and complexity of the activity of the credit institution (art. 32 BA). Moreover, these principles will be applied to (i) executive managers, (ii) employees who hold a position where they can assume risks, (iii) those employees who exercise control, and (iv) every worker who receives a global remuneration, provided that this remuneration is included in the same standard of remuneration established for executive manager, employees who are in a

position take risks and employees who assume any kind of control over the company.

Credit institutions are required to present at the Bank of Spain all the information that the supervisor may need in order to check the level of compliance of this obligation. In particular, they will present a list of people whose position may significantly affect the risk profile of the entity (art. 31.1 BA). This list should be presented every year, as well as when there are any significant changes. The Bank of Spain will detail the way the entities are required to present this list (art. 32.2 BA).

Regardless of the obligations established in the article 450 of the EU Regulation 575/2013, credit institutions are also required to disclose the total remuneration yearly received by every member of the board of directors (art. 32.3 BA).

IV. 2 The remuneration policy of Spanish credit institutions will be established according to the following principles. First, the remuneration policy shall incentivize a proper and effective risk policy. Therefore, it will not offer incentives for assuming a higher level of risk than it is desirable for the company. Second, the remuneration policy shall be compatible with the company's strategy, as well as its goals, values and long-term interest, and it shall include several measures to avoid conflict of interests. Third, those employees who perform functions related to the control of the company are required to be independent from the units that they supervise. Likewise, these employees will be paid according to the goals related to their functions,

regardless of the result of the business area that they supervise. Four, the remuneration of executive managers who are in charge of the risk management of the entity shall be directly supervised by the remuneration committee. Five, the remuneration policy shall clearly distinguish between criteria for the establishment of: (i) *fixed remuneration*, which shall reflect the experience of the employee in the company as well as the responsibility in the company according to what is agreed in his/her contract; (ii) and *variable remuneration*, which shall reflect a sustainable performance and adapted to the risk, as well as the higher performance required and agree in his/her contract (art. 33.1 BA).

On the other hand, the board of directors shall adopt and review on a regular basis the general principles of the remuneration policy, and will be responsible for the supervision of its application. In addition, the remuneration policy will be subject, at least once a year, to an internal and independent assessment, with the aim of checking whether the remuneration procedure adopted by the board of directors is being followed (art. 33.2 BA).

Finally, the remuneration policy of the members of the board of directors will be subject to the approval by the shareholders' meeting, in the same terms as it is provided for Spanish listed companies (art. 33.3 BA).

IV. 3 The variable component of the remuneration is subject to several requirements established in article 34 of the Spanish Banking Law. First, when the remuneration is linked to the company's outcome, it will be based on an assessment which combines the outcome of the person (assessed according to financial and non-financial criteria), the outcome of the unit business, and the

global outcome of the credit institution. Second, the assessment of the outcome will be measured on a multiyear basis, in order to guarantee a valuation process based on long-term outcomes. Moreover, the effective payment of the components of the remuneration based on the outcome will be spread out along the period that takes into account the underlying economic cycle of the credit institution and its risks.

Third, the total amount of the variable remuneration should not limit the capacity of the entity to strengthen its capital. Four, the guarantee-variable remuneration is compatible with neither a healthy risk management nor the principle of compensating the performance. Five, the guarantee-variable remuneration will be an exception. This remuneration will be possible only when the entity hires new people, it has a healthy and strong level of capital, and in any event this guarantee-variable remuneration will be limited to the first year of the person.

Six, both fixed and variable components of the remuneration will properly be balanced in the total remuneration. The fixed component shall constitute a highly enough part of the total remuneration, so it will be applied a fully flexible policy regarding the variable component.

Seven, the entity is required to establish appropriate ratios between both fixed and variable remuneration. In this sense, the variable component cannot be greater than 100% of the fixed component of the total remuneration for each person. Nevertheless, the shareholders' meeting will be able to approve a higher level of variable component, provided that it is not greater than 200% of the fixed component. The approval of the highest level of variable remuneration

will be made according to the following procedure: (i) the shareholders' meeting will make a decision based on the detailed recommendation given by the board of directors, which will provide information about the number of people affected and their positions, as well as the foresee effect over the maintenance of capital of the entity; (ii) the shareholders' meeting will adopt the decision for a majority of, at least, two-thirds of the share capital with voting rights. If not possible to reach the aforementioned quorum, the agreement will be adopted by a majority of, at least, three-fourths of the share capital with voting rights; (iii) the board of directors will inform the shareholders about the matters to be approved within a reasonable time; (iv) the board of directors shall immediately inform the Bank of Spain about the recommendation heads to the shareholders' meeting, including the highest level of variable remuneration which has been proposed, and it will prove that this level of remuneration does not effect to the solvency of the entity; (v) the board of directors shall immediately inform the Bank of Spain about the decision made by the shareholders' meeting, including the highest percentage of variable remuneration approve by the shareholders. The Bank of Spain will use the information that the receive to compare different practices among entities, and also to provide the European Banking Authority with that information; (vi) If so, those employees directly affected for the application of the highest level of variable remuneration will not be allowed to exercise, directly or indirectly, their voting rights, in case of those decisions referred to the application of the maximum level of variable remuneration.

Likewise, the Bank of Spain may authorize the entities to apply a theoretic discount rate (according to the guide published by the European Banking Authority), equivalent to 25% of the global variable remuneration, provided that it is paid in 5 or more years. Nevertheless, the Bank of Spain may establish a higher percentage.

Eight, payments generated by the advance resolution of a contract will be based on the outcome got in the course of the time and will not compensate bad outcome or improper behaviours. The Bank of Spain may define the cases that may imply a reduction in the amount of the aforementioned payments for advance resolution.

Nine, the remuneration package will be adapted to the long-term interest of the entity, so it will include provisions related to delays, performance and recoveries. Ten, when the outcomes are assessed in order to calculate the variable component of the remuneration, this outcome will be adjusted to both current and future risks, and it will take into account the cost of capital and liquidity of the entity.

Eleven, the assignment of the variable components shall take into account both current and future risks. Twelve, at least 50% of the variable component will be fixed reaching a fair equilibrium between: (i) shares or financial instruments linked to shares or non-financial instruments, in the case of non-listed credit institutions, and (ii) when it were possible, other instruments that may determine the Bank of Spain, or others that may be swap into equity.

Thirteen, at least 40% of the variable component of the remuneration will be divided in a period between 3-5 years, and it will be properly adapted to the nature of the business, risks and the activities of a particular member.

Fourteen, the variable remuneration will be paid only if the credit institution has a healthy and sustainable financial situation, and it is justified over the basis of the outcome of the company, the unit business and the person who is going to receive the payment. The total variable remuneration can be reduced if the entity has negative or not significant benefits.

Fifteen, the pension policy will be compatible with the company's strategy, its goals, values, and long-term interests. Sixteen, the company will not be allowed to establish remuneration policies that might harm a healthy assumption of risks. Seventeen, the variable remuneration will not be paid through instruments that may break the applicable law.

IV. 4 The Spanish Banking Act also imposes new provisions if credit institutions receive financial aid from public authorities. Namely, when a credit institution receives public money, the variable remuneration will be strictly limited to a percentage of net incomes, unless it is compatible with the maintenance of its capital requirements. Second, credit institutions will also be required to restructure their remunerations in the way they may suit with a proper risk management and long-term growth of the entity. Likewise, it is also possible to establish limits to the remuneration of the board of directors and the management team. Finally, the new regulation imposes that the members

of the board of directors will not receive any variable remuneration, unless it is properly justified (art. 35 BA).

IV. 5 All credit institutions are required to create a remuneration committee. This committee will be formed by non-executive directors. Moreover, at least one-third of these members, and in any case the chairman, must be independent directors (art. 36.1 BA). Nevertheless, the Bank of Spain may determine that some entities, according to their size, internal organization, nature and complexity of their activities, may jointly constitute both the appointments committee and the remuneration committee (art. 36.2 BA).

V. The EU lawmaker has recently enacted the Regulation (EU) No 575/2013 and the Directive 2013/36/EU with the aim of facilitating the creation of the Banking Union. The main goal of this Directive is to coordinate national provisions concerning access to the activity of credit institutions and investment firms, the modalities for their governance, and their supervisory framework. In this context, and with the aim of adapting these new rules to local law, Spain has enacted the Royal-Decree 14/2013, focused on prudential requirements for credit institutions and investment firms, as well as a new Banking Law (*Ley 10/2014*), which provides –among other aspects– new rules regarding corporate governance and remuneration policies. This note has described how these new rules have been implemented in Spanish Banking Law, as a first step to analyse in a future research the level of efficiency of these new rules by comparison with the measures implemented by other European countries.

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# CORPORATE GOVERNANCE OF BRITISH BANKS AND DUTIES OF DIRECTORS: PRACTICAL IMPLICATIONS OF THE ROYAL BANK OF SCOTLAND'S DEMISE

Pierre de Gioia Carabellese\*

**ABSTRACT:** *Corporate governance and directors' duties can be viewed as two sides of the same coin: the latter allow the shareholders to appreciate and evaluate the paradigm of conduct of the "governors" of the corporation and, ultimately, to judicially request an assessment of the potential liabilities. In the interplay between governance and duties in Britain, there appears to have been a "glitch" in the mechanics of the duties (particularly the duty to promote the success of the company and the duty to exercise care). This malfunctioning, in this work dissected with regard to corporate law theory and in consideration of both the common law evolution and statutory development across the Channel, is further laid bare by way of the discussion of an empirical case, the collapse of Royal Bank of Scotland. The lessons learned from that case study, as well as a more speculative cogitation on the legal theory surrounding the directors, would appear to mark the need for a more persuasive corporate governance of the credit institutions and listed companies not simply in the U.K. but in the EU*

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\* Pierre de Gioia Carabellese is Associate Professor in Business Law at Heriot-Watt University, Edinburgh Solicitor and Notary Public in Edinburgh, Lawyer in Rome

*members states also, as suggested not without courage in this contribution.*

**SUMMARY:** 1. Introduction - 2. The directors' duties; common law and statutory development - 2.1 The duty to promote the success of the company – 2.2 The duty to exercise reasonable care, skill and diligence - 3. A practical implication of the duties: royal bank of Scotland collapse - 4. Different reading of sect. 172 and 174 of the companies act 2006 - 5. Possible evolution of the theory of corporate governance, for banks and listed companies, in Britain and EU – 6. Conclusion

1. A convincing definition of “*corporate governance*” has proved unworkable<sup>1</sup> given the regularity with which its guises change and transform relative to the angle of observation - the various jurisdictions - from within which the jurist may observe the phenomenon<sup>2</sup>. This area of law, typically populated by soft legislation<sup>3</sup> rather than mere statute and

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<sup>1</sup> See MINTZ, *Corporate Governance in an International Context: Legal Systems, Financial Patterns and Cultural Variables*, in *Corporate Governance: an International Review*, 2005, p. 582.

<sup>2</sup> Despite this, it can be convincingly affirmed (See DE GROOT, *Corporate Governance as a Limited Legal Concept*, Kluwer Law International, 2009, 5) that “*corporate governance is largely part of that branch of the law that is called company law*”, company law, in turn, being “*part of a much larger realm of the law that can be called economic law*”.

<sup>3</sup> Notably, in countries such as Britain, there is a recurrence of, probably not totally useful, “Reports”. See DE GIOIA CARABELLESE, *Non-executive Directors and Auditors in the Context of the UK Corporate Governance: Two (or Too Many) “Pirandellian” Characters still in the search of an Author?*, in *European Business Law Review*, 2011, p. 759.

It is worth mentioning that, in addition the legislation, the UK corporate governance of listed companies is permeated by a “code”, of no mandatory nature, called the UK Corporate Governance Code. See FRENCH - MAYSON - RYAN, *Mayson, French & Ryan on Company Law*, in 30th edn, Oxford University Press, 2012, pp. 428 - 429.

conceptually located along the demarcation line where the disciplines of law and economics meet, on the one hand generates a great deal of passionate enthusiasm amongst law experts in booming markets and increasing profits while, on the other, it would appear to evoke predicaments within the “pathological” development of the events (*i.e.* market failures and even scandals) which occur. In such scenarios, the loss of profits on the part of shareholders and its potential causal link to the conduct of the directors should become a fertile ground of assessment reserved for judges, the latter being called upon to decide whether the resolution of the directors may be regarded as giving rise to a contractual liability vis-à-vis the “principal”.

Against this backdrop lies the analysis of this work, the purpose of which is to discuss how the theory of corporate governance in Britain (relating to the main duties of the directors in general, and to the duty to promote the success of the company and the duty of care, skill and diligence in particular) interacts with business pursuits in practice. As to the corresponding empirical analysis, the case study to be subjected to close scrutiny shall be the purchase, by the Royal Bank of Scotland, of ABN AMRO. It was an acquisition that, eventually, precipitated the decline of the “Scottish giant” and gave rise to the need for its consequent bailout by the British Government, thereby averting its otherwise inevitable liquidation.

2. Across the Atlantic, it is stressed, without an apparent mistake, that the boards of directors constitute the “*epicentre of the U.S. corporate governance*”,<sup>4</sup> simply because the management body,<sup>5</sup> as opposed to the shareholders, assumes charge of the corporation; directors are, not simply metaphorically but also factually, the “governors” of the legal entity.

From a non-legal perspective,<sup>6</sup> directors are:

“...individuals chosen by a company’s shareholders to manage its affairs and to make the important decisions concerning the direction the company to take...”

The area of directors’ liabilities is not always perfectly defined in law. This would appear to engender, to a certain extent, a philosophical oxymoron: on the one hand, the directors are endowed with a power

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<sup>4</sup> See MACEY, *Corporate Governance. Promises Kept, Promises Broken*, Princeton University Press, 2008, p. 51.

<sup>5</sup> The “*management body*” can be defined in a different jargon according to the different languages and the multifarious jurisdictions; nonetheless, the gist of the role and its practical consequences will not change. Because this contribution is cogitated and drafted from the Eastern shores of the “Atlantic”, the EU jurisdictions, and the same EU legal framework, will be the familiar terrain of this discussion. Remarkably, at EU level, the pan-European model of company (*Societas Europaea* - introduced by “*Council Regulation (Ec) No 2157/2001 of 8 October 2001 on the Statute for a European company [..]*”) caters for a dual system of corporate governance: (a) the two-tier one, where the *Societas Europaea* is managed by a management board, appointed (or removed) by a (larger) supervisory board on its turn appointed by the shareholders’ meeting; (b) the one-tier system, where the governance of the company is bestowed by the members upon a single administrative body. See MAITLAND-WALKER, *Guide to European Company Laws*, Thomson/Sweet & Maxwell 2008, pp. 8 - 9; VAN GERVEN - STORM (eds.), *The European Company*, Cambridge University Press, 2008. For the most recent comparative analysis in the corporate law, see SIEMS - CABRELLI, *Comparative Company Law. A Case-Based Approach*, Oxford University Press, 2013.

<sup>6</sup> Among the others, WORTHINGTON - BRITTON, *The Business Environment*, 5th edn, Pearson, 2006.

which is, to all intents and purposes, absolute from a managerial point of view, thus rendering them the “*natural focus of inquiry when companies fail or underperform*”; on the other hand, the general standard according to which the potential liabilities are assessed, is traditionally<sup>7</sup> a subjective one and hinges on the concept - lenient as it may be - of “good faith”.<sup>8</sup> *Ergo*, directors, so long as they have acted in a *bona fide* manner, shall not be held accountable.<sup>9</sup>

These doctrinal conclusions, above summarised in accordance with their main axioms, are regarded in this work from a British perspective, particularly in regard to the corporate governance of banks listed in a regulated market, and consideration of a standard of conduct to be expected of directors.

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<sup>7</sup> As ascertained in this work, this approach seems to permeate particularly Britain and the Anglo-American “world”.

<sup>8</sup> For an exhaustive discussion of the *bona fides* in the British corporate governance before the enactment of the CA 2006, see FARRAR - HANNIGAN, *Farrar’s Company Law*, 4th edn, Butterworths, 1998 pp. 377 - 391; HANNIGAN, *Company Law*, Lexis Nexis, 2003, pp. 225 - 244.

<sup>9</sup> At scholarly level, this axiom seems to be taken from granted also by the most authoritative sources. See MACEY, *Corporate Governance. Promises Kept, Promises Broken*, 4, p. 52.

Likewise, in some same common law *decisa* (particularly, the American *The Walt Disney Company Derivative Litigation*, 825 A.2d 275, Del.Ch., 2003) is was held, not without a degree of Machiavellian ruthlessness, that to “*redress for failures that arise from faithful management must come from the markets, through the action of shareholders, and the free flow of capital*”. In this scenario, as echoed by Scholars (MACEY, *Corporate Governance. Promises Kept, Promises Broken*, 4, p. 52), Courts should remain outside the markets!

From amongst the list of general duties conveyed by the British company framework,<sup>10</sup> two spring to the immediate attention of an observant party: the duty to promote the success of the company and the duty to exercise skill, competence and diligence.

2.1 The duty to promote the success of the company, introduced into statute by the ultimate edition of the British Corporate legislation,<sup>11</sup> which managed to successfully codify the previous case law, is encompassed within sect. 172 which literally dictates that a director shall act *“in the way he considers, in good faith, would be likely to promote the success of the company for the benefit of its members as a whole”*.

It is a trite statement, amongst Scholars,<sup>12</sup> that the duty under discussion is a fiduciary one, given the fact that the law would appropriately impose it on any kind of relationship - therefore, not simply one existing between a company and its director - where, in accordance with the expected conduct of trust and confidence, a party undertakes to act on the behalf of another.

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<sup>10</sup> A possible additional terrain of analysis, particularly in light of the case study perused in this paper, could have been sect. 173 of the Companies Act 2006 (henceforth also the “CA 2006”). Nevertheless, this specific duty (duty to exercise independent judgement) is deliberately beyond the bounds of this discussion although a doctrinal debate on it can be read in DIGMAN - LOWRY, *Company Law*, 7th edn, Oxford University Press, 2012, pp. 357 - 358; GIRVIN - FRISBY - HUDSON, *Charlesworth’s Company Law*, 18th edn, Sweet & Maxwell, 2010, pp. 334 - 335.

<sup>11</sup> Again, the CA 2006.

<sup>12</sup> See DAVIES, *Introduction to Company Law Clarendon Law Series*, 2nd edn, Oxford University Press 2010, p. 155.

Usually coupled with the duty in question is a second theme, namely the expected conduct of the directors and, more specifically, whether this duty must be discharged by the latter in keeping with the interests of either the broad spectrum of various stakeholders in the company or, alternatively, the limited cluster of its shareholders.<sup>13</sup>

In Britain, based on the vision advocated by the final draft of the CA 2006, the latter solution is adopted, although the terminology eventually embraced (“*success*”) assumes a distinctly more general tone than the specific and transparent “*value given to the shareholders*”.<sup>14</sup>

Additionally, the interests of the members shall be “enlightened”<sup>15</sup>, as in Britain there is an emphasis placed on the fact that the directors, in tying the success of the company to the interests of the shareholders,

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<sup>13</sup> See FRIEDMAN, *The Social Responsibility of Business is to increase its Profits*, in *The New York Times Magazine*, 13 September 1970; ID., *Capitalism and Freedom*, University of Chicago Press, 1962. The sole reason a director exists would be to use the resources available and engage in profit maximising activities, therefore increasing the shareholder value.

<sup>14</sup> It is emphasised doctrinally that “*the more general word is clearly the appropriate one, because not all companies formed under the [Companies] Act [2006] are aimed at maximising the financial interests of their members.*” See DAVIES, *Gower and Davies Principles of Modern Company Law*, 8th edn, Thomson/Sweet & Maxwell, 2008, p. 511. This could be the case of charities, the management of which is certainly driven by the success of the relevant organisation, although the profit of the activity is not meant to benefit any member.

In the more recent edition of the same Authors (DAVIES - WORTHINGTON, *Gower & Davies. Principles of Modern Company Law*, 9th edn, Sweet & Maxwell, 2012, p. 54) it is emphasised that the “*new statutory formulation clearly rejects the “pluralist” approach, at least to the extent that it might have given all stakeholders some sort of equivalent status, allowing all to have the right to enforce directors’ duties.*”

<sup>15</sup> The “*Enlightened Shareholders Values*” or, simply, “*ESV*”, to use the relevant, quite common acronym. The topic of the ESV is extraneous to the analysis of this paper and treated in a mere tangential way.

must also pay heed to the further interests of additional stakeholders such as employees, suppliers and customers, likewise to the impact of the company's activities on the community and environment.<sup>16</sup>

Just how this directors' duty is interpreted in the practical *decisa* of the courts is a question that appears more shrouded in caliginous and insidious implications than the plain words utilised by the legislator would leave room to believe.

Historically, the judicial interpretation of this duty owed by the directors of the company to the shareholders has been "tethered" to a subjective criterion, instead of an objective one: simply put, so long as the director believes in good faith that, with his resolution and that of his co-directors, he is contributing to the success of the company, that is sufficient to safeguard him from any accountability for mismanagement and, more importantly, from any medium and long term consequences of his conduct. Such a pre-ordained outcome is inferable from an entrenched court decision, *Re Smith and Fawcett Ltd*<sup>17</sup>, where it was held that the best interests of the company are what the director, not the court, deems as such. Following this line of reasoning, the actual likelihood that the

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<sup>16</sup> More specifically and controversially: (a) the likely consequences of any decision in the long term; (b) the interests of the company's employees; (c) the need to foster the company's business relationships with suppliers, customers and others; (d) the impact of the company's operations on the community and the environment; e) the desirability of the company maintaining a reputation for high standards of business conduct; the need to act fairly as between members of the company. See, among SCHOLARS - DAVIES, *Introduction to Company Law*, 11, pp. 155 - 156 and, with harsh but justified criticism, KEAY, *The Corporate Objective*, Edward Elgar 2011, pp. 226 - 228.

<sup>17</sup> [1942] Ch 304 CA.

director will be found liable in Britain can be simplified to a rather narrow corridor of possibilities wherein “*careless or naïve*” conduct has exclusivity. Therefore, solely and probably paradoxically, a scenario where the director has acted *mala fide* to pursue the failure of the company, but not its success, will give rise to such an outcome.<sup>18</sup>

Over the last decade, the statutory provisions of the CA 2006, particularly sect. 172, rather than “biting the bullet” and establishing a logical test,<sup>19</sup> has chosen to adhere, unceremoniously, to case law tradition as well as to the Anglo-American theory. In this latter respect, it is inferred that, because directors are merely asked to act in a “*bona fide*”

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<sup>18</sup> Remarkably, in the same statement of Margaret Hodge MP, Government Minister responsible for the Companies Act 2006, it is affirmed: “*We believe it is essential for the weight given to any factor to be a matter for the director’s good faith judgement. Importantly, the decision is not subject to the reasonableness test.*” (HC Standing Committee D, Fifteenth Sitting, 11 July 2006, Cols 591,593).

Paradoxically, though, in Britain, not unlike its EU counterparts, there used to be in force (and it still exists, as a result of the Financial Services and Markets Act 2000), a regime of “approved persons”. In light of this micro-legislative framework, some categories of qualified employees, including directors, of financial institutions and investment firms are required to have, among the other qualifications, “*competence and capability*” and “*financial soundness*”, so that they can be “*approved*” (or “disqualified” later) by the competent authority (more recently, the Financial Conduct Authority and/or the Prudential Regulation Authority). See Financial Conduct Authority, *FCA Approved Persons* at [www.fca.org.uk](http://www.fca.org.uk), accessed 1 August 2014.

<sup>19</sup> This canon is meant to be based on what a sound and capable manager would have done in similar conditions. This test can be qualified as an “objective criterion” or, as explained later in this paper (see Chapter 4 of this paper), a “qualified subjective” one.

As mentioned in the further footnote 39, in a brief comparative analysis with non-British corporate legislations, in Germany the parameter expected of a director is the care exercised by a diligent and prudent manager. In meditating on this terminology, a re-elaboration in Britain of the principle of good faith in a more speculative way, where the good faith is not that of the lay man, but that of a manager (therefore an utmost good faith), would not lead to an interpretation different from that adopted in an advanced legal system such as the German one.

manner in relation to the interests of a company, the subjective test, and the case law legacy entailed to it, should be applied accordingly. The most recent *ratio decidendi* in *Cobden Investments Ltd v RWM Langport Ltd and Ors*<sup>20</sup> perpetuates and reinforces that extrapolated from *Howard Smith Ltd v Ampol Petroleum Ltd*<sup>21</sup> with its underground “theme” according to which the court “will not depict decisions which directors arrived at honestly”. Essentially, a subjective test is credited therewith, whereas the objective one appears to be inexorably discredited.

Ultimately, despite the codification in Britain of the common law duty to promote the success of the company, the doctrinal assertion that sect. 172 has created expectations that, practically, cannot be delivered prevails.<sup>22</sup> The insertion, within the provision, of the “*bona fide*” principle, devoid of any additional qualification<sup>23</sup> and thus in some court decisions used interchangeably with “*honestly*”,<sup>24</sup> continues to represent an obstacle

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<sup>20</sup> See EWHC 1362 (CA), 2009. For more recent *decisa*, see *Vivendi v Richards*, 2013, EWHC 3006, although in the latter events predate the promulgation of the CA 2006.

<sup>21</sup> [1974] A.C. 821. More recently, *GHLM Trading Ltd v Maroo* [2012] EWHC 61 (Ch).

<sup>22</sup> See ASHTON, *How Fred the Shred Got Away with It: Loud Calls for Company Law Reform*, in *Birckbeck Law Review*, 1, 2013, p 187. A slightly different view is advocated in this work, namely the good faith under sect. 172, despite the need for reforms, could be already construed in a more progressive and less literal way, so as to allow the categorisation of *bona fides* as a “qualified subjective” one. See more in depth later Chapter 4.

<sup>23</sup> As mentioned in the following footnote 39, the British statute in a more convincing way could refer, *mutatis mutandis*, to the “utmost good faith” or *uberrima bona fides*, a concept existing in the Marine Insurance Act 1906, as regards the duty of disclosure owned by the insured to the insurer. Among the several contributions on this notion, see BENNETT, *The Law of Marine Insurance*, 2nd edn, Oxford University Press, 2006, pp. 99 - 181.

<sup>24</sup> See *Smith & Fawcett Ltd* (n 16) at 306; *Regentcrest Plc (in liquidation) v Cohen* [2001] 2 B.C.L.C. 80.

towards a straightforward recognition of a breach of the duty to promote the success of the company.<sup>25</sup> This contention also holds true in cases where clear losses have befallen the corporate entity, such as in the case study under discussion.

2.2 In regards to the kindred duty (*“the duty to exercise reasonable care, skill and diligence”*), which is not fiduciary, little guidance is offered to the jurist tasked with solving the conundrum under discussion. As highlighted doctrinally,<sup>26</sup> the duty under sect. 174 of the *CA 2006*, is underdeveloped due to a relative paucity of case law in the area. The reason for this would appear to stem not simply from the inherent difficulty in establishing close ties between poor commercial judgements and incompetence, but rather also from the fact that this duty, like its counterpart under sect. 172 of the *CA 2006*, was traditionally conceptualised in subjective terms.<sup>27</sup>

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<sup>25</sup> Given the business environment where companies operate, the business judgement rules should remain unprejudiced and unaffected, that is to say the exclusion of liability for decision entailed to which there is a risk, when this risk is acceptable because in tune with a duty of care. In this respect, this implicit parameter is widely accepted both in the U.S. and in the EU countries. See GRUNDMANN, *European Company Law. Ius Communitatis I*, 2nd edn, Intersentia, 2012, p. 267.

<sup>26</sup> See HANNIGAN, *Board Failures in the Financial Crisis: Tinkering with Codes and the Need for Wider Corporate Governance Reforms*, in *Company Lawyer* (32)12, 2011, p. 363 (Part 1); ID., *Board Failures in the Financial Crisis: Tinkering with Codes and the Need for Wider Corporate Governance Reforms*, in *Company Lawyer*, 2012, 33(1) 35 (Part 2).

<sup>27</sup> Famously, in *City Equitable Fire Insurance Co Ltd* [1925] Ch.407, it was held that “a director need not exhibit in the performance of his duties a greater degree of skill than may reasonably be expected from a person of his knowledge and experience”.

However, more recently, this old-fashioned reading of the care and competence expected of a director (merely subjective), from which the relevant case law had already started distancing itself by the 1990s,<sup>28</sup> has altered after the enactment of the CA 2006 and particularly sect. 174 which seems to link the duty at stake to an objective/subjective test, as elucidated by the most prominent Scholars,<sup>29</sup> although an “absolute” convergence of the doctrinal stances continues to be lacking.<sup>30</sup>

3. Royal Bank of Scotland Group plc could be characterised as a relatively small banking group until the 1970s', whereupon it grew considerably over the ensuing decade, due in most part to fortunate business diversifications: (a) the acquisition and implementation of the first telephone insurance company (Direct Line); (b) the first UK internet

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<sup>28</sup> See *Norman v Theodore Goddard* [1991] B.C.L.C. 1028. For more updated courts decisions, see *Weaving Capital (UK) Ltd v Dabha* [2013] EWCA Civ.71.

<sup>29</sup> See SEALY - WORTHINGTON, *Sealy's Cases and Materials in Company Law*, 9th ed, Oxford University Press, 2010, p. 331. It is emphasised that the approach adopted is based on a minimum standard that is objectively expected of a person in the directors' position; “*that standard may then be raised by the subjective element of the test if the particular director has any special knowledge, skill and experience.*” (underlining not per original text).

<sup>30</sup> Some Scholars (DAVIES - WORTHINGTON, *Gower and Davies Principles of Modern Company Law*, 13, p. 518, particularly footnote 52) still believe that the subjective test would reduce - and not increase - the “objective” level of care, skill and diligence expected of a director.

“*This test also contains an objective element, because the director could be held liable for failing to live up to the standard which a person of his or her skills is reasonably capable of reaching, but the strong restriction in the proposition is the subjective one, since the director can never be required to achieve a standard higher than that which he or she is personally capable of reaching.*”

Although in this work the first interpretation is propounded, admittedly a more transparent wording in this area would be desirable.

banking services. However, in a case of *"biting off more than it could chew"*, what would have satisfied the palate of good administrators became inadequate for the voracious mouths of the directors of RBS. By the late 1990s', the tipping point had grown ever closer, with more ambitious projects undertaken and geared towards the creation of a bona fide "giant" in the financial industry. Although, at the outset, the project successfully completed a series of transactions, a serious blow to the stability of the group was delivered by the acquisition, in 2007, of the Dutch bank ABN AMRO. The target bank was a questionable purchase anyway, but especially so given the timing of the move. The greatest concern stemmed from problems with sub-prime mortgages, mainly overlooked at the appraisal stage; these losses, which would have loomed large on the radar of a purchaser carrying out any due diligence, required RBS, after the acquisition, to write-off debts on behalf of the new subsidiary totalling £1.5 billion. Furthermore, from a macro-economic point of view, the transaction occurred against an unfavourable economic landscape; the Scottish financiers had chosen not to heed a universal maxim among farmers (certainly revered in Scotland) reminding that one should ensure, when enjoying the fruits of a good harvest, to save some grain for the winter to come. Beyond the metaphor, the acquisition was completed by RBS when the financial markets were riding high on the crest of a wave and, thus, at a time when the only reasonable expectation thereafter should have been exclusively a decrease in the value of the stock market.

The RBS case-study has been briefly revisited in this chapter in order to establish, from a purely legal angle of observation, how the failure of a credit institution<sup>31</sup> and, ostensibly, a case of mismanagement on the part of their managers reverberates in terms of (a) both interaction with the applicable corporate law rules addressed to the directors and (b) the *decisa* existing in Britain in this area of economic law.

4. From a non-legal point of view, the ill-fated management of RBS seems to be confirmed by the facts,<sup>32</sup> the absolute and irrefutable insolvency of the bank, testified by the same chairman of the BoD,<sup>33</sup> and the disastrous chain of these events with the despicable purchase of ABN AMRO, occurred just before.

On these factual circumstances, from a legal standpoint, two considerations are possible.

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<sup>31</sup> So far, it can be said that the RBS collapse is the worst failure of any listed company in the history of the British capital markets. For a reconstruction of the events of the “RBS saga”, see FORREST, *Recklessness and Risk Taking: A Disregard for Directors Duties Set out in the Companies Act 2006 is to Blame for the Demise of the Royal Bank of Scotland*, Business Management with Business Law Dissertation, Heriot-Watt University, School of Management and Languages, Edinburgh, Academic Year 2013/2014.

<sup>32</sup> Therefore, this seems to be not simply a lack of success in the maximization of the shareholders, but a dissolution and cancellation of the assets of the same legal entity. The “lack of success of the company”, in the specific case, is “corroborated” also by the collapse in the value of the shares of the bank, down to a low 9 pence per share (from more than 600 pence in 2007, before the purchase of ABN AMRO), despite the bail-out ordered by the British Treasury, the latter being tantamount to £ 37 billion of tax payers’ money. See ASHTON (n 21) 198.

<sup>33</sup> DARLING, *Back from the Brink*, Atlantic Books, 2011.

Firstly, sect. 172 of the CA 2006, in its current articulation, draws a decidedly tenuous, albeit not inconceivable, connection between the deleterious management of a company<sup>34</sup> and any liability on the part of its inept directors. More recently, some authoritative voices have risen in unison<sup>35</sup> to hold the principle of good faith culpable, doctrinally, as an impediment to the healthy functioning of the apportioning of liability under sect. 172. Nonetheless, this work seeks to demonstrate that the *bona fide* principle itself would be rendered immaterial within the context of sect. 172 if it was construed, not without a speculative interpretation, as a qualified good faith, tied to the actions of a competent manager, rather than to those of the lay man. Admittedly, this implication would be even more straightforward if the tenor of sect. 172 explicitly identified the *bona fide* principle at stake to be an *uberrima bona fide* principle, but not an "ordinary one".<sup>36</sup>

Additionally, in turning to the duty to exercise care, skill and competence, sect. 172 of the CA 2006 would appear to entertain safe

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<sup>34</sup> Such as the reckless acquisition of ABN AMRO by RBS, in the case study mentioned in this paper.

<sup>35</sup> See FISHER, *The Enlightened Shareholder – Leaving Stakeholders in the Dark: Will Section 172(1) of the Companies Act 2006 Make Directors Consider the Impact of their Decisions on Third Parties?*, in *International Company and Commercial Law Review*, 2009, pp. 10 - 12; KEAY, *The Duty to Promote the Success of the Company: Is It Fit for Purposes?*, University of Leeds – Centre for Commercial Law and Practice - School of Law Working Paper, August 2010, pp. 1 - 37 at papers.ssrn.com, accessed 20 July 2014; KEAY, *Directors' Duties*, 2nd ed, Jordan Publishing, 2014.

<sup>36</sup> Therefore, a re-wording of sect. 172 of the CA 2006 would be, as endorsed at scholarly level, therapeutic and helpful. See, in this respect, the following Chapter 5 below. Incidentally, radical amendments to s. 172(1), CA 2006, albeit not specifically concerned with the good faith, have already been suggested at more authoritative level. See KEAY, *The Corporate Objective*, n 15, pp. 226 - 228.

harbour which shareholders can avail of for protection should the need arise. The reckless acquisition of a bank by another credit institution at an over-inflated value and its subsequent causal link to the demise of that bank, as epitomised by the case study under discussion, may constitute a likely breach of this duty. This can be affirmed by more convincing means than any dissection of sect. 172 will accomplish, due to the fact that the new wording of sect. 174, which lacks any indication as to the parameter of "good faith", is now safely "fastened" to the dual subjective/objective test.<sup>37</sup>

5. The preceding analysis, particularly in light of the case study examined, has succeeded in identifying a lack of legal efficiency within the British legal system, and specifically within the discipline applicable to directors of entities both listed and engaged in reserved businesses (such as the banking one).

On the one hand, the common law legacy (in the way it has construed - historically - the duties of directors) and, on the other, the interpretation which Scholars apply to such duties (at times unreasonably strict), have together proved instrumental in preventing Britain from implementing an advanced framework of corporate responsibility.

The RBS case study, briefly analysed in this work, seems to suggest that there is considerable room for improvement in the legal apparatus,

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<sup>37</sup> At least in the way it is more progressively construed, recently, by British Scholars. See footnote 29 above.

which regulates corporate governance in Britain mainly, but probably elsewhere too – improvement necessary to reverse the trend of dwindling credibility attributed to such institutions by investors.

First and foremost, an initial step on the road to “redemption” could be taken by re-evaluating how the concept of good faith “fits” within the directors’ duties, particularly within the above mentioned duty to promote the success of the company. In this respect, it is possible to affirm that a prospective statutory evolution in the *sedes materiae* of sect. 172 could follow one of two possible avenues:

- (a) Either the deletion of the good faith principle in connection with the duty under sect. 172, CA 2006. Such a “move” would render the canon in question a purely “objective one”.
- (b) Or, as previously alluded to and in a less “revolutionary” fashion, to re-word the current sect. 172 so as to add the adjective “utmost” and so narrow the parameter of good faith required. This re-branding would stress what is already somewhat inferable, albeit not remotely explicit in the current tenor<sup>38</sup>.

In both cases, the proposed changes would find indirect support from a comparative analysis, as similar processes of assessment of the

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<sup>38</sup> By following this second option, the *ratio essendi* of the concept of good faith, authoritatively advocated at scholarly level too (MACEY, *Corporate Governance. Promises Kept, Promises Broken*, 4, p. 52), would not be affected in the British system of corporate governance.

conduct of directors have become “part of the furniture” in some Continental systems, particularly the German one.<sup>39</sup>

Secondly, irrespective of whether a change to the current legislation on directors’ duties is accepted, an additional shot at redeemed credibility for the beleaguered state of corporate governance in Britain would be to adopt a different approach; to elaborate, at EU level, the competent authorities would be entrusted with a power to promote, independently, legal proceedings against the directors for the violation of one or more

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<sup>39</sup> Without any pretence of completeness of analysis, it can be recalled that the German corporate governance seems to display the most straightforward and credible mechanism of assessment of the directors’ liability: “*The managing directors have to apply a standard of care exercised by a “diligent and prudent manager”*” (MAITLAND-WALKER, *Guide to European Company Laws*, 5, p. 369). In essence, it can be affirmed that in that jurisdiction, where the corporate law provisions do not indulge in the multifarious but ineffective conducts expected of directors in Britain, standard shall be regarded a qualified subjective one.

As regards Italy, a civil law country with a principle of good faith profoundly permeating the discipline of the contract, the standard of care the directors have got to comply seems to be, *de facto*, an “objective one”, without any good faith being recalled. More specifically, “*art 2392 of the Italian Civil Code prescribes that directors must fulfil the duties imposed on them by law and the articles with the diligence required by reason of their office and that of their specific competence, and they are jointly and severally liable to the company for damages resulting from their failure to observe this requirement [..]*.” See ANDENAS - WOOLDRIDGE, *European Comparative Company Law*, Cambridge University Press, Cambridge, 2009, p. 322.

Finally, in the Netherlands, a civil law jurisdiction too, the standard seems to be slightly more vague and blurred; to elaborate, at art. 9, Book 2, of its Civil Code: “*the directors may become personally liable vis a vis the company when they fail to observe specific obligations under the law [..]; if they make a mistake for which they are seriously to blame [..]*.” See WALING, *Guide to European Company Laws*, 5 in MAITLAND-WALKER (eds.), p. 673. In this respect, see also: DORRESTEIJN – MONTEIRO - TEICHMANN - WERLAUFF, *European Corporate Law*, 2nd edn, Wolters Kluwer, 2009, p. 192; ANDENAS - WOOLDRIDGE, *op. cit.*, pp. 370 - 371. A proper duty to promote the success of the company is conversely extraneous to the area of the directors’ duties in the Netherlands.

statutory duties.<sup>40</sup> Such an action, to be codified in an appropriate piece of EU legislation, would not be derivative in nature (in lieu of the shareholders of the company concerned), but rather would be a direct one, as the overriding aim of this manoeuvre would, in a marked departure, be the protection of the investors for listed companies and, in respect to banking and financial entities, the protection of depositors. The aforementioned competent authorities could take one of two possible forms. Predominantly, it will be the authority in charge of the supervision of the securities market, as far as listed companies are concerned. However, if the listed company was also engaged in a reserved activity (such as a banking one), the relevant supervisor should be entrusted with a similar power. If such a theory was put into practice, Britain, on the one hand, would require no radical amendment to the backbone of the common law theory of directors' duties, for the simple reason that, as just acknowledged, non-listed companies would not be affected by the prospective change. On the other hand, the parameter of responsibility which directors of listed companies, as well as of entities operating in reserved areas of business (such as the banking one), must conform to

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<sup>40</sup> It is commonly reminded (MACEY, *Corporate Governance. Promises Kept, Promises Broken*, 4, p. 130) that “*litigation in the form of class actions and shareholder derivative sanctions is conventionally believed to be the most important corporate governance mechanism available to U.S. investors.*” However, it is added (*ibid* 130) that this “*belief is both inconsistent with the corporation-as-promise approach taken in this book and wrong*”. Conversely, the postulation of this work is that, ultimately, mandatory rules in these areas are necessary (including “pan-European” duties of directors of EU-based listed companies and banks), as trust has turned out to be flawed in the recent experiences of financial collapse of banks, and litigation is the credible corollary of an effective corporate governance.

would become aligned to the most advanced legislations, be subject to a strong set of rules, be created under statute and be mandatory in nature.

Beyond this, an even more intriguing topic of discussion, although, in all likelihood, not yet ripe for immediate legislative implementation but certainly adequate for the purposes of a mere theoretical analysis, centres on the opportunity to initiate a move within the European Union towards promoting a communal regime of civil liability of directors of listed companies (and banks and investment firms). Such proposals, in the past put forward without success in some specific areas of the law of financial markets,<sup>41</sup> may soon become fertile ground on which to launch a more ambitious action plan in the matter of corporate entities.<sup>42</sup>

Finally, in Britain, such a reform would cater for an additional purpose, *ergo* to close the loop on the outstanding issues currently existing in the corporate litigation too. In essence, the current British legal system, in a very arguable way, would appear to excessively deter any prospect of shareholder litigation too: the CA 2006, at part 11, contemplates a number of multifarious requirements that must be met by a shareholder before a case on maladministration of a company can be

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<sup>41</sup> It is for instance the case of the German proposal, in the build-up to the Prospectus Directive, to introduce a harmonization in the civil liabilities of the EU jurisdictions in the area of information to the markets. See SCHAMMO, *EU Prospectus Directive*, Cambridge University Press 2011, p. 241.

<sup>42</sup> It has been more than ten years since an Action Plan to Modernise Company Law was promoted. See Communication from the Commission to the Council and the European Parliament, *Modernising Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward*, COM, p. 284, 21 May 2003. Among commentaries to this, see VOSSESTEIN, *Modernization of European Company Law and Corporate Governance*, Kluwer Law International, 2010.

heard on its merit, particularly the “prima facie” case that must be previously established at judicial level, according to sect. 261(2) of the CA 2006.<sup>43</sup> These aspects mark the British legislation out as the “black sheep” in this area, at least when view comparatively relative to other EU jurisdictions.

6. Although it has been said that corporate governance is concerned predominantly with promises, rather than contracts,<sup>44</sup> a credible *corpus iuris* of the directors’ liabilities is unworkable without a body of persuasive compulsory rules aimed at tackling the mismanagement of the directors. A system of corporate governance enthusiastically based on the intangible value of trust is ill-equipped to withstand a harsh economic climate, such as that wrought by the recent financial crises, and to determine a standard of competence and diligence which the relevant directors were expected to reasonably comply with.

The present work has illustrated that, in Britain, despite the most recent developments and a somewhat erratic passage from common law to statute, the body of law specific to directors’ liabilities, has fallen some

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<sup>43</sup> Among the several contributions to this area, see KEAY - LOUGHREY, *Something Old, Something New, Something Borrowed: an Analysis of the New Derivative Action under the Companies Act 2006*, in *Law Quarterly Review*, 2008 p. 469; DINE - KOUTSIAS, *Company Law*, 7th edn, Palgrave Macmillan 2009, p. 204.

<sup>44</sup> The reason for this is that the relationship between public shareholders and directors is expected to be based on trust, the latter being ultimately “*the belief that the managers who run corporations will keep the promises that they make to investors*” (MACEY, *Corporate Governance. Promises Kept, Promises Broken*, 4, p. 1).

way short of securing the standards of a corporate democracy. At the risk of forcing the issue, the main pursuit of corporate governance (the maximization not only of profits on behalf of the shareholders, but of the company itself) has assumed the questionable mythical status of a chimera in Britain: *de facto*, the enforcement of the relevant precepts is hindered, not particularly by the tenor of the law provisions (although the wording of sect. 172 is not immune to ambiguity), but rather by a very strict and narrow interpretation of its judiciary.

In the case study examined, it is obvious that the directors' execution of their responsibilities to a large British bank, listed in the share-market, has been found desperately lacking and has fallen some way short of the expected standard of conduct which company directors should adhere to. Furthermore, such a conclusive failure on the part of the RBS directors would have been regarded, in other advanced jurisdictions, as a blatant violation of a director's duty. Notwithstanding such a damning conclusion, from the dual perspective of sect. 172 and 174 respectively, of the CA 2006, no violation of duties was surfaced by any British court, nor indeed was any proceeding successfully pursued!<sup>45</sup> Although it is not reasonable to expect a director (or board of directors for that matter) to perpetually guarantee the attainment of profits, there are losses which, if

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<sup>45</sup> What can be gathered from both surfing across the internet and flipping through newspapers is that, indeed, in Britain, in May 2013, a proceeding has been filed in the London High Court by RBS Shareholders Action Group against the directors of RBS. See BRINDED, *RBS Shareholders Action Group Secures Indemnity Insurance to Pursue £4bn Claim*, IB Times, 2 May 2014, available at [uk.news.yahoo.com](http://uk.news.yahoo.com) accessed 7 August 2014.

In this respect, is it possible to say: too late, too little?

incurred, cannot pass the test of reasonableness, as their magnitude is so disproportionate to the standard of conduct expected of a capable director in similar circumstances.

On the one hand, a more transparent definition in Britain of the duty to promote the success of the company<sup>46</sup>, accompanied by a more courageous judicial approach to the exegesis of already existing norms,<sup>47</sup> and, on the other, the power to promote derivative proceedings bestowed upon the authorities too and applied across the Union,<sup>48</sup> may work in tandem to drive the realization of both maximized company profits, whilst also ensuring the stability of capital markets.

Thus far, the British legislation and the preceding reliance on the common law, in theorising the duty to promote the success of the company, has painted a façade - beautiful to gaze at but of negligible benefit to shareholders, investors and depositors, as the RBS case study has clearly corroborated. Perhaps, as alluded to in this work, the objective now should be to lay down the foundations of a solid corporate governance system, applicable to entities operating in the modern domain of capital markets as well as to credit institutions, with a harmonised classification of liabilities, composed in Brussels as opposed to London.

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<sup>46</sup> As previously clarified in this work, the wording should either dispense with the canon of good faith or, alternatively, bolster the wording so as to effectuate the decidedly more rigorous requirement of “utmost good faith”.

<sup>47</sup> Consistently with what already “unearthed” under Chapter 2B above, a more progressive reading of the new objective/subjective test permeating sect. 174 of the CA 2006 would be desirable.

<sup>48</sup> This should apply exclusively to listed companies and credit institutions, as suggested in this work.

## CORPORATE GOVERNANCE AND THE MAIN BANK SYSTEM IN JAPAN: THE ROLE OF BANKS IN JAPANESE CORPORATE GOVERNANCE

Keisuke Sasaki - Yasuyoshi Masuda\*

**ABSTRACT:** *The distinguishing features of Japanese corporate finance are that the proportion of debt to banks comprised of externally-sourced funding is high, and many corporations establish a main bank, which leads to a large amount of mutual shareholding between corporations and banks. There are many empirical studies on corporate governance under the main bank system in Japan, but there are two whose claims are at odds with each other. We demonstrated explicitly that, in spite of the fact that activities of main bank governance constituted one systematic economic phenomenon, the economic activities of the main banks and corporations that corresponded to the variance of productivity shocks and exogenous parameter changes, differed before and after the market adjustment. The funding of Japanese corporations reflects the corporate governance of company shareholders and stakeholders. The irrational economic behavior seen in corporations' cross-holdings of stock can result in decreased efficiency in corporate finance. To reduce this irrationality, it is necessary to strengthen the integrity of Japan's financial structure. Small- and medium-sized corporations with low capital adequacy ratios will then probably accept loans based on rational and open relationships, from all types of banks and non-bank financial institutions.*

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\* Keisuke Sasaki is Full Professor of Applied Microeconomics at the Department of Economics, Toyo University, Tokyo.

Yasuyoshi Masuda is Full Professor of Monetary Economics at the Department of International Economics, Toyo University, Tokyo.

**SUMMARY:** 1. Introduction - 1.1. The Basic Framework of Corporate Finance in Japanese Corporate Governance - 1.2. Changes and their background in Corporate finance after the 1990s - 1.3. Corporate Finance and Money Flow - 2. The main bank system and cross-shareholding - 2.1. The strong dependence of corporations on main banks in Japan - 2.2. Problems that result from cross-shareholding - 3. A corporate governance model and some of its implications - 3.1 The corporate governance model under conditions of production uncertainty caused by corporations - 3.2. Market equilibrium of corporate governance under the main bank - 4. Concluding remarks - 4.1. Finance theory and the state of Japanese corporate governance - 4.2. The main bank system and shareholding - 5. Bibliography

1. 1.1 We provide an overview of the corporate governance of banks in Japan, including changes the practice has undergone and its current state, identify current problems, and consider how these problems should be addressed. Corporate governance is broadly defined as "systematic mechanisms and structures that regulate business operators in order to improve the general economic welfare of the stakeholders," and its purpose is to maximize corporate value.<sup>1</sup> These stakeholders include not only shareholders (outside investors), but also employees, clients, creditors (banks with which companies do business), etc.

The following items have previously been identified as distinguishing features of Japanese corporate governance, compared with corporate governance in Europe and the US. The distinguishing features of the Japanese organizational architecture are that the board of directors is composed of employees promoted from within the firm, the scale of the board of directors is

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<sup>1</sup> See MIYAJIMA [2011] (p. 2) for this definition.

larger, the proportion of external board members (non-executive directors) appointed is lower, and compensation of board members is not closely linked to performance. Another distinctive feature is that the proportion of long-term, continuous business with banks and client companies is higher. The distinguishing features of Japanese corporate finance are that the proportion of debt to banks comprised of externally-sourced funding is high (that is, the proportion of funds raised from bonds is low), and many corporations establish a main bank, which leads to a large amount of mutual shareholding between corporations and banks.

It is difficult for us to specify the effects that these organizational features and long-term, continuous business relationships have on the operational efficiency of corporations. However, since the bubble burst in the 1990s, various problems have occurred in the Japanese economy and financial structure, and the financial system has also lacked consistency with international standards such as the Basel regulations. So, the features of Japanese corporate finance have gradually been reformed in the process of changing the Japanese financial system.

1.2 The nature of corporate finance in Japan underwent great changes due both to liberalizing finance, (i.e. deregulating it), beginning with the Big Bang in the financial markets that spanned the 1980s and the 90s, and to the accommodating global standards. The cross-shareholding ratio of listed companies, which had been 14.3% at the end of the fiscal year 1986, fell to 8.4% by the end of the fiscal year 2006 (See Table 1). Reasons cited for this change include the decline of stock prices after the 90s, the fact that shareholding had become the responsibility of corporations (due to the transition of corporate

accounting to market-value accounting), and the fact that shareholding with clients corporations had become difficult under the Basel regulations.

**Table 1.** Figures related to Japanese corporate finance

Year end	1986	1991	1997	2002	2006	2008
Cross-shareholdings ratio	14.3	14.5	13.5	10.8	8.4	8.5
Debt to total asset ratio	67.5	62.4	58.2	53.8	48.7	48.7
Corporate bond ratio	23.7	37.6	30.9	22.2	17.3	12.9
Ratio of main banks lending to total lending	23.6	24.6	25.9	N.A.	31.0	31.1
Main banks holding ratio to shares issued	4.4	4.2	4.1	N.A.	3.1	3.1

1. Average of all companies' financial data listed with first section of the Tokyo Stock Exchange.
2. Cross-shareholdings ratio = Total number of cross-held shares / Total number of shares issued.
3. Debt to total asset ratio = Debt / Total asset.
4. Corporate bond ratio = Outstanding of corporate bonds / Total debt.
5. Ratio of main banks lending to total lending = Outstanding of main banks' lending / Outstanding of total lending.
6. Main banks holding ratio to shares issued = Total number of main-banks holding shares / Total number of shares issued.
7. Main banks are listed by the first bank of each company registered in Nikkei company profiles.

**Source:** MIYAJIMA [2011], Table 1, p8.

The debt-to-equity ratio of large corporations had been 67.5% at the end of the fiscal year 1986 but fell to 48.7% by the end of the fiscal year 2006. This decline was attributed to the following developments: Excess debt that had been incurred during the "bubble period for assets" in the latter half of the 80s was adjusted; with the maturation of securities market, corporations made efforts to improve their capital adequacy ratio; the review of financial institutions became more rigorous, and the internal funds of corporations since 2000 had increased due to their profits.

Corporate debt ratio, which had been 37.6% at the end of the fiscal year 1991, dropped to 12.9% by the end of the fiscal year 2008. The direct financing (i.e., the development of the securities market) brought about by the financial Big Bang after the 90s was advanced, but it encouraged greater debt dependence that had been the characteristic of corporate financing (via the superiority of indirect financing). This development is attributed to what happened during the bubble period for assets in the latter half of the 80s, and thereafter. In the latter half of the 80s, stock prices rose, causing a rapid increase in the issuance of convertible bonds and debts with warrants and leading, ultimately, to the depression of stock prices after the 90s. This decrease then resulted in a rapid decline in equity finance.

The relationships between the corporations and the main banks are complicated. The shareholding ratio of the main banks is falling, but the loan rate appears set to rise over the long run. Due to the same reasons as for the decline in the cross-shareholding ratio given above, the main banks have stopped holding the shares of their clients, but our judgment of the situation should be that the main banks' functions themselves have been strengthened due to the decline in the credit-worthiness of the corporations. Therefore, the key characteristics of Japanese corporate finance at present are that the ratio of direct financing (securities market) is low and the influence of the banks over corporations is greater than it was in the 1980s.

1.3 The main distinguishing feature of money flow in Japan is that the proportion of indirect financing is high. The corporate sector raises capital from banks and insurance companies, financial intermediaries with abundant capital. When reviewing the ratio of indirect and direct financing, we must consider the structure of household financial assets as well as the structure of corporate debt and capital. In Japan, 53% of household financial assets are composed of cash

and bank deposits, while 27% are in insurance and pensions. In total, 85% of funds are from indirect financing.<sup>2</sup> In the corporate sector, 26% of fund-raising is done through borrowing. This amount exceeds the proportion in the United States and the euro area, clearly showing the dominance of indirect financing in Japanese money flow.

Indirect financing has the advantage of producing stable money flow, but its disadvantage is that it makes it more difficult to create innovation and new ventures. Innovation is essential to industry, so we must boost direct financing to encourage it. In addition, the reason many businesses had trouble raising funds when the bubble burst in the 90s and financing from banks to businesses decreased was that they were excessively reliant on indirect financing for their funding. Therefore, it is essential to have both financing routes available, which is another reason why direct financing should be encouraged.

The Japanese government has implemented changes to the financial environment in order to expand direct financing. In 1998, it implemented Acts for the Financial System Reform. The Acts included deregulation of financial products and financial institutions, which led to diversification in financial institutions and innovation in the securities exchange. In 2001, the government created a policy to invigorate the securities market, utilizing securities investment trusts and loan securitization, etc. However, indirect financing did not decrease. In fact, it actually increased from its level in the 90s. The main reason why indirect financing is central to Japanese money flow is because of one aspect of Japanese corporate financing mentioned in section 1.2, businesses are heavily reliant on banks. Another reason is that banks wield a

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<sup>2</sup> The data used in this section are quoted from Bank of Japan [2014], *Flow of Funds: Overview of Japan, US, and the Euro Area*, Bank of Japan, March 25, 2014.

large amount of power as stakeholders, compared to banks in Europe and America.

2. 2.1 The strong dependence of Japanese corporations on loans from banks corresponds to the benefits and disadvantages of indirect financing described above. Even though there are benefits in providing stable money flow to corporations, excessive dependence on loans subjects corporations to risks directly linked to those of banks when they are in crisis. Small- and medium-sized corporations, in particular, rely on loans from banks for a large portion of their debts, so when banks are in crisis, they are directly impacted by a "credit crunch."

Moreover, we frequently observed the following practice by banks at the end of the 1990s. When borrower corporations at risk of bankruptcy were late in paying their interests, banks often provided them with "forbearance lending", that is, they gave additional loans for the funds needed to pay the interest. Fundamentally, it is irrational to make additional loans to corporations with a high likelihood of bankruptcy. Such debts should be collected as soon as possible. "Forbearance lending" resulted from the following factors: The banks were motivated to evade the financial downturn immediately ahead but they lacked the ability to take any rational action due to their overly close relationship with the corporations. This sort of irrational relationship led to even more serious problems in the main bank system. When corporations faced increasing risks of bankruptcy, banks outside the main banks tended to have the latter raise the ceiling on loans. Only the main banks became exposed to the above-mentioned irrational financial action.

The special feature of the main bank system is that both the banks and the borrower-corporations maintain an "implicit" understanding with respect to their financial transactions over a long period of time. Some corporate financial

theories claim that the close relationship between business firms and banks are effective at reducing the agency cost (i.e., the cost of producing information from the monitoring activities of creditors and examiners, that is, the signaling cost of the creditors), in that the agency cost eliminated the asymmetric information between the banks which are the creditors and the corporations (i.e., the managers).<sup>3</sup>

The intimate relationship between the main banks and the corporations contributed to the productivity increases of Japanese corporations until the early 1980s, but that intimate relationship slackened in the process of financial liberalization after the latter half of the 1980s, leading to the weakening of corporate governance. It is a generally held view that the fundraising of business firms in the latter half of the 1990s had become difficult, which led to an economic slump. However, empirical studies verify that, "the main bank system had not been contributing to the rise of productivity of Japanese corporations since the beginning."

There is no doubt that the excessively close relationship between the banks and the corporations led to the distortion of corporate finance, but new practices have started to correct this distortion. After the financial crisis of 1997-98, the bankruptcy risks of banks increased and there was an increase in the number of main banks which chose not to rescue their clients. As a result, by the beginning of the 21st century, the general view became that the main bank system would collapse. However, after the financial crisis, many corporations came to attach great importance to the main banks once again in order to stabilize their fund raising efforts. The rise in the financial ratio of the main banks is indicative of this return to previous practices. Due to the implementation of the Financial Revitalization Program that was announced in

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<sup>3</sup> See STIGLITZ and WEISS [1981], AOKI [2001], and OSUGI [2013] for details.

October 2002, and to strict investigations of banks by regulators, the main banks no longer take any extreme irrational actions (although a great number of cases do remain in which banks did not or could not take rational action.) Those distressed corporations that managed to survive by relying on this type of irrational financial relationship are called “zombie corporations”<sup>4</sup> and are considered to constitute the key factor in the decline of the entire industry’s productivity.

2.2 Cross-shareholding is shown in terms of the rise in the ratio of shareholding of non-financial corporations and banks, according to departments, in the ratio of shareholding. Cross-shareholding as a policy to prohibit acquisition is linked to two characteristics of governance. First, corporate governance is shifted from the outsider to the insider. Second, the main bank and the business manager have the governance force rather than the shareholder. These are the characteristics of traditional Japanese corporate governance. When seen from the perspective of the basic principle of modern corporations elsewhere (with the corporate owner as the stockholder and the manager as the agent of the stockholder), the resistance of a manager and a main bank to acquisition by an outsider, as often seen in Japan, is strange.

The high-level cross-shareholding between business firms and banks continued until the mid- 1990s, but it rapidly dwindled after 1997.<sup>5</sup> Due to the financial crisis, both banks and business firms faced the risks of bankruptcy for

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<sup>4</sup> A term used by HOSHI - KASHYAP [2001] to refer to corporations that have remained in the market due to protection from the government and the intimate relationship with the banks, in spite of the fact that they should have withdrawn from the market. This term has been used generally in corporate finance and industrial organization theories.

<sup>5</sup> The data used in this section are from Tokyo Stock Exchange Inc. [2014], *Heisei25nendo Kabushiki-Bunpu-Joukyo Chousa-Kekka* (2013 Share- ownership Survey), Tokyo Stock Exchange Inc., June 19, 2014.

the following reasons. First, they had sold their share holdings to secure liquidity. Next, they had to evade the risks of stock prices falling, due to the adoption of market-value accounting. Third, when the main banks became unable to continue to provide loans to distressed corporations, the corporations had less incentive to continue engaging in cross-shareholding with them. Finally, given the Basel Capital Accords, it had become difficult for banks to have cross-shareholding deals with their clients. During that period, the receiving companies of the stocks that had been dumped were in foreign sectors (i.e., were non-residents of Japan).

The decrease in cross-shareholding continued until around 2004. Thereafter, acquisitions that relied on acquisition funds became popular and corporations in the same industry, such as steel, engaged in cross-shareholding with each other. Based on the thinking of traditional corporate governance, the cross-shareholding between rival corporations was an irrational one in that it impaired profit. However, the revival of cross-shareholding took place within the field of only a few businesses. It tended to decrease after the 1990s.

Moreover, there were many business managers who considered that cross-shareholding would prove to be the key factor for maintaining and raising stock prices. To be sure, if circulating stocks decreased, stock prices could rise, in light of the demand and supply in the stock market. However, when capital that was originally meant to promote the growth of the corporations (as the funds for investment in research and development, and in facilities), were shifted to the stock holding of other companies, stock prices did not necessarily rise. If stock prices were determined by long-term corporate profit and the growth of dividends, then cross-shareholding would not be the main factor in the rise of stock prices in any comprehensive way.

3. 3.1 There are many empirical studies on corporate governance under the main bank system in Japan, but there are two whose claims are at odds with each other. Horiuchi and Fukuda [1987], a representative study, conducted investigations into Japanese corporations to learn whether the fluctuations of financing costs and operating costs cancelled each other out, or whether an increase/decrease in operation income produced an increase/decrease in loans. Their investigations led them to conclude that the main banks never shared the risks that the corporations were confronting, and neither did they become the supplier of stable loans. On the other hand, Tsutsui [1998, 2000] concluded that due to the risk sharing that corporations were confronting, main banks supplied them with long-term loans to stabilize their performance. The objective of the following theoretical analysis lies in demonstrating explicitly that the contrastive difference in these conclusions could be attributed to a difference in measurement, even though it was conducted on one and the same economic phenomenon.

In this paper, we postulate that: (i) only the banks could access the market of deposits that had been organized and the main banks not only supplied the loans, but also participated in the production activities of corporations (Section 2); (ii) corporations had the possibility of moving to another main bank, based on the standard of reservation profit. In the analysis below, we introduce the uncertainty of production to the model made up of this other main bank and the corporations and call it the corporate governance model.<sup>6</sup>

For the sake of simplification, we assume that bank  $j$  ( $=1, \dots, n$ ) was related to numerous corporations in corporate governance and a corporation

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<sup>6</sup> BASU [2003] presented the "interlinkage model" that used reservation utility and SASAKI [2012] went further by conducting an analysis that also considered production uncertainty. The corporate governance model of this paper has modified the interlinkage model that introduced SASAKI [2012]'s production uncertainty and applied it to the analysis of the governance activities of the banks.

could face a productivity shock. Given this situation, the disturbance term  $\tilde{\mu}$  of the benefit  $s_j(\tilde{\mu})$  was subject to the "productivity shock" that the main bank could not control based on normal distribution,  $\tilde{\mu} \sim N(0, Var[\tilde{\mu}])$ . When that happened, the benefit given to bank  $j$  would be the number of corporations with respect to the given production state (reservation profit  $\bar{\pi}$ ) of the corporations, that is, it would become the function of the scope  $m$  of governance and can be expressed by the following equation.

$$(1) \quad s_j(m_j, \bar{\pi}; \tilde{\mu}) = s_j(m_j; \tilde{\mu}), \quad \partial s_j(m_j; \tilde{\mu}) / \partial m_j > 0, \\ \partial^2 s_j(m_j; \tilde{\mu}) / (\partial m_j)^2 < 0.$$

In our analysis we assume that all the corporations had reservation profits  $\bar{\pi}$ . Therefore, if the borrowing rate  $r$  indicated by the main bank and the profit  $\pi(r, k)$  from the invested capital  $k$  were  $\pi(r, k) < \bar{\pi}$ , the corporation would move to another main bank.<sup>7</sup> The impact of the rate of interest applied to the profit of the corporations and the invested capital were considered to be  $\partial \pi / \partial r \leq 0$ ,  $\partial \pi / \partial k > 0$ . Moreover, the main bank is constrained from controlling the movement of a corporation to another main bank when low invested capital  $k$  and high interest rate  $r$  are seen, but it is in the same situation as the monopolist confronting the conditions of demand. Here, we assume the borrowed loan  $M(r)$  to satisfy  $dM(r)/dr \leq 0$ , because high interest rates decrease corporate borrowing. The amount borrowed could generally be expressed as

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<sup>7</sup> In order to determine the market equilibrium endogenously, a total number  $\sum_{j=1}^n m_j$  that also includes the scope of other main bank governance is important, but we postulate the existence of the number of corporations ( $\pi(r, k) \geq \bar{\pi}$ ) with no constraint by ignoring this total number for sometime, (Section 3.2).

$M(r, k)$ , made up of the rate of interest  $r$  and the invested capital  $k$ . However, even as a general assumption, given the fact that the corporations, which are the borrowers, locate on the indifference curve of the reservation profit  $\bar{\pi}$ , the invested capital  $k$  depended on the rate of interest  $r$ . So, the amount of borrowing would be  $M(r, k(r)) = M(r)$ . Given this situation, if the main bank had sufficient money holdings to satisfy the borrowing demands of the corporations, the net profit which could be obtained from the loan with the rate of interest of the deposit,  $\bar{r}$ , would be indicated as  $(r_j - \bar{r})M(r_j)$  and the maximization problem of the total profit of bank  $j$  would be given by the following equation.

However, the constraint condition  $k_j = R(r_j, \bar{\pi})$  indicated the invested capital that corresponded to the interest rate  $r$  under the condition of reservation profit  $\bar{\pi}$ , would have satisfied  $\partial R / \partial r \geq 0$  and  $\partial R / \partial \pi > 0$ , based on the standard assumptions of the corporate profit  $\pi(r, k)$ .

$$(2) \quad \max_{\{r_j, k_j, m_j\}} E[\Pi_j(r_j, k_j, m_j; \tilde{\mu}) = m_j(r_j - \bar{r})M(r_j) + s_j(m_j; \tilde{\mu}) - m_j k_j | k_j = R(r_j, \bar{\pi})].$$

Even under the general production condition  $s_j(m_j; \tilde{\mu})$ , all the results given below could be derived,<sup>8</sup> but in this paper we assume the production condition as  $s_j(m_j; \tilde{\mu}) \equiv \bar{s} - \exp[-\rho(\alpha + m_j + \beta\tilde{\mu})]$  ( $\alpha > 0$ ,  $\beta > 0$ ,  $\rho > 0$ ) because

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<sup>8</sup> SASAKI [2011], who has conducted an analysis of non-profit organizations that differed from the banking industry of this paper, has derived various theorems under general conditions, without using a specific objective-function. Since benefit  $s_j(m_j; \tilde{\mu})$  has satisfied the same conditions, even if the general production function is assumed, the following results could be obtained with the method used in SASAKI [2011].

the derivation process would be long.<sup>9</sup> Here the parameter  $\rho$  is the index that showed the strength of diminishing returns. Subsequently, the first-order conditions for the maximization of the total expected profit by bank  $j$  would be as follows:

$$(3) \quad dE[\bar{s} - \exp[-\rho(\alpha + m_j + \beta\tilde{\mu})]]/dm_j \\ = R(r_j, \bar{\pi}) - (r_j - \bar{r})M(r_j).$$

$$(4) \quad M(r_j) + (r_j - \bar{r})dM(r_j)/dr_j = \partial R(r_j, \bar{\pi})/\partial r_j.$$

Given this situation, the profit derived from the invested capital  $k$  and the money lending  $M$  are interlinked, but when the rate of interest  $r$  was decided, the scope of governance  $m$  would be determined block-recursively. Here  $R(r_j, \bar{\pi}) - (r_j - \bar{r})M(r_j)$  would be expressed by  $\theta(r_j, \bar{\pi})$ . When the main bank that is confronted by uncertain profit had reached the maximization of the expected profit, that is to say, when it had achieved the lowest  $\theta(r_j, \bar{\pi})$ , its rate of interest would be expressed by  $r_j^*$ . At this point, the scope of the governance  $m_j^*$ , with respect to the given rate of interest, must satisfy the following condition. In order to simplify the notation below, subscript is given only when necessary.

$$(5) \quad dE[\bar{s} - \exp[-\rho(\alpha + m + \beta\tilde{\mu})]]/dm = \theta(r, \bar{\pi}).$$

The following proposition can be obtained from the results achieved so far.

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<sup>9</sup> As  $s_j(m_j; \tilde{\mu}) = \bar{s} - \exp[-\rho(\alpha + m + \beta\tilde{\mu})]$  has satisfied  $\lim_{m \rightarrow \infty} s(m) = 0$  and  $\lim_{m \rightarrow \infty} s(m) = \bar{s}$ , if the formula that determined the invested capital  $k_j = R(r_j, \bar{\pi})$  and the borrowed capital  $M(r_j)$  are continuous, the existence of equilibrium configuration  $\{r_j, m_j, k_j | j = 1, \dots, n\}$  would be guaranteed.

**Proposition 1:** *In the governance of a corporation in a condition of uncertain productivity due to the main bank, the presence of a productivity shock would not exert any impact on the rate of interest  $r$  under the given reservation profit  $\bar{\pi}$ . Therefore, the main bank, in spite of the fact that it was controlling the rate of interest on the funds borrowed and the invested capital, would absorb the impact of the productivity shock by its scope  $m$  of the main bank governance, thanks to the given reservation profit  $\bar{\pi}$ .*

Even if the definition were changed to  $\tilde{\phi} \equiv \alpha + \beta\tilde{\mu}$ , the results of the analysis of this paper would not be impacted in any way. Therefore, if we consider  $\tilde{\phi}$ , which included disturbance term  $\tilde{\mu} \sim N(0, Var[\tilde{\mu}])$ , to be also the normal distribution  $\tilde{\phi} \sim N(E[\tilde{\phi}], Var[\tilde{\phi}])$ , the expected value  $E[s(\tilde{\phi})]$  would be:

$$\begin{aligned}
 (6) \quad E[s(\tilde{\phi})] &= E[\bar{s} - \exp[-\rho(m + \tilde{\phi})] | m + \tilde{\phi} \equiv f(\tilde{\phi})] \\
 &= \bar{s} - \exp\left[-\rho E[f(\tilde{\phi}) + \rho^2 Var[\tilde{\phi}]/2]\right] / \sqrt{2\pi Var[\tilde{\phi}]} \\
 &\quad \times \int \exp\left[\frac{(f(\tilde{\phi}) - E[f(\tilde{\phi})] + \rho Var[\tilde{\phi}])^2}{2Var[f(\tilde{\phi})]}\right] df(\tilde{\phi}) \\
 &= \bar{s} - \exp[-\rho(m + E[\tilde{\phi}]) + \rho^2 Var[\tilde{\phi}]/2].
 \end{aligned}$$

Therefore, the condition of maximizing the total expected profit would be as follows. The scope of governance  $m$  would have satisfied the equation in terms of the rate of interest  $r^*$ .

$$(7) \quad \rho \exp[-\rho(m + E[\tilde{\phi}]) + \rho^2 \text{Var}[\tilde{\phi}]/2] = \theta(r^*, \bar{\pi}).$$

The following proposition can be derived from these results.

**Proposition 2:** *In the governance of the corporations under the condition of uncertain productivity due to the main bank, the existence of a productivity shock would increase the scope of governance  $m$ , given the reservation profit  $\bar{\pi}$ . If the variance  $\text{Var}[\tilde{\phi}] (> 0)$  increased/decreased, the scope of governance  $m$  would increase/decrease under the condition of the given reservation profit  $\bar{\pi}$ .*

$d(dE[s(m; \tilde{\phi})]/dm)/d\text{Var}[\tilde{\phi}] > 0$  has been established from the above formula, so the main bank would work to maximize the total expected profit by increasing the scope of governance  $m$ , with respect to the increase of the variance of the productivity shock.

In the next section, we will examine the market adjustment of the banks and the corporations.

3.2 Here, for the sake of simplification, if we assume this market as a closed economy and the upper limit of the scope of governance  $N$  as being present, it is possible to find the reservation profit  $\bar{\pi}$  that satisfies the following equation. When that has been found and  $\{\bar{\pi}, r_j, m_j, k_j | j = 1, \dots, n\}$  have satisfies formula (3) and (4), as well as the following formula (8), with regard to all the banks  $j$ , only then would the equilibrium configuration results.

$$(8) \quad \sum_{j=1}^n m_j(\bar{\pi}, r_j) = N.$$

In the analysis up to now, we have treated the reservation profit  $\bar{\pi}$  as a given condition, that is to say, we have determined the scope of main bank governance by stabilizing the indifference curve of reservation profit  $\bar{\pi}$ , but there existed a governance scope that corresponded to the various reservation profit respectively. Thus, it is possible to obtain the demand curve  $\sum_{j=1}^n m_j(\bar{\pi})$  of the governance scope  $m$ , by using the derivation method of the standard function of demands. We have expressed the rate of interest of lending that the main banks have selected under the given reservation profit  $\bar{\pi}^*$ , as  $r_j^*$ , the governance scope as  $m_j^*$  and each of the items under the reservation profit  $\bar{\pi}^{**}$  as  $r_j^{**}$  and  $m_j^{**}$ . Given this situation, if  $\bar{\pi}^{**} < \bar{\pi}^*$ ,  $\theta(r_j^{**}, \bar{\pi}^{**}) < \theta(r_j^*, \bar{\pi}^*)$  is established, and the scope of governance satisfies formula (7), then  $\sum_{j=1}^n m_j^{**} > \sum_{j=1}^n m_j^*$  would be established for all the banks  $j$ .

Under the high reservation profit  $\bar{\pi}$ , these results, led to  $\sum_{j=1}^n m_j(\bar{\pi}, r_j) < N$  and could lead an excessive number of corporations to try to secure profit by changing to low reservation profit. As a result, the reservation profit  $\bar{\pi}$  would decrease until formula (8) was satisfied and market adjustments would be carried out, after which adjustments to the interest rate on lending and invested capital, equilibrium configuration  $\{\bar{\pi}^*, r_j^*, m_j^*, k_j^* | j = 1, \dots, n\}$ , would be achieved. Accordingly, the variance of productivity shocks and exogenous parameter changes would never be absorbed exclusively by the scope of governance, as it was not mentioned in the propositions above, and they would produce changes in the interest rate  $r_j$  of the loans of the main bank and the invested capital  $k_j$ .

4. 4.1 Given that the possibility for corporations to move to another bank, based on the standard of reservation profit placed a constraint on the banks' behavior, the changes caused by a productivity shock would impact the reservation profit of every corporation through the market adjustment of each main bank and corporation. Both the interest rate of loans and invested capital would be impacted by the changes caused by the shock. Therefore, we can interpret the propositions above as indicative of the situation before the market adjustment. We demonstrated explicitly the reason why the claims of two representative empirical studies, mentioned in section 3, are at odds with each other. We did so by explaining that, in spite of the fact that activities of main bank governance constituted one systematic economic phenomenon, the economic activities of the main banks and corporations that corresponded to the variance of productivity shocks and exogenous parameter changes, differed before and after the market adjustment.

The relationship between corporate finance and the securities market is also important, even though it was not the subject of the theoretical analysis in this paper. Since the late 1990s three factors have changed Japan's corporate finance: (i) decrease in debt ratio (rise in capital adequacy ratio); (ii) rise in the loan-to-value ratio from main banks (simultaneous decrease in corporate bond ratio); (iii) reduction of cross-shareholding ratio of main banks. These do not necessarily follow one of the basic theories of corporate finance, viz. the so-called "trade-off."<sup>10</sup> Rather, changes since the late 1990s are consistent with

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<sup>10</sup> The hypothesis is that the corporations determined the configuration of debts and stocks (shareholders' equity) so that the corporations could maximize their corporate value (market capitalization). HIROTA [2011] conducted an empirical analysis into whether the fundraising of Japanese corporations followed the "trade-off" hypothesis.

another basic theory, “pecking order.”<sup>11</sup> This funding of Japanese corporations reflects the corporate governance of company shareholders and stakeholders. On the other hand, irrational economic behavior seen in corporations’ cross-holdings of stock and close relationships with main banks, such as described in section 2.2, can result in decreased efficiency in corporate finance. To reduce this irrationality, it is necessary to strengthen the integrity of Japan’s financial structure.

4.2 The intimate relationship between main banks and corporations is correlated with shareholding. Due to the fact that they tend to have very small capital, it is difficult for Japanese corporations, particularly the small and medium-sized ones, to fund raise extensively in capital markets by issuing stocks and corporate bonds.<sup>12</sup> So, they must rely on banks for fundraising. The banks have been lending funds to corporations through such methods as setting up real estate securities to cover the low capital adequacy ratio of the borrower to control the risks. For their part, being aware that debt was more advantageous than stocks when considering their corporate taxes, the corporations have also proactively borrowed from banks, setting up a low figure for their capital adequacy ratio.

In particular, the main banks have been making loans to corporations even when their capital adequacy ratio was low. Along with asking for tradeoffs,

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<sup>11</sup> With the downturn of the securities market from the 90’s lessening capital demands, reducing the funding for securities, and giving procurement priority to banks (main banks), since 2000, internal reserves have expanded, thereby increasing dependence on internal funds. This phenomenon is known as a “Pecking order.”

<sup>12</sup> The capital adequacy ratio of major corporations in Japan started to increase in the latter half of the 1990s and has reached the same level as that of the corporations in the West. However, even now, the capital adequacy ratio of the small- and medium-sized corporations is low, when compared with their counterparts in the West.

such as handling employee accounts and securing golden parachutes, they tacitly agreed (through implicit contracts) to provide liquidity when the borrower-corporations faced crises. This situation led to the emergence of cross-shareholding between the banks and the corporations. The banks, which were the creditors, joined the corporations as their owners and raised their stakeholders' position even higher. When the creditors became the shareholders the structure of the corporate governance became complicated and rendered the stakeholders' position ambiguous. However, with market-value accounting and the Basel regulations already established, cross-shareholding is in the process of becoming recognized as being irrational. It is almost certain that cross-shareholding will continue to decline.

Accordingly, the main bank system will lose implicit contracts for cross-shareholding, so the corporate ratio that determines the main banks will probably fall. When this fall occurs, along with the dissolution of the main banks, banks will carry out transactions with the borrower-corporations, based on "hard information," such as their financial statements. Small- and medium-sized corporations with low capital adequacy ratios, needing to raise the same, will then probably accept loans based on rational and open relationships, from all types of banks and non-bank financial institutions. This likelihood, in turn, means that Japan will become more like the U.S. in its corporate financial system.

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# INNOVATION'S GOVERNANCE AND INVESTMENTS

## FOR ENHANCING COMPETITIVENESS OF MANUFACTURING SMES

Nunzio Casalino - Stefan Ivanov - Toshko Nenov\*

**ABSTRACT:** *To become innovative and competitive manufacturing contractors, SMEs have to be capable to supply manufacturers with advanced equipment, components, and tools for improved manufacturing and engineering operations. Besides, despite their foremost numbers and importance in job creation, traditionally SMEs encounter difficulty in obtaining formal credit or equity. Maturities of commercial bank loans extended to SMEs are often limited to a period far too short to pay off any sizeable investment. Many European governments and international financial institutions have tried to address the problems of high transaction costs and risks by creating subsidized credit programmes and/or providing loan guarantees. Such projects have often fostered a culture of non-repayment or failed to reach the target group or*

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\* Nunzio Casalino is Associate Professor of Business Organization at Guglielmo Marconi University, Rome, Italy.

Stefan Ivanov is Associate Professor of Electrical Engineering and Electronics at Technical University of Gabrovo, Bulgaria.

Toshko Nenov is Full Professor of Electrical Engineering and Dean of the Faculty of Electrical Engineering and Electronics at Technical University of Gabrovo, Bulgaria.

Although the article is the result of joint observations of the three authors, the paragraphs 1, 2, 3, 4, 5, 7, 9 have to be attributed to Nunzio Casalino, while the abstract and the paragraphs 6, 8 have to be attributed jointly to Stefan Ivanov and Toshko Nenov.

*achieve financial self-sustainability. Further, it tries to understand what are the main barriers for SMEs with respect to the realisation of their innovative potential and their capacity to improve internal processes by the adoption of innovative manufacturing techniques and a graduated organizational change. They are becoming particularly important for achieving greater productivity, lower operational costs, and higher revenues (usually characterized by reduced access to external finance, unavailability of wider distribution channels, low internationalization, etc.). The purpose of this article at last is to clarify how on-line training on automation and innovation fields can bring economic and organizational benefits. Innovative training contents can improve manufacturing knowledge of managers and employees, especially on industrial automation systems.*

**SUMMARY:** 1. Introduction. - 2. Fiscal policies and financial incentives. - 3. Organizational impact of finance on SMEs automation. - 4. Financing matters for SMEs. – 5. Innovation transfer application. - 6. Organizational aspects and human resources. - 7. The research project and methodology. - 8. Interdisciplinary character and typologies of the focused learning contents. - 9. Conclusions.

1. Finance has been identified in many business surveys as the most important factor determining the survival and growth of small and medium-sized enterprises (SMEs) in European countries. Access to finance easily allows SMEs to undertake productive investments to expand their businesses and to

acquire the latest technologies, thus ensuring their competitiveness and that of the nation as a whole.

Poorly functioning financial systems can seriously undermine the microeconomic fundamentals of a country, resulting in lower growth in income and employment.

The current economic crisis has weakened the financial health of many small and medium-sized firms (SMEs), especially in industries in which foreign, low-cost producers have entered the market and are threatening the survival of the existing competitors. In addition, new government regulations can change a profitable SME niche business into an enterprise disaster in just a few weeks or months. There have been significant debates about the impact of innovative manufacturing techniques on economic performance<sup>1</sup> and competitiveness in general<sup>2</sup>, and on productivity, efficiency, and innovation in particular. The diffusion of automation can produce new opportunities for SMEs. It overcomes the concept of traditional organization, emphasizes the interdependence between the organization of jobs and technology.

Notably, in seeking an explanation for the acceleration in productivity and economic growth experienced in many industrialized countries, many economists have looked at the development, application, and utilization of ICT as a critical factor. Information and communication technologies, automation

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<sup>1</sup> See JOHN - SENBET, *Corporate Governance and Board Effectiveness*, New York University, USA 1983

<sup>2</sup> See FONTANA - LORENZONI, *Il Knowledge Management*, LUISS University Press, Rome, Italy, 2004.

and robotics are changing manufacturing processes in industry<sup>3</sup>. In parallel also on the scientific and vocational education level, the integration of different fields like mechanics, electronics and information technologies (mechatronics) is practiced since years. Nevertheless, many especially small enterprises have rather conservative approaches to new technologies and thereby miss many opportunities by utilizing improved technologies. SMEs need highly qualified staff, competent in operating with new machines and in managing sophisticated production processes. AutoMatic project addresses the problem of low or missing overview about possibilities offered by industrial automation systems. It adapts and develops an innovative approach and learning contents targeted specifically to SMEs to qualify staff on industrial automation systems<sup>4</sup>.

Hence, at the firm level, the expectations are of greater efficiency, lower costs, and access to larger and new markets, while governments see the application and use of ICT as generating higher productivity, and competitiveness. This paper tries to understand what are the main barriers for SMEs with respect to the realisation of their innovative potential and their capacity to create employment (reduced access to external finance, unavailability of wider distribution channels, low internationalisation, etc.). Moreover, as first argued by New Growth Theory<sup>5</sup>, the capacity of continuous

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<sup>3</sup> See BUTLER, *A practical model for technology and innovation management*, Portland International Conference on Management of Engineering and Technology, PICMET, 1, pp. 103 - 105, 1999.

<sup>4</sup> See CASALINO, *Learning to Connect: a Training Model for Public Sector on Advanced E-Government Services and Interorganizational Cooperation*, in *International Journal of Advanced Corporate Learning (IJAC)*, Austria, vol. 7, no.1, 2014.

<sup>5</sup> See ROMER, *Increasing Returns and Long-Run Growth*, in *The Journal of Political Economy*, 94, 1986.

innovation has become a key factor in the global competition of high-income regions in order to acquire the additional factors of production and the new value adding processes, which are necessary to keep an economy on a sustainable growth path. SMEs seem to be the ideal vehicle to promote both goals - sustainable innovation-based economic growth and employment creation - without trade-offs, given, as frequently assumed, the high flexibility as well as the relatively labour-intensive mode of production in SMEs. However, the issue as to how realistic these expectations are is anything but resolved.

Despite experience with a different number of SMEs' promotion programmes, it is also still debated as to which specific policy measures are really suitable to guarantee undistorted competition by compensating firm-size specific disadvantages, such as the SMEs' restricted access to public resources.

2. Many governments and international financial institutions have tried to address the problems of high transaction costs and risks by creating subsidized credit programmes and/or providing loan guarantees. Such projects have often fostered a culture of non-repayment or failed to reach the target group or achieve financial self-sustainability. On average, neither tax measures nor financial supports for R&D are perceived as sufficient to encourage SMEs and to improve manufacturing processes<sup>6</sup>.

Many enterprises highlight that existing tax measures discouraged them to engage in automation investments. A significant majority of SMEs support

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<sup>6</sup> See UNCTAD/ITE/TEB/Misc.3, United Nations Conference on Trade and Development, *Improving the Competitiveness of SMEs in Developing Countries, The Role of Finance to Enhance Enterprise Development*, public report, United Nations, New York and Geneva, 2002.

the statement that taxation discouraged the adoption also other innovative placements. The majority of the SMEs confirm that public financial support was insufficient to support R&D, diffusion and uptake of information systems. These findings are consistent with other levels of satisfaction with government intervention in, amongst other things, innovation regulation<sup>7</sup>.

However, another correlation can be established, namely with GDP per capita and available public funds to support SMEs industrial policies, thus revealing material boundaries to proactive manufacturing policies. Accordingly, for the new EU member states in the survey, streamlining some of the EU structural funds towards innovation and stimulation of manufacturing will be highly appropriate in light of previous relevant experience. Use of international loans can also be an option although many of those are seen as too expensive in light of the financial capabilities of the countries at this stage. About 44 percent of the SMEs indicated that the current education system delivered adequately trained personnel to engage in innovative manufacturing usage and 28 percent stated that the system delivered inadequately trained personnel. Compared to existing staff skills and training of firm personnel, which for 69 percent of all firms appeared sufficient to support the uptake of ICTs, newcomers to the labour market still have a learning trajectory to go through. In all countries, the education system is positively evaluated as adequately preparing for production

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<sup>7</sup> See CHESBROUGH, *The New Business Logic of Open Innovation*, in *Strategy & Innovation*, 1, pp. 11 - 15, 2003.

usage by a significant but moderate majority of SMEs<sup>8</sup>. Figures on education deviate from the traditional pattern with regard to the government's role in promoting ICT. For obvious reasons, innovative public policies are not the only factor affecting this score, which is dependent on overall levels of pedagogical quality as well. Most of all the speed of response of the educational system in the surveyed countries is still insufficient to accommodate the dynamism and the requirements of the businesses. This stems, in part, from the weak relationship between the business and education and R&D communities. It is the obligation of the government to create an environment that stimulates this relationship and hence makes the educational system more adaptive and flexible to the requirements of the business.

National differences in the appreciation of production services as a stimulating factor for technologies' adoption in the economy correlate relatively well with other governmental efforts to stimulate innovation. However, overall levels of appreciation are significantly lower than for other factors, indicating that the provision of online services is a relatively weak stimulus for the uptake of ICT services in the business community<sup>9</sup>.

Programs to raise awareness of the utilization of manufacturing technologies in firms and innovative demonstration programs can give a strong contribute to improve automation usage. Almost 21 percent of all firms

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<sup>8</sup> See JOHANNESSE - OLSEN - OLAISEN, *Aspects of innovation theory based on knowledge-management*, in *International Journal of Information Management*, Vol. 19, No. 2, pp. 121 - 139, April 1999.

<sup>9</sup> See UNCTAD/ITE/TEB/Misc.3, United Nations Conference on Trade and Development, *Improving the Competitiveness of SMEs in Developing Countries, The Role of Finance to Enhance Enterprise Development*, public report, United Nations, New York and Geneva, 2002.

indicated that private awareness raising and demonstration programs were not sufficient. In other words, they could be improved. Following this line of argument, the challenges that the EU is facing with regard to its basic economic and political foundations are arising at a time when stability in these areas is becoming an ever more important prerequisite for stimulating investment and encouraging innovation. The EU's leaders need to continue their efforts to stabilize the political and economic macro environment in order to establish confidence and encourage investment. Yet this is only the first step; the EU must also succeed in addressing a number of challenges on the micro level. In today's world, there are few "independent variables" or "autonomous players". Rather, the competitive advantage of a country is dependent on multiple, interdependent factors – not least of which include its leaders' ability to act on issue areas in a coordinated and collaborative fashion. Thus, the EU's ability to address the challenges of establishing a stable political and economic environment, setting-up the appropriate framework conditions to in still confidence in the business environment, and catalysing innovation in the economy is dependent on a concerted effort of multiple actors, working across sectors or domains in a systemic, inclusive and transparent manner.

3. High administrative costs of lending or investing small amounts do not make SMEs' financing a profitable business. As a result, commercial banks are

generally biased toward large corporate borrowers<sup>10</sup>, who provide better business plans, have credit ratings, more reliable financial information, better chances of success and higher profitability for the banks<sup>11</sup>. When banks do lend to SMEs, they tend to charge them a commission for assuming risk and apply tougher screening measures, which drives up costs on all sides. Many European governments and international financial institutions have tried to address the problems of high transaction costs and risks by creating subsidized credit programmes and/or providing loan guarantees. Such projects have often fostered a culture of non-repayment or failed to reach the target group or achieve financial self-sustainability.

Changing market conditions thus force smaller firms to adapt or reinvent their business through new technologies or unique value propositions. At the same time, small firms face several constraints in differentiating their products and changing their business model. A major liability is that small firms lack the required internal financial resources and technical capabilities. They therefore must collaborate with external partners to innovate successfully, to develop new sources of income, and to reach more profitable positions in the competitive landscape. Innovative manufacturing techniques adoption and organizational change are becoming essential for achieving greater industry productivity, lower operational costs, and higher revenues. The close correlation

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<sup>10</sup> See CASALINO - MAZZONE, *Externalization of a banking information systems function. Features, regulatory and critical aspects*, in *The Interdisciplinary Aspects of Information Systems Studies*, D'ATRI - DE MARCO - CASALINO (eds), Physica-Verlag, Springer, Heidelberg, Germany, pp. 89 - 96, 2008.

<sup>11</sup> See CAPRIGLIONE - CASALINO, *Improving Corporate Governance and Managerial Skills in Banking Organizations*, in *International Journal of Advanced Corporate Learning (iJAC)*, vol. 7, no. 3, Austria, 2014.

between these dimensions of improved economic performance from ICT and organizational change<sup>12</sup> corresponds well with findings from other studies on the impact of technologies on firm performance. It has thus often been argued that the effective utilization of information systems requires more horizontal organizational structures with greater levels of responsibility for the overall coordination of work placed on the individual employee. It also requires the implementation of clearer functional descriptions of tasks. All this often requires a complete re-shaping of the organizational structure of the firm where all aspects of the organizational development are consequently given attention<sup>13</sup>. Hence, it is important to note that the firms are going through a period of rapid modernization, emphasizing improved production processes and flexible organizations that can address the needs of the market, as part of transformations of the socio-economic fabric to a market-driven economy. This may in part explain why ICT is combined with other factors, such as new marketing strategies and organizational change. Today there is a strong need to collect more revealing data on technologies adoption and its impact on SMEs, the need for more rigorous analysis of how ICT investments and use affects innovation<sup>14</sup>, and the need for better understanding how this can translate into productivity increasing and enhancing competitiveness. How to correlate SMEs

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<sup>12</sup> See CASALINO - D'ATRI - FADDA, *Organisational impact and exploitation of the results of an Italian research project for e-health and medical training*, ECIS 2005 - European Conference on Information Systems, Regensburg, Germany, 2005.

<sup>13</sup> See DAWES, *Interagency Information Sharing: Expected Benefits, Manageable Risks*, in *Journal of Policy Analysis and Management*, vol. 15, no. 3, pp. 377 - 394, 1996.

<sup>14</sup> See SIMON, *Applying Information Technology to Organization Design*, in *Public Administration Review*, 33(3), pp. 268 - 278, 1973.

in the internationalisation processes or whether they only function as suppliers in global value chains, dominated by large-scale transnational enterprises<sup>15</sup>, is an open question. Without doubt, the current wave of internationalisation is accelerating the diffusion of innovation across industries. Yet it is unclear whether SMEs are driven by globalisation or whether they are a driving force in this process.

It is clear from many studies that a wide utilization of information systems is already having an impact on economic performance among firms. This is reflected in the findings on the impact of ICT on economic performance, where it is evident that ICT is a substantial contributor to productivity, profitability, and growth<sup>16</sup>. Accordingly, a new marketing strategy is particularly relevant for translating the introduction and use of ICT into the improvement of profitability. This is mainly because the use of technologies together with new marketing initiatives enables firms to strengthen their position in existing markets or enter new markets, thereby improve profitability.

Manufacturing technologies is particularly important for lowering operational costs and increasing revenue. In addition to identifying the immediate impact of ICT on the economic performance of SMEs<sup>17</sup>, it is possible to identify how firms use ICT to improve their future performance<sup>18</sup>, namely through innovation. ICT is only a minor facilitator of innovation; it only becomes

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<sup>15</sup> See GATTI, *I costi nel governo dell'impresa. Strumenti di supporto dei processi decisionali*, Cedam, Padua, Italy, 2000.

<sup>16</sup> See KAPLAN, *Discontinuous innovation and the growth paradox*, in *Strategy and Leadership*, USA, March-April, pp. 16 - 21, 1999.

<sup>17</sup> See MILLER, *Interoperability: What is it and why should I want it?*, Ariadne Magazine, 2000.

<sup>18</sup> See FONTANA - CAROLI, *Economia e gestione delle imprese*, McGraw-Hill, Milan, 2003.

powerful in combination with a number of other complementary factors. The main factors contributing to innovation in SMEs are:

- changes in salary structure;
- training of staff;
- capital investment in equipment;
- organizational change;
- new market strategy.

In most of the sectors surveyed, ICT contributes more to process innovation than to product and relational innovation<sup>19</sup>. The use of information systems is thus mainly for changes in production processes within the organization<sup>20</sup>, rather than the development of new products or the furthering of relationships especially with suppliers. It was demonstrated that relatively fewer firms report decreasing costs because of ICT. Automation is the adoption of control systems and ICT to reduce the need for human work in the production of goods and services<sup>21</sup>. In the scope of industrialization, automation is a step beyond mechanization. Whereas mechanization provided human operators with machinery to assist them with the muscular requirements of work, automation greatly decreases the need for human sensory and mental

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<sup>19</sup> See CAPRIGLIONE - CASALINO, *Improving Corporate Governance and Managerial Skills in Banking Organizations*, in *International Journal of Advanced Corporate Learning (iJAC)*, vol. 7, no. 3, Austria, 2014.

<sup>20</sup> See D'ATRI - DE MARCO - CASALINO, *Interdisciplinary Aspects of Information Systems Studies*, Germany, Physica-Verlag, Springer, pp.1 - 416, 2008.

<sup>21</sup> See CASALINO - DI PERSIO, *Integrating medical services, training and education: the Hermes project platform*, in *ATL - Advanced Technology for Learning Journal*, ACTA Press Anaheim - Calgary - Zurich, Vol. 1, Issue 2, pp. 71 - 80, 2004.

requirements as well. Automation plays an increasingly important role in the world economy and in daily experience. Automation has had a notable impact in a wide range of industries beyond manufacturing (where it generally originated). In general, automation has been responsible for the shift in the world economy from industrial jobs to service jobs. The result has been a rapidly expanding range of applications and human activities. Design and manufacturing of products are important for information technology industry and can assist design, implementation, and monitoring of control systems.

4. Well-functioning and sustainable mechanisms for SMEs financing require institution building and a market approach. Lending institutions must improve their ability to provide financial services to SMEs through commercial mechanisms that lower costs and minimize their risk exposure. Only in this way will financial institutions find SME lending to be more profitable, and thus be encouraged to construct lending programmes targeted at SMEs.

There are also a number of trends in the financial services industry that are forcing banks<sup>22</sup> to have a closer look at the SME markets. Globalization trends are increasing competition especially for servicing large corporate customers and driving down margins and fees. The improving liquidity of securities markets in many countries is increasingly providing large corporations direct access to the capital markets and allowing them to bypass financial intermediaries. Therefore, banks are under increasing pressure to expand their

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<sup>22</sup> See CASALINO - MAZZONE, *Externalization of a banking information systems function. Features, regulatory and critical aspects*, in *The Interdisciplinary Aspects of Information Systems Studies*, D'ATRI - DE MARCO - CASALINO (eds), Physica-Verlag, Springer, Heidelberg, Germany, pp. 89 - 96, 2008.

business<sup>23</sup> towards SME customers and to develop mechanisms to improve the profitability of lending to SMEs.

To compete effectively in the SME financing sector, banks need to provide financial services that meet the specialized needs of SMEs while coping with the high risks and costs associated with servicing them. To achieve this, an increasing number of banks<sup>24</sup> have adopted separate strategies to service SME customers. The current trend is to shift from a product-based focus to a more customer oriented focus of providing packages of financial services tailored to their needs. This has the potential of considerably improving the banks' relations with the SME sector, as well as increasing the profitability of providing financial services to it. The main initiatives undertaken by banks to support better the SME sector include<sup>25</sup>:

- reducing information asymmetry of SMEs and high perceived risks by using credit scoring systems; adopting reliable information providers and risk self-assessment for the SME entrepreneurs; assessing the level of risk; sharing risk with third parties; and setting up special support units for high risk customers such as the start-ups;

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<sup>23</sup> See USKOV - CASALINO, *New Means of Organizational Governance to Reduce the Effects of European Economic Crisis and Improve the Competitiveness of SMEs*, in *Law and Economics Yearly Review Journal*, vol. 1, part 1, pp. 149 - 179, Queen Mary University, London, UK, 2012.

<sup>24</sup> See CASALINO - MAZZONE, *Externalization of a banking information systems function. Features, regulatory and critical aspects*, in *The Interdisciplinary Aspects of Information Systems Studies*, D'ATRI - DE MARCO - CASALINO (eds), Physica-Verlag, Springer, Heidelberg, Germany, pp. 89 - 96, 2008.

<sup>25</sup> See UNCTAD/ITE/TEB/Misc.3, United Nations Conference on Trade and Development, *Improving the Competitiveness of SMEs in Developing Countries, The Role of Finance to Enhance Enterprise Development*, public report, United Nations, New York and Geneva, 2002.

- reducing costs of lending by applying latest information technologies<sup>26</sup>; streamlining the organization and simplifying the lending process;
- developing products better adapted to SME's needs;
- improving financial services for SMEs through training of bank staff and the segmentation of SME customers;
- cooperating with SME organizations and other business development providers in order to reduce risks and costs and combine financial with non-financial services.

5. As regards innovation transfer, Joseph Schumpeter is often mentioned as the first economist having drawn attention to the importance to it, defining five types of innovation ranging from introducing a new product to changes in industrial organization. The Oslo Manual clarified the definition of the two more technical definitions but still it appears that "innovation" is not easy to define precisely<sup>27</sup>. Some researchers gave approximately definitions<sup>28</sup> on:

- Science: how to understand things;
- Technology: how to do things;
- Management: how to get things done;
- Creation: bringing into existence;
- Invention: devising something new or a new way to do things;

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<sup>26</sup> See DE MARCO, *Le metodologie di sviluppo dei sistemi informativi*, Franco Angeli, Milan, 2004.

<sup>27</sup> See OCDE, *Oslo Manual: The Measurement of Scientific and Technological Activities. Proposes Guidelines for Collecting and Interpreting Innovation Data*, Paris, France, 2005.

<sup>28</sup> See BOURNE - MILLS - BICHENO - HAMBLIN - WILCOX - NEELY - PLATTS, *Performance Measurement System Design: Testing a Process Approach in Manufacturing Companies*, in *International Journal of Business Performance Management*, vol. 1 issue 2, pp. 154 - 170, 1999.

- Innovation: turning an idea into income.

The innovation is a science and explains what innovation and creativity means by these simple formulas<sup>29</sup>:

*1. Creativity = Idea + Action*

By this, Archibald means that the “idea” is just the beginning to create something. People must do something to bring the idea and create something.

*2. Innovation = Creativity + Productivity*

In real terms the sequence is: get an idea, test or prototype it, produce a finished item and bring it into use. In the case of artists, this corresponds to: get inspiration, sketch it, put it down on canvas, and finally exhibit the work. For many businesses, the ultimate goal is the idea to produce profit. In this case, innovation must come from ideas that lead to sales.

*3. Profitable Innovation = Innovation + Marketing*

The innovation process is a combination of various activities starting from research but including design, market investigation, process development and may include organizational restructuring, employee development, etc. Innovation implies creativity and dynamism that will benefit the company and result in a higher standard of living. However, as a conclusion it must be kept in mind that measurement of innovation is very difficult. Technology transfer is the process by which existing knowledge<sup>30</sup> and capabilities developed under public R&D funding are used to fulfil public and private needs. Besides an organization must become a learning organization and there must be a constant

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<sup>29</sup> See ARCHIBALD, *Innovation and creativity*, UK Idea, Scotland, 2012.

<sup>30</sup> See CARNEIRO, *How does knowledge management influence innovation and competitiveness?*, in *Journal of Knowledge Management*, Vol. 4, No. 2, pp. 87 - 98, 2000.

and unstinting market focus. Market and learning orientation are less formal, less structured<sup>31</sup>, and less progressive in SMEs<sup>32</sup>. Learning-orientation “is a mechanism that directly affects a firm’s ability to challenge old assumptions about market and how a firm should be organized to address it”. SMEs have a natural advantage in that it is easier to create a learning environment in smaller organizations<sup>33</sup>.

Specifically, organizational learning is a workplace learning, which is a lower-level learning style involving the use of existing knowledge to enhance operation efficiency in SMEs<sup>34</sup>. To expand, a learning organization can be described as possessing:

- commitment to learning: the degree to which an organization values that which promotes a learning culture by believing that learning is key to improvement and competitive advantage;
- shared vision: an organization-wide focus on learning, or direction of learning that is evident across all levels of an organization;
- open-mindedness: willingness to critically evaluate the organization’s operational routine and to accept new ideas by continually judging the

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<sup>31</sup> See GIBB, *Small firms’ training and competitiveness: building upon the small business as a learning organization*, in *International Small Business Journal*, 15, pp. 13 - 29, 1997.

<sup>32</sup> See MEZIOU, *Areas of strength and weakness in the adoption of the marketing concept by small manufacturing firms*, in *International Small Business Journal*, 29, pp. 72 - 78, 1991.

<sup>33</sup> See SINKULA - BAKER, *Learning orientation, market orientation and innovation: integrating and extending models of organizational performance*, in *Journal of Market Focused Management*, 4, pp. 295 - 308, 1999.

<sup>34</sup> See KESKIN, *Market orientation, learning orientation and innovation capabilities in SMEs: an extended model*, in *European Journal of Innovation Management*, 9 (4), pp. 396 - 417, 2006.

quality of decisions<sup>35</sup> and activities taken and perceptions about marketplace;

- intra-organizational knowledge sharing: collective beliefs or behavioural routines related to the spread of learning among different units within the organization by having mechanisms for sharing lessons learned in organizational activities from department to department (unit to unit, team to team).

6. A new flexible production system involves many changes into firm's organization chart with the increasing use of automation, often pointing out the problem of the lack of trained staff. Indeed, very few workers were able to actively practice with new technology. This structure has to be modern and efficient and its staff have to be extremely skilled. Staff has to use the best technology available at the moment in the market (PLC, systems' controls, numerical controls, systems of distributed automation, industrial technologies, barriers of protection, etc.). The business structure must integrate and elaborate information coming from different sources, considering the operational needs of each firm.

As it regards the different business functions, they must be shaped so that results are accessible from this information. It is necessary to improve competences to allow solutions of personalized automation. We analyse in the detail the main competences. The technical person must also take care of the

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<sup>35</sup> See CASALINO - D'ATRI, *Quality, usability and economical aspects in a medical web-based training service*, 4th IASTED International Conference on web-based education - WBE 2005, Grindelwald, Switzerland, ACTA Press, Vol., Zurich, pp. 304 - 310, 2005.

management of the cars related to specific phases of the production trial and must verify the conformity of the result in comparison to the standards, affecting the necessary regulations and intervening on possible anomalies. The technical staff must be able to use the principal programming languages and application, developing the ability to work in team and for objective, using different methodologies, as for instance the project management. The principal occupations are assembled in the technical offices and in the centres of research and development<sup>36</sup>. Some unit profiles:

- the *technician*, in collaboration with administrative personnel, develops experimental researches using all necessary competences for the carrying out of the activities;
- the *engineer of trial* is the person who knows the trial that must be automated. In most cases, he coincides with the planner (mechanic) head;
- the *electric planner* designs the structure of the electric system that the cars and the different uses of the production trial;
- the *expert of field* defines typology, position and technical specifications of several sensors and essential actuators to check and watch the trial;
- the *planner of automatic controls* is traditionally also an expert of measures and covers the necessary competences of an expert of field. They define the control system architecture and the specifications;
- the *person responsible for maintenance* is another figure whose role is increasingly growing;

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<sup>36</sup> See D'ATRI - DE MARCO - CASALINO, *Interdisciplinary Aspects of Information Systems Studies*, Germany, Physica-Verlag, Springer, pp. 1 - 416, 2008.

- the *person of maintenance of automation* must know how to distinguish between corrective maintenance and improved maintenance.

Then the role of management, it is to improve the quality of the products, the flexibility, to reduce the times of production, to adjust laws and rules and to improve the use of the available resources<sup>37</sup>. This is possible by means of suitable choices of investment, actions of marketing and naturally through an adjusted plan of production. This last phase must be managed through a fit allocation of human resources and with the control of the productive trials making use of automation. As it regards the control of the production trials, the principal problem is the quick obsolescence of the firm's products. The solution is therefore the use of flexible systems of production that develop, in an automatic way, different products. Therefore, we can distinguish three types of competences to recognize industrial automation:

- *methodological competences*. The figures have technical competences, tied to the routine of automation;
- *technological competences*. Methodological competences are realized in solutions implemented through technologies therefore technological competencies are necessary for those who are working with industrial automation;
- *competences of trial*. Automation requires knowledge<sup>38</sup> on the trials to automatize. Rather, experience shows that the automation of a productive

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<sup>37</sup> See KESSLER - CHAKRABARTI, *Methods for improving the quality of new product innovations*, Portland International Conference on Management and Technology, PICMET, pp. 405 - 408, 1997.

<sup>38</sup> See CARDINAL - ALESSANDRI - TURNER, *Knowledge modifiability, resources, and science-based innovation*, in *Journal of Knowledge Management*, Vol. 5, No. 2, pp. 195 - 204, 2001.

trial often induces to find formal and general descriptions of the same process;

- *technological complexity*. Technological complexity should not be too far ahead of scientific understanding, as it would limit the commercial viability of the innovation by being too sophisticated for the end-user.

7. SMEs are generally resistant not only to training but also to other forms of wider participation. Generally, they also engage in less management development activities than larger firms. Their managers are much less likely to have formal appraisals or discussions on their training needs<sup>39</sup>. SMEs must still provide the ability for managers to learn by experience, bringing their knowledge, skills and values into the workplace and putting them into practice. Inevitably, these resources are limited and sometimes inadequate. This can be potentially harmful for an organization, sacrificing the strength and consistency of its culture to achieve short-term gain.

AutoMatic project, titled "Development of curriculum and innovative training tools for industrial automation systems for people employed in SMEs" addresses the problem of low or missing overview about possibilities offered by industrial automation systems. It develops approaches and learning materials directed specifically to SMEs to qualify staff in terms of industrial automation

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<sup>39</sup> See LUKAS - FERRELL, *The effect of market orientation on product innovation*, in *Journal of the Academy of Marketing Science*, 28 (2), pp. 239 - 247, 2000.

systems<sup>40</sup>. AutoMatic has been selected for co-financing under the Lifelong Learning Programme, Leonardo da Vinci, Transfer of innovation projects (Leonardo da Vinci Transfer of Innovation; ID LLPLINK: 2009-1-BG1-LEO05-01640). The project website is available on [www.automatic-project.eu](http://www.automatic-project.eu).

The topic of innovation is addressed twofold in the project AutoMatic. On the one hand, a new learning approach in the field of industrial automation addressing the needs of small companies is developed; on the other hand, innovation processes supported by information and communication technologies are directly addressed by one of the five modules included in the project and are subject of all modules.

**Figures 1 – 2)** Some screenshots of the main pages with the training courses available in the Automatic Project website



<sup>40</sup> See CASALINO, *An Innovative Model of Transnational Learning Environment for European Senior Civil Servants - Organizational Aspects and Governance*, 11th International Conference on Enterprise Information Systems - ICEIS, Milan, Italy, INSTICC, pp. 148 - 153, 2009.

During the project has been developed an innovative training approach e-learning platform, several learning contents and specific simulation tools<sup>41</sup> in the field of industrial automation systems, which are applicable in European SMEs. AutoMatic builds upon an existing approach developed in the pilot project “International Curricula of Mechatronics and Training Materials for Initial Vocational Training” for vocational schools developed by Tallinn Technical University, Estonia.

The project consortium is composed by:

- Gabrovo Technical University, Bulgaria - [www.tugab.bg](http://www.tugab.bg) (project promoter and coordinator);
- ECQ - European Centre for Quality, Sofia, Bulgaria - [www.ecq-bg.com](http://www.ecq-bg.com) (project coordinator);
- Tallinn University of Technology, Estonia - [www.ttu.ee](http://www.ttu.ee);
- LUISS Guido Carli University, Rome, Italy - [www.luiss.it](http://www.luiss.it);
- Multidisciplinary European Research Institute, Graz, Austria - [www.merig.org](http://www.merig.org).

Target groups are practitioners in SMEs who intend to get an introduction and overview about industrial automation processes are the main target group of AutoMatic. The project also addresses students in vocational education as end users as well as teachers and trainers as intermediates. The developed products can support SME employees that want to improve their

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<sup>41</sup> See CASALINO, *Simulations and Collective Environments: New Boundaries of Inclusiveness for Organizations?*, in *International Journal of Advances in Psychology (IJAP)*, Vol. 3, Iss. 4, USA, 2014.

qualification or re-qualify and need to increase their flexibility with respect to market demands and successful realization on the common labour market<sup>42</sup>.

**Figures 3 – 4)** Some screenshots of exercises and simulations available in the Automatic Project website



Between the results achieved, interactive training tools for industrial automation systems were developed. More specifically innovative curricula and the following 5 training modules targeted at SME management and staff:

- ICT Based Means for Automation and Innovation;
- Sensors in Industrial Automation;
- Actuators in Industrial Automation;
- Application of PLC in Industrial Automation;
- Industrial Networks and Interfaces in Automation Systems.

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<sup>42</sup> See CASALINO - D'ATRI - FADDA, *Organisational impact and exploitation of the results of an Italian re-search project for e-health and medical training*, ECIS 2005 - European Conference on Information Systems, Regensburg, Germany, 2005.

8. To understand the typology of the professional and specialized contents, follows a short description of the training modules:

The first module "ICT based means for automation and innovation" is dedicated to the managerial aspects of automation and innovations in small and medium enterprises. In it is given an analysis of their impact on SMEs and what are the main reasons to be used automation in the industry. The high flexibility of SMEs makes them the perfect companies, which via automation will achieve sustainable economic development based on innovation and job creation.

The training module "Sensors in Industrial Automation" presents basic knowledge about sensors used in automation systems. In this is given a classification of sensors separating them as temperature, force and mechanical stress, pressure, position, displacement, velocity and acceleration, flow, humidity and gas sensors. The requirements and the basic principles of sensors are also discussed.

The module "Actuators in industrial automation" describes different types of actuators used in automated systems. It is given a classification of these devices. The module includes information about the principle of operation of electric drives (converting electrical into mechanical energy, types of motors, the classes of protection), about the principle of electric frequency converters, soft starters, different motors and servos. There are presented electromagnetic actuators and solenoids with linear and rotational motion. It is given description about hydraulic and pneumatic actuators and different types of valves used in these devices. There is also review of industrial robots and examples of their use in the various fields of industry.

The main purpose of the module "Application of PLC in industrial automation " is to give basic knowledge about programmable logic controllers. Here is described the hardware components of the PLC, the existing types of PLC and the principle of their operation. It is given a review of PLC programming languages, structure of PLC programs, data types, variables addressing, the basic principles of Boolean logic and the corresponding Boolean logic functions. There are presented mathematical functions and functions for data conversion. In the module are observed different types of proportional-integral-differential (PID) controllers and their behaviours. At the end of the module are presented sample applications with the relevant PLC control programs and explained the main requirements how to be selected the proper PLC.

The module "Industrial networks and interfaces in automation systems" examines the utilization of standard interfaces and networks in automation systems. In the module are described the characteristics of modern control systems with network communication. Discussion in the text is mainly on types of communications networks, network models and topologies, physical and logical structure of the networks and the characteristics of industrial networks.

A special part also is dedicated to the specifications of several networks as Profibus, CAN, ControlNet, Ethernet and others.

The modules ICT Based Means for Automation and Innovation, Sensors, Actuators and the Application of PLC in Industrial Automation, as well as Industrial Networks and Interfaces in Automation Systems consist of text based materials interactive examples, exercises and a self-assessment tool. AutoMatic materials are designed to be used in course based training sessions, but at the

same time support individual learning. In AutoMatic platform was integrated a “virtual teacher” that speaks slowly, with a clear voice and a perfect intonation. Therefore, AutoMatic proposes an innovative approach for the training with a virtual teacher that holds the lessons, so that the distance training is combined with a similar direct contact<sup>43</sup>.

AutoMatic platform also offers auto-evaluation forms through which the learners can verify the acquired knowledge level. Such forms, at the end of every subject, allow the worker to verify immediately the acquired knowledge through the portal. Four different sections were developed for each training module:

- training courses;
- exercises;
- self-assessment;
- links & references.

The learning tools and materials are available in 5 languages: English, Bulgarian, Estonian, German and Italian. The learning tools and materials are available on-line, on dvd and on traditional booklets.

To explore the link between innovation and efficient production in the SMEs, we conducted a multiple-case study using in-depth interviews with

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<sup>43</sup> See CASALINO - BUONOCORE - ROSSIGNOLI - RICCIARDI, *Transparency, Openness and Knowledge Sharing for Rebuilding and Strengthening Government Institutions*, in KLEMENT - BORUTZKY - FAHRINGER - HAMZA - USKOV, *Web-based Education - WBE 2013*, IASTED-ACTA Press Zurich, Innsbruck, Austria, 2013.

representatives of SMEs to find commonalities and success factors. The main practical results arisen<sup>44</sup> are the following:

- increased flexibility of SME employees who want to improve their qualification;
- increased motivation of target groups and their commitment for life-long learning and career planning;
- a good impact on the quality of vocational training and international co-operation in the area of industrial automation systems by providing time-saving and user-friendly approaches.

9. One of the principal ways to increasing the access of small businesses to formal financial services is to create conditions that encourage financial institutions to serve small businesses. The old unprofitable approach of providing limited services to a limited number of customers' needs to be replaced by a "mass-customized approach" that uses technology to increase the number of small business clients but at the same time reduces transaction costs, improves asset quality and broadens service offerings. The result is a business model that offers a complete set of financial services tailored to the needs of individual small business clients with an improved bottom-line contribution per customer, thus enhancing profits for banks.

Studies on the process of information technology acquisition<sup>45</sup> clearly show that these systems go through several evolutionary stages. During this

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<sup>44</sup> See VERHEES - MEULENBERG, *Market orientation, innovativeness, product innovation and performance in small firms*, in *Journal of Small Business Management*, 42(2), pp. 134 - 155, 2004.

development the priority in order to succeed doesn't seem to be tied only to the acquisition process, but mainly to the paths of learning and organizational change<sup>46</sup>.

Experience suggests that these paths should be designed and carefully managed in order to allow the acquisition and effective use of ICT applications by the users and the whole enterprise. The traditional methodology for the training, in fact, results incomplete to furnish a suitable medium in the professional training field, because of dynamic and continuous changes in the ICT sector and the increasing demand of knowledge more and more in the quality field<sup>47</sup>. AutoMatic can really contribute to the success of the SMEs. The strategy is based on the creation of a system for the training that meets the distance learning with the traditional benefits; therefore, the two different methodologies are integrated. In fact, on one side, the distance statement is a comfortable method for the training of a vast entourage of people within automation, but on the other hand, many people does not believe in the effectiveness of such method of statement because of the lack of an instructor that mostly involves the trainees.

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<sup>45</sup> See KENNERLEY - NEELY, *Measuring performance in a changing business environment*, in *International Journal of Operations and Production Management*, vol. 23 issue 2, pp. 213 - 229, 2003.

<sup>46</sup> See CASALINO, *Gestione del cambiamento e produttività nelle aziende pubbliche. Metodi e strumenti innovativi*, pp. 1 - 201, Cacucci, Bari, Italy, 2008.

<sup>47</sup> See CASALINO - ARMENIA - CANINI, *A system dynamics approach to the paper dematerialization process in the Italian public administration*, in *The Interdisciplinary Aspects of Information Systems Studies*, D'ATRI - DE MARCO - CASALINO (eds), Physica-Verlag, Springer, Heidelberg, Germany, pp. 399 - 408, 2008.

The professional contents developed for AutoMatic project can be used to improve the qualification of people working in small and medium enterprises, for retraining and achieving a greater flexibility on the labour market. They can also be used by students, consultants and professionals for their advanced training in all the fields related the manufacturing automation.

The research project activities included also the analysis of some indicators and specific key aspects that regard the current situation of automation and innovation culture in the European SMEs. These are:

- what is the current situation of quality aspects dissemination through on-line courses?
- how are the main models used and applied?
- what role can have national agencies or institutions, as the universities, on the diffusion of innovation culture<sup>48</sup> or the implementation of automation for SMEs through both traditional and web-based learning?
- how organizational and cultural specificities affect automation implementation?

The importance of automation is increasing for the reason that lack of quality control and assurance systems<sup>49</sup>, lack of accreditation and certification procedures, poor conformity marks, are still diffused. Such impediments are considered as major potential and unnecessary technical barriers to trade,

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<sup>48</sup> See JIN, *Organizational innovation and virtual institutes*, in *Journal of Knowledge Management*, Vol. 3, No. 1, pp. 75 - 83, 1999.

<sup>49</sup> See CASALINO - D'ATRI - MANEV, *A quality management training system on ISO standards for enhancing competitiveness of SMEs*, 9th International Conference on Enterprise Information Systems - ICEIS 2007, Funchal, Madeira, Portugal, INSTICC, pp. 229 - 235, 2007.

especially concerning international competitiveness and globalization<sup>50</sup>. It is important to underline that SMEs consolidated experiential capital<sup>51</sup> have to meet rapidly and effectively the challenges of globalization and the new knowledge-driven economy aims.

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<sup>50</sup> See FONTANA - LORENZONI, *Il Knowledge Management*, LUISS University Press, Rome, Italy, 2004.

<sup>51</sup> See MARR - GRAY - NEELY, *Why do firms measure their intellectual capital*, in *Journal of Intellectual Capital*, Vol. 4, issue 4, pp. 441- 464, 2003.

**A CRISIS, PUBLIC POLICIES, BANKING GOVERNANCE,  
EXPECTATIONS & RULE REFORMS:  
WHEN WILL THE HORSE GO BACK TO DRINK?**

Marco Sepe\*

**ABSTRACT:** *This paper analyses the crisis that the Eurozone is going through. The focus is on the effort of monetary authorities and policies and on the proper functioning of the credit system intermediation valuing their effects to reverse the economic cycle in the Eurozone. Limits and controversial interventions set by national self-interest can paralyze or make this economic cycle macroeconomically less efficient. However, these interventions must result credible before being implemented and administrated. This credibility in itself can sometimes be sufficient to achieve the objectives, as confirmed by the story of spreads on government bonds.*

**SUMMARY:** 1. Introduction – 2. The limits of public policies: monetary policy... - 3. *(continued)* ... and the government policies (budgetary, fiscal and structural) – 4. The need for a combination of the intervention policies and the relevance of the transmission belts for policies – 5. The current situation and the possible measures on expectations and rules.

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\* Marco Sepe is Full Professor of Law and Economics at Università Unitelma La Sapienza in Rome

1. The crisis that the Eurozone is going through is far deeper than the Great Depression of the 30s and the “light at the end of the tunnel”, by some glimpsed at the beginning of this year, is risking to be nothing more than a mirage. This is the trivial consideration that emerges from the discouraging data that, this September, was recorded by the European (Eurostat)<sup>1</sup> and National (Istat)<sup>2</sup> statistical agencies, which indicate how the weak economic recovery in the first months of the year has lost momentum and is showing signs of falling back on a marshy stagnation, if not on a new recessive spiral.

The issue is not just the size in absolute or relative terms of the re-dimensioning of the fundamentals of the economies<sup>3</sup>, but the duration of the re-dimensioning cycle, which has now reached the biblical “lean cow”<sup>4</sup> seven years and continues to mark a paved path of suffering, poverty, social indignation and anger<sup>5</sup>, to whom the Old Continent is still unable to give adequate and convincing answer, wrapped in the debate between the

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<sup>1</sup> Inflation down in the Eurozone from 0.4% to 0.4% on an annual basis and GDPs of the major countries essentially stagnant, with a sharp slowdown in growth also in Germany.

<sup>2</sup> Italy in deflation for the first time since September 1959, with the consumer price index in August 2014 that marks a - 0.1% from the previous year; consolidation of the recession in the first trimester, with gross domestic product still in contraction, on August 6th, at a -0.3% on an annual basis; unemployment increased by 0.2 percentage points to 12.6%, with the juvenile unemployment reaching the threshold of 42.9%.

<sup>3</sup> The real GDP in Italy from 2008 to 2013 included has dropped of about 8,9% and in the Eurozone of the 2,6%

<sup>4</sup> See Genesis, 37,2-48,22

<sup>5</sup> See CAPRIGLIONE – TROISI, *L'ordinamento finanziario dell'UE dopo la crisi*, Utet, 2014, p. IX of the presentation.

supporters of a Lutheran rigorism and a Neo-Keynesianism that finds in the abeconomics its most complete expression<sup>6</sup>.

And as with all dialectics, the spread rising, from one side to another, of extremist voices does nothing but exacerbate the terms of the debate, with consequences both in terms of domestic<sup>7</sup> and foreign<sup>8</sup> policy and in terms of institutional relations, being at least unusual (if not "out of line", in the light of the principle of independence of the ECB placed by art. 130 of the TFEU and its Statute), that the Minister of Finance of one of the member countries, would

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<sup>6</sup> As known the Abeconomics, launched in the Spring 2013 by the Japanese Prime Minister Shinzō Abe, in order to lift Japan from decades of economic depression that struck it, is based on three principles: a) highly expansionary monetary policy to: 1) counteract the chronic deflation and increase inflation (with significant benefits in the public debt); 2) depreciate the yen in order to promote Japanese exports threatened by Chinese competition; 3) to maintain interest rates at very low or in negative (in order to discourage savings); b) budgetary and fiscal policy marked by a sharp increase in public spending (plus 1.5%), so to reach 11.5% in Public deficit.

<sup>7</sup> The reference is, among other things, the position adopted by 54 members of the Democratic Party (the majority party in Italy), which were in favor of abolition, even by referendum, of the obligation to balance the budget, as set out in Article 81 of the Constitution, following the reform to Constitutional Law 1/2012, an obligation which constitutes one of the cornerstones of the Treaty on stability, coordination and governance in the Economic and Monetary Union (known as the Treaty on the fiscal compact) signed in Brussels March 12, 2012 by all EU countries (with the sole exception of the United Kingdom and the Czech Republic).

<sup>8</sup> It is the case of the position taken by the French Minister of Economy Montebourg, supported by his colleague for Education Hamon, that, in criticizing "the German obsession" and its management for budgetary rigor, had asked for a change of direction of the French government on economic matters, considering it necessary to "give priority to the exit from the crisis and overshadow the dogmatic deficit reduction that leads to austerity and unemployment." This firm position, not appreciated by the German partners (as explained Finance Minister Schauble) brought on August 25 to the resignation of Prime Minister Valls and the formation by the same of a new executive on behalf of the President Hollande.

make himself public interpreter of the thoughts of the ECB president<sup>9</sup>, and that to this follows a phone call (no matter if outgoing or incoming) by the Head of the Government of the same Country to get “clarifications on the question”<sup>10</sup>.

Specifically, the “casus belli” was the speech given by the President of the ECB, Mario Draghi, at the bank’s annual symposium, held in Jackson Hole, on August 22<sup>nd</sup>, concerning unemployment in the United States and the Euro Area<sup>11</sup>.

In his speech, Mario Draghi highlighted that the unemployment trend in the United States and in the Euro area was essentially the same from 2008 until the beginning of 2011 when it stretched apart (with a decrease in the United States and an increase in the Euro Zone), re-conducting this split to cyclic and structural factors.

Furthermore, after the crisis of financial institutions, in the USA, despite the size of public debt, there has not even been the sovereign debt crisis that affected many EU countries, in which (and primarily in Italy) the liquidity provided by the Central Bank to the circuit of intermediaries has been largely diverted to meet the need of the public debt, thereby subtracting resources to investments and growth.

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<sup>9</sup> Schauble: Draghi frainteso sul rigore. Il corso della BCE non è cambiato, in [corriere.it](http://corriere.it), where the Minister words are “I know Mario Draghi very well, i think his words have been misunderstood”.

<sup>10</sup> For all see, “*La telefonata di Merkel a Draghi e i timori tedeschi sull’addio al rigore*”, in [corriere.it](http://corriere.it), where the renewed German proposal to establish an European Commissioner with a Veto on the financial laws of individual countries is also shown.

<sup>11</sup> It can be read on [www.ecb.europa.eu](http://www.ecb.europa.eu).

The conclusion reached by Draghi is that the complexity of the unemployment phenomenon in the Euro Zone (in other words, the exit from the ongoing crisis situation) must be based on coherent policies, which operate on both the demand and supply side, both at national and European level and, therefore, on an overall strategy that combines monetary, budgetary, fiscal policies and structural reforms.

The stakes consist in the "monetary union" itself, considering that, in the long term, the adhesion of individual countries to the Euro, is not possible without sustainable levels of employment and, given the costs of fragmentation / pulverization of the single currency, each country should have an interest in avoiding it.

Indeed, it seems inappropriate and excessive to ascribe to the text of the speech, the metamorphosis into a "dove" of the President of the ECB - where it suggests that "the flexibility present in European standards could be used to better support the weak economic recovery and to cover the necessary structural reforms", without mentioning explicitly the budgetary rigor - considered that the reference to its rules (and not to any exemptions) and to the posts set by it, although considered to be very high, doesn't seem to be a suggestion or an "endorsement" to the governments where the crisis bites more, to question its respect.

If anything, it is highlighted the urgency of a strong "exit strategy" from a crisis now too persistent, whose social costs undermine, at its very foundations,

the monetary union, where it is emphasized that "the risk of doing too little is greater than that to do too much"<sup>12</sup>.

However, it doesn't seem common heritage of the members of the Governing Council of the ECB, the option for a medicine that quickly crushes the disease, while making the patient exposed to new (and different) infections, to be dealt with by appropriate checks and balances, rather than a wait and see therapy that, sipping the dosage to avoid potential imbalances, definitively and irrevocably debilitates the patient already at the end of their tether.

If nothing else, it demonstrates the fact that the ECB, since the beginning of the year, announced and made a number of progressive measures of expansive character to support the economy that could also be the subject of a unitary and total package (and therefore probably have a greater impact on expectations), and also the last decision of the past 4th September to lower interest rates by 0.10 basis points (similar to the one of the 11th June last year) has been taken only by a majority, although extensive, as pointed out by its own President.

Furthermore, the monetary lever, beyond the different accents and interpretations of the role it should play in the promotion of the public welfare, can not make up for the shortcomings of government policies remains authoritatively carved by Draghi's words, in his last public appearances, has

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<sup>12</sup> This statement, for some analysts and commentators, was assonant to the "whatever it takes" pronounced in the summer of 2012, in the middle of the sovereign debt crisis, in which the President of the ECB announced interventions on the secondary market in support of government bonds of countries in difficulty, and that led to the collapse of the spread Bund / BTP from 500 points to around 140 – 150 today.

always advocated the need for a joint effort, a coordinated strategy, a "composite medicine" by a concerted "team of doctors", to address the insufficiencies and limitations of individual public policies, national and European, to cope with the continuing crisis.

2. The Monetary policy in the Euro area is in fact only supranational and at the same time this is an advantage (for the weight that the single currency takes in the international context), but also a limitation, since any national imbalances can not be offset by "regionalist" monetary policies, although coordinated, such as those carried out by the central banks of each country prior to 1992.<sup>13</sup>

The conventional tools for monetary policy (maneuvers on interest rates<sup>14</sup>, open market operations<sup>15</sup> and reserve requirements<sup>16</sup>) and "non-

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<sup>13</sup> Similar considerations can be extended to the exchange policy, with the additional specification that the "specific weight" of the single currency in the world economy has resulted in an increase of the difficulties in the room for maneuver of the changes themselves.

<sup>14</sup> As it is known, the Governing Council of the ECB sets the rate of participation in the main refinancing operations (currently 0.05%, a record low), which is the rate at which the ECB is willing to transact with the market and therefore indicates the orientation of the monetary policy, as well as the interest rate for deposits at the central bank (or deposit rate for the over-night, currently negative - 0.20%, a minimum record) and the interest rate for the marginal lending facility (currently at 0.30%, a minimum record) rates that relate to operations to the standing counterparts and are, as a rule, the maximum and minimum values for the overnight interest rate.

<sup>15</sup> The open market operations, through which the ECB in order to achieve price stability, influences the conditions of the money market and, therefore, the level of interest rates short term, are of four types: a) the main refinancing consisting of regular liquidity-providing operations with a weekly frequency and a maturity; b) refinancing long-term, substantial operations in liquidity with a maturity of three months; c) tuning, which have no pre-established date and are meant to regulate unforeseen fluctuations in liquidity or interest rates; may be refinancing or deposit; d) structural type.

conventional"<sup>17</sup> ones, if not used wisely and appropriately dosed, can be inefficient and can present any contraindications.

Specifically, the bearish maneuvers on rates become much more insensitive as lower the level of these diminishes and make the monetary policy ineffective, being it clear that interest rates close to zero or even negative, not necessarily decrease the saving and hoarding propensity, in an economic environment characterized by uncertainty (also due to geopolitical factors<sup>18</sup>), with stagnant growth prospects and deflationary tendencies.

Ordinary liquidity injections, mainly oriented towards the short term, are unsuitable to deal with a crisis whose time profiles have gradually lengthened, and those "unconventional" - beyond the risks associated with increases of the inflation in relation to their size and the "laziness" that could generate in national governments (in the adoption of the reforms needed to stabilize the

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<sup>16</sup> These are mandatory deposits of banks on accounts from the same turned on at the national and individual NCBs, which are remunerated at the rate on the main refinancing operations. The maneuver on minimum reserves may relate to both the reserve base, and the rate of reserve that the remuneration (in this case only the latter case is considered ordinary measure).

<sup>17</sup> Are amongst these, the provision of liquidity at a fixed rate with full allotment, the expansion of assets eligible as collateral, the provision of liquidity in the longer term, the provision of liquidity in foreign currency purchases definitive of certain public and private debt securities, structured or not, and the change in the reserve requirement ratio. In any case, the rules that govern the operations of the ECB to allow this flexibility very large and very diverse modes of intervention, in order to maintain and restore the transmission mechanism of monetary policy. Specifically, the most significant changes of the ECB in the period 2010-2012 involved the activation of the Securities Market Programme (SMP), the Longer Term Refinancing Operations (LTROs) and the announcement of Outright Monetary Transactions (OMT).

<sup>18</sup> Among these primarily, the worsening of the crisis Ukraine and the increasingly explosive situation on the different fronts in the Middle East.

public finances) – introduce uncertainties linked to their actual incidence and destination.

It is no coincidence that the debate on the program of "quantitative easing" in the Eurozone finds points of friction not only on the sizing and on the possible effects of the same<sup>19</sup>, but also on the mode of application, in a context characterized by a plurality of States with economic fundamentals that are still divergent, even in a common process of gradual deterioration; making it questionable whether to realize this program primarily through the purchase of securities of issuers (public as well as private) of the countries in greatest difficulty (and therefore in view of solidarity) or by spreading purchases on the basis of the shares in the capital of the ECB<sup>20</sup>.

Then, when it comes to private securities, like the case of the announced program to purchase Covered Bonds and ABS (asset backed securities), that is guaranteed securitized securities, representing loans to businesses and households, held by vehicles mainly from banking, the limit - and it could not be otherwise - is represented by the fact that the ECB can only buy "titles simple and transparent," and characterized by "seniority" that comforts their goodness, not being permissible that the ECB, in pursuing the monetary policy objectives, transfers in its budget excessive risks or ones difficult to control.

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<sup>19</sup> Perhaps for this reason, the President of the ECB, in the press conference following the meeting of the Board of Directors dated 4 September 2014, prompted by a question on the concept of "quantitative easing", he emphasized that in his view the concept in question has not got only a quantitative dimension, but also "qualitative", being all the interventions of the ECB's direct purchase of securities, previously only eligible as collateral or guarantee.

<sup>20</sup> See SARCINA, *Il corridoio (stretto) della Bce Ma ora anche la Bundesbank vede la frenata europea*, in *corriere.it* of the 19th of August 2014.

Then, when it comes to non-conventional measures involving injections of liquidity with a specific destination to the real economy (and thus with the specific objective of avoiding that they address and sell out in financial investments that merely reflect on the trends of interest rates and on the prices of financial assets) the actual fallout they have in the final overcoming of the "credit crunch" must be verified.

In particular, the Governing Council of the ECB, at its meeting of the 5<sup>th</sup> June 2014, launched a program for a number of long-term refinancing operations (TLTROs - Targeted Longer-Term Refinancing Operations) to support the process of bank lending to the non-financial private sector (households and non-financial firms)<sup>21</sup> and promptly covered by the Decision of the same ECB on July 29<sup>th</sup>, 2014 (ECB / 2014/34)<sup>22</sup>.

The program includes eight refinancing operations on a trimestral basis (of which the first two in September and December 2014) executed in a decentralized manner by the national central banks, using standard procedures auctions at a fixed rate corresponding to the rate for the main refinancing operations with the addition of a fixed differential of 10 basis points with interest payable in arrears at the expiration of (2018) or at the time of the early redemption.

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<sup>21</sup> The program in question, along with the announced purchase of covered bonds and ABS which should start in October 2014, are the last of the packages of non-conventional measures that the ECB has fielded since 2008, experiencing both the announcement effect and, if found necessary, the actual application. The unconventional measures occurred over time have had as main objectives initially support the banking sector, then the secondary market for government securities, and now the real economy.

<sup>22</sup> See it published in the *Official Journal of the European Union* 29.08.2014

In the first two operations, each participant is entitled to receive funding for an amount that does not exceed its initial credit limit, equal to 7% of the total outstanding stock of "eligible loans" on April 30, 2014, intending loans to non-financial corporations and households (including non-profit institutions serving households) residing in the Member States whose currency is the euro, with the exception of loans to households for house purchase<sup>23</sup>. For subsequent financing transactions, each participant is entitled to receive an additional upper limit that takes into account new "eligible loans" made.

The regulation, however, does not provide specific penalties, but that of early repayment on the 29<sup>th</sup> September 2016, for those banks that do not

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<sup>23</sup> The sterilization in the proportioning of the plafond of loans to households for house purchase - which would appear penalizing the private building sector, which is also severely affected by the crisis - is justified by the need to divert the injection of liquidity mainly to businesses and the recovery in consumption. On the one hand, don't seem to be excluded from the commensuration of the plafond the loans to construction companies who then will undertake their mortgage shares to the buyers; on the other hand, the connected transaction for the purchase of ABS can monetize for the own banking system, mainly the securitized mortgage loans related to private and home purchases already disbursed, with the possibility to mobilize new resources for the same purpose.

It should however be noted that in the amount of eligible loans the "securitized" ones shall not be included, even though the balance sheet, this confirms that the access to TLTROS is granted preferably only to those banking institutions that operate according to the typical pattern of "originate to hold" and not of the "originate to distribute". The affirmation of the "originate to distribute" model opposed to the "originate to hold" model, and in the absence of "lock in" clauses, was indeed one of the main reasons why scholars reconnect the outbreak of the crisis, as it has meant that banks, by providing credit or investing in financial assets to be sold, rather than keep, they place little attention in properly selecting and controlling applications. In other words, the financial system, and in particular the banking system, seem to have betrayed their "mission", their *raison d'être*, that of "professional evaluators of creditworthiness."

comply with the use of the financing<sup>24</sup>, so that only improperly we can speak about a "hypothecation," but rather of funding conditioned in their stay at the overall consistency of the "eligible loans" into being and, therefore, the commitment of the bank in the financing of the interested sectors.

Therefore, the actual transmission capacity to the real economy of the monetary stimulus in question will be verified<sup>25</sup>, in a context that also sees the ECB engaged, as holder of the supervisory functions, the verification of the suitability of the loans made.

However, it is clear that in the intention of the monetary authorities, the simultaneous launch of the purchase of covered bonds and ABS should have a multiplicative effect of the available resources for the TLTROs, in the case where the cash of the banking system coming from the sales transactions of CV and ABS would be used in loans to households and businesses, expanding the total amount of eligible loans under which is allocated the additional upper limit of the TLTROs.

More generally, it should be noted that the non-conventional measures taken by the ECB during the crisis and otherwise finalized, now in support of a macro economic sector, now of an other (and particularly the TLTROs recently launched), mark the final sunset of the rigorist interpretations about the absolute neutrality that should characterize the performance of monetary policy

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<sup>24</sup> The same penalty is provided for those who omit reports for the verification of the parameters and for the respect of the constraint.

<sup>25</sup> The circumstance that in the first operation in September 2014, the ECB has only allocated 82.6 billion to 255 banks in the Eurozone, compared to 150 estimated by analysts, is certainly not a good omen, although higher expectations are linked to the operation shall be of December.

and that consider the objective of price stability the only lighthouse of the latter.

In this context, the text of Articles 119, paragraph 2 and 127 paragraph 1 TFEU<sup>26</sup>, takes on a new meaning, reserving the monetary authorities an active role in support of economic policies and in the achievement of the general welfare, a role that can not be abdicated and that meets only the limit of the respect for the principle of an open market economy with free competition (as well as of the aforementioned inflation target).

3. If the monetary lever, considered in isolation, does not ensure the start of a solid and lasting recovery, even the national budgetary and fiscal policies, as well as structural reforms, meet political constraints, institutional and acceptability in an exhausted economic and social context , where the room for maneuver for policy makers is very small.

Specifically, fiscal policies based on the increase of expenses find their limit in the prohibition of excessive deficits as in art. 126 TFEU, including those arising from investment expenditures, as these are not yet legally excluded from the calculation of the deficit being only provided that the Commission, in its report that initiates the infringement procedure, must take *"into account also the possible difference between the government deficit and government spending for investments and .... all the other relevant factors, including the economic and budgetary position in the medium term of the Member State"*.

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<sup>26</sup> In them it is stipulated that the task of monetary policy, without prejudice to the primary objective (but not exclusively) of maintaining price stability, it is also to support the general economic policies in the Union, in accordance with the principle of a market economy open and free competition.

The advertisements of the policy aimed at excluding the investment expenditures (but then identify what falls within that definition) from the respect of the fateful 3% in the calculation of the deficit / GDP ratio are therefore misleading, or at least do not comply with the regulation, resulting at the time still in a mere wish of the treaty changes to be taken at European level<sup>27</sup>.

It is known, then, that expenditure policies considered by the markets less productive or sustainable, multiply their adverse effect on the deficit, providing an immediate effect on the cost of refinancing the stock of public debt.

Similarly, policies to reduce or reclassify expenditures (spending review), designed to make it more productive – so that to overcome the praxis of linear cuts that leave unaltered the margins of inefficiency of expenditures and the lack of ability to act as a driving force multiplier in some areas - collide against the income positions acquired, and against the limits of political and social acceptability of the policies themselves; all that in an exasperated socio-economic context, where the chance that entries that prospect politically apathetic drifts, if not anti-democratic are followed and heard rises.

Even fiscal policies, aimed at rationalizing and reducing the burden of a total pressure that has reached the limits of sustainability (id est: approaching and, according to some calculations, surpassing countries such as Italy half of

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<sup>27</sup> Different arguments are not deducible from the Treaty on the “fiscal compact”.

the income produced), denounce limitations and obstacles which go beyond the need to maintain the stability and consolidation of accounts.

In the situations in which they do not resort to quick-fix interventions, which bring little benefit, where it is necessary to defibrillate the economy with strong jolt, the assumption of policy choices that favor families and consumption or business and work, raise controversies and discussions that have sometimes taken the accents of the "chicken" quarrels, familiar to Manzioni, by postponing or sometimes preventing the adoption of concrete initiatives, which should focus on those areas where the "fiscal multiplier" is more elevated<sup>28</sup>.

Finally, also structural reforms, intending those regulatory and organizational changes of the public and private order of a Country designed to increase its productivity and efficiency, by themselves do not constitute the key to a recovery that wants to be solid and lasting.

Beyond the fact that many of these are not "zero cost" and therefore have an impact on public finances and all present "transition costs", the launching of effective structural reforms finds resistance in corporate interests always present and active (even in a context where the weight and the voice of unions and associations appear to be reduced by the conviction that the sacrifices to overcome the crisis, however, must be made at all levels).

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<sup>28</sup> Draghi, in his intervention at Jackson Hole, underlined how *“there is leeway to achieve a more growth-friendly composition of fiscal policies. As a start, it should be possible to lower the tax burden in a budget-neutral way. This strategy could have positive effects even in the short term if taxes are lowered in those areas where the short-term fiscal multiplier is higher, and expenditures cut in unproductive areas where the multiplier is lower. Research suggests positive second-round effects on business confidence and private investment could also be achieved in the short-term.”*

In addition to this there are the degenerations/superfetations of a “pushed reformism”, sometimes colored by personalistic and protagonistic ambitions of the politics promoters, which feed a bewilderment, if not an exasperation towards reforms to horas, often patched and that (even when necessary) sometimes forget whole segments of civil society (the experience of “income-deprived (voluntary) early retirees” in Italy is symptomatic in this regard); on the other hand, gives rise to confusion for the changeability of a legislative system that does not find peace, gradually spreading the conviction that in many areas, not so much reform is needed, but rather to make the existing legislation functional, now inadequately applied (in other words, what is there to work properly).

Limits largely coinciding with those described above also meet expenditure policies, fiscal and structural of the Union, to which are added others with the same institutional nature of a community of States and not of a unitary state and of the principle of subsidiarity, which characterizes its action.

The public-private investment program of 300 billion euros proposed by the next President of the European Commission Jean-Claude Juncker, to raise aggregate demand and raise the fortunes of the European economy will have to overcome the pitfalls of its composition and addressing, in an institutional context that sees essentially already two Unions of Europe (the 28 states and the Eurozone to 18), but only one Parliament, which is responsible for the recruitment or ratification of the decision, and in which the weight of the Non-Euro Countries is still relevant.

It is not to be excluded that national self-interest that sometimes come into European politics, verging in some cases into hegemonic tendencies, can paralyze or make macroeconomically less efficient the program in question.

Moreover it was the same Mario Draghi, in a speech at Jackson Hole, to solicit a discussion on harmonization of fiscal and budgetary policy in the euro area in order to facilitate growth, given that, unlike in the more advanced economies, budgetary and fiscal policy of the Eurozone is not based on a budget adopted by parliament only, but on the aggregation of 18 national budgets and a budget union.

Criticality also meets the theme of structural reforms (and institutions) at EU level, designed to encourage a greater appeal, overcoming that feeling of bureaucratic machine, distant from the needs of the citizen and unable (or even hostile) to transpose and realize the instances, blocked by those diversities that should be a wealth, if not solved in the short-sighted defense of special interests, national or regional.

And, in a spiral that feeds between eurosclerosis and euroscepticism, the inability of the European institutions to find appropriate responses to the crisis operates as a catalyst for those who see the diaspora of the United States or a multi-speed Union as the only possible answers that contest the fact that you can ask individual countries structural reforms from those who are not able to reform themselves.

In this context, proponents of a renewed European constituent spirit, of a more cohesive political union, which among other things centralizes in the EU

the decision-making on fiscal policy and taxation<sup>29</sup>, with the sale of portions of sovereignty by the individual Member States - beyond the teleological meaning ascribed to phenomena such as the sectoral forthcoming entry into operation of the mechanism of the European banking supervision only<sup>30</sup> - they find a convincing bank or a new momentum only in the "fear of foreigners" as well as was revealed in relation to the need to cope with the fundamentalism of the Islamic Caliphate or the Ukrainian crisis.

Underlying theme remains the identification, beyond the geographical boundaries of the characteristics of a common European identity, a theme that the enlargement of the Union (even beyond the current geographic boundaries) places, even before the choice of the political institutional (monoblock or modular) that the Union will have in the future.

4. The list of limitations and weaknesses that public policies, taken individually, denounce in the promotion of initiatives to find a way out of the doldrums of the crisis makes the need for a comprehensive strategy essential, operating both on the demand side and the supply side, is able to give new impetus to the recovery.

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<sup>29</sup> The French President Hollande, at the time of his inauguration in 2013, in announcing a radical change in French politics, represented his support for a European initiative aimed at achieving the goal of "a political union within two years and a European economic government "; see, MONTEFIORI, *The poster Hollande "economic government for the euro countries"*, editorial published by *corriere.it* of May 17, 2013.

<sup>30</sup> On the fact that the idea according to which the EU banking could constitute the first step towards a political union must remain relegated (at least at the time) in the sphere of "wishful thinking", see the careful consideration by CAPRIGLIONE, *L'Unione bancaria Europea. Una sfida per un'Europa più unita*, 2012, pp.88 ff.

But a coordinated and coherent combination of public policies, albeit an essential condition for overcoming the crisis, could not be pointed out as enough where the drive belts and, in particular, the banking system (which in Europe intermediate still 80% of capital), will not transfer the incentives put in place by public policies properly and efficiently to businesses and households.

It is therefore necessary that the banks do "their job" properly, fully realizing that according to the ethical/functional approach proposed in other writings, beyond ideological or philosophical connotations, is their *raison d'etre*, their "natural function": that of professional evaluators of creditworthiness, with a predominantly redistributive perspective oriented towards the real economy<sup>31</sup>.

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<sup>31</sup> See SEPE, *Impresa e finanza tra Etica e profitto*, in VV. AA., *Finanza, Impresa e nuovo Umanesimo*, edited by Capriglione, 2006, p.49 where, with a more general reference to finance, I say that “*In generale i meccanismi finanziari, di qualunque tipo essi siano, svolgono due funzioni tra loro collegate: quella di sistemi di accumulazione di risorse per il loro utilizzo posticipato nel tempo e quella di sistemi di redistribuzione di risorse tra soggetti deficitari ed eccedentari. Tutti gli studi economici assegnano alla moneta e al credito la funzione primaria di riserva di valore; la finanza è il meccanismo attraverso il quale questa riserva di valore viene tralata nel tempo e redistribuita, allocando il surplus di valore conservato e non consumato, ove ve ne è maggiore richiesta. Va da sé che tra le due funzioni segnalate, quella accumulativa di riserva di valore e quella redistributiva, la prima ha natura strumentale, ancillare alla seconda: non ha infatti senso economico un’accumulazione di risorse finalizzata a se stessa. Si può pertanto convenire che la finanza assolve eziologicamente a una funzione eminentemente redistributiva. La caratteristica di questa redistribuzione è che essa avviene non con beni reali o servizi, che soddisfano bisogni primari dell’uomo, ma per il tramite della riserva di valore rappresentata dalla moneta e dal credito. Ma moneta e credito hanno un significato solo quando possono essere trasformati in beni e servizi, così come la finanza realizza appieno la sua missione redistributiva solo quando resta collegata al soddisfacimento di bisogni reali dell’uomo. Emerge in tutta la sua dimensione etica il collegamento tra economia reale ed economia finanziaria: un’economia finanziaria che non operi per soddisfare le esigenze dell’economia reale o addirittura si sviluppi in antitesi alla stessa tradisce la sua stessa ragion d’essere. In particolare, si colloca al di fuori di un corretto rapporto tra economia finanziaria ed econo-*”

To make this happen it is not only necessary that the financial system and banks must be equipped with the necessary liquidity to meet the needs of a stifled economy, or that the portfolios of businesses and households must be inserted resources (one-off or structural) that allow the reactivation of the circuit of trade, but it is necessary for the financial system as a whole, in pursuit of its redistributive "mission", to adopt a governance capable of expressing management policies attentive to the satisfaction of "basic needs" (meaning those related to real economy and that does not end in mere financial speculation), oriented towards economizing, alienated from conflicts of interest and based on operational fairness.

The task is certainly not easy in a context characterized, on the one hand, by a long period of deterioration of the economic fabric, where the generalized impoverishment excluded the marginal operators from the economic circuit and many others (more than in the past) are reported in public and private risk centrals, on the other hand, where the AQR (asset quality review) linked to the centralization of banking supervision in the ECB highlighted the flaws of investigations, evaluations and staking in the financial statements that have not always taken into due account the effects of the crisis.

The risk is therefore that the liquidity provided by monetary policy at minimal cost (which have no precedent in the history of the euro) and destined

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*mia reale una finanza che tende alla sua pura autoconservazione, verso investimenti finanziari più remunerativi, in una logica che vede il profitto fine a sé stesso, diventando strumento di prevaricazione e di potere. Ciò ovviamente non esclude che la finanza debba perseguire un profitto, perché è questo che consente alla finanza stessa di autoperpetuare i suoi meccanismi distributivi, ampliandone gli effetti, in quanto la ricchezza finanziaria prodotta (il profitto) in una spirale virtuosa si presta ad essere reimpiegata nel soddisfacimento di bisogni primari dell'uomo."*

to the financing of the real economy is not actually withdrawn from the banking system and placed in the circuit of trade, due to the lack of economically profitable initiatives to support, for fear of a resurgence of defaults, to the same inability of brokers to select real jobs in an increasingly financialised circuit, to the deflationary expectations at the time that mark the progress of the economic cycle.

Nor is it likely to await less than rigorous evaluations by the centralized supervision on loans that banks will be going to make. The contribution of the Unique Vigilance System in the process of exiting the crisis, can not and should not lead to a lowering of the level of efficiency of controls or to an increased elasticity of the risk assessments.

From a systemic point of view, the centralization of supervision in the hands of the ECB will lead instead to a close up of management policies and conduct of intermediaries in different countries and, therefore, to a greater efficiency of the banking system as a whole in carrying out the role of transmission belt of the economy, avoiding any divergent behavior, that find reason in regulatory asymmetries (otherwise present between the national regulations) or in policies and various supervisory practices.

However, not only the risks of the market are a test for credit institutions in their role as a stimuli transmission belt for economic regrowth.

From Basel II onwards decisive role was also taken by the legal and reputational risks associated with the progress of the activity and the failure to comply with the rules that govern it, depending on the potential impact on the

economic capital that improper conduct could have on the stability of the intermediary .

But the authorities' attention to these risks has been gradually breaking free compared to the economic and financial consequences to the them related, so that taking rigorous measures against intermediaries who have completed credit management irregularities that violated primary rules, administrative or statutes, shall be released by the relation of cause and effect that such irregularities and violations, potentially, they may have with the occurrence of financial loss<sup>32</sup>.

Even this way shows that the stability of the broker is no longer considered an "absorbent" purpose, both because those who acts in violation of the rules unduly enjoys a competitive advantage which distorts the market, also because it betrays the very essence of brokerage, founded on proper transmission of input cost in the redistribution process.

5. But when will consistent and concerted efforts of monetary authorities and policies and the proper functioning of the credit system intermediation be able to reverse the economic cycle also in the Eurozone?

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<sup>32</sup> Not by chance in Italy the adoption of measures of extraordinary administration, has been increasing in proportion over time, based on the art. 70, paragraph 1, lett. a) of the Tub (serious administrative irregularities or serious violations of the laws, regulations or bylaws that regulate the activity of the bank)and those based on Article. 70, paragraph 1, lett. b) (prediction of serious financial losses).

The deflationary signals last registered in some countries and the related medium-term inflation expectations in the Euro area<sup>33</sup> have legitimized the top of the ECB to adopt the expansionary monetary policy measures mentioned above, winning the German resistance, based on the axiom that the problem is not the lack of liquidity, but the level of total debt and therefore the uncertainty about the sustainability of the same and on the stability of public finances, given the devastating effects it would have on the economic system the default of the largest among the debtors.

This uncertainty would induce the holders of liquidity to a hoarding wait-and-see behavior (so-called liquidity preference) and a reduction in consumption and investment spending, which tends to degenerate into a deflationary and recessionary spiral that feeds on itself<sup>34</sup>. In a monetarist perspective, then, we would not be much of a problem in the presence of quantity, as of a problem of speed of money circulation, tied to expectations.

The risk in such a scenario, where the expectations do not change and the expenses for the consumers spending and investment start back, would be the so-called "Liquidity trap" described by Keynes, where the fall in short-term interest rates close to zero and in the occurrence of increases in the monetary

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<sup>33</sup> In early September 2014, the ECB has further revised down inflation forecasts for the euro area already lowered in the previous trimester, fixing them at 0.6% for 2014, 1.1% for 2015 and all '1.4% for 2016 (previously 1%, respectively, 1.3% and 1.5%), and this in a context in which the Governing Council of the ECB has set as an objective of monetary policy is to maintain' inflation in the medium term, below, but close to, 2%.

<sup>34</sup> The maintenance of liquidity preference would unknowingly operators to realize their worst expectations, triggering a vicious circle of declining demand for goods, rising unemployment, falling incomes.

base does not come to reflect corresponding changes in the rate of inflation, stating the ineffectiveness of the monetary policy itself.

In this context, the Keynesian solution, as noted, provides for public intervention to increase the level of aggregate demand, an option which, if the stringent constraints imposed by the Treaty are not revised, it is only possible for those who do not have such constraints (the Union itself)<sup>35</sup>, but who do not actually get into debt, and for those who still margin debt, being able to invest in a low interest rate environment in infrastructures and reforms that raise their competitiveness.

Therefore the behavior of Countries so-called “Virtuous”, which, abdicating the role of engine of the European economy, decided not initiate public policy for investment in infrastructures or proceed only tentatively in this direction, giving the medium to long-term increases in their productivity appears short-sighted.

In simplified terms above, the solution to the crisis passes then, ultimately, through the change of expectations or the change of rules in terms of the public sector debt (those relating to the Stability and Growth Pact and the Treaty on the Fiscal Compact ).

The change in expectations, beyond the profiles of irrationality to which they are imbued, can not be based on the profession and dissemination of a faith-based optimism, but it involves changing the convenience of current and prospective evaluations of economic operators, changing only possible through

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<sup>35</sup> And to this is linked the debate on the introduction of Eurobonds or less and therefore the mutualisation of the debt between countries.

the recruitment and implementation of public policies (national and EU) consistent, decisive and credible, that affect the incentives.

And perhaps it is not the uniqueness of the recipes proposed (or the different accents which are placed on one or the other of the ingredients), the first element of inefficiency of these. Some progress in this direction seems to have been finally achieved, if only with the acceptance of the principle, broadly shared, the need for a comprehensive strategy that combines monetary measures, fiscal policies and fiscal and structural reforms.

In addition, the recipes, even before they are implemented and administrated must result credible, credibility which is sometimes in itself sufficient to achieve the objectives, as confirmed by the story of spreads on government bonds<sup>36</sup>.

You can not, however, rely on the effectiveness of "announcement effects", where the proposed initiative is not supported by shared intentions, clarity and stability of the decision taken, the certainty of timing, sustainability and effective capability of creation. Credibility is indeed a good feeding with the achievements of what has been announced.

With regard to the change of the rules, it does not seem fatal for the purpose of overcoming the crisis to intervene on those that govern the action of monetary policy. These rules, which would deserve adequate critical reassessment<sup>37</sup>, in fact have not been an obstacle to a monetary policy

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<sup>36</sup> See note 12.

<sup>37</sup> From several parts was primarily invoked a reformulation of the tasks of monetary policy, which sees (see. Art. 119 and 127 of the TFEU and Article. 2 of the Additional Protocol n. 4 on the Statute of the ESCB and of the ECB) as a main objective of price stability and, without prejudice to this, to support the

intervention, having the guidance of the euro treasured of all the flexibility allowed by them.

As to the limits set by European standards in terms of public debt, beyond the theoretical correctness of their quantification<sup>38</sup>, the path of their reinterpretation appears politically unviable in relation to the stiffness of the source from which they are placed<sup>39</sup> and the radical opposition of certain countries.

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general economic policies of the Union, to align it with that of the Fed, putting all the objectives on the same plane (see. Section 2.A of the law where it requires the central bank "to promote 'Effectively the goals of maximum employment, stable prices, and moderate long-term interest rates") leaves to the discretion of the Fed itself the evaluation of the relative weight that the targets in each specific situation to have, and therefore the option whether to mediate between the targets themselves or give predominating in a given context to one between them.

Second, the prohibition should be reconsidered, now absolute (see. Art. 123 TFEU), financing monetary state. Such a radical foreclosure, which has its roots in historical contexts in which it was enshrined the independence of the Central Bank by the Government, is on the one hand excessive by reference to a currency (the euro) does not state, but rather a supranational; on the other hand, almost symptomatic of a legal capacity reduced state compared to banks and financial institutions that have access to the credit of the Central Bank and, ultimately, contrary to the principle of economy, where the state is convenient to borrow from the Central Bank than the market. It goes without saying that the funding of the state should be a right (not an obligation) of the Central Bank, subordinate, in terms of quantity, to an analysis of the think-about guy and, therefore, the maintenance of public accounts can allow the return.

On these issues and on the assumption of the role of lender of last resort by the ECB in relation to subjects illiquid or insolvent, see for everyone, most recently, the reflections of CIOCCA, *Le Banche Centrali dopo la crisi*, in [apertacontrada.it](http://apertacontrada.it)

<sup>38</sup> We refer to the anecdotes related to how it became the setting to 3% of the ratio de-deficits / GDP (on this point see, the seriousness of the parameters on which Europe, in [www.moneyriskanalysis.com](http://www.moneyriskanalysis.com))

<sup>39</sup> A modification of the numerical values of the parameters of debt, contained in the Protocol aggiuntive 12 of the TFEU and on the excessive deficit procedure, in fact requires a modification of the treaties (and thus unanimity), whereas it was mentioned above as the target level of inflation in the medium term, the ECB is contained in a decision of the same, assumable by a majority, and it is still identified a flexible manner (see. note 32).

But this does not preclude a flexible interpretation of these, taking into account that the set thresholds are used to define a path of convergence and not the guard value of the reliability of the creditworthiness of a State, judgment for which the markets are responsible for (otherwise not understandable why markets, albeit at rates that take into account the relative risk, continue to fund states that structurally have deviations from the parameters in question).

Therefore, in view of a convergence in the medium term there are no obstacles in the discipline of the TFEU to the use of margins for an increase in productive public expense, which is aimed at financing investment and structural reforms.

As well as, even temporal trespassing contained within the threshold for the purposes in question, where concerted in the view of a realistic and verifiable path of fiscal consolidation, do not seem to be contrary to the spirit of the rules on excessive deficit of the TFEU; that even in the light of the concrete elastic application of this framework and of which in the past have benefited those who now call rigorist readings<sup>40</sup>.

In this way we could bring back to their correct size and rating, accounting tricks, as well as endorsements at the European level, such as the inclusion in the proportioning of the national GDP of the value of the illegal

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<sup>40</sup> Besides, even the Treaty on the fiscal compact (cf.. Art. 3, paragraph 1, lett. C)) recognizes that in the case of "exceptional circumstances" states can temporarily deviate from their medium-term objective or the adjustment path towards this goal, where "exceptional circumstances" means (cf.. art. 3, paragraph 2, letter b) unusual event outside the control state that has a major impact on the financial situation of the public administration, or periods of severe economic downturn; it being understood that the above temporary deviation does not endanger fiscal sustainability in the medium term.

activities, wealth that the state should tackle preventing the formation and that only the need for more room for maneuver for public spending, allows to "legitimize", albeit to these limited purposes<sup>41</sup>.

What is certain is that we are at a turning point in the process of Europeanization and that on the assertion on the value of a "responsible flexibility" gambles the future of some achievements (economic integration, the euro, the overcoming of individualism in view more cohesive forms of union between states, more than half a century, have decided to share a common destiny) that an epochal financial crisis still threatens.

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<sup>41</sup> In terms of "a mere shame" expresses it, SCALFARI, *The caliphate threatens us but Europe thinks of nothing*, in *repubblica.it*