WHY HAS TO BE DIFFERENT INTERNAL CONTROL SYSTEM IN CO-OPERATIVE BANKS?

A SURVEY AROUND COOPERATIVE ENTREPRENEURSHIP, BANK RISKS AND THE CONCEPT OF ORGANIZATIONAL CONTROL (*)

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1. *Introduction*

The aim of this survey is to reason on the internal control system as something different from a mechanism conceived due to agency issues. The paper suggests an overview in which internal governance does not deal *directly* with the potential conflicts of interest between members and managers, but arises from the entrepreneurial activity features, therefore valorizing *how* cooperative banks exercise their business. This argumentation is connected to the "organizational control" concept, referring to a peculiar competence of the management body: to enable the business to function, in fact, it is necessary to plan and fit out a series of procedures, rules and functions useful for the decision-making process, in order to give qualified support to the management body, in particular with reference to its supervisory function. In doing so, the procedural organization of the activity aims to satisfy the "control instances" emerging from the business. In this sense, the internal control functions, such as compliance, risk management and internal auditing, represent the

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organizational arrangements preordained to support the corporate actors: because of the typical associated risks, only companies exercising a banking activity must "build" an internal structure to prevent and manage them. From this perspective, the aim is to interpret the imposition *ex lege* of the internal control system in credit institutions while in companies exercising other activities it is not binding: the banking activity needs a process system to identify, manage, monitor and report the risks to which it is or might be exposed.

If the banking nature of the activity requires, by itself, the implementation of the internal control arrangements on one side, it is important to note on the other side that not all banking activity is the same, because it depends on *what* every credit institution has decided to do and, above all, on *how* the same institution does it. This means that every bank, for the fact of conducting banking as a minimum, needs an organizational structure to be able to control the risks arising from that kind of business in order to ensure an alignment between members' and managers' interests, not as a priority, but first of all with the objective of providing the latter with the means to carry out their work well, mainly offering support for the supervisory function of the management body. Thus, in the end, it is necessary in order to help fulfil properly and as a result to protect the public interests associated with the banking activity.

As stated, there are different methods of exercising banking activity and the specific one has to be reflected in the decisions made to carry out and to realize the procedural control of the enterprise. Thus, in each credit institution, the internal governance has to be adequate for the specific "way of doing banking", seeking to take into account the risks and the instances of control arising from the real banking entrepreneurship and to give a response with consistent organizational resources.

In this order of ideas, it will be simple to understand that cooperative banks pursue an activity characterized by peculiar features that differ from those of other credit institutions ([1]). Although the banking harmonization process of the 1990s led to a "level playing field" in the banking sector, as well as with regard to the list of activities subject to mutual recognition ([2]), it is impossible to disclaim the persistence of the specificity of the cooperative phenomenon, thanks above all to how this special institutional category conducts banking activity. All cooperative banks across Europe, despite their different business models, present a common way of behaving in banking, according to

([1]) On the behavioral differences between cooperatives and traditional firms, see the essay by P. KALMI, *The Disappearance of Cooperatives from Economic Textbooks*, in *Cambridge Journal of Economics*, 2007, Vol. 31, pp. 625–647.

([2]) The reference is obviously made to Directives 77/780/ECC and 89/646/ECC.

a paramount and basic set of principles that marks the European cooperative banking sector as «*commonality with diversity*» ([3]).

2.1. *The multifaceted concept of "control" in corporations and the peculiar side of "organizational control"*

What are we talking about when we refer to "control" inside corporations? It is impossible to give a unique response to this question, because there is not only one form of control and it spreads all over the entrepreneurial structure in several ways. There are quite well-known meanings of control as far as that concerning the activity fulfilled by the board of auditors or the supervisory role undertaken by the board of directors. To simplify, such a concept is the classical moment of "reaction" related to that of "action" (that is, the management moment), the "biphasic scheme" according to which it is used to synthetize the internal dynamics and the entrepreneurial distribution and balance of powers. In a broad sense, this conjugation of "control" describes a situation in which someone has to watch over the work carried out by someone else, and it starts from the common idea that the company is subjected to potential conflicts of interest between owners and managers ([4]). This kind of control has already received deep interest from both theory and regulation, as the latter codified the suggestions given by the former ([5]).

At the same time, however, there are also meanings of "control" that the legislator took into account only recently, because in this case the interaction process between law and economic

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([3]) R. AYADI, D.T. LLEWELLYN, R.H. SCHMIDT, E. ARBAK, W.P. DE GROEN, *Executive Summary*, in *Investigating Diversity in the Banking Sector in Europe*, Centre for European Policy Studies, Brussels, 2010.

([4]) On the theoretical agency issue see: C. JENSEN, W.H. MECKLING, *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*, in *Journal of Financial Economics*, 1976, Vol. 3, No. 4, p. 5 («agency relationship as a contract under which one or more persons (the principal(s)) engage another (the agent) to perform some services on their behalf which involves delegating some decision making authority to the agent»); E.F. FAMA, M.C. JENSON, *Separation of Ownership and Control*, in *Journal of Law and Economics*, June 1983, Vol. XXVI, p. 301; K.J. ARROW, *The Economics of Agency*, in *Principals and Agents: The Structure of Business*, edited by J.W. Pratt, R.J. Zeckhauser, Harvard, 1985, p. 37; H. DEMSETZ, *The Economics of the Business Firms*, Cambridge, 1995, p. 15; O. HART, *Corporate Governance: Some Theory and Implications*, in *The Economic Journal*, 1995, p. 678. From a wider perspective, concerning mechanisms that deal with agency problems (called "agency paradigm"): D.T. LLEWELLYN, *Issues in the Governance of Life Mutuals*, paper commissioned for the Myners enquiry into Governance of Life Mutuals, HM Treasury, London, 2004.

([5]) See J.S. JOHNSTONE, *The Influence of the Nature of the Firm on the Theory of Corporate Law*, in *Journal of Corporation Law*, 1993, Vol. 18, pp. 213–244.

sciences appears rather more difficult and has required more time for conscious transposition. Metabolizing the theoretical elaboration of the organizational studies, the regulation frameworks all over the world nevertheless began to pay attention to the "entrepreneurial activity proceduralization", as a duty concerning the management body in order to enable the business to function and to implement the organizational basis of the decision-making process. Beside the interest for the dynamics of corporate bodies and in the governance issues related to the ongoing activity, the legislative perspective also started to intervene in advance, during the moment in which the structure has to be built up and the useful resources for managing and controlling the economic initiative chosen. The focus is not centred on how the already established structure has to work, giving, for example, indications about the composition of the board or the remuneration problems – all arrangements that contribute anyway, as is obvious, to the proper organizational balance but from a perspective *hierarchically higher* than the one we are now trying to explain –. The emphasis of this approach (complementary to traditional corporate governance, enriched by this deeper sensibility regarding internal procedural problems) is rather on the needs that exist "round the back", behind the "running business" and behind the combination of "action" (management) and "reaction" (control). In other words, the lawmaker specifically faces the questions: what makes decision-making possible? What resources does it need?

The concept of organizational control is extremely important because it deals with the specific characteristics of the entrepreneurial activity in order to enhance the capacity of those who have to take business decisions to be aware and informed of what is taking place: in particular, the procedural framework of the activity as well as the internal control system as part of it are conceived by regulators to support the management body in governing risks. Because of the high level of uncertainty connected to banking activity and to the aleatory risk-taking process, the guidelines made by some International Committees, before, and the transposing mandatory rules, then, agree on imposing a "control background" to help directors and managers with dedicated and qualified technical resources for risk governance ([6]).

Thus, we have called this phase, to the rear of corporate governance, "entrepreneurship processing", and it is a declination of control linked to the necessity to plan the basis of the firm structure, in order to give legislative rank and dignity to the method of implementing what is necessary to make the decision-making process possible. According to this perspective, the banking

([6]) This way of reasoning should not be confused with the so-called Stewardship Theory, on which see, above all, L. DONALDSON, J.H. DAVIS, *Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns*, in *Australian Journal of Management*, 1991, Vol. 16, No. 1, pp. 49–64; J. DAVIS, F.D. SCHOORMAN, L. DONALDSON, *Towards a Stewardship Theory of Management*, in *Academy of Management Review*, 1997, Vol. 22, No. 1, pp. 20–47.

entrepreneurship is relevant not because of the relationship between shareholders and management but because from the *nature* of this activity stem some specific risks that need a peculiar organization inside the company. Hence, it is possible to understand why in banks an internal control system is a mandatory organization structure while in other companies exercising different forms of entrepreneurship the internal control system is under the responsibility and the discretion of the managers: it is not the subject, the bank, that is relevant but its object, banking. The banking activity has induced the legislator to intervene by making a choice *ex lege*.

Thus, the lawmaker, thanks also to the "moral suasion" role played by the most reliable international committees and boards ([7]), began to metabolize the result of the economic studies and try to transpose the related principles into rules. The result is that the organizational duty lies with the board of directors and the management. As regards the Italian legal framework, the provisions are imposed on the managers and on the board of directors, respectively, to take care of implementing an organizational structure appropriate for the nature and size of the *enterprise* (in Italian juridical terms, "enterprise" means "economic activity"), and to monitor that the appropriate quality reflects the features of the activity (as required by Article 2381 of the Italian Civil Code). It is relevant that the board of auditors has the duty to monitor ex post whether the organizational structure chosen is appropriate for the nature and size of the *company*: in this case, in fact, the control function has to assess the decisions made in the context of the organizational control of pertinence to the executive and supervisory management.

The managerial role is primarily perceived to be running the business operations efficiently and effectively, which includes the product, design, procurement, personnel, management, production, marketing and finance functions within the boundaries of the company under which it trades. By contrast, however, the governance role is not concerned with running the business of the company, per se, but with the directors giving overall direction to the enterprise, by overseeing and controlling the executive actions of the management and by satisfying legitimate expectations for accountability regulation by interests beyond the corporate boundaries.

The necessity to give legislative rank and dignity to the way of implementing what is necessary to make the decision-making process possible has institutionalized the concept of "internal governance": «Internal governance aims at ensuring that an institution's management body (both the supervisory and management function) is explicitly and transparently responsible for

([7]) A clear example is the truly prolific dialogue between the Basel Committee on Banking Supervisors and the European Parliament and the Council of the European Union (thinking, for the past, of the link between the Basel II Framework and the Directives 2006/48 EC and 2006/49/EC and, for the future, of the influences of the Basel III Accord and the new Directive 2013/36/EU).

its business strategy, organization and internal control. Internal governance is the responsibility of the management body (both the supervisory and management function). It is concerned mainly with setting the institution is organized, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey, and how internal control (including risk control, compliance, and internal audit) is organized» ([8]).

What the European Commission recently said about that is extremely rich in meaning: «*Financial institutions' internal governance cannot be reduced to a simple problem of conflicts of interest between shareholders and the management. Consequently, the rules of corporate governance within financial institutions must be adapted to take account of the specific nature of these companies*» ([9]). The nature of the company means not only the banking nature and thus its specific needs for organizational control, but also the peculiarities that stem from the cooperative and mutual enterprises, and in light of those, these characteristics reflect the instances in order to standardize the way in which the entrepreneurship activity functions with the use of processes and procedural issues.

2.2. *The internal control system as part of an organizational structure consistent with the entrepreneurial activity*

There is an essential difference between *internal corporate control* and *entrepreneurial activity control*: the first deals with the traditional control function of the corporate bodies (for example, the role of the auditors' board or the monitoring function of the board), while the second concerns the specific organizational competence of the management body, which we previously called "organizational control". The latter refers not only to the management's power to direct and govern its business, but also, and especially, to the decision about the technical arrangements to satisfy the initiative's economic needs in order to be able to "run". Decisions are made in accordance with the duty to set and take care of an organizational structure appropriate for the characteristics of the enterprise.

([8]) COMMITTEE OF EUROPEAN BANKING SUPERVISORS, *Guidelines on the Application of the Supervisory Review Process under Pillar 2*, 25 January 2006.

([9]) EUROPEAN COMMISSION, *Green Paper on Corporate Governance in Financial Institutions and Remuneration Policies*, 2 June 2010.

It must be borne in mind that the decision-making process in banking activity acquires a specific meaning, different from the one it has in other entrepreneurial activities, for two reasons: on the one hand, the risks emerging from this kind of activity are technical and involve specific skills in order to understand their features; on the other hand, banking activity involves public interests, and the legislation has the duty to protect credit consumers and savers, also in the light of the same marked risk level of the business. Therefore, this is why the regulators move towards an authoritarian intervention in indicating the organizational mechanisms that are necessary to implement an internal structure *adequate* for the banking activity ([10]). Without overpowering the private autonomy of bankers, the law imposes a strictly already designed organizational structure only with regard to its essentials, that is, the one provided with the internal control system, because both the board and the managers need qualified competences to understand well the risks undertaken and the consistence with the strategic perspective imparted and to ensure a more proceduralized way of conducting business (i.e. of taking business decisions) thanks to a sort of "control staff" supporting the decision-making process.

In such an approach, an internal control system offers an *instrumental* service to business functioning, because it allows managers (above all, the non-executive ones) to undertake systematic monitoring of the equity, economic and financial state of the company, and in particular it helps them to identify, manage, supervise and report the risks the credit institution is or might be exposed to ([11]).

Regarding the general purpose of the organizational control of putting in place the business activity by providing administrators with the means to be able to exercise it, the internal control system, by itself, responds to the specific aim to facilitate it in government of the risk to which the same business gives rise. Thanks to the internal control arrangements and functions, in fact, the board is equipped with and assisted by a qualified group of offices that have to control the way in

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([10]) FINANCIAL REPORTING COUNCIL, *Boards and Risks. A Summary of Discussion Companies, Investors and Advisers*, September 2011, p. 7; THE INSTITUTE OF RISK MANAGEMENT, *Risk Appetite and Tolerance*, Guidance Paper, 2011, in *www.theirm.org/publications/documents/IRMRiskAppetiteFullweb.pdf.*

([11]) As is well known, one of the most important reference frameworks regarding the internal control issues is the one formulated by the COMMITTEE OF SPONSORING ORGANIZATIONS OF THE TREADWAY COMMISSION (COSO). Recently, the renewed edition was published (the COSO III Framework, *Internal Control-Integrated Framework*, June 2013), developing and improving the last documents (COSO I, 1992, and COSO II, 2004). In this context, the instrumental role of the internal control system to the advantage of the management body is clearly specified: «*internal control is broadly defined as a process, effected by an entity's board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories:* i) *effectiveness and efficiency of operations;* ii) *reliability of financial reporting;* iii) *compliance with applicable laws and regulations*».

which the managers work. The nature of this control function has to be intended above all to be supervision and advisory support performed in advance, during the phases of the decision making still in progress in order to assure the effectiveness of management, rather than a feedback control. Conversely, this last form of control pertains to the bard of auditors, which executes in principle a synthesis control regarding how the organizational structure is made up and how the internal control system works: this is the meaning of saying that it is placed higher hierarchically, since its task represents a control of final instance, closing all the monitoring activities made before its (re)action moment.

In the decision-making process, all the actors involved have to work to be aware of what they are doing and how every single act could have an impact on the general business strategy. From such a perspective, if the internal control system operates towards the finality of enhancing the overall works of the management body, one of its principal objectives is to improve the information flows, in particular the ones intercurrent between the board and the managers. The specialized information that these actors need to conduct the business are available through interrogation of the internal control system, the response from which should be useful to decision makers to appreciate whether the horizon towards which the economic initiative is moving is consistent with the strategic goal in the long term, as well as with the public objectives of consumer protection.

As it has been attempted to argue, the internal control system as well as the broader theme of "organizational control" constitutes an instrument that is not to the direct benefit of the members operating as a sort of "sentinel" in their service. In fact, all internal control processes are designed to alert the management and the board rather than being at the service of ownership, which could be informed of the control devices' results only in a mediated way by the auditors' board or, at least, by the board of directors.[12] From the same perspective, the compliance, risk management and internal audit functions have to be considered instrumental organizational structures firstly to the management action rather than to protect the members' interests. This will be even clearer in answering the question: to whom do the internal control functions report? The internal controls' findings are technical data and information useful for understanding the business situations and the impact of management decisions. They represent resources for fulfilling managers' duties properly.

([12]) «*The responsibilities of the board include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship*» (see the corporate governance definition provided by the CADBURY COMMITTEE, *Report on Financial Aspects of Corporate Governance*, Paragraph 2.5, 1992, still now adopted by the FINANCIAL REPORTING COUNCIL, *UK Corporate Governance Code*, September 2012).

Thus, the internal control system refers to the management body and it "finds its summit", the one to whom it reports, in the board ([13]).

In the light of this reasoning, the internal control system derives primarily from the entrepreneurial activity features and works to make feasible its proper execution thanks to the management of the emerging risks. If it is intended to adopt the agency model as a theoretical approach, this could not be used in the usual way, but, at most, to read the relationship between the executives and the non-executives, between the board and the management. The processes and the control offices operate in order to keep the management and supervisory functions aligned, in particular enhancing the latter in the lack of oversight due to the distribution of competences and to the difficulty in finding information qualified to observe whether the strategic objectives were respected.

The internal control functions arise as a tool to solve the problems of agency and information asymmetry, not directly between ownership and management, but rather between the board, on the one hand, and the executive directors in charge of managing the company, on the other. The internal control practices deal with «*the setting of an appropriate strategy and risk tolerance/appetite levels, a holistic risk management approach and effective reporting lines to the management body in its management and supervisory functions*» ([14]).

3. *The ongoing crisis and the new attention to risk governance: the recent modernization process of the regulatory framework*

Until a few years ago, the widespread idea about the internal control system deemed it to belong to corporate governance arrangements and, as part of them, it had to be regarded, *sic et simpliciter*, as a structure designed for the direct benefit of the members ([15]). In developing

([13]) See EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, 24.5, London, September 2011: «*The control functions should be established at an adequate hierarchical level and report directly to the management body*».

([14]) EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, 1.22, London, September 2011.

([15]) See M.C. JENSEN, *Agency Cost of Free Cash Flow, Corporate Finance, and Takeovers*, in *American Economic Review*, 1986, Vol. 76, No. 2, p. 323; M.C. JENSEN, *The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems*, in *The Journal of Finance*, 1993, Vol. 48, No. 3, p. 831; W. MCINNES, *Auditing into the 21st Century*, Edinburgh, 1993, p. 29; M.B. ADAMS, *Agency Theory and the Internal Audit*, in *Managerial Auditing Journal*, 1994, Vol. 9, No. 8, p. 8; L.F. SPIRA, M. PAGE, *Risk Management: The Reinvention of Internal Control and the* increasingly the interest in all the profiles and the facets involved in enhancing the balance of powers inside corporations, this field is right now "in search of boundaries", because in the last years it has reached a particularly enlarged scope risking confusing the different aims of the different governance tools and as consequence losing effectiveness in its application. Therefore, recently, the corporate governance themes have started to organize themselves, to avoid becoming a conceptual "melting pot" embracing all the issues relating to the *interna corporis* of the credit institution. One of the future governance challenges concerns exactly the legislative technique and the way of enucleating every specific thematic area, seeking to explain the content in a more perceptive way in order for it to be well understood by the recipients ([16]).

It is relevant to note that the financial crisis that erupted in 2007–2008 demonstrated that weak internal governance issues are not to be imputed as a direct trigger of instability but rather as a crucial underlying factor.[17] In fact, the "organizational failures" are referred more to the insufficient implementation of the existing guidelines instead of the regulatory gap, and this was due also to a not always full awareness of the role that every governance arrangement has to play, for example (and in particular) the internal control system ([18]). Therefore, the new codifications have sought to

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Changing Role of Internal Audit, in *Accounting, Auditing & Accountability Journal*, 2004, Vol. 16, No. 4, pp. 640–641; A. GRANDORI, *Reframing Corporate Governance: Behavioral Assumptions, Governance Mechanisms and Institutional Dynamics*, in *Corporate Governance and Firm Organization*, Oxford, 2004, p. 13 ss.; P.L. DAVIES, *Principles of Modern Company Law*[18], London, 2008, p. 365; B. HANNIGAN, *Company Law*[2], Oxford, 2009, p. 115; J.D. RENDTORFF, *Responsibility, Ethics, and Legitimacy of Corporations*, Copenhagen, 2009, p. 196; S. GIRVIN, S. FRISBY, A. HUDSON, *Company Law*[18], London, 2010, p. 291; A.J. BOYLE, J. BIRDS ET ALII, *Company Law*[8], Bristol, 2011, p. 363; R.A.G. MONKS, N. MINOV, *Corporate Governance*[5], Padstow, p. 34; D. FRENCH, S. MAYSON, C. RYAN, *Company Law*[29], Oxford, 2012, p. 375; M. BLAIR, *Ownership and Control: Rethinking Corporate Governance for the Twenty-first Century*, Washington, 1996.

([16]) J. ARMOUR, W.G. RINGE, *European Company Law 1999-2010: Renaissance and Crisis*, in *ECGI Law Working Papers*, 2011, no. 175; B.R. CHEFFINS, *The History of Corporate Governance*, in *ECGI Law Working Papers*, 2012, no. 184.

([17]) This is the opinion of most international boards: FINANCIAL STABILITY FORUM, *Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience*, 7 April 2008, in *www.financialstability board.org/publications/r_0804.pdf*; INTERNATIONAL MONETARY FUND, *The Recent Financial Turmoil – Initial Assessment, Policy Lessons and Implications for Fund Surveillance*, 9 April 2008, in *www.imf.org/external/ np/pp/eng/2008/040908.pdf*; G20, *Declaration Summit on Financial Markets and the World Economy*, 15 November 2008; G30, *Financial Reform: A Framework for Financial Stability*, January 2009; EUROPEAN COMMISSION, *Corporate Governance in Financial Institutions: Lessons to be Drawn from the Current Financial Crisis, Best Practices*, 2 June 2010.

([18]) P.O. MÜLBERT, *Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms*, in *ECGI Law Working Papers*, 2009, No. 130; N. HOWSON, *When "Good" Corporate Governance Makes "Bad" Financial Firms: The Global Crisis and the Limits of Private Law*, in *Michigan Law Review*, 2009, Vol. 108, p. 44; G. KIRKPATRICK, *The Corporate Governance Lessons from the Financial Crisis*, in *Financial Market Trends*, OECD, 2009, No. 1; P.O. MÜLBERT, R.D. CITLAU, *The Uncertain Role of Banks' Corporate Governance in Systemic Risk Regulation*, in *ECGI Law Working Papers*, 2011, No. 179; P. COLLAZOS, *The Big Financial Crisis*, in *Basel III and* improve the level of comprehensibility and intelligibility of the dispositions, also changing the method of regulation: from the former principle-based regulation, in fact, the last interventions present a more detailed prescriptive framework ([19]), moving the centre of gravity between heteronomy and autonomy in order to individuate the adequate organizational structure to banking activity ([20]).

At the same time, anyway, in the modernization process of the corporate governance regulations, the internal control system is acquiring a more defined role than the one it played before and a strong sign in this sense is given by some statements made by authoritative international boards: "All too often, the focus appears to have been on internal controls for the purpose of financial reporting so that risk management became divorced from corporate strategy and its implementation" ([21]). This strong declaration attests to the heterogenesis of the internal control system purposes, until just now regarded mainly as a structure to serve and protect immediately the members' interests.

From this perspective, the attention of the regulators is focused on the activity's characteristics, on the level of risk tolerance and risk appetite decided by the board and on the presence of an internal control system capable of providing what the corporate actors need to fulfil their duty properly, in accordance with control instances arising exactly from the entrepreneurial activity's features ([22]). In particular, the interest is centred on the need to manage risk in an enterprise and to adjust it to the corporate strategy, so the risk managers are valorized as an essential part of implementing the company's strategy in order to ensure the awareness of the risk that the

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Beyond, edited by F. Cannata, M. Quagliarello, London, 2011, p. 3; A.N. BERGER, B. IMBIEROWICZ, C. RAUCH, *The Role of Corporate Governance in Bank Failures during the Recent Financial Crisis*, in *European Banking Center Discussion Papers*, 2012, No. 23.

([19]) See A. ENRIA, P.G. TEIXEIRA, *A New Institutional Framework for Financial Regulation and Supervision*, in *Basel III and Beyond*, edited by F. Cannata, M. Quagliarello, London, 2011, p. 427 and L. DALLA PELLEGRINA, D. MASCIANDARO, *Good Bye Light Touch? Macroeconomic Resilience, Banking Regulation and Institution*, in *Journal of Risk Governance and Control*, 2013, forthcoming (essay read in advance thanks to the courtesy of the authors). On the impacts of the crisis on the regulation policy see G. CAPRIO, V. D'APICE, G. FERRI, G.W. PUOPOLO, *Macro Financial Determinants of the Great Financial Crisis: Implications for Financial Regulation*, *ISTEIN Working Paper Series*, 2010, No. 12.

([20]) As it has been correctly noticed, «"Soft law" is not necessarily all that soft in its effect. The moral pressure that can be exerted by it can result, ultimately, in "shaming the banks into better ways"» (R. MCCORMICK, *What Makes a Bank a "Sustainable Bank"?*, in *Law and Economics Yearly Review*, 2012, Vol. I, No. 1, p. 102).

([21]) OECD, *Corporate Governance and the Financial Crisis: Conclusions and Emerging Good Practices to Enhance Implementation of the Principles*, February 2010.

([22]) R. AYADI, E. ARBAK, W.P. DE GROEN, *Implementing Basel III in Europe: Diagnosis and Avenues for Improvement*, in *CEPS Policy Brief*, 2012, No. 275.

company is facing ([23]). Accordingly, the essential document of the European Banking Authority explains that an institution should set the properties of its organization structure taking into account the size and complexity of the institution and the nature and scope of its activities: thus, «*the management body should be able to rely on the work of control functions, including the Risk control function, the Compliance function and the Internal Audit function*» ([24]).

Most of these indications have recently become prescriptive rules thanks to the emanation on June 2013 of the Regulation 2013/575 and the Directive 2013/36/EU (the so-called "CRD IV"). From a general perspective, these last legislative interventions are consistent with the increased sensitivity of regulators to the relationship between the board and the managers as a reason for the establishment of the internal control system: because their work has to face the complexity and technicism of banking activity, they need resources to know what they have to do and to avoid the distribution of skills and powers implying agency problems. Actually, behavioural corporate governance studies have revealed that the quality of the decision-making process concerns firstly the search for balance between the different groups of subjects existing in the corporate structure, in particular focusing attention on the behavioural dynamics within the management body ([25]).The marked attention to the nature and the scope of credit institutions' activity seems to testify to the

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([23]) Among others, OECD, *Corporate Governance and the Financial Crisis: Conclusions and emerging good practices to enhance implementation of the Principles*, February 2010 and BASEL COMMITTEE ON BANKING SUPERVISION, *Principles for enhancing corporate governance*, October 2010 (in particular, see Principle 6: «*Internal controls are designed, among other things, to ensure that each key risk has a policy, process or other measure, as well as a control to ensure that such policy, process or other measure is being applied and works as intended. As such, internal controls help ensure process integrity, compliance and effectiveness. Internal controls help provide comfort that financial and management information is reliable, timely and complete and that the bank is in compliance with its various obligations, including applicable laws and regulations. In order to avoid actions beyond the authority of the individual or even fraud, internal controls also place reasonable checks on managerial and employee discretion. Even in very small banks, for example, key management decisions should be made by more than one person ("four eyes principle"). Internal control reviews should also determine the extent of an institution's compliance with company policies and procedures, as well as with legal and regulatory policies*»).

([24]) EUROPEAN BANKING AUTHORITY, *Guidelines on Internal Governance*, 1.35, London, September 2011.

([25]) M. HUSE, *Renewing Management and Governance: New Paradigms of Governance?*, in *Journal of Management and Governance*, 2003, No. 7, p. 211 ss.; C.M. DAILY, D.R. DALTON, A.A. CANNELLA, *Corporate Governance: Decades of Dialogue and Data*, in *Academy of Management Review*, 2003, p. 371; J. GABRIELSSON, M. HUSE, *Context, Behavior and Evolution: Challenges in Research on Boards and Governance*, in *International Studies of Management and Organization*, 2004, p. 11; M. HUSE, *Accountability and Creating Accountability: A Framework for Exploring Behavioral Perspectives of Corporate Governance*, in *British Journal of Management*, 2005, p. 65; H. EES, J. GABRIELSSON, M. HUSE, *Toward a Behavioral Theory of Boards and Corporate Governance*, in *Corporate Governance: An International Review*, 2009, p. 307; P. SCHWIZER, M.G. SOANA, M. F. SUTTER-RÜDISSER, *I consiglieri irrazionali: la behavioral corporate governance può spiegare la crisi?*, in *La banca commerciale territoriale nella crisi dei mercati*, edited by D. Masciandaro, G. Bracchi, Rome, 2012, p. 121.

increased awareness of regulators of the specificities of cooperative banking, which are by law different from those of other companies.

Nevertheless, if, on the one hand, the new dispositions on the governance issues and the internal control system give more value to the characteristics of the entrepreneurial activity in driving the method to design the organizational structure, on the other, the more detailed and stricter method of regulation, paradoxically, allows decreased space to decide which control tools are necessary for the business's needs: this is also reflected in sacrificing the implementation of the principle of proportionality, not always giving adequate space to its applications ([26]).

In this sense, it is also useful to underline that the crisis has involved cooperative banks less than other credit institutions. In theory, cooperative banks present heavier agency problems because of their ownership structure: the members are larger in number, have smaller ownership stakes and are more dispersed, so they, always in abstract, do not have a strong influence on managers. The concrete experience has revealed, on the contrary, that cooperative banks have reacted better than their competitors thanks to their way of "doing banking" besides their peculiar corporative organization.

When the crisis erupted in 2007–2008, in fact, the cooperative network was completely insulated from the financial storm that hit the banking industry. The main reason was that cooperative banks had not strayed from prudent and balanced banking activity aimed at serving firms and households in their local area. They had pursued a traditional and efficient originate-to-hold (OTH) model of lending funded mainly by retail deposits and plain vanilla bonds. On the asset side, cooperative banks had maintained a solid liquidity buffer and had not invested in toxic assets or in exotic investment instruments. Central institutions were not involved in investment banking activities but focused on developing and providing the associated banks with products and services. Lastly, cooperative banks have always relied on a large equity base, prudent use of securitization, transparency in business practices and a reliable internal safety net and have always enjoyed a good reputation. For all these reasons, the cooperative network also proved to be resilient in the secondary phase of the crisis. The number of members and clients has shown a steady increase, reflecting the trust that cooperative banks have earned in their local areas.

([26]) See EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS, *EACB Key Messages and Comments Regarding Commission Proposal for a Directive Establishing a Framework for the Recovery and Resolution of Credit Institutions and Investments Firms*, Brussels, November, 2012, p. 9. On the importance of giving way to a proportionality-based and fine-tuned approach to regulation see G. FERRI, *Credit Cooperatives: Challenges and Opportunities in the New Global Scenario*, *Euricse Working Papers*, 2012, Vol. 31, No. 12, p. 4.

Also recognizing the peculiar way of operating referring to cooperative banks, it has been deemed that the resilience of the stakeholder model stems from its competitive advantage, rather than from alleged regulatory interference ([27]).

4.1. *The banking cooperative enterprise and the arising control instances*

Adopting the concept that the internal control system is part of an organizational structure consistent with the characteristics of the entrepreneurial activity, it is consequently easy to understand the reason why the internal control arrangements have to be different in cooperative banks. Cooperative banks are special companies for two reasons: because they are *banks* and because they are *cooperative*. Firstly, this credit institution is, to all effects, a bank and, as it pursues this kind of activity, it has to be equipped with an internal control system; secondly, it is a cooperative enterprise so it has a peculiar way of functioning that has to be taken into consideration in creating its internal structure ([28]).

This point of view is consistent with the perspective of people who perceive the opportunity of a distinction between the shareholder value (SHV) and the stakeholder value (STV) banks ([29]), because the latter conceive the objective of "maximizing value" as serving the interest of their member customers. In cooperative banks, depositors can become members who own the organization and could influence the course of the entire business policy: the interests of members as depositors coincide with the interests of the members as owners and this implies that these credit institutions are mainly involved in deposit-taking and the provision of credit to households and

([27]) See G. FERRI, P. KALMI, E. KEROLA, *Governance and Performance: Reassessing the Pre-Crisis Situation of European Banks*, in *Financial Cooperatives and Local Development*, edited by Y. Alexopoulos, S. Goglio, Routledge, 2012, p. 37.

([28]) In this sense, see EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS, *Corporate Governance Principles in Co-operative Banks*, Brussels, June 2006.

([29]) C. CORNFORTH, *The Governance of Co-operatives and Mutual Associations: A Paradox Perspective*, in *Annals of Public and Co-operative Economics*, 2004, Vol. 75, no. 1, p. 11; R. AYADI, E. ARBAK, S. CARBÓ VALVERDE, F. RODRIGUEZ FERNANDEZ, R.H. SCHMIDT, *Investigating Diversity in the Banking Sector in Europe: The Performance and Role of Savings Banks*, Centre for European Policy Studies, Brussels, 2009; J.M. GROENEVELD, D.T. LLEWELLYN, *Corporate Governance in Cooperative Banks*, in *Working Paper Rabobank Nederland*, Utrecht, 2011; G. COCO, G. FERRI, *From Shareholders to Stakeholders Finance: A More Sustainable Lending Model*, in *International Journal of Sustainable Economy*, 2010, Vol. 2, No. 3, pp. 352–364; R. AYADI, *Diversity in European Banking. Why Does it Matter?*, in *CEPS Commentary*, 2010.

individual entrepreneurs, including small and medium-sized enterprises (SMEs). Hence, the nature of principal–agency problems in cooperative banks is peculiar and different from those of SHV banks, owing to the absence of the conflict between shareholders and depositors ([30]). In fact, from a supervisor's perspective, the purpose of banks' corporate governance is less to safeguard the integrity of the promises made by corporations to investors than to safeguard the promises made to depositors and other debtholders ([31]).

The business objective of cooperative banks does not focus on the maximization of short-term shareholder value but is rather centred on increasing the benefit of its members, who typically maintain a long-term relationship with their bank: therefore, the interests of the members are at the centre of cooperative banks' business strategies ([32]).

The essence of the basic cooperative banking model is based on a stable banking approach principally focused on retail banking in the home country, accompanied by a tendency for a longer term and risk-averse view: «*The primary mission of Cooperative banks is to promote the economic interest of their members, who are their customers. Cooperative banks strive to do so by offering quality products and services at attractive prices from the perspective of what is good for the customer. They have an impact presence on the conditions of products in the whole banking market and support the economic and social integration of individuals*» ([33]).

By the nature of its constitution, the net economic value provides an intergenerational endowment without final owners: in other words, the net worth of the cooperative bank is not owned by the current cohort of members, but rather by the cooperative itself ([34]).

As the cooperative business behaviour is peculiar, its internal governance has to reflect the specificity of its "way of banking doing" and in particular has to take into account that its essential

([30]) C.E. CUEVAS AND K.P. FISCHER, *Cooperative Financial Institutions: Issues in Governance, Regulation and Supervision*, in *World Bank Working Paper*, 2006, No. 82.

([31]) P.O. MÜLBERT, *Corporate Governance of Banks after the Financial Crisis – Theory, Evidence, Reforms*, in *ECGI Law Working Paper*, 2009, No. 130.

([32]) On the key characteristics of cooperative banks: R. AYADI, D.T. LLEWELLYN, R.H. SCHMIDT, E. ARBAK, W.P. DE GROEN, *Investigating Diversity in the Banking Sector in Europe*, Centre for European Policy Studies, Brussels, 2010, p. 13.

([33]) See EUROPEAN ASSOCIATION OF CO-OPERATIVE BANKS (EACB), *Cooperative Banks in Europe: Values and Practices to Promote Development*, Brussels, 2005.

([34]) As has been well argued by W. FONTEYNE, *Cooperative Banks in Europe – Policy Issues*, *IMF Working Papers*, 2007, No. 159: «net economic value is in essence an owner-less intergenerational endowment that is available for use by current members, under the implicit or explicit understanding that they will grow it further and pass it on to the next generation of members».

business is mostly typical and centred on the channeling of funds between lenders and borrowers, who are (even if not necessarily) largely the same institution members. Normally, cooperative banks have to face credit risk and concentration risk and these kinds of "uncertainty" do not require a high level of control arrangements and tools. However, this does not imply that the "control instances" are weak or non-existent, but rather that they manifest themselves in a peculiar way (such as the issues relating to democratic decision making ([35])) or that they are peculiar is the instance to manage the reputational risk.

For this reason, the proportionality principle acquires a specific valence for cooperative banks, because it represents the balance point between the space of intervention of the regulators in deciding which organizational devices a bank has to establish as a minimum and the space for private autonomy in creating a structure that conforms to and is adequate for (and therefore proportionate to) the entrepreneurship size, without using resources in excess of the control instances for which they are ideated to respond ([36]).

4.2. *The specificity risks of cooperative banks to be monitored by the internal control system*

If the aims of the internal control system arise from the activity features, taking the role of support in governing the associated risks, and if cooperative banks present a common paradigm of entrepreneurship, despite the existence of a different business model, it is important to survey the common essence of cooperative banking activity.

In particular, attention should be paid to determining the kinds of risks arising from the unifying features that the internal organizational arrangements have to face, in accordance with the idea that the organizational dress of the company is sized in relation to the characteristics of its activity ([37]).

([35]) On which see D.C. JONES, P. KALMI, *Economies of Scale Versus Participation: A Co-operative Dilemma?*, in *Journal of Entrepreneurial and Organizational Diversity*, 2012, pp. 37–63.

([36]) «*There is no "one-size-fits-all"*», as stated by the COMMITTEE OF EUROPEAN BANKING SUPERVISORS, *Guidelines on the Application of the Supervisory Review Process under Pillar 2*, January 2006.

([37]) E. GUALANDRI, *Basel III, Pillar 2: The Role of Bank's Internal Governance and Control Function*, in *ssrn.com/abstract=1908641*.

From this perspective, it is important to valorize the cooperatives banks' institutional vocation for strong local ties, which implies a more efficient assessment of creditworthiness and customers' risks in the local area. In particular, these credit institutions put at the centre of their business strategies the interests of their members, who are also their customers. In a broad sense, cooperative banks are focused on the local community, seeking to maximize the customer value and to promote the local economy. Thus, their method of banking is strictly related to relationship banking ([38]), because of their attention to customer value ([39]).

The close proximity to their customers gives cooperative banks a set of information advantages ([40]), in order to monitor constantly the exposure to credit risk. In this sense, it is also argued that cooperative banks could benefit from the peer-monitoring mechanisms that develop in the context in which the bad behaviour of each one has a negative impact on the entire community, producing a disadvantage and a sort of collective animadversion. Several studies have highlighted the role of social sanctions within a tightly knit community, which may be a valuable substitute for the missing incentive of enforcement roles ([41]).

The risk characteristics of cooperative banks derive from their same strengths, which could become weaknesses: the internal control system has to be enhanced by virtue of the proximity of the banks to their borrowers and the local information the banks may have due to their proximity to their borrowers. Even if the cooperative banks tend to be lower risk takers ([42]), the fact of being in proximity to their member-customers needs a peculiar organizational process in order to assure the proper assessment of credit risks or it could transform into a risk factor: the strong local presence

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([38]) See A.W. BOOT, *Relationship banking: What Do We Know?*, in *Journal of Financial Intermediation*, 2000, p. 7.

([39]) J.H. GROENEVELD, *The Cooperative Banking Model: Performance and Opportunities*, in *New Paradigms in Banking, Financial Markets and Regulation?*, edited by M. Balling, F. Lierman, F. Van den Spiegel, R. Ayadi, D.T. Llewellyn, The European Money and Finance Forum, Wien, 2012, p. 103.

([40]) See F. BARTOLI, G. FERRI, P. MURRO, Z. ROTONDI, *What's Special about Banking in Italy? Lending Technologies, Complementarity, and Impact of Soft Information*, in *Le banche sono speciali? Nuovi equlibri tra finanza, imprese e Stato*, edited by D. Masciandaro, G. Bracchi, Rome, 2010.

([41]) J.E. STIGLITZ, *Peer Monitoring and Credit Markets*, in *World Bank Economic Review*, 1990, Vol. 4, No. 3, pp. 351–366; H.R. VARIAN, *Monitoring Agents with Other Agents*, in *Journal of Institutional and Theoretical Economics*, 1990, Vol. 146, No. 1, pp. 153–174; T. BESLEY, S. COATE, *Group Lending, Repayment Incentives and Social Collateral*, in *Journal of Development Economics*, 1995, Vol. 46, No. 1, pp. 1–18; G. FERRI, T.S. KANG, I. KIM, *The Value of Relationship Banking During Financial Crises: Evidence from the Republic of Korea*, *World Bank Policy Research Working Papers*, 2001, No. 2553.

([42]) As noted in M. CIHÀK, H. HESSE, *Cooperative Banks and Financial Stability*, in *IMF Working Papers*, 2007, No. 2 and in J.H. GROENEVELD, *Morality and Integrity in Cooperative Banking*, in *Ethical Perspectives*, 2011, Vol. 18, No. 4, pp. 515–540.

allows banks to have a better understanding of the needs and the risk profiles of their customers and to mitigate asymmetric information thanks to arrangements that valorize this relationship in accordance with the professional boundaries. It has been deemed that the managers and the directors of cooperative banks are rarely replaced and so they act in a self-referential way. At the same time, however, it has been argued that the long tenure of cooperative banks' directors could even help in pursuing long-term objectives ([43]), also a benefit with reference to the volatility of the bank's profit ([44]).

As already stated, cooperative banks normally have to face the traditional banking risk as well as the credit and the concentration risks ([45]). In managing these kinds of risks, cooperative institutions have to valorize their proximity to the community of reference in order to reduce the information asymmetries on borrowers. However, at the same time, the strength that the relationship banking presents as regards the governance of the credit risk presents as a counterface the emergence of high reputational risks. Because of the social values inherent in cooperative banking activity, these banks must implement an internal system capable of monitoring with particular attention the issues of which public sensibility is more aware, in particular regarding the confidence vested in the banking operations. In this sense, the impact from involvement in money laundering due to a mismatch between internal processes or to the lack of a well-organized compliance plan will be higher in a cooperative bank than in other credit institutions.

From this perspective, all the internal control arrangements should remain vigilant regarding the effects related to the poor image of the banking activity and, speculatively, enhance the ability to use the peer-monitoring mechanisms, in particular with the organization of a well-formalized information path that involves the top management or the board, which are equipped with an informative picture that may be larger, for the most sensitive issues.

([43]) G. FERRI, *Credit Cooperatives: Challenges and Opportunities in the New Global Scenario*, *Euricse Working Papers*, 2012, Vol. 31, No. 12, p. 11.

([44]) See W. FONTEYNE, *Cooperative Banks in Europe – Policy Issues*, *IMF Working Papers*, 2007, No. 159 and M. CIHÀK, H. HESSE, *Cooperative Banks and Financial Stability*, *IMF Working Papers*, 2007, No. 2.

([45]) On the peculiar risks arising from cooperative banks' *modus operandi* see F. CANNATA ET ALII, *Italian Mutual Banks and the Challenge of Basel III*, in *Bank of Italy Occasional Paper*, 2013, No. 158.

5. *Conclusions*

As cooperative banks do not present the traditional agency problem that exists in the case of SHV banks, it could also be argued that even the way in which they exercise their entrepreneurial activity is different from that of their competitors and this peculiarity is reflected in the instances of control to which the several arrangements encompassed in the internal control system have to respond.

Cooperative banks follow a business model with a longer-term objective centred mostly on the traditional intermediation between savings and credit. They operate by favouring the members over external subjects according to their mutualistic and social spirit. In the light of these characteristics, the internal control system has to improve the management's works particularly with reference to the measures that are better suited to strengthening relationship banking to favour responsible behaviour. It is important to create an organizational structure with a dimension consistent with concrete risks faced by the enterprise and preordained to enhance the information advantage they have regarding the community of reference.

As it was clearly highlighted, the capacity to cater for the future generations' needs is the "way of doing" of that entrepreneurial activity that contributes to the sustainable development: «*We regard sustainable development – defined as development that meets the needs of the present without compromising the ability of future generations to meet their own needs – as a fundamental aspect of sound business management*» ([46]). Cooperatives offer a way to link the past and the future, enabling the intergenerational transfer of wealth, and this peculiar way of behaving in business must be "controlled" by the internal control arrangements: "controlled" in the sense that those organizational resources have to encourage and protect the "commonality with diversity" that distinguishes the STV banks, in order to ensure they do not lose their essence – as «diversity matters» ([47]) – also in accordance with the responsibilities that every bank, as an institution carrying out banking activity and involving public interests, has in front of the credit consumers and savers.

([46]) UNEP *Statement of Commitment by Financial Institutions on Sustainable Development*, 2012.

([47]) See the acute reasoning of C. BORZAGA, G. FERRI, F. SABATINI, *Editorial*, in *Journal of Entrepreneurial and Organizational Diversity*, 2011, pp. 1–6.