Marco Perrone

Corporate Governance and Internal Control System of Banks

An analysis of the Italian Banking Industry

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alla mia famiglia...

Alla fine di questo percorso di vita e di studio il mio primo pensiero non può non andare a mia madre e a mio padre. Solo il loro supporto e la loro stima incondizionata hanno permesso il raggiungimento di questo importante traguardo.

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Introduction

Issues concerning corporate governance of banking organizations have reached levels of global importance over the last two decades. The current international financial crisis has further focused the attention of policy-makers on the relevance of corporate governance in the banking industry. Many observers attribute current events to failures in corporate governance: negligent board oversight and failures of the internal control system have probably been among the most important causes of the subprime crisis (Erkens, Hung, and Matos, 2009).

In response to the current crisis and its implications, international and Italian supervisory authorities have developed stringent corporate governance rules with a deep impact on the organizational structure of banks and on their internal control systems. Supervisory authorities and public opinion have called for banking groups to intervene and modify their corporate governance structures, with a particular focus on issues regarding their internal control systems. Indeed, sound internal control processes are critical to facilitate the safe and sound management of banking organizations, and increase the reliability of the financial system (Basel Committee on Banking Supervision - BCBS, 1998).

Various academics have explained specific corporate governance issues and agency problems in banks (e.g. Macey and O'Hara, 2003). The internal control system represents one of the strategic instruments of internal governance necessary to meet established goals and maintain the bank's financial viability (Tarantola, 2008). In this context, international organizations and supervisory authorities have made efforts in recent years to provide principles concerning corporate governance (e.g. OECD, 2004) and internal controls for banking corporations (BCBS, 1998). Although, the choices regarding corporate risk management necessitate strategic decisions for each banking organization and the establishment of specific governing bodies[1]. Policy makers must provide important guidelines regarding a wide range of organizational aspects involved in the banking

[1] I'm aware of the existence of different corporate governance models providing differences in the governance structures of companies and in the assignment of responsibilities, although in this work the notion of governing bodies is used to identify all corporate organisms that exert the supervisory, management and control functions.

business. Despite this need, supervisors continue to come from the highest levels of the banking institutions. They tend to provide general governing principles, focused especially on the role and responsibilities of governing organisms, among which the control and management bodies and senior management. Supervisory authorities require that "all banks, regardless of size, have an effective system of internal controls that is consistent with the nature, complexity, and risk inherent in their on- and off-balance-sheet activities and that responds to changes in the bank's environment and conditions" (BCBS, 1998). These requirements recognized the power of banks to structure their functions in charge of corporate risk management in light of their operating complexity, size and specifically in function of the bank's strategies. The implementation of an adequate internal control system that complies with the organizational requirements provided by public authorities is fundamental to the efficient and profitable management of banks because it allows them to reduce capital requirements and it is effective especially in the management of non-measurable risks, such as strategic, reputational and compliance risks. The aim of this paper is to examine how these general principles have been translated into the organizational structures of the main Italian banking groups, with a particular focus on corporate control functions, and to comprehend whether their internal control systems are indeed adequate to ensure the safe and sound management of the financial institutions in keeping with their goals of value creation and financial stability.

After an analysis of the responses provided by nine leading Italian banking firms to a targeted questionnaire and to specific interviews, it has been possible to gather evidence of the main characteristics and mechanisms of integration of the internal control system, with a particular focus on corporate control functions. Furthermore, the study describes the main trends among Italian banking firms, in terms of organizational solutions. In consideration of the evidence which emerged and international best practices, as well as suggestions provided by expert consultants in the field of corporate governance in banking organizations, an effort has been made to provide some recommendations concerning the basic requirements, in term of organizational solutions and of mechanisms of organizational and operating integration, that should be respected in the development of an efficient and effective internal control system.

The paper begins with a review of major findings regarding corporate governance issues currently facing banking organizations. This is followed by an analysis of how liquidity production, the presence of a safety net, and the role of prudential regulation and supervision, affect agency problems in banks. It proceeds with an overview of the evolution of the regulations regarding the corporate governance of banking firms, both at the international and Italian level.

The second chapter is devoted to explore the main internal and external corporate governance mechanisms and structures, and analyze how they affect incentives and power with regards to assuming and managing risk. The shareholder structure, board of directors, and alignment of management incentives are also examined in this light before moving on to both direct and indirect market discipline.

The internal control system of banking corporations and its role in achieving corporate goals, in line with sound management of business activities, are addressed in the third chapter. After having briefly described the role and responsibilities of governing bodies, the most relevant corporate functions within the internal control system are described and analyzed.

This paper concludes by presenting the most relevant information which emerged from the empirical study of nine leading Italian banks, underlining the most significant features of the internal control system with reference to corporate functions as well as possible future changes in the environment and conditions of these nine financial institutions. Moreover, a referential framework is provided for the implementation of a highly functional internal control system for banking groups, suggesting targeted organizational requirements and focused mechanisms of integration necessary to enhance the effectiveness of the system of internal control.