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# Ethics in Risk Management Practices: Insights from the Italian Mutual Credit Co-operative Banks

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## Abstract

This paper explores the role of ethical values within Enterprise Risk Management practices. For the purpose of our analysis, we refer to the Italian mutual credit cooperative banks, as ethical banks, since they are managed according to the distinguishing principles of economic and social profitability. This paper attempts to make a contribution to existing literature, giving evidence to the role of ethics in risk management practices as a new driving value for business activities. Moreover, this study provides "lessons" for the international community, concerning the possibility for mutual credit cooperative banks to make profits not via the achievement of high financial spreads but through the creation of services for the community.

**Keywords:** *Enterprise Risk Management, Ethics, Mutual Credit Cooperative Banks.*

## Introduction

This paper explores the role of ethical values in risk management practices within the banking sector. The concept of risk management is widely discussed in theory and practice. A number of studies (Miller and Power, 1992; Blum, 1994; Basak and Shapiro, 2001) have addressed the issues related to the definition and quantification of risks, intending numbers and calculations as capable estimates for an unpredictable future. However, a different strand of literature has recently underlined the need for taking into account a hitherto "uncounted area" (Mikes, 2011), emphasizing the growth in importance of organizational dynamics in risk management practices (Power, 2004; Gephart et al., 2009). As a result, Enterprise Risk Management (ERM) has emerged as a holistic approach for identifying, measuring and managing risks (Power M., 2009; Arena et al., 2010).

Enterprise Risk Management is particularly relevant for the banking industry for a number of reasons. First, banks identify risks as the typical object of their core business, characterized by the intermediation between, those who produce financial surplus and who bear financial deficit or debt. Additionally, as banks play a fundamental role in economic (Levine, 2004) and sustainable development (Scholtens, 2006), there is a constant focus on the definition, measurement and control of risks.

The extant literature has emphasized that there is only minimal understanding concerning how enterprise risk management works in action (Mikes, 2009). Also, recent financial crises have shown the failure of traditional large banks (Tarantola, 2011), revealing substantial weakness in risk management practices (Paape and Spekle, 2012). The focus of our analysis is on the Italian Banking Sector due to the fact that Italian banks are under the supervisory authority of Bank of Italy, which has developed additional and specific rules for risk management in addition to those fixed on a European level (Maffei, 2010). Indeed, due to the prudent regulatory framework issued by the supervisory authority, according to Draghi (2010), the crisis has had only an indirect effect on Italian banks.

Since a number of contributions (Power, 2009; Chua, 2007) have revealed that the ethical variables, sometimes obscured by measurement and calculations, could represent an unexplored and potentially interesting field of study to deepen understanding on ERM, this research particularly refers to the Italian mutual credit cooperative banks. According to San Jose et al. (2011), such banks can be defined as ethical banks, as they are managed according to the principles of social and economic profitability. In fact, ethical banks should obtain a social profitability in terms of both, the funding of economic activities with a social value, and the absence of investments in speculative projects. Also such banks operate with a constant effort to ensure its economic sustainability, in order to guarantee the investments in socially and environmentally relevant projects.

On the basis of the above considerations, this paper explores the role of ethics in risk management practices. Moreover, our research aims to clarify the contribution offered by the Italian mutual credit cooperative banks, as ethical banks, from both, the theoretical and practical perspective, to the international debate on risk management.

The reminder of the paper is structured as follows: the second section examines the evolution of the concept of risk, underlying its effect on risk management practices; the third section describes the Italian mutual credit co-operative banks, intended as ethical banks; the fourth section discusses the implications of the study, explaining the lessons for the international community from the Italian Mutual Credit Cooperative Banking Sector; the last section concludes the study and shows some hypotethical further developments.

## From "Risk" To "Uncertainty": The Evolution In Risk Management Practices

Despite the widespread use of variability measures as risk proxies, the concept of risk and the effectiveness of existing risk management practices still remains questionable (Aaker and Jacobson, 1990; Baird and Thomas, 1990; Collins and Ruefli, 1992). Literature has commonly described risk as the unpredictability of economic and financial results (Miller and Power, 1992; Sitkin and Pablo, 1992), mainly related to the variation of corporate performance that could not be forecast ex ante (March and Shapira, 1987; Miller and Power, 1992). The technical concept of risk is focused on the probability of events, measurable and calculable in their own amounts. According to Ewald (1986) the calculus of risk makes the incalculable 'calculable', with the help of accident statistics, probabilities and through generalized statistical formulae. Thus, researchers and practitioners have attributed to the calculus of risk as an important social function in making the industrial system capable of dealing with its own unforeseeable future. Indeed, numbers and calculations are intended as tools able to summarize complex relationships using ratios and other quantitative measures that, on one hand, are easily readable and understandable by informed users (Wahlstrom, 2009) and, on the other hand, are capable to serve as the backbone of performance measurement in order to define strategic planning. Another notable issue is that, especially within financial sector, the concept of risk assumed a negative meaning as the negative variation of corporate performance.

However, a second strand of literature (Bhimani, 2009; Millo and MacKenzie, 2009; Power, 2009, Arena et al., 2010) has strongly emphasized the subjective and inter-subjective features (Kleindorfer and Saad, 2005) of risk. As a consequence of such market evidences and also due to the increasing turbulence and complexity in the competitive environment, the concept of risk is conceived as a new and much broader perspective of unpredictability, called uncertainty, (Beasley et al., 2005; Gordon et al., 2009; Hoyt and Liebenberg, 2009; Pagach and Warr, 2010), including environmental and organizational aspects (Mikes, 2011; Arena et al., 2010; Gephart et al., 2009; Miller, 2008) that influence the overall corporate performance (including economic and financial results). As a result, this concept of risk, although including economic and financial aspects, is strictly related to some cultural, social and environmental aspects that cannot be measured by numbers (Keindorfer, 2010). In addition, the growing importance of the influence exerted by the emergence of organized stakeholder groups, who put the spotlight on environmental or social issues, cannot be underestimated and has lead to an increasing attention to the risk management practices. Therefore, those social, cultural and ethical features, previously subsumed to the hegemonic weight of a scientific approach (Power, 2009), have now become more visible. Accordingly, they are in need of an appropriate assessment, and require an overall management.

As the risks have always been seen as unavoidable to achieve firms' goals, the different tools of risk management have always received great attention from both, researchers and practitioners. Until the mid 1990, risk management theory mostly remained confined to terminological elaborations and technical considerations based on theories of finance, occasionally drawing on behavioural insights such as those of March and Shapira (1987). The risk management ideal is based on risk quantification and the rendering of an increasing number of risk types susceptible to quantification, measurement and control (Jorion, 1997; Dowd, 1998; Duffie and Pan, 1997). In this context, organizations used to manage their risks through a highly disaggregated method called the "silo approach" (Bowling and Rieger, 2005; Meulbroeck, 2002), under which the various categories of risk are managed in separate units within the firms. However, this approach to risk management has shown relevant disadvantages. Indeed, managing each risk class in a separate silo might create inefficiencies related to the lack of coordination between the various risk management departments. At the same time, calculation and measurement of risks make visible and valuable only one part of a more complex whole. Moreover, the perverse consequences of the risk management systems during the recent financial crisis have shown that the questions pertaining the coherence of any trust in numbers, still persists.

The increasing importance of unquantifiable uncertainty has recently been associated to a rising attention of organizational risk management practices, moving away from the traditional silo approach toward a holistic risk management system (Arena et al., 2010), to manage each of the risk classes as part of the firm's overall (Miccolis and Shah, 2000; Cumming and Hirtle, 2001; Lam, 2001; Meulbroek, 2002), called Enterprise Risk Management (ERM). ERM enables firms to benefit from an integrated approach in managing risks as strategic opportunities (Liebenberg and Hoyt, 2003), on one hand, it aims to support managers in making day-to-day decisions (Arena et al., 2010; Power, 2009), on the other hand, it provides a more objective basis for resources allocation, in order to improve both, the capital efficiency and the return on equity.

Enterprise risk management has been developed, as have the evolutions of many regulatory frameworks for corporate governance, in response to a series of well-publicized corporate scandals and failures across the world (Collier and Ampomah, 2005). It was clear from these cases that the existing systems of self-regulation, as well as the ability of the judicial system, to identify and penalize any misconduct was lacking and largely ineffective (Arnold and Sikka, 2001). However, the most recent financial crisis has shown the inefficiencies of such reforms in risk management practices, especially with regard to the Enterprise Risk Management Integrated Framework published by the Committee of Sponsoring Organizations of the Treadway Commission (COSO).

In addition, due to the progressive importance of Enterprise Risk Management system within the self-regulatory processes of companies (Power, 2007), it has also taken on a "moral" character, mainly because the certifications of the effectiveness of risk management process may enhance public trust in senior management of organizations. Indeed, ERM emanates from the domain of internal control, which tends to emphasize values of regulatory compliance and external accountability. However, such external exposure, coupled with the link to internal controls, has created scope for ambiguity and discretion in its implementation. Certainly, recent literature has often emphasized that a model of regulatory assurance, or an *illusion of control* (Holt, 2004) has been created by ERM designs. In particular, as Power (2009) highlights, the danger of ERM lapses into the so-called "rule based compliance", and in this case the failure become embedded in managers' decision making and business processes. In this regard, ERM as a part of the internal control system is also highly problematic, due to the difficulties in defining its effectiveness, which is in principle unknowable, and because of the growing diffusion of the internal control, which might itself be a source of risk (Power, 2004).

In this regard, what should be noted is that organizations should implement new forms of control that go beyond the regulatory requirements, in order to support risk management practices. In fact, a number of studies (Cowton and Thompson, 1999; Francis and Armstrong, 2003; Scholtens, 2006) have strongly emphasized the great importance of soft variables, such as decision maker's mental models, prior experience, beliefs, and ethical values, intended as complementary elements of decision making under uncertainty that do not privilege measurement (Kleindorfer and Saad, 2005).

## Ethics In Italian Mutual Credit Co-operative Banks

Historically, the cooperative movement in Italy came out during the second half of the 19th century, and since the very beginning cooperatives have been characterised by either, a political or religious orientation. In particular, it is possible to identify three different influences related to the development of cooperative banks in the Italian context.

The first cooperatives flourished in the 19th century on the wave of Giuseppe Mazzini's liberal thought (Zamagni, 2006). At the same time Italy experienced both the development of cooperative to organise consumer and producers' groups, as well as the foundation of new forms of retail banks. A second generation of cooperatives, came into sight in the last decades of the 19th century, under the influence of the development of socialism and communism. This kind of cooperative has emerged particularly in the North of Italy. Specifically, several group of socialist inspiration were created in the Padana Valley as a reaction to the agrarian crisis of 1882-83. In fact, Leo Wollemborg funded the first mutual cooperative bank in 1883 in Loreggia, close to Padua.

A third group of cooperatives was born to support the interests of Catholic Church's engagement in social issues, after the encyclical of Pope Leo XIII Rerum Novarum of 1892 aimed at taking concrete initiatives to stimulate economic development of rural inhabitants and urban proletariat (Zamagni, 2006). The foundation of such cooperative banks quickly spread throughout the Italian territory. Currently, the Italian banking industry is characterised by the existence of three main typologies of banks: Commercial Banks, with investor-owners, Popular Banks, with borrower-owners, and Mutual Credit Cooperative Banks with borrower-owners which differently from the shareholders of the Banche Popolari, do not receive dividends. At the present time, there are 412 mutual credit cooperative banks on the Italian territory, which constitute about 8% of the total credit provision in the Italian banking system. Such banks are under the supervisory authority of the Bank of Italy and are regulated in a specific section of the banking law (Testo Unico Bancario - T.U.B).

This paper mainly refers to the mutual credit cooperative banks.

Italian mutual credit cooperative banks operate within the "Credit Cooperation", a European network structured in three levels (local, regional and national levels), that works as system of values based on a shared strategy. The Cooperative Credit in Europe has 47 million members, serving 140 million customers with over 60 000 branches and holds a market share of 20% on average, and much higher in a number of countries. Through this network, each of the mutual credit cooperative banks may benefit from the strength of the system in which it operates based on the same principles of each individual bank: autonomy, localism, local roots, solidarity and mutuality.

On a deeper level, mutual credit cooperative banks direct their activities toward an *internal mutuality*, an economic and social value creation for the client-member and toward the pursuit of economic, social and environmental advantages for the local community, aim to achieve the cultural and moral development, as well as the cooperation and the cohesion, called *external mutuality*. Moreover, mutual credit cooperative banks also fulfil a purpose related to the *systematic mutuality*, in favour of the other cooperative banks, to enhance the cooperation and the creation of the network.

Italian mutual credit cooperative banks can then be properly defined ethical banks, since their distinctive features can be easily recognised in the literature about ethical banks. In fact, ethical banks differ from the others because of their ideology, ideals and funding principles which imply that the ethical commitment must be met not only in the actions of the bank, but also in the actions of their subsidiaries and partners (San-Jose et al., 2011). In addition, the literature emphasises two accepted characteristics that define ethical banking (Cowton and Thompson, 1999; Green, 1989; Kendric, 2004; Lynch, 1991): the social profitability and the economic profitability. These banks aim to the achievement of economic profitability that implies good management for ensuring the economic sustainability. On the other hand, mutual credit cooperative banks' activity is also oriented to the achievement of social profitability, defined as both, the presence of investments with a social value and the absence of investment in speculative projects or services related to "negative areas" (i.e. pollution, pornography, tax evasion, drug, mafia). In particular, mutual credit cooperative banks refer financial activity to projects that, through their objectives (ecology, employment, renewable energy) or the people they target (those who cannot obtain a loan from the traditional bank) create only positive value for the social environment of their area of interest.

In general, the mutual credit cooperative banks interpret their financial role in conjunction with the economic and social needs of the reference local community, that is attention for "*non bankable persons*" and young people, sustainable growth of small-medium sized entities, as well as environmental safeguard and protection for the artistic heritage. The main goal of such banks is to promote a bottom-up development of the society.

These banks are indeed characterised by two souls, that is the role of financial intermediaries, that have to reach an economic profitability to ensure the achievement of the members' needs, as well as the character of socially responsible entities with the aim of contributing to the development of communities and reference areas.

The ethical nature of the mutual credit cooperative banks' activity is strongly declared in their (voluntary) statutes. All the mutual credit cooperative banks identify as their main goal the favouring of the members and the local community, pursuing the improvement of their moral, cultural and economic conditions, as well as promoting the development of the cooperation, the social cohesion and the responsible and sustainable growth of the reference territory.

The ethical nature of the Italian mutual credit cooperative banks is also confirmed by the Catholic social thinking:

> *"The experience of Italian mutual credit cooperative banks is a concrete expression of the complementarity and subsidiarity between the individuals and the whole (....). From an ethical perspective this is reflected in a strong social sensibility associated with a reasonable respect for the individuals' autonomy. Such sensibility is significant in that it favours the roots between entities and their territory, aiming at an enrichment of the economic conditions through an ethical managerial behaviour (...) as it is significantly shown by the experiences of the Italian Credit Cooperation"* (Pope Benedetto XVI).

Mutual credit cooperative banks play a very important role in the Italian banking sector, through a widespread dissemination in several cities (sometimes representing the unique bank of the local community), serving a large share of clients and involving an increasing number of members/shareholders. The following table shows the Italian mutual credit cooperative banks (MCCB) in numbers:

| | |
|---|---|
| Number of MCCB | 412 |
| Affiliates | 4,411 |
| Towns With MCCB | 2,705 |
| Clients | 6,700,000 |

## Risk Management In Ethical Banks: An Exploration Of The Italian Mutual Credit Cooperative Banks.

Our analysis refers to the Italian mutual credit cooperative banks to explore the role of ethics in risk management practices, because this case is particularly interesting for several reasons. In particular are characterized by the distinctive characteristics of their internal governance, their strong territorial root and their regulatory requirements. According to the Italian law, mutual credit cooperative banks should conduct their business primarily for the members – shareholders (T.U.B., article 35) and each of the members has one vote in the general assembly, independently of the number of shares owned, according to the principle "one head - one vote".

Furthermore, mutual credit cooperative banks are strongly rooted in their local territories and found their activities on the relationships with local entities and families. For this reason, each of the members of these banks has to prove the residential, the registered office or the continuous activity in the local community of reference for the bank itself. With specific reference to their regulatory requirements, it is worth noting that mutual credit cooperative banks, in order to identify their categories of risk, manage their risk to assess the appropriate minimum capital requirements. All banks have to adopt the requirements of the International Convergence of Capital Measurement and Capital Standards: a Revised Framework (commonly referred to as New Capital Accord or Basel II) issued by the Basel Committee on Banking Supervision.

Thus, these banks, in spite of being small banks, are required to comply with the regulatory requirements provided at the European and the National Level for large banks, and these lead to many possible economic constraints. Mutual credit cooperative banks do not have to distribute benefits to their members, but in principle they have to manage and reduce their overall risk, in order to secure future investments for the economic, social and environmental development of their local communities. For this purpose, mutual credit cooperative banks implement practices and procedures in order to identify, to analyse and to assess risks, determining the tolerable degree of exposure to risk, and taking appropriate steps to avoid legal action, loss of reputation and public inquiry.

Beyond the regulatory requirements, it should be emphasized that risk management in mutual credit cooperative banks refer not only to rigorous risk classifications and numerical measurements, but must also consider the controllers' experience and intuition, expanding the "softer instrumentations" (Kleindorfer and Saad, 2005) into the domain of non – measureable strategic uncertainties (Mikes, 2011). Thus, risk management processes in mutual credit cooperative banks are argued to be strongly supported by ethical values Risk assessment of the investments concerns not only the increase in income for the bank, but also encompasses a broader perspective, which takes into account the economical, social and environmental benefits for the community of reference.

The purpose of risk management in the Italian mutual credit cooperative banks is two-fold and refers to management of resources and management of stakeholder. The first one is related to the adoption of an alternative and new guarantee arrangement within the process of granting found. In this regard, to give priority to the social performance, Italian mutual credit cooperative banks do not consider only the real or traditional guarantee based on patrimonial collateral but also a number of other elements such as the activities carried out in and for the local community, the recognised socially responsible behaviour in the conduct of the professional and managerial activities, the seriousness of the productive investment proposed, as well as a strong fiduciary element related to the acknowledge reputation of the entrepreneur, who lives and operates in the community. On the other hand, the ethic in risk management practices could represent a driver for stakeholder management. Indeed, as mutual credit cooperative banks aim to achieve the social development of their local territories, could contribute to build and to increase social capital through good relationships with local firms, families and the community in general.

## Lessons For The International Community

As the analysis of the Italian mutual credit cooperative banks has shown, the role of ethics in risk management strategy starts with commitment from the top management for an ethical culture. It is a result of appropriate policies, procedures and systems in place to reward ethical conduct and to censure unethical actions. However, ethical risk management does not correspond only to the mere compliance of such procedures defined by the top management. An ethical risk management strategy, as for the case of the Italian mutual credit cooperative banks, is also strictly related to both the integrity and ethical values of managers and (eventually) shareholders. Ethics influence either, risk management strategy in creating the organizational infrastructure which promotes ethical conduct of business, or risk assessment, driving the banking activities not only (or, not exclusively) toward the achievement of financial gains, but also to consider the economical, social and environmental benefits. An effective ethical risk management has the potential to contribute to building or increasing social capital, as per the above examined banks, that via their ethical-driven ERM are able to achieve positive social, environmental and financial results, through the good relationships with stakeholders. Indeed, the value of (fiduciary) relationships increases both the legitimacy of the companies in their area of interest, and the power of trust established between clients and managers of the organizations. Also, an ethical risk management leads to a positive relationship between stakeholders' management and shareholders' value, which as a result, leads to improved financial performance.

Moreover, our analysis also clarifies what contribution can be offered by the Italian mutual credit cooperative banks from both, the theoretical and practical perspective, to the international debate on enterprise risk management. Following to the call for more empirical research on the issue related to the effectiveness in risk management system, our research aims to provide a different theoretical perspective for managing risks, also considering the need to take appropriate actions in order to improve the stakeholder value protection. The implementation of a new Enterprise Risk Management system, as Ethical Enterprise Risk Management, leads toward a reflexive mutual cooperation between the organization and its stakeholders. Beyond the compliance to regulatory requirements, an ethical risk management could become a part of an organization's strategic thinking and contribute to the best alignment between the objectives of both the firms and their stakeholders in order to improve the economical, social and environmental development of local community of reference.

Moreover, as a result of the weakness in enterprise risk management systems, our analysis has also implication in practice, showing how ethical enterprise risk management works in action, also taking into account the need to strengthen the risk management system of the firms. Ethics in risk management could represent a tool of support *ex ante* for the definition of strategic planning, contributing to improve also the economic and financial results. This is particularly true if we look at the recent financial crisis. Indeed, mutual credit cooperative banks had the chance to leverage the crisis as an opportunity of growth, as well as an occasion of success. These banks, due to their strong root with the territories of reference and the strong fiduciary duty, during financial crisis have continuously granted their assistance to people and entities, contributing to the economic and sustainable development (i.e. social profitability) of their communities. Also, these have attained profits ensuring their economic profitability and the subsequent constant investments in project with social and environmental value.

In this way, the relevance of our analysis is not limited to the Italian context, as the above lessons could be exportable and applicable to other countries. The ethical nature of the mutual credit cooperative banks should be considered as a sort of theoretical framework as well as a new *modus operandi* in order to support the economic growth and, at the same time, the sustainable development of the community of reference. Moreover, the introduction of ethics in enterprise risk management practices could enable the firms to increase the social *well-being* through the achieving of positive economic results for the organization. Thus, leaving the *well-having* perspective, mutual credit cooperative banks tend toward a new strategy "*not finance for finance, but finance for development*".

## Conclusions

This research provides evidence of the effectiveness of the Risk Management practices within the banking sector. For the purpose of our analysis, we have examined the Italian Mutual Credit Cooperative Banks because, according to San Jose (2009), they can properly defined ethical banks. Recent literature (Caldarelli et al., 2011; Costa et al., 2010) has strongly emphasized the fundamental role played by ethical requirement for the management of an entity. All the ethical restrictions are necessary to reconcile the entity's interests (or utility) with those of society and are not detrimental for the purposes of the entity, but rather they are factors favouring consolidation and lasting prosperity.

Our analysis particularly refers to the risk management practices and, through the analysis of the Italian mutual credit cooperative banks, aims to provide an exploration of the role of ethics in risk enterprise risk management practices. However, several future remarks could be still considered. This paper focuses on mutual credit cooperative banks, as ethical banks. However, an interesting future development for this research could be the exploration of the role of ethics in risk management practices within large banks, as unethically organizations. At the same time another notable approach might be the investigation an ethical enterprise risk management in a different country setting. Additional question that remains to be considered is about the extent to which risk management practices can be ethically oriented and the extent to which they must fulfil certain economic constraints. Another notable approach might refer to the investigation of how an ERM based on ethical values works in action in a different kind of company with a relevant social role (i.e. audit company). An interesting further development for this research could be related to the area of microfinance, in order to prevent that there will be organisations, micro companies, black economy or groups excluded from the traditional financing system, either because of a lack of resources (poverty), their geographical situation or because they belong to a certain social or ethnic group■

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