

Playing by the Rules within Banks

Monica Baraldi

This paper investigates the relationship between formal and informal rules for control principles and processes within banking organizations. Current studies and best practices show an increasing attention towards the planning of effective control systems, as an important strategic management tool. The analysis here focuses on banking rules, with particular reference to the Italian and European systems. The case of Intesa Sanpaolo Group provides practical evidence for the necessity to integrate different perspectives of analysis in risk and uncertainty monitoring.

Field of Research: Risk Control and Law

1. Introduction

Foremost, this contribution will present the instruments of control given by the norms of the Bank of Italy in compliance with the European normative and the evolution of the self-regulation for crediting companies. The principles of supervision originating from the Bank of Italy exhibit minimum requirements and the essential factors for the activity of banks according to healthy and prudent management criteria, contemporarily respecting complex objectives that are effective and competitive within the financial system. The receivers of this discipline are the authorized banks in Italy, parent companies of financial groups, and single enterprises controlled within the banking system. Subjects for risk are credit, interest rates, market, liquidity, operations, regulations, fraud, and infidelity by dependents, laws, and reputation. The category remains open and leaves space to other uncertain operations to identify opportunity according to the characteristics of each economic entity.

Nonetheless, the environment of control designed by the Bank of Italy considers the criteria of planning and functioning of internal control systems. They are intended to respect the internal procedures and efficient management of the widest category of operative company risks. However, the system of rules given by the Bank of Italy does not constitute the only element of regulation on which the operational continuity of the activity of crediting companies is based. Important guidelines with respect to the organization of the banks' activity are issued, in fact, by international organisms particularly from work documents issued by the Basel Committee and by the Committee of European Banking Supervisors (CEBS). In either case, be that it is made up of laws coming from institutions or internal regulations more or less codified, the mechanisms tied to the definition of the "rules of the game" starts with

Baraldi

the comprehension of the nature of the rules themselves, whose role can be profoundly different depending from which source and the scope with which they are issued and diffused in society (Schauer, 2002). In this context, it is confirmed that the rules have the hidden virtue of guiding a part of the decision making systems towards other useful activities, even if the results of the application of the rules, when those are contrary to the rational justification of that same rule, should be discussed on the basis of their future effectiveness in order to recover its whole value. In order to test the previous considerations in a real context, an example of the characteristics of the internal control systems of IMI Investimenti, a sub-holding of one of the most flexible and dynamic Italian economic entities, Intesa Sanpaolo Group, is provided below.

2. Literature Review

The need for better control systems is an important topic for bank managers. In Italy, as well as within other European Countries, the concern for a uniform coordination among strategies, organizational structures, and control systems became highly necessary especially during the Nineties, also in relation to the activity of the Basel Committee on Banking Supervision.

A wide review of the main effects produced over the Italian banking system within the new European normative framework is available in the economic literature. De Laurentis G. (2005), Kross (2007), Forestieri (2003), and Schwizer P. (2006) are only some of the many authors who have deeply analysed the institutional and operational changes within the Italian and European banking systems. Two other significant sources of analysis come from the documentation issued by ABI, the Italian Banking Association, over the last twenty years and the Bank of Italy.

The main contribution of the described literature is related to the following topics: the description of new market opportunities for banks within the international competitive arena, the analysis of formal modelling of incentive systems, and the thorough examination of business and operational activities for the dynamic and balanced development of the banking industry. Our work specifically investigates the effects of the regulation system applied to banks internal control systems and the consequent relation they have with new organizational and managerial processes. Operators and professionals related within the banking system have to develop the ability of playing by rules from several sources (Schauer F., 1991).

On one side, national and international authorities and committees (Bank of Italy, Basel Committee, Committee of European Banking Supervisors) still continue to issue new rules to supervise and reduce operational and institutional risks in the banking system. On the other hand, normative prescriptions coming from the institutional environment have to be considered in relation with the internal control processes effectively implemented within each organization. In fact, the framework designed by the law and formal recommendations regarding planning and control systems in banks can lack details. Professional roles and functions are organized in order to manage the larger variety of risks and create an effective control environment in compliance with the main guidelines shared as common values among organizations. In order to deeply understand the effectiveness of the main control instruments, an investigation of the hard and soft issues able to support

management decisions must be made. Especially in complex organizations financial and human resources developing the “supportive risk culture” potentially represent a source of competitive advantage (Kross W., 2007). A sustainable transfer of risk awareness and responsibility into corporate culture, pragmatically approaching management data quality issues, and communication regarding risk can positively qualify the risk profile of an organization.

3. Methodology and Research Design

This section investigates the two main systems of rules that support the internal control activities of the Italian bank sector. In particular, the paper identifies the legal control system and the administrative control system and successively provides an example of IMI Investimenti S.p.A. to demonstrate how this practice combines different tools for the planning of the effective internal control system.

3.1 Control Systems within Banks: the Legal Control

The policy oriented to the Italian banks is not exclusively focused on the legal control of the bank activity. The informative objective of the internal control system is, in fact, more complex and is oriented towards a management more aware of diverse types of company risk. The principles of supervision by the Bank of Italy were issued in 1999 and are strongly inspired by the activity of the Committee of Sponsoring Organizations of the Treadway Commission. The internal control system becomes defined as a group of rules, procedures, and organizational structures conceived to respect company's strategies and perceive the following aims:

- Monitoring the efficiency and effectiveness of company processes;
- Trustworthiness and integrity of information;
- Operations that abide by the law, supervisory principles, and internal procedures.

The first requirement for the control system is related to a separation between the government's activity and that of control, as a guarantee to eliminate a conflict of interests between involved parties. The three levels of control individualized by the Bank of Italy are the following:

- Operational audit;
- Risk management;
- Activity of internal auditing.

The operational audit refers to the procedures often with direct involvement of customers. Risk management has the objective of individualizing the principal risk factors that can occur in the development of most general bank activities, with special attention to the measurement of those factors and of controlling results produced by managerial activities. Internal auditing is principally focused on the verification of procedures within diverse organizations. The correct functioning of the internal control system is also based on organizational dynamic processes and procedures that verify the behaviour of different factors. The principles of supervision issued by the Bank of Italy affirm that the governance of the bank is directly responsible for the planning and maintenance of an effective and efficient system of

Baraldi

controls. This signifies that the directors and the managers are directly called to activate appropriate control procedures, provide the best instruments for the maintenance of an adequate level of risk management, and formulate a reporting system that can fit the needs of diverse stakeholders. Among the principal promoters of the evolution of formal banking controls is the *Basel Committee On Banking Supervision*. It has the principal scope of finding a homogeneous strategy of development for control systems in affiliated countries, with respect to the national legal environment. The principal requirements of the Basel Committee are summarized within Pillar 1, Pillar 2, and Pillar 3.

3.2 Control Systems within Banks: the Administrative Control

With existing laws in mind, there has been an increasing demand for self-regulation, involving professionals and institutions to write guidelines and behavioural principles. In Italy, the Code of Self-Discipline for listed companies issued by Borsa Italiana S.p.A. has introduced a specific section dedicated to the procedure of internal control defined as the system of rules, procedures and organizational structures oriented to adequate identification, measurement, management and supervision processes for the risk management within a healthy and effective organization. The Code of Self-Discipline establishes that the board is responsible to organize an internal control committee constituted of non-executive and independent administrators. It also defines particular duties for the internal control committee such as providing help to identify company's risks and to supervise some informative processes within the organization.

At point 8.C.2 of the Code there is also a reference to the Legislative Decree 231/2001, one of the most relevant Italian normative on control systems. In particular, Decree 231 introduces the general principal of administrative responsibility to a legal person for the crimes committed in their own interests by subjects that are in a high position in the governance of the organization. The principal criminal categories are: corruption and extortion, aggravated fraud towards the State, and crimes related to public service supply. Decree 231 in article 6.1 establishes that if the crime has been committed by people in a high position in the hierarchy, the entity does not respond if the executive board has adopted, and effectively applied, models of the organization and management adequate to prevent this kind of crime to happen. The Decree (art. 6.3) also establishes that the previous models refer to the codes of behaviour issued by the associations representative of the entities and approved by the Ministry of Justice. In the specific case of banks, the association of categories is the Italian Banking Association (ABI).

From an organizational perspective (De Laurentis, 2005), individualizing the environmental characteristics of the bank is necessary to provide the definition and the comprehension of control criteria. The external elements that define the environment referred to are: national and international norms, constraints and opportunities originating from technology, socio-cultural evolution of customers, and competitive dynamics. Strong and weak signs perceived by the company listening to its market should translate these into proactive strategies in comparison to changes and relevant tendencies, which influence operations within the company. The clear definition of processes that have to be developed within the company requires the intervention of managerial instruments of varying nature in order to support the

Baraldi

decision making process. Seen from this prospective, one of the fundamental works of top management could be its contribution to share a company culture sustaining control systems. The rationality of risk management within a banking company, should not be, in fact, interpreted only from a formal point of view, but should be inserted spontaneously in a context of opportunity to reach planned strategic objectives for healthy and prudent management.

The instruments of soft management can be distributed within the whole organization, eventually in a deliberate formal way (Simons, 2006). This can be done, for example, by operational risk committees added to the already existent control processes, in order to develop this specific function. For this type of committee the presence of administrators, people responsible for business and structure, as with people responsible for the function of operational risks are recommended (Kross, 2007). The construction of an efficient and effective risk control system cannot ignore the involvement of informative accounting systems and arguments about the economic convenience. We refer in particular to the analysis of company processes through methods adopted for the implementation of economic ways to manage resources, such as: activity based management, process management, flexible programming, and balanced scorecards used for monitoring indicators and parameters of performance (Kaplan and Norton, 2001).

However, the formalization of decision-making systems that can contemplate diverse risk factors is not able to completely eliminate the unforeseen ties to the evolution of management. Excessive attention to the elimination of risk factors eventually generates an excessive use of resources, which do not economically justify further reduction of risks. Research for an efficient boundary of risk management does not exclude that individual sensibility remains active. Each actor within the organization can individually mature and respect the characteristics of the activity happening. This occurs when the culture supporting risk management is shared within the organization independently from the formal initiatives coming from established virtuoistic practices or in application of normative ties.

In particular, the organizational developments can be tied to the use of soft variables, that refer to the proposition of new and more sophisticated models of function for the social system through new balanced relationships and interactions between human, technological and structural resources (Davenport, 2005). Among the results of this evolution one finds the use of managerial instruments based on the analysis and planning of different phases of company processes, even through the use of qualitative parameters for the evaluation of each step of the process (business process improvement, total quality management, lean management). In particular, within the area of operational risk management, are introduced dedicated management techniques such as: checklists, security controls, what-if analysis, decision trees, interviews and analysis of personnel satisfaction, and drill-down processes. Observing the new organizational tendencies there emerges, therefore, the highest interest towards the analysis of learning capabilities developed by human resources within the company. The objective is to create a learning organization (Senge, 2006) based on two categories of instruments: hard and soft for the development of skills and sustainable opportunities of organizational change.

4. Discussion of Findings

The evidence of the combination of formal and informal rules for the planning of internal control systems can be found in the case of Intesa Sanpaolo Group. The banking group is organized as a multi-divisional form with a central role of coordination assumed by the corporate. From interviews of operators within the internal control area emerged that the methodology of Intesa Sanpaolo has been planned in conformity with the national legislation and the best practices matured from experiences with the European and American financial markets. The internal control system of IMI Investimenti S.p.A., a sub-holding of Intesa Sanpaolo, is articulated in different levels of analysis:

Tab. 1 Risk Assessment model of the Audit Function

Risk factors (driver)	First level of analysis
Organizational risks	<ul style="list-style-type: none"> • Distribution of power and delegation authority • Organizational structure • Human Resources • Labor processes
Legal and contractual risks	<ul style="list-style-type: none"> • Legal and contractual aspects • Outsourcing
Accounting System Risks	<ul style="list-style-type: none"> • Accounting and financial statement • Operational risks related to the business
Compliance Risks	<ul style="list-style-type: none"> • Supervisory Authority • Legislation
Technological Risks	<ul style="list-style-type: none"> • Planning and control systems • Environmental safety • Back up and contingency

The second level of Risk Assessment provides coordination among specific risk factors that are evaluated from 0 to 5, in relation with the above mentioned classification.

Tab. 2 Evaluation of risk factors of second level

Evaluation	Interpretation
0	The risk is not managed. Total exposure to the risk.
1	High exposure to the risk. The management of the risk is not adequate.
2	Significant exposure.
3	Acceptable exposure. The management of the risk is adequate.
4	Limited exposure. The management of the risk is effective and efficient.
5	The management of the risk is excellent.
na (not available)	The risk is not present.

Risk is acceptable only when the residual risk reaches the level of 2 points for each area (10 if we consider the 5 areas). If this level of security is not reached, the organization has to provide other instruments of evaluation for the management of the different activities that are in compliance. The model of Risk Assessment foresees analysis every three months within each unit of the group. The Audit Function of the corporate has to aggregate all the results for a systematic reporting about the risk level of the group activity.

Baraldi

There emerges a balanced combination of control processes based on hard and soft variables that refer to formal and informal rules. In any case, Intesa Sanpaolo Group is the result of a merger that took place in 2006. The subjects responsible for the internal control system are still at work to find the most effective control system that considers both the organizational characteristics and needs of the two banking groups that merged.

5. Final Considerations on Banking Administration based on Regulations, Transparency and Entrepreneurship

From the research provided here, it would appear that the development of economic activity in the banking system demands a heightened ability to behave through a complex system of regulations. This is the result of the formal and informal mechanisms of individual organizations, and from national and international judicial ordinance. Planning processes according to effective and efficient standards, the construction of appropriate control structures, and the diffusion of an organizational culture supporting risk governance are not factors that indicate foreseeable or fortuitous gains. Carrying out such requirements at times involves other implementation and safeguard challenges, which include:

- An information system that is inadequate or not homogenous amongst various economic units within one organization;
- Corporate proceedings that are not transparent;
- A corporate culture that is not aligned with risk management;
- A lack of resources channeled toward the formal and informal devices that support this management;
- An excessive trust in the corporate information system.

The recent diffusion of auto-regulating tools within corporations has given rise to new forms of development in the system of regulation, which is continually more aligned with ethical principles and shared social norms coordinated with the operating legislation that is occasionally insufficient in sustaining the full range of the business's decision-making operations. Through these findings, the company's political role also emerges when the decision-making system involves the complex interaction amongst cognitive styles and deep-rooted systems of behavioral values (Clegg, 1990). One of the primary principals for the proper functioning of the organization comes to coincide with the characteristics of its own human resources, as an active part of the organization. Even with respect to the consistent and dynamic law of the sector, the individual matters can distinguish themselves through their capacity to reconcile rules with their behavioral flexibility in sustaining a learning organization. Managing corporate instability is facilitated if- beyond effective legislation- the decision-making system can also rely on its capacity for auto-regulation as an expression of social intelligence and of balance between individual objectives and those of the organization.

References

ABI 2001, *Linee guida dell'Associazione Bancaria Italiana per l'adozione di modelli organizzativi sulla responsabilità amministrativa delle banche*, Bancaria Editrice, Roma.

Baraldi

Aristotele 1986, *Etica Nicomachea*, Rizzoli, Milano.

Basel Committee 1998, *Framework for Internal Control System of Banking Organisations*, Basel.

Blau, P.M. 1956, *Bureaucracy in Modern Society*, Random House, New York.

Crozier, M. 1963, *Le phénomène bureaucratique*, Editions du Seuil, Paris.

Davenport, T. 2005, 'The Coming Commoditization of Processes', *Harvard Business Review*, vol. 83, no. 6, pp. 101-108.

De Laurentis, G. 2005, *Strategy and Organization of Corporate Banking*, Springer, Berlin.

Ellickson, R.C. 1991, *Order Without Law*, Harvard University Press, Cambridge.

Forestieri, G. 2003, *Corporate e investment banking*, Egea, Milano.

Freeman, R.E. 1984, *Strategic Management. A Stakeholder Approach*, Pitman, New York.

Hare, M.R. 1997, *Sorting Out Ethics*, Oxford University Press, Oxford-New York.

Hart, H.L.A. 1994, *The Concept of Law*, Oxford University Press, New York.

Hastings, C. 1993, *The New Organization: The Growing Culture of Organizational Networking*, McGraw-Hill, London.

Hopwood, A. 1974, *Accounting and Human Behavior*, Prentice-Hall, London.

Hunt, B. 2003, *The Timid Corporation*, Wiley, West Sussex.

Kaplan, R.S. and Norton, D.P. 2001, *The Strategy Focused Organization*, Harvard Business School Press, Boston.

Kross, W. 2007, *Organized Opportunities: Risk Management in Financial Services Operations*, Wiley, New York.

Michael, L.M. 2006, 'Business Ethics: the Law of Rules', *Business Ethics Quarterly*, vol. 16, no 4, pp. 475-504.

Rawls, J. 1999, *A Theory of Justice*, Belknap Harvard, Cambridge.

Schauer, F. 1991, *Playing by the Rules*, Oxford University Press, New York.

Seligman, A.B. 1997, *The Problem of Trust*, Princeton University Press, Princeton.

Sen, A. 1987, *On Ethics and Economics*, Blackwell, New York.

Senge, P.M 2006, *The Fifth Discipline*, Random House, New York.

Simons, R. 2006, *Levers of Organization Design*, Harvard Business School Press, Boston.

Stone, C. 1975, *Where the Law Ends: The Social Control of Corporate Behavior*, Harper and Row, New York.