

Bank Governance: Models and Reality*

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1. Introduction and main conclusions

The etymology of the word 'govern', from the Latin *gubernare*, "to steer", "to set a course", immediately conveys the sense of a complex action of direction, control, and organization. In economic affairs, the term naturally turns one's mind to 'how' one obtains a given result rather than to 'what' lies upstream and downstream of the process of production and exchange. This is the body of thought that frames Adam Smith's cherished image, in *The Wealth of Nations* (1776, p. 6), of the "eighteen distinct operations" that went into the manufacture of a pin. The same school also embraces the recent definition of corporate governance in the Cadbury Report (1992) as a system of corporate direction and control.

This short essay treats a set of reflections on the system of direction and control of banks, with special reference to Italian banks. The analysis moves from a review of some theoretical premises to an examination of the three main activities that, in practical terms, make up bank governance: administration, control and organization. The work concentrates on the individual intermediary, subsequently offering some brief conclusive considerations on the governance of banking groups.

In both the first and the second part of the work, the emphasis is essentially microeconomic. After locating the analytical foundations for treating the enterprise as a structure of governance more than as a

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production function, the study finds in the theory of information asymmetry and of principal-agent problems the microeconomic bases for assigning banks an essential role as centres of risk and opportunity management to the benefit of the entire economy.

To qualify as effective 'overseeing shareholders' in the outside world in a complementary relationship with the market, however, banks have to overcome a good many internal problems. Confrontation with the reality represented first and foremost by the regulatory framework reveals just how much room there is for improving the efficiency and incisiveness of credit institutions' policy-making and control organs, in the uneasy compromise between pursuing private interest and safeguarding the public good of stability.

The search for reasonable balance between the exigencies of effective economic management and the necessity to curb conflict of interest in the conduct of the directors leads, in the second part of the essay, to a proposal for reform of the Board of Auditors, making that body the full and complete representative of minority shareholders. In addition to reforming the mechanism of appointment of auditors, the revision should also provide for higher qualifications and for adequate new technical support from the bank, especially in the area of risk monitoring, in order to permit more effective oversight of "compliance with the law and with the articles of incorporation", as prescribed by law (Civil Code, Article 2403). In verifying and safeguarding the legality of the bank's operation – think of their heightened responsibilities in combating money laundering – the Board of Auditors has the fundamental duty of preserving and strengthening the good reputation, the bond of trust, that more than anything else constitutes the prime asset of any bank.

The critical frontier in the governance of banks, unlike industrial enterprises, is not solely that between shareholders, directors and internal auditors. In the fiduciary relationship with customers – typically, with large-scale borrowers – there is a weak link, exposed to the risk of added moral hazard and significant distortion, namely branch managers and their relations with the bank's head office. To resolve this and other potential problems of micro-governance, Italian banks must radically rethink the organizational mentality and personnel management methods that have prevailed to date.

We need to get rid of hierarchical arrangements centred on rule-following and seniority, so as to foster a mentality of responsibility and professional capability. Otherwise, even very substantial

downsizing could well prove insufficient to pull us out of the state of depressed profits and shortage of assets that now afflicts the Italian banking system.

Focusing on the microeconomic aspect, i.e. 'how' a bank works (or doesn't), this essay touches only marginally on the macroeconomic thesis that ordinarily serves as cornerstone to many discussions of the (in)efficiency of the Italian credit system. I refer to the public ownership of many leading Italian banks and the supposed urgent need for a swift and generalized withdrawal of the state from the banking industry.

It is my own view that as in discussions of governance, so in discussions of bank privatization the enunciation of simplistic postulates is as vain as dangerous (Sarcinelli 1996e). Gradually, firms and banks need to cross over to arrangements characterized, respectively, by a diminished role for family-based capitalism and by a reduced government ownership. In both cases, however, the process cannot be imposed from above in violation of the rules and the state of the market.

It is not by such Taleban-style dogmas that our economy and our banks will steer their difficult passage through the choppy seas of globalization and the single currency.

2. Theoretical models

2.1. *Production function or structure of governance?*

What are the analytical foundations of corporate governance, and in particular of banking governance? The question may appear incongruous in an essay devoted mainly to the assessment of actual experiences. Nonetheless, at least a tentative response to the need for some micro-foundation will help to put an otherwise disparate set of observations in a unifying framework.

Decentralized coordination of the market, centralized governance of the firm – these are the fundamental assumptions underlying the work of economists in the two centuries of history that have been played out since Adam Smith developed his "invisible hand". A felicitous synthesis was offered by Ronald Coase (1937, p. 388) in the

observation that the marginalist paradigm assigns to the enterprise the role of an "island of conscious power" in the "ocean of unconscious cooperation" represented by the market.

Starting from the common postulates of unlimited rationality, perfect information, no opportunistic behavior, and negligible transaction costs, the theoretical edifice of marginalist equilibrium theory thus rested on the curious twin pillars of decentralized exchange in the market and centralized production in the firm. In a way, the parallelism between them is exogenous to the model. Faith in the allocative efficiency of the market via the price system was long matched by a concept of the firm hinging above all on productive efficiency, i.e. a mechanical capacity to transform input into output.

In this view, organization is relevant only as a function of technology. It represents a model in which the enterprise is likened to a producers' cooperative, always efficiently coordinated by the central personage, the owner-entrepreneur. The latter is the true arbiter of all acts of corporate governance in the phases of planning, operation and control. In the neoclassical design of an 'optimizing' enterprise – one unremittingly engaged in maximizing profit and minimizing costs – correct organizational arrangements are postulated exogenously and any dysfunctions are attributed to unidentified factors, such as the "X-inefficiencies" proposed by Leibenstein (1966).

More generally, following the kind of approach taken by Arrow and Debreu, the design of a single, ideal "first best" schema takes precedence, and the numerous "failures" in applying the theory to reality have to be explained case-by-case. As far as the firm is concerned, the neoclassical optimization model fails to provide a unified explanation of such matters as the separation of ownership and control, while the repercussions of the disjunction emerge mainly in the form of substantial transaction costs and severe agency problems.

Only by postulating limited rationality does one narrow the gap between theory and reality. What were previously considered as curious exceptions become the general rule. No longer a mere production function, the firm as institution discovers its intrinsic *raison d'être* as a structure of governance that is alternative or complementary, but not merely parallel, to the market; i.e., it is a network of largely informal, implicit contracts whereby rational individuals seek to contain transaction costs and attenuate the severe moral hazard entailed in the existence of opportunistic conduct.

This school of critical rethinking may be reasonably taken as the basis for a theory of corporate governance. A cursory review of these analysts necessarily begins with two seminal contributions, that of Ronald Coase (1937) on vertical integration decisions by firms as a typical problem of curbing transaction costs and that of Adolf Berle and Gardiner Means (1932) analyzing the moral hazards stemming from the separation of ownership and control in large modern corporations.

Descending from these founders, essential elements for a theory of corporate governance are to be found in the work of Robin Marris (1964) on "managerial capitalism", in Herbert Simon's development of the postulate of limited rationality (1991), and in the reevaluation of the role of institutions thanks to Douglass North (1991). One of the products of a type of examination that is certainly not exhausted is, finally, the interdisciplinary approach of the "new institutional economics" (Williamson 1996).¹ The latter, joining economic analysis with organization theory and the study of legal forms, contends that transaction costs and agency problems make it impossible to isolate the supply of any good or service from the content of governance embodied in it.

2.2. *Elements of a micro-foundation for banking governance*

The slow evolution of the theoretical concept of the firm from production function to governance structure has not yet fully impacted on banking enterprises. This lag should come as no surprise, considering that it was not until the early Seventies that two worthy economists developed a first, fundamental effort to model banks' behavior according to the neoclassical canons of profit maximization (Klein 1971 and Monti 1972).

Assuming perfect information and risk-neutrality and adopting special hypotheses on the market power of the bank to set the prices of financial instruments, Klein and Monti were able to formulate a relation determining the optimal interest rate on loans as a function of the yield on government paper and the elasticity of credit demand but independent of the deposit rate. In the quarter-century since, the features of this original approach have been variously extended and

¹ For an application of this interdisciplinary approach, see Ciocca (1997).

modified in an effort to accommodate less unrealistic assumptions, especially with regard to the conditions of uncertainty in which banks operate. A review of the broad range of results obtained (Marotta and Pittaluga 1993), sometimes sharply contradicting the indications derived by Klein and Monti, shows just how severe are the limitations of the simplistic theoretical concept of the enterprise as efficient production function, especially with reference to banking.

Mechanically transposing the optimizing framework used for non-financial enterprises, the neoclassical approach to credit intermediation offers a typical exercise in comparative statics, hence a short-run analysis. In this context the Klein-Monti models assume the existence of the banks and simply seek to rationalize their cyclical behavior, *ex post*.

Inevitably, settling the nature and the structural function of banks means taking as central a fairly substantial body of 'failures', i.e. of deviations from the canons of the general equilibrium model. The first theoretical response was offered in the early Sixties by advocates of the "new view" (Gurley and Shaw 1960), who related differences between banks and other intermediaries to the existence of specific regulations. The contributions of the legal restriction theory twenty years later (Fama 1980) were along basically the same lines. For both schools, only legislative constraints can ensure the survival of banks as a separate 'species' within the otherwise undifferentiated genus of financial intermediaries.

Without appeal to the role of law, a sounder theoretical foundation for the existence of banks was developed progressively in the course of the Eighties, borrowing concepts and analyses from information and contract economics, non-cooperative game theory, and the analysis of complex organizations. As in other sectors so in credit intermediation, the turning point in theoretical understanding proved to be the acknowledgement of agency problems and transaction costs.

As regards agency problems, let me recall briefly that in a 'first best' situation the exchange of information between creditor and debtor is perfect and the cost of financial capital accurately reflects the risk of the project or firm being financed (Sarcinelli 1994). In the real world, though, information asymmetry induces opportunistic behavior by borrowers or forms of moral hazard, so that market value tends to reflect the average risk of various projects, not the specific risk of each. Consequently, outside financing inescapably entails

agency costs; these are the added costs that the provider of funds must sustain to 'monitor' the behavior of the borrower. In these circumstances the existence of banks is justified by lower costs of monitoring debtors (Diamond 1984 and Williamson 1986).

As regards transaction costs, the peculiarity of credit intermediation emerges above all in economies of scale whereby banks can provide liquidity on demand "on both sides of the balance-sheet", i.e. simultaneously to depositors and borrowers (Rajan 1996). Upstream, the advantages stem from amassing funds from a broad population of depositors, from lesser information asymmetry, and from better risk diversification in exposure to borrowers. Downstream, the very synergies possible between the economies realized on the deposit-taking and lending fronts give banks the potential for greater efficiency than other specialized intermediaries.

In short, these more promising, modern analytical approaches see the rationale for banks not so much in 'what' they produce as in 'how' they manage to offer, more efficiently, services that could otherwise be provided by other intermediaries or direct interaction between creditors and debtors in the marketplace. This pre-eminence of the 'how' over the 'what', qualifies banks as structures of governance rather than as production functions. Williamson's thesis (1996) that the supply of a good or service cannot be dissociated from its governance content is perhaps more immediately applicable to banks than to any other kind of enterprise.

Called upon to help the market overcome typical problems of governance, credit intermediaries can do so effectively only if they have efficient management and control systems at their disposal. Consequently, the resolution of any problems of banking misgovernance that arise - which is the subject of the second part of this essay - is an indispensable precondition for credit intermediaries' helping to overcome the inefficiency of others and thus to achieve more nearly optimal equilibria.

"Who shall guard the guardians?" Around this question, following the path indicated by Diamond's seminal work (1984), one may group the various analytical issues raised by the recent theoretical debate, especially in the Anglosaxon world (Prowse 1997). Who monitors the banks? How is this monitoring exercised? What are the respective roles of regulation and market mechanisms, assuming that the purpose of the former is to safeguard the bank's stability while that of the latter is to maximize the return to shareholders? How do

deposit protection schemes affect the delegation of monitoring by depositors to banks and the principal-agent relationship between shareholders and bank managers? What are management's objective variables and how far might they diverge from those of the ownership – maximizing expenditure, say, instead of profit? How can the risk preferences of the bank's operations directors be monitored and directed?

More detailed theoretical and practical examination of some of these issues in the Italian context is left to the second part of this essay. For the present, it is worth noting that no comprehensive analytical answer to this cluster of questions has yet emerged. Nevertheless, the suggested solutions, fragmentary though they may be, would appear to concur in indicating a combination of external regulation and internal organizational incentives as the prescription for an efficient and transparent structure of corporate governance in banking. Examples of such solutions are the following: deposit protection schemes providing only partial coverage and with variable premiums, to avoid the complete irresponsibility of depositors for monitoring the bank's performance; calibrated schemes of equity participation for managers (inside ownership) as an expedient for curbing their possible penchant for excessive risk-taking.²

Summing up, the theoretical discussion concerning a hypothetical basis in microeconomics for the system of banking governance suggests the existence of a complex interdependency between external regulation and internal control mechanisms, so that on empirical examination one is led to reject the possibility of substituting the latter for the former or *vice versa* (Prowse 1997). The weakness of boards of directors (at least by comparison with those in industry) and the rareness of hostile takeover bids for banks saddle the supervisory authorities with operating a last-resort control machinery, which is certainly more costly than that which could be provided by the market (Prowse 1995). At the same time, the heart of banking governance is now being more properly identified, theoretically as well as empirically, not so much in the dysfunctions stemming from managers' preference for maximizing some value other than net

² A study of bank failures in the US in the 1980s (Gorton and Rosen 1995) located the main cause not in the commonly deprecated system of deposit insurance at a fixed premium (i.e., regardless of the riskiness of the bank) but in the invulnerability of management; that is, not in moral hazard but in the arrangements of corporate governance.

return to shareholders as in devising external and internal mechanisms for sound, conscious risk monitoring. This, to my mind, is the most interesting direction for continuing investigation.

2.3. *The Rhenish and the Anglosaxon models*

Pending an assessment of the advances made by the more organic analysis of the microeconomic foundations of banking governance, our review of theoretical models would not be complete without at least fleeting reference to the solid body of work (Franks and Mayer 1994, Mayer 1994) centring on the distinction between 'banking' economies (those based on intermediaries) and 'market' economies (those hinged on capital markets).

Very briefly, the former are characterized by the modest incidence of stock-exchange-listed corporations, relatively concentrated ownership, and long-term relations between banks and firms. The latter, conversely, feature a high proportion of firms listed, relatively diffuse ownership and short-term banking relations (Sarcinelli 1992, 1996a, 1996c, 1996d).

On closer inspection, perhaps what really distinguishes the two models is the importance of banks' role in solving the general problems of corporate governance in the economy as a whole. As we have seen, these problems derive from contractual incompleteness, informational asymmetries, agency problems and transaction costs. Even more accurately, we might say that what distinguishes the two models is the differing involvement of banks in the management of risk.

In market-centred economies, the response to failures of the Walrasian equilibrium comes by way of horizontal dispersion of risk among a large number of investors; and the role of banks is not unlike that of other financial intermediaries and even of non-financial enterprises. In the lucid taxonomy devised by Tonveronachi (1997, p. 118), the credit intermediary becomes a 'securitised bank' that "lives off the market, is part of it, and in fact is one of the satellite institutions which make the market more efficient and powerful". The securitized bank takes exogenously from the market both prices and predetermined assessments of risk. The contribution of such an institution to governance for the benefit of the outside world is slight at best.

At the other extreme, in the banking economy, the emphasis is on the vertical or intertemporal model of risk sharing that is established between banks and firms in the long run. Exploiting its superior information, what Tonveronachi calls the "relationship" bank internalizes the governance functions that could otherwise be developed by the market. It generates and supplies private information, assesses and independently prices credit risk, consolidates its domination of the market by building up a store of reputation, which depends chiefly on its human capital, i.e. the skill and competence of its staff.

Obviously, different types of regulatory arrangements are appropriate to the two models. In the relationship bank system, a few intermediaries bear virtually all the risks that are reallocated within the entire financial market. This requires a system of complex, iron-clad rules (Tonveronachi 1997) that ensure stability even in the face of intense, prolonged exogenous disturbances that could engender systemic risks. Such regulations will embrace limitations on maturity transformation, capital ratios based on solvency and market risks, limits on large exposures, and limits on equity participation in non-financial enterprises.

Such a set of rules is much less necessary when what is involved is a large number of securitized banks. Given horizontal risk dispersion and short-term perspectives, the market itself may suffice to give the right incentives to intermediaries as to firms in general to spur effective and efficient corporate governance.

Finally, turning to look at Italy, it is clear that our system is atypical with respect to both the Rhenish paradigm of the relationship bank and the Anglo-American paradigm of the securitized bank. The distinction between market-centred and bank-centred economies cannot cover cases like the Italian, in which legislative 'separation' between banking and industry has produced the degeneration of a bank-centred system but also blocked the development of a market-centred model. Given Italy's still highly fragile financial market, what Tonveronachi (1997, p. 116) calls the "insurance bank" – with multiple-bank borrowing by customers, real collateral, reliance on state guarantees for medium-term loans and especially subsidized credit – struggles to evolve into the relationship or universal bank.

The established practices and attitudes of banks or corporations – not only legal but organizational – cannot be violated by the injection of major elements alien to their tradition or derived from

foreign systems. It takes time, a sense of measure, and above all the ability to distinguish what is the genuine fruit of a specific, intrinsic mode of being from what is brought by "regulation" (Prowse 1994). Regulation affects the concentration of ownership and influences, in general, financial monitoring of borrowers; and these, in turn, are the most efficient instruments for solving problems of agency in corporations, including banks.

As the evolution towards universal banking proceeds, the type and scope of regulation will also, unavoidably, have to be brought up to date. At the same time, the increasing involvement of Italian banks in 'external' risk management obviously heightens their own 'internal' control requirements. The ability of Italian banks to produce a positive governance externality as the "watchdog shareholder" for the industrial system (Ciocca 1997, p. 161) depends on a coherent, effective mix between the regulatory framework and established practice. Only on this condition can the Italian bank truly become a bank of reference (*Hausbank*) without being prey to a few, minority "debtors of reference" (Siglienti 1996, p. 91).

3. Institutional and organizational solutions

3.1. Administration

Building on the insights but also weighing the limitations of existing models, we now take a closer look at bank governance in Italy. In our study we adopt the hypotheses that an enterprise is essentially a governance structure and that the mission of governance is more intense for banking enterprises, owing to the size and multiplicity of the risks to which they are structurally exposed. In this framework our focus is essentially *internal*, identifying three basic levels of bank governance: administration, i.e. direction and management, controls and culture and human capital.

On the administrative level, our analysis of the actual pattern of governance in Italian banking necessarily begins with the classical issue of ownership and control, and the related question of our intermediaries' objective functions.

No one is unaware of the massive state presence in the ownership of Italian banks. Going by the standard of direct or indirect control of over 50 percent of equity, a recent study based on balance sheet data puts the share of public banks in Italy at 57 percent (Conti and Fabbri 1996). A second generally recognized fact is the low profitability and high costs of the Italian banking system, typified by average real per capita labour costs nearly 50 percent higher than in the UK or Germany (Ciocca 1997).

At this point it is simplicity itself to infer the causal link between these two facts – massive state presence and poor profit performance – and conclude that the root of our credit system's serious problems is an inefficient ownership-control combination. In this thesis, paradoxically, the weakness of Italian banks depends precisely on their *not* suffering the typical defect of bank governance, i.e. a dissociation between the objectives of owners and managers. For in this view bank managers and the state share identical preferences for 'spending' rather than profit. For the public owner, the growth of expenditure might better serve such macroeconomic purposes as employment or investment incentives, while for managers the temptation of 'empire building' corresponds to the desire to strengthen their influence and prestige within and outside their banks.

With reference to government, note further the lack of incentives to efficiency for state managers. The latter's equivalence to 'wage-earners', for practical purposes, certainly favoured attitudes of collusion, if not outright co-management, with the trade unions, and this attitude spread to state-owned firms, whose outlook frequently failed to include profit-making. In contrast with government proper, however, the outward propagation, especially to the banks, of the distortions of this dangerous 'politics of consensus' resulted in overstaffing combined with higher per capita personnel costs.³

If the foregoing diagnosis were exhaustive as well as accurate, the remedy would be relatively simple, or at least unequivocally identifiable. The generalized, indistinct privatization of every bank

³ The serious structural constraints, both of mentality and of organization, stemming from the management's lack of the profit motive undercuts the attractiveness of Italian privatizations, especially in the eyes of international investors. The poor participation at the sale of the controlling stake in Banco di Napoli is a case in point. Hence the need for radical treatment, including merger with BNL, one co-purchaser; for while the latter remains publicly owned, over the years it has also demonstrated a much more pronounced market orientation.

still in public hands would enable the market to restore the invaluable profit orientation, at least as far as the banks' owners are concerned. The entry of private shareholders could then engender salutary problems of control over management, to be dealt with through such typical instruments of governance as performance-related compensation, stock options and the like.

Unfortunately, as always, reality is more complicated than such neat generalizations. In fact, when the necessary qualifications are made, the postulate of the causal link between public ownership and inefficiency in Italian banking and the profession of faith in the market's ability to make banks profit-oriented become somewhat shakier.

Internationally, for example, it has been observed (Conti and Fabbri 1996, Sdravovich 1997) that there are some credit systems that are efficient, or at least more efficient than ours, yet have a high portion of publicly owned banks, some higher even than the Italian. In Germany, state ownership amounts to 60 percent of the banking industry, but average real per capita labour costs are one third lower than in Italy.

Even within Italy, moreover, the linkage between market exposure and profitability needs qualification in the light of four possible models (Bruzzone 1997): bank corporations controlled by public foundations; corporations controlled by other public or private entities; cooperative banks (*banche popolari*); and mutual banks (*banche di credito cooperativo*), formerly known as rural and artisans' banks.

Considering cooperative banks and mutual banks, we see in Table 1 that over the past five years these two groups have done substantially better than banks organized in the legal form of joint-stock corporation. The latter suffered a drop of 43 percent in the income/funds ratio between 1991 and 1995, compared with 15 percent for cooperative banks and 30 percent for mutual banks.

Curiously, this elementary check shows that banks organized in legal forms less open to market mechanisms (cooperatives) have proven more profitable. Certainly this is due to exploitation of advantages, especially of location, that may be eroded in the long run by the spread of competition. Nonetheless, my feeling is that the better earnings performance of these classes testifies that a bank's efficiency does not necessarily depend on having some particular formal juridical model or on the ouster of public ownership but may

TABLE 1

NET INCOME AS A PROPORTION OF TOTAL ASSETS
(in percentage)

	1991	1995
Incorporated banks	1.4	0.8
Cooperative banks	2.04	1.7
Leading mutual banks	2.6	1.8

Source: Bank of Italy.

also relate to 'micro' requisites such as the practicability of adaptable, effective internal governance. A key strength of the cooperative banks and mutual banks is certainly their homogeneous shareholder base and a close fiduciary relationship that ordinarily makes for "accurate *ex ante* selection of managers" (Bruzzone 1997, p. 191) and constant monitoring of their action. Perhaps this is why relatively small cooperatives among shareholders who are also 'clients' have managed to outperform large profit-oriented corporations.

Obviously, the relative success of Italy's cooperative banks cannot be adduced to make a case for general application of the cooperative model or for small- and medium-sized institutions as the solution to problems of bank governance, much less to rebut or attenuate the necessity for privatization.

As has been stressed often enough (Sarcinelli 1997b), to survive in today's Europeanized and globalized world, the Italian banking system will have to combine the *gradual* elimination of public ownership with a process of concentration that can give birth to an adequate number of 'players' on the continental scale. In any case, it is precisely this prospect that makes for the critical importance both of the market and of organizational innovation and internal incentives to improve the strategy formulation and management of Italian banks.

As for the market, let us not forget that the growing difficulty of disinvesting when one disapproves of the management's conduct has led British and American shareholders to organize, providing strong economic incentives to institutional investors, for monitoring and direct control of investee companies (IRS 1995). The problem is all the more relevant in a thin market like Italy's.

Internally, with the increasing complexity and growing risks of operating a large bank, a judgement on the top policy-making bodies' organizational adequacy becomes fundamental. To do their job, directors must have not only personal integrity but also proven competence, and in fact this is prescribed by Article 26 of the 1993 Banking Law. But these qualifications should be examined earlier in the process, at the designation of Board members by the shareholders' meeting, instead of being assessed, as now, by the appointee's 'peers' at a meeting of the Board of Directors itself. The Board should retain the power of cooptation to fill a mid-term vacancy.

For the same reasons – complexity and multiplicity of risks – power should not be concentrated in the hands of a single person, be he Chairman of the Board or Managing Director (Sarcinelli 1997a). All the more so if both positions are held by the same person. Also to be avoided is a situation in which the Managing Director wields all effective powers and the Chairman has mere functions of representation. If there is a single Managing Director, power should be shared with the Chairman of the Board; and if the Chairman is to be assigned only representative functions, there should be two or more Managing Directors. The German *Vorstand*, in fact, comprises a number of members. Barring urgent decisions, which have to be taken jointly, the powers of Chairman and Managing Director should be delimited according to subject matter and amount. An American study has found that both strategy formulation and efficiency are likely to suffer when too much authority is delegated to a single manager who does not hold a significant stake in the bank and when the major shareholders are not very active in its management (Spong, Sullivan and De Young 1995).

Another problem is that of holding down the number of board positions held by individual directors, so that they have enough time to devote to each single company.⁴ This is a proper concern, although of course one must distinguish between managers of a banking 'group' – with the potential for useful synergies from membership in a large though not infinite number of subsidiaries' boards – and external, independent members.

To enhance the efficiency of direction and management, in banking as in other corporations, one proposal currently under dis-

⁴ A French committee coordinated by Marc Viénot, Chairman of Société Générale, has recommended a limit of five directorships.

cussion is that to split boards of directors along German lines, with one board responsible for management and the other for oversight (Coopers & Lybrand 1996). Another is the formation of management committees with specified mandates, as in the Anglosaxon models.

For Italy, the two-board German model is desirable only if representation is to be given to interests other than those of the owners (Kregel 1997) – employees, say (Sarcinelli 1997a). For the time being this is not the case of the Italian credit system, or of the industrial system, for that matter. The model of corporate governance cannot be decided irrespective of the type of capitalism in which it must operate. In Italy, the need is to make the system a bit less family-based, somewhat more market-oriented, quite more rule-observant and infinitely more transparent.

As for management committees, these are beginning to be found in Italian banks, sometimes purely advisory, sometimes with decision-making powers, on mandate from the Board of Directors. Among the matters treated systematically by such committees are above all integrated asset and liability management, liquidity position and loans. Again, these are topics that point to the management of risk – credit risk, market risk, counterparty risk, trading risk – as the quintessential, pervasive characteristic of banking.

In Italian banks especially, it is in risk management that one may gauge in practice the importance of a proper and efficacious system of administration, even more than of control and oversight, as we shall see below. Only with suitably risk-weighted measures of profitability can direction, i.e. the setting of the course, be conducted correctly.

Frequently, in citing the entrepreneurial nature of banking, as set out in Article 10 of the Banking Law, people forget that a dollar of profit for a bank is different, in degree if not in kind, from a dollar earned by a manufacturing company. The difference lies in the content of risk and risk management associated with banks' generation of value.

The presence of directors and managers attentive to the complicated problems of risk assessment and management is essential for the governance of the banking enterprise. This sensitivity must be suitably attuned to the preferences of the institution as such.

Getting the top banking policy-makers to take correct account of risks, however, is complicated by the fact that managers venture not only the bank's capital and their depositors' savings but also their own human capital, i.e. their personal reputation and influence

(Milgrom and Roberts 1994). This delicate problem of governance can be solved, provided that one can design systems of executive compensation that can mould their preferences to the degree of risk that the bank deems acceptable. The problem is, in turn, relevant for the agents in the dealing room.

Alongside the matter of incentives, a necessary condition of effective governance is accurate, promptly accessible information and suitable methods of risk adjustment, on the basis of which to update indications as to optimal allocation of capital resources to develop strategic business and contain the risks of loss.⁵

The problem of incentives, massive information needs and complex methods of risk management may thus form serious obstacles to putting Italian bank directors in a position to do their duty, ensuring the "sound and prudent management" mandated by Article 5 of the Banking Law. In matters particularly technical or difficult, the Board of Directors should be able to turn to a consultant, preferably not the same one used by management. Recognizing this danger quite naturally implies considering the importance of internal and external checks and controls and the perhaps even greater importance of the organizational culture of the bank.

3.2. Controls

Of the three banking governance functions dealt with in this essay, certainly the control function is the most delicate. To begin with, to be efficient the design of *internal* controls must necessarily be correlated with the nature and incidence of external controls – by market and supervisory authorities – on the banks' operations (Sdravovich 1997). In the present work, we consider the case of the Italian banks.

As a preliminary, a key question is exactly how far the banks can be considered as equivalent to ordinary enterprises. Authoritative opinions, including those voiced in the present *Special Issue*, offer

⁵ These are the techniques of Risk Adjustment Performance Measurement (RAPM). In essence, these methods consist in the abandonment of the traditional concept of unimpeded pursuit of profit (maximum return) in favour of maximization of profit conditional upon the acceptable level of risk (optimum return). Accordingly, such indicators as ROA and ROE are supplanted by RORAC (Return on Risk Adjusted Capital) and RAROC (Risk Adjusted Return on Capital). On this topic, which is just beginning to be discussed in Italy, see, for example, Schena (1996).

interesting, and differentiated, views. Some find "banks as enterprises, operating in full autonomy in a competitive market" (Ciocca 1997, p. 161). Others hold that "[b]anking, by contrast, is an administered market, in that crucial aspects of entrepreneurial management are subject to the administrative assessment of the supervisory authority" (Visentini 1997, p. 176).

Without embarking upon an eminently theoretical discussion of similarities and differences between these two views, it seems useful to note that, all things considered, the mixture of market and supervisory authority, i.e. of impersonal mechanisms and administrative oversight, is unavoidable. This follows, here as elsewhere, from the banks' twofold objective of maximizing private profit and upholding the public interest in the stability of the financial, economic and, ultimately, social system.

Can banks carry out the mission of safeguarding the public interest relying solely on the free play of market forces? The Italian legislative framework, like that of other countries, answers in the negative. To prevent systemic contagion deriving from improper use of the fiduciary mandate consigned to banks (Sarcinelli 1996b), competitive mechanisms must be regulated and controlled. Nevertheless, the remedy for 'market failures' does not do away with the risk of 'supervisory failures', if the administrative control instruments themselves, albeit indirect and prudential, were to generate new problems of moral hazard (Tarantola Ronchi 1996).

On these premises, the scope of external supervisory controls in Italy is given by the purposes and instruments envisaged by law. The purposes, as laid down in Article 5 of the Banking Law, are: *a*) the sound and prudent management of the institutions subject to supervision; *b*) the overall stability of the system; *c*) the efficiency and competitiveness of the financial system, and hence of its components; and *d*) compliance with provisions concerning credit. The main types of control comprise the use, preferably, of prudential instruments consisting in universal rules designed to contain the risk of banks' operation and ensure capital adequacy.

The dense and highly ramified grid of external controls exercised by the supervisory authorities is a most useful touchstone in considering the mechanisms of governance now in place within Italian banks for internal controls. Three 'actors' are necessary referents: the internal Board of Auditors, outside auditors, and the internal organs for risk monitoring and technical-operational controls.

For the Board of Auditors to exercise effective monitoring powers over the management of the corporation, whether this is a bank or a non-financial enterprise, a necessary condition is sufficient: independence of its members from the Board of Directors. As noted, the need here is for transparency, and if this is to be served in substance as opposed to mere bureaucratic form, it must be guaranteed by the systematic counterbalancing of interests. Rather than assign representatives to minority shareholders in the slate of directors voted, wouldn't it be more effective to enhance and foster the dialectical interplay between Board of Directors and Board of Auditors? Accordingly, I feel that the latter, or at least a part of it, should be elected by the minority shareholders; this would overcome the situation in which "the Board of Auditors may prove ineffective, as in practice controller and controllee have the same origin" (Angelici and Ferri 1996, p. 402). The Board of Directors, chosen by the majority, would have the power, and the duty, to run the corporation, to guarantee rapid, unanimous decision-making. The Board of Auditors, elected by the minority, would have the task of preventing the directors from acting in conflict-of-interest with the corporation, or to the detriment of minority shareholders in intra-group operations, contesting, where necessary even in Court, the resolutions of the Board of Directors.

As part of a reform already projected,⁶ the redesign of the Board of Auditors should make this body more effective in carrying out the mandate already assigned to it under present law of monitoring the administration of the corporation and overseeing "compliance with the law and with the articles of incorporation" (Civil Code, Article 2043). In checking and safeguarding the legality of management, the Board of Auditors has the fundamental duty to preserve and strengthen the reputation and the bonds of trust of the institution, which more than anything else constitute the prime asset of any bank. To enable it to concentrate sufficiently on monitoring and overseeing the "sound and prudent management" of the banking enterprise, the

⁶ The delegation of powers to the government under Law 52 of 6 February 1996, Article 21 (4). This clause provides that "in reordering the regulations governing intermediaries, financial markets and the securities markets and other related matters, the rules governing corporations that issue securities on official markets may be modified, with special reference to the Board of Auditors, the powers of the minority of shareholders, voting syndicates and group relations, according to criteria that strengthen the protection of saving and of minority shareholders". The provision gives a two-year delegation of power to the government, expiring at the start of 1998.

Board could be relieved of the tasks of accounting verification and checking the propriety of the accounting standards, which could perfectly well be delegated to the outside auditors. This would resolve the present overlapping of authority. The Board of Auditors should be empowered to appoint or at least designate the outside auditing firm, with mandate not to exceed the present legal maximum of nine years. Similar rotation requirements should be set for the Board of Auditors itself. The total renewal of the Board should entail a change in the outside auditing firm.

For internal auditors and the outside auditing firm, as for directors, for that matter, the requirements of integrity and above all of competence should be made stricter. The increasing complexity of bank management in globalized markets certainly raises the level of skill needed to perform the job of 'monitor' effectively. Similarly, this growing complexity increasingly demands constant liaison between the Board of Auditors and the bank's internal control structures (Patalano 1993).

Moving away from the traditional inspection-centred approach, the logic of internal controls in banking now emphasizes a better articulated 'technical-operational' approach. The new method relies above all on the development of sufficient, systematic data flows as support for prevention or early-warning systems, including remote signalling, of economic difficulties in given geographical areas or branches of the economy. This is the framework in which the supervisory authorities have now allowed banks to use their own, internal models of market-risk assessment and monitoring, as an alternative to the standard method of determining compliance with the capital ratios.⁷

As a most authoritative observer has noted (Padoa-Schioppa 1996, p. 80*), "the internal model offers clear advantages to both banks and supervisors". For the former, most especially, the development of its own system for measuring and monitoring risk will foster the more widespread and consistent establishment of a risk-management culture. In other words, internal systems alleviate the danger of reducing risk assessment to a dichotomy, with a definite border between soundness and pathology, i.e. some threshold value "above which the bank is secure and below which it should be shut down"

⁷ This is the burden of an amendment, adopted in late 1995, to the capital adequacy agreement under the auspices of the Bank for International Settlements.

(Goodhart 1996, p. 15). This only applies, of course, if the bank's independently developed model produces diagnoses and remedies (for market risk, naturally, but also for credit risk) that are richer and more articulated than the capital adequacy ratios approach taken in the Basle Agreement.

At the same time, reliance on internal systems requires adequate safeguards against abuses, to ensure that freedom from standard parameters does not simply translate into the removal of proper controls. Given that "it is every taxpayer's dream to be free to devise his own income tax form" (Padoa-Schioppa 1996, p. 80*), the efficacy of internal controls depends on a consistent set of incentives that makes the proper exercise of this activity both practicable and 'advantageous' for the bank itself. For instance, the accuracy of a bank's proposed method of assessing and managing risks must pass objective back-tests run on the past history of the bank. Such retrospective tests should be based on suitable hypotheses about the supervisory authorities' possible reactions in case they find that the constraints set by the internal model have been violated by the bank management. Similar tests might certify improvement in a bank's risk management ability, with beneficial impact on its reputation and, hence, its rating in financial markets.

Given the challenge but mainly the opportunity of strengthening their internal capability for managing the risks stemming from financial market operations, Italian banks are now faced with the need to develop "monitoring units" with a capacity for consistent control and management of the entire set of risks undertaken.⁸ To be effective, these units must be clearly set apart from any sort of hierarchical subordination to the managers responsible for operations. In the same way, this control body should be independent from the top corporate decision-makers (the managing director and the general manager) who run the business of the banking enterprise. In my opinion, therefore, the optimal position of the risk control unit is in parallel with the internal inspectorate, reporting hierarchically to the director(s) assigned to oversee non-operational support departments or else directly to the Chairman of the Board. Like the technical-operational control functions, the results of the risk control unit should be communicated to the Board of Auditors.⁹

⁸ Technically, the instrument for coordinated risk monitoring consists in the methodology for calculating the aggregate called "value at risk". See J.P. Morgan (1995).

⁹ This approach represents an effort to enrich and qualify that of Bernardini and Rossetti (1997), in which the risk control unit is assigned genetically as staff to the

3.3. Organization

The third level of our reflection on the modes of bank governance, and in particular Italian bank governance, is organization, understood essentially as the planning, management and culture of human capital. In restricting our attention to 'personnel' resources, we certainly do not intend to deny the importance of such other factors as the bank's technological and informational assets. Yet it is technological progress itself that has increased the importance of the human factor in the bank's capability for effective self-governance and, as a consequence, its ability to serve as an effective instrument for solving the 'problems' of governance that afflict market mechanisms in matching creditors and debtors. In a technological environment that heightens the operational potential of branches and tends to make banks flatter, shorter, it is increasingly clear that decentralized decisions play a powerful role in determining the overall 'quality' and efficiency of the bank, especially in terms of risk management. At the same time, there is a more pronounced need to render the entire corporate value system – culture and work organization – consistent with the top management's system of objectives and controls.

"What is relatively easy for outsiders and supervisors is to check other formal mechanisms and processes. What is much more difficult to assess is human quality and culture." Charles Goodhart's observation (1996, p. 7) serves as an effective introduction to the serious problems that often afflict relations between central administration and branches in modern banks. In his fine essay in this volume, Giovanni Ferri (1997) points to the significant risk of moral hazard as a plausible cause of the very high turnover of branch managers in Italian banking, especially in the largest banks.

In short, changing their assignment on average once every three years serves the purpose of preventing branch managers from gaining an information edge over the head office in knowledge of local borrowers that might, potentially, be exploited for personal ends that

executive organs. Both the BIS (1997) and the United States GAO (1996) recommend that such units be independent and report to the Board of Directors directly. As for the relations between the risk control unit and the technical-operational control functions, the former has the job of monitoring the adequacy of the limits on assuming risks, the latter that of checking effective compliance with such limits.

do not coincide with the interests of the bank. However, the lack of local roots inevitably weakens customer relations and helps prompt multiple banking. All in all, this solution to the problems of agency between head office and branch managers ultimately weakens the whole bank's ability to optimize long-term objectives, and in particular to invest enough in information to assess the riskiness of its customers.

How can banks get out of this situation and avert collusion between branch managers and local borrowers? Ferri (1997, p. 246) suggests "periodical, on-site internal auditing". Certainly, such inspections can be helpful. In my opinion, however, the high road to overcoming informational asymmetry between head office and branches is through such typical 'preventive medicine' as: diversified, exhaustive internal flows of data and operational information; consistent planning and control systems that make the branches too perceive the need to contain and actively manage risks, which otherwise is felt only by the top management of the institution.

In other words, the conduct of branch managers can be subjected to closer observation by increasing the quantity and above all the quality and the timeliness of the data regularly reported to the head office through the data network. In the same way, the risk of moral hazard is reduced when branch managers are given risk-adjusted earnings objectives and less importance is attached to such factors – still very often considered primary – as mere quantitative growth of lending, deposits or total assets.

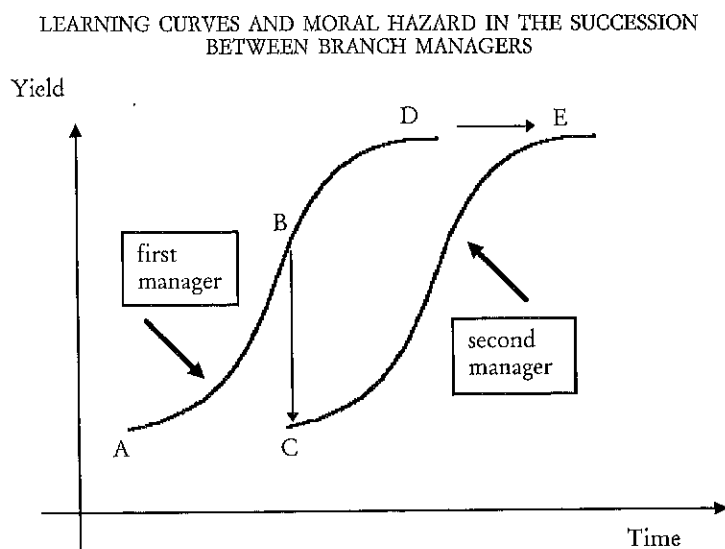
Moreover, banks should avoid giving new branch managers what amounts to a fixed term. Given the virtual certainty of holding his position for a relatively short time (three years, on average), the new branch manager will tend to concentrate the balance-sheet 'clean-up' at the start of the term and be more inclined to excessive risk taking towards the end. Breaking this logic, which is reminiscent of a 'political cycle' of a sort, is realistic if the expedients set forth above – inspections, better information flows, planning and risk-centred local controls – are supplemented by a degree of uncertainty over the term of branch managers' appointments and by deferred rewards and penalties to reflect the lag with which loans are progressively written down to non-performing status, bad debt and, alas, loss.

On these premises, an optimal situation would have branch directors' term of office determined case-by-case depending on the actual 'learning curve' of each. Further, the accumulated knowledge

of customers' creditworthiness and opportunities for developing customer relations should not be dispersed when the manager is replaced. One way to ensure the transmission of these informational resources would be the continuous updating of a sort of 'strategic file' with the map, the history and the prospects of the accounts most significant to the branch's expansion. The job of speeding up the learning process for the new manager could be assigned, in part, to 'sector' specialists, i.e. the branch officers most directly and continuously involved in relations with client firms. Of course, failing an effective system of incentives and thorough information flows, an agency problem *vis-à-vis* the new branch manager would threaten to arise.

The contrast between the 'optimal situation' and that of excessive turnover of branch managers is diagrammed in Figure 1, which plots time in office against the manager's risk-adjusted yield performance. We posit that this yield rises with time, at first in ever-larger and then in ever-smaller increments. We further suppose that owing to agency problems the director's term is cut off (at B) before he reaches the top yield level (at D).

FIGURE 1



Note: A-B-C is the path denoting early replacement of the branch manager because of the problem of moral hazard *vis-à-vis* the central administration. A-D-E denotes the optimal state.

The replacement occurs without transmission of the old manager's customer knowledge to his substitute (from B to C). This implies an abrupt downward shift in yield, the new manager practically starting over from scratch on his own individual learning process. Thus the consequences of this problem of governance are a lower average yield and heightened volatility of yields in branches.

Efficient information systems, effective operational planning, the use of strategic files by branches, and the cooperation of non-opportunistic sector specialists can overcome the sub-optimal condition, achieving two key results. The first is the maximization of the short-term yield obtained by leaving the branch manager in office long enough to complete the collection of information on the present situation and prospects of customers (in the Graph, remaining in office up to D instead of just to B). The second, perhaps even more important, is the medium-term optimization gained by ensuring that with every change the entire stock of knowledge built up by his predecessors is made available to the incoming manager (in the Graph, moving from D to E).

This simple extension of Ferri's model may help us to see how crucial to organizational arrangements and human resource management are the problems of banking governance and, naturally, efforts to resolve them. As the foregoing example illustrates, the relevant 'frontier' of widespread, efficient governance in banking is moving steadily downward, from the insulated precincts of the boardrooms where directors and auditors meet to the 'trenches' manned by branch managers, sector officers and loan employees. Like a waterfall, the problems of moral hazard cascade down from the relations between shareholders and directors to those between head office and branch managers, and from there to the interaction between the latter and the officers responsible for customer screening and monitoring. Accordingly, the possibility of making the bank effectively governable increasingly depends not on a proliferation of controls and inspections but on the self-generated ability of the entire staff to take responsibility in the shared effort to optimize both risk and return.

Faced with the need for generalized responsibility, the personnel management philosophy still prevailing within Italian banks risks being quite out of place. A recent study (NEWFIN 1996) demonstrates compellingly that the dominant mind-set is still that of the 'internal market', with sharply vertical career lines, automatic ad-

vances, excessive emphasis on seniority, a culture hinging on the execution of tasks rather than the achievement of objectives. In a word, our banks' organization charts still bear too much of a resemblance to the nomenclature of a vast army no longer used to battle, and too little to agile companies of highly motivated, result-oriented professionals (Sarcinelli 1996f).

It will not be easy, nor can it be quick, but going over to a system of human resources management that is more efficient and more attentive to individual responsibility is unquestionably necessary. We must abandon the hierarchical schema and combine what remains sound and useful in the old methods with a growing openness to the philosophy of the external labour market. This means extending the range of professional osmosis beyond the confines of *amakudari* (Teranishi 1997), i.e. the recruitment of managers drawn from the central bank or the ministries, and opening banks to more fertile contact with the world of industry.

It is now an established point, and not only among specialists, that Italian banks are very seriously overstaffed. In my own opinion, though, downsizing will be of little help unless first, or at least in parallel, we reshape, from the bottom up, the culture and organization of governance of the personnel that will face the challenges, old and new, of banking on the threshold of the third millennium.

3.4. *Postilla on banking groups*

These reflections on the theoretical and practical aspects of governance in banking cannot be concluded without a brief postilla on groups. The key importance of the group of enterprises in interpreting Italian industrial development has been persuasively underscored by thorough economic analysis (Barca *et al.* 1994). At the same time, the phenomenon of bonds of control between companies has received greater attention in law and regulations, although the creation of a less uncertain legal framework came "as so often happens in recent laws, not by the high road but on the sly" (Angelici and Ferri 1996, p. 532).

As far as the credit system is concerned, a crucial passage was the enactment of the new Banking Law in September 1993. This framing legislation clearly outlined the structure, confines and functions of the

banking group in Italy. The Law lays down the pregnant 'mission' of governance assigned to the parent company over the subsidiaries.

Article 61 (4) in fact states that the "parent undertaking" carries out the "activity of management and coordination" and "shall issue rules [...] for the implementation of the instructions issued by the Bank of Italy in the interest of the stability of the group". As the referent of the central bank, the parent undertaking answers for the promptness and quality of the information needed to carry out consolidated supervision (Article 66 (4)); and it remains responsible for the group members' compliance with prudential rules.

All in all, these requirements are demanding indeed; meeting them implies the "compact aggregation of strongly homogeneous activities" that the law ascribes to the design of the banking group (Tarantola Ronchi 1996, p. 96).¹⁰ Given the difficulty of these duties of 'external' governance, a key link between parent bank and subsidiaries becomes interlocking directorates, and perhaps also boards of auditors, within the group (Bianco and Pagnoni 1997). It is the direct presence and contribution of representatives of the parent bank that determines the efficacy of the direction and governance of the subsidiaries in pursuing the private objective of profit and growth and safeguarding the public good of stability.

As was pointed out in the Section on administration, an indispensable safeguard for effective management of the banking group, as of the industrial group, consists in the right balance between the potential synergies of directors serving on many different boards and the need for enough time to play an active, conscious directing role within each. A survey presented in this special issue (Bianco and Pagnoni 1997) puts the average number of positions held by Italian bank directors at 1.5, not significantly different from that for firms.

Monitoring, at the group level, appears to be a more delicate problem. Earlier we contended that in a salutary dialectic between managers and monitors, the Board of Auditors should represent minority shareholders and should have the power to appoint, or at least designate, the external auditing firm. From the group standpoint, the advantage of having a single firm audit the entire group's books, adopting uniform standards and valuation methods, is self-

¹⁰ At the end of 1995 the special register listed 91 banking groups, with 632 Italian members (158 banks, 328 financial companies, and 146 instrumental companies) and 204 foreign member companies. Italian banking groups thus comprised a total of 836 companies.

evident. Yet having a single auditing firm for the entire group depends on the 'uniformity' of the minority shareholders in the various group members; and, for foreign subsidiaries, also on the presence of that firm in the relevant country. Should the former condition not obtain, then the principle of minority protection should prevail, and hence the independent choice of each subsidiary's Board of Auditors. Should the latter not obtain, the choice of auditing firm would be unconstrained. In any case, the parent bank's auditor should always have access to all the subsidiaries included in the consolidation, to check on intragroup dealings and contracts (Sarcinelli 1997a).

As far as conflicts of interest are concerned, the parent bank's Board of Auditors, like those of the subsidiaries, should pay special attention to safeguarding the minority's interests with respect to intragroup operations. For that matter, under present law these transactions, like those with significant shareholders and with directors, already require a unanimous vote by the Board of Directors and the approval of the Board of Auditors: one more reason for the Board of Auditors to be elected, at least in part, by minority shareholders.

Last in order of presentation, but not in order of importance as regards the governance of banking groups, is the organization constraint. In our treatment of the single bank it was noted that a detailed, timely flow of information between centre and branches is essential to good governance, especially risk management. At the group level a prompt, reliable information system is all the more crucial, considering among other things the supervisory obligations imposed by the central bank.

Beyond information, the challenge of governance within the banking group likewise involves organizational attitudes and personnel management. In this sphere, however, cohabitation with financial institutions that are more dynamic and more inclined to the logic of the external labour market may prove an invaluable stimulus to the more traditional structures of the parent bank in the drive for innovation and efficiency.

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