



Managing risk in credit cooperative banks: Lessons from a case study



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ABSTRACT

The aim of this paper is to explore how the implementation of enterprise risk management (ERM) practices can help organisations to pursue both economic and social goals. To do so, we look at the credit cooperative banking sector, which often attempts to conduct socially responsible business practices. To deepen our understanding of how such banks deal with risk, we provide an in-depth study of one credit cooperative bank. The analysis highlights the peculiarities of ERM practices implemented in a specific context and explains how an ERM system enables credit cooperative banks to manage the risks associated with a duality of purpose.

This research is relevant from a theoretical perspective because it addresses new trends in the risk management literature, thus elucidating how ERM systems can be implemented to support dual-purpose organisations. The study also adds to the literature on ethical banking, as it offers an in-depth description of how ERM systems work in this particular context. This paper also has practical implications; it provides insights to similar banks on how to manage risk in a way that supports social development in their local communities. Our analysis is also of interest to other types of socially-oriented businesses, which may follow a similar approach to operationalise ERM practices.

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1. Introduction

During the recent financial crisis, the traditional large banks experienced a distinct decline in their performance (Landsman and Peasnell, 2013) due to significant weaknesses in their risk management practices, which became painfully visible (Paape and Speklè, 2012; Magnan and Markian, 2011; Fraser and Simkins, 2010; Harner, 2010; Power, 2009). Consequently, financial firms worldwide are currently under significant pressure to strengthen their risk management systems (Tekathen and Dechow, 2013).

Effective risk management is central to sound corporate governance, and it adds value for stakeholders (Paape and Speklè, 2012). In this regard, banks have changed their decision-making processes towards a different and more complex approach that integrates social, environmental and consumer concerns into their core strategies (Barbu and Vintila, 2007; De la Cuesta-González et al., 2006; Scholtens, 2006). They have also redesigned their risk management processes accordingly (Linsley and Shrives, 2006) and carry out risk-based due diligence to identify, prevent and mitigate all

risk events, including financial and non-financial ones, to minimise possible adverse impacts on overall performance (Milano, 2010).

Because of the aforementioned considerations, the idea of enterprise risk management (ERM) has gained substantial momentum (Lundqvist, 2014; Paape and Speklè, 2012; Frigo and Anderson, 2011). ERM enables organisations to effectively deal with uncertainty, and its associated risks and opportunities, to achieve performance and profitability targets and prevent the loss of resources (COSO, 2004). Therefore, we argue that such an approach enhances banks' capacity to preserve and create value for their stakeholders, which includes not only economic profit but also social benefits.

A growing number of academic researchers (Demidenko and McNutt, 2010; Weitzner and Darroch, 2010) and practitioners (Institute of Internal Auditors, 2013; Institute of Risk Management, 2012) have begun to address the connection between ERM implementation and both economic and social value. However, as yet, there is no empirical evidence concerning how ERM systems can be organised in order to balance and manage the risks associated with the aforementioned duality of purpose. To fill this gap, our research explores how ERM practices work within financial institutions that aim to achieve both economic and social value. To better focus the analysis, we look at the credit cooperative banking sector because banks in that sector are recognised by regulators

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(European Commission, 2011) and professional associations (International Cooperative Banking Association, 2013) alike as being especially affiliated with social business behaviours. Indeed, they are described in the literature as *ethical banks*, as characterised by San-Jose et al. (2011).

Credit cooperative banks, as ethical banks, have a twofold purpose: as financial intermediaries, they have to achieve economic profitability in order to meet the shareholders' needs, while, at the same time, they operate to promote the economic and social development of local communities (San-Jose et al., 2011; Barbu and Vintila, 2007; Buttle, 2007; Cowton and Thompson, 2001). For this reason, these banks provide funding to local businesses and non-bankable persons (Ayadi et al., 2010) that have frequently experienced financial exclusion because they carry more risk than those that large commercial banks are typically prepared to fund.

Credit cooperative banks' risks are those of their clients, namely a combination of economic and social risks that are translated into the banks' activity, forcing these financial institutions to face a wider range of risk categories (other than financial ones) in order to achieve their targets. Therefore, ERM assumes a crucial role, especially in the context of credit cooperative banks, because it allows them to holistically handle riskiness according to the specific nature of these banks' business model, including their peculiar governance structure.

Hence, the aim of this paper is to investigate how the implementation of an ERM system can help such banks, which aim to achieve both economic targets and social value, to better identify, manage, and mitigate their risks.

More specifically, our analysis answers the following research questions:

1. How do credit cooperative banks operationalise ERM?
2. How does the governance structure of credit cooperative banks shape ERM?
3. How does ERM allow credit cooperative banks to achieve both economic and social performance?

To deepen our understanding of how ERM may help organisations that aim to achieve both economic and social purposes, our analysis employs a single case study of an Italian credit cooperative bank.

The remainder of the paper is structured as follows. Section 2 elucidates the main characteristics of the business model of cooperative banks to which we refer in our analysis. Section 3 assesses prior studies on ERM practices. Section 4 describes the research method. Section 5 focuses on the case study itself, while Section 6 discusses the main findings of the research. The last section concludes the study, considers the implications of the analysis and makes suggestions for further research.

2. The business model of credit cooperative banks

During the last few years, a number of factors, both theoretical and practical, have contributed to banks' attempting to add value to stakeholders (European Commission, 2011; Arena et al., 2011; Barbu and Vintila, 2007; Scholtens, 2006). Attention has been devoted to the banking system because it has the power to orient and redirect external firms' performance, thus generating a more comprehensive engagement with the potential to move the whole economic system towards the creation of social value (De la Cuesta-González et al., 2006).

To improve value for stakeholders, banks are including social value, along with economic purposes, into their decision-making processes (De Graaf, 2006) and are taking into account the economic and social risks associated with their investments (European

Commission, 2011; Scholtens, 2006; De la Cuesta-González et al., 2006). This also implies that banks have started to assess their clients on the basis of their social and environmental performance, thus stimulating the pursuit of non-profit-oriented goals from their borrowers, investors and other actors in the external environment.

The growth in importance of non-profit-oriented issues has increased interest in the area of the banking system that centres its activity on humans rather than money. Different from traditional banks, this kind of locally-rooted financial firm pays more attention to the external, non-economic consequences of all economic decisions. Hence, such organisations fund entrepreneurs who are promoting business models that increase social value, guarantee ecosystem protection, and develop democratic decision-making processes. This kind of bank avoids engaging in financial practices for speculative purposes and instead promotes the idea of the creation of value for the community as a whole (Ayadi et al., 2010).

The literature defines such banks, which are shaping a different idea of finance, as ethical banks and identifies the duality of purpose as their distinguishing feature. Importantly, ethical banks aim to achieve both economic and social profitability (San-Jose et al., 2011; Barbu and Vintila, 2007; Cowton and Thompson, 2001). *Economic profitability* should be regarded as a good management practice on the part of the bank that helps to guarantee economic sustainability and durability over time, while *social profitability* involves funding economic activities with a social role as well as the absence of investments in speculative projects (San-Jose et al., 2011). These targets have to be achieved jointly, since the social dimension, which makes the bank ethical, can only be pursued if the bank is economically sustainable. In other words, the financial *objectives of these organisations* are merely their means of realising the ultimate *objectives of people*, which are non-financial in nature.

It has been argued (San-Jose et al., 2011; Cowton, 2010) that such banks build their core business on the following three principles, which represent the meeting point between traditional and ethical banking systems (Viganò and Nicolai, 2006): *affinity*, *responsibility* and *integrity*. The affinity principle is based on investments that meet the interests of both shareholders and depositors, and refers to the banks' responsibility for decision making regarding the placement of assets as well as the final destination of deposited funds. The responsibility principle is about being accountable to the local community as a whole for the consequences of a bank's behaviour. The integrity principle, fostered by close proximity to customers, is related to the attempt to avoid financial exclusion, which often includes immigrants, women, and the very young and very old, i.e. the so-called non-bankable people, to which credit is denied (Cowton, 2010).

This ethical approach to banking has inspired many European financial institutions (De Clerck, 2010), who have gradually operationalised the aforementioned driving principles in their activity, sometimes adopting different legal structures that allow them to operate for the achievement of social purposes. Such banks may be not linked to a particular association or may belong to a specific network (Buttle, 2007), as is the case for credit cooperative banks.

The literature supports the contention that the three principles discussed above, as well as the theoretical underpinnings of ethical banks, have been put into practice in the business model of credit cooperative banks (San-Jose et al., 2011; Barbu and Vintila, 2007; Buttle, 2007; Thompson and Cowton, 2001). 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 little or no collateral and 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 (Viganò and Nicolai, 2006). The historical motivations related to

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