FSB FINANCIAL STABILITY BOARD

Peer Review of Italy

Review Report

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Foreword

The peer review of Italy is the third country peer review under the FSB *Framework for Strengthening Adherence to International Standards*.[1] FSB member jurisdictions have committed to undergo periodic peer reviews focused on the implementation of financial sector standards and policies agreed within the FSB, as well as their effectiveness in achieving the desired outcomes. As part of this commitment, Italy volunteered to undertake a country peer review in 2010.

This report describes the findings and conclusions of the Italy peer review, including the key elements of the discussion in the FSB Standing Committee on Standards Implementation (SCSI) on 13 December 2010. The draft report for discussion was prepared by a team chaired by Martin Wheatley (Hong Kong Securities and Futures Commission) and comprising Christian Carreon Alvarez (Mexican Ministry of Finance), Michael Kehr (BaFin Germany), William Mason (UK FSA), Gopalakrishnan Sreekumar (Reserve Bank of India), and Tuncay Yildiran (Capital Markets Board of Turkey). Costas Stephanou (FSB Secretariat) provided support to the team and contributed to the preparation of the peer review report.

The analysis and conclusions of the peer review are largely based on the Italian financial authorities' responses to a questionnaire designed to gather information about the initiatives undertaken in response to the relevant FSAP recommendations.[2] The review has benefited from dialogue with the Italian authorities as well as discussion in the FSB SCSI and in the FSB Plenary.

[1] The framework is available at http://www.financialstabilityboard.org/publications/r_100109a.pdf.

[2] The FSAP report for Italy is available at http://www.imf.org/external/pubs/ft/scr/2006/cr06112.pdf.

Glossary

BF	Banking Foundation
BCBS	Basel Committee on Banking Supervision
BCP	Basel Core Principle
BI	Bank of Italy
CLF	Consolidated Law on Finance
CONSOB	Italian Companies and Stock Exchange Commission
COVIP	Italian Supervisory Agency for Pension Funds
CRD	Capital Requirements Directive
EC	European Commission
ECB	European Central Bank
EU	European Union
FSAP	Financial Sector Assessment Program
FSC	Financial Stability Committee
IAIS	International Association of Insurance Supervisors
ICP	Insurance Core Principle
IFRS	International Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IRB	Internal Ratings-Based approach (Basel II)
ISVAP	Italian Supervisory Authority for Private Insurance Companies
LTV	Loan-to-Value (ratio)
MEF	Ministry of Economy and Finance
MIC	*Mercato Interbancario Collateralizzato*, collateralized interbank market
MiFID	Markets in Financial Instruments (EU Directive)
MoU	Memorandum of Understanding
OTC	Over-the-Counter
SME	Small and Medium-sized Enterprise
TAR	Regional Administrative Tribunal (Lazio)

FSB country peer reviews

The FSB has established a regular programme of country peer reviews of its member jurisdictions. The objective of the reviews is to examine the steps taken or planned by national authorities to address IMF-World Bank Financial Sector Assessment Program (FSAP) recommendations concerning financial regulation and supervision as well as institutional and market infrastructure. FSB member jurisdictions have committed to undergo an FSAP assessment every 5 years, and peer reviews taking place typically around 2-3 years following an FSAP will complement that cycle.

A country peer review evaluates the progress made by the jurisdiction in implementing FSAP recommendations against the background of subsequent developments that may have influenced the policy reform agenda. It provides an opportunity for FSB members to engage in dialogue with their peers and to share lessons and experiences. Unlike the FSAP, a peer review does not comprehensively analyse a jurisdiction's financial system structure or policies, nor does it provide an assessment of its conjunctural vulnerabilities or its compliance with international financial standards.

Executive summary

Italy underwent an FSAP in 2005–06 that included detailed assessments of seven key financial sector standards, including for the banking, insurance, and securities sectors. The FSAP team concluded that "*Italy's financial system appears sound and… the system's strength is supported by a high degree of conformity to supervisory and regulatory standards.*" In the areas of financial regulation and supervision, the FSAP highlighted three key challenges: further enhance banking supervision; strengthen the insurance supervisor; and expand requirements on corporate governance, disclosure, and investor protection.

The Italian financial system showed much resilience to the recent global financial crisis, although it was affected by the knock-on effects on the economy (see section 1). This resilience can be attributed to the traditional, relationship-oriented business model and stable retail funding base of Italian banks, as well as to the prudent regulatory and supervisory framework that promoted conservative mortgage lending practices and discouraged banks from participating in complex securitization activities and sponsoring structured investment vehicles. All major financial institutions remained profitable over this period, and only few of them made use of the facilities provided by the government. The various stress tests recently carried out confirmed the ability of these institutions to withstand more adverse scenarios. The resilience of the traditional business model of Italian banks during the crisis raises the broader issue, which goes beyond the scope of this report, of the circumstances under which financial innovation is a driver of economic growth (by improving the efficiency of resource and risk allocation) or a source of systemic instability (by facilitating the accumulation of imbalances and exacerbating tail risks).

As with other countries, the crisis made evident the need for further strengthening the policy framework to cope both with domestic vulnerabilities and with the increased global interconnectedness of the financial system. The business model of most Italian banks, which

relies heavily on lending activities, has served them well in terms of resilience. On the other hand, their uncertain profitability outlook (tied to prospects for the Italian economy), as well as their ownership structure in some cases, may act as constraints on their ability to raise equity quickly - although Basel III implementation provides them with a relatively long transition period. Further strengthening the capital base of the banking sector, without undermining the supply of credit to the economy, may therefore require the authorities' attention going forward. The Bank of Italy (BI) has already encouraged Italian banks, particularly the largest ones, to strengthen their capital base accordingly. The FSB welcomes this initiative as part of broader efforts to improve banking sector resilience.

With respect to banking supervision (see section 2), the Italian authorities have made advances in the legal protection of supervisors; past due loan classification requirements; adoption of a comprehensive regulation on connected lending; and increase in supervisory resources devoted to on-site inspections as well as in the frequency of examinations. The regulation on connected lending, in particular, has assumed greater importance in light of parallel regulatory changes that would substantially repeal the "banking-industry" separation principle. Since most of these steps have only recently been undertaken, it is too early to judge their effectiveness and ultimate impact. However, there exists scope for more progress in some areas. A generalized adoption of a 90-day past due loan classification requirement, which could be phased in so that it does not lead to undesirable pro-cyclical effects, would be more consistent with the spirit of relevant international standards and would send a strong signal on the robustness of the Italian banking sector. Indeed, more harmonised and transparent loan classification definitions and practices at the international level would allow greater cross-country comparability of banks' financial condition and strengthen financial stability. In addition, and as mentioned in the relevant FSAP recommendation, the BI should be legally empowered to directly and expeditiously remove bank directors and senior officers who may have become unfit for their duties and thereby undermine the sound and prudent management of the bank.

The increased resources devoted to the supervisory process in recent years by the BI address the FSAP recommendation to consider greater use of external auditors in specific areas in the execution of its own mandate. The use of external experts, particularly auditors, is an area in which international standards currently allow a great deal of discretion, reflecting the broad range of practices across countries. External auditors are helpful in analysing and reporting on problems already identified in financial institutions, particularly in light of resource constraints by supervisors. However, experience shows that outsourcing of supervisory work to third parties is not a substitute for proper supervisory oversight.

Significant progress has clearly been achieved in many areas of the insurance regulatory and supervisory framework (see section 3), particularly as it relates to inspection powers, supervisory processes (including greater emphasis on risk-based supervision and on-site inspections), and dealing with fraud. Major steps have also been undertaken in the supervision of reinsurance activities and in the registration and oversight of insurance intermediaries. The recent application by the insurance supervisor (ISVAP) to become an IAIS Multilateral MoU signatory is particularly welcome, and the completion of this process is expected to further enhance cross-border supervisory cooperation and information sharing.

Going forward, the expansion of the scope and content of fit-and-proper requirements, as envisaged in regulation drafted by the authorities, would be another positive step. As is the case for all EU insurance regulators, the implementation of Solvency II will place increasingly heavy demands on supervisory resources and may require ISVAP to prioritise its activities accordingly. In doing so, it will need to remain vigilant and ensure its staff do not focus exclusively on Solvency II processes at the expense of ongoing prudential supervision. Adequate supervisory resources are a precondition for effective supervision, particularly when major regulatory reforms are underway.

The Italian authorities have also made good progress in corporate governance, investor protection, and market transparency (see section 4). Improvements are apparent in strengthening minority shareholder rights and independence requirements via legal amendments, although there are diverse views on the correct model and balance regarding the presence of minority shareholders in the management of companies (as is the case in Italy). The enhanced oversight and enforcement of corporate governance requirements for insurers, the expansion of public disclosure requirements for insurers (including on their investment products) and bank debt issuers, as well as the strengthening of the monitoring framework to ensure adequate investor protection (including on the marketing of structured products by banks) are commendable steps for increasing market confidence. In terms of additional steps, providing legal protection for those parties that are responsible to report any corporate governance deficiencies would also enhance their ability to communicate freely with ISVAP.

The problems that have arisen from the sale of OTC derivatives products to Italian municipalities have parallels in other countries, and raise broader issues about the appropriate definition of a sophisticated investor and about policy measures to ensure that complex derivatives and other structured products are sold only to suitable investors. The sales of such products in some FSB member jurisdictions were partly driven by the long period of low volatility and low long-term interest rates that preceded the global financial crisis, which may have prompted complacency about risk and a search for yield among investors. Many jurisdictions distinguish between sophisticated and other investors, and have different regulatory requirements (registration, suitability, disclosure at point-of-sale etc.) accordingly. However, defining a sophisticated investor is not easy and suitability varies not only according to this definition but also based on the specific circumstances of each individual investor. In addition, the fact that the majority of sales in many of these countries took place on a cross-border basis by a small group of large foreign investment banks introduces an additional dimension of complexity in the choice of appropriate measures. Policy development work is currently taking place internationally to address some of these issues, but sophisticated investors also need to take greater responsibility for undertaking due diligence to understand the risks associated with complex products.

1. Recent market developments and regulatory issues

Financial system structure

The structure of the Italian financial system has not changed substantially since the 2005-06 FSAP. Banking remains the most important financial sector (82% of total system assets, or 243% of GDP) followed by insurance (12% and 36% respectively). The system expanded by around 40% in asset size since 2004, with the greatest increase accounted for by pension funds and banking foundations as well as finance companies (leasing, factoring, and consumer credit). By contrast, insurance sector assets have not grown in size relative to GDP since 2004. After three years of consecutive declines, insurance premiums rose back up to 7.7% of GDP in 2009, reaching pre-crisis levels. The institutional investment sector (insurance companies, investment funds, pension funds, and individually managed portfolios) remains small by international standards.[3] Total lending to GDP stood at 118% at end-2009, rising by 22 percentage points since 2004. This relatively low ratio by Euro area standards can be attributed mainly to Italian households' low financial debt, particularly in the form of mortgages. The size of corporate debt to GDP is comparable to regional peers, although it is relatively shorter-term and more variable rate.

With respect to equity markets, the size of the Italian stock exchange (*Borsa Italiana Spa*) remains relatively limited despite its merger with the London Stock Exchange and the efforts devoted to the development of a market segment dedicated to small and medium-sized enterprises (SMEs). By the end of 2009, the Borsa had 291 listed firms, which was an increase of only 22 since 2004. The stock market capitalization reached 29% of GDP at end-2009, dropping by 20 percentage points since 2005 as a result of the significant decrease in stock prices following the financial crisis.

In the banking sector, the wave of mergers and acquisitions that began in the late 1990s continued to increase concentration, albeit from a low base. By the end of 2009, the top two and five banking groups held 34% and 53% respectively of the system´s total assets. Nonetheless, the banking sector landscape is characterized by a large number of small cooperative and regional banks operating under different local economic environments. Major asset management companies, investment firms, and finance companies are mainly controlled by banking groups that follow the universal banking model. 25 banking groups were listed in the stock market in 2009, accounting for 64% of the sector's assets. The shareholders of the main groups are banking foundations[4] (around 20% of voting capital), non-bank financial and insurance companies (around 18%), as well as industrial companies,

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[3] According to the OECD, the financial assets of insurance companies and open-end investment funds were equal to only 20% of households´ financial assets in Italy, while in France, Germany and the U.K. this figure was 83%, 54%, and 46% respectively.

[4] Banking foundations (BFs) are regional, private, not-for-profit entities (including for tax purposes) that are supervised by the Ministry of Economy and Finance (MEF). They were initially public savings banks that have been required since 1990 to segregate their banking activities in separate joint stock companies, and since 1999 to gradually relinquish control of them. BFs are currently not allowed to own majority stakes in joint-stock companies, while major BFs may not control banks alone or jointly with other BFs (but can do that with other shareholders). The law sets governance principles for them, the most prominent of which is that local communities should be adequately represented in their governing bodies. BFs rely on the income generated from their investments to support various social and community projects.

while institutional investors play a modest role. The internationalization of the banking sector increased significantly since 2004, with foreign lending by Italian banks representing 27% of their total lending in 2009 (8% in 2004), primarily in Germany, Austria, and other Central and Eastern European countries. Foreign banks operating in Italy in the form of branches and subsidiaries accounted for 18% of system assets in 2009 (8% in 2004).

Regulatory framework and crisis response

In contrast to other developed markets, the Italian financial system withstood the direct effects of the financial crisis well. While the market prices of various securities instruments plunged, the initial effects on banking and insurance sector performance were relatively limited. This can be attributed to a few key factors including:

- the reliance of Italian banks on a more traditional business model, characterized by a relatively high reliance on lending, strong customer relationships, small trading activities[5], and minimal exposure to toxic assets;
- the characteristics of their funding base, with a predominance of stable retail funding sources (including both deposits and bonds)[6]; and
- the absence of a domestic subprime mortgage market segment given the limited recourse of Italian households to the debt market and prudent lending practices.

The relatively mild initial impact of the crisis can be also attributed to a prudent regulatory and supervisory stance as well as more fundamental institutional factors. For example, the authorities point out that their approach to model validation may have discouraged banks from participating in complex securitization activities. In mortgage lending, the requirements for personal guarantees encourage conservative loan-to-value (LTV) ratios[7]; banks are subject to credit product sales rules, including by third parties; and legislation against usury prevents riskier lending at high interest rates. Moreover, a 1999 law requires that special purpose vehicles be registered and periodically report their activities and data to the authorities. The Bank of Italy (BI) also subjected banks sponsoring structured investment vehicles to strict oversight and moral suasion, thereby avoiding some of the liquidity-related problems that impacted such institutions in other countries. Finally, the fact that the BI is also responsible for supervising non-bank financial intermediaries, and that such entities are required to register and (when above a size or complexity threshold) to comply with capital and governance requirements, may have reduced regulatory arbitrage possibilities.

However, the crisis had significant knock-on effects on the real sector, resulting in a contraction of GDP by 5% and an increase in public debt by 10 percentage points (reaching 115.8% of GDP) in 2009. Given their dependence on Italy's economy and their traditional business model, banks and other financial institutions were more affected in the aftermath of

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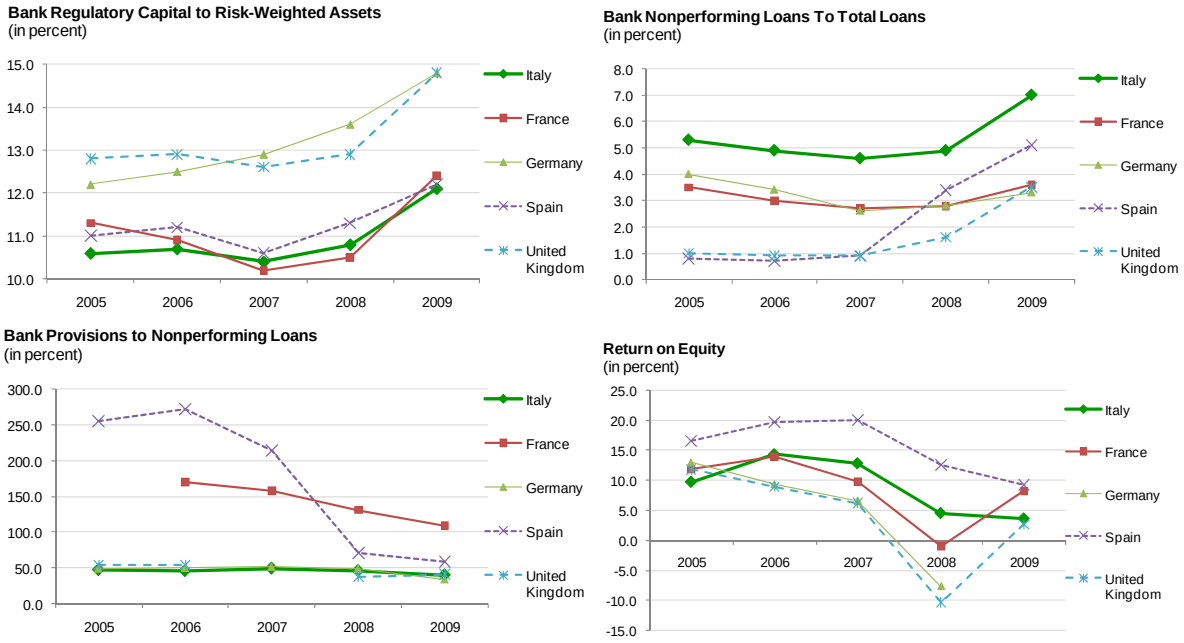
5 Loans and receivables represented 73% of Italian banks' total assets at end-2009 compared to an average of 44% for European Union (EU) banks, while trading assets represented 11% and 20% respectively.

6 Retail funding, in the form of deposits and bonds not held by financial intermediaries, accounted for 54% of the total funding of Italian financial institutions at end-2009, compared to 46% on average for the Euro area.

7 According to the European Central Bank's (ECB) report "Housing Finance in the Euro Area" (March 2009, available at http://www.ecb.int/pub/pdf/other/housingfinanceeuroarea0309en.pdf), the typical LTV ratio for a first-time home buyer was 65% in Italy at end-2007, compared to 79% for the Euro area on average.

the crisis.[8] Bank profitability, for instance, declined relatively more in 2009 than in 2008 due to a contraction in net interest income and relatively low trading income (compared to foreign peers). The quality of banks' loan portfolios, particularly for firms, deteriorated, and the level of provisions increased significantly (see Figure 1). However, no major financial institution actually recorded losses over this period.

Figure 1: Banking Sector Performance - Cross Country Comparison (2005-09)



Source: IMF Global Financial Stability Report (October 2010).
Note: The cross-country comparability of some of the above figures is hampered by differences in definitions. For example, the above non-performing loan figures do not include overdue and restructured loans that are classified as non-performing by the Bank of Italy, which amounted to 1.4% of total loans as of end-2009.

The strains in international capital markets meant that, although Italian banks were relatively more shielded than foreign peers, they had to face an increased cost of funding. This was particularly the case for larger banking groups that were more dependent on wholesale markets for their funding needs and had relatively lower capital buffers. These groups responded by putting in place several strategies to increase their recourse to retail funding, reduce their risk-weighted assets, and raise funds through equity issuance and sales of non-core assets, including in a few cases by tapping the public recapitalization instruments made available by the authorities (see below). These actions may have contributed to a contraction of total lending (particularly to firms) starting in March 2009, although this can also be attributed to a reduction in loan demand. Smaller banks, which had large enough capital

[8] In the case of the two largest Italian banking groups, exposure through loans and securities to Central and Eastern European countries, arising from their local operations there, is also significant and represents an additional source of credit risk. See the Financial Stability Report by the Bank of Italy (December 2010, at http://www.bancaditalia.it/pubblicazioni/stabilita-finanziaria/rapporto-stabilita-finanziaria/2010/rapstaeco-1/en-rapstaeco1/1-Financial-Stability-Report.pdf).

buffers when the crisis erupted, fared relatively well, and continued to support the economy with new lending, especially to SMEs. Some very small institutions (mainly mutual banks) that already had weak financial condition, as well as some specialized intermediaries that relied almost exclusively on wholesale funding, became distressed, although their resolution did not raise systemic implications. In spite of the generally limited use of derivatives in Italy, the volatility in rates induced by the crisis led to problems for some municipalities that had purchased over-the-counter (OTC) derivatives products from banks (see section 4).

In line with efforts coordinated at the international level, and with the approval (where necessary) of the European Commission (EC) on state aid matters, the Italian authorities introduced a series of measures to safeguard financial stability and to reform the regulatory framework. These can be broadly divided into four categories:

- sustaining banking sector liquidity by introducing government guarantees and swaps for bank liabilities (Decree-Law 157 of 2008, converted into Law 190/2008), establishing a Collateralized Securities Loan facility under which the BI can lend Euro area government securities to Eurosystem banks against investment grade collateral for a month, and setting up a collateralized interbank market (MIC) by the BI in which funds are traded anonymously and counterparty risk is mitigated by the pooling of collateral;
- strengthening the capitalization of distressed banks (Decree-Law 155 of 2008, converted into Law 190/2008) by allowing the MEF to subscribe to capital increases by banks or bank holding companies that the BI deems to be undercapitalized. These shares would carry no voting rights, but would have preference in the distribution of dividends, and their purchase would be accompanied by a stabilization and strengthening plan that would be overseen by the BI;
- supporting the strength and ability of the banking sector to finance the economy through special equity instruments ("Tremonti bonds") issued by sound banks, eligible as Tier 1 regulatory capital, and subscribed by the MEF (Decree-Law 185 of 2008, converted into Law 2/2009); and
- protecting depositors by introducing a state guarantee to protect them against all bank failures until October 2011 (Decree-Law 155 of 2008).

It is worth noting that measures to strengthen the capitalization of distressed banks, to use government guarantees and swaps for bank liabilities to sustain liquidity, and to protect depositors in the event of a bank failure have not been utilized; the first two of these have expired at the end of 2009. The "Tremonti bonds" facility was only used by four banks that applied to the scheme for around €4 billion; the limited take-up can be attributed to the resilience of banks as well as to the facility's conditionality. The value of transactions undertaken in the collateralized securities loans facility was close to €5.4 billion, with the last transaction carried out in March 2009. The Collateralized Securities Loans facility and the MIC have been running since 2008-09, and the latter will soon be replaced by a new market segment that will evolve into a triparty repo market in which the Italian Central Clearing Counterparty (*Cassa di Compensazione e Garanzia*) will guarantee trades.

The insurance sector weathered the aftermath of the crisis relatively well. The drop in life insurance premiums and the large losses experienced in investment portfolios in late 2008 have been reversed recently. Concerns about financial system fragility served as an incentive

to further strengthen supervisory activities, market monitoring, and the assessment of insurers' ability to absorb future shocks via stress tests (see section 3). Moreover, the private insurance supervisor (ISVAP) introduced regulations to set more stringent provisions regarding index-linked products and to temporarily relax mark-to-market valuations for certain balance sheet items of insurers as a means of coping with procyclicality.

Although banks' liquidity position improved progressively since early 2009, the controls introduced at the height of the crisis - weekly monitoring of net liquidity positions, simulations based on stress scenarios, frequent contacts with market participants, checks on operating arrangements and procedures, targeted inspections - continue. The BI issued a regulation in December 2010 on improving banks' liquidity risk management in line with the recent EU Directive (2009/111/EC). With regards to prudential supervision, the BI issued a Guide for Supervisory Activity in mid-2008 focused on risk analysis and covering all aspects of the inspection process. The BI also launched in 2008 a program of stress tests, to be conducted on a yearly basis, involving experts from various areas in the design of the tests and in the analysis of results. This program combines two complementary approaches:

- a top-down approach for analyzing banking book risk exposures (credit and interest rate risks) accounting for possible feedback effects and contagion channels; and
- a bottom-up approach for credit, market and liquidity risk analyses, based on internal data and methodologies of major banking groups, which also allow capturing risks in firms characterized by complex trading activities and liquidity structures.

The BI participated in the European Union (EU)-wide stress tests initiative coordinated by the Committee of European Banking Supervisors over the last two years, and conducted the 2010 EU-wide stress test exercise on a bottom-up basis. The five largest Italian banking groups participated in the exercise and remained above the threshold value of 6% for a Tier 1 capital adequacy ratio, although their projected ratios at the end of 2011 were relatively low compared to other EU banks.[9] The authorities attribute this result to lower initial capital adequacy ratios (partly due to more stringent limits applied on capital deductions and hybrid instruments) and limited government capital injections in Italian banks compared to other EU countries, and point out that the leverage ratios of these banks are relatively lower. Regarding troubled banking institutions, the regulatory framework underpinned by the special resolution regime established in 1993 by the Consolidated Banking Law has not undergone major adjustments as a result of the crisis.

In terms of coordination at national level, a Memorandum of Understanding (MoU) for cooperation on financial stability was signed by the MEF, BI, the securities market regulator (CONSOB), and ISVAP in March 2008. The involved parties, on a voluntary basis and in accordance with their competence, agreed to cooperate, exchange information and assessments to strengthen financial stability, as well as to prevent and manage financial crises with potential systemic effects. The MoU also established a Financial Stability Committee (FSC) comprised of these bodies (with the MEF Minister and General Manager acting as the Committee's Chairman and Secretary respectively) that analyzes financial stability issues,

[9] See the European Banking Authority (http://www.eba.europa.eu/EuWideStressTesting.aspx) and the BI (http://www.bancaditalia.it/vigilanza/stress_test;internal&action=_setlanguage.action?LANGUAGE=en) websites for more information on the methodology and results of the stress tests.

develops emergency plans, and conducts crisis simulation exercises. The FSC is mandated to meet at least twice a year, but has met several times on an ad hoc basis since 2008, particularly during periods of high tension in financial markets.

In addition to their participation in international and European financial reform initiatives, the Italian authorities are in the process of introducing new regulations that materially revise prudential norms on qualifying holdings of banks in non-financial entities and on related party lending (see section 2); have recently implemented the EC Directive on credit to consumers (2008/48/EC) that enhances the authority of the BI in consumer protection for traditional banking services and revises the mandate and standards applicable to non-banking financial institutions; have substantially revised the framework for credit intermediaries; and have introduced significant improvements to the insurance framework (see section 3).

Italy has weathered the market turmoil following the Greek debt crisis relatively well. High domestic private savings, low household indebtedness, the absence of a housing bubble, as well as a resilient banking sector, have all contributed to this performance. Italian banks continue to access wholesale funding markets, as indicated by their relatively low use of ECB refinancing facilities[10], although the cost of such funding has increased and its average maturity has declined recently. However, the prospects for a rapid resumption of economic growth appear constrained by the fact that pre-existing structural weaknesses, which have been exacerbated by the financial crisis, still need to be addressed.[11] In addition, the banking sector operates with a relatively lower level of capitalization compared to other major EU markets, while the deterioration in credit quality, low interest rate environment, and modest economic outlook may limit earnings prospects.

Lessons and issues going forward

The Italian financial system showed resilience to the financial crisis as a result of its sound characteristics and of a prudent regulatory and supervisory framework. This framework helped to limit imprudent market practices prior to the crisis and to contain contagion effects during the crisis. As in other countries, the crisis also changed policy priorities, putting more emphasis on the adoption of a system-wide approach to financial oversight, the close monitoring of liquidity and funding risks, and the regular stress testing of financial institutions. In addition, the Italian authorities introduced a series of measures to safeguard financial stability and to reform the regulatory framework in order to enhance the system's resilience. Financial institutions generally remained profitable over this period, and few of them made use of the facilities provided by the government. The various stress tests recently carried out confirmed the ability of these institutions to withstand more adverse scenarios. The resilience of the traditional business model of Italian banks during the crisis raises the broader issue, which goes beyond the scope of this report, of the circumstances under which financial innovation is a driver of economic growth (by improving the efficiency of resource

[10] While Italian banks account for about 12% of Eurosystem assets, their share of ECB funding has rarely exceeded 6% in the last two years.

[11] These include a high level of public debt, low productivity growth, and declining competitiveness. For details, see the latest Article IV report (IMF Country Report No. 10/157, May 2010, available at http://www.imf.org/external/pubs/ft/scr/2010/cr10157.pdf).

and risk allocation) or a source of systemic instability (by facilitating the accumulation of imbalances and exacerbating tail risks).

Nonetheless, the crisis made evident the need for further strengthening the policy framework to cope with domestic vulnerabilities and with the increased global interconnectedness of the financial system. The business model of most Italian banks, which relies heavily on traditional lending activities, has served them well in terms of resilience. On the other hand, their uncertain profitability outlook (tied to the prospects for the Italian economy), as well as their ownership structure in some cases, may act as constraints on their ability to raise equity quickly - although Basel III implementation provides them with a relatively long transition period. Designing strategies to foster higher capital levels for the banking sector, without undermining the supply of credit to the economy, may therefore require the authorities' attention going forward. The BI has already encouraged Italian banks, particularly the largest ones, to strengthen their capital base accordingly. The FSB welcomes this initiative as part of broader efforts to improve banking sector resilience, which involve a variety of strategies by member jurisdictions to incentivise additional equity raising by banks from private sources.

2. Banking supervision

The assessment of compliance with the Basel Core Principles (BCPs) for Effective Banking Supervision, conducted in 2003 and incorporated in the FSAP, found the Italian supervisory framework to be of a high standard. At the same time, it made several recommendations to improve compliance with some of these principles[12]:

- BCP 1.5 - Providing legal protection to supervisors against court proceedings stemming from measures adopted in the performance of their functions in good faith. The BCP assessment acknowledged Bank of Italy's (BI) practice to cover the costs of legal defense for its employees, but noted that this was not fully equal to legal protection;
- BCP 8 and BCP 21 - Tightening loan-loss classification and related provisioning requirements by adopting the international practice of using 90-days past-due for impaired loans, which would raise transparency and cross-country comparability of banks' financial accounts;
- BCP 10 - Introducing comprehensive regulation on lending to connected or related parties, including its definition, overall limits, and reporting requirements;
- BCP 14 - Amending the banking law and applicable regulations to legally empower the BI to remove expeditiously those bank directors or senior officers who may have become unfit for their duties, to revoke the appointment of a bank's external auditors when their performance is deficient, and to provide the BI with the authority to establish the scope and standards to be achieved in banks' external audits; and

[12] The assessment of Italy was undertaken before the BCPs were last revised, so the principles mentioned in this report do not correspond to the ones that have been in use since 2006.

- BCP 19 - Reviewing the means by which the BI may derive greater benefit from the work of external auditors in specific areas (e.g. money laundering) in the execution of its own mandate, as a way to address the level of resources and related inspection cycle.

Steps taken and actions planned

BCP 1.5 (Legal protection): Legal protection for staff of all financial supervisory agencies was introduced through a legal amendment in 2006. The new provision states that the supervisory authorities, members of their respective boards and employees are liable for damages they have caused within the performance of their functions if they have acted intentionally (i.e. to cause a damage) or with gross negligence. This provision does not appear to directly protect supervisors from legal action stemming from measures adopted in good faith in the performance of their duties. However, the authorities assert that, since actions undertaken intentionally to cause harm and those undertaken in good faith are mutually exclusive according to the Italian legal framework[13], this amendment would have the effect intended by the relevant BCP and the FSAP recommendation.

BCP 8 (Loan evaluation and loan loss provisioning) and BCP 21 (Accounting standards): The Italian authorities transposed the EU Capital Requirements Directive (CRD), which reflects the Basel II Accord, into their prudential framework in December 2006. The CRD allows for a transitional implementation period until end-2011, during which the less stringent 180-day past due loan classification requirements can be used as a general option for certain types of exposures.[14] Italy, like some other EU countries, has availed of this option. The CRD (and the Basel II Accord) also allows EU members to apply, on a permanent basis, a number of days past due between 90 and 180 for "retail" exposures and for claims on "public sector entities" under the IRB approach. Italy has adopted a 180-day past due requirement for these exposures as well. As of end-2009, portfolios for which a 180-day (as opposed to 90-day) past due definition applies represented around 40% of the total on-balance sheet exposures for credit risk of Italian banks. Among them, around 5% represented exposures to "retail" and "public sector entities" under the IRB approach.

The BI has maintained a common definition of impaired assets for reporting, prudential, and accounting purposes. As a result of the alignment in definitions, an exposure classified as past due according to prudential rules is now subject to an individual assessment for impairment. With regard to loan loss provisioning, the adoption of International Financial Reporting Standards (IFRS) - on a consolidated basis from 2005 and on a solo basis from 2006 - led to the reduction in general provisions for performing loans, while it has made the determination of specific provisions for impaired loans more severe compared to the previous accounting regulations - for example, by incorporating the 'time value' effect of credit losses for impairment.

[13] According to article 28 of the Italian Constitution, public authorities and their employees do not enjoy any immunity from tort action, so any provision to limit their liability is exceptional. In addition, immunity is never granted for gross negligence, which in the Italian legal framework is always equated to fraud.

[14] These include "non-commercial and public sector entities", "corporate" and "retail" exposures under the standardized approach, and "corporate" exposures under the IRB approach.

The impact of the financial crisis on the real economy (including concerns about a credit crunch) has delayed the BI's plans to move, prior to December 2011, to a 90-day limit for past due exposures falling under the transitional regime provided by the CRD. The BI intends to introduce a 90-day limit for those exposures by the end of 2011, and to extend it to also include exposures for which national authorities are permanently allowed by the CRD to adopt a past due requirement falling between 90 and 180 days.

Two other regulatory requirements by the BI on loan classification are worth noting in this context: the materiality threshold and the offsetting of past due exposures. The concept of materiality is contemplated both in the Basel Accord and in the CRD, and some discretion is provided to national authorities on how to adopt it. This concept has been implemented in Italy as follows: under the obligor approach, if the past due amount (irrespective of the number of days past due) for an exposure does not exceed a materiality threshold of 5% of the borrower's total drawn exposures, then the regulation does not treat the borrower as past due. The aim of the regulation is to avoid classifying all exposures (performing and non-performing) to an obligor as past due when only a small part of them is actually past due. By contrast, no materiality threshold is in place under the transaction approach.

As to the offsetting norm, undrawn credit facilities are allowed to be offset against past due exposures before estimating the materiality threshold. This treatment represents a peculiarity of the Italian prudential framework. The authorities contend that the assumption behind this norm is that if the credit facility is still available to the obligor, then the bank must have evaluated that the delay on repayment does not represent evidence of an effective deterioration of the obligor's creditworthiness that would result in cancellation of the facility.

The materiality and offsetting norms may have the effect of understating non-performing assets. However, the authorities note that their impact on loan loss provisioning is limited, since a relatively large amount of exposures that is not classified as past due as a result of these norms goes back to performing status in a short period of time (i.e. they are "cured").[15] The BI intends to evaluate the appropriateness of maintaining the offsetting norm by taking into account, on the one hand, the credit and financial market developments and the regulatory guidance adopted by other EU members and, on the other hand, the need to avoid overstating the amount of non-performing exposures given the relatively high "cure" rate.

BCP 10 (Connected lending): With regard to connected lending, the BI issued a consultative paper in May 2010 containing a draft regulation on exposures and conflict of interest of banks and banking groups towards their related parties. This regulation, which was informed by a survey of banks conducted during 2008-09, seeks to introduce several prudential tools - limits, procedural rules, principles on organization and internal controls, supervisory reporting - including the ability by the BI to set special limits and/or procedural rules on a case-by-case basis as needed.[16] The consultation process was closed in August and the

[15] An analysis of the amount of exposures not yet classified as 180 days past due as a result of the application of these two norms shows that, after only 3 months, 28% of them had become fully performing again.

[16] For example, the BI can identify related parties different from those included in the general definition on a case-by-case basis and considering the ability to influence the bank's management. Should a breach of prudential limits occur, the bank (or banking group) must notify the BI and adopt appropriate measures. For as long as limits are breached, the minimum capital requirement is increased by an amount equal to that which exceeds the threshold and, if the related party is a bank shareholder, its voting rights are suspended.

authorities intend to issue this regulation by mid-2011 at the latest. The draft regulation is also closely aligned with a recent regulation issued by CONSOB on the transparency and correctness of related party transactions by listed companies (see section 4).

BCP 14 (Internal control and audit): On the FSAP recommendation relating to internal control and audit, the BI has not yet been assigned legal authority to remove bank directors and senior officers. The law could be amended in the near future by taking advantage of the move to implement the changes to the CRD regarding, inter alia, the remuneration policies of banks (CRD III). However, although deliberations are currently in progress, a full-fledged proposal is not yet in place.

BCP 19 (Validation of supervisory information): Italian legislation envisages in some cases the possibility to mandate certain supervisory tasks to other authorities, but not to external auditors given the independent analysis that needs to be conducted. The authorities stress that inspections involve a resource-intensive and in-depth process, and that they have become even more intrusive and frequent following the financial crisis, particularly for larger intermediaries.[17] The number of inspectors and of inspections has also increased between 2007 and 2009, and these inspections are tailored to banks' specific characteristics and perceived riskiness. For example, targeted thematic reviews aim at verifying compliance with anti-money laundering requirements by supervised entities. As regards large Italian cross-border banking groups, the BI examines them on a continuous basis through inspections targeted on relevant risk profiles, and coordinates with foreign authorities through colleges of supervisors. As concerns small and medium sized banks, a more flexible approach is followed, with resources focused on those showing significant problems.

According to Legislative Decree 39/2010, all banks and any other financial institution deemed to be a 'public interest entity' (as well as the companies of the group to which such an entity belongs) are subject to an external audit. Small mutual banks had thus far been exempted from this obligation; such an exemption will be reconsidered in the context of the adoption of the necessary implementing regulation. External auditors are supervised by CONSOB and therefore the BI has no direct control over their appointment/removal. However, as a result of the recent Decree, banks have to inform the BI of any changes to their external auditors. According to the banking law, banks' auditors are also obliged to notify the BI of any acts or facts that may represent a breach of banking regulation or may result in the issuance of an adverse opinion on the annual accounts. The BI may request to the auditors other information or documents, and can inform CONSOB of any irregularity that emerges during its inspections. CONSOB, in turn, assesses the most appropriate supervisory measure, which may include revocation of the mandate. The BI can also convene a general meeting of shareholders in order to decide whether to remove the external auditor. Finally, although the BI has no power to establish the scope and standards to be achieved in banks' external audits, it can indirectly (and partly) influence them by setting supervisory rules on interaction with auditors for the purpose of prudential regulation of banks' organizational and corporate governance arrangements.

Lessons and issues going forward

[17] A new guide to supervisory activity, which introduces review and evaluation principles, new instruments of analysis and typology of inspections, was issued in 2008 and came into force in 2009.

The Italian authorities have made advances with regard to the legal protection of supervisors, past due loan classification requirements, adoption of a comprehensive regulation on connected lending, and increase in supervisory resources devoted to on-site inspections as well as in the frequency of examinations. The regulation on connected lending, in particular, has assumed more importance in light of parallel regulatory changes that would substantially repeal the "banking-industry" separation principle.[18] Since most of these steps have only recently been undertaken, it is too early to judge their effectiveness and ultimate impact.

The increased resources devoted to the supervisory process in recent years by the BI address the FSAP recommendation to consider greater use of external auditors in specific areas in the execution of its own mandate. The use of external experts, particularly auditors, is an area in which the BCPs allow a great deal of discretion, reflecting the broad range of practices across countries. External auditors are helpful in analysing and reporting on problems already identified in financial institutions, particularly in light of supervisory resource constraints. However, experience shows that outsourcing of supervisory work to third parties is not a substitute for proper supervisory oversight. In particular, it is important to have a strong supervisor with a clear mandate, effective tools and adequate resources, as recommended in the 2010 FSB report on supervisory intensity and effectiveness.[19]

There exists scope for more progress in some of the areas mentioned in the FSAP. A generalized adoption of a 90-day past due loan classification requirement, which could be phased in so that it does not lead to undesirable pro-cyclical effects, would be more consistent with the spirit of relevant international standards and would send a strong signal on the robustness of the banking sector. While the details described here are specific to Italy, the variation in loan classification practices across jurisdictions is a broader issue arising from the fact that international regulatory guidance[20] currently allows significant national discretion, which may impede the cross-country comparability of banks' financial condition and weaken financial stability. Finally, and as mentioned in the relevant FSAP recommendation, the BI should be legally empowered to directly and expeditiously remove bank directors and senior officers who may have become unfit for their duties and thereby undermine the sound and prudent management of the bank. This authority exists in several other major countries and is being considered by the EC for adoption at EU level.

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[18] As part of the adoption of the EU Merger Directive 2007/44/EC, recent amendments to the Banking Law have abolished the prohibition for a person involved significantly in non-financial activities to acquire more than 15% of, or to control, a bank. In addition, a draft BI regulation on qualifying holdings will soften the previous strict limits to banks' holdings in industrial companies.

[19] See "Intensity and Effectiveness of SIFI Supervision - Recommendations for enhanced supervision" (November 2010, available at http://www.financialstabilityboard.org/publications/r_101101.pdf).

[20] See the Basel II Framework (November 2005, available at http://www.bis.org/publ/bcbs118.pdf) and "Sound credit risk assessment and valuation of loans" (June 2006, available at http://www.bis.org/publ/bcbs126.pdf) by the Basel Committee on Banking Supervision (BCBS).

3. Insurance regulation and supervision

The FSAP noted substantial improvements in the regulatory and supervisory framework for the insurance sector, including a more forward-looking and risk-based approach to supervision and initial steps towards implementation of the EU Directive on Solvency II. The authorities were actively pursuing a number of legislative and supervisory initiatives that held the potential to materially improve the level of observance in the coming years. However, several of the Insurance Core Principles (ICPs) were assessed as only partly or largely observed, leading to recommendations in several areas (see Annex) including:

- providing legal protection to those involved in the supervisory process;
- enhancing the autonomy (notably with respect to budgetary processes) and accountability of the supervisory agency;
- greater sharing of information with relevant foreign supervisors;
- increasing the frequency and scope of on-site inspections of both insurers and intermediaries; and
- strengthening supervision of insurance intermediaries, notably by requiring that all intermediaries operating in Italy be subject to registration and direct supervision.

Steps taken and actions planned

ICP 1 (Conditions for effective supervision): The legislation implementing EU Directive 2003/41/EC has clearly defined the responsibilities between the pensions supervisor (COVIP) and ISVAP. The Law on Saving of 2005 states that COVIP is the competent supervisor for transparency and market conduct, while ISVAP is the competent supervisor for the assessment of sound and prudent management of insurance undertakings and of the effect of pension products on their stability.

Since 2005, reporting on consolidated accounts of insurance companies has been based on IFRS although individual entity reporting is still based on Italian Generally Accepted Accounting Principles (GAAP), consistent with EU Regulation 1606/2002. A draft law allowing the government to apply IFRS also to individual accounts has been postponed as a result of the financial crisis until the implementation of Solvency II.

An alternative dispute resolution mechanism envisaging mediation in civil and commercial matters will be applied as from March 2011, which would complement the complaints procedure currently offered by ISVAP. Any legal action concerning insurance, banking and financial contracts must be preceded by a conciliation phase before a mediator or a mediation college. Mediators help the involved parties to come to an out-of-court settlement which will then be acknowledged by a civil court. Completion of these new procedures will be a prerequisite for court proceedings.

ICP 2 (Supervisory objectives): Revisions to the Insurance Code in 2006 explicitly and comprehensively address the purpose, means, and scope of supervision. The main supervisory actions for the year are communicated in ISVAP's annual report, which is publicly available.

ICP 3 (Supervisory authority): The Law on Saving limits civil liability of ISVAP supervisors and their officers to cases of fraud or gross negligence (see section 2). A Code of Conduct that was introduced in 2008 addresses issues such as integrity and external advisers as well as conflicts of interest, and applies to ISVAP directors, staff, and external advisers.

The implementation of the FSAP recommendation on budgetary independence for ISVAP requires a legislative amendment. However, ISVAP's budget continues to remain dependent on MEF approval and to transfer any financial surplus to other authorities, thereby limiting ISVAP's financial and human resource capabilities. New regulatory requirements and obligations resulting from forthcoming changes in EU legislative frameworks – including the Solvency II Directive (2009/138/EC) and subsequent implementing measures – will have implications for staffing and budget. In addition, the need to increase and intensify the frequency, scope, and depth of on-site inspections will require additional efforts to train (as well as retain) existing and recruit additional highly qualified staff.

ISVAP's financial statements are published on its website and in the official gazette. They are also subject to investigation by the Court of Auditors on the proper use of public funds in terms of effectiveness and efficiency; these reports are publicly available. Moreover, in terms of meetings with industry representatives, ISVAP management and staff periodically meet with relevant associations and with boards of individual insurers to discuss insurance market and regulatory developments.

ICP 4 (Supervisory process): ISVAP has continued to move towards a risk-based approach, which now encompasses:

- its board taking firm risk into account in deciding on the firms to target for inspection, and the inspection program being subject to review as key prudential risks materialise;
- the development of a handbook, subject to regular updates based on experience, to harmonize inspection visits (see ICP 13); and
- the assessment of qualitative aspects of risk management at firms following the implementation of Regulation 20/2008.

Risk-based supervision remains a work in progress - for example, ISVAP has yet to inform firms of their risk ratings. A full risk-based supervisory framework will only be introduced, in a quantitative sense, when Solvency II is implemented in Italy at the end of 2012.

In terms of the FSAP recommendation that consideration be given to establishing a specialized independent tribunal for appeals against ISVAP decisions, the Lazio Regional Administrative Tribunal (TAR) was formally designated as the specialized court for such cases. This has benefited the expertise of those deciding cases and improved the speed of decision making. In 2010, and partly based on the successful experience with insurance, the Italian government determined that all financial supervisory cases (i.e. those involving banks and asset management firms as well as insurers) should be heard by the Lazio TAR.

ICP 5 (Supervisory cooperation and information sharing): ISVAP signed a Memorandum of Understanding (MoU) with the Swiss supervisor in 2006, while agreements with China and Israel are currently in preparation. An application to the International Association of Insurance Supervisors (IAIS) Multilateral MoU has recently been filed with the IAIS and will, once the application procedure is completed, enable ISVAP to exchange information

with a large number of insurance supervisors worldwide as well as satisfy the reciprocity requirement mentioned in the FSAP recommendation.

ICP 7 (Suitability of persons): The Italian authorities are in the process of preparing regulation to expand the scope and content of fit and proper requirements, although the desire to have common rules for banks and insurers has led to a rather long gestation period. Within the constraints of the current framework, ISVAP already contacts home supervisors of foreign insurance firms, including from outside the EU, setting up operations in Italy as part of its fit-and-proper assessment process. On the narrower issue of the disposal of shares, the implementation of EU Directive 2007/44 in 2010 has empowered ISVAP to require the disposal of shares if a significant owner no longer meets the fit and proper requirements, with ISVAP specifying the time frame, on a case-by-case basis, in which the shares must be sold.

ICP 8 (Changes in control and portfolio transfers): ISVAP was granted more precise and detailed powers to scrutinise significant increases or decreases in capital or voting rights in early 2010. It is actively using these powers and can refuse permission for a proposed transaction if, for example, it has concerns about the probable solvency position of a merged entity. In addition, under Regulation 14/2008, it is now a requirement for an independent actuary to prepare a report on the impact a proposed change in control will have on policyholders, prior to the transaction being permitted.

ICP 10 (Internal control) and 18 (Risk assessment and management): ISVAP introduced in 2005 a circular on corporate governance rules, internal control systems, risk management and internal auditing, which was subsequently consolidated into Regulation 20/2008 (see section 4). Internal audit plans and reports of the board of statutory auditors are now reviewed by ISVAP. In addition, the Insurance Code now gives ISVAP the power to convene directly (and, if desirable, confidentially) the auditing actuary and the appointed actuary.

ICP 13 (On-site inspection): Around 100 on-site inspections have been performed in each of the last few years. However, the number of person-days has increased significantly compared to 2005, indicating greater intensity of inspections and more focus on the effectiveness of risk management systems. ISVAP has introduced pilot on-site inspections mainly for major insurance groups, in which it gives advance notice and thereby allows these entities to prepare and send documentation in advance of the visit that is subject to later verification and discussion on-site. This approach will be expanded to include all insurers, although ISVAP also stands ready to investigate on-site without further notice in emergency cases. A handbook for on-site inspection has been developed, and it contains information on different risk areas that need to be examined during inspections (see ICP 4).

ICP 15 (Enforcement or sanctions): The legislation has not been amended to restrict or suspend dividends or other payments to shareholders when such payments would jeopardize the insurer's solvency.[21] Regarding fit-and-proper requirements for directors, chief executives, and supervisory board members, ISVAP carries out at the moment of appointment an overall assessment of existing requirements, although (as previously mentioned) a revision of the current fit-and-proper framework is under development. As regards breaches of fitness or propriety requirements arising from previous involvement in

[21] However, the Insurance Code does prescribe that dividends cannot be distributed to the parent company if they jeopardize the insurer's solvency.

bankruptcy or failures, these are automatically discharged in the Italian legal framework after a certain time period. The same regime is in force for the banking sector and, to some extent, for listed companies, so it will be necessary to ensure a common approach across these sectors for any future changes.

ICP 17 (Group-wide supervision): A coordination agreement was signed between the BI, CONSOB and ISVAP in March 2006, and a Protocol for collaboration was signed between the MEF, BI, CONSOB, and ISVAP in March 2008 (see section 1). Under the terms of the former agreement, there is cooperation and exchange of information between the authorities with respect to financial conglomerates that are supervised by more than one agency. There is also a regular program of meetings between supervisors of the largest groups, in which solvency, intra-group transactions, and risk concentrations are discussed. ISVAP also participates in several supervisory colleges, cooperating with relevant non-EU supervisors in them, and leads colleges for international groups with headquarters in Italy. Where ISVAP is the lead supervisor, it seeks relevant prudential information from other supervisors. Where an overseas group is involved, ISVAP will provide prudential information on the Italian operations to the foreign lead supervisor.

ICP 19 (Insurance activity): In response to the FSAP recommendation, ISVAP issued Circular 574 in 2005 asking insurers to create adequate management tools to systematically monitor their reinsurance strategies, their consistency with the level of risk retention, and internal responsibilities regarding outward reinsurance. ISVAP has also increased the number of its assessments of reinsurance coverage in recent years, and it maintains a database that allows the analysis of credit risk and exposures including the terms of reinsurance.

ICP 21 (Investments): ISVAP Regulation No. 20 requires the board of directors to define and, at least once a year, review risk policies including for investment risk. More detailed rules, including a strategic investment policy approved by the board and its main elements, are included in draft regulation that was recently issued for public consultation, and ISVAP expects to have this regulation in place by end-2010. ISVAP required all Italian insurers to run standardised stress tests, on the basis of risk factors and parameters determined by itself, in 2008 and 2009, and undertook further supervisory work in light of the results. It also participates in the stress tests of the largest EU insurance groups, including Italian insurers, such as those which were undertaken in late 2009/early 2010 by EU supervisors. ISVAP now requires all insurers to prepare contingency plans for approval by their boards, and regularly reviews them during inspections. Finally, the assets held by Italian insurance undertakings are monitored monthly, and the results are shared within the FSC.

ICP 23 (Capital adequacy and solvency): Italy implemented the EU Directive on reinsurance in 2008 and will implement Solvency II by end-2012. ISVAP has taken a conscious decision not to impose a capital requirement on insurers or reinsurers in excess of the minimum specified under the Solvency I Directive, but to apply such a requirement as needed if it is concerned about the nature of the business an insurer is writing or the quality of the controls it reviews.

ICP 24 (Intermediaries): Italy implemented the Insurance Mediation Directive (2002/92/EC) into its Insurance Code, thereby considerably deepening and broadening supervision over intermediaries. There are about 4,200 brokers, 39,000 agents, and almost 200,000 canvassers who had to be registered under the amended Insurance Code. The electronic register of

insurance and reinsurance intermediaries, which is maintained by ISVAP, was set up in 2007 and can be accessed by the public via its website. Breaches of intermediaries' duties may result in fines and, in more serious cases, in the removal from the register, which is tantamount to a temporary ban.

Intermediaries have since then also been subject to professional requirements that include qualifying examinations, professional training, periodic update, and rules of conduct. All intermediaries are subject to period on-site inspection by ISVAP, including banks and other financial intermediaries of insurance products. Some on-site inspections were undertaken in recent years, mostly in emergency cases (serious breaches or financial distress). In addition, insurers must submit annually a report which contains details of their relation with intermediaries, including infringements or terminations of agreements. With regards to claims adjusters, no decision to amend the existing legislation to allow their registration for material damages other than those resulting from the use, theft, and fire of motor vehicles and crafts has been taken. It has to be noted, however, that the current legislation already covers most of the relevant non-life classes of the Italian market.

ICP 25 (Consumer protection): ISVAP's regulations currently require intermediaries to obtain information from prospective policyholders in order to assess their insurance needs, and to inform policyholders adequately. In addition, intermediaries need to avoid direct and indirect conflicts of interests in proposing and managing insurance contracts or, if such conflicts are inevitable, not to prejudice the interest of policyholders. Participating interests of 10% or more held by an intermediary in an insurer, or vice versa, are to be disclosed to prospective policyholders. Selling practices for direct selling (internet and phone) are addressed by Regulation 34 that requires insurers to provide policyholders with clear information before the conclusion of the contract, to give them full assistance in case of claims, and to avoid unsolicited services and communications. Moreover, Regulation 35 of May 2010 provides a unitary framework to insurers with regards to disclosure obligations to policyholders (pre-contractual as well as contractual) and to advertising of insurance products. Finally, as of 2009, multi-year non-life insurance contracts can be terminated after 5 years, while tacit renewals are possible but cannot last for more than two years.

ICP 27 (Fraud): ISVAP has undertaken considerable work in identifying and controlling fraud in recent years. It analyzed the relation between the level of fraud and the number of cases by different claims handlers and, building on the results of this empirical work, it has instructed insurance companies to better resource their operations in some provinces, to improve their information technology processes, and to strengthen their loss adjustment controls. ISVAP has also investigated the degree to which the boards of insurance undertakings are aware of claims management and fraud prevention, and has required boards to spend substantially more effort on anti-fraud monitoring.

Insurers are required to collect and report fraud data annually to ISVAP. In 2009, it worked with insurers (with the support of the Italian privacy authorities) to enhance the ease with which insurance companies could access its database to look for information that would help them identify fraudulent claims. The enhanced web accessibility of its claims database, a requirement for faster submission of rationalised industry data sets, and the ability of insurers to batch transfer information out of the system, have given Italian insurers a significantly enhanced ability to detect fraudulent claims.

Lessons and issues going forward

Significant progress has clearly been achieved in many areas of the insurance regulatory and supervisory framework, particularly as it relates to inspection powers, supervisory processes (including greater emphasis on risk-based supervision and on-site inspections), and dealing with fraud. In particular, the way that ISVAP has sought to encourage and work with the industry to fight insurance-based financial crime offers a model for other countries seeking to reduce fraudulent general insurance claims. Major steps have also been undertaken in the supervision of reinsurance activities and in the registration and oversight of insurance intermediaries. The recent application by ISVAP to become an IAIS Multilateral MoU signatory is particularly welcome, and the completion of this process is expected to further enhance cross-border supervisory cooperation and information sharing.

Going forward, the expansion of the scope and content of fit-and-proper requirements, as is envisaged in regulation currently under preparation, would be another positive step. As is the case for all EU insurance regulators, the implementation of Solvency II will place increasingly heavy demands on supervisory resources and may require ISVAP to prioritise its activities accordingly. In doing so, it will need to remain vigilant and ensure its staff do not focus exclusively on Solvency II processes at the expense of ongoing prudential supervision. Adequate supervisory resources are a precondition for effective supervision, particularly when major regulatory reforms are underway.

4. Corporate governance, investor protection, and market transparency

The FSAP noted that the Italian corporate governance framework incorporated a high degree of investor protection – in some areas more stringent than international practice – but that its benefits were not always fully realised. In particular, highly concentrated ownership, cross-shareholdings, and pyramid structures made it difficult for minority shareholders to implement or enforce the rights that were enshrined in the law. The FSAP welcomed reforms that had given CONSOB more resources, augmented its autonomy, and raised pecuniary sanctions.

In terms of enhancing corporate governance practices, the FSAP recommended strengthening the application of minority shareholder rights by mandating a majority of independent directors and requiring that the Board of Directors include a representative of minority shareholders. On the insurance sector (ICP 9), it recommended that consideration be given to requiring that all insurers conform to corporate governance requirements applicable to listed companies as a way of strengthening governance and protecting policyholders. It also recommended that legal protection be provided for those parties required to report relevant concerns to ISVAP, and that ISVAP should strengthen its assessments of compliance with corporate governance requirements (including via regular contact with the boards, senior management, and auditors of insurers) and of the effectiveness of practices in this area.

With regards to investor protection issues, the FSAP recommendations focused primarily on the selling practices of intermediaries notably as regards:

- disclosure of the risk characteristics of structured products sold by banks, including in marketing these instruments to SMEs; and
- enhanced monitoring of market intermediaries by CONSOB to ensure compliance with suitability and information disclosure requirements under the EU's Markets in Financial Instruments (MiFID) Directive.

On market transparency, the FSAP recommended that full prospectus requirements be applied to non-listed bank debt instruments and that ISVAP be given the power to require disclosure of the financial situation of insurance firms (to be made consistent with disclosure requirements for publicly listed firms to the extent possible) and of the risks to which they are subject (ICP 26). It also recommended that all insurers be legally obliged to make their annual audited financial statements easily available to stakeholders, and that ISVAP publish, on an entity-specific basis, some of the relevant information it collects in supervisory returns. This information would include the balance sheet, income statement and solvency margin; include both year-end and interim data; be made available as soon as possible after the end of each reporting period; and be accessible over the Internet.

Steps taken and actions planned

Corporate governance: With regard to minority shareholders, the two relevant legislations are the Italian Civil Code (company structures) and the Consolidated Law on Finance (CLF, minority shareholder rights), which have been amended in 2005-06. Article 147 of the CLF provides that for two-tier[22] listed companies, at least one member of the Board of Directors has to be elected from the minority slate that obtained the largest number of votes and is not linked in any way with the shareholders who received the highest number of votes. In addition, the same article also requires at least one of the members of the Board of Directors, or two if the Board of Directors is composed of more than seven members, should satisfy certain independence requirements. Moreover, the individuals elected as members of the Board of Auditors must comply with an independence and integrity test, while the chair of that Board will be elected by members who are elected by the minority shareholders. If the company is organized under a one-tier system, at least one third of the member of the Board must comply with the above mentioned independence requirements.

The modalities for the election of Board members are established in detail in the Issuers Regulation issued by CONSOB. Additional disclosure requirements regarding the independence of members of the board and of control bodies, as well as on corporate governance and ownership structures, are imposed on publicly listed firms. CONSOB also issued in March 2010 new rules on related party transactions that provide for an enhanced

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[22] "*Traditional Italian companies have a somewhat unusual corporate structure. They follow neither the Anglo-American model of unitary board elected by the shareholders, nor the German model of a shareholder-elected supervisory board, which itself appoints a management board. Rather, the shareholders of traditional Italian companies elect two boards: a Board of Directors and a Board of Statutory Auditors. New legislation [Legislative Decree 6/2003]... now permits Italian companies much greater flexibility in their organizational structures, allowing them to select either a unitary board, a two-tier board, or the traditional Italian model. To-date, however, virtually all listed companies continue to retain the traditional Italian model.*" For more details on Italian corporate structures, see the chapter on investor protection and corporate governance by Drummond and Friedman in "*Italy: Selected Issues*" (IMF Country Report No. 05/41, February 2005, available at http://www.imf.org/external/pubs/ft/scr/2005/cr0541.pdf).

role for independent directors in overseeing such transactions and for additional transparency in order to strengthen the protection of minority interests.[23]

With regards to the insurance-related corporate governance recommendations, ISVAP issued Circular 577 in 2005 that provided a comprehensive framework of corporate governance rules, internal control systems, risk management, and internal auditing for both listed and unlisted insurance companies. The circular was consolidated in Regulation 20/2008, which also includes specific instructions on compliance and outsourcing arrangements. The new framework includes specific provisions about the role of the board of directors, senior management, the effectiveness of internal controls and other functions (internal audit, risk management and compliance). It has enabled ISVAP to assess, both via on-site inspections (see section 3) and off-site analysis in recent years, compliance with, and the robustness of, corporate governance in insurance undertakings on a solo basis and at group level.

On the other hand, no action has been taken with regards to providing legal protection for those parties required to report concerns to ISVAP in respect of their fulfilment of this requirement. The Italian authorities believe that those parties - especially external auditors and actuaries of all financial firms and listed companies - already have a legal obligation to report such concerns to the relevant supervisory authorities, and that they are shielded by this obligation and by the confidentiality duties imposed by law on these authorities. It is worth noting that the same regime is in force for the reporting duties of external auditors appointed by other financial institutions and listed companies, since they also have to report any concerns to the relevant supervisory authorities (see section 2).

Investor protection: With respect to disclosure requirements and enhanced monitoring of market participants, a new set of rules on the provision of investment services for banks and investment firms entered into force in 2007 following the implementation of MiFID. Following an extensive consultation procedure, CONSOB issued Communication 9019104 in March 2009 with detailed requirements for intermediaries to act correctly and transparently in the distribution to retail customers of illiquid financial products (bank bonds, insurance financial products, and derivatives). It recommends measures for intermediaries on transparency, prescribing price-monitoring methods, and requiring that intermediaries have in-depth knowledge of the illiquid products distributed and of the customers receiving offers. Intermediaries must provide the customer with information on the correct value, implicit and explicit costs of the illiquid product distributed, and any deferred costs. The intermediary is also required to have an in-depth knowledge of customer preferences, particularly in terms of investment horizons, so as to guarantee balanced advice. These provisions have been adopted in subsequent guidance prepared by intermediaries' associations, which has been verified (together with guidance on suitability, best execution, and retail contracts) by CONSOB.

Amendments to the CLF in 2005 provide that the subscription and placement of financial products issued by banks and insurance companies shall be subject to the same conduct of business rules applicable to the carrying out of investment services (i.e. those provided for under MiFID). CONSOB's Regulation on Intermediaries therefore provides that banks shall comply with the conduct of business rules when they issue and sell own financial products.

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[23] A simplified regime is envisaged for newly listed companies and for smaller companies. Certain transactions may also be fully or partly exempt from application of the regulation.

CONSOB has launched since 2007 an extensive review of the operation of investment firms and banks as part of the implementation of MiFID. Numerous activities have been undertaken in recent years to ensure compliance with this framework, including meetings with corporate officers, requests for information, on-site investigations of supervised entities, as well as sanctions and other disciplinary measures. Following investigations of the operations of major intermediaries, CONSOB recently held meetings with the boards of directors of some of these firms to discuss sales policies and investor protection issues.

With regards to the specific marketing of derivatives, CONSOB carried out on-site inspections of major players in cooperation with the BI and held meetings with bank boards to examine the sale of OTC derivatives as hedges to local authorities and the continued monitoring of their effectiveness. This was driven in large measure by the problems created from the sale of OTC derivatives products - primarily interest rate swaps - by major, mostly foreign banks to Italian municipalities in recent years.[24] While these contracts allowed municipalities to swap fixed-rate loans for (initially) lower variable rates, the crisis caused them to generate significant losses as a result of volatility in rates. In response, several municipalities have engaged in litigation procedures against banks, claiming that they were wrongly sold these products. In December 2008, the Italian Parliament passed Law 203/2008 that prohibits local municipalities, provinces and regions from entering in derivatives contracts, issuing 'bullet' obligations (i.e. repayment of entire principal at maturity), and ignoring the upfront component of derivatives contracts from debt calculations. The authorities are in the process of introducing additional regulations governing the sale of such instruments.

Market transparency: Regarding non-listed bank instruments, the Saving Law 262/2005 applied prospectus publication requirements to public offerings of such instruments. As a result, in line with the relevant FSAP recommendation, debt instruments issued by banks are currently subject to full prospectus requirements as provided in Prospectus Directive 2003/71/CE.[25] It is worth noting that, even if not provided in EU legislation, CONSOB applies disclosure (prospectus) requirements to investment products issued by insurance companies. Examination of the prospectuses of various financial products filed with CONSOB in 2009 led to several requests for updates of information provided to investors.

With regards to insurance, ISVAP has issued a number of regulations on the structure and presentation of financial statements for listed and non-listed insurance and reinsurance undertakings (including groups), as well as provisions on solvency. These accounts must be accompanied by a report of the Board of directors about the financial position of the firm, the development and performance of its management, and the principal risks and uncertainties.

In order to strengthen disclosures in the financial sector, the BI, CONSOB, and ISVAP issued in 2009 a joint recommendation concerning "disclosure in financial reports on the going concern assumption, financial risks, and tests of assets for impairment and uncertainties in the use of estimations". The same authorities issued in 2010 a new joint recommendation on

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[24] According to the authorities, the notional value of these contracts by local authorities amounted to around €43 billion at the end of 2009.

[25] A simplified prospectus not subject to CONSOB's prior approval is allowed in a few cases, such as repeated plain vanilla non-equity offerings below a certain monetary amount.

disclosure in financial reports, tests of assets for impairment, terms of financial loan/debt agreements, plans for debt restructuring, and use of the fair value. ISVAP has also recently issued a Regulation on Transparency in which insurance undertakings are required to disclose as pre-contractual information their solvency ratio. However, no specific steps have been taken by ISVAP to-date to publish, on an entity-specific basis, some of the information provided to it in supervisory returns, although the forthcoming implementation of Solvency II is expected to further enhance disclosure requirements.

Lessons and issues going forward

The Italian authorities have made good progress in terms of addressing the relevant FSAP recommendations, although additional actions could be undertaken in a few areas. Improvements are apparent in strengthening minority shareholder rights and independence requirements via the amendments provided in the Civil Code and the CLF. The enhanced oversight and enforcement of corporate governance requirements for insurers also appear to address the relevant FSAP recommendation. Expanding public disclosure requirements for insurers (including on their investment products) and bank debt issuers, as well as strengthening the monitoring framework to ensure adequate investor protection (including on the marketing of structured products by banks) are also commendable steps for increasing market confidence. In terms of additional steps to address the FSAP recommendations, providing legal protection for those parties that are responsible to report any corporate governance deficiencies would also enhance their ability to communicate freely with ISVAP.

The financial crisis has highlighted the importance of corporate governance for the sound management of financial institutions.[26] The amendments provided in the Civil Code and the CLF in Italy provide a good opportunity for minority shareholders to be represented in management, especially in the Board of Auditors of financial institutions. However, while minority shareholders' rights are an essential feature of good corporate governance practices, there is a range of views on the correct model and balance regarding the presence of minority shareholders in the management of companies. These views vary across countries, reflecting different historical experiences, legal traditions, and corporate structures.

The problems arising from the sale of interest rate swaps and other OTC derivatives products to Italian municipalities have parallels in other countries[27], and raise broader issues about the appropriate definition of a sophisticated investor and about policy measures to ensure that complex derivatives and other structured products are sold only to suitable investors. The sales of such products in some FSB member jurisdictions were partly driven by the long period of low volatility and low long-term interest rates that preceded the global financial crisis, which may have prompted complacency about risk and a search for yield among

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[26] See, for example, the Walker Review of corporate governance in UK banks (November 2009, available at http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/d/walker_review_261109.pdf), "Bank Governance: Lessons from the Financial Crisis" by Ard and Berg (World Bank Crisis Response Note 13, March 2010, available at http://rru.worldbank.org/documents/CrisisResponse/Note13.pdf), and "Principles for enhancing corporate governance" by the BCBS (October 2010, available at http://www.bis.org/publ/bcbs176.pdf).

[27] Similar derivatives-related problems by local authorities surfaced across several developed countries (e.g. Australia, Belgium, France, Norway, Portugal, UK, and US). See "Municipal Bombs" by Dodd (IMF Finance & Development, June 2010, at http://www.imf.org/external/pubs/ft/fandd/2010/06/pdf/dodd.pdf).

investors. Such products, especially when they are customized and hence lack market liquidity, are susceptible to misuse since they can leave the end-user at a disadvantage compared to the dealer bank. While the retail public at-large is not considered sophisticated, most other market participants are eligible for these products and subject to 'caveat emptor'.[28] A broad range of policy measures can be undertaken to address this problem, ranging from the complete prohibition of such transactions for certain categories of investors to specific position limits, additional information disclosure and reporting rules, and customer suitability and fiduciary requirements. Many jurisdictions distinguish between sophisticated and other investors, and have different regulatory requirements (registration, suitability, disclosure at point-of-sale etc.) accordingly. However, defining a sophisticated investor is not easy and suitability varies not only according to this definition but according to the specific circumstances of each individual investor. The fact that the majority of sales in many of these countries took place on a cross-border basis by a small group of large foreign investment banks introduces an additional dimension of complexity in the choice of appropriate measures. Policy development work is currently taking place at the international level to address some of these issues.[29]

[28] As with all EU member states, the definition of a professional investor adopted in Italy is based on the provisions of the MiFID .

[29] In particular, IOSCO is developing investor suitability principles for the distribution of complex financial products, and it will shortly be issuing a report with principles on point of sale disclosure for retail investors regarding collective investment schemes and similar products. The European Commission has recently issued a consultation paper on the reform of MiFID, which includes the strengthening of rules on the sale of complex products. See also "Customer suitability in the retail sale of financial products and services" by the Joint Forum (April 2008, available at http://www.bis.org/publ/joint20.pdf).

Annex: Italy peer review – Selected FSAP recommendations

a. Banking supervision

Relevant BCP Assessment Recommendations	• Principle 1.5 (Legal Protection): The authorities should give consideration to amendments to the legislation to provide legal protection to the supervisory authority and its officers against the possibility of legal action stemming from measures adopted in good faith in the performance of their functions. • Principles 8 (Loan Evaluation and Loan-Loss Provisioning) and 21 (Accounting Standards): During the transitional period allowed by Basel II for the case of Italy to use less stringent 180 days past due requirements, rules and procedures should be modified to conform in due course to the widely accepted international practice of 90 days past due. The BI [Bank of Italy] may wish to consider, in the exercise of its regulatory powers, revising the applicable instructions so as to better align provisioning with the estimated losses of the loan portfolio of the banking system so that banks can better withstand a sudden deterioration in credit conditions. • Principle 10 (Connected Lending): The BI is strongly recommended to consider the issuance of a comprehensive regulation on connected lending to address the issues of definition, overall limits, and reporting. • Principle 14 (Internal Control and Audit): The authorities should consider amending the 1993 BL [Banking Law] and applicable regulations to legally empower the BI to remove expeditiously those banks directors or senior officers who may have become unfit for their duties. • Principle 19 (Validation of Supervisory Information):Given its current level of resources, and the related factor of its 3- to 6-year inspection cycle, the BI should review the means by which it may derive greater benefit from the work of external auditors in specific areas (e.g., money laundering) in the execution of its own mandate. It should also review the status of some banks, albeit extremely small institutions, which are not subject to external audit. The BI should also consider revising the 1993 BL so as to obtain the power to revoke the appointment of a bank's external auditors when their performance is deficient and to provide it with the authority to establish the scope and standards to be achieved in banks' external audits. In light of the rapid changes in the banking industry and risk management technology, the BI should continue to keep the adequacy of resources under review.

b. Insurance regulation and supervision

Relevant ICP Assessment Recommendations	• Principle 1 (Conditions for effective insurance supervision): It is recommended that the responsibilities for the supervision of pension products be clearly defined in a manner that supports the ability of ISVAP to conduct prudential supervision of insurers selling such products, while avoiding the duplication or conflict of supervisory requirements applicable to the insurers. It is recommended that the accounting and supervisory reporting requirements applicable to insurers under Italian GAAP be harmonized with IFRS as far as possible. This will provide both ISVAP and other stakeholders with a consistent basis for the evaluation of insurers and minimize the reporting burden. It is recommended that a specialized alternative dispute resolution mechanism, such as an independent ombudsman, be established to deal with complaints of insurance consumers (or all financial sector consumers). This could hasten the resolution of some problems and lessen the burden on the courts and on ISVAP. It is recommended that steps be taken to improve the timeliness and consistency of the legal process. This will assist consumers both directly, in the resolution of insurance claims and disputes, and indirectly, by aiding

	in the efficient winding-up of failed insurers. • Principle 2 (Supervisory objectives): It is recommended that ISVAP explicitly communicate the principal objectives of insurance supervision and explain how its plans and activities support these objectives. • Principle 3 (Supervisory authority*):* It is essential that a supervisory authority be able to take good-faith actions without fear of lawsuits. Therefore, it is recommended that both the board of directors and staff of ISVAP be protected against lawsuits for actions taken in good faith while discharging their duties, if not through formal protection under the law then at least through liability insurance or a written promise of indemnification for costs. It is also essential that those working for a supervisory authority be able to be completely objective in the exercise of their duties. It is recommended that ISVAP establish and enforce a code of conduct that includes a prohibition on dealing in shares and investing in companies subject to ISVAP's supervision, and that it impose the same requirements on external specialists that it retains. ISVAP's independence from government, assurance of access to funding and accountability could be enhanced by making changes to the cost assessment and financial reporting processes. It is recommended that ISVAP's budget and assessment formula be subject to the approval only of its board of directors, rather than requiring a decree by the MoF, and that its audited financial statements be published in its annual report. It is also recommended that ISVAP's meetings with industry representatives to discuss its priorities and their budgetary impact include an annual explanation of the main items of expenditure for the most recent year and the budget for the coming year. • Principle 4 (Supervisory process*)*: It is recommended that ISVAP develop criteria for assessing the overall risk of an insurer and define the nature of supervisory action corresponding to various levels of risk, and communicate this information to the industry. It is recommended that once ISVAP is confident of its ability to perform overall risk assessments, it inform each insurer of its particular risk rating. It is recommended that consideration be given to establishing a specialized independent tribunal as the first level of appeal against decisions of ISVAP. This could improve both the speed with which appeals are resolved and the consistency of decisions, while reducing the workload of both ISVAP and the courts. • Principle 5 (Supervisory cooperation and information sharing): It is recommended that ISVAP take steps to exchange information with relevant supervisors outside of the EU/EEA. It is also recommended that legislation be amended to remove the requirement of reciprocity as a condition of such exchanges. These actions will help to ensure that ISVAP is adequately informed of developments that may affect all supervised entities. • Principle 7 (Suitability of persons): It is recommended that the legislation be amended to require that all senior management of an insurer, not just the chief executive, meet fit and proper requirements. It is recommended that the fit and proper requirements be defined and applied broadly enough to consider an individual's competence and soundness of judgment for fulfilling the responsibilities of the particular position, the diligence with which the person is fulfilling or is likely to fulfil those responsibilities and whether the interests of policyholders or potential policyholders of the insurer are, or are likely to be, in any way threatened by the person holding that position. This will enable the supervisory authority to take action to address serious problems in the direction or management of an insurer. It is recommended that ISVAP contact the home supervisor of any non-EU/EEA insurer, as a regular part of the process of assessing the fitness and propriety of its key functionaries. • Principle 8 (Changes in control and portfolio transfers): It is recommended that ISVAP document and publish the specific criteria that it will apply in assessing proposed changes in control and portfolio transfers. It is recommended that consideration be given to including a requirement, either in the legislation or among the assessment criteria, that a report be prepared by an independent actuary regarding the risks that a proposed change in control or portfolio transfer may pose

	to the interests of the policyholders of both the transferee and transferor. • Principles 10 (Internal control) and 18 (Risk assessment and management): It is recommended that the draft circular on internal control and risk management be finalized and implemented with high priority. It is recommended that ISVAP strengthen its off-site assessment of internal controls by routinely reviewing internal audit plans and reports, as well as reports of the board of statutory auditors. It is recommended that ISVAP meet regularly with the head of the internal audit function, the appointed actuary, the external auditor, the auditing actuary and the board of statutory auditors to obtain information from them regarding the effectiveness of internal controls. Such meetings should take place on a confidential basis, without management present, and it is recommended that the persons involved have legal protection from liability for providing information to ISVAP. It is recommended that legislation be amended, as necessary, to facilitate these changes. • Principle 13 (On-site inspection): It is recommended that ISVAP significantly increase both the number and scope of its on-site inspections. It is recommended that ISVAP provide advance notice of its inspections, except in cases of specific compliance concerns. Advance notice would enable an insurer to make the relevant staff available for discussions with the inspectors, would be less disruptive to the insurer's operations, and promote a more cooperative relationship that should increase the flow of information to ISVAP. It is recommended that ISVAP's on-site inspections seek to assess not only compliance with requirements but the effectiveness of an insurer in identifying and managing its risks. • Principle 15 (Enforcement or sanctions): It is recommended that legislation be amended to explicitly enable ISVAP to restrict or suspend dividends or other payments to shareholders, when such payments would jeopardize the insurer's solvency. It is recommended that legislation be amended to provide that no breach of fitness or propriety requirements will be automatically disregarded after three years have passed, but that certain breaches may be disregarded by ISVAP after such period. This will help to protect insurers and their policyholders from individuals who have committed serious or recurrent adverse actions. • Principle 17 (Group-wide supervision): It is recommended that ISVAP systematically exchange quantitative and qualitative information with its Italian counterparts responsible for supervision of the banking, securities and pension sectors, where a supervised insurer is a member of a group that includes companies operating in the other sectors. This will assist ISVAP and the other supervisors in assessing the overall risk profile of a group, as well as possible implications to the individual supervised entities. It is recommended that ISVAP contact the home supervisor of any non-EU/EEA insurer operating in Italy, as a regular part of the process of assessing the potential impact of group activities on such insurer. • Principle 19 (Insurance activity): It is recommended that the draft circular on reinsurance be finalized and implemented with high priority. It is also recommended that ISVAP implement its plans to increase the depth and breadth of its off-site and on-site assessments of reinsurance. Taken together, these recommendations should help to ensure that insurers have appropriate reinsurance programs in place, commensurate with the levels of risk determined by their boards of directors and acceptable to ISVAP. • Principle 21 (Investments): The investment requirements are focused on ensuring the quality of assets supporting the technical provisions. It is important that the board of directors take overall responsibility for both the quality and suitability of all of an insurer's assets. Therefore, it is recommended that ISVAP require each insurer to have an overall strategic investment policy and that such policy be approved and reviewed annually by the board of directors. It is also recommended that ISVAP provide guidance regarding the main elements to be addressed by an insurer's investment policy. It is recommended that ISVAP regularly review the results of the stress testing of assets, for those insurers that already undertake such testing and for others, once such testing is required in accordance with the circular on internal control and risk management. ISVAP should also review the contingency plans that

	will developed by insurers in accordance with that circular. • Principle 23 (Capital adequacy and solvency): Although reinsurers are supervised by ISVAP, they are not subject to the solvency margin requirements. Since the ICPs apply to the supervision of both insurers and reinsurers, it is recommended that Italy take action to extend relevant prudential requirements to reinsurers. This might be accomplished through implementation of the EU Directive on reinsurance. Under the current solvency margin approach, some EU insurance supervisors have provided guidance to insurers that a higher level of capital adequacy is expected of them. It is recommended that ISVAP establish and communicate a solvency control level in excess of the minimum solvency margin. It is recommended that ISVAP regularly review the results of the stress testing of solvency, once such testing is required in accordance with the circular on internal control and risk management. • Principle 24 (Intermediaries): The implementation of the EU Directive on Insurance Intermediation, through the new insurance code, will strengthen the legal framework with respect to those intermediaries who are required to register with ISVAP. It is recommended that the new insurance code be adopted and that its provisions on insurance intermediation be implemented with high priority. The new insurance code is expected to include provisions that would address the significant number of individuals dealing with the public in the sale of insurance that are currently outside the scope of registration, i.e., sub-agents, financial promoters, and bank and post office employees. It is recommended that legislation be adopted to require that all insurance intermediaries operating in Italy be subject to registration and direct supervision, and that the conditions of registration include demonstration, through examination, of adequate insurance expertise. It is recommended that ISVAP cooperate with CONSOB and the Bank of Italy, as appropriate, to ensure that all insurance intermediation activities are subject to periodic on-site inspection. It is recommended that claims adjusters dealing with any class of insurance be required to register with ISVAP. These recommendations should help to ensure that consumers are being adequately served and advised in their insurance dealings. • Principle 25 (Consumer protection): It is recommended that insurers and intermediaries be required to seek information from consumers that is appropriate in order to assess their insurance needs, with respect to all classes of insurance, before giving advice or concluding a contract. It is also recommended that insurers and intermediaries be required to disclose possible conflicts of interest to existing or potential policyholders, with respect to all classes of insurance. It is recommended that ISVAP perform an analysis of the use of multi-year non-life insurance contracts and take action in response to deal with any potential abuses posed by the use such contracts. • Principle 27 (Fraud): It is recommended that ISVAP explicitly require that insurers and intermediaries implement procedures and controls against fraud and that it assess their effectiveness periodically.

c. Corporate governance, investor/consumer protection, and market transparency

Relevant FSAP Recommendations	• Strengthen the application of minority shareholder rights by mandating a majority of independent directors and requiring that the Board of Directors include a representative of minority shareholders. • Enhance the monitoring of banks' internal guidelines on the marketing of structured products to small and medium sized corporations to ensure that risks are appropriately disclosed
Relevant ICP Assessment Recommendations	• Principle 9 (Corporate governance): It is recommended that consideration be given to requiring that all insurers conform to all of the corporate governance requirements applicable to listed companies. This would help to strengthen the governance of all insurers and the protection of their policyholders. It is recommended that legislation provide for legal protection from liability for those parties required to report

	concerns to ISVAP, in respect of their fulfilment of this requirement. This would reinforce their ability to communicate freely with ISVAP. It is recommended that ISVAP strengthen its off-site and on-site assessment of both compliance with corporate governance requirements and the effectiveness of insurers' corporate governance practices. Such assessments could include regular reviews of minutes of the board of directors and board of statutory auditors, materials provided to these boards and business plans. Regular, ongoing contact between supervisory staff and the senior management of insurers, along with periodic meetings with their boards and auditors, would also contribute greatly to the ability to make such evaluations. • Principle 26 (Information, disclosure & transparency towards the market): It is recommended that legislation be amended to clarify ISVAP's power to require insurers to disclose information on their financial situation and the risks to which they are subject. It is also recommended that ISVAP establish disclosure which, to the extent practical, is consistent with the disclosures required of listed companies. It is recommended that legislation require all insurers operating in Italy to make their annual audited financial statements easily available to stakeholders. It is recommended that ISVAP publish, on an entity-specific basis, some of the information provided to it by insurers in the supervisory returns. It is recommended that the information: include the balance sheet, income statement and solvency margin; include both year-end and interim data; be made available as soon as possible after the end of each reporting period; and be accessible over the Internet. It is recommended that legislation be amended, as necessary, to facilitate such publication.
Relevant IOSCO Assessment Recommendations	• Principle 14 (Principles for issuers): Full prospectus requirements as provided in the Prospectus Directive (2003/71EC) should be applied to non listed debt instruments issued by banks. • Principle 23 (Principles for market intermediaries): CONSOB should consider enhanced monitoring of market intermediaries to ensure compliance with suitability and information disclosure requirements, within the limits of the MIFID Directive.