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Reporting and managing risk in Italian banks:
beyond legal compliance

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**REPORTING AND MANAGING RISK IN ITALIAN BANKS:
BEYOND LEGAL COMPLIANCE**

Introduction

This thesis focuses on the issues related to the reporting and the management of risk in the banking sector, with specific reference to the Italian context. The thesis is oriented towards a deeper understanding on these issues, with especial attention to the importance of "to be compliant" with current regulation. In particular, the issues outlined above are addressed through the adoption of multiple theoretical and methodological perspectives, in order to progressively engage with the field of interest.

For the purposes of the analysis, a conceptual premise is due. Indeed, any study about risk disclosure and risk management requires 'risk' to be defined. In everyday language 'risk' is used very broadly; for example in lieu of hazard, threat or harm (Lupton, 1999). Specifically, finance literature typically defines risk as "*quantifiable uncertainty*" (Miller and Power, 1992; March and Shapira, 1987), measurable in its own amount, which incorporates the probability of loss. In other words, some authors define "*risk*" as referring to a set of outcomes arising from a decision that can be assigned probabilities whereas "*uncertainty*" arises when probabilities cannot be assigned to the set of outcomes (Watson and Head, 1998). These definitions of risk and uncertainty reflect events that have occurred during the modern era (Reddy, 1996). Pre-modern ideas of risk were connected to the occurrence of natural events, for example hurricanes (Lupton, 1999). The development of probability calculations and the insurance industry during the industrial revolution impacted upon ideas of risk. The chances of outcomes then became susceptible to mathematical calculations and compensation could be paid out when a negative outcome occurred (Miller and Power, 1992, Ewald, 1991). Recent literature has shown how the concept of risk, intended as quantifiable and measurable, has evolved in uncertainty (Mikes 2011; Power, 2009), defined as the unpredictability of environmental or organizational variables that impact on corporate performance. Thus, the focus shifts from a concept of unpredictability of economic and financial results to a broader concept of unpredictability, related to the external and internal variables influencing the overall corporate performance.

In order to give information useful to decision makers, all these aspects of risks, intended as non-financial, need to be adequately disclosed and managed.

The concepts of risk reporting and risk management have received considerable attention in recent years (Miihkinen 2013, Miihkinen 2012; Oliveira et al. 2011, Linsley and Shrives, 2006; Power, 2004). Indeed, it is worth noting that most of the studies on risk disclosure have mainly focused on non-financial companies risk disclosure provided by banks is still relatively under-researched (Oliveira et al. 2011).

It is worth noting that financial firms are risk management entities, as their core business is to take risks and to provide liquidity. Therefore, banking companies can be expected to divulge significantly different types of risk disclosure (Bessis, 2002). Also, risk disclosure is raised to a particular level of importance within banking organizations in comparison with non-financial firms because banks are inherently more opaque (Huang, 2006). Indeed, banks own few physical and visible assets, and investors can assess a bank's performance and asset quality based only on accounting numbers. However, it is well known that aggregate accounting numbers without reasonable level of breakdown is less informative for banks than it is in industrial firms, because the most important information usually lies in the details of the sources of income and expenses, or quality of assets. Investors need this information to make forward-looking judgements on wich incomes are sustainable and which expenses are recurring (Huang, 2006). Yet, due to the complexity of financial environments and the increasing diversity in the information needs, banks should comply also with the supervisory regulation from Basel Committee of Banking Supervision, which seeks to foster a secure and reliable financial sector (Oliveira et. al., 2011).

In this regard, what should be noted is that many initiatives have been made by *regulators* such as the IASB and the Basel Committee to standardize financial reporting of banks, to make information more comparable across the sector. In particular, it has been argued that "*one area in which supervisors are well suited to take on a productive role is in enhancing comparability by promoting the use of supervisory definitions and reporting classifications in public disclosure*". (Basel Committee of Banking Supervision, 1998). The main aim of (different sources of) regulation is to make banking risk disclosure of use to investors.

To enhance banks risk disclosure, regulators and standard setters have attempted to develop a complex set of standards, thus requiring more information on different types of risks (Frolov, 2007; Dobler *et al.*, 2011). However, despite the continuous raising of the minimum requirements, financial companies do not generally provide adequate information on risk (ICAEW, 2011), and practitioners (ICAEW, 2011, 2002; E&Y, 2008; KPMG, 2009, 2008; PWC, 2008) still warn about the lack of information on banks' risk taking. Moreover, despite the increasing in the quantity of the information provided as a result of the new requirements to be complied with, the vast amount of research on this topic agreeing that risk disclosure is not useful for stakeholders as it is not really detailed, not forward-looking, not sufficient for the assessment of the overall risk profile (Magnan and Markarian, 2011; Paape and Speklè, 2012), and not relevant for the decision making process (Beretta and Bozzolan, 2004), as well as the general consensus on the inadequacy of current risk disclosure, literature is far from being conclusive. Therefore, there is need to further investigate the reason for the (un)usefulness of risk disclosure by banks.

Several authors attempt to find out some possible causes explaining the inadequacy of risk information. Some of them recognised the importance of mandatory rules for an effective and useful risk disclosure, others made call for a strong enforcement system for the adoption and the application of the requirements issued by different regulators. On the other hand, recent studies ascribe the (un)usefulness of risk reportig to the regulatory system itself, and highlight some limitations of current regulations *per se* rather than the question of compliance. More in depth, they shed light on the degree of discretion contained in the exsisting multiple requirements, which allows insiders to disclose what they want to disclose. It has been argued that managers have been seen to omit information allowing third parties to modify their understanding both of risks and the accuracy of the suggested profitability (Leuz, 2010; Thuèlin et al., 2006).

On the basis of the above consideration, drawing on the role that insiders may paly in influencing risk disclosure, it could be of interest to shift the focus from the external perspective (mainly related to the reporting risk), to the internal perspective pertaining the management of risk within banking organizations.

Recent years have seen an explosion of interest in banking risk management (Arena et al. 2010, Gephart et al., 2009; Power, 2007; Scapens & Bromwich, 2009), which has moved from peripheral functional areas of the organization to the corporate level. Publications, corporate websites and official reports often contain specific sections devoted to how (financial) organizations manage their risks. Also, risk management standards issued by professional organisations have also stimulated interest in the development of risk management systems (for example Committee of Sponsoring Organizations of the Treadway Commission, 2012, 2004, Association of Insurance and Risk Managers, 2002).

However, the latest financial crisis has shown relevant failures of traditional large banks (Linsley and Slack, 2012), revealing substantial weaknesses in their risk reporting and risk management practices (Paape and Speklè, 2012; Magnan and Markarian, 2011; Power, 2009). Literature emphasized that financial reporting do not properly account for uncertainity, did not adequately monitor, measure and disclose the impact of risk taking by banks on financial statements, and did not warn of impending meltdown. On the other hand, shortcoming in accounting interacted with failures in governance and risk management practices (Magnan M. and Markarian G., 2011). In many cases, risk management systems failed not because of computer model per se but because of failure in governance, as information about exposure and strategies did not reach senior management (Kirkpatrick, 2009). Moreover, a majority of banks have indicated that their boards were not properly knowledgeable about their risk management (Lapido et al., 2008). In contrast to expectation and estabilished best practices, this suggest that risk management is not at the heart of the planning and governance, a blatant functional failure.

In response to the above described failures relating the both the accounting and governance systems, interest in Enterprise Risk Management (ERM) has grown rapidly, with regulators, professional associations and even rating firms calling for its adoption (Arena et al., 2010). Enterprise Risk Management (ERM) has been proposed as a new instrument to predict risks and help organisations achieve their goals. It is centred on the idea of risk management as a transversal process that addresses all those events, which could prevent the achievement of corporate objectives.

Many banks have adopted the mission and principles of ERM. However, in literature there is a lack of evidence of studies examining how enterprise risk management works in action (Mikes, 2009), and there are few critical contributions addressing how its organizational assembling evolves, and contributes to an effective risk management style (Gephart et. al., 2009; Power, 2009).

What should be emphasized is that, during the last few years an increasing number of voices have urged calls have been made for the introduction of ethical consideration into firms' activities as well as in their decisions making processes (Barbu and Vintilà, 2007; de Graaf, 2006). To this purpose, two conditions must be met: individuals who have an ethical concern must take part in the market and have sufficient resources to transmit a clear and strong message to firms (Brickley et al., 2002). In this regard, it has been argued that the banking system could fulfil these two conditions and can generate ethical engagements, not only for itself and for its customers, but also for society through achievement of social purposes (de La Cuesta-Gonzàlez et al., 2006). Consequently, calls have been made for for fully integrating social and ethical values into banking enterprise risk management practices, in order to strengthen the holistic system for managing uncertainty as well as increasing the stakeholder value protection. The (inter)relation between business ethics and Enterprise Risk Management Practices has been answered by a slowly growing collection of academic (Demidenko and Mc Nutt, 2010; Weitzner and Darroch, 2010) and practitioners (as for example, The Institute of Internal Auditors, The Global Association of Risk Professionals, the Institute of Risk Management), who have begun to address issues in this field.

Given the above-cited still debated issues concerning the reporting and the management of risk in the banking sector, it is worth emphasizing at this stage the importance of deepening current knowledge on these concerns, by also shedding light on the need to go further the mere compliance with current regulation, thus moving to an ethical approach, in order to disclose and managing risk effectively. Above all, the topic is relevant to the Italian context, which is expected to enhance the usefulness of risk disclosure as well as the effectiveness of risk management systems.

The Italian setting is extremely relevant because there is a government regulator (Bank of Italy) overseeing compliance with risk disclosure. Moreover, Italy adopts "interventionist enforcements" (Bischof, 2009), which are regarded as a critical tool for achieving the minimum disclosure requirements (Frolov, 2006; Oliveira et al., 2011). Hence, it is interesting to discuss if the Italian regulation, which is characterize by a strong enforcement system, is able to enhance the usefulness of risk disclosure by banks.

A second aspect to take into account is that the above-cited literature on mandatory risk disclosure in the banking sector has largely neglected the effects of increasingly detailed regulation that requires information on risks in two different reports, i.e., notes to financial statement and public report required by the third pillar of the New Capital Accord (henceforth, public report). Therefore, it could be of interest to further investigate how Italian banks provide risk information and, therefore, if it is of use to investors, by focusing on the characteristics of such information to find out any differences between the notes to the financial statements and the public report, both prepared according the instructions of the Bank of Italy.

Also, as a result of the increasing attention paid to the need for ethical values in "doing business", there is need to move from the external perspective to the internal perception of risk, analysing how to deal with risk issues within banking companies.

Hence, the thesis is divided in three chapters, as follows:

- ✓ CHAPTER ONE: *Enhancing the usefulness of qualitative risk disclosure by banks: the role of current regulation in Italy;*
- ✓ CHAPTER TWO: *(Un)useful risk disclosure: explanation from the Italian banks;*
- ✓ CHAPTER THREE: *Enterprise Risk Management in local banks: a case study.*

At this stage, it is worth emphasizing that although each of the papers/chapters investigates a specific issue and adopts its own theoretical and methodological approach, the design of the overall research is conceived as a whole. The choices relating to specific topics, theoretical models of reference and methodological approaches have been made also with regard to the findings and emerging issues that arose gradually while the study was in progress.

The first chapter aims to address whether the increasing in risk disclosure standard and authoritative disclosure recommendations are able to enhance the usefulness of banking risk disclosure by Italian banks. Indeed, as discussed above, recent literature emphasized that regulators and standard-setters face a taxing challenge in deciding how risk disclosure could be regulated most effectively, in order to make company risk reporting more useful to investors (Miihkinen 2013, Miihkinen 2012, Oliveira et al. 2011, Leuz 2010).

What should be noted is that, as clarified above, Italy system enforces the regulation more strictly, (Bischof, 2009), and introduces a national government regulator (Bank of Italy) overseeing compliance with risk disclosures. Such a system entails additional provisions for financial institution issued from Bank of Italy (Circular no. 262/2005 and Circular no. 263/2006), which should imply an high level of quality/quantity of the information on risks. In this regard, it is also interesting to underline that Italian banks have to comply with different sources of law, i.e. accounting rules and supervisory principles. To meet different information needs, and to protect several interests involved, regulators require Italian banks to provide information in three different reports (Notes to the Financial Statement, Management Commentary, Public Report).

As a result of the increasing in regulatory requirements to be complied with, and due to the additional provisions that better specify what is stated at the European level, the degree of detail of qualitative risk information required should be higher than under the previous regulation. It should also be higher than risk disclosure by banks operating in States that do not imply "interventionist enforcement" system. Consequently, qualitative risk disclosure by Italian banks is expected to be of use, in concrete terms, to investors.

Thus, this paper provides a systematic analysis of the qualitative information required by different regulators, and discusses the ability of such the regulatory framework to enhance the usefulness, in terms of comparability, verifiability, timeliness and understandability, of risk disclosure (IASB, Framework 2010, par. QC19).

The second chapter, in acknowledging several limitations in the first research, the reasons why risk disclosure looks less useful than it ought to be, by analyzing the risk disclosure provided by Italian banks. Indeed, although regulation requires complex disclosures, it is recognised that they are not relevant to assessing the risk profile of banks, as initially intended.

Accordingly, it investigates how risk information is provided by Italian banks, focusing on the characteristics of the information to assess the overall quality of disclosure, to find any differences between the Notes to Financial Statements and the Public Report, both prepared in compliance with the instructions of the Bank of Italy. A content analysis of the risk infromation made available by 66 Italian banks has been carried out to investigate the variation in the level of risk disclosure between the Notes to Financial Statements and Public Reports. In the end, we use a regression model for disclosure quality to find out what the bank-specific factors that influence the quality of disclosure are.

Differently from the first and second chapters, the third one pays attention to the management of risk, with the aim to examine from the internal perspective the problems concerning “how to deal with risk issues”. More in depth, shifting the focus from the question of compliance with current regulation (intended as both rules and recommendation) to the concerns relating to the *effectiveness* of the implementation of enterprise risk management system (ERM) within a particular kind of banking firms.

In particular, as a result of the calls for the introduction of ethical consideration into firms’ activities as well as in their decisions making processes (Barbu and Vintilà, 2007; de La Cuesta-Gonzàlez et al., 2006), this paper aims to explore how Enterprise Risk Management (ERM) can lead banks to achieve their economic and social purposes. Such banks are a particularly suitable basis for studying the relationship between business ethics and ERM due to the fact that they aim to achieve strong social purposes.

A single case study on the most representative mutual credit cooperative bank of the South of Italy is employed. The results are discussed drawing on the theoretical framework developed by Bowie (1999) in order to apply Kantian ethics to the organizational design of a business firms.

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CHAPTER 1

Enhancing the usefulness of qualitative risk disclosure by banks: the role of current regulation in Italy

Enhancing the usefulness of qualitative risk disclosure by banks: the role of current regulation in Italy

ABSTRACT

Purpose: This paper analyses banking risk disclosure regulation in Italy. It addresses whether the increasing in risk disclosure standard and authoritative disclosure recommendations are able to enhance the usefulness of banking risk disclosure. For the purposes of the analysis, we rely on what is clearly stated by the IASB: "The usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable" (Framework 2010, para QC19).

Design: The study relies on the Italian country setting, identified as an example of best practice for risk disclosure. In particular, this research examines the different risk disclosure requirements, issued by different regulators, to be provided in three different documents (Notes to the Financial Statement, Management Commentary, Public Report). More in depth, we focus on qualitative information, which should provide more detailed insights relating to the choices of the management of risks.

Findings: The results shed light on some limitations of the complex system of risk disclosure regulation, highlighting the overlaps and/or lacks of the multiple requirements. They also provide a basis for some critical thoughts about the ability of current regulation to enhance the usefulness of risk disclosure, emphasizing that the weaknesses of banking risk disclosure do not represent a question of compliance but reflect the inefficiencies of regulation per se.

Value: This research aims at being relevant from a theoretical perspective, by contributing to risk disclosure literature through a critical analysis of the current risk disclosure regulation. It also provides a contribution for national and international standard setters, policy makers, and supervisory authorities, by highlighting some limitations of the complex system of risk disclosure regulation.

Keywords: IFRS 7, accounting regulation, banking sector

1. Introduction

The aim of financial reporting is to provide information that is useful to existing and potential users (FASB, 1978; IASB, 1989, 2010). To this end, information must be relevant and faithfully represents what it purports to represent (IASB, 2010).

However, the lack of usefulness of accounting information currently issued by firms has been frequently remarked by scholars (Paape and Speklè, 2012; Magnan and Markarian, 2011; Bushman and Landsman, 2010; Leuz, 2010; Frolov, 2007; Linsley and Shrives, 2006; Beretta and Bozzolan, 2004; Verrecchia, 2001), practitioners (EFRAG 2012; ICAEW, 2011; ICAEW 2002; E&Y, 2008; KPMG, 2009, 2008; PWC, 2008), and standard setters (IASB 2012), especially for information concerning risks. In this regard, it has been argued that the inadequacy of current risk information is one of the main weaknesses in the accounting information disclosed by firms (Cabedo and Tirado, 2004).

To enhance the usefulness of the external risk information, over the last years several rules relating to risk disclosure have been issued from different regulators, thus defining a continuous raising of the minimum requirements, both quantitative and qualitative, to be complied with (Regulation n. 108/2006; Directive 2003/51/EC, and Directive 2004/109/EC). Recent studies have investigated, from both theoretical and practical perspective, the issues related to accounting regulation and the usefulness of risk disclosure. Frolov (2007) summarized the reason why we have mandatory risk disclosure rules in banking, and level of "desirability" of disclosure requirements. On the other hand, some authors have recently addressed certain limitations of current accounting regulation in enhancing the usefulness of risk disclosure by firms, emphasising the discretion built into risk disclosure requirements. In this regard, it has been argued that the discretion allowed by current regulatory system does not merely rely on the content of the accounting standards, but is likely to be a function of each country's institutional setting (Leuz, 2010; Bischof, 2009, Ball et al., 2003). However, despite the general consensus on the inadequacy of current risk disclosure regulation, there has been little attempt by academic community to discuss if the new requirements can make influence on the usefulness of risk disclosure.

Given this background, this research focuses on banking risk disclosure regulation in Italy, with specific regard to qualitative aspects, as they should enable a better understa*nding* of firms' decisions in providing more detailed insights relating to the management of risks (Abraham et al., 2012; Berger, 2011; Beyer et al., 2010). More in depth, the study addresses whether the increasing in risk disclosure standard and authoritative disclosure recommendations are able to enhance the usefulness of banking risk disclosure. For the purposes of the analysis, we rely on what is clearly stated by the IASB: "*the usefulness of financial information is enhanced if it is comparable, verifiable, timely and understandable*" (Framework 2010, par. QC19).

More in depth, this paper focuses on qualitative information required by different regulators, to be provided in different reports (Notes to the Financial Statement, Management Commentary, Public Report).

What should be clarified from the outset of this research is that we do not want to criticize one or more requirements specifically, nor to suggest some specific change of thereof. Rather, the purpose is to stimulate some reflections about the current regulatory model, and to understand whether or not the raising of minimum requirements leads to a more useful risk disclosure.

The analysis refers to the banking sector, which is a particular interesting field. On one hand, banking activity mainly relies on management, measurement, control and communication of risks, which are the key-drivers of banking value creation (Maffei, 2010). On the other hand, banks should comply with additional and specific regulatory requirements related to different sources of law (i.e. Basel II, as endorsed by Directive 2006/48/CE and Directive 2006/49/CE, and, starting from 2015, Basel III, draft Directive COM/2011/452 e COM/2011/453), due to the fundamental role played in the economic system. In such a field, risk disclosure moves from a mere technical practice to a broader and relevant matter from the economical, political, and social perspective, becoming crucial for different users (Allegrini, 2011).

The research is carried out within the Italian setting. The Italian setting is extremely relevant because there is a government regulator (Bank of Italy) overseeing compliance with risk disclosure.

Moreover, Italy has been identified as an example of best practice for risk disclosure (Bischof, 2009), mainly for the active and interventionist role played by the Supervisory Authority (Banca d'Italia), who issued additional administrative provision for banks to apply the IFRS and the Basel II Accord.

However, despite the multiple sources of law, and the high level of enforcement, both aiming at enhancing the usefulness of qualitative risk disclosure by the Italian banks, the analysis shows some lacks and/or overlaps in Italian risk disclosure regulation. It implies that, although Italian banks formally comply with both the international and national law, there is room for them to choose what they want to show, with undeniable effects on the effective usefulness of the information provided.

The contribution of the research is twofold. On the one hand, the paper adds to prior literature through a critical analysis of the different sources of the current risk disclosure regulation in a specific context. In addition, the research could be of interest for practitioners and regulators, by highlighting some limitations of current regulation and emphasizing for the need for framing a more systemic complex of risk disclosure requirement, in order to ensure the usefulness of risk disclosure.

The reminder of the paper is organized as follows. The next section describes the role, the structure, and the purpose of the existing risk disclosure regulation. Subsequently, the research provides a systematic overview of the Italian risk disclosure regulation, emphasizing the requirements issued by different regulators. The discussion section, drawing on the Italian case, highlights the (un)usefulness of risk disclosure, while the last section concludes the study.

2. Theoretical background

Regulation represents the conceptual underpinning for any relationship between firms and the modern State (Leuz, 2010; Moran 2010). As a necessary response to the complexities of economic government in capitalist democracy, it increased in importance and became a necessary alternative to majoritarian models of democratic decision-making (Moran, 2010), which imply a less active and interventionist role of the State (Majone, 1999).

From a theoretical perspective, the ideology of regulation relies on the constant effort of the State in pursuing the public interest, trying to meet the political reasons with the economic constraints. In this regard, regulation recognizes a role for "lobbies", regarded as groups of key parties in the economy, playing an active and powerful role in the political process, by making pressures towards specific regulatory choices. In this view, special interest lobbying is not perceived as a sort of bribery, but rather as a mechanism through which regulators are informed about political issues (Sutton, 1984).

From a practical perspective, the framework briefly described above fits, in essence, with what accounting regulation is. Accounting regulation is to be intended as the output of a complex regulatory process, resulting from multiple interactions between different political ideologies and different interests to be considered.

In particular, the European Union, choosing to adopt the IFRS, agreed with a specific regulatory model established on a principle-based system of accounting standards, in which the Standard Setting Body is not responsible for the definition of a set of mandatory rules. Indeed, due to their "principle-based nature", accounting standards are not legally binding *per se*, but must go through the due process of endorsement before becoming law in the EU (Di Pietra and Riccaboni, 2002). In addition, they have to be enforced by different national regulatory systems. Consequently, despite the adoption of a common set of accounting standards should led to a more useful information, risk disclosure requirements differ considerably across Europe, and even if enforcement systems appear to be similar in design, there can be substantial differences in enforcement intensity (or practices).

With specific reference to risk disclosure, the main accounting standard is IFRS 7 "*Financial Instruments – Disclosures*" (henceforth, IFRS 7). IFRS 7 superseded IAS 30 and replaced all parts of IAS 32, thus embracing all disclosure requirements related to the use of financial instruments. The above-mentioned standard aims at meeting growing concerns about risks arising from financial instruments, that were brought up particularly by the Joint Working Group (JWG) of Standard Setters in its Draft Standard (Joint Working Group of Standard Setters, 1999) and by the Bank for International Settlements in the Third Pillar of the Basel II Framework (Basel Committee on Banking Supervision, 2004).

As IFRS 7 can be regarded as a result of a common effort for regulating risk disclosure most effectively, the new requirements are expected to increase the usefulness of risk disclosure, which should be able to provide a "real" picture of the overall banking risk profile.

However, accounting literature addressed considerable doubts that these benefits occurred as a result of worldwide IFRS application (Allegrini 2011; Hail et al., 2010; Bischof, 2009;). Specifically, it has been highlighted that, despite IFRS 7 adoption has had a positive effect on the quantity of risk information, it had not equally increased the quality of risk disclosure provided by European banks (Bischof, 2009). In other words, the raising of minimum risk disclosure requirements has not been followed by growth in the usefulness of risk information, which is enhanced if it is comparable, verifiable, timely and understandable (IASB, Framework 2010, QC4).

Despite several efforts have been made to converge countries' risk reporting standards, some relevant issues, related to the information to be reported and the "right" level of risk disclosure, still remain unanswered. The first point in turn leads us to the issue of what the goals of reporting regulation are.

If the main goal (Zingales, 2009) of risk reporting is to produce cost savings for investors as a whole (both small investors and financial intermediaries), risk disclosure should report all those information desired by users, and that firms are willing to provide voluntarily, stipulating private contracts (Ross, 1979). Otherwise, if risk reporting aims to reduce costs from fraud and agency conflicts, risk disclosure should report all those information needed for controlling the *insiders*, in order to identify (and reduce) their possible misconduct (Leuz, 2010).

Another central argument related to risk disclosure regulation pertains the level of detail and pervasiveness of the existing requirements or, in other words, the degree of discretion allowed by current regulatory system. In this regard, recent literature pointed out that discretion is a double-edged sword, and highlighted the *pros* and *cons* of regulating risk reporting through principle-based standards (Leuz, 2010; Moran, 2010). Principles-based standards give more discretion to firms, by enabling managers to convey private information that resides within the firm and to adapt reports so that they better reflect the underlying riskiness of the economic reality.

Such an approach can save costs to firms, if it requires those disclosures that almost all firms are willing to give voluntarily (Mahoney, 1995). However, the discretion also allows insiders to make use of risk reporting in order to show what they want to show, and to hide potentially relevant proprietary information (to their competitors or to the public as a whole).

Regarding the discretion built into banking risk reporting regulation, it has been emphasized that it does not merely rely on the content of the accounting standards, but is likely to be a function of each country's institutional setting (Leuz, 2010; Bischof, 2009, Ball et al., 2003). More in depth, with specific reference to the IFRS 7 adoption, cross-country differences still persist, relating to those interpretations of the above mentioned principle that not only clarify but also restrict several disclosure choices.

As far as the "specific" banking regulation is regarded, what should be noted is that EU lacks a common Supervisory Authority, which could ensure the fully harmonization of banking supervision across Europe. The Guidelines issued by the European Banking Authority (EBA) for promoting convergence of supervisory practices are to be intended as mere "recommendation", without any force of law (Bischof, 2009). Hence, a crucial role in defining mandatory banking supervisory provisions is played by the Supervisory Authorities of each State.

Therefore, the poor usefulness of risk disclosure, in terms of lack comparability, verifiability, timeliness and understandability, is likely to be partially explained by different home country regulations and, more in depth, by the heterogeneity in the application of both IFRS 7 and supervisory provisions.

3. The Italian country setting

This section describes the risk disclosure regulatory system in Italy, by clarifying the peculiarities relating to the existence of several sources of law, which are mandatory in different way, and identifying the specific requirements issued by different regulators. The aim is to addresses whether the increasing in detailed risk disclosure standard and authoritative disclosure recommendations are able to enhance the usefulness of banking risk disclosure.

The analysis focuses on qualitative requirements, which integrate quantitative data, with the purpose to give a complete information of the banking overall risk profile through additional and complementary elements, thereby facilitating users in the different investment choices.

What should be noted is that Italian banks are required to provide (qualitative) risk information in three different reports: notes to the financial statement, management commentary, and public report.

Regarding risk disclosure in the notes to the financial statements, *IFRS 7 Financial Instruments: disclosures* (as endorsed by Regulation EC n. 1126/2008 and subsequently slightly amended by further regulations), which is regarded as the primary sources of law, requires information on the nature and extent of the risks that arise from financial instruments. The standard recommends quantitative and narrative information on credit risk, collateral and other credit enhancements, liquidity risk, market risk and sensitivity analysis, and other market risk. However, in order to avoid affecting information, no specific format for disclosure is required or even suggested.

Although IFRS are legally binding in Italy, and IFRS 7 represents the main standard for risk disclosure, the decree-law n. 38 of 28 February 2005 conferred on the national supervisory authority the jurisdiction to issue the administrative provisions to apply the IFRS in the banking sector. Consequently, Bank of Italy has issued the *Circular 262/2005 Bank's financial statement: layouts and preparation* (henceforth, Circular), which is periodically amended to account for changes in European Union accounting regulations.

Circular introduces further instructions representing a secondary source of law for risk disclosure. In particular, with the aim to ensure the comparability of financial statement for external users, unlike IFRS 7, Circular insists on a mandatory and specific format for the notes, and specifies that a section of the notes should be organized in such a way as to provide quantitative and qualitative information on credit risk, securitisation, interest rate risk and price risk, exchange risk, liquidity risk and operational risk.

Hence, within risk disclosure requirements for the notes to the financial statement, analogies and differences exist between accounting regulation (IFRS 7) and national instructions (Circular 262/2005).

The table below shows some similarities between the above-mentioned sources of law.

Table 1 – *Similar requirements between IFRS 7 and Bank of Italy instructions*

IFRS 7	CIRCOLARE 262/2005
Objectives, policies and processes to manage credit risk, as well as methods used to measure the risk *and* Any changes [in the previous requirements] from the preceding year *and* Risk exposure and how credit risk occurs	General information on the credit risk *and* Management, measurement and control systems of the credit risk
The methods and assumptions used in developing the sensitivity analysis *and* Changes since last year in the methods and assumptions used, as well as the reasons for such changes *and* An explanation of the method used to prepare this sensitivity analysis, as well as the main parameters and assumptions underlying the data supplied *and* An explanation of the purpose of the method used, as well as the constraints that could make information not fully reflect the fair value of assets and liabilities involved	General aspects, management processes and measurement methods of interest rate risk and price risk
Risk exposure and how market risk occurs *and* Objectives, policies and processes to manage market risk, as well as methods used to measure the risk *and* Any changes [in the previous two requirements] from the preceding year.	General aspects on the market risk
Risk exposure and how liquidity risk occurs *and* Objectives, policies and processes to manage liquidity risk, as well as methods used to measure the risk *and* A description of how it manages the liquidity risk *and* Any changes [in the previous two requirements] from the preceding year	General aspects, management processes and measurement methods of the liquidity risk
A description of securities and other improvements taken credit *and* Where the assets are not readily convertible into cash, its policies to alienate or dispose of by other means such assets, or for use in its activities.	Technique to mitigate credit risk

Table 1 identifies qualitative risk disclosure requirements issued by both, the international accounting standard and domestic law, and shows that the two regulators require for the same risks, thus highlighting some overlaps in current regulation. On the basis of the above consideration, some reflections are due. Bearing in mind the idea at the basis of Italian regulatory system, the role of the National Authority should consist of providing further and more specific prescriptions to apply IFRS. However, as is clarified by table 1, the additional provisions issued by Bank of Italy seems to be more general and less detailed than IFRS 7, which better specifies the qualitative information about risk to be reported (see, for example, what is stated for *technique to mitigate credit risk*).

In addition, there are also requirements issued only by one of the two regulators. In fact, Italian banks are required to comply with IFRS, also with reference to certain items that are not explicitly addressed by Bank of Italy[1]. Likewise, Italian Supervisory Authority sometimes requires particular information even if not covered by the IASB. Table 2 sets out in detail the cases of mismatch.

Table 2– *Different requirements issued by IASB and Bank of Italy*

IFRS 7	CIRCOLARE 262/2005
Information about the credit quality of financial assets that are not in arrears or have deteriorated its value.	General aspects, management processes and measurement methods of the operational risk.
An analysis of the maturities of financial liabilities that shows the time remaining contractual maturity.	Qualitative information on securitizing
When the sensitivity analysis were not representative of the risk inherent in a financial instrument, the entity inform this, and why it creed that sensitivity analyses lack representativeness.	

A significant difference between the two mentioned sources of law pertains operational risk. What should be noted is that, unlike the Bank of Italy, IFRS 7 does not require for operational risk in the notes to the financial statement, due to the lack of close relation to financial instruments, as well as to the absence of an accounting

[1] *Basis for Conclusion on IFRS 7, section BC65 2005* «(…) the Board noted that the definition and measurement of operational risk are in their infancy and are not necessarily related to financial instruments. It also decided that such disclosures would be more appropriately located outside the financial statements. Therefore, the Board decided to defer this issue to its research project on management commentary».

measure for it. Therefore, the IASB defers the presentation of operational risk information in management commentary[2].

However, beyond the considerations relating to specific regulatory requirements, what should be noted is that national law, which is expected to ensure a larger degree of enforcement, fails in its aim.

In theory, Italian Supervisory Authority should better specify what is stated by the IASB, especially for those issues not covered by IFRS 7. In practice, Bank of Italy does not clarify the European accounting regulation, as is silent about some items laid down by the International Accounting Standard Board. Indeed, there are no additional provisions relating to the credit quality of financial assets, to the analysis of the maturities of financial liabilities, as well as to the sensitivity analysis that are not representative of the risk inherent in a financial instrument. Bank of Italy has not issued further and more detailed directions for preparing financial statements in accordance with international accounting standards.

Therefore, the above consideration allows us to affirm that Italian regulation is not helpful for the enforcement and interpretation of IFRS 7, as it does not clarify disclosure choices in essence.

Hence, risk disclosure provided by Italian banks in the notes to the financial statement is heavily affected by the characteristics of the regulatory system. On the one hand, international guidelines do not suggest a specific format, in order to ensure that risk disclosure derives directly from the corporate information flows, thus avoiding to constrain risk disclosure to the "rigidity" of certain patterns previously identified. On the other hand, national provisions fail in the attempt to better specify what is stated by the international standard for risk disclosure since, as clarified from Table n. 1 and 2, Circular 262/2005, in some cases, requires information more general than IFRS 7, while in others, does not compel some of the IFRS 7 requirements.

[2] International Accounting Standards Board (2005), *Basis for Conclusion on IFRS 7*, Section BC65: "(…) the Board noted that the definition and measurement of operational risk are in their infancy and are not necessarily related to financial instruments. It also decided that such disclosures would be more appropriately located outside the financial statements. Therefore, the Board decided to defer this issue to its research project on management commentary".

Consequently, the set of risk disclosure rules is sometimes redundant, sometimes is lacking, and is not ensuring, in essence, an effective system of strong enforcement, only in theory ensured by Italian risk disclosure regulation.

Regarding risk disclosure in management commentary, the primary source of law does not specify mandatory provisions regarding the risk disclosure *format*. Indeed, the IASB has not issued a specific standard, just introducing an *IFRS practice statement* (Caldarelli, 2010), which is not mandatory in the EU. European accounting regulation merely defines the contents of risk disclosure, which should cover only the major categories of risk (strategic, commercial, operational and financial) and the related procedures of risk taking and risk mitigation. Therefore, Italian banks have to comply only with the secondary source of law. In this regard, National Authority also establishes that Italian banks should show "further information" not provided in the notes to the financial statement, about the aims and policies related to their risk taking as well as the management and hedging of financial risks (price risk, credit risk, liquidity risk, and risk of fluctuation in cash flows). Clearly, there is also room here for discretion in delivering qualitative information on risk.

In addition, banks are required to provide risk disclosure in a further document, that is the "Public Report" required by the third pillar of the *Committee's International Convergence of Capital Measurement and Capital Standards: a Revised Framework* (henceforth, Accord), formalized in Directive 2006/48/EC and Directive 2006/49/EC, recently amended by Directive 2010/76/EC. The third pillar of the *Basel Committee's International Convergence of Capital Measurement and Capital Standards: a Revised Framework* (henceforth, Accord), as agreed by the European Directives 2006/48/EC and 2006/49/EC of 14 June 2006, contains a large number of options for risk disclosure, and discretion that may be applied depending on the specific national circumstances.

Since decree-law n. 297 of 27 December 2006 conferred on the Bank of Italy the jurisdiction to issue the administrative provisions, these directives have been transposed in Italy through *Circular 263/2006 "New regulations for the prudential supervision of banks"* (henceforth, Circular 236/2006), that is the secondary source of law relating to the prudential supervision (capital structure and capital adequacy).

The preparation of this document meets the disclosure requirements relating to capital adequacy and risk exposure, and also pursues objectives of accountability and transparency of management, to be of use for different market participants.

The following table shows the similarities and differences between requirements enclosed in the New Capital Accord and the provisions defined in Circular 263/2006[3].

Table 3 – A comparison between New Capital Accord and Bank of Italy instructions

NEW CAPITAL ACCORD	BANK OF ITALY INSTRUCTIONS
Credit risk general disclosures for all banks	**Credit risk** general disclosures for all banks
Credit risk: disclosures for portfolios subject to the standardised approach and supervisory risk weights in the IRB approaches	Credit risk: disclosures for portfolios t reated under the standardized approach and specialized lending and equity exposures treated under IRB approaches
Credit risk disclosures for portfolios subject to IRB approaches	**Credit risk** disclosures for portfolios under IRB approaches
Credit risk mitigation disclosures for standardised and IRB approaches	**Risk mitigation techniques**
Counterparty risk General disclosure for exposures related to counterparty credit risk	**Counterparty risk**
Securitisation disclosure for standardised and IRB approaches	**Securitization transactions**
Market risk disclosures for banks using the standardised approach	-
Market risk disclosures for banks using the internal models approach (IMA) for trading portfolios	**Market risks** disclosures for banks using the internal models approach (IMA) for position risk, foreign exchange risk and commodity risk
Operational risk	**Operational risk**
Equities disclosures for banking book positions	**Equity exposures** disclosures for banking book positions
Interest rate risk in the banking book	**Interest rate risk position in the banking book**

From Table n. 3 it is easy to find out some areas of overlaps/redundancy related to all cases in which the risk-items are formally covered by both the Basel Committee and

[3] Circular 263/2006 follows the Directive's requirements, which, therefore, have not been reported in the table.

national Authority. Indeed, the two sources of law identify the same risk categories to be disclosed in the public report. In other words, banks show in two different reports the risk items.

However, for each risk category, there are some differences pertaining the information to be substantially disclosed. Some explanations are described below. With regard to credit risk, the Accord also suggests a discussion of the management policy and requires banks that have partly (but not fully) adopted either the foundation IRB approach or the advanced IRB approach to show additional information. In relation to market risk, the agreement Accord requires information for banks using the standardized approach, while the Circular does not compel it at all. With regard to the communication of market risk related to trading portfolios, assuming use of internal models approach (IMA), the Accord calls for an illustration of the requirements supporting the determination of the capital adequacy by the bank. However, with regard to the aspects pertaining "equity exposures", the Circular introduces additional specifications related to the characteristics of the remuneration and incentives systems applied for the parties involved in the control of risks, with a particular focus on the criteria used for the evaluation of the results achieved and the adjustment and correction policies implemented.

Risk disclosure in the Public Report is affected by the lack of a systematic regulation. Beyond the similar attention paid from different regulators to the same risk issues, what emerges from the analysis is a lack of national regulation on certain elements required by the Accord (such as, for example, policies for managing credit risk) and a choice of the Circular to consider some unique aspects not covered by the Basel Committee, but without bothering to define any areas of discretion.

It should be noted that, beyond mandatory risk disclosure required by different regulators, Italian banks may provide additional information, voluntary in nature, in order to provide a picture as detailed as possible about their overall risk exposure.

4. Discussions

The active role of the State in defining processes which are critical to the regulation of economic life was considered of great importance, (Moran, 2010; 2002) especially with reference to the theory and practice of accounting. As a result of the recent financial crisis, many European countries (such as Belgium, Germany and Ireland) have changed their regulatory framework, by introducing, for supervisory purposes, an *ad hoc* national Authority of the banking firms (Masciandaro et al., 2012). The effort aimed at introducing a stronger enforcement system in order to better specify the rules/principle issued at European level, in order to improve the usefulness of risk disclosure to investors.

On this basis, the study addresses whether the increasing in risk disclosure standard and authoritative disclosure recommendations are able to enhance the usefulness of banking risk disclosure.

Italy adopts the "*interventionist enforcement*" system, and introduces a national government regulator (Bank of Italy) overseeing compliance with risk disclosures. Such a system entails additional provisions for financial institution issued from Bank of Italy (Circular no. 262/2005 and Circular no. 263/2006), which should imply an high level of quality/quantity of the information on risks. In this regard, it is interesting to underline that, due to the fundamental role played in the economic system, Italian banks have to comply with both, accounting rules and supervisory principles different sources of law. Also, to meet different information needs, and to protect several interests involved, regulators require two different sets of disclosures, which have to be provided by Italian banks. As a result of the increasing in regulatory requirements to be complied with, and due to the additional provisions that better specify what is stated at the European level, the degree of detail of qualitative risk information required should be higher than under the previous regulation. It should also be higher than risk disclosure by banks carrying out their activities in different States that are not "interventionist enforcement". Consequently, qualitative risk disclosure by Italian banks is expected to be of use to investors.

However, the systematic review of the multiple risk requirements issued by different regulators, acting at different hierarchical levels, revealed some limitations of current system of risk disclosure regulation.

The analysis identified several lacks and/or gaps of regulation, which may explain the inadequacy of qualitative risk disclosure by Italian banks to reflect their actual riskiness, according to what has been revealed by recent empirical research

(Allegrini, 2011). In other words, as a result of the increasing in minimum regulatory requirements, the usefulness of risk related information has not increased.

In this regard, the study attempts to provide some reflections on current risk disclosure regulation that may explain the (un)usefulness of risk disclosure revealed by recent studies, by referring to the concept of *usefulness to investor* defined by the IASB as a function of *comparability, verifiability, timeliness and understandability*.

What should be noted is that, despite the joint effort made to converge countries' reporting standards (Macchioni, 2010), over years recommended by scholars (ICAEW, 2011; Zen e Baldan, 2007; Linsley e Shrives, 2006; ICAEW 2002), substantial differences in reporting regulation and practices still remain across countries. On the one hand, the high degree of discretion of current regulation does not allow Italian banks to achieve the comparability purposes. Also, it has been argued that the "principle-based" nature of IFRS implies the use of professional judgment, leading to non-comparable reporting practices (Oliveira et al., 2011; Leuz, 2010). On the other hand, the so-called "Basel Accords", regarded as supervisory provisions specifically for the banking sector aiming at ensuring investors' protection, needs to be endorsed by each State, thus reflecting the specificity of different home-country regulation, with inevitable effects on comparability of risk information. In addition, what should be remembered is that the Basel Committee, regarded as an organization aiming at promoting and encouraging international cooperation in the field of banking supervision, has no formal authority or a self-regulatory power and, therefore, does not issue principles and rules mandatory in nature, but suggest practical guidelines that are no legally binging.

Consequently, the *comparability* of risk disclosure reflects the inefficiencies of current requirements due to the different disclosure choices allowed, which are unlikely to be understood fully because of non-alignment with what is the actual riskiness of the bank. Therefore, users do not know whether banks disclose bad or good news, and are likely to face considerable difficulty in comparing that profile across the sector.

With reference to the achievement of the "*understandability*" purposes, there is need to underline that the vagueness and misleading nature of the statements may lead to a potential increasing in multiple interpretations by readers. In this regard, previous research found that the understandability of narratives was poor, due to a general lack of qualitative information to explain in greater detail numerical disclosure (Allegrini, 2011; Fortuna, 2011). Therefore, users are likely to face considerable difficulty in capturing the appropriate risk profile of a credit institution, because not detailed information is usually given and, where given, is dispersed throughout the different document public available.

Speaking in the IASB's word, "*verifiability helps assure users that information faithfully represents the economic phenomena (…). Verifiability means that different knowledgeable and independent observers could reach consensus, although not necessarily complete agreement, that a particular depiction is a faithful representation*" (Framework, 2010, para QC26). In this regard, what should be remarked is that the guidelines issued by the different regulators, more or less prescriptive, enabling preparers of financial statements to manage information to be disclosed. More in depth, current regulatory requirements allowed insiders to manage the information that may reveal some reduction in the ability of the bank to create value in the future.

Regarding the *timeliness* of risk disclosure, the Basel II requirements introducing higher capital requirements to capture the credit risk of complex credit activities. The introduction of such requirements was intended to promote the build up of capital buffers in good times, so that they could be drawn on in period of stress. In terms of disclosures, banks will be required to disclose information about their regulatory capital elements. However, the recent financial crisis has reveled the inefficiencies of financial regulation in defining e supervising risk disclosure practices.

What should be emphasized is that the presence of a more enforced regulation does not eliminate certain degree of discretion and, therefore, does not necessarily represent a reason for higher information transparency (Dobler, 2005; 2011). Despite previous studies (Allegrini, 2011) have revealed that qualitative risk information by Italian banks reflects the application of minimum requirements of the different regulators, it is inadequate to describe the overall risk profile of the company.

Hence, the inefficiencies of the qualitative risk disclosure provided by the Italian banks are due not only (or exclusively) to the enforcement mechanisms and does not represent just a problem of compliance *per se*, but also shed some light on the existing limitation of current rules in terms of degree of detail, the pervasiveness of the information required.

5. Conclusions.

This study highlights some critical issues of the current risk disclosure regulation, with specific regard to the Italian banking sector. More in depth, this study provides a systematic overview of the complex *apparatus* of qualitative risk disclosure regulation, by referring to the primary and the secondary sources of law issued by different regulators.

Through the analysis of the enforcement level and effectiveness of the legal constraints, we aim to shed light on the degree of discretion allowed by the above-mentioned set of rules, and to discuss some potential effects in terms of comparability and faithfulness of risk disclosure. Hence, the analysis emphasizes the well-known call for a more systematic and effective set of rules for risk disclosure, also for such countries where the interventionist enforcement approach is applied.

More in depth, the research suggests the introduction of a more effective strategy, shared by all EU members, for the adoption and the implementation of risk disclosure requirements, in order to fill the gap between the more general European regulatory framework and the different specific national guidelines. Moreover, a thoughtful reflection about the key elements to be introduced and/or strengthened in risk communication, and the opportunity to define a less comprehensive but more restrictive rules for companies, is recommended.

On the basis of the above considerations, the contribution of this paper is twofold. The research aims at being relevant from a theoretical perspective, by contributing to risk disclosure literature through a critical analysis of the current regulation. Moreover, although the analysis refers to the Italian context, it addresses some critical issues relevant for other European and foreign countries presenting a similar enforcement system.

The study also provides some helpful suggestions for national and international standard setters, policy makers, and supervisory authorities, by highlighting some overlaps and/or lacks of the complex system of current risk disclosure regulation that are not able to enhance the usefulness of their risk information.

In this way, the above theoretical considerations could represent a valid starting point to define some guidelines for discussing and re-defining the *status quo* of the current risk disclosure regulation.

However, further research could try to test for risk disclosure with empirical evidence, by examining in detail the information provided by banks in different risk reports, in order to understand if the compliance with current regulation is able to enhance, in practice, the usefulness of risk disclosure.

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CHAPTER 2

(Un)useful risk disclosure: explanations from the Italian banks

Chapter 2

(Un)useful risk disclosure: explanations from the Italian banks

ABSTRACT

Purpose: the purpose of this research is to examine the risk disclosure provided by Italian banks, focusing on the characteristics of the information to assess the overall quality of disclosure, to find any differences between the two mandatory reports (notes to financial statements and the public report) both prepared in compliance with the instructions of the national supervisory Authority.

Design*:* We carried out a content analysis on analysed a total of 66 financial statements and public reports 66 to investigate the variation in the level of risk disclosure between the two risk reports.

Findings*:* Our findings show that although Italian banks formally comply with the Bank of Italy's instructions, there is room for them to choose the characteristics of the information, with undeniable effects not only on the quantity of the disclosure provided in each report and for each risk factor, but above all, in terms of quality.

Value: this research will complement prior studies by focusing on an under-researched setting, such as the banking sector, and providing evidences relating to a report which has never been analysed before. Also, focusing on the Italian banks, the study will allow us to take into account the issues relating to risk disclosure in a context characterized by increasing regulation, strong legal enforcement and, therefore, the expectation for more useful information. In addition, the findings of the paper will allow a more comprehensive analysis of the issues relating to risk disclosure, highlighting existing strengths and limitations, as well as the need for a systematic framework, shared at the European level, to ensure the usefulness of information. In the end, the results will be of interest also for standard setters and supervisory bodies, as the research will shed light on some overlaps of the two competing regulations.

Keywords: *accounting regulation, narrative risk disclosure, banking sector*

1. Introduction

In the wake of the global financial crisis of 2007, regulators have encouraged companies to enhance their narrative risk disclosure, requiring more information on different types of risk, to be provided in different mandatory reports (Frolov, 2007; Dobler *et al.*, 2011). However, despite the continuous raising of the minimum requirements, when regulators do demand narrative information, they essentially fix *what* information should be reported, without clarifying *how* it should be provided. That said, there may be an expectation that companies, while formally complying with *what* a regulation requires, can use their discretion in the choices relating to *how* the information on risk is to be reported (Linsley and Shrives, 2000; Dobler, 2008; Bischof 2009). Consequently, the flexibility allowed by current requirements should be taken into account since they leave a certain degree of discretion regarding how to report information, and the characteristics of disclosure on different kinds of risk may reflect this.

Recent findings show that companies do not generally provide adequate information on risk (ICAEW, 2002, 2011). In fact, such information, although indeed available, is generally not monetary or forward-looking, but is neutral, mainly descriptive and focused on financial risks (Helliar *et al*., 2002; Beretta and Bozzolan, 2004; Cabedo and Tirado, 2004; Dobler *et al*., 2011; Abraham *et al*., 2012; Mokhtar and Mellett, 2013). Furthermore, it is also irrelevant to risk assessment (Magnan and Markarian, 2011). It should be noted that research on risk disclosure is still limited and, since several questions remain unanswered, there is much room for investigation (Woods *et al.*, 2007). The need to deepen current knowledge on such issues is becoming more relevant also because, as emphasised by Woods *et al.* (2009), substantial diversity in numerical and narrative disclosure still persists globally.

In this context, a fundamental problem is the technical complexity of the current regulation on risk disclosure, especially in the banking sector, which appears to be less successful than expected (ICAEW, 2011). Indeed, although regulation requires complex disclosures, it is recognised that they are not relevant to assessing the risk profile of banks, as initially intended.

Despite general consensus on the inadequacy of current risk disclosure, it could be of interest to further investigate in greater detail the above-mentioned issues in order to understand better the reasons why risk disclosure looks less useful than it ought to be.

A first step is to look at the quality of information, as it is widely known that the poor quality of disclosure is a major problem, given its crucial role in determining the decision-usefulness of the information (ICAEW, 2011).

Secondly, it is worth considering that narrative risk disclosure is not only a function of regulation *per se* but also depends on firm-specific factors (Dobler *et al.*, 2011). This is particularly relevant in the banking sector, where narrative disclosure on risks must be provided in different reports, on a number of different aspects, and with a varying degree of emphasis within each report. Consequently, and given that some flexibility is allowed, a second aim of this study is to understand what the bank-specific factors that may drive disclosure choices and the quality of the information are.

Especially, in view of the foregoing considerations, the subject of this research is the mandatory narrative risk disclosure provided by Italian banks. The Italian setting is extremely relevant for the issues discussed due to the importance of the supervision of the Bank of Italy (Draghi, 2010). Indeed, Italy unlike other countries, such as the UK and Germany, adopts "interventionist enforcements" (Bischof, 2009), which are regarded as a critical tool for achieving the minimum disclosure requirements (Frolov, 2006; Oliveira *et al.*, 2011). Moreover, interventionist enforcement by the Bank of Italy refers to two mandatory reports (notes to the financial statements and the public report), which contain information on the same financial risks, but with varying degrees of detail regarding several aspects (Caldarelli *et al.*, forthcoming).

Given this context, we examine how risk information is provided by Italian banks, focusing on the characteristics of the information to assess the overall quality of disclosure, to find any differences between the notes to financial statements and the public report required by the third pillar of the New Capital Accord (henceforth, public report), both prepared in compliance with the instructions of the Bank of Italy.

Afterwards, an analysis is carried out to understand what the bank-specific factors that explain the level of quality of the narrative risk disclosure provided by Italian banks in the two above-mentioned reports are.

The first step in the research is to detect the characteristics of disclosure and the differences between the reports. On the basis of the framework developed by Beretta and Bozzolan (2004) - who investigated the issues related to voluntary disclosure provided by Italian listed companies - suitably adapted to take into account the issues related to mandatory disclosure and the specificities of the Italian banking sector, our research involves observation of the presence/absence of a standard set of characteristics - along with the following semantic properties: type of measure, economic sign, outlook, nature and time frame - in each risk section of the aforementioned reports. The final sample is made up of 66 Italian banks.

Then, we observe variables such as profitability, measures of risk, and governance features, to explain the level of quality of the disclosed information in the two reports examined.

The remainder of the paper is structured as follows. In Section 2, we present the risk disclosure regulations. In Section 3, we assess the findings of previous studies and develop our hypotheses. In Section 4 we describe the research design and data sets. In Section 5 we present and discuss our results, and we provide our main conclusions in Section 6.

2. Risk disclosure regulation in Italy

This section briefly reviews the main requirements of risk disclosure regulations in Italy, to highlight the level of discretion that they allow. It is worth noting that, to ensure the completeness of the discussion, we concisely summarize the demands of all the documents in which the information about risks is needed under current regulation. However, it should be borne in mind that the paper focuses on only two of the documents explained in the following paragraphs: the notes to financial statements and the public report.

2.1. The risk disclosure regulation for the notes to financial statements

With particular reference to risk disclosure in the notes to financial statements, the IFRS 7 *Financial Instruments: disclosures* (as endorsed by *Regulation EC n. 1126/2008* and subsequently slightly amended by further regulations) requires information on the nature and extent of the risks that arise from financial instruments. It recommends quantitative and narrative information on credit risk, collateral and other credit enhancements, liquidity risk, market risk and sensitivity analysis, and other market risks. Nevertheless, no specific format is required or even suggested.

What should be remarked is that the Italian banking sector is characterised by a high level of enforcement (Bischof, 2009), and accordingly *decree-law n. 38 of 28 February 2005* conferred on the Bank of Italy the jurisdiction to issue the administrative provisions to apply the IFRS in the banking sector. Consequently, further instructions were introduced in the form of *Circular 262/2005 Bank's financial statement: layouts and preparation* (sic), which is periodically amended to account for changes in European Union accounting regulations, and Italian banks have to comply with these requests.

Thus, with special regard to risk disclosure, unlike the IFRS 7, the Circular insists on a mandatory and specific format for the notes to financial statements. In addition, it also specifies that a section of the notes is to be organised in such a way as to provide quantitative and narrative information on credit risk, securitisation, interest rate risk and price risk, exchange risk, liquidity risk and operational risk. However, despite the greater degree of detail, the current requests for narrative information still leave room for discretion in relation to *how* this disclosure should be provided.

In addition to the requirements for the notes to financial statements, Circular 262/2005 also establishes that Italian banks should show "further information" in the management report not provided in the notes to the financial statements, regarding the aims and policies of their risk taking and the management of financial risks. Clearly, there is also room here for discretion in providing narrative information on risk. However, this report is not object of our investigation as the current legal provisions allow too much flexibility and freedom not only on *how* disclosure should be provided but also with reference to *what* should be disclosed.

2.2. The risk disclosure regulation for the public report

The third pillar of the *Basel Committee's International Convergence of Capital Measurement and Capital Standards: a Revised Framework* (henceforth, Accord), as agreed by the European Directives 2006/48/EC and 2006/49/EC of 14 June 2006, contains a large number of options for risk disclosure, and discretion that may be applied depending on the specific national circumstances.

Since *decree-law n. 297 of 27 December 2006* conferred on the Bank of Italy the jurisdiction to issue the administrative provisions, these directives have been transposed in Italy through *Circular* 263/2006 *New regulations for the prudential supervision of banks*.

Circular 263/2006 adheres to the directives by requiring more general information on credit risk management policies and market risk than the original Accord. In particular, the Circular requires quantitative and narrative information on credit risk, counterparty risk, securitisation, market risk, operational risk, equities, and interest rate risk. It is worth noting that the directives have recently been revised to strengthen the regulation, supervision and risk management of the banking sector, introducing a number of new requirements, such as securitisation exposure and the sponsorship of off-balance sheet vehicles. However, despite the undeniable improvements, also in this case, a high level of discretion persists, with regard to *how* the disclosure should be provided.

3. Assessing prior research and developing the hypotheses

A number of researchers have previously analysed the quantity and quality of corporate risk disclosure, in single or comparative national data settings, given the distinct nature of country-specific risk reporting regulations. Mainly drawing on ICAEW (2011), we now make an assessment of the most recent studies on risk disclosure, by specifically considering the papers that address the characteristics of narrative risk disclosure in both financial and non-financial companies, and also those with a clear focus on the effects of firm-specific factors. In so doing, we do not consider articles that examine the relationship between disclosure characteristics and market reactions, as these beyond the scope of this paper.

Our primary aim was to discover (if possible), i) the objectives of such research, ii) the regulations referred to, iii) the reports examined, and, iv) their findings, in order to shed some light on the state of the art, as well as to identify any areas requiring further research.

As a first stage, we review here the most relevant studies that focus on the characteristics of narrative risk disclosure, but with no reference to any firm specific factors. With regard to narrative risk disclosure characteristics in the English-speaking setting, Abraham *et al.* (2012) analysed the usefulness of the risk information disclosed by US listed companies in their annual reports. They found that risk information had increased as a result of regulatory initiatives, and it was acknowledged that regulation was effective in theory, but difficult to implement in practice because of unintended consequences. The analysis of narrative information showed that non-monetary disclosure was more common than monetary disclosure, only a small percentage of narrative disclosures related to the future, and the tone of such disclosure was mainly neutral.

Marshall and Weetman (2002) studied mandatory narrative risk disclosure in compliance with SEC and ASB requirements in the annual reports of US and UK listed companies. They found two opposing forces, namely the regulator's expectation for clarity and transparency *versus* the managements' need to protect the entity. The study also showed that disclosure regulations could have a different impact in two different regulatory environments, despite their simultaneous development under similar sets of influences.

Moving from the English-speaking setting to the Continental context, the majority of the research on the characteristics of narrative risk disclosure was carried out by focusing on Germany. Dobler (2005a) in particular discussed empirical evidence from Germany, emphasising how risk disclosure improved somewhat after firms were explicitly obliged to report on their risks, possibly due to a previous lack of experience and practice, vague disclosure rules, or poor enforcement. Moreover, Berger and Gleißner (2006) showed that in Germany, even under a mandatory reporting regime, there is still an information asymmetry in the risk information disclosed in the annual reports.

Dobler (2005b) also discussed national and international developments in the regulation of risk reporting involving German legislation, German standards, EU directives, and international and US standards, thereby providing a comparative international overview of mandatory risk disclosure and a perspective for international convergence. He made it clear that the existence of an international standard on risk reporting could enhance comparability among entities internationally, and there is some potential for convergence in risk reporting requirements. Dobler (2008) also adopted and reviewed discretionary disclosure and "cheap-talk" models in an attempt to analyse risk reporting incentives and their relationship to regulation. He linked restricted risk reporting with attempts to regulate, affirming that regulation may to some extent mitigate the effects of incentive-driven restrictions, but can nevertheless have adverse effects on risk reporting.

Dobler *et al.* (2011) carried out a multi-country investigation of comprehensive corporate risk disclosure in annual reports. They analysed the attributes and quantity of risk disclosure and its association with the level of firm risk in US, Canadian, UK, and German settings. They found a consistent pattern, where risk disclosure was most prevalent in management reports, and concentrated on financial risk categories, including relatively little quantitative and forward-looking disclosure across the countries studied.

In relation to the foregoing studies, focusing on the semantic properties of information, it is possible to highlight that their conclusions mainly refer to disclosure that is generally not monetary or forward-looking, but is neutral, mainly qualitative and focused on financial risks. Moreover, most of these studies also emphasise that risk disclosure characteristics are influenced by the degree of detail of regulation and enforcement. However, none of these studies concentrated on risk disclosure in different mandatory reports (multi-mandatory risk disclosure), nor did they take into account the reporting of different kinds of risks. Given the lack of evidence in the empirical research on multi-mandatory risk disclosure, and the distinguishing characteristics of the Italian accounting regulations, we test a set of hypotheses mainly concerned with differences in the characteristics of risk disclosure *between* two reports, *i.e.* the notes to the financial statements and the public report.

Thus, although taking for granted the characteristics of risk disclosure as previously stated, we argue that there can be a substantial effect on such information, in terms of differences *between* the reports, according to the regulatory requirements considered. Indeed, it is worth noting that, as explained in Section 2, the Bank of Italy's instructions require selected, but less detailed risk disclosure in the notes, and selected and detailed risk disclosure in the public report. Hence, as argued by Dobler (2005a, 2008), Lajili and Zéghal (2005), and Dobler *et al.* (2011) discretionary disclosure might be more prevalent in notes to financial statements, and banks may emphasise mandatory risk disclosure in their public reports, which are enforced more strictly. Furthermore, as discussed in Section 2, the regulation examined requires either disclosure for different categories of risk, or different disclosure on the same risk in both reports. Arguably, it is important to highlight that despite the mandatory requirements, regulation leaves room for discretion, not only in providing details on the source or on the management of the single risks (see Linsley and Shrives 2000; Lajili and Zéghal 2005; Dobler *et al.*, 2011), but also with reference to the characteristics of disclosure of each single risk within that report. In this regard, it is important to highlight that the above studies agree on the fact that the discretion in the choices relating to *how* the information on risk has to be reported (Linsley and Shrives, 2000; Dobler, 2008; Bischof 2009) can negatively affect the quality (and the usefulness) of disclosure.

Accordingly, we formulate our first hypotheses as follows:

HP1a *The characteristics of narrative risk disclosure in the mandatory categories will differ* in *the notes to the financial statements and the public report.*

HP1b *The quality of narrative risk disclosure will differ* in *the notes to the financial statements and the public report, and this depends on the different characteristics of the information for the mandatory categories.*

Further research has examined the characteristics of narrative risk disclosure, by also analysing the effects of firm specific factors. Especially, with reference to the US context, Campbell *et al.* (2012) analysed SEC-mandated firms which included a section on risk factors in their Form 10-K. They examined the information content of newly created risk factor sections and offered two main findings.

They found, firstly, that firms facing greater risk show more risk factors, and that the type of risk determines whether or not the firm devotes a greater portion of their disclosures to describing that risk type. On the other hand, the results of Campbell *et al.* (2012) supported the SEC's decision to make risk factor disclosure obligatory, given that the disclosures in this newly created section appear to be firm-specific. Above all, they reported the significant influence of the following variables: size, leverage, auditor typology, taxation, and extraordinary items.

Lajili and Zéghal (2005) analysed the risk disclosure provided by Canadian companies in the notes and management discussion, in accordance with the CICA handbook requirements. They found the risk information to be almost exclusively qualitative in nature, and its location in the reports followed Canadian risk disclosure regulations. Moreover, they showed a high degree of intensity for both mandatory and voluntary risk management disclosure. In their view the disclosure appeared to lack uniformity, clarity and quantification, potentially limiting its usefulness. They used size, leverage and profitability in their analysis to carry out an ANOVA test, and reported that these variables were not significant, recommending caution in the interpretation of results because this was probably also due to the fact that they considered companies from different sectors.

In the UK, Linsley and Shrives (2006) explored risk disclosure in the annual reports of listed firms. They found that qualitative, forward-looking, and good-news risk disclosure were each more commonplace than their opposites. Their results suggested a positive relationship between risk disclosure quantity and size, while proxies for the level of firm risk, unlike Campbell *et al.* (2012), were insignificant or showed mixed results. Also, Linsley *et al.* (2006) analysed banking risk disclosure through an examination of the annual reports of a sample of UK and Canadian banks, creating a coding grid based on the risk disclosure categories as set out by the Basel Committee in the Pillar 3 (Market Discipline) consultative document of 2001. Their results suggested that there was no association between levels of risk disclosure and either bank profitability or the level of risk within the banks. However, they did find a positive association between levels of risk disclosure and both bank size and the number of risk definitions, and there appeared to be no statistically significant difference in the risk disclosure levels of the Canadian banks compared with the UK banks.

Linsley and Lawrence (2007) examined risk disclosures of companies within their annual reports. Tests were carried out to measure the level of readability of the risk disclosure, and to assess whether directors were deliberately obscuring information about bad risk. Their main conclusions related to the importance of the provision of transparent risk information to the marketplace, in order to enhance the clarity of published risk information. Abraham and Cox (2007) analysed the annual reports of listed companies and examined business risk, financial risk, and internal control risk disclosure in accordance with FRS 13 and the requirements of the Turnbull Report. They suggest that size and the characteristics of ownership and governance are determinants of the quantity of risk disclosure.

In the Italian case, Beretta and Bozzolan (2004) analysed voluntary disclosure in the reports of non-financial public companies, and concluded that the quantity of disclosure is not a satisfactory proxy for the quality of disclosure. They developed measures of the quality of risk disclosure, which reflect its different aspects. It is noteworthy that in their work they referred to quasi-voluntary disclosure, given the limited mandatory requirements. Their results showed that although firms provided formal disclosure, there was substantial non-disclosure regarding risk. Moreover, they showed that, in line with previous studies, size has a significant impact on the aspects in question. Thus, since previous studies on the analysis on firm-specific factors explaining the characteristics of risk disclosure report mixed results, we formulate the following hypotheses.

HP2a *The quality of the narrative risk disclosure is associated with profitability.*

HP2b *The quality of the narrative risk disclosure is associated with the measures of risk.*

HP2c *The quality of the narrative risk disclosure is associated with governance features.*

Note that, unlike previous studies, we do not hypothesise an association between the quality of the narrative risk disclosure and size, because size is used to calculate an index for the relative quantity of disclosure used to assess the quality of the narrative disclosure.

4. Research design and data sets

4.1. The sample

We examined all the Italian banks required to publish consolidated financial statements and full public reports. Hence, we removed from our sample: i) Italian banks belonging to a group; ii) branches of non-European Union banks as specified in a list by the Bank of Italy; iii) Italian banks not belonging to a group, if controlled by a European holding and if they have total assets of less than 10 billion euros. We also removed those banks that have been subject to mergers and acquisitions, and those banks not providing full public reports.

We analysed a total of 66 financial statements and public reports, all issued in the year 2011. Our analysis refers to the year 2011, and we therefore have no concerns in terms of first-time application, because in that year the *Circular 262/2005 Bank's financial statement: layouts and preparation* was adopted for the fifth time, and the *Circular* 263/2006 *New regulations for the prudential supervision of banks* was adopted for the fourth time. Moreover, in 2011 as a consequence of the financial crisis, public opinion exerted pressures on Italian financial intermediaries in terms of accountability requests and this arguably could have led Italian banks to pay greater attention to their disclosure.

4.2. Method

We used content analysis to investigate the variation in the level of risk disclosure between the notes to financial statements and public reports. This method involves the use of code words, phrases and sentences according to an established framework (Bowman, 1984). Content analysis is usually applied to archival data, and its aim is to infer the underlying meanings present in the texts being investigated (Smith, Taffler, 2000). Content analysis can allow researchers to go behind the text as presented and enable them to make valid inferences about hidden or underlying (and possibly unintended) meanings and messages of interest (Weber, 1990; Denscombe, 1998). Content analysis is an important technique (Krippendorf, 2004), and is useful for examining data and facts measured via an underlying framework, distinguishing them from background noise.

4.2.1 Content analysis by disjunctive codifying

We performed content analysis by selecting sentences as coding units. Milne and Adler (1999) argued that as a basis of coding, sentences are far more reliable than any other unit of analysis. Both Beretta and Bozzolan (2004) and Linsley and Shrives (2006) used sentences to codify risk disclosures. One drawback of using sentences as coding units is that a company's writing style can influence the outcome of the disclosure measurement. Thus, if a firm decides to dilute its risk-related discussion thinly among a mass of other words, it may not be possible to detect the risk-related information at the sentence level of analysis (Beretta and Bozzolan, 2004). It is difficult to overcome this drawback, which therefore constitutes a limitation of the analysis.

Because some criticism has been levelled at this method, due to the subjectivity that might affect the analysis (Linsley and Shrives, 2006), some validation is essential (Bowman, 1984). In particular, to increase the reliability of the coding, it was undertaken by a team of three people. Tests of reliability have been used elsewhere to check for consistency in coding (Milne and Adler, 1999; Beattie *et al.*, 2004). Following discussion and interpretation of the analytical framework, the three researchers independently coded an initial sample of five reports. To overcome the problem of the subjectivity in content analysis, we chose a two-step strategy of analysis.

The first step in the measurement of risk disclosure consists in the observation of the presence/absence of a standard set of characteristics in each examined section (*disjunctive codifying*). In this way, the collection of information from a textual source is less arbitrary because the researchers are not required to evaluate the intensity of a factor in each sentence. All they have to do is identify the sentences that contain a particular phrase.

Like Beretta and Bozzolan (2004), we propose a framework for the analysis of risk disclosure characteristics that considers four dimensions: the nature of the required information, the economic sign attributed to the expectations, the type of measures used to quantify and qualify the expected impacts, and the orientation of the outlook of the communicated risk. We also include the time frame.

For each detailed requirement, we verify whether any information is disclosed or not. Where it is not disclosed, we verify whether or not this was due to the operational activities of the business.

We use the following semantic proprieties:

- **Type of measure**: financial, non-financial.
- **Economic sign**: positive, equal, negative.
- **Outlook**: hypothesis – expectation, programs, actions or decisions taken, actual state.
- **Nature**: qualitative, quantitative, mixed.
- **Time frame**: historical, future-oriented, intertemporal.

The result of the coding process is a matrix B of binary variables associated with a weight matrix W containing the frequencies of the considered aspects measured in each section required in the notes to the financial statements and the public report (in terms of the number of sentences containing a particular aspect). The robustness of the approach used here was tested by measuring the response matching level of the coding, which was carried out by three independent researchers working on the same documents. By considering the responses of the researchers pairwise, we calculated mean values of inter-rater reliability π Scott's index of 0.86, with values included in the range 0.84 – 0.89. A π value of 0.75 represents a satisfactory level of inter-rater reliability (Hackston and Milne, 1996).

A further analysis of the coherence of the coding, which considered the simultaneous actions of the three researchers, was carried out using Bhapkar's test (1966). Bhapkar's test checks for marginal homogeneity for all categories simultaneously. The term 'marginal homogeneity' refers to the equivalence (lack of significant difference) of one or more of the row marginal proportions and the corresponding column proportion(s) in a contingency table between two categorical variables – in this case, row variable X is the adopted content coding and column variable Y is the distribution of the responses of the different researchers. For all the characteristics considered, the statistical outcome was not significant (considering a threshold of 0.1 for an I-type test error). We conclude that the coding of the three researchers was concordant. We included the pilot banks in the analysis to avoid a reduction in the number of examined banks.

4.3. Measurement

In order to identify what the bank-specific factors that explain the level of quality of the narrative risk disclosure are, we carried out a two-step process.

First, drawing on Beretta and Bozzolan (2004), we attempted to evaluate the quality of the disclosure according to the dimensions of relative quantity, density, depth, and outlook profile. Afterwards, we used the following variables: profitability, measures of risk, and governance features to find out if these influence the quality of disclosure. Hence, the purpose of this sub-section is to clarify the measurement issues involved in the analysis.

First, we explain the measurement issues related to the index for assessing the quality. In particular, quantity (the first dimension forming the overall quality index) is regarded as the absolute number of pieces of information disclosed, and has to be considered as a proxy of the amount of disclosure provided by banks. However, the literature emphasises that an absolute index (e.g., the number of phrases containing risk disclosure) is not adequate to appreciate the relative quantity of disclosure. Beretta and Bozzolan (2004) and Linsley and Shrives (2006) demonstrated that size is highly positively correlated to the total number of risk disclosures, the number of financial risk disclosures, and the number of non-financial risk disclosures. We measure size as *total assets* (widely used in literature) and *equity* (which has relevant implications for risk tolerance in the banking sector), both of which are shown in the balance sheets of the banks concerned.

In line with these positions (Beattie *et al*., 2002) an OLS regression equation was estimated using as an independent variable, and an index for the relative quantity of disclosure is proposed, by using the normalized residuals of the regression as a proxy for the disclosure quantity. The regression model is the following:

$$\hat{D}_i = \beta_0 + \beta_1 \cdot SIZE_i \tag{1}$$

Afterwards, the relative quantity index (RQ) was calculated by using Eq. (2), as the difference between the observed disclosure D_i and the estimated disclosure $\hat{D}_i$, and then normalised between 0-1.

$$RQ_i = D_i - \hat{D}_i \tag{2}$$

Moreover, to assess the relevance that risk-related information assumes within each report, we also considered the weight it has inside the overall communication, understood as the density of disclosure. In this regard, we considered the potential effects of the style of writing, since relevance of risk information disclosed can be influenced by the extent to which it is diluted. Thus, in accordance with previous studies (Beretta and Bozzolan, 2004) we define density as the ratio between the number of sentences about risks and the total number of sentences included in the analysed documents as shown in Eq. (3). As a consequence, the value assumed by the DEN index is between 0 and 1 and increases as the relevance becomes higher.

$$DEN_i = \frac{1}{k_i}\sum_{j=1}^{k_i} RFL_{ij} \tag{3}$$

where DEN_i is the density index for the *i-th* bank; k_i is the number of sentences in the report of bank *i*; RFL_{ij} is a binary variable that assumes 1 if the sentence *j* in the report of bank *i* contains risk information and 0 otherwise.

A third measure, as already highlighted, is the depth of disclosure, calculated by considering the economic sign used to communicate the expected performance, as shown in Eq. (4).

$$DPT_i = \frac{1}{k_i}\sum_{j=1}^{k_i}\left(ECSP_{ij} + ECSE_{ij} + ECSN_{ij}\right) \tag{4}$$

where DPT_i is the depth index for the *i-th* bank; k_i is the number of sentences in the report of bank *i*; $ECSP_{ij}$, $ECSE_{ij}$, $ECSN_{ij}$ are three binary variables that assume 1 if the sentence *j* in the report of bank *i* contains a positive, equal or negative economic sign respectively and 0 otherwise.

In the end, yet in line with Beretta and Bozzolan (2004) we considered the index for the outlook profile as it is shown in Eq. (5), which varies between 0-1 and assumes higher values when the company discloses information regarding actions taken or programs to face identified risks.

$$OPR_i = \frac{1}{k_i}\sum_{j=1}^{k_i}\left(OHE_{ij} + OP_{ij} + OA_{ij} + OAS_{ij}\right) \tag{5}$$

where OPR_i is the outlook profile index for the *i-th* bank; k_i is the number of sentences in the report of bank *i*; OHE_{ij}, OP_{ij}, OA_{ij}, OAS_{ij} are four binary variables that assume 1 if the sentence *j* in the report of bank *i* contains an orientation about Hypothesis Expectation, Orientation about Programs, Orientation about Actions or Orientation about Actual State respectively and 0 otherwise.

Finally, on the basis of the above-standardised indicesm a synthetic measure of the quality was calculated in accordance to the following equation (Eq. 6).

$$QUALITY_i = \frac{1}{4}\left(RQ_i + DEN_i + DPT_i + OPR_i\right) \tag{6}$$

At this stage, we mainly focus on the measurement issues concerning the bank-specific factors that may possibly influence the quality of disclosure.

The first primary variable is related to the *profitability* measure. Linsley *et al.* (2006) explained that mixed results may be expected when testing for a profitability-disclosure level association, but they also argued that banks that are better at risk management have higher levels of relative profitability, and therefore wish to signal their superior risk management abilities to the market. We measure profitability as *ROE* and *earnings per share*.

Linsley and Shrives (2006) emphasised that previous studies testing for a relationship between *leverage* (as a possible *measure of risk*) and disclosure produced no clear findings. Dobler *et al.* (2011) found leverage to be positively associated with the level of disclosure in the USA, but negatively associated with it in Germany. Here, we measure leverage using the *debt/equity ratio*. To account for the variability of disclosure due to the degree of risk faced by banks, we also use two specific variables strictly linked to *bank risk-weighted assets* (*tier 1* and *tier 2* capital ratios), as well as using external ratings. We took the values of tier 1 and tier 2 from the mandatory reports. We also verified the presence of an external rating in the mandatory reports, and its score. In addition, we analysed *liquidity*, which is generally used to assess the capacity of firms to meet their short-term financial obligations. As a proxy for liquidity, we retrieved quantitative information on credit, classified according to the Bank of Italy's instructions, as past due, grounding, restructuring and outstanding.

As far as *governance features* are concerned, we verified the *listing status*, because the degree of disclosure is predicted to be greater the more the company relies on the equity market (Lopes and Rodrigues, 2007). Listed companies have lower monitoring costs alongside greater disclosure. Although banks belong to the same industry, we verify whether narrative risk disclosure varies among the three different typologies of banks as regulated by the Italian law on financial intermediaries (*Testo Unico Bancario*), namely Limited banks (*banca società per azioni*), Popular banks (*banche di credito popolari*) and Mutual Cooperative banks (*banche di credito cooperativo*). It is worth noting that the main differences concern ownership structure and the governance model used. Thus, we measured the *percentage of shares owned by the first two shareholders* (Lopes and Rodrigues, 2007). We also verified the corporate *governance model*, classified as *monistic, horizontal dualistic and vertical dualistic*. Beretta and Bozzolan (2004) highlighted the fact that corporate risk disclosure is still at the discretion of the *board of directors*, appearing more as a matter of voluntary disclosure than as a question of complying with regulations. Abraham and Cox (2007) specified that different types of board directors fulfill different functions, with both the number of executives and the number of independent directors being positively correlated with the level of corporate risk reporting. Thus, more disclosure may be expected from companies with a higher proportion of independent directors. We measured the *percentage of independent directors* and *members of the audit committee*. With respect to the Italian corporate governance regulations, we also verified the number of members of the *supervisory board*. Furthermore, since *high profile auditing companies* demand high levels of disclosure (Lopes and Rodrigues, 2007), we also use a dichotomous variable to signal whether or not the audit company belongs to the 'big 4'.

5. Results

The findings of the analysis are organised as follows. First, we examine the disclosure by risk factors; second, we compare the disclosure between the two reports examined on the basis of the above cited semantic properties, also focusing on the association between risk factors and semantic properties; third we assess the overall quality of risk disclosure, by employing a multidimensional measure for the two documents. In the end, we use a regression model for disclosure quality to find out what the bank-specific factors that influence the quality of disclosure are.

In the following tables we report the descriptive statistics for the risk factors for the notes to the financial statements (table 1*a*) and the public report (table 1*b*).

Table 1*a* - *Risk factors for the notes to the financial statements*

		Mean	SD	Range
	Total Disclosure	84.8	37.6	0 – 222
	Total Disclosure per content	14.3	6.27	0 – 37
Content				
	Credit Risk	69.1	36.1	0 – 205
	Exchange Risk	6.3	4.5	0 – 25
	Interest Rate and Price Risk	39.4	26.9	0 – 124
	Liquidity Risk	18.0	17.1	0 – 100
	Operational Risk	16.2	11.4	1 – 58
	Securisation	22.5	30.2	0 – 136

Table 1 *b* - *Risk factors for the public report*

		Mean	SD	Range
	Total Disclosure	204.5	129.1	30 – 598
	Total Disclosure per content	20.5	12.9	3 – 60
Content				
	Risk mitigation techniques	15.0	7.5	0 – 26
	Securitization transactions	11.4	3.9	0 – 16
	Equity exposures	85.5	60.7	0 – 341
	Credit risk: general disclosures	4.7	1.3	0 – 7
	Credit risk: disclosures for portfolios treated under IRB approaches	2.0	6.1	0 – 27
	Credit risk: disclosures for portfolios treated under the standardised approach	9.2	3.0	0 – 15
	Counterparty risk	14.0	3.4	8 – 22
	Market risks Exchange risk and commodity risk	1.3	5.3	0 – 25
	Operational risk	5.6	1.8	0 – 12
	Interest rate risk on positions in the banking book	11.4	3.9	0 – 16

In general, what should be noted observing the tables above is that, from a merely quantitative point of view, as the total disclosure per content index reveals, Italian banks devote more effort to the presentation of the information on risks required for the public report (on average 20.5 sentences per content) compared with those reported in the notes to financial statements (on average 14.3 sentences per content).

However, looking at the two tables separately, with regard to the notes to financial statements, it is worth noting that the more relied upon risk factors are Credit Risk (69.1 sentences on average), Interest rate and Price Risk (39.4 sentences on average) and Securitisation (22.5 sentences on average). Focusing on the public report, the majority of the information aims to explain the issues related to Equity exposures (85.5 sentences on average).

On the other hand, table 2 (below) allows us to compare the disclosure in the notes to the financial statements and in the public report on the basis of its semantic properties, to get a more comprehensive idea of the characteristics of the information reported in the two documents.

Table 2 - Comparison between the notes and the public report

		Notes to the Financial Statements			***Public Report***			**T test**
		Mean	**SD**	**Range**	**Mean**	**SD**	**Range**	**P-value**
Semantic Properties								
Time frame	*Historical*	1.9	2.7	0 – 13	1.4	4.7	0 – 47	0.496
	Future	0.3	1.5	0 – 11	0.2	0.6	0 – 3	0.396
	Intertemporal	13.1	6.8	0 – 39	20.9	15.1	5 – 72	<0.001***
Economic Sign	*Negative*	0.1	0.4	0 – 2	2.3	2.1	0 – 15	<0.001***
	Equal	9.2	7.3	0 – 41	37.0	21.8	3 – 133	<0.001***
	Positive	5.6	5.7	0 – 24	5.7	9.8	0 – 48	0.987
Type of Measure	*Financial*	12.5	6.6	0 – 41	6.2	10.1	0 – 49	<0.001***
	Not Financial	13.7	6.3	0 – 40	38.8	22.3	5 – 135	<0.001**
Nature	*Quantitative*	12.6	7.1	0 – 43	42.6	25.8	5 – 135	<0.001***
	Qualitative	0.0	0.0	0 – 0	0.1	0.2	0 – 1	----
	Mixed	2.3	3.7	0 – 18	2.8	9.1	0 – 47	0.721
Outlook orientation	*Hypotheses on Expectation*	0.7	1.8	0 – 13	2.9	5.8	0 – 27	0.007***
	Programs	1.3	2.9	0 – 15	0.2	0.7	0 – 4	0.002***
	Actions or decision taken	8.1	6.6	0 – 24	6.9	9.9	0 – 51	0.441

	Actual state	3.3	1.8	0 – 14	36.7	23.7	3 – 133	<0.001***

Slightly significant 0.05 < p ≤ 0.1; **Moderately significant 0.01 < p < 0.05; * Strongly significant p < 0.01.*

Concerning the time frame, both documents are affected by the prevalence of intertemporal information. In particular, the *p-values* highlight a strongly significant difference between the two reports considered, with more information disclosed in the public report.

Also the p-values regarding the economic sign confirm the greater attention to the information disclosed in the public report. In both cases, however, there is a preference to disclose equal information.

Moreover, while the amount of positive information is almost the same within the different documents, it is possible to identify a highly significant difference between the two reports, with more negative information disclosed in the public report rather than in the notes to financial statements.

With reference to the type of measure, the two documents appear quite different, with the public report more prone to provide non-financial information.

In terms of the nature of the information, there is a prevalence of quantitative disclosure, with a significant difference between the amount of information delivered in the notes to financial statements (on average 12.6 sentences) and in the public report (on average 42.6 sentences).

In the end, concerning the outlook, the majority of the disclosure is focused on the actual state in the case of the public report, and on the actions/decisions taken in the notes to the financial statements.

Significant differences can be detected between the reports in relation to the four items considered, with the public report divulging a greater amount of disclosure for all of them, except for the actions/decisions taken.

In addition, in the following tables (3a and 3b; 4a and 4b), the relationship between risk factors and the economic sign as well as the type of measure is analysed. What emerges is an evident association in both cases (the Exact Chi-square test of association is statistically significant at the 1% level).

Table 3*a* - *Risk factors by type of measure for the notes to the financial statements*

	Type of Measure		
Risk Factors	*Financial*	*Non financial*	*Total*
Credit Risk	653 49,6%	664 50,4%	1317 100%
Exchange Risk	20 5,9%	318 94,1%	338 100%
Interest Rate and Price Risk	50 28,4%	126 71,6%	176 100%
Liquidity Risk	15 27,3%	40 72,7%	55 100%
Operational Risk	4 7,0%	53 93,0%	57 100%
Securisation	28 71,8%	11 28,2%	39 100%
Statistics	*df*	*Value*	*P-value*
Exact Chi-square	5	271.47	<0.001***
Cramer V		0.14	

Slightly significant 0.05 < p ≤ 0.1; **Moderately significant 0.01 < p < 0.05; * Strongly significant p < 0.01.*

Table 3*b* - *Risk factors by type of measure for public report*

	Type of measure		
Risk factors	*Financial*	*Nonfinancial*	*Total*
Risk mitigation techniques	1 0.5%	198 99.5%	199 100%
Securitization transactions	269 39.3%	416 60.7%	685 100%
Equity exposures	15 1.1%	1387 98.9%	1402 100%
Credit risk: general disclosures	0 0.0%	62 100.0%	62 100%
Credit risk: disclosures for portfolios treated under IRB approaches	0 0.0%	25 100.0%	25 100%
Credit risk: disclosures for portfolios treated under the standardized approach	0 0.0%	123 100.0%	123 100%
Counterparty risk	118 52.7%	106 47.3%	224 100%
Market risks Exchange risk and commodity risk	1 5.6%	17 94.4%	18 100%
Operational risk	5 6.5%	72 93.5%	77 100%
Interest rate risk on positions in the banking book	0 0.0%	151 100.0%	151 100.0%
Statistics	*df*	*Value*	*P-value*
Exact Chi-square	9	941,64	<0.001***
Cramer V		0.56	

Slightly significant 0.05 < p ≤ 0.1; **Moderately significant 0.01 < p < 0.05; * Strongly significant p < 0.01.*

The above tables (3a and 3b) allow us to assess the association between risk factors and type of measure for the two documents.

With reference to the notes to the financial statements, there is a strong preference for non-financial information for all the risk factors, with the only exception of disclosure on securitisation, which is mainly financial. Also regarding the public report, it is possible to recognise a focus on non-financial information for all the risk factors considered, except for the disclosure on counterparty risk, which is characterised by a prevalence of financial information.

Table 4a - Risk factors by economic sign for the notes to the financial statements

	Economic Sign			
Risk factors	*Negative*	*Equal*	*Positive*	*Total*
Credit Risk	3 0.4%	446 64.5%	242 35.0%	691 100%
Exchange Risk	2 2.2%	60 65.9%	29 31.9%	91 100%
Interest Rate and Price Risk	10 6.0%	120 71.4%	38 22.6%	168 100%
Liquidity Risk	0 0.0%	20 36.4%	35 63.6%	55 100%
Operational Risk	2 3.6%	24 43.6%	29 52.7%	55 100%
Securisation	1 2.8%	25 69.4%	10 27.8%	36 100%
Statistics	*df*	*Value*		*P-value*
Exact Chi-square	10	65,72		<0.001***
Cramer V		0.03		

Slightly significant 0.05 < p ≤ 0.1; **Moderately significant 0.01 < p < 0.05; * Strongly significant p < 0.01.*

Table 4b - Risk factors by economic sign public report

	Economic Sign			
Risk factors	*Negative*	*Equal*	*Positive*	*Total*
Risk mitigation techniques	3 1.5%	156 79.2%	38 19.3%	199 100%
Securitization transactions	23 3.3%	372 53.2%	304 43.5%	685 100%
Equity exposures	0 0.0%	1389 99.8%	3 0.2%	1402 100%
Credit risk: general disclosures	0 0.0%	61 96.8%	2 3.2%	62 100%
Credit risk: disclosures for portfolios treated under IRB approaches	1 3.6%	25 89.3%	2 7.1%	25 100%
Credit risk: disclosures for portfolios treated under the standardized approach	0 0.0%	123 100.0%	0 0.0%	123 100%
Counterparty risk	123 53.0%	99 42.7%	10 4.3%	224 100%
Market risks Exchange risk and commodity risk	0 0.0%	16 94.1%	1 5.9%	18 100%
Operational risk	0 0.0%	67 94.4%	4 5.6%	71 100%
Interest rate risk on positions in banking book	3 2.1%	131 91.0%	10 6.9%	151 100.0%
Statistics	*df*	*Value*		*P-value*
Exact Chi-square	18	2051,62		<0.001***
Cramer V		0.59		

Slightly significant 0.05 < p ≤ 0.1; **Moderately significant 0.01 < p < 0.05; * Strongly significant p < 0.01*

The other tables (4a and 4b) provide other relevant evidence for the association between risk factors and economic sign in the two documents. In this regard, the notes to financial statements mainly show neutral information for all the risk factors considered, except for liquidity risk and operational risk, whose disclosure is mainly based on positive results. On the other hand, the results for the public report show that information is mainly neutral for all the risk factors, but not for the counterparty risk, which in the majority of cases is reserved for disclosing “bad news”.

Apart from the issues relating to the amount and semantic properties of the information provided by Italian banks, we also attempted to assess the quality of the disclosure, from the perspective of the dimensions of relative quantity, density, depth, and outlook profile. In this regard, it is worth remembering that the four indices obtained from the analysis of the two documents were standardised according to Eq. (5) and the quality index was calculated from their arithmetic mean. The following table (5) shows the descriptive statistics of the four standardised components used to assess the quality of the disclosure, and the overall quality index.

Table 5 - *Normalised indices for assessing the quality of risk disclosure*

Risk disclosure charachteristics	N	Mean	SD	Range	N	Mean	SD	Range	*P*-value
Quantity	66	0.385	0.168	0 – 1	66	0.395	0.199	0 – 1	0.766
Density	66	0.566	0.215	0 – 1	66	0.393	0.203	0 – 1	<0.001***
Depth	66	0.441	0.187	0 – 1	66	0.738	0.142	0 – 1	<0.001***
Outlook profile	66	0.390	0.179	0 – 1	66	0.351	0.145	0 – 1	0.180
Quality	66	0.446	0.097	0.000 – 0.632	66	0.469	0.104	0.254 – 0.778	0.191

Slightly significant 0.05 < p ≤ 0.1; **Moderately significant 0.01 < p < 0.05; * Strongly significant p < 0.01.*

What emerges is that with reference to the indices for the relative quantity and the outlook profile, the analysed documents do not significantly differ from each other.

However, the density of disclosure is significantly higher within the notes to the financial statements (56.6%) than in the public report (39.3%) where the disclosure on risks is more diluted. On the contrary, in terms of depth, the findings for the public report show a higher degree of depth (73.8%) than the notes to the financial statements. Moreover, what should be noted, is that the overall quality index does not significantly differ between the two documents, but is a little higher for the public report (46.9%) than for the notes (44.6%).

At this stage, it is important to verify to what extent the proposed index for quality of the documents depends on the factors identified in the literature as drivers of disclosure. The results of the regression models are presented in table 6.

Table 6 - *Regression model for disclosure quality*

	Notes to financial statements				***Public Report***			
	Parameter	*Standard Error*	*P-value*		*Parameter*	*Standard Error*	*P-value*	
Intercept	0,764	0,123	<0,001	***	0,457	0,073	<0,001	***
Auditors type: Big 4	0,023	0,052	0,329		0,101	0,058	0,043	**
Bank Type: Cooperative	-0,071	0,040	0,039	**	0,095	0,043	0,015	**
Governance: Traditional model	-0,237	0,082	0,003	***	0,037	0,063	0,281	
Number of Independent directors	0,023	0,021	0,139		-0,134	0,109	0,112	
Leverage	-0,004	0,004	0,180		-0,008	0,005	0,057	*
Listing status: listed	0,062	0,037	0,050	**	0,045	0,047	0,171	
Number of members of the supervisory body	-0,013	0,004	0,001	***	-0,010	0,004	0,007	**
Rating: A	-0,018	0,035	0,304		0,091	0,037	0,008	**
ROE	0,001	0,001	0,093	*	-0,127	0,092	0,086	*
Tier 1	0,017	0,007	0,013	**	0,001	0,003	0,370	
	df	*F stats*	*P-value*		*df*	*F stats*	*P-value*	
Model	10	10.342	<0.001	***	10	8,319	<0,001	***
Error	45				54			
Total	55				64			
Adjusted R^2			0.453				0.365	

With reference to the notes to the financial statements, the findings show that quality increases as the ROE and TIER 1 increase and if the company is listed. However, the quality decreases if the banks adopt the traditional corporate governance model, if the number of members in the supervisory body increases, and also when they belong to the cooperative type. On the other hand, referring to the public report quality increases if the banks are rated A, if the auditor is one of the Big 4, and if the bank belongs to the cooperative type.

However, quality decreases as the ROE increases, if the number of members in the supervisory body increases, and as the leverage increases. What is interesting to highlight here is that despite the quality indices for the two documents not differing significantly (see table 5), there are different reasons for such levels of quality in the two reports. Also, it is worth emphasising that the regression model is able to explain a substantial part of the quality of disclosure.

On the basis of the previous results, the **HP1a** (*the characteristics of narrative risk disclosure in the mandatory categories will differ* in *the notes to the financial statements and the public report*) is confirmed. Indeed, the two documents show peculiar semantic properties which, especially in relation to the type of measure and the economic sign, are also significantly associated with specific risk factors.

With regard to the overall quality index there is no substantial difference, and **HP1b** (*The quality of narrative risk disclosure will differ* in *the notes to the financial statements and the public report, and this depends on the different characteristics of the information for the mandatory categories)* is not confirmed. In this regard, one could argue that there is no point in bothering banks to provide additional disclosure and to comply with two different requirements if there is no substantial difference in the degree of quality (and usefulness) of the information.

However, insofar as we consider the single elements of the index, what emerges is that the density of disclosure is significantly higher within the notes to the financial statements than in the public report, while in terms of depth, the findings for the public report show greater depth than to the notes to the financial statements. This intuitively depends on the characteristics of the information in the different mandatory categories and, above all, signals a kind of complementarity between the two documents, which arguably serve two different purposes in terms of usefulness and (real) primary users.

The **HP2a** *(the quality of the narrative risk disclosure is associated with profitability*) is confirmed, but the profitability measure (ROE) shows mixed effects on the quality of the two documents considered. This is quite intuitive in the notes and in line with the previous results (Linsley *et al.*, 2006), which support the idea that banks that better manage risks have higher relative profitability, and wish to signal their superior ability to the market. On the contrary, the profitability measure has a negative effect on the quality of the public report.

Arguably, this is because if performance decreases, the management is encouraged to provide deeper explanations and a higher level of quality of narrative disclosure in the *ad hoc* risk report so as to indirectly justify the lower performance shown in the financial statements, and to clarify that this is not related to a change in the level of bank riskiness.

With reference to **HP2b** (*the quality of the narrative risk disclosure is associated with measures of risks*), the results confirm the hypothesis and show coherent effects on the level of quality in the narrative risk disclosure in relation to the two documents. However, what should be noted, is that different risk measures have an impact on the quality of the information delivered in the notes to the financial statements and in the public report. As far as the first is concerned, TIER 1 positively influences the quality of disclosure probably because, as previously emphasised for the profitability measure, a high TIER 1 is a positive sign in terms of protection against unexpected loss, and the bank wishes to signal its superior ability to the market. With regard to the public report, the effect that the variable *Leverage* shows can be interpreted in the light of the fact that when it increases, the management is willing to deliver more accurate information and a higher level of quality of narrative disclosure in the *ad hoc* risk report to indirectly justify the higher leverage. Consistently, when the *External Rating* that is obtained is A, the management is highly motivated to further captivate the attention of the Rating Agencies and to further convince them of the positive situation of the bank, in order to preserve its rating. Notably, the best place to provide information to serve this aim is the *ad hoc* risk report.

In regard to **HP2c** (*the quality of the narrative risk disclosure is associated with governance features*), the results confirm the hypothesis. In particular, it should be noted that the banks audited by one of the Big4 are more prone to provide higher quality information in the public report. This, in line with the above reasoning, is probably because the management privilege the *ad hoc* risk report to deliver all the information that the auditor can regard as useful for the assessment of the internal control system on which, by law, they have to express a judgement in addition to their audit function. Indeed, although the public report is not subject to audit, since this document results from the risk management system of the bank, debatably the quality of the public report is a proxy to evaluate the quality of the internal control system.

Consequently, those banks audited by one of the Big4 can rely on the *ad hoc* risk report to indirectly signal their abilities in managing risks in order to get better judgments regarding their internal control system. Moreover, as already highlighted, if the bank is a cooperative, the quality of the public report increases, but the quality of the notes to the financial statements decreases. This countervailing effect needs further explanations. In particular, one could argue that this is related to the legal and statutory requirements that characterise this type of bank in Italy. These kinds of bank are not listed and operate within a three-level network (local, regional and national), managed at the national level by *Ferdercasse*. A characteristic feature is that the network provides supervision and support for the cooperative banks, which carry out their activities mainly for their members. They are strongly rooted in the territory and aim to contribute to the economic, social and environmental development of the local community. Also, these banks cannot invest in speculative projects and are driven by principles of mutuality. It is worth noting that, as the Bank of Italy has recently recognised, the cooperative banks usually have good internal control systems, thanks to the cited systemic and networking relationships that characterise their model. Accordingly, and in line with the above discussion, it is reasonable to expect that disclosure on risk is provided with a greater degree of quality in the *ad hoc* risk report, rather than in the notes to the financial statements, because the former benefits in terms of its structure and object from the good quality of the internal control system that the networking relationships of the cooperative banks are able to ensure.

In corroboration of the previous results, listed banks tend to disclose high quality information on risk in the notes to the financial statements in order to signal to the financial markets and investors their superior ability in managing risk.

With reference to the governance, model the findings show that the quality of risk disclosure in the notes to the financial statements decreases if banks adopt the traditional governance model. This can probably be interpreted by taking into account the fact that in the banks that switched to the other governance models, there is stronger supervision on the board of directors that, consequently, wish to signal through the financial statements its superior ability in managing risks with positive effects on performance.

In the end, for both documents, there is a negative effect on the quality of information if the number of the members of the supervisory body increases. What can be argued is that when the bank perceives deficiencies and weaknesses in its internal control system, it can try to hide this situation by employing an increasing number of subjects in the supervisory body.

However, the presence of a greater number of individuals cannot solve the problems relating to the cited weaknesses of the internal control system, which are consequently reflected in a lower quality of information.

6. Conclusions

This paper has examined the issues relating to mandatory narrative risk disclosure, moving from the criticisms raised over the last few years by many academics and practitioners, sharing the view that current risk disclosure is inadequate and not useful for decision-making. In our view this topic deserved further attention to understand better the reasons why risk disclosure looks less useful than it ought to be. The peculiarities of the Italian banking sector regulation lead us to examine the banks' risk disclosure focusing on the differences between the notes to the financial statements and the public report. This allowed us to have a more comprehensive idea of the impact that discretion permitted by current regulation has on risk disclosure and its quality.

Our findings show that although Italian banks formally comply with the Bank of Italy's instructions, there is room for them to choose the characteristics of the information, with undeniable effects not only on the quantity of the disclosure provided in each report and for each risk factor, but above all, in terms of quality. In this regard, our findings help to elucidate these aspects by highlighting what are the bank-specific factors that explain the different degree of quality between the reports.

The interesting aspect to underline is that despite the different semantic properties of disclosure in the two reports – a natural consequence of the content of regulation – nevertheless, the degree of quality is almost the same, and certainly not completely satisfactory.

A possible reason for the poor quality can be ascribed to the existence of overlaps of the two competing regulations that, despite requiring different information to satisfy specific aims, request the preparation of two different reports on the same risks and risk factors. This creates the premises to push banks to provide different information, in different ways, and in different reports, looking for expected possible benefits.

It is worth noting, that the interpretation of our results needs to encompass a broader perspective, taking into account the issues related to the need for a more coordinated effort by regulators, to possibly limit such overlaps, with the aim of avoiding banks to promoting a report or a section to the detriment of specific requirements, and opting for risk disclosure characteristics that mask their own risk profile. In addition to the above-mentioned overlaps, the low quality of disclosure, rendering it less useful than it ought to be, may also be explained with reference to some gaps (in terms of degree of detail or source of information) in the regulatory requirements, that need to be carefully heeded by regulators.

In this view, we can conclude that the significance of this study goes beyond the debate taking place in the academic arena, since it can be largely relevant for those responsible for setting international and national accounting standards, the Basel Committee on Banking Supervision, and the domestic supervisory authorities, particularly concerning the possible introduction of requirements that are more explicit and detailed than the existing ones. Yet it is also important for those who prepare and audit financial reports, who may benefit from the deeper understanding needed to comply with current mandatory requirements.

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CHAPTER 3

Enterprise Risk Management in local banks: a case study

Chapter 3

Enterprise Risk Management in local banks: a Case Study

ABSTRACT

Purpose: The aim of this research is to explore how Enterprise Risk Management (ERM) can lead businesses to achieve their economic and social purposes. In order to focus this analysis, we are going to look at the credit cooperative banking sector, which is especially conducive to social and responsible business conduct.

***Design**:* To deepen our understanding of how such banks can deal with risk issues, we provide an in-depth study of one credit cooperative bank.

***Findings**:* This research shows how ERM practices enable credit cooperative banks to make profits by supporting the economic and social development of local territories.

Value: This research provides both a theoretical contribution and practical contribution, addressing new trends in enterprise risk management and giving some insights for similar banks on how to manage risk to achieve the growth of the local community.

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

1. Introduction

During the last few years an increasing number of voices have urged that we pay more attention to business ethics in international business, on the grounds that not only are all large corporations now internationally structured and thus engaging in international transactions, but that even the smallest domestic firm is increasingly buffeted by the pressures of international competition (Barbu and Vintilà, 2007). This approach is necessary at present because calls have been made for the introduction of ethical consideration into firms' activities as well as in their decisions making processes (de Graaf, 2006). To this purpose, the market must have the ability to transmit ethical demands to firms and to do so, two conditions must be met: individuals who have an ethical concern must take part in the market and have sufficient resources to transmit a clear and strong message to firms (Brickley et al., 2002). In this regard, it has been argued that the banking system could fulfil these two conditions and can generate ethical engagements, not only for itself and for its customers, but also for society through achievement of social purposes (de La Cuesta-Gonzàlez et al., 2006)

However, the recent financial crisis has shown relevant failures of traditional large banks (Linsley and Slack, 2012), revealing substantial weaknesses in their enterprise risk management [ERM henceforth] practices (Paape and Speklè, 2012; Magnan and Markarian, 2011; Power, 2009). It has to some extent damaged consumer confidence and levels of trust in business (European Commission, 2011). As a result, there is an increasing demand for fully integrating social and ethical values into enterprise risk management practices, in order to strengthen the holistic system for managing uncertainty as well as increasing the stakeholder value protection. This call for increasing attention to international business ethics and Enterprise Risk Management Practices has been answered by a slowly growing collection of academic (Demidenko and Mc Nutt, 2010; Weitzner and Darroch, 2010) and practitioners (Institute of Internal Auditors, The Global Association of Risk Professionals, the Institute of Risk Management), who have begun to address issues in this field.

It should be noted that, despite a growth in the interest paid to the issues of business ethics and holistic risk management practices, there is a lack of description about the relationship between business ethics and Enterprise Risk Management in practice. Does business ethics support ERM or does ERM support business in pursuing ethical purposes?

The aim of this research is to explore how ERM can lead businesses to achieve social and ethical purposes. In order to focus this analysis, we are going to look at the mutual credit cooperative banking sector, which is especially conducive to ethical and responsible business conduct (European Commission, 2011). Mutual credit cooperative banks are a particularly suitable basis for studying the relationship between business ethics and ERM due to the fact that they aim to achieve strong social purposes. Recent literature defines such banks as “ethical banks” (San Jose et al. 2011) since they have a twofold purpose: as financial intermediaries, they have to achieve an economic profitability to meet the members’ needs but, at the same time, they operate to promote social development of the local community. To this end, they have to provide funding to local businesses, which are frequently more risky than firms that large banks are prepared to fund.

To deepen our understanding of how such banks can deal with risk issues and how ERM can be organized in order to balance the need for funding small businesses (usually quite risky) and the need to promote the economic and social development of local community, we provide an in-depth study of one mutual credit cooperative bank.

The reminder of the paper is structured as follows. Section 2 elucidates the conception of business ethics that we adopt for the purposes of our analysis. Section 3 assesses prior research on the issues related to business ethics and ERM. Section 4 describes the research method. Section 5 focuses on the case study. The last section concludes the study and discusses the implications of the analysis, addressing some further developments.

2. Conception(s) of Business Ethics

This section aims to clarify how business ethics is conceived and to elucidate the conception of business ethics that we adopt for the purposes of our analysis. Hence, the ambition is not to provide an exhaustive and comprehensive review of the different conceptions of business ethics, but our goal is simply to outline briefly the notion of ethics to which we refer.

In this regard, despite the significant growth in attempts to formalize or, more accurately, state what business ethics means, there is no unique and commonly accepted definition of ethics. Furthermore, the issues related to the practical fulfilment of ethical values are still vague, and therefore how business ethics practically works within organizations still remains in question.

What should be noted is that the vagueness of the concept of business ethics has lead to a number of contributions over the years. Some people define business ethics as an element embraced in the broader conception of Corporate Social Responsibility (CSR), linking the concept of business ethics with the issues of CSR (see for example Carroll, 1999; Epstein, 1987; Votaw, 1972; Garriga and Mele, 2004; de la Cuesta-Gonzàles et al., 2006). In this regard, the European Commission states that '*to fully meet their corporate social responsibility, enterprises should have in place a process to integrate social, environmental, ethical, human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders, with the twofold aim of maximizing the creation of shared value for their owners/shareholders and for their other stakeholders and society and identifying, preventing and mitigating their possible adverse impacts* (European Commission, 2011). Carroll specifies that "*the social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time"*. He also states that ethics is not inconsistent with the logic of economic profit as profitability is a *conditio sine qua non* for business, in order to ensure its efficiency and effectiveness. In this perspective, the legal requirements represent '*the rules for the game'*, while the '*ethical responsibility*' is the kinds of behaviors and ethical norms that society expects businesses to follow, and this encompass behaviors and practices that are beyond what is simply required by the law. Likewise, Garriga and Melè (2004) in their study aimed at mapping CSR theorizing, identify among other things a group of "ethical theories", based on the ethical responsibilities of corporations to society (such as the Common Good approach, the Stakeholder theory, The Human Rights approach and Sustainable Development), which they regard as useful in providing foundations for the concept(s) of CSR.

However, a different strand of literature (San Jose, 2011; Viganò and Nicolai, 2006; Choi and Jung; 2008; Bowie; 1999) has highlighted that business ethics should not be considered as merely a component of CSR, because it is a much broader concept. In this regard, it has been argued that the ethical nature of entities goes further than the conception of Corporate Social Responsibility.

CSR can be referred at as a "*self-regulating mechanism whereby companies integrate ethical, social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis*" (European Commission, 2011). This implies that, in some cases, socially responsible entities may direct their activities towards the achievement of social and ethical concerns. However, it does not necessarily imply a specific ethical commitment around decision making-process. In this regard, it has been argued (Arthur et al., 2007) that the problem of CSR lays in the fact that it is too often played out on the periphery of companies where it cannot influence the profit-driven decision making of the core business. On the contrary, the ethical nature of entities is strictly related to the existence of a direct ethical commitment within the organization, which is able to pervade all the aspects in the decision-making processes. Business ethics meets firms' activity not only in their actions, but also in the actions of their subsidiaries and significant partners (San Jose et al., 2011).

For the purposes of our analysis, we are going to refer to this latter strand of literature in approaching our discourse on business ethics because it fits more closely with the social and ethical purposes of mutual credit cooperative banks. That is, we regard business ethics as something that goes beyond the corporate social responsibility of the entity, by permeating the culture of the entity itself and every operation carried out, as it is consistent with the way in which ethical banks view their purposes.

However, the nature of business ethics is not well defined in literature. The concept of business ethics is frequently related to the ethical values of the managers involved in decision-making process. Some authors argue that business ethics is concerned with the moral philosophy, values and norms of behaviour that guide a corporation's behaviour within society (Francis and Armstrong, 2003). Parker (1998) defines the end-point of business ethics as the moment where judgments are translated into some kind of practices: this is the point where ethics can determine behaviour. In this regard, different lists of ethical values have been provided (see Francis and Armstrong, 2003). However, it has been argued that ethical principles are not universally constituted across time and space (Neimark, 1995) but they should be adaptable in any situation irrespective of its complicated or inflexible nature (McNutt and Batho, 2005).

In order to provide a philosophical underpinning, we mainly build our conception of business ethics on the idea that businesses do not need an "ethics of their own" (Moriarty, 2005), since business ethics has a solid foundation in political philosophy. Indeed, it has been argued that the central problems of political philosophy mirror the central problems of business ethics and, in this view, businesses can draw on principles already constructed by political philosophers, suitably adjusted for the differences in voluntariness and toughness between states and business (Moriarty, 2005).

Accordingly, our main reference is the revision of the Kantian approach[4] provided by Bowie (1999), who highlighted the rich implications that Kant's moral philosophy has for business practice. In Kantian terms we can view profits as a consequence of good business practices (from a broader perspective) rather than as the goal of

[4] Kant regarded the "categorical imperative", intended as a requirement of reason binding on all rational beings, as the fundamental principle of ethics. Although Kant spoke of "the" categorical imperative, he formulated it in many ways. Most commentators focus on three formulations:
1. Act only on maxims, which you can will to be universal laws of nature.
2. Always treat the humanity in a person as an end, and never as merely a means.
3. So act as if you were a member of an ideal kingdom of ends in which you were both subject and sovereign at the same time.
Kant believed that only human beings can follow laws of their choosing (i.e. act rationally). Human beings are the only creatures that are free, and it is the fact that we are free that enables us to be rational and moral. The ethical person is the person who acts from the right intentions. We are able to act in this way because we have free will. (Bowie, 1999)

business. The main idea is that attention to issues other than profits (e.g. a meaningful work for employees, a democratic work place, non-coercive relationship with suppliers, meeting with social needs) paradoxically has the potential to enhance the profits: i.e. profits can be enhanced if a manager focuses on respecting the humanity of all the stakeholders.

Therefore, we refer to the framework developed by Bowie in order to apply Kantian ethics to the organizational design of a business firm. This framework is informed mainly by the following principles (1999):

1. The business firm should consider the interests of all the affected stakeholders in any decision it makes.

2. The firm should allow those affected by the firm's rules and policies to participate in the determination of those rules and policies before they are implemented.

3. It should not be the case that, for all decisions, the interests of one stakeholder automatically take priority.

4. When a situation arises where it appears that the interests of one set of stakeholders must be subordinated to the interests of another set of stakeholders, that decision should not be made solely on the grounds that there are a greater number of stakeholders in one group than in another.

5. No business rule or practice should be adopted which is inconsistent with the first two formulations of the categorical imperative. (Each member of the organization stands in a moral relationship to all the others and the managers of a business firm should respect the humanity in all the persons in the organization)

6. Every profit-making firm has a limited, but genuine, duty of beneficence.

7. Every business firm must establish procedures designed to ensure that relations among stakeholders are governed by rules of justice.

This set of principles, derived by Bowie (1999) for applying the Kantian ethics to businesses, provides the basis on which we will discuss the case study later in the paper.

3. Enterprise Risk Management: an overview

Enterprise Risk Management is defined as "*a process, affected by an entity's board of directors, management and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives*" (COSO, 2003:6). According to Mikes (2009), this definition of ERM sounds very similar to the widely used definition of management control provided by Antony (1965). In particular, due to the emphasis on the strategic features and purposes of ERM, it can be regarded as a strategic management control system, which helps an entity to get to where it wants to go and to avoid pitfalls and surprises along the way (Collier, 2009). It should be noted that *the premise of enterprise risk management is that every entity exists to provide value for its stakeholders. All entities face uncertainty, and the challenge for management is to determine how much uncertainty to accept as it strives to grow stakeholder value* (COSO ERM, 2004). In order to increase value for their stakeholder, it has been argued that businesses today need to fully integrate ethical and social values into their risk management practices (European Commission, 2011).

In this regard, the existing literature on ERM has emphasized the importance of the internal environment for the appropriate implementation of an ERM system in a particular organization (Gordon et al, 2009; COSO ERM 2004) and that this is very likely to vary from firm to firm. The suggestion that there is no universally ideal ERM system is quite intuitive and has been suggested elsewhere (e.g., The Financial Reporting Council's Report, 2005; Beasley et al., 2005; Moeller, 2007). In this regard, a number of contributions have studied the details of enterprise risk management practices in specific organizational settings (Arena et al., 2010; Mikes, 2009; Wahlstrom, 2009; Woods, 2009). It has been argued that, for an effective ERM, companies must look beyond the technology and establish a culture of risk management throughout the organization, permeating its existing practices and the individual behavior of managers in everyday decisions (Mikes, 2011). For instance, Arena et al. (2010), emphasizing the "context specific" and "highly organizationally dependent" nature of enterprise risk management, have confirmed the continually evolving mutual interaction between ERM and other pre-existing risk management practices. Woods (2009) reports significant variety at the operational level of the ERM system within a single large public sector organisation. With particular reference to the banking sector, Mikes (2009), through the analysis of two large banks, concludes that systematic variations in ERM practices exist, even within a single industry setting.

After the recent financial crisis, banks need to strengthen their risk management practices taking into account social and ethical needs in order to support sustainable development and to improve stakeholder value protection (Magnan and Markarian, 2012). However, despite calls having been made for more responsible behaviour by financial institutions (European Commission, 2011), there is a lack of descriptions of how banks operationalize enterprise risk management practices in order to achieve their economic, social and ethical purposes.

It is widely accepted that Enterprise Risk Management is a key component of corporate governance (Demidenko and Mc Nutt, 2010). It provides a means of attaining an entity's objectives by monitoring performance of (say) an agent by a principal and assuring that the principal's (i.e., the stakeholder) interests are met via the diligent and efficient behaviour of the agent (the entity). 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 (COSO ERM, 2004; Nocco and Stulz, 2006). To respond to this challenge, many organizations are appointing a member of the senior management team to oversee the enterprise's risk management process. Some authors such as 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 a direct reporting line to the chief executive officer or chief financial officer. Senior management leadership of ERM helps to 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, nor that support for a mechanistic view on risk management is implicit in COSO's recommendations on risk appetite and tolerance. On the other hand, several semi-regulatory bodies (Casualty Actuarial Society Committee on Enterprise Risk Management 2003; Committee of Sponsoring Organizations of the Treadway Commission 2004) and professional associations (Institute of Internal Auditors, The Global Association of Risk Professionals, the Institute of Risk Management, European Commission) are trying to standardize and codify the so-called best practices and, in so doing, have emphasized the importance of a strong ethical commitment in the holistic management of risk. In this regard, the recent literature (e.g. Demidenko and McNutt, 2010; Drennan, 2004) has attempted to identify a link between corporate governance, ethics and ERM, considering ethics as a key element of corporate governance and highlighting that an effective ERM is based on the ethical governance of risk. They argue that Enterprise Risk Management is a key component of the ethics applied in corporate governance. This has developed into a philosophy to assist organizations within the process of protecting shareholders' value while also increasing the bottom-line profitability. However, the question of how organizations with a governance structure based on ethics 'do' Enterprise Risk Management still remains unanswered.

On the other hand, a number of 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 to managing all the risks confronting an organization, ERM is predicated to lower the firm's overall risk of failure and thus increase the performance and, in turn, the value of the organization (Gordon et al, 2009). In this regard, Gordon et al. (2009) 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. The purpose of the analysis in this paper is to clarify how ERM enables a particular kind of banks to achieve their performance and profitability targets. In particular, it has been argued (Demidenko and McNutt, 2010) that ERM represents a tool to ensure financial stability as well as to achieve social profitability. However, there is no in-depth analysis of how the ERM allows social banks to pursue their economic, social and ethical purposes.

Our analysis aims to answer the following research questions:

- ✓ How do credit cooperative banks operationalise ERM?
- ✓ How does the governance structure of credit cooperative shape ERM?
- ✓ How does ERM allow credit cooperative banks to pursue their economic and social purposes?

4. Research design

To address the research questions, we are going to look in detail at the specific case of a mutual credit cooperative bank in order to understand how business ethics shapes the practice of ERM (Ahrens and Chapman, 2007; Scapens, 1990).

We refer to the case of Banca di Credito Cooperativo (BCC) di Napoli, the main mutual credit cooperative bank within the Neapolitan region. Since this region is an underdeveloped area in a developed country, this case study is of relevant interest, aiming to deepen our understanding of how to encourage the economic and social growth in areas that need not only financial investment, but also social investments for their growth.

The analysis of the case study is based on both, the internal and the external environment of BCC di Napoli. Hence, we use internal sources (interviews with the managers and internal documents, not usually available to the public) and external sources (all reports published by the company, newspaper articles and other public coverage of the company).

As the primary source of information, we rely on interviews with the Chairman and the Board of Directors, since they are responsible for achieving the ethical purposes of the bank. We also rely on interviews with other top managers, i.e. the risk management team and with credit risk controllers, as they are directly involved in enterprise risk management processes. In addition, we interviewed 2 clients that have been closely involved in particular investment projects. In sum, we collected 20 in-depth interviews, each between two and two and a half hours in length. The following table 1 provides the list of interviewees.

Table 1: The interviews

INTERVIEWEES' FUNCTIONAL POSITION	NUMBER OF INTERVIEWEES FOR EACH POSITION
Chairman and Board of Directors	3
General Directors	2
Director of Legal & Compliance	1
Financial Accounting Division	1
Risk Controller	1
Risk Management team	3
Chief Credit Officer	1
Credit risk controller	2
Financial Officer	2
Department of Accountability and Transparency	1
Head of Branch	1
Clients	2

As there is no clear theoretical link between business ethics and ERM, we wanted to keep the interviews open and so we used semi-structured questions. These semi-structured questions provided a number of key topics to be discussed during the interview, rather than representing literal questions to be asked of interviewees. These interviews were used to gather information on the ethical principles of the bank, and how and to what extent these ethical principles can influence the banking activity. We also asked for information about the how this bank is able to balance economic profitability and social needs and, in doing this, the role played by ERM. The interviews were recorded and then transcribed for analysis. Telephone follow-up with the respondents was conducted where issues were unclear or missing.

During the interviews, we collected many relevant internal documents as well as specific data that would help us to learn about the risk management process, and corroborate the interview responses. These documents included a complete set of the procedures of BCC di Napoli, comprising, summaries of risk management procedures, strategic plans, and other related matters. Public information about the company was used as an additional source of information.

The following table lists the external and internal documents to which we referred.

Table 2: External and Internal documents

EXTERNAL DOCUMENTS	INTERNAL DOCUMENTS
Regulation of Credit Cooperation	Strategic Plans (2009-2015)
Chart of Values	Operational Plan
Chart of Cohesion	General Regulation Statement
Chart of Finance	Internal procedure on management of savings
Social Reporting of the Credit Cooperation *(Bilancio Sociale*	Riskiness Measure Report

e di Missione del Credito Cooperativo)	
Financial Statements 2011-2010	Internal procedure on lending process
Newspaper Articles (*Il Sole 24 Ore*)	Credit risk reporting
	Liquidity Monitoring
	Asset management and Liability Management Process
	Audit Plan

In order to collect other evidence we had the opportunity to attend some important corporate meetings, since one member of the research team is a member of the bank's Supervisory Committee. Attendance at such meetings allowed us to collect informal evidence on the corporate environment, and made us aware of personal relationships between the different members of the board. In this regard, it should be noted that we benefited from very good access to relevant information, as this bank wants to promote its practices and consequently people were not at all reluctant, but were very willing, to show how they work.

To avoid the bias that an individual researcher might bring to the study, we worked in a team in each step of the analysis. All researchers contributed to the definition of the key topics for the interviews. At least 2 members of the team were involved in each interview, if more than one interview had been arranged at the same time. As soon as possible the recordings were listened to, transcribed and then discussed by the team. Sometimes the researchers involved in the interviews provided the other members of the team with informal evidence and notes taken during the fieldwork. Differently, corporate meetings were attended by all the researchers. At the time, working notes were taken and, as soon as the meetings ended, they were converted into reports separately prepared by each member of the team.

The researchers organized the transcripts chronologically and discussed the interviews, summarizing the data, where possible, around the conception of business ethics provided in Section 2 and the relevant themes about ERM outlined in Section 3. The issues that were impossible to summarize in such themes were discussed separately and associated with one or more issues of broader interest.

5. CASE STUDY

5.1 Setting the context

Credit cooperative banks represent an integral and well-established part of the European financial system. Historically, the birth of credit cooperative banks in Europe was a response to the challenge of providing affordable loans to the emerging class of workers, shopkeepers and farmers with no or little collateral who had limited access to credit. Due to the fact that credit obtained from money lenders was often available only at exorbitant interest rates, the central idea of a cooperative credit institution was simple: the people excluded from the financial system had to be self-reliant. Credit was to be financed internally, i.e. by the group's collective savings. If external funds were needed, they were to be borrowed on the group's joint liability. However, the historical motivations related to the birth and the development of the credit cooperative banks still persist.

Over the last years, academics and practitioners have paid increasing attention to the issues of credit cooperative banks, focussing on their features and peculiarities. Some authors define such banks as "ethical banks", which aim to achieve both economic profitability and social profitability (San Jose et al, 2011: Barbu and Vintilã, 2007; Buttle, 2007; Thompson and Cowton, 2001). It has been argued (San Jose et al, 2011, Cowton 2010) that such banks, in achieving their economic and social purposes, builds their core business on the following three ethical principles, which represent the meeting point between traditional banking and business ethics (Viganò, 2001): *Affinity, Responsibility* and *Integrity.* The *Affinity* principle is based on investments that meet the interests of both shareholders and depositors and concerns the responsibility of the banks in decisions regarding the placement of the assets as well as the final destination of deposited funds. The *Responsibility* principle is about being accountable for consequences of the bank's behaviour for the local community as a whole. The *Integrity* principle, fostered by close proximity to customers, is related to the attempt to avoid financial exclusion, a phenomenon involving social categories such as immigrants, women, young and old people i.e. the so-called non-bankable people, to which credit is denied (Cowton, 2002). In this sense, the funding of groups not financed by the traditional banking system is a specific feature of the credit cooperative banks.

The International Cooperative Alliance (2007) defines credit cooperative banks as "*Autonomous associations of persons united voluntarily to meet their common economic, social, cultural needs and aspirations through a jointly-owned and democratically-controlled enterprise*". Such banks operate on the basis of their distinguishing features: economic and social purposes, mutuality, governance structure and democratic principle (Ayadi et al., 2010).

The first peculiarity of the credit cooperative banks is related to their twofold purpose: economic profitability and social profitability. These banks, as financial intermediaries, have to meet the members' needs to ensure economic profitability but, at the same time, they have the character of socially responsible entities with the aim of contributing to the development of communities and local areas. It means that economic profitability is one of the objectives of the bank, but it is not exclusive or even the primary objective. This position is described well in Christensen et al. (2004) and in Ayadi et al. (2010) as "dual bottom line" institutions indicating that cooperative banks need to generate profit in order to survive and expand, but that profit is not the sole or even primary bottom line objective. Likewise, Groeneveld and de Vries (2009) argued that "…cooperative banks claim that they do not aim to maximise short-term profits while healthy profitability is an important necessary condition for cooperative banks to safeguard their continuity, to finance growth and credit, and to provide a buffer for inclement times… profit is not a goal in itself". Clearly, credit cooperative banks need to be assessed in terms of their economic performance, since economic performance determines their ability to survive as financial institutions over the longer term. However, economic or financial performance cannot be the only standard of assessment, since economic or financial success is not an end in itself for any organisation. The financial objectives *of organisations* are merely the means for realising the ultimate objectives *of people*, and these are non-financial in nature (see Simon, 1952).

Cooperative banks operate on the basis of the mutuality principle. The mutuality principle represents a different way to make profits. The mutuality principle states that organizations have to provide services to their members on more favorable terms, through the comparative advantage of establishing trust (Kay, 2006). The mutuality principle aims to provide benefits to member/shareholder related to their membership rather than to achieve economic benefits. The special value of mutuality rests on its capacity to establish and sustain long-term relationships. In particular, it should be reflected in the company's constitution.

Credit cooperative banks are effectively owned and controlled by their local customers through the *membership concept*. Cooperative banks are owned by their members, who are private citizens and individual entrepreneurs who have a stake in the bank. However, a cooperative bank may have customers who are not members. In general ownership stakes in cooperative banks are not transferable. Members cannot sell their ownership stakes in an open secondary market, although in some cases they can sell them back to the bank. Exit is however possible through the repayment of the members' shares. Whilst there are exceptions, the almost exclusive source of capital for a cooperative bank is retained profits. These profits are retained within the bank and are added to reserves (capital) and dividends are generally not paid although members may sometimes be able to vote for a limited distribution of profits.

In order to align the banks' objectives with their members' interests, their governance is built on the democratic principle. Accordingly, the voting rights of the user-members are allocated in accordance with the 'one member, one vote' principle rather than in proportion to the size of ownership stakes.

However, despite the several common key features of credit cooperative banks, there is no single universal model within individual countries or across countries that is common to every cooperative bank. This means that there is no completely homogeneous set of cooperative banks across Europe. Therefore, the European mutual cooperative banking sector can be characterised as *Commonality with Diversity* (Ayadi et al., 2010). The nature of a cooperative bank is often described by its internal statutes and by its laws or articles of association. National laws on cooperatives also exist, providing the general principles of operation and the protection of members and third parties (Ayadi et al., 2010).

In Italy, there is not a specific law to determine the fundamental nature and general operational principles of cooperative banks, but they are regulated by a chapter of the broader national law on the banking sector (Testo Unico Bancario - TUB, 2007). The cooperative banking sector represents a growing proportion of banking activity in Italy and the trend is likely to continue in the years to come (Istat, 2012). Although government support is available in some notable cases at the European level, Italian credit cooperative banks are private enterprises, i.e. organisations that use resources to add value in the creation of goods and services (Catturi, 2007) and are referred to as Banche di Credito Cooperativo (henceforth, BCC).

BCCs play a very important role in the Italian banking sector through the widespread distribution in many cities (sometimes representing the only bank in a local community). They serve a large number of clients and have an increasing number of members/shareholders. In particular, BCCs maintain a significant presence in the less populated municipalities, i.e. those with less than 5,000 inhabitants, which helps them to achieve greater proximity and provide better access in these areas.

The following tables show the BCCs in numbers (Caldarelli et al. 2012):

NUMBER OF BCCs	AFFILIATES	TOWNS WITH BCCs	CLIENTS
412	4,411	2,705	6,700,000

Data in billion of euros

DEPOSITS	LOANS	LOANS TO FIRMS	REGULATORY CAPITAL
152.2	139.9	93.4	19.7

According to the mutuality principle, BCCs conduct their business *primarily* for its members/shareholders. More specifically, due to Italian law, BCCs must carry out at least the 50% of their banking activity for members/stakeholders (art. 35 T.U.B.). It is important to highlight that, in order to emphasize the strong relationship with the local region, all members of BCCs have to prove they are resident (the registered office or the continuous activity) in the local community. According to Italian law (art. 37 T.U.B.), BCCs have to allocate 70% of profits to their legal reserve, with 3% to the Mutual Fund and the distribution to members cannot be more than 2.5% above the interest free rate. The remainder is to be used for charitable purposes.

BCCs operate within the “European Association of Cooperative Banks”, an European network of credit cooperative banks, that represents and defends, within the EU institutions, the interests and the needs of cooperatives and promotes cooperation through the coordination of different national authorities. The network exists at three levels: local, regional and national. BCCs, at local level, are grouped into separate regional federations, which provide technical assistance and undertake internal auditing for their members. In Italy, the functions of these regional bodies are overseen by the national association, Federcasse, which is also in charge of the

BCCs' strategic planning functions. Within this network, BCCs operate in a decentralised manner (Di Salvo, 2002). Most of the centralised functions are available on a voluntary basis, effectively maintaining the autonomy of the local banks. This high degree of autonomy enables them to better meet their local members' needs.

BCC di Napoli is a 'young' bank founded in 2007 and carries out its banking activities in Naples, in the South of Italy. As with all BCCs, BCC di Napoli aims to achieve economic profitability to guarantee its economic sustainability (*Il Denaro*, 19 luglio 2012). On the other hand, its activities are also oriented to the achievement of social profitability, which means funding economic activities with social value for the local community (start-ups, renewable energy, plastic recycling and soon) and not funding investment in speculative projects or services which are regarded as "negative areas" (i.e. pollution, pornography, tax evasion, drugs, mafia, etc). The main goal of BCC di Napoli is to promote bottom-up development of the Neapolitan community through assisting young people not financed by traditional large banks, promoting sustainable growth of small-medium sized entities, as well as observing its duty of beneficence. As declared by the Chairman in the Annual Meeting for the approval of the Financial Statement 2010,

> 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 (Chairman).

According to the mutuality principle, BCC di Napoli conducts over 70% of its activity[5] for its members/shareholder. At a deeper level, BCC di Napoli directs its activities toward internal mutuality, viewed as the creation of economic and social value for the client-member. At the same time, BCC di Napoli aims to pursue the

[5] It should be noted that BCC di Napoli conducts more of its activity for its members, than the minimum required by law, which is 50%of banking activity.

economic, social and environmental interests of the local community, i.e. external mutuality. Moreover, BCC di Napoli fulfils purposes related to systemic mutuality, with the other cooperative banks, to enhance cooperation and promote the development of the network.

At this stage, it can be illustrated how the ethical nature of BCC di Napoli fits with some of the principles of business ethics outlined by Bowie. The following table shows how the driving values practically attained by BCC di Napoli relate to the theoretical conception of Business Ethics developed by Bowie, as explained in Section 2.

Table 3: Principle of Business Ethics (Bowie, 1999) vs Driving Values of BCC di Napoli

Principle of Business Ethics (Bowie, 1999)	**Driving values of BCC di Napoli**
The business firm should consider the interests of all affected stakeholders in any decision it makes.	*Affinity Principle*: BCC di Napoli's investments meet the interests of both shareholders/members and clients.
The firm should allow those affected by the firm's rules and policies to participate in the determination of those rules and policies before they are implemented.	
It should not be the case that, for all decisions, the interests of one stakeholder automatically take priority.	*Democratic Principle* The voting rights of the shareholders/members are allocated in

When a situation arises where it appears that the interest of one set of stakeholders must be subordinated to the interests of another set of stakeholders, that decision should not be made solely on the grounds that there are a greater number of stakeholders in one group than in another.	accordance with the 'one member, one vote' system rather than in proportion to the size of ownership stakes. *Responsibility principle*: BCC di Napoli is accountable for consequences of their behaviour on the local community as a whole.
No business rule or practice should be adopted which is inconsistent with the first two formulations of the categorical imperative.	
Every profit-making firm has a limited, but genuine, duty of beneficence.	BCC di Napoli invests more than the minimum required by law in funding of activities with social, cultural and environmental advantages for the local community.
Every business firm must establish procedures designed to ensure that relations among stakeholders are governed by rules of justice.	*Integrity Principle*: BCC di Napoli attempts to prevent that there will be organisations, micro companies, black economy or groups excluded from the financing system.

In practice, BCC di Napoli practically fulfils *"the interests of all the affected stakeholders in any decision"* principle of Bowie *(1999),* as it is similar to the Affinity Principle, which considers the members' interests and the stakeholders' needs in defining the placement of assets. Furthermore, in accordance with Bowie's view - *the interests of one (or one set of) stakeholder(s) should not take automatically priority, and that decisions should not be made solely on the grounds that there is, for example, a greater number of stakeholders in one group than in another* – BCC di Napoli ensures that in decision making there is no prevailing interest because of ownership stakes (i.e. *Democratic Principle*), and more broadly that the needs of the local community as a whole are considered (i.e. *Responsibility Principle*), and also that the bank is accountable for the consequences of its behaviour to the local community. Finally, another interesting aspect of similarity is that according to the *Integrity Principle* BCC di Napoli, talking in Bowie's terms, "*seeks to ensure that relations among stakeholders are governed by rules of justice".* Indeed, one of the most important characteristics of such a cooperative bank is that it has a commitment to equal opportunities, by including such organisations as micro companies, groups otherwise excluded from the financial system or the black economy. Moreover, BCC di Napoli's activities, in the words of Bowie (1999), result in *"a limited but genuine duty of beneficence",* as it invests money in activities for the promotion of the health, environmental safeguards and protection of the artistic heritage. Although two of Bowie's principles find no match in the table, it should be emphasized that, as highlighted by Bowie (1999), in BCC di Napoli "*no business rule or practice should be adopted, which is inconsistent with the first two formulations of the categorical imperative".*

5.2 Mission and Objectives

BCC di Napoli's activity is strongly rooted in the Neapolitan region and, rather than maximising short-term economic value, it seeks to maximise from a broad perspective the interests of its members/shareholders, who typically maintain long-term trusting relationships with the bank.

BCC di Napoli's Mission is clearly declared in its Statute:

> Carrying out its activities, BCC di Napoli is based on the principle of mutuality without speculative nature. Its purpose is to create favourable conditions for its members and the local community in the products and services provided by the bank, pursuing the improvement of the moral, cultural and economic conditions and promoting the development of cooperation as well as the social cohesion, the responsible growth and the sustainable development of the territory in which it operates. (art. 2, Statute).

As confirmed in the interviews, the mission is shared and embedded within the organization as a whole. All the interviewees emphasized that they perceive BCC di Napoli as "our bank" with an "*open door policy*" or *"familiar approach"*. In this regard*,* The Chairman emphasized as follows*: My personal commitment is to assure that people share a common vision of the role and the potential of our bank, not only for the needs of the mistreated territory of Naples, but also for the cooperative network as a whole. Communication makes people feel involved in the activities, part of a family with the same values*. *We just communicate, as soon as we can, everything that matters: communication is knowledge and knowledge is the oxygen for our activity*". (Chairman). This is also confirmed by the interview with the Risk Controller, who said: "*You really need to talk each other if you want to build a team rather that just the sum of individuals with their autonomous conflicting opinions".* (Risk Controller)

When we were in the bank for the interviews, we realized that there were daily meetings between the members of each team and also of each member separately with the team leader to discuss problems, suggestions or strategies of action for any special cases. There were also informal meetings, as the employees frequently had lunch together and discussed specific problems of their activities during the day or recent news from newspaper articles that could have an impact on BCC di Napoli's activity.

Given the values which shapes the ethical nature of BCC di Napoli, which were already addressed above, what it is important to show here is that the strong commitment of top management to promote a corporate mission in day-to-day practices of the bank is positively perceived and welcomed by all the employees. In this way, such values represent an integral part of everyone's work within BCC di Napoli. In this regard, one member of the Accounting Division said:

> We share values, we share goals, we act for our community and all these aspects of my work make me feel better at the end of the day. I feel lucky to

> be an employee of this bank because this bank plays a relevant role for the Neapolitan community. (Member of the Accounting Division)

However, the following quotes from the interview with the Chairman clarify the extent to which BCC di Napoli has to achieve its social purposes.

> Researchers: As Chairman, how do you see the Mission of BCC di Napoli?
>
> Chairman: The mission of BCC di Napoli is to achieve the common good of the local community.
>
> Researcher: Is BCC di Napoli a sort of charitable institution?
>
> Chairman: (….) Obviously no, it is not. BCC di Napoli is a bank and, as a bank, has to make profits in order to ensure its existence and durability.

The mission is clearly translated into BCC di Napoli's objectives, both economic and social. BCC di Napoli's economic objectives are identified by the General Director and formalized in specific risk return indicators. The economic objectives, as defined by the General Director, are examined by the Chairman and the Board of Directors, and approved by them. The main economic objective is growth in the number of members/shareholders, in order to increase the amount of capital, as this is the only source of new money. The interview with the General Director and the analysis of the internal operational plan showed that in 2007 the bank had two targets related to the number of members/shareholders. The first was quite cautious (2900 members for the end of 2010) than the other more optimistic (3400 members by the end of 2010). It is worth noting that BCC di Napoli is actually achieving its economic targets (Strategic Plan 2012). At the end of 2011, BCC di Napoli had increased its members, which were 3,164 with a total amount of € 7,326,500 of the share capital.

On the other hand, BCC di Napoli's social purposes are defined by its local community. It is important to highlight that all members of the Board of Directors drew attention to the role of local firms and people in defining the bank's social purposes. They are actively involved in the objective setting process, as it represents a distinguishing feature of BCC di Napoli's 'modus operandi' which relates to the *ethical nature of its banking activity. In this regard, clarifying that BCC di Napoli does not have its own social purposes, one member of the Board said:*

> *In order to promote the economic and social development of the Neapolitan community, we do not have to identify social purposes of the bank, because BCC di Napoli does not have its own social purposes. Our role (the role of the bank) is just to help our members and local people to achieve what they want to achieve, if their projects are relevant for the growth of our territory. For this reason, in 2009 we realized that we had to actively involve our members, people and local firms in order to know more specifically which social benefits they are looking for. (Member of the Board of Directors)*

In order to meet the needs of the local community, an exercise was undertaken in which the Head of the Branch[6] *collected data from local people (members/shareholder and external clients) from the different Municipalities where BCC di Napoli operates, in order to find out what are their priorities in terms of social purposes. The following quote from the Head of the Branch of BCC di Napoli explains how local people are involved in the objective setting process:*

> *On the basis of our knowledge of the Neapolitan region and considering the instructions of the Board of Directors, the strategic planning function and I identified a list of 21 social needs of our community, grouped into 10 categories. To gather information from the shareholders/members, I prepared a questionnaire to be submitted by email to them. On the other hand, to collect data from the external people I interviewed 350 external clients with the help of two cashiers. We had a discussion with them, to understand what are the major problems in the Municipality in which they live and how, in their opinion, BCC di Napoli could support the local development. All the clients were very willing to spend half an hour of their time talking with*

[6] This bank has just one branch, which is located in Naples.

> *us, and one of them said: "The Neapolitan community really needs this sort of banking activity and I want to promote you (the bank) and your activity within my family and my friends. This is the only way we have to fill our gap in terms of economic growth and local development" (Head of Branch).*

Once all information from the different respondents was gathered, the social needs were aggregated in order of priority. It is interesting to note that the opinions expressed by the interviewees are not related to their age and gender, but to the Municipality in which they live. The following lists shows the social purposes that BCC di Napoli aims to achieve, in order of priority of needs as expressed by the Neapolitan community (Strategic Plan, 2010):

1. *Local Firms (including start-ups)*
2. *Artisans and Farmers*
3. *Occupation*
4. *Environment*
5. *Combating Crime*
6. *Health*
7. *Education*
8. *Immigrants*
9. *Culture*
10. *Sport*

The Board of Directors and the strategic planning function discussed the above classification of social needs, in order to define the right direction of BCC di Napoli's activity. However, in this regard it is important to note the following quote from the interview with the Chairman:

> We don't want to identify different social needs or modify the priority as expressed by the Neapolitan community. Our role is just to ensure whether or not they are consistent with our risk appetite, in order to ensure that our bank is able to achieve them as well as to support the local community (Chairman).

5.3 The operationalization of ERM

The development of a risk appetite framework in BCC di Napoli, which dates back to 2009, shapes the on-going attitude to risks in areas that are central to its key strategy. This is confirmed by the interview with the Risk Controller, who said: "We define risk appetite as the amount and type of risk we are willing to accept in the pursuit of our objectives" (Risk Controller).

It should be noted that BCC di Napoli, along with other traditional large banks, has to comply with the rules set out in the regulatory regime issued at European level (Basel II and Basel III, starting by 2013). This regulatory regime provides a set of metrics that enter *de jure* in the risk appetite statement, such as Tier 1 or Total Capital ratios. Nevertheless, the relevant regulatory discipline for risk appetite is Pillar 2 of the Basel 2 framework, made up by two components, Internal Capital Adequacy Assessment Process (ICAAP) and the Supervisory Review and Evaluation Process (SREP).

In compliance with the regulatory framework, BCC di Napoli's defines its Risk Appetite Framework, according to the following structured approach to:

1) Define the risk capacity by identifying regulatory constraints that restrict its capacity to accept risk (Strategic Plan, 2011). BCC di Napoli's regulatory constraints are classified as:

- Financial – these tend to be quantitative in nature and therefore easier to interpret. (Capital ratios and liquidity metrics are examples of financial regulatory constraints).

- Other – these tend to be predominately qualitative in nature and therefore require judgment in interpreting requirements and assessing compliance. (Examples include maintaining compliance with legislative and regulatory requirements, and adhering to privacy and information security regulations).

2) Establish and regularly confirm risk appetite, as defined by drivers and self-imposed constraints to limit or otherwise influence the amount of risk undertaken. More in depth, drivers can be regarded as objectives that imply risks, which BCC di Napoli must accept to generate the desired financial return (Operational Plan, 2011). On the other hand, self-imposed constraints represent quantitative and qualitative statements that restrict the amount of risk BCC di Napoli is willing to accept. Examples of such self-imposed constraints are: ensure capital adequacy by maintaining capital ratios in excess of regulatory thresholds, maintain low exposure to market risk, ensure sound management of liquidity and funding risk, maintain a generally acceptable regulatory risk and compliance control environment, maintain a risk profile that is no riskier than that of the average peer. For each category of self-imposed constraints BCC di Napoli has a set of quantitative and qualitative key measures, which are regularly reviewed and updated, and approved by the Risk committee and the Board of Directors. (Riskiness Measure Report, 2010)

3) Translate risk appetite into risk limits and tolerances that guide BCC di Napoli in its risk taking activities (Riskiness Measure Report, 2010). Risk limits are quantifiable levels of maximum exposure BCC di Napoli will accept. They are established only for risks that are financial and measurable, such as credit risk and liquidity risk. Risk tolerances are qualitative statements about BCC di Napoli's willingness to accept risks that are not necessarily quantifiable and for those risks where BCC di Napoli does not have direct control over the risks it accepts (such as legal risk and reputational risk). The bank also communicates risk limits and tolerances through policies, operating procedures and limit structures.

4) Regularly measure and evaluate the Bank's risk profile against risk limits and tolerances, ensuring appropriate action is taken in advance of risk profile surpassing risk appetite (Operational plan, 2011).

However, as emphasized in an interview with the Risk Controller, BCC di Napoli has an implicit and not formalized risk appetite, embedded in its risk management culture as well as in its direct ethical commitment. In this regard, the Risk Controller said:

> Our risk culture is permeated by the direct commitment of all individuals to the social purposes that the Bank aims to achieve. We don't want to minimize all risks that BCC could take in the future, but we want to assume and manage as much as we can those risks that the bank must take in order to meet its members' needs as well as to sustain the local growth. Therefore, the risk management process in BCC di Napoli can be regarded as a strategic priority shared by all employees. Also, a key element of the culture is the long term trust relationship with the employees, who share the ethical purposes of the bank. Therefore, our risk appetite is defined by a formal framework developed in our internal procedures, but also incorporates a "soft component", related to our internal environment. (Risk Controller)

Once it has defined its risk appetite, BCC di Napoli identifies risks that may affect its banking activity. The interviews with the Risk Controller and the Board of Directors clarified that the risk identification aims to identify both the main and the emerging risks. In particular, the Risk Controller said:

> While some fear that the attempts to capture such risks, as ambiguously defined "emerging risks", may trap banks in a long series of stress tests and scenario planning, we agree that a broader perspective on plausible risks, even if remote, could have a significant systemic impact would be highly beneficial. (Risk Controller)

At the same time, risk identification in BCC di Napoli is an iterative process, which requires both a bottom-up and top-down approach. On one hand, on the basis of the scenarios analysis the Risk Controller and the Board of Directors, who have a more comprehensive view of BCC di Napoli's activities, specify a plausible range of risks that the bank has to take and, consequently, define the role and responsibilities for the management of each kind of risk. On the other hand, the risk identification process in BCC di Napoli also refers to the information provided by the Credit Risk Controller, the Compliance Officer, the Supervisory Committee, as well as the Money Laundering Committee. As emphasized by the Chairman: "*Due to their previous experience, Executives could bring more to the discussions. They can make valuable observations particularly because they sit on other boards and can bring different perspectives*". (Chairman). What should be emphasized is that all the interviews confirmed that all employees involved in the risk identification process are encouraged to be 'creative and communicative'. In this regard, we report a quote from the Risk Controller during one corporate meeting:

> There is no computer that can churn out a list of emerging risks. We are a few of people and we have a lot of ideas. So we are working on ways to get us to communicate concerns or ideas about the risks that may occur. All of you may have an idea that we haven't thought about or each of us (Risk Controller and the Board of Directors) may focus on the wrong things or miss something small, and others can help highlight 'the risk of today's bright ideas' (Risk Controller).

The following table shows the main risks which affect BCC di Napoli's activities and the organizational functions involved in the management of those risks.

Table 4: Main risks and risk functions in BCC di Napoli

WHAT	**WHO**
CREDIT RISK	Credit Risk Monitoring Function
LIQUIDITY RISK	
MARKET RISK	

COMPLIANCE RISK	Compliance Officer
STRATEGIC RISK	General Director & Strategic Planning Function
CONCENTRATION RISK	Concentration Risk Committee
OPERATIONAL RISK	Risk Controller
CRIME RISKS	Prevention Of Crime Risks Committee

However, with reference to the above categories of risk, a distinction should be highlighted. The management of some of the above risks is mandatory while the management of others is voluntary. According to the European and Italian law, BCC di Napoli identifies credit risk, liquidity risk, market risk, compliance risk, strategic risk, concentration risk, strategic risk and operational risk. Each of these risks is measured, monitored and managed by a specific organizational function/committee of BCC di Napoli. What should be noted is that, although it is not prescribed by law, BCC di Napoli identifies, measures, monitors and manages a particular category of risks, i.e. the Crime risks, by appointing a specific committee. In general, this category of risks can encompasses a number of risks associated with crime; however, BCC di Napoli considers only money laundering risk, bribery risks and fraud risk management, as relevant for its banking activities. The following table provides a picture of the different risks, classified in terms of their likelihood and impact, which BCC di Napoli has to manage due to its specific activity, as a basis for determining how to prioritize such risks.

Table 5: Risks Map of Bcc di Napoli

	IMPACT				
LIKELIHOOD	Incidental	Minor	Moderate	Major	Extreme
Frequent				Credit Risk Liquidity	

				Risk	
Likely		Compliance Risk	Reputational Risk	Concentration Risk	
Possible	Market Risk	Crime Risks		Operational Risk	
Unlikely			Strategic Risk		
Rare					

The credit risk and the liquidity risk are the most important risks that BCC di Napoli has to manage, because its activity consists of providing loans to both members/shareholders and external clients. However, it is also important to consider the concentration risk, due to the fact that BCC di Napoli carries out its activity only in the Neapolitan region. With reference to the operational risk, it is important to highlight that BCC di Napoli is a young bank, and consequently the definition of its procedural actions is still in progress. Furthermore, BCC di Napoli does not take specific account of market risk, as it explicitly avoids investment in speculative activities. What should be noted, however, is that BCC di Napoli is relatively safe from Crime Risks, as its internal procedures define a complex set of controls to avoid crimes occurring.

5.4 Roles and Responsibilities of Enterprise Risk Management in BCC di Napoli

The Risk Controller is the coordinator of the Enterprise Risk Management process and he controls the activities involved in the risk management process and ensures that the internal procedures are observed by all the different functions.

The Risk Management team in BCC di Napoli receives monthly a complex set of risk indicators from each of the different organizational functions involved in the management of the specific risks. Once the different reports are collected, the Risk

Management Team aggregate the data into a dashboard, in order to generate a complete view of the overall risk exposure. The Risk Controller reports monthly (until last year every three months) to the Board of Directors the overall risk exposure aggregated in the dashboard, emphasizing the key risk indicators for each category of risk. However, as emphasized during the interviews with the Risk Controller and the member of the Board of Directors, the dashboard is only regarded as diagnostic control tool, in order to periodically scan for anything unusual that might indicate a potential problem. In this regard, one member of the Board cryptically stated:

> We have the detailed and updated internal procedures, we refer to sophisticated risk measures to define different ratios and indexes. According to the law, we organized different risk information in different reports and those reports should be accurately read. However, they can help us to make our choices, to select the investment projects, to define the strategy, but they cannot reflect the real risk exposure of BCC di Napoli. This is for sure (Member of the Board of Director).

However, the risk management process in BCC di Napoli is not only related to the introduction of different quantitative tools and measurement techniques (as required by law) to calculate and minimize those risks that can be measured in numbers – i.e. risks which can be regarded as 'hard risk'. As emphasized by the Risk Controller,

> We calculate 'hard risk' *ex ante* and we consequently allocate the regulatory capital. We feel that the measurement of risks, despite regular and detailed, cannot reflect the risk exposure of the Bank as a whole. (Risk Controller)

As clarified by the interviews with a member of the risk management team, the ERM process in BCC di Napoli benefits from the active participation of all people involved in the risk management activities at different levels of the organizations. Indeed, it should be noted that such people are ***actively*** involved in risk management processes and not only merely compliant with the procedures. Instead, they point out any situations not covered by the procedures and emphasize when anomalies occur. In this regard, he noted: "*Actually, this sort of activity goes beyond my work but it is related to my personal commitment for my work, for my bank and for my territory*" (a member of the Risk Management team). On the other hand, the personal commitment of each employee is crucial because it is on the basis of the alerts provided by the different functions that the Risk Controller tries to define how the Bank should operate in specific circumstances.

Also, the enterprise risk management process is mainly informed by the personal background of the people involved in the process, especially in the evaluation of qualitative information which cannot be reduced to numbers; this is called 'soft information' in BCC di Napoli. In this regard, the Risk Controller emphasized:

> We have formal meetings every three months in order to evaluate those risks that are not measurable and not quantifiable, but we also have frequent informal discussions about what is happening and how the external events can have an impact on our performance. Recently, we realized that our risk management could make the bank relatively safe from negative events. However, we cannot predict the future or anticipate catastrophic circumstances. But… who is able to do this? This is what helps us (the bank) to reduce surprises along the way and to achieve its economic purposes and social purposes (Risk Controller).

What should be noted is that the Risk Controller recognised that the active involvement of all the employees, their personal previous experiences and their direct commitment to the purposes that BCC di Napoli's aims are the most important tools for managing operational risk:

> My experience suggests that operational risk, in most of the cases, is related to the humans' behaviour and their ability to learn from previous mistakes. In my opinion, these are the most important 'indicators' which are able to ensure an on-going risk management process and its effectiveness (Risk Controller).

5.5 The Credit Risk Management in BCC di Napoli

The most important risk for BCC di Napoli is credit risk. The Credit Risk Officers calculate quantitative risk indicators for each of major lending area and aggregate them into an overall risk of the credit portfolio and draft a detailed report, which is submitted to the Chief Credit Officer. It should be noted that, during the interviews, the Chief Credit Officer emphasized that, despite the role of regulation in defining the risk management practices and procedures that BCC di Napoli is required to comply with,

> (….) the difference between BCC di Napoli and the other traditional large banks is that the management of the credit risk goes beyond how to secure our (the bank's) money, but aims to evaluate whether or not we are going to provide funding with a social value for our territory. To this end, the credit risk management process in BCC di Napoli has some particularities related to the purposes we want to achieve (Chief Credit Officer).

These peculiarities concern the credit risk assessment process. One peculiarity is related to the fact that BCC di Napoli screens both financial and non-financial aspects of investment projects. The first step in the risk assessment process aims to verify if the project is consistent with the bank's risk appetite as well as to evaluate its economic profitability in terms of risk-return ratios. To this end, an important role is played by the personal and financial guarantees that the client is able to provide (Internal Procedure on Lending Process, 2010). However, to assess the risk of each loan, BCC di Napoli also considers a greater amount of information, and this provides a broader picture of the investment project, with a specific focus on its benefits and advantages for the local community. This information includes the reputation and the integrity of the entrepreneur and the trust relationship with the bank, as well as the evaluation of environmental, occupational and cultural benefits of the project for the Neapolitan region. It should be noted the both the Risk Manager and the Credit Risk Controller gave great importance to the role of qualitative information in assessing the risk of each loan. Indeed, the Risk Controller emphasized the particular role of such information, which in the view of BCC di Napoli, can be regarded as a sort of 'additional guarantee'. More specifically, the Credit Risk Controller said:

> The information related to the entrepreneur (including its legal position and moral conduct as well as the purposes that he aims to achieve with its economic activities) is crucial for us. Of course, we need a financial guarantee to ensure that the client will give the money back. But the additional information represents an important sort of guarantee for us, i.e. the guarantee that we will put money in a project that can bring benefit for the local community. We regard at this information as 'additional' because, usually, the other large banks do not care so much about that….. I mean…. We require more information that our client would not need to provide to other banks to receive the money. So this information is 'additional' for us, but it is not 'secondary' or 'minor in importance' for sure. It is the core of our business activity. (Credit Risk Controller)

In this regard, it should be noted that, due to the fact that BCC di Napoli's activity is based on a long-term trust relationships between itself and clients, they benefit from a high level of information.

As there are no standard procedures, the Chairman and the Board of Directors in collaboration with the Risk Controller, carry out an evaluation of the information related to the 'additional guarantees'. Due to the fact that the Chairman and the Board of Directors are responsible for the achievement of the BCC di Napoli's social purposes, they are actively involved in the evaluation of investment projects to ensure that the bank puts money into projects that have social value for the local community. However, in order to be aware of risks that could not be quantified in numbers, they rely on the experience-based judgment of the Risk Controller, who is also involved in the selection of the investment projects. Also, BCC di Napoli benefits from the knowledge and experience of the people involved in the management of risk at different level, because they can contribute to the strategic choices of BCC di Napoli. In this regard, a member of the Board of Director provided an example:

> Last year, we had to decide whether give money or not to a firm which operates in a plastic recycling business. This is a particular business in our region, often influenced by criminal organizations (i.e. Camorra). Actually, our concern was also about the identity of the Entrepreneur, which called to my mind some criminal organizations of the Neapolitan area. However, this project was really relevant for the environment and profitable from the economic perspective. We decided to arrange an *ad hoc* meeting with the Chairman, the Board, the General Director, the Prevention of Crime Risks Committee, the Risk Controller and the Chief Credit Officer to evaluate this project. One member of the Prevention of Crime Risks Committee provided more personal information about the Entrepreneur because he had a personal relationship with him and gave more details about his moral conduct and responsiveness in doing business, also referring to some public information that we really ignored. For this reason, we decided to give a chance to this Entrepreneur, asking for different documents in order to evaluate the firm and its legal position. Then we decided to put money into this investment project. At the end of the year, this firm was proclaimed by the Italian Environmental Association as a benchmark for the firms which operate in plastic recycling business (Member of the Board of Director).

However, it should be noted that the Board of Directors is involved in the evaluation of every project, even the small loans. Although the internal procedure on lending process (2010) states that "*the Board of Directors authorizes the Head of the Branch to grant loan up to the amount of 2,000 euros, after the proper evaluation of the Credit Risk Controller"*, the Credit Risk Controller clarified that, apart from the formal administrative procedure, the lending process for small loans is exactly the same in practice, in terms of the evaluation of both financial and social aspects as well as the additional information required. Also, although the members of the Board are not required to check the box for the grant of the loan, the Credit Risk Controller usually discusses with the Chairman or another member of the Board about the evaluation of the small loans. In this regard, he clarified as follows:

> We are aware of the historical and rooted problems of crime that have plagued our beautiful city for a long time and we still have this sort of problems embedded in our territory. Unfortunately, this is one of the most important threats for our activity and the unique way to be involved is being transparent with clients, members and above all for all the aspects of our internal processes (Credit Risk Controller).

The interview with the Head of the Branch confirmed that the activities related to the funding of small loans are not carried out only at the lower level of the bank and provided an example:

> In 2009, we received in two days four requests for funding (from 1,500 euros to 2,000 euros) from four young local firms, who carry out their activity in the same Municipality of the Neapolitan region. Two of them were involved in the plastic recycle business and the other two firms were operating in the clothing industry. Such firms provide patrimonial collateral, but they were not willing to give detailed information about the destination of the money and were very vague about that. I personally had a chat with all of them in order to understand their purposes, why they are asking for money…. But they did not

> convince me at all and I decided to not finance them. However, I had a discussion with one member of the Board of Directors and, as I presumed, he agreed with me. Two weeks later, the newspaper showed a number of criminal actions related to specific criminal organizations. Does this suggest something? (…….) We will be never able to know it but…… I'm very happy with how our bank is taking action. (Head of the Branch)

Another peculiarity of the ERM process in BCC di Napoli concerns the credit monitoring process. BCC di Napoli monitors the destination of the funding once a loan is granted, in order to ensure that the money is actually invested in projects with social purposes. The Chairman explained that, in order to monitor the destination of the funding provided by BCC, "*the bank not only provides finance, but is actively involved in project design as well as in the implementation of the projects which the community needs to grow*. Additionally, each member of the Board of Director emphasized that BCC di Napoli is willing to accept delays in payments due to temporary difficulties for its clients, if the project is relevant for the sustainable development of the community. This was confirmed by one of the BCC di Napoli clients who said that BCC did not modify the interest rate for the loan granted.

It is important to highlight that, in order to promote the local growth, BCC di Napoli has recently issued € 2,000,000 of three year bonds which can only be purchased by people from Naples. These bonds are to be used only within the Neapolitan community, and they are particularly intended for funding small businesses, artisans and start-ups in the Neapolitan area. *We will be more accountable and we will provide the community with information on our website about the customers we'll give the money to. They will be "clean" businesses, young people who have business ideas but, unfortunately, find the doors of finance closed. (Chairman).* Also, BCC di Napoli devotes a portion of its earnings to charity purposes that are not strictly related to the banking activity that BCC di Napoli carries out: e.g. health, education, environmental protection, employment and 'reduction of the black economy'. In this regard it should be noted that although

BCC di Napoli is required by law to comply with this sort of "duty of benefice", the bank does not just spend the minimum for charity purposes. The goal is to trigger a virtuous circle whereby the citizens of Naples invest in BCC di Napoli, which then finances local companies, and the benefits come back to the city in the form of local development and jobs.

5.6 The Role of the BCC's Network

The Enterprise Risk Management system in BCC di Napoli benefits from the control activities of the Internal Audit function as well as from the supervision of the External Audit for credit cooperative banks. What should be noted is that such activities are carried out at Network level, with the aim to ensure that all the cooperative banks operate in line with the ethical principle of the Network, to achieve both economic and social purposes.

The Internal Audit function of all the banks (including BCC di Napoli) within the network of cooperative banks is outsourced at the regional level. However, Federcasse has prepared a contract that draws the attention of BCCs on the need to "customize" - the procedures, times and types of controls - the contract on the basis of their characteristics business.

More in depth, the internal audit function evaluates the Enterprise Risk Management system of BCC di Napoli through both external controls and such activities in loco. The former consists of processing the data derived from the quarterly supervisory reports on risk management; analysing the relation between the general risk that the BCC will take and the effects on the system of Cooperative Credit banks; identifying the methodologies used, the operating media or the organizational solutions aimed at ensuring an adequate risk management.

The latter is related to the assistance to the management and the Board of the bank, in relation to the different demands for risk management, in particular in drafting the internal rules and procedures. In particular, as a result of meetings *in* *loco* and accurate analysis of the financial statement and the internal documents (Rules, Regulation process, implementing provisions, procedures, reports, orders of service), the internal audit function defines a process of preliminary audit for BCC di Napoli. Then, the Internal Audit activities analyse the different risks identified by the management, focussing on the different tools and techniques for controlling and managing the 'hard risks', thus quantifying the score for the residual risk. After a discussion with Board of Directors and the risk controller, the preparation of a master plan follows, indicating the priorities for action. The following quote from the Risk Controller provide an overall picture of the role of the Internal Audit function in BCC di Napoli, and also considering the broader perspective its role within the Network of Cooperative banks.

> The Internal Audit activities are not properly outsourced, as they are carried out outside the bank but inside the network of cooperative banks, on the basis of specific standards for such banks. However, although the specific standards are specific for cooperative banks as they take into account the social purposes that all BCCs (and BCC di Napoli) aim to achieve, last year they obtained the certification of the alignment to the audit international standards for professional practice. (Risk Controller)

Hence, what arises is that, thanks to the Network of cooperative banks, BCC di Napoli combines the economic constraints and social purposes of such banks, as characterized by a flexible organizational structure with features of traditional large banks. Hence, on the one hand the Internal Audit represents a "mentor" for BCC di Napoli, helping to orient the ERM process to achieve economic and social purposes. On the other hand, it provides an additional element of transparency for its clients, as it is compliant with the main international standards.

In addition, with the aim of providing assurance on the effectiveness of the ERM system, BCC has opted for a voluntary external audit provided by Pricewaterhouse Coopers (and Deloitte starting with the financial statement of 2012). This represents a further attempt to be transparent and accountable to the local community in order to attract new members/shareholders to the BCC di Napoli's network with the aim of legitimating its activities and increasing its reputation within the Neapolitan community.

It should be noted that BCC di Napoli also benefits from the external audits specifically for credit cooperative banks provided by *Federcasse*, the Italian federation for credit cooperative banks. This audit activity is a different form of control, which aims to ensure that there is no speculation and that the banking activity in carried out in the light of the mutuality principle. With particular reference to the ERM system, the external audit aims at providing assurance on the effective role played by the ERM in achieving the ethical purposes.

6. DISCUSSIONS

This section aims to discuss the relationship between business ethics and Enterprise Risk Management. To this end, we are going to answer the key research questions on the basis of the analysis carried out in the case study section, trying to combine the conception of business ethics developed in the Section 2 and the issues addressed by the existing literature on ERM explained in the Section 3.

The existing literature (e.g. Arena et al., 2010) has shown that ERM is not a standardized process, rather it represents a "context specific" system, which differs from firm to firm and needs to be embedded in organizational values, structure and purposes. Accordingly, the first research question pertains the way in which mutual credit cooperative banks operationalize ERM. The case study elucidates that the Enterprise Risk Management system of BCC di Napoli consists of a twofold order of activities. On the one hand, the risk management activities refer to a specific set of metrics that enter *de jure* in the risk management system of all banks (i.e. Tier 1, Total Capital ratios, Internal Capital Adequacy Assessment process – ICAAP- and the Supervisory Review and Evaluation Process) according to the regulatory regime issued at European level (i.e. Basel II and Basel III starting by 2013). Hence, BCCs, along with other traditional large banks, manage their risk through a systematic process aimed at defining the objectives according to their risk appetite, identifying risks, monitoring and controlling all the risks that can have an impact on their banking activities, using different risk measures and indexes. On the other hand, the case study shows that the operalization of ERM process is built on the ethical nature of the organization that is fully shared by its employees. Indeed, the ERM process encompasses a different order of activities based mainly on human behaviour as, for example, the collection and the analysis of 'soft' information about the values of clients and the purposes of each investment projects. In addition there are formal and informal discussions between the employees about all the risks that may occur as well as the trust relationship between the bank, the members/shareholder and the external clients. This practically means that all the people feel actively involved in the risk management process of the bank, considering it as a strategic priority not only for the bank, but also for themselves and the community in which they live. What is important to highlight is that these activities are not prescribed by law and they go beyond what is required by the internal procedures about the management of risks. Such activities are exclusively related to the internal environment, which is permeated by the ethical commitment of all individuals to the social purposes that the bank aims to achieve.

Considering the operationalization of the holistic system for managing risks in BCC di Napoli enables us to answer the second research question about how the governance structure of credit cooperative banks shapes ERM. Many researchers (Paape and Speklè 2012; Demidenko and Mc Nutt, 2010; Beasley et al., 2008; Nocco and Stulz, 2006; Liebenberg and Hoyt, 2003; Lam 2011), semi-regutalory bodies (Casualty Actuarial Society Committee on Enterprise Risk Management 2003; Committee of Sponsoring Organizations of the Treadway Commission 2004) and professional associations (Institute of Internal Auditors, The Global Association of Risk Professionals, the Institute of Risk Management, European Commission) have examined the ERM from the governance perspective. Most (Beasley et al., 2008; Committee of Sponsoring Organizations of the Treadway Commission 2004; Liebenberg and Hoyt, 2003; Lam 2011), in studying the effectiveness of the risk management system, have suggested the introduction of standardised governance models and the appointment of specific members of the senior management team, in order to embed risk strategy throughout the enterprise, as well as to oversee the Enterprise Risk Management process.

It is well known that credit cooperative banks have a lean governance structure, with restricted levels of employees, for reasons of costs minimization. Such banks do not have strong support at the senior management level and do not appoint specific members (i.e. Chief Risk Officer or Chief Financial Officer) to be responsible for managing their risks, as suggested by recent literature and the semi-regulatory bodies. However, what should be noted is that credit cooperative banks are able to pursue the effectiveness of the ERM process via the active participation of all people involved in risk management activities at the different levels of the organization. Indeed, the Board of Directors is responsible for the definition of both the economic and social objectives of the bank, but it is also actively involved in the evaluation of the investment projects, including small loans. On the other hand, at the executive level, the employees involved in the management of risks provide information and measures about the risks of their function, and also about activities that go beyond their own work. Indeed, because of the importance of their experience in the risk management area, their personal commitment to the purposes of the bank, their knowledge about the local territory and, sometimes, their personal relationships with the clients, they are encouraged to participate in risk identification, as well as the different phases of the risk management process. The Risk Controller coordinates the process by ensuring information flows between Board of Directors and the executive level both bottom up and top down, and more generally acts as a *trait d'union,* as he monitors all the information that is diffused and shared between the different functions for managing risks. However, the Risk Controller is not only responsible for the overview of the ERM process but he is actively involved the process, as he also helps the Board of Directors in the selection of investment projects. Hence, the governance structure of the credit cooperative banks, which relies on the direct ethical commitment of all members of the organizations, shapes the ERM practices in terms of roles and responsibilities, which are less structured, less formalized but, as they are allocated either implicitly or explicitly between all people involved in the management of risks, much more embedded within the bank itself. Moreover, the fact that all people within the organization share the purposes of the bank represents an additional key element in supporting and sustaining the effectiveness of the management of risk process.

At this stage, there is a need to clarify how ERM allows credit cooperative banks to pursue their economic, social purposes and ethical purposes, by answering the third research question. Because of the distinguishing features of cooperative banks, and thanks to the active role played by the Network of BCCs in supporting the achievement of their purposes, the ERM is fully embedded and integrated throughout such banks. In this way, such banks are able to achieve their economic, social and ethical purposes. Indeed, with reference the economic purposes, the ERM is helpful to cooperative banks in defining objectives that are consistent with banks' risk appetite, using not only financial measures and sophisticated techniques, but also considering important information, regarded as 'soft' information, that is relevant to the definition of a broad picture of all the projects that the banks are prepared to fund. With reference to the social purposes, ERM process pays more attention to the evaluation of the effects of the banking activity and the benefit for the local community. To this end, an important role is played by the personal commitment of the people involved in the management of risk. With reference to the ethical purposes, it is to note that, despite mutual credit cooperative banks having to devote a portion of their profit to charitable purposes, the ERM is helpful in ensuring that such banks are able to invest in charitable activities more than the minimum required by law. Indeed, the system for managing risk is not intended to be as a mere tool of compliance. It is oriented to help the bank to ensure the development of the local community

What should be noted is that the ERM is able to help credit cooperative banks to achieve their economic, social and ethical purposes because it is mainly informed by, and built on, the principles of business ethics suggested by the framework developed by Bowie.

The following table shows how the ERM is shaped by the principles of Business Ethics (as defined by Bowie, 1999):

Table 6: Principles of Business Ethics (Bowie, 1999) and Enterprise Risk Management

<table>
<tr><th>Principles of Business Ethics
(Bowie, 1999)</th><th>Enteprise Risk Management</th></tr>
<tr><td>The business firm should consider the interests of all affected stakeholders in any decision it makes.</td><td>The ERM process in credit cooperative banks considers the interests of all stakeholders starting with the objective setting process, with particular reference to the social purposes that the banks aim to achieve, as they are defined from their (external and internal) clients.</td></tr>
<tr><td>The firm should allow those affected by the firm’s rules and policies to participate in the determination of those rules and policies before they are implemented.</td><td>The ERM process in credit cooperative banks relies on the active participation of the employee in defining practice and rules from time to time before they are implemented.</td></tr>
<tr><td>It should not be the case that, for all decisions, the interests of one stakeholder automatically take priority.</td><td rowspan="2">The ERM process attempts to manage risks considering the interests of all stakeholders, without giving automatic priority to the interests of one (or a group) of them, as the ERM helps such banks to achieve the growth of the local community as a whole.</td></tr>
<tr><td>When a situation arises where it appears that the interest of one set of stakeholders must be subordinated to the interests of another set of stakeholders, that decision should not be made solely on the grounds that there are a greater number of stakeholders in</td></tr>
</table>

one group than in another.	
No business rule or practice should be adopted which is inconsistent with the first two formulations of the categorical imperative.	The ERM process helps credit cooperative banks to manage their risks considering the humanity and its economic and social development as an end, rather than a mere means to achieve their economic purposes.
Every profit-making firm has a limited, but genuine, duty of beneficence.	The ERM process enables credit cooperative banks to pursue their ethical purposes, also observing their (limited) duty of beneficence.
Every business firm must establish procedures designed to ensure that relations among stakeholders are governed by rules of justice.	The ERM process in credit cooperative banks is designed to (attempt to) give money to people which credit is denied, due to their lack of financial guarantees, by avoiding that there will be people excluded from the financial system.

The above table shows how, using the framework developed by Bowie, it is possible to apply the Kantian ethics to business activity, with particular reference to the ERM process. Many academics and practitioners are quite skeptical about the introduction of business ethics into banking activity and, in particular, about its role in enterprise risk management system. Some of them regard business ethics as a more abstract, theoretical and subjective issue that does not meet the needs and the purposes of economic activity. However, the purpose of this study is not to provide a philosophical underpinning for the management of risks, but to deepen our understanding of the relationship between Business Ethics and Enterprise Risk Management in practices. Indeed, as was underlined in the introduction, it is still unclear if the Enterprise Risk Management supports credit cooperative banks in pursuing their ethical purposes or Business Ethics supports Enterprise Risk Management system. As a result of our analysis of BCC di Napoli, we can argue that Business Ethics and Enterprise Risk Management are closely interrelated in the specific context of credit cooperative banks. In this sense, the interrelation can be illustrated as a circle: the ERM helps credit cooperative banks to achieve their economic, social and ethical purposes but, at the same time, in such banks the ERM is mainly built on the ethics shared and diffused within such organizations.

7. CONCLUSIONS

This research aims to understand how ERM works in action in credit cooperative banks, which have a twofold purpose: economic profitability and social development of local territory. In other words, the aim of this research is to clarify how ERM can help such banks to achieve their economic, social and ethical purposes. To this end, we referred to mutual credit cooperative banks since they have been defined in recent literature as “ethical banks” (San Jose et al., 2011) and due to the fact that they have been regarded as especially conducive to ethical and responsible business conduct (European Commission, 2011).

This study contributes to the literature in different ways. On the one hand, the study contributes to the literature on ERM, filling the gap related to the lack of description about the relationship between business ethics and ERM in practices. In this regard, through an in-depth description of a specific credit cooperative bank, the study clarifies how the Enterprise Risk Management system is practically shaped by business ethics. On the other hand, this study contributes to the literature on ethical banks by providing an in-depth description of how such banks *practically* manage their risks in a holistic way and in explaining role of ERM in achieving their purposes, with particular reference to issues of financial exclusion.

Moreover, in showing how the Enterprise Risk Management system helps credit cooperative banks to achieve their economic and social purposes, this research has some important implications in practice for similar banks in many countries which want to promote the economic growth of local communities. Indeed, the study sheds light on different aspects of ERM practices in each step of the holistic process for managing risks, often they are not related to the formal procedures of the banks, but embedded in the ethical nature of the organization.

At this stage several questions still need to be considered. This paper focuses on credit cooperative banks as ethical banks. However, an interesting future development for this research could be to explore how enterprise risk management can lead other kind of banks (not specifically ethical banks) to achieve their social purposes. An additional question that remains to be considered is about the extent to which enterprise risk management practices can be *ethically oriented* and the extent to which they must fulfil certain economic constraints. Also, since the recent literature has emphasized the lack of research on issues related to micro companies, the black economy and groups excluded from the traditional financing system, either because of poverty or because they belong to certain social or ethnic groups, an interesting further development for this research could be related to the area of microfinance.

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Concluding remarks and further research

This thesis focuses on the issues related to the reporting and the management of risk in the banking sector, with specific reference to the Italian context. The thesis is oriented towards a deeper understanding on these issues, with especial attention to the importance of "to be compliant" with current regulation. In particular, the issues outlined above are addressed through the adoption of multiple theoretical and methodological perspectives, in order to progressively engage with the field of interest.

The motivation behind this study lays primarily in the awareness that banks are risk management entities. It is well argued that risk disclosure is raised to a particular level of importance within banking organizations in comparison with non-financial firms because banks are inherently more opaque (Huang, 2006). Yet, due to the complexity of financial environments and the increasing diversity in the information needs, banks should comply also with the supervisory regulation from Basel Committee of Banking Supervision, which seeks to foster a secure and reliable financial sector (Oliveira et. al., 2011). Therefore, banking companies can be expected to divulge significantly different types of risk disclosure (Bessis, 2002). However, as relevant literature has extensively shown over the years, recent financial crisis revealed the failure in banking risk reporting and risk management practices. More in depth, it has been argued that shortcoming in accounting interacted with failures in governance and risk management practices (Magnan M. and Markarian G., 2011). Indeed, in many cases, risk management systems failed because of failure in governance, as information about exposure and strategies did not reach senior management (Kirkpatrick, 2009). For this reason, this study is motivated also by the need for further investigation pertaining the implementation of the holistic risk management system, with especial regard to how they can be effective.

On this basis, and taking into account the characteristic features of the Italian banking sector (Bischof, 2009), the thesis examined from different perspectives how financial companies disclose and manage their risks, by also highlighting the need to move from the mere compliance perspective to an ethical-oriented dimension.

Consequently, and in light of the specificities of the institutional environment, the thesis was divided in three chapters, based on different theoretical frameworks and methodologies, to address the above-cited issues.

The first chapter examined the different risk disclosure requirements, issued by different regulators, in order to understand in detail which risk information should be reported by Italian banks in the three different reports identified by different regulators (Notes to the Financial Statement, Management Commentary, and Public Report). The research complements prior studies by focusing on an under-researched setting, such as the banking sector. Also, it study represents a valid contribution in that it provides a systematic overview of the current regulatory requirements for risk disclosure and discuss, from a theoretical perspective, whether the increasing in risk disclosure standard and authoritative disclosure recommendations are able to enhance the usefulness of banking risk disclosure by Italian banks.

The second chapter, moving from the limitations of the first step of the research, also encompassed the empirical perspective, to deepen the issues relating to how risk information is provided by Italian banks, focusing on the characteristics of the information to assess the overall quality of disclosure, to find any differences between the Notes to Financial Statements and the Public Report, both prepared in compliance with the instructions of the Bank of Italy. Such an approach allowed to find out why risk disclosure by Italian banks looks less useful than it ought to be. Also, focusing on the Italian banks, the study will allow us to take into account the issues relating to risk disclosure in a context characterized by increasing regulation, strong legal enforcement and, therefore, the expectation for more useful information. In addition, the results of the analysis allow a more comprehensive analysis of the issues relating to risk disclosure, highlighting existing strengths and limitations, as well as the need for a systematic framework, shared at the European level, to ensure the usefulness of information. In the end, the results will be of interest also for policy makes, standard setters and supervisory bodies, as the research will shed light on some overlaps of the two competing regulations, with particular regards to the high degree of discretion that regulators allow to *insiders*.

Afterwards, to broaden the sphere of attention encompassing the problems relating to the "management" of risk information from the managers, the third chapter shifted the focus from the external viewpoint, pertaining the risk disclosure public available, to the internal perspective, relating to implementation of holistic systems for managing risks, that is Enterprise Risk Management (Mikes, 2011; 2009; Arena et al., 2010; Gephart et al., 2009; Power, 2009, COSO Report, 2004).

Also, because of the increasing demand for integrating ethical values in "doing business" (Barbu and Vintilà, 2007; de Graaf, 2006), this chapter referred to credit cooperative banks, which are a particularly suitable basis for studying the relationship between business ethics and ERM due to the fact that they are especially conducive to ethical and responsible business conduct for the society (European Commission, 2011). The study is carried out by employing a single case study and framed by the redefinition of Kant's moral philosophy provided by Bowie (1999), which explains how to apply the Kantian ethics to businesses.

The findings elucidate how ERM can help such banks to achieve both their economic and ethical purposes. In this way, the study contributes to the literature on ERM, filling the gap related to the lack of description about the relationship between business ethics and ERM in practices. In this regard, through an in-depth description of a specific credit cooperative bank, the study clarifies how the Enterprise Risk Management system is practically shaped by business ethics. On the other hand, this study contributes to the literature on ethical banks by providing an in-depth description of how such banks practically manage their risks in a holistic way and in explaining role of ERM in achieving their purposes, with particular reference to issues of financial exclusion. Moreover, in showing how the Enterprise Risk Management system helps credit cooperative banks to achieve their economic and social purposes, this research has some important implications in practice for similar banks in many countries which want to promote the economic growth of local communities. Indeed, the study sheds light on different aspects of ERM practices in each step of the holistic process for managing risks, often they are not related to the formal risk management procedures of the banks, but embedded in the ethical nature of the organization.

In the end, what should be noted is that given importance of the banking sector in ensuring the financial stability of the system as a whole, the issues highlighting the costant effort of international regulators to enhance the usefulness of risk reporting are of relevant interest. Also, the analisys, from an internal perspective, of the implementation of holistic systems for managing risk from an ethical dimension towards the achievement of the development of the global community should not be underestimated. Hence, the findings of this thesis have crucial implications also from a social perspective. Indeed, in providing a better understanding of the strategies of reporting and managing risk, the thesis represents an essential contribution also for context other than Italy.

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