



EUROPEAN CENTRAL BANK

EUROSYSTEM

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OPINION OF THE EUROPEAN CENTRAL BANK

of 31 August 2016

on the Banca d'Italia's circular implementing the reform of Italian cooperative banks

(CON/2016/41)

Introduction and legal basis

On 21 July 2016, the European Central Bank (ECB) received a request from the Banca d'Italia for an opinion on draft circular No 285 implementing the reform of *banche di credito cooperativo* (BCCs, 'Italian cooperative banks') (hereinafter the 'draft circular'). The draft circular follows the conversion of Decree-Law No 18 of 14 February 2016 into law, which amended Legislative Decree No 385/1993 (hereinafter the 'Consolidated Law on banking')¹.

The ECB's competence to deliver an opinion is based on Articles 127(4) and 282(5) of the Treaty on the Functioning of the European Union, and the third and sixth indents of Article 2(1) of Council Decision 98/415/EC², as the draft circular relates to the specific tasks conferred upon the ECB concerning the prudential supervision of credit institutions, the Banca d'Italia and rules applicable to financial institutions insofar as they materially influence the stability of financial institutions and markets. In accordance with the first sentence of Article 17.5 of the Rules of Procedure of the European Central Bank, the Governing Council has adopted this opinion.

1. Purpose of the draft circular

- 1.1 The purpose of the draft circular is to implement Articles 37-bis and 37-ter of the Consolidated Law on banking concerning cooperative banking groups.
- 1.2 The draft circular defines the structure of a cooperative banking group and lays down conditions that must be fulfilled by the cooperative banking group members. Under the draft circular, a cooperative banking group is composed of: (a) a parent bank; (b) BCCs that have entered into a cohesion contract; and (c) other banks that are not BCCs, and financial and ancillary services undertakings³ controlled by the parent bank. Under the draft circular, the parent bank is the sole entity that may exercise the powers of direction and coordination over the affiliated banks and is responsible for ensuring stability and sound and prudent management of the cooperative banking group. The activities falling within the sole responsibility of the parent bank shall not be outsourced or delegated.

¹ See Opinion CON/2016/17. All ECB opinions are available on the ECB's website at www.ecb.europa.eu.

² Council Decision 98/415/EC of 29 June 1998 on the consultation of the European Central Bank by national authorities regarding draft legislative provisions (OJ L 189, 3.7.1998, p. 42).

³ See paragraph 2 of Section II, Chapter 2 and Section II, Chapter 3 of the draft circular.

- 1.3 In addition, a cooperative banking group may also include a local sub-group that includes a sub-holding bank based in a specific geographical area. This sub-holding bank supports the parent bank in the task of directing and monitoring the BCCs by giving the parent bank's instructions to the BCCs. All entities of the sub-group, including the sub-holding bank, are subject to the parent bank's powers of direction and coordination⁴.
- 1.4 By entering into a cohesion contract, the BCCs join the cooperative banking group and agree to be subject to the parent company's direction and coordination, powers and control. The parent company's powers include: (a) issuing binding instructions to the affiliated banks and to the other companies of the cooperative banking group; (b) taking appropriate corrective actions if affiliated BCCs do not comply with the parent company's instructions; and (c) issuing sanctions proportionate to the seriousness of the breach of contractual obligations in question. Compliance with the parent bank's instructions in accordance with the cohesion contract is ensured by a system of controls and interventions over the affiliated banks, which is proportionate to their individual risk profiles⁵.
- 1.5 The parent bank's powers include: (a) corporate governance of the cooperative banking group and its members, including the procedures for appointing, removing and replacing the members of the management and control bodies of the affiliated banks; (b) internal control and IT systems; (c) control and intervention over the affiliated banks; (d) prudential requirements and reporting; (e) decisions of strategic relevance and (f) sanctions⁶.
- 1.6 The draft circular requires the parent bank and the affiliated banks to enter into a cross-guarantee scheme, whereby the parent bank guarantees the liabilities of all affiliated banks and each affiliated bank guarantees the parent bank and the other affiliated banks for their own liabilities. The cross-guarantee scheme has two dimensions. Firstly, the participating banks are jointly liable, within the limits of their individual obligations, for the liabilities of each participating bank that defaults on its creditors (external guarantee). Secondly, there is a mechanism of intra-group financial support by which the participating banks offer each other the financial support needed to ensure their solvency and liquidity, and, in particular, to comply with prudential requirements and satisfy requests by the competent authority. This mechanism also helps in avoiding resolution proceedings⁷.
- 1.7 The draft circular also confers powers on the competent authority, i.e. the ECB or the Banca d'Italia, as the case may be, in line with Council Regulation (EU) No 1024/2013⁸. In particular, the following decisions will not be effective or implemented until authorisation is granted by the competent authority: (a) withdrawal; (b) exclusion from the cooperative banking group; (c) admission or denial of admission to the cooperative banking group. The draft circular also

4 Section II, Chapter 4 of the draft circular.

5 Paragraphs 1, 3, 5 and 6 of Section III, Chapter 1 of the draft circular.

6 Section III, Chapters 1.1 to 1.8 of the draft circular.

7 Paragraphs 1 and 4 of Section III, Chapter 2 of the draft circular.

8 Council Regulation (EU) No 1024/2013 of 15 October 2013 conferring specific tasks on the European Central Bank concerning policies relating to the prudential supervision of credit institutions (OJ L 287, 29.10.2013, p. 63).

empowers the parent bank to instruct the affiliated banks to implement the competent authority's instructions⁹.

2. General observations

- 2.1 The ECB welcomes the fact that the draft circular provides for the parent bank to create the cooperative banking group under its powers of direction and coordination, which are specified in the cohesion contract between the parent bank and the affiliated cooperative banks. These specifications are aimed at ensuring that the cooperative banking group's strategic direction and internal control systems are uniform, as well as ensuring that the cooperative banking group complies with prudential requirements applicable to it.
- 2.2 The ECB takes note of the powers conferred on the ECB as the competent authority by virtue of the draft circular, in line with Regulation (EU) No 1024/2013.
- 2.3 As noted by the ECB in a previous opinion¹⁰, the establishment of a cooperative banking group involves significant challenges for the parent company in terms of risk governance and control systems. In particular, the ECB has emphasised that the parent company should be able to direct and coordinate the cooperative banking group, including by giving direct instructions to the affiliated banks under any circumstances to ensure compliance with applicable prudential rules and supervisory requirements as well as to ensure that the cooperative banking group entities' operations and strategies are in line with the cooperative banking group's policies and objectives. It is of great importance that cooperative banking groups have well-designed control functions, including risk management, compliance, internal audit and planning, and reporting exclusively to the parent company.

3. Specific observations

- 3.1 Under the draft circular, the parent bank performs the internal control functions on behalf of the affiliated banks by way of outsourcing arrangements, although maintaining adequately organised operational support units located at the biggest affiliated banks should be possible¹¹. However, since one of the main objectives of the reform is to more specifically set out the parent bank's exclusive powers of direction and coordination over the affiliated banks, it would be useful to add an explicit clarification to this provision. Such clarification should indicate that the operational support units shall nevertheless be functionally dependent on, and subordinated to, the parent bank's control functions.
- 3.2 The draft circular does not fully clarify the parent bank's decision making powers with regard to granting loans over a certain amount. Consistently with the Italian regulatory framework on banking

⁹ Section I Chapter 3; paragraph 5 of Section III Chapter 1; paragraph 5 of Section III Chapter 1.5; Section III Chapter 3.2; and paragraph 2 of Section IV Chapter 2 of the draft circular.

¹⁰ See paragraphs 3.1.5 and 3.1.6 of Opinion CON/2016/17.

¹¹ First indent of paragraph 3 of Section III, Chapter 1.3 of the draft circular.

groups¹², the draft circular should also provide for establishing a cooperative banking group-wide control system in respect of large transactions. In particular, the parent bank should be given specific powers to confirm loan transactions, whether in the form of a loan, guarantee or any other credit-granting instrument, that exceed a specific percentage of the affiliated bank's own funds. Similarly, the parent bank should be empowered to approve transactions where the total exposure towards the same client or a group of connected clients is above predefined thresholds.

- 3.3 Under the draft circular the parent bank may stipulate in its by-laws for up to 50 per cent of the positions in its corporate bodies to be allocated to the directors and auditors of affiliated banks with a lower risk profile. The selection procedure for these positions is based on merit and takes into account the candidates' previously demonstrated skills and the results achieved in managing the banks of the cooperative banking group. However, the draft circular does not mention key managers¹³. The Banca d'Italia may wish to consider extending the merit-based part of the selection process to key function holders in the parent bank as well as the local sub-groups. Key function holders may be subject to additional rotation requirements in order to ensure their independence.
- 3.4 Under the draft circular, the parent bank has the power to provide instructions regarding management and evaluation of non-performing loans (NPLs)¹⁴. The parent bank should manage directly the most important class of NPLs, i.e. the bad loans portfolio (*sofferenze*), which would provide several advantages.
- (a) It would enable the parent bank to develop an effective strategy for negotiating and carrying out bad loan disposals, including managing such bad loans after disposals take place, where relevant.
 - (b) It would assist in developing a comprehensive, consistent and robust medium- and long-term management strategy for bad loans at the parent company level across the cooperative banking group.
 - (c) It would provide guidance as regards separating the bad loan unit from the lending unit.
- 3.5 Under the draft circular, the parent bank and the affiliated banks must equip themselves with mechanisms to integrate IT systems and data management processes to ensure reliable and accurate risk measurement on an individual and consolidated basis¹⁵. In this respect, a deadline for the implementation of a unified IT system should be introduced. In particular, the draft circular should be amended to ensure that cohesion contracts provide for a single IT system and data management process to be adopted within a reasonable period of time, but no later than three years from the date of entry into the cohesion contract. An adequate integration mechanism would

12 See Articles 53(4) and 67(1)(b) and (d) of the Consolidated Law on banking, as implemented in Section V (internal controls) of Part I, Title IV, Chapter 3 and Section IV (large exposures) of Part II, Chapter 10 of the Banca d'Italia's Circular No 285/2013; Chapter 5 (risk activities towards related entities) of Title V of the Banca d'Italia's Circular No 263/2006.

13 Second indent of paragraph 1 of Section III, Chapter 1.1 of the draft circular.

14 Second indent of the last paragraph of Section III, Chapter 1.3 of the draft circular.

15 Last paragraph of Section III, Chapter 1.4 of the draft circular.

- need to be adopted during the intermediate period to ensure reliability and accuracy of risk measurement on an individual and consolidated basis.
- 3.6 The draft circular confers on the parent bank the following powers and tasks: (a) monitoring and classifying risks to which the participating banks and the system as a whole are exposed; (b) powers of intervention; (c) conducting risk assessment and communicating the findings to the participating banks¹⁶. The draft circular should specify that these powers and tasks are to be conducted by the parent bank annually, at a minimum, and more frequently, if required, due to an affiliated bank's risk profile.
- 3.7 Under the draft circular, the cohesion contract gives the parent bank the power to: (a) issue instructions to the affiliated banks to ensure compliance with prudential requirements on a consolidated and individual basis; (b) define and adopt risk measurement methodologies for regulatory purposes; (c) set rules and criteria for the internal capital adequacy assessment process (ICAAP) that need to be applied by the affiliated banks at individual level; (d) implement instructions from the competent authority¹⁷. In this respect, it is important that the draft circular requires the parent bank to establish uniform criteria for the stressed scenario to be applied by each BCC as part of the ICAAP¹⁸.
- 3.8 The draft circular restricts the scope of the parent bank's control over the affiliated banks, including its intervention and sanctioning powers. The oversight activity must be strictly linked to a set of predefined indicators, the results of the overall oversight activity, and the outcome of the previous intervention. These early warning indicators must refer to the following matters, at a minimum: own funds, credit risk, profitability, liquidity and fund raising¹⁹. These provisions should further specify that this oversight function is built on a framework of progressive metrics under a 'traffic light' approach. The oversight function should be designed in a way that will prevent, to the greatest extent possible, the imposition of measures by the competent authority on an individual or consolidated basis. In particular, the oversight function should be based on a system of early warning and intervention or recovery indicators that would allow the parent bank to: (a) verify affiliated banks' compliance with the instructions issued by the parent bank; (b) classify the level of risk to which the affiliated banks are exposed; (c) provide the grounds to uphold its corrective actions and sanctions imposed on the affiliated banks in accordance with the cohesion contract; (d) promptly provide appropriate measures of intra-group support as referred to in the cross-guarantee scheme.
- 3.9 The draft circular outlines the administrative process that a bank intending to become a parent bank must follow in order to establish a cooperative banking group. If the new cooperative banking group qualifies as a significant supervised entity for the purposes of the Single Supervisory Mechanism, the Banca d'Italia only takes a decision regarding the application after having first

16 First indent of the paragraph 5 of Section III, Chapter 2 of the draft circular.

17 Paragraph 3 of Section III Chapter 1.5 of the draft circular.

18 In accordance with Section II (internal capital adequacy assessment process) of Part I, Title III, Chapter 1 of the Banca d'Italia's Circular No 285/2013.

19 Paragraphs 2 and 3 of Section III Chapter 1.4 of the draft circular.

consulted the ECB²⁰. This should ensure that the ECB is able to fulfil its tasks specified in Article 4(1) of Regulation (EU) No 1024/2013. It is understood that this administrative process is without prejudice to the powers conferred on the ECB by Council Regulation (EU) No 1024/2013. Under that Regulation, the ECB is the competent authority responsible for authorising and withdrawing authorisations of credit institutions, taking up the business of a credit institution and ensuring compliance with Directive 2013/36/EU of the European Parliament and of the Council²¹, which requires credit institutions to have in place robust governance arrangements.

- 3.10 In order to exclude an affiliated bank from the cooperative banking group, the draft circular requires 'the most severe circumstances' to be present²². However, in order to ensure legal certainty, the draft circular should contain more clearly specified requirements for such an exclusion. Moreover, there should be more specification as regards the requirement for the cohesion contract to refer to 'serious violations'²³.

This opinion will be published on the ECB's website.

Done at Frankfurt am Main, 31 August 2016.

[signed]

The President of the ECB

Mario DRAGHI

²⁰ Paragraph 3 of Section V Chapter 1 of the draft circular.

²¹ Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms, amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC (OJ L 176, 27.6.2013, p. 338).

²² Section III, Chapter 1.7 of the draft circular.

²³ Section III, Chapter 3.1 of the draft circular.