TOWARDS AN ETHICAL ENTERPRISE RISK MANAGEMENT: THE CASE OF AN ITALIAN MUTUAL CREDIT COOPERATIVE BANK

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ABSTRACT

Recent financial crisis has shown corporate governance failures (Linsley and Slack, 2012) as well as substantial weakness in risk management practices (Magnan and Markarian, 2011). This paper explores the role of Ethics as a key element of corporate governance 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 research is supported by a single case study of Banca di Credito Cooperativo di Napoli, as the most representative mutual credit cooperative bank of the South of Italy. This paper makes a contribution to existing literature giving evidence of the effectiveness of an Ethical Enterprise Risk Management process. Moreover, this study provides "lessons" for the international community, emphasizing that an ethical maturity in ERM practices contributes to the improvement of the economic and financial results.

KEYWORDS

Enterprise Risk Management, Ethics, Mutual Credit Cooperative Banks.

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1. INTRODUCTION

The emergence and evolution of Enterprise Risk Management (ERM) in practice has been widely discussed from both, researchers and professional associations (Institute of Internal Auditors, The Global Association of Risk Professionals, the Institute of Risk Management).

ERM differs from traditional conceptions of risk management in its enterprise-spanning aspirations (Paape and Speklè, 2012). Shifting the focus of risk management function from primarily defensive toward increasingly offensive and strategic (Liebenberg & Hoit, 2003), strategic, operational, reporting and compliance risks are addressed simultaneously rather than separately.

Several semi-regulatory bodies have published frameworks, trying to standardize and codify so-called best practices. The most prominent of these is the COSO ERM framework (Power, 2009; COSO, 2004a). Given the influence of these frameworks, an academic risk management literature is start to develop and empirical studies have addressed the effects of the standards and recommendations on risk management effectiveness (Paape and Speklè, 2012).

However, recent financial crisis has shown corporate governance failures (Linsley and Slack, 2012) as well as substantial weakness in risk management practices (Magnan and Markarian, 2011). It has been highlighted (Magnan and Markarian, 2011) that research so far has looked at governance system singly, ignoring the complex amalgam of forces that shapes a firm's governance environment. On the other hand, firm are under significant pressure to strengthen their risk management practices, in order to improve the stakeholder value protection.

In this regard, a number of contributions have highlighted the issues related to ethics in Enterprise Risk Management practices as a key element of corporate governance (Demidenko and Mc Nutt, 2010; Weitzner and Darroch, 2010). However, since there is no empirical research addressing the issues related to ethics and ERM, this paper aims to explore how an ethical Enterprise Risk Management works in action, emphasizing its role in improving organizations’ governance.

For the purposes of our analysis, we mainly refer to the Italian mutual credit cooperative banks that, according to San Jose et al. (2011), can be defined ethical bank since they are managed according to the principles of social and economic profitability. We expect that the ethical nature of this organization could be useful to deepen understanding on the role of ethics of ERM as a key element of corporate governance. Thus, this paper aims to answer to the following research questions:

- ✓ How Ethics is helpful in supporting Enterprise Risk Management?
- ✓ What contribution can be offered to the international community from both, the theoretical and practical perspectives, through the exploration of Ethics in Enterprise Risk Management within ethical banks?

This study employs holistic case study (Jeppesen and Loft, 2011), according to the recent call for adopting this type of investigation in management accounting (Chenhall and Euske, 2007; Chua, 2007; Curtis and Turley, 2007; Robson et al., 2007).

The reminder of the paper is structured as follows. Section 2 assesses prior researches. Section 3 describes the methodology of the study and the research design. Section 4 analyses the case of the Banca di Credito Cooperativo di Napoli. Section 5 provides theoretical reflections and discusses the implication of the analysis. The last section concludes the study, addressing some further developments.

2. LITERATURE REVIEW

A number of studies focus the attention on the factors related to the ERM adoption (e.g. Beasley et al., 2005; Kleffner et al., 2003; Liebenberg and Hoyt, 2003). The trend toward the adoption of ERM programs is usually attributed to a combination of external and internal factors. The major external influences that have driven firms to approach risk management in a more holistic manner are a broader scope of risks arising from factors such as globalization, industry consolidation, and deregulation and corporate governance. Internal factors are centred on an emphasis to maximize shareholder wealth, improving capital efficiency, stabilizing earnings, and reducing the expected costs of external capital and regulatory scrutiny. However, some evidence suggests that ERM adoption might be conditional on the legal and regulatory environment, considered critical to extensive ERM deployment (Beasley et al., 2005), and perhaps also on cultural factors (Liebenberg and Hoyt, 2003). In this regard, recent literature indicates that the factors associated with ERM adoption are similar across different national contexts (Paape and Speklè, 2012).

Other studies address the effects of ERM adoption on firms' performance (Beasley et al., 2008; Gordon et al., 2009). By adopting a systematic and consistent approach (or process) to managing all of the risks confronting an organization, ERM is predicated on lower a firm's overall risk of failure and thus increase the performance and, in turn, the value of the organization (Gordon et al, 2009). The link between a holistic approach to risk management and an organization's performance/value is clearly noted in the following definition of ERM provided by the Casualty Actuarial Society Committee on Enterprise Risk Management (2003, p. 8) as well as by the Committee of Sponsoring Organizations of the Treadway Commission (2004, p. 2). In this regard, Gordon et al. (2009) have identified five specific firm factors (environmental uncertainty, industry competition, firm complexity, firm size, and board of directors' monitoring) that are believed to have an impact on the ERM-firm performance relation.

It has been recognised the importance of the contingency perspective toward the appropriate implementation of ERM system for a particular organization (Gordon et al, 2009; COSO ERM 2004), that should surely change from firm to firm. The fact that there is no universally ideal ERM system is, of course, intuitive and has been suggested elsewhere (e.g., The Financial Reporting Council's Report, 2005; Beasley et al., 2005; Moeller, 2007). Furthermore, the contingency view of enterprise risk management system is consistent with the literature that examines the more generic notion of management control systems.

Another cluster of papers explores the details of risk management practices in specific organizational setting (Arena et al., 2010; Mikes, 2009; Wahlstrom, 2009; Woods, 2009). Emphasizing the nature "context specific" and "highly organizationally dependent" of enterprise risk management, empirical researches (…..) have confirmed a continually evolving mutual interaction between ERM and other pre-existing risk management practices. It has been argue that, for an effective ERM, companies must look beyond the technology to establish a culture of risk management throughout the organization, permeating the existing practices and the individual behavior of managers in everyday decisions (Mikes, 2011). For instance, Arena et al. (2010) provide case study evidence from three Italian firms demonstrating that ERM is translated and alters the behaviour and mind-set of the actors who, in different capacities and for various reasons, become translators of the different control practices and participate in managing uncertainty. Mikes (2009), through the analysis of two large banks, concludes that systematic variations in ERM practices exist, even within a single industry setting. In addition, Woods (2009) reports significant variety at the operational level of the ERM system within a single large public sector organisation.

In addition, existing literature (Liebenberg and Hoyt, 2003; Beasley et al. 2008; Paape and Speklè, 2012) examines ERM from a governance perspective. According to the COSO ERM framework, one of the challenges associated with ERM implementation is determining the appropriate leadership structure to manage the identification, assessment, measurement, and response to all types of risks that arise across the enterprise (Nocco and Stulz, 2006). To respond to this challenge, many organizations are appointing a member of the senior executive team to oversee the enterprise's risk management process. Some authors Liebenberg and Hoyt (2003) and Beasley et al. (2008) rely on data on Chief Risk Officer appointments as their sole indicator for ERM adoption, arguing that the appointment of a chief risk officer is being used to signal both internally and externally that senior management and the board is serious about integrating all of its risk management activities under a more powerful senior-level executive (Lam, 2001). There is a prevailing view that an ERM initiative cannot succeed, because of its scope and impact, without strong support in the organization at the senior management level with direct reporting to the chief executive officer or chief financial officer. Senior executive leadership over ERM helps communicate and integrate the entity's risk philosophy and strategy towards risk management consistently throughout the enterprise (COSO ERM, 2004). However, it has been recently underlined (Paape and Speklè, 2012) that there is no evidence that the application of the COSO framework improves risk management effectiveness, neither that support for the mechanistic view on risk management is implicit in COSO's recommendations on risk appetite and tolerance.

Due to the growth in importance of the interactions between operational practices and ethical boundaries within organizations (Power, 2009), a number of contributions have addressed the issues of the closely connection between ERM and business ethics (Francis and Armstrong, 2003) The Ethics of Enterprise Risk Management system represents an important constrains in the recent risk management framework (COSO ERM) as well as a key component of corporate governance (Demidenko and Mc Nutt, 2011). Business ethics is intended as a set of moral philosophy, values and norms of behaviour that guide firms within society (Francis, 2000), bring business benefits, related not only to the social profitability but also to the economic profitability (Sison, 2000; Joiner and Payne, 2002). Ethics in Enterprise Risk Management practices should support the increasing of the triple bottom line profitability (Weitzner and Darroch, 2010), in order to contribute to the best alignment between the objectives of both, the firms and their stakeholders, leading enterprise risk management practices toward a good management of stakeholder relations. In this way, ethics in ERM is able to ensure the effectiveness of risk management practices and contribute in assisting the process of protecting stakeholder's value, (Demidenko and Mc Nutt, 2011; Weitzner and Darroch, 2009; Drennan, 2004; Francis and Armstrong, 2003).

3. RESEARCH DESIGN

This research is supported by holistic single-case study (Jeppsen and Loft, 2011; Ahrens and Chapman, 2007). Single examples from cases can be of general interest (Silverman, 1993) and still remain grounded in their specific context. Case study approach is particularly useful for exploratory research where an inductive approach can be adopted, using theory to explain empirical observations (Otley and Berry, 1994).

We consider the case of Banca di Credito Cooperativo di Napoli (BCC) because of its economic and social role, as the largest and most representative mutual credit cooperative bank of the South of Italy. This is an underdeveloped area that needs not only for financial investments but also for initiatives in areas of activities such as health, education and employment in order to support its economic development.

Our initial research problem defined at the outset of the study is formulated in quite broad terms identifying the phenomenon to be studied. It is designed to focus our research efforts on the role played by ethics in ERM practices. In particular, the research questions refer to an investigation of the role of ethics in enterprise risk management practices and become progressively more narrowed during the research process as new concepts in order to discover their relationship. Moreover, the exploratory nature of our research makes it difficult to derive hypotheses about the dynamics of enterprise risk management practice in light of ethical values from the extant literature. Therefore, the research is undertaken without prior theories or variables because they are likely to impede the discovery of the relevant variables and the relationships among them.

The analysis of the case study is based on both, external and internal environment of the BCC di Napoli. Hence, we consider internal sources (interviews to the managers and internal documents, not usually made available to the public) and external sources (all reports published by the company, newspaper, financial statements, other public coverage of the company). First, we rely on a series of in-depth, tape-recorded interviews with multiple individuals with different perspectives as our primary source of information. We met with Chairman, CFO, risk manager and with the top management team as well as with credit staff that have been closely involved in particular investment projects and have thus interacted in defining risk management practices. The length of the interviews varies from one to two and a half hours. Collecting data has occurred from multiple respondents because no single individual in the organization had a complete knowledge about the role of ethics in Enterprise Risk Management practices. The contribution of multiple respondents also has other benefits. On the one hand, it guards against idiosyncratic views being treated as representative of the entire organization. On the other hand, it reduces the effect of *ex post* rationalizations or distorted reconstructions of events. A semi-structured questionnaire is used to guide the process of our study. Semi-structured interviews are considered preferable to structured ones because the theory is continuously developing and therefore, the data collection has to be designed to allow this flexibility (Strauss and Corbin, 1990). The set of questions is structured around a number of key topics that have to be discussed during the interview, rather than representing literal questions to be asked during the field interviews. To increase the reliability of our case study, as a support of the data collected through the interviews, we have also referred to documentary evidences (Yin, 1974). These documents included a complete set of the procedures of BCC, comprising, summaries of risk management procedures, strategic plans, and other related matters. Public information on the company was used as an additional source of information. Interpreting and organizing the diverse and complex body of data gathered during our research was a challenging task, which had to be undertaken in a rigorous way.

4. THE CASE OF BANCA DI CREDITO COOPERATIVO DI NAPOLI

Banca di Credito Cooperativo di Napoli (BCC) is a young mutual credit cooperative bank and represents the main mutual credit cooperative bank within the area of Naples (the largest city in the south of Italy). It is based on the relationships between managers and clients. For this reason, an important role is played by moral behaviour of the managers because it increases the trust established depositors and managers. The main ethical principles that guide BCC in performing its economical and social activities are the following: Affinity – associated with the concept of positive criteria in investment, joint shareholder responsibility and asset quality – is based on asset placement that matches the interests of depositors and savers and concerns the responsibility of financial entities in decisions regarding the final destination of deposited funds. Responsibility – linked to the concept of the absence of negative criteria for investments and to CSR – is about those involved being accountable for the social and economical consequences of their behaviour. Integrity - related to the concept of financial exclusion - is the responsibility to prevent that there will be organisations, micro companies, black economy or groups excluded from the financing system, either because of a lack of resources (poverty), their geographical situation or because they belong to a certain social or ethnic group.

The on-going commitment to ethical behaviour by the managers contributes positively to economic development of BCC as well as to the growth of legitimacy in Neapolitan territory. BCC presents these ethical standards, in a code of professional ethics aiming for both self-regulation and also the profession's commitment to the public. The code of conduct has been developed and enforced by top-management of businesses and the code does not restricted to the shareholders. It includes the views of the employees in order to improve sharing, participation and commitment of all stakeholders to bcc's vision. While ethical variables have a relevant role in BCC, the implication of regulatory requirements should not be underestimated. Due to the central role played in the economic system related to its core business, BCC is subject to specific requirements with reference to the techniques used to identify, measure, manage, control and monitor risks.

First, BCC is under the supervisory authority of Bank of Italy, which regulates its purpose and defines its governance system. According to the Testo Unico Bancario, BCC conducts its business primarily for the shareholders (art. 35 T.U.B.). Therefore, the activities of BCC di Napoli are designed to encourage members and local communities in the operations and banking services, continuing the improvement of the moral, cultural and economic development and promoting cooperation, education and retirement savings and social cohesion, sustainable and responsible growth of the territory in which it operates. Members (shareholders) must be at least 200 and the value of their participation should not exceed the nominal value of 50.000 €. In addition, each of the members has in the general assembly, independently of the number of shares (the one-head one-vote system). Moreover, in order to emphasize the strong relationship with the local territory, it is important to highlight each of the members of BCC has to prove the residential, the registered office or the continuous activity in the local community of reference for the bank itself. Moreover, according to the prescriptions of the law (art. 37 T.U.B.), BCC devotes the 70% of profits to the legal reserve, allocate another portion to the Mutual Fund for the Development of the Cooperation, and usually the remaining part is to be used for mutuality or charity purposes. Therefore, the distribution of benefits between shareholders is only residual in BCC. BCC should aim to the achievement of economic profitability that implies only a good management of the bank to guarantee the economic sustainability. On the other hand, BCC's activity is also oriented to the achievement of social profitability, understood as the funding of economic activities with social value added and expressed as marginal external benefit that is added to marginal private benefit and as the unconditional absence of investment in speculative projects or undertakings that develop products or services related to "negative area" (i.e. pollution, pornography, tax evasion, drug, mafia). *Our activity refers 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 our area of interest (Chairman)*. Therefore, Banca di Credito Cooperativo di Napoli directs its banking 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, aimed to achieving the cultural and moral development, as well as the cooperation and the cohesion, called external mutuality. Moreover, BCC also fulfils a purpose related to the systematic mutuality, in favour of the other cooperative banks, to enhance the cooperation and the creation of a network between cooperative banks. Furthermore, Banca di Credito Cooperativo di Napoli is required by law to identify the categories of risk and adoption of risk measurement provided for Basel II, in order to stat the appropriate minimum capital requirements, (regulatory capital). Although BCC does not have to make a profit, BCC has to manage and reduce their risk in order to secure future investments. BCC manage its risk through the application of practices and procedures in order to identify, to analyse and to assess risks, determining the degree of exposure to risk that BCC should accommodate, and taking appropriate steps to avoid litigation, loss of reputation and inquiry. Moreover, in order to manage its risks, BCC is compliant with the framework defined at the European level by COSO ERM. Beyond the regulatory requirements, it should be emphasized that risk management in BCC refers not only to both a rigorous risk classification and a numerical measurement, but it also considers the controllers' experience and intuition, expanding the "softer instrumentations" into the domain of non – measureable strategic uncertainties. Moreover, risk management process in BCC is strongly supported by the ethics; indeed, risk assessment of the investments concerns not only (or not exclusively) the increase in income for the bank, but also the economical, social and environmental benefits for the community of Naples

The good governance of BCC ensures that ethical values, codes, roles and responsibilities are implemented in a clear risk management structure. In this regard, the Chairman of BCC says: *"The governance structure is, most of the time, a feature that creates additional value to our activities"*. Audit committee focuses on the challenge of overall risk profile and on the definition of the framework. The internal auditor focuses on assurance of the effective risk management and maintains its objectivity consistent with the establishment. The Chief Risk Officer (CRO) coordinates enterprise risk management process. The responsibilities of the ERM function are split between "advisory role", relating to facilitation of the process and recommendation, and approval (management role) with priority in the area of facilitation and recommendation.

5. DISCUSSIONS, CONCLUSIONS AND FUTURE REMARKS

As it has been underlined the danger of ERM lapsing into "rule based compliance" (Power, 2009; Ryan et al, 2002), not only it is difficult to define its effectiveness but also a growing diffusion of ERM system itself could represent a source of risk (Power, 2004). In this regard, a number of studies (Cowton and Thompson, 1999; Francis and Armstrong, 2003; Scholtens, 2006) emphasize the great importance of the mangers' moral behaviour and highlight the role played by ethical principles as the value-driver of business activity (Caldarelli et al., 2011). The presence and the diffusion of ethical values within organization contribute to create and to increase confidence and trust between (financial and not financial) institutions and their stakeholder.

The role of ethics in risk management strategy starts with commitment from the top management for an ethical culture; it is a result of the appropriate policies, the code of conduct, the procedures and the systems in place to reward ethical conduct and to censure unethical actions. However, ethical risk management does not only correspond to the compliance of such codes and procedures defined by top management. In particular, an ethical risk management strategy is also strictly related to both the integrity and ethical values of the managers/shareholder. Ethics influence risk management strategy in creating the organizational infrastructure that promotes ethical conduct of business. Ethics support risk assessment oriented to increase not only (or not exclusively) business income, but also the economical, social and environmental benefits for the community of reference. On the other hand, ethics also represent a support in manage those risks associated with the lack of moral behaviour, giving assurance on internal auditor's independence, and supporting organizations in avoiding the fraud risk.

The purpose of an enterprise risk management ethically connoted is twofold and refers to management of resources and management of stakeholder. The former is related to the adoption of an alternative and new guarantee arrangement within the process of granting found. Mutual credit cooperative banks do not refer (or not mainly refer) to 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, an ethical risk management leads to a positive relationship between stakeholder management and shareholder value. An ethical risk management does contribute to build and to increase social capital through the good relationship with the local firms, families and community in general. The value of relationships increases both the legitimacy of the company in its area of interest and the power of trust established between clients and managers of organization. As a result, an effective stakeholder management leads to improve financial performance.

This research aims to provide an exploration of the role played by ethics within Enterprise Risk Management practices. 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.
According to the call for more empirical research addressing the issues related to Ethics and ERM, this study provides evidence on the effectiveness of the holistic risk management system in conjunction with a strong ethical maturity. For the purposes of our analysis, we refer to the Italian Mutual Credit Cooperative banks, as ethical banks, since the ethical nature of this organization is useful to deepen understanding on the role of ethics in ERM practices.

On the basis of previous considerations, it is possible to answer the fist research question: *How Ethics is helpful in supporting Enterprise Risk Management?*
Ethics in enterprise risk management practices contributes to the improvement of the economic and financial results. Ethics in Enterprise Risk Management enables firms to make large profits not via the achievement of high financial spreads but through the creation of services for the community, also supporting the economical and social development for the local territories. Unlike the traditional national and international banks, that show a significant decreasing in income in their financial statements, mutual credit cooperative banks could leverage the crisis as the opportunity of growth, as well as a chance of success. Leaving the well-having perspective, mutual credit cooperative banks conduct their business through the way of well-being.
At this stage there is need to answer the second research questions: *What contribution can be offered to the international community from both, the theoretical and practical perspectives, through the exploration of Ethics in Enterprise Risk Management within ethical banks?* From the theoretical perspective, our research emphasize the role played by ethics in ERM as different theoretical perspective for managing risks. What we want to underline is the need for a strong ethical maturity in each stage and within the different activities of the risk management process. This study has shown the importance of the role played by ethics considered merely an element of the internal environment, but must permeate ERM practices in the whole, as the engine of a holistic risk management process. In this regard, the implementation the role of Ethics should be more and more emphasized in order to define a new framework, as an Ethical Enterprise Risk Managemenet.

In this way, our analysis has also implication in practice, showing how an 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. 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.

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. 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. Also, recent literature has emphasized the need for taking into account organisations, micro companies, black economy or groups excluded from the traditional financing system, either because of a lack of resources (poverty) or because they belong to a certain social or ethnic group, an interesting further development for this research could be related to the area of microfinance.

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