BANKS’ INTERNAL CONTROLS AND RISK MANAGEMENT: VALUE-ADDED FUNCTIONS IN ITALIAN CREDIT COOPERATIVE BANKS

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Abstract

A critical component of safe and sound bank management is constituted by an effective and efficient system of internal controls, which help to ensure that the goals and objectives of a bank will be met, that long-term profitability targets will be achieved, and maintain reliable financial and managerial reporting. Such a system can also ensure that the bank will comply with laws and regulations as well as policies, plans, internal rules and procedures, and decrease the risk of unexpected losses or damage to the bank’s reputation.

The paper describes the essential elements of a sound internal control system and through a qualitative approach, it shows how is tied to the rules attaining capital requirements and, above all, to the purpose of the Internal Capital Adequacy Assessment Process (ICAAP) which aims at determining the adequate capitalisation of a bank given the risks endured as well as future risks arising from growth, and new business lines. After the recent financial crisis ICAAP is becoming more and more relevant and a central component of an effective strategy for managing risk and creating value. All principles and considerations are referred to Italian Credit Cooperative Banks particular both for dimension and for governance and risk management. They have been contacted though local federations and the results confirm the existing of weakness in internal controls.

Keywords: internal control system, risk management, risk appetite, Pillar II, ICAAP

JEL classification: G21, G28, G32

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1 Introduction

The heightened interest in internal controls is, in part, a result of significant losses incurred by several banks and financial markets during the recent crisis. An analysis of the problems related to these losses indicates that they should have been avoided if the banks had maintained effective internal control systems. Such systems would have prevented or enabled earlier detection of the problems that led to the losses, thereby limiting damage to the banks.

In this context regulators have asked, why financial regulation and Basel II framework have not been able to really prevent those troubles, and how financial regulation must evolve in order to prevent this meltdown (Opplinger, 2009).

The crisis has strongly reinforced the role of internal control of risks and capital adequacy as well as the relevance of Pillar II with the Internal Capital Adequacy Assessment Process (ICAAP) that has the ability to determine the adequate capitalisation of a bank given its risks.

The paper tries to answer, through a qualitative approach, the following questions: what is the relationship between internal controls and risk assessment? What is the role of regulatory framework in determining changes in risk exposure? Is regulatory pressure of the new rules and requirements effective to improve banking stability, in particular in Italian Credit Cooperative Banks?

Few studies are based on these questions (Brewer et al., 2008; Cerrone, 2012) and for this reason the paper really contributes to an advance in knowledge about how new rules referred to internal controls affect banks and their choices in relation to risk management policies.

Italian Credit Cooperative Banks are particular as they apply each rule according to the principle of proportionality which influences their policies and plans.

The management body is responsible for...
ensuring that the bank has in place the three independent functions that constitute an efficient system of internal controls. These functions are, at least, risk control, compliance and internal audit. The risk control function ensures that risk policies are complied with. The compliance function identifies and assesses compliance risk. The internal audit function is an instrument for the management body to ensure that the quality of the risk control function and the compliance function is adequate. Internal control also includes, e.g. accounting organization, treatment of information, risk assessment and measurement systems.

Strictly connected with ‘internal control’ is also ‘internal governance’ used, as opposed to the term ‘corporate governance.’ While corporate governance has a wider scope and includes issues that concern the shareholders and other stakeholders of an institution, internal governance focuses on the responsibility of management body (both supervisory and senior management functions). It is mainly concerned with setting the institution’s business objectives and its appetite for risk, how the business of the institution is organised, how responsibilities and authority are allocated, how reporting lines are set up and what information they convey, and how internal control (including risk control, compliance, and internal audit) is organised.

There is considerable interest in the topic of internal controls and their contribution to management of any business (Rittenberg, 2006). This developing role of the internal controls is due to their characteristics of being “a system of internal administrative and financial checks and balances designed by management, and supported by corrective actions, to ensure that the goals and responsibilities of the organization are achieved” (Cahill, 2006).

The development of international financial markets has given banks the opportunity to design new products and to provide a wide range of services, increasing also risks (Palfi et al., 2009). Simultaneously, there is growing management recognition of the importance of implementing a good internal control system as the recent crisis and some international banks’ troubles have highlighted fraud and negligence as the major contributory factors. The success of internal controls is strongly associated with five elements (Messier, 1997; Candreva, 2006): control environment, risk assessment, control activities, information and communication and monitoring. The purpose of this paper is to provide an overview of current developments in the regulation about internal controls, also connected with the Internal Capital Adequacy Assessment Process, introduced by Basel II Pillar 2. The current position of banks about ICAAP will be considered after some years of its adoption as a risk controlling process. Qualitative considerations focus that the new rules about internal controls induce the banks to be necessarily regulators’ compliant.

The paper is organized as follows. The next two sections review the related literature and provides the focus of the study by analyzing the effectiveness of regulation internal controls and of ICAAP, confirming for this that the most relevant theoretical contributions are often focused on capital management more than on the relevance of the process itself. The third section is a focus on the characteristics of the actual regulation based on Basel II and in particular on Pillar 2 and its core principles of internal capital adequacy assessment process whose aim is that of inducing the management to examine, control and measure not only the Pillar 1 risks, but also to the global risk exposure of the bank. Other two sections are devoted to Italian Credit Cooperative system and its relationship with the new rules about internal controls. Finally, the paper concludes by presents major findings of the study limitations of the study and future research directions.

2 Theoretical framework of internal control: literature review

The contributions by the Committee of Sponsoring Organizations of the Treadway Commission (COSO) are currently very relevant to help organizations in implementing enterprise risk management (ERM). The COSO document Enterprise Risk Management — Integrated Framework explicitly states that organizations must embrace risk in pursuing their goals (COSO, 2012). The key is to understand how much risk they are willing to accept, and to what extent should the risks accepted be expression of stakeholders’ objectives and attitudes towards risk. Moreover the organization must ensure that its units are operating within bounds that represent the organization’s appetite for specific kinds of risk. The notion of an entity’s “risk appetite” embodies the above mentioned situations2.

Enterprise Risk Management (ERM) is not isolated from strategy, planning, or day-to-day decision making. ERM is part of an organization’s culture, just as making decisions to attain objectives is part of an organization’s culture. To fully embed ERM in an organization, decision makers must know how much risk is acceptable as they consider ways of accomplishing objectives, both for their organization and for their individual operations.

In order to determine internal controls efficiency it is important to consider the conceptual framework (Savcu, 2007). By measuring and evaluating the effectiveness of organizational controls, internal control system itself is an important managerial

\[ \text{Risk appetite is the amount of risk, on a broad level, an organization is willing to accept in pursuit of value. Each organization pursues various objectives to add value and should broadly understand the risk it is willing to undertake in doing so}. \] (COSO, 2012)

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control device (Carmichael et al., 1996), which is directly linked to the organizational structure and the general rules of the business (Cai, 1997). Another more comprehensive definition is based on the institutional environment; many standards can be used in order to assess the effectiveness of internal controls. The success of internal controls is strongly associated with five elements (Messier, 1997; Candreva, 2006): control environment, risk assessment, control activities, information and communication, and monitoring (as described by the COSO Report). Specifically, control environment reflects the attitude and the policies of management with regard to the importance of internal control system in the economic unit; it is also influenced by the background of the economic unit, and has a great influence on business activities. Regarding risk assessment, it can be claimed that it is the identification and analysis of relevant risks associated with achieving the business objectives (Karagiorgos et al., 2009). Hence, control activities are the policies, procedures, and mechanisms that enforce management’s directives. The information and communication component refers to the identification, capture, and communication. Finally, it is commonly acceptable that internal control systems need to be monitored in order to assess the quality of the system’s performance over time. Hence by monitoring, it is ensured that the findings of audits and other reviews are promptly resolved (Rezae et al., 2001). The growing importance of internal controls in banking sector has led to systematic research into the factors that improve the performance of this function in banks.

3 The legal framework of internal control and risk management: regulation on banks’ internal controls

The Basle Committee has studied recent banking problems in order to identify the major sources of internal control deficiencies (BSBC, 2010 a; 2010, b). The problems identified reinforce the importance of having bank directors and management, internal and external auditors, and bank supervisors focus more attention on strengthening internal control systems and continually evaluating their effectiveness. Several recent cases demonstrate that inadequate internal controls can lead to significant losses for banks. Moreover, this framework is consistent with the increased emphasis of banking supervisors on the review of a banking organization’s risk management and internal control processes. It is important to emphasize that it is the responsibility of a bank’s board of directors and senior management to ensure that adequate internal controls are in place at the bank and to foster an environment where individuals understand and meet their responsibilities in this area. In turn, it is the responsibility of banking supervisors to assess the commitment of a bank’s board of directors and management to the internal control system.

The most relevant control breakdowns in banks are summarized in table 1.

Without exception, cases of major loss reflect management inattention to, and laxity in, the control culture of the bank, insufficient guidance and oversight by boards of directors and senior management, and a lack of clear management accountability through the assignment of roles and responsibilities.

These cases also reflect a lack of appropriate incentives for management to carry out strong line supervision and maintain a high level of control. Many banking organizations that have suffered major losses neglected to recognise and assess the risks of new products and activities, or update their risk assessments when significant changes occurred in the environment or business conditions. Many recent cases highlight the fact that control systems that function well for traditional or simple products are unable to handle more sophisticated or complex products (BCBS, 2013).

Lack of segregation of duties in particular has played a major role in the significant losses that have occurred at banks.

| Table 1. Typical control breakdowns in banks |
| ♦ Lack of adequate management oversight and accountability, and failure to develop a strong control culture within the bank. |
| ♦ Inadequate recognition and assessment of the risk of certain banking activities, whether on- or off-balance sheet |
| ♦ The absence or failure of key control structures and activities, such as segregation of duties, approvals, verifications, reconciliations, and reviews of operating performance. |
| ♦ Inadequate communication of information between levels of management within the bank, especially in the upward communication of problems |
| ♦ Inadequate or ineffective audit programs and monitoring activities |

To be effective, policies and procedures need to be effectively communicated to all involved in an activity. Some losses in banks occurred because relevant personnel were not aware of or did not
understand the bank’s policies. In many cases, also audits were not sufficiently rigorous to identify and report the control weaknesses associated with problem banks. In other cases, even though auditors reported problems, no mechanism was in place to ensure that management corrected the deficiencies.

4 Regulation on banks’ risk management systems

Basel II published in final form in 2006 a three-pillar approach to risk and capital management for banks. Pillar 1 outlines a complex set of definitions, processes, and formulas to calculate minimum regulatory capital requirements. Pillar 3 mandates the disclosures that banks must make to provide investors and the public with full transparency. Pillar 2 describes the mandatory processes for both banks and regulators to fulfill the capital-adequacy requirements. Banks have to conduct an Internal Capital Adequacy Assessment Process (ICAAP) to demonstrate that they have implemented methods and procedures to ensure adequate capital resources, with due attention to all material risk. The ICAAP supplements Pillar 1’s minimum regulatory capital requirements; it considers a broader range of risk types and the bank’s risk- and capital-management capabilities. At the center of most banks’ ICAAP are their internal risk models. These models often calculate capital requirements that are lower than the regulatory minimum because of diversification effects and other adjustments that can be explicitly considered in internal models. By law, banks cannot undercut the regulatory minimums. More often than not, however, the ICAAP may result in higher capital requirements, for two main reasons: a broader range of risks is covered compared with Pillar 1 definitions. While banks spent a good deal of time and money developing these models, by far the greater part of their attention before the economic crisis was focused on compliance with Pillar 1. Recent regulatory changes to Pillar 1, which constitute the bulk of the Basel III proposals, have only made that focus more acute.

5 Basic principles of ICAAP

The ICAAP is based both on quantitative elements of the risk management process (i.e. on the internal capital requirements and the calculation of the internal capital estimates), and on qualitative elements designed to strengthen the bank’s internal environment.

Each bank must maintain an appropriate relationship between these elements, or better between the internal capital requirements and the effectiveness and transparency of the risk management processes, whereby it must be aware that capital itself is not an adequate substitute for a safe and sound risk control policy. On this basis banks must follow some specific principles for a full implementation of the ICAAP; this are commonly defined by CEBS (2006) These principles consist in the bank’s responsibility, to provide detailed argumentation to supervisors; the proportionality of the process according to the nature, scope and complexity of the business that the bank pursues, the sophistication of its risk management system and the approaches that the bank uses to calculate minimum capital requirements; the focus on risks which have a material impact on the bank’s current or future capital adequacy; by considering bank’s risk profile and the impact of the external factors of the environment in which it operates; moreover, in the ICAAP process, relevance must be assigned to the influence of the business cycle, the environmental factors that can have an adverse impact on the adequacy of the bank’s internal capital requirements, and the bank’s strategic plans and their dependence on macroeconomic factors, by formulating relevant and sufficiently detailed scenarios of exceptional situations (stress tests). Table 2 summarizes the common steps in which ICAAP is generally articulated by banks.

Table 2. Common ICAAP Steps

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<td>♦ Assess all the risks the bank is exposed</td>
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<td>♦ Calculate how much capital is required to offset each risk using adapted models</td>
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<td>♦ Apply stress tests to assess how this capital might be affected by changing business conditions</td>
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<tr>
<td>♦ Define how much capital (internal or economic capital) should be held</td>
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<td>♦ The board and the senior management must demonstrate understanding of their roles and responsibilities with full documentation and formalized approval process</td>
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Careful planning of the internal capital requirements for current and future periods is the key for long-term stability according to bank’s risk-bearing capacity (Gropp, 2010). For this reason the internal capital requirements, calculated for the purpose of the ICAAP, may be higher or lower than the minimum capital requirements. There are various reasons for this: (a) the consideration of risks and

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3 In several instances, information about inappropriate activities that should have been reported upward through organizational levels was not communicated to the board of directors or senior management until the problems became severe. In other instances, information in management reports was not complete or accurate, creating a falsely favourable impression of a business situation.

4 For example, the bank can make the argument with the supervisor for a lower internal capital requirements for an individual risk (to which it is more exposed) by virtue of a high-quality internal control environment based on which it can effectively manage and mitigate the risk.
factors that are not included in the minimum capital requirement; in this case the internal capital requirement is higher than the minimum capital requirement;

(b) the use of advanced risk measurement techniques, such as economic capital models;

(c) the consideration of the effects of correlations and diversification.

To measure its risk exposure and to calculate the internal capital requirement each bank should differentiate among risk typologies. In fact for Pillar 1 risks, the calculation of internal capital requirements follows the approaches for calculating minimum capital requirements or its own methodologies; for risks not entirely covered by minimum capital requirements, the less-sophisticated approaches to calculating minimum capital requirements cannot fully take into consideration all the specific factors in the bank’s exposure to a specific risk, as the assumptions on which their (regulatory) methodologies are based do not allow for this; and then, for the risks that are not subject to minimum capital requirements, in their assessment (if materially significant), the bank uses its own quantitative or qualitative methodologies.

6 Objectives and role of the internal control framework

Internal control is a process effected by the board of directors, senior management and all levels of personnel. It is not solely a procedure or policy that is performed at a certain point in time, but rather it is continually operating at all levels within the bank. The board of directors and senior management are responsible for establishing the appropriate culture to facilitate an effective internal control process and for monitoring its effectiveness on an ongoing basis and each individual within an organization must participate in the process. The main objectives of the internal control process are as follows:

1. Efficiency and effectiveness of activities (performance objectives); they pertain to the effectiveness and efficiency of the bank in using its assets and other resources and protecting the bank from loss. The internal control process seeks to ensure that personnel throughout the organization are working to achieve its goals with efficiency and integrity, without excessive cost or placing other interests (such as an employee’s, or customer’s interest) before those of the bank;

2. Reliability, completeness and timeliness of financial and management information (information objectives); they address the preparation of timely, reliable, relevant reports needed for decision-making within the bank. They also address the need for reliable annual accounts, other financial statements and other financial-related disclosures and reports to shareholders, supervisors, and other external parties.

The information received by management, the board of directors, shareholders and supervisors should be of sufficient quality and integrity that recipients can rely on the information in making decisions.

3. Compliance with applicable laws and regulations (compliance objectives). They ensure that all banking business complies with applicable laws and regulations, supervisory requirements, and the bank’s policies and procedures. This objective must be met in order to protect the bank’s reputation.

7 The Italian Credit Cooperative System

The Italian Credit Cooperative system is based on a network comprising 388 cooperative banks called Banche di Credito Cooperativo, Casse Rurali, and Casse Raiffeisen in Alto Adige; associative structures; and several service companies, all of which work together to guarantee a complete and diversified range of products, in keeping with the values and identity of a cooperative. The most important feature of these cooperative banks (BCCs) is that of being local, mutual, not-for-profit cooperatives. BCCs, which are found throughout the length and breadth of Italy, have served local communities for the past 130 years, promoting development and meeting their social and economic needs, as stated in article 2 of the BCC Corporate Statute.

5 Good practice indicates that in this case the internal capital requirements can be lower than the minimum capital requirements. The bank must nevertheless build its capital in an amount equal to or higher than the minimum capital requirements.

6 Even in this case the internal capital requirements can be lower than the minimum capital requirements, whereby the bank should have capital that is equal to or higher than the minimum capital requirements.

7 In the area of credit risk, for the purposes of the ICAAP the bank must therefore consider the residual risk as a result of the use of credit protection to reduce exposure to credit risk and securitization exposure. For operational risk, the ICAAP establishes that the bank must consider the risks deriving from its planned business strategy and the risks deriving from the scope and complexity of its business, where these risks conform to the definition of operational risk.

8 The commonly classified types of risks are as follows: Pillar I Risks - Credit Counterparty risk Operational risk Market risk Equity Risks; Additional refinements to Pillar I Risks - Residual risks Securitisation risk Model risk IRC/CRM/Stressed VaR; Pillar II Risks - Credit concentration risk Country risk Interest rate risk in the banking book - Overall IR Liquidity risk Settlement risk Other risks - (e.g. Reputation/Strategic Risk). However this classification is only a simplification as the definitions of the risks under review may differ (and consequently the risk inventory) because the number of defined risk types can vary from bank to bank and the risks may be defined in a broad or narrow sense.

9 “The Bank aims to serve the interests of its stakeholders and members of the local community through the provision of financial operations and services, to improve their moral, cultural and economic conditions, promoting collaboration and teaching the benefits of saving and forward planning as well as encouraging social unity and responsible, sustainable growth in the surrounding territory. The Bank distinguishes
The BCCs are double faceted banks: they act as financial intermediaries, with their fundamental activities of loans and savings accounts, and as Corporate Social Responsibility (CSR) companies.

Hence BCCs offer all banking services normally offered by other financial institutions. However, BCCs differ from other banks in a number of ways; first and foremost in that their primary objectives are the wellbeing of their stakeholders and the development of the local economy.

Table 3. Credit Cooperative System – Facts and Figures

- 388 banks with about 4,446 branches
- 1,151,156 members
- Over 37,000 employees work for the Credit Cooperative Banks
- There are cooperative banks in 101 provinces and 2,706 municipalities
- Total Funding (funding from financial institutions, funding from non-financial institutions, bonds): €188 billion
- Loans: €136.2 billion
- Total Equity (capital + reserve): €20 billion (+1,8%)

(Data from June 2013; www.creditocooperativo.it)

The Credit Cooperative system is composed of an associative structure and a corporate system. The associative structure is subdivided into three levels: local (BCCs), regional (Local Federations) and national (Federcasse).

The individual BCCs are associated with the Local Federations (representing one or more regions) which in turn are members of Federcasse, the Italian Federation of BCCs. Federcasse represents and protects the rights of its associated banks, offering them legal, fiscal, and organizational assistance, while providing support in communications and training so as to benefit the entire system. There are fifteen Local Federations.

The BCCs (called Casse Rurali e Artigiane until 1993) were founded in the late nineteenth century as a new form of credit system in the same vein as the model developed by Friedrich Wilhelm Raiffeisen in Germany, based on localism and inspired by Christian ethics.

The first Italian cooperative bank, Cassa Rurale di Loreggia, was opened in 1883 by Leone Wollemborg, in the province of Padova. In 1890 a young priest named don Luigi Cerutti founded the first Catholic Rural Bank in the province of Venice.

The encyclical Rerum Novarum of 1891, written by Pope Leo XIII, became the manifesto of a widespread social movement; and by 1897 there were 904 Casse Rurali e Artigiane banks.

During the fascist period – following the introduction of the Banking Law of 1937 – many of the cooperative banks were ordered to close. After the war, the advent of the Italian Republic and Article 45 of the Italian Constitution which acknowledges the social role of mutual cooperatives, saw the relaunch of Casse Rurali e Artigiane banks.

In 1950 Federcasse (Federazione Italiana delle Casse Rurali e Artigiane), originally founded in 1909, was reformed, going on to become a member of Confcooperative in 1967.

Iccrea (Istituto di Credito delle Casse Rurali e Artigiane) was founded in 1963, with the aim of facilitating, coordinating and augmenting the services offered by the individual cooperative banks through financial intermediation and assistance.

In 1993 the Casse Rurali e Artigiane banks changed their name to Credit Cooperative Banks (Banche di Credito Cooperativo, BCCs). In the same year the Banking Law came into force, lifting the legal limitations which had previously governed the banking operations of cooperative banks. The BCCs were then able to offer all the services and products of other banks and to extend them to anyone, whatever their profession, working or residing in the catchment area of the bank.

During the nineties the system was reorganised and in 1995 Iccrea Holding S.p.A was founded as the parent company of Gruppo Bancario Iccrea. The latter also comprises a number of subsidiary companies which supply the BCCs with a vast range of financial products and services.

In 1997 the Depositors’ Guarantee Fund of the Credit Cooperative (Fondo di Garanzia dei Depositanti del Credito Cooperativo) was formed. This fund is an obligatory financial instrument to protect the depositors of the BCCs in the consortium.

In 2004 the Bondholders’ Guarantee Fund of the Credit Cooperative (Fondo di Garanzia degli Obbligazionisti del Credito Cooperativo) was formed. This financial instrument protects the credit rights of BCC bondholders. The BCCs are the only banks in Italy to offer such a guarantee.

In 2008 the Institutional Guarantee Fund of the Credit Cooperative (Fondo di Garanzia Istituzionale del Credito Cooperativo) was formed to protect BCC clients; safeguarding the liquidity and solvency of the banks through measures of corrective action, financial support, and crisis prevention.
8 The major elements of an internal control process in credit cooperative banks

The Credit Cooperative system is characterized by a large number of small banks, in which all the rules approved by regulators are applied according to the principle of proportionality (BCBS, 2009). Moreover the new rules by the Bank of Italy (Banca d’Italia, 2013) are forcing banks to organize their internal control system to become more consistent with the overall risk taking policy of the bank, in other words in the definition of the own “risk appetite framework” (COSO, 2012). The Ital Credit Cooperative banks are becoming rules compliant, as they are obliged to have adopted all the rules from July 2014.

Nevertheless the internal control process, which historically has been a mechanism for reducing instances of fraud, misappropriation and errors, has become more extensive, addressing all the various risks faced by banks. It is now recognized that a sound internal control process is critical to a bank’s ability to meet its established goals, and to maintain its financial viability.

Through the collaboration with local federations, board of directors and senior management have received questionnaires about the structure of their control system and the respect of the principles it is based on. The information covered the last three years (2010-2012) and have been elaborated considering the new rules evolution of July 2013. This section illustrates the most relevant elements of an internal control process in Credit Cooperative Banks and in the conclusions are summarized the qualitative results deriving from the answers received.

Firstly, internal control system consists of five interrelated elements:
1. Management oversight and the control culture;
2. Risk recognition and assessment;
3. Control activities and segregation of duties;
4. Information and communication;
5. Monitoring activities and correcting deficiencies.

The problems observed in recent large losses at banks can be aligned with these five elements.

The effective functioning of these elements is essential to achieving a bank’s performance, information, and compliance objectives.

The board of directors provides governance, guidance and oversight to senior management. It is responsible for approving and reviewing the overall business strategies and significant policies of the bank as well as the organizational structure. It has the ultimate responsibility for ensuring that an adequate and effective system of internal controls is established and maintained. Board members should be objective, capable, with a knowledge or expertise of the activities of and risks run by the bank. A strong, active board, particularly when coupled with effective upward communication channels and capable financial, legal, and internal audit functions, provides an important mechanism to ensure the correction of problems that may diminish the effectiveness of the internal control system.

The board of directors should include in its activities (1) periodic discussions with management concerning the effectiveness of the internal control system, (2) a timely review of evaluations of internal controls made by management, internal auditors, and external auditors, (3) periodic efforts to ensure that management has promptly followed up on recommendations and concerns expressed by auditors and supervisory authorities on internal control weaknesses, and (4) a periodic review of the appropriateness of the bank’s strategy and risk limits.

Senior management is responsible for carrying out the directives of the board of directors, including the implementation of strategies and policies and the establishment of an effective system of internal control. Members of senior management typically delegate responsibility for establishing more specific internal control policies and procedures to those responsible for a particular business unit. Delegation is an essential part of management; however, it is important for senior management to oversee the managers to whom they have delegated these responsibilities to ensure that they develop and enforce appropriate policies and procedures.

Compliance with an established internal control system is heavily dependent on a well-documented and communicated organizational structure that clearly shows lines of reporting responsibility and authority and provides for effective communication throughout the bank. The allocation of duties and responsibilities should ensure that there are no gaps in reporting lines and that an effective level of management control is extended to all levels of the bank and its various activities.

Another essential element of an effective system of internal control is a strong control culture. It is the responsibility of the board of directors and senior management to emphasize the importance of internal control through their actions and words. This includes the ethical values that management displays in their business dealings, both inside and outside the bank.

In varying degrees, internal controls are the responsibility of everyone in a bank. Almost all employees produce information used in the internal control system or take other actions needed to effect control. An essential element of a strong internal control system is the recognition by all employees of the need to carry out their responsibilities effectively and to communicate to the appropriate level of management any problems in operations, instances of non-compliance with the code of conduct, or other policy violations or illegal actions that are noticed. This can best be achieved when operational procedures are contained in clearly written
documentation that is made available to all relevant personnel. It is essential that all personnel within the bank understand the importance of internal control and are actively engaged in the process.

While having a strong internal control culture does not guarantee that a bank will reach its goals, the lack of such a culture provides greater opportunities for errors to go undetected or for improprieties to occur.

Banks are in the business of risk-taking. Consequently it is imperative that, as part of an internal control system, these risks are being recognized and continually assessed. From an internal control perspective, a risk assessment should identify and evaluate the internal and external factors that could adversely affect the achievement of the bank’s performance, information and compliance objectives. This process should cover all risks faced by the bank and operate at all levels within the bank. It differs from the risk management process which typically focuses more on the review of business strategies developed to maximize the risk/reward trade-off within the different areas of the bank.

Effective risk assessment identifies and considers internal factors (such as the complexity of the organization structure, or the nature of the bank’s activities) as well as external factors (such as fluctuating economic conditions, changes in the industry and technological advances) that could adversely affect the achievement of the bank’s goals. This risk assessment should be conducted at the level of individual businesses and across the wide spectrum of activities and subsidiaries. This can be accomplished through various methods.

The risk assessment process, and the definition of the risk appetite (ABI, 2011) also includes evaluating the risks to determine which are controllable by the bank and which are not. For those risks that are controllable, the bank must assess whether to accept those risks or the extent to which it wishes to mitigate the risks through control procedures. For those risks that cannot be controlled, the bank must decide whether to accept them or to withdraw from or reduce the level of business activity concerned.

In order for risk assessment, and therefore the system of internal control, to remain effective, it is needed to continually evaluate the risks affecting the achievement of the bank’s goals and react to changing circumstances and conditions. Internal controls may need to be revised to appropriately address any new or previously uncontrolled risks. Often these risks can be best understood when considering how various scenarios (economic and otherwise) affect the cash flows and earnings of financial instruments and transactions.

Control activities are designed and implemented to address the risks that the bank identified through the risk assessment process described above. Control activities involve two steps: (1) the establishment of control policies and procedures; and (2) verification that the control policies and procedures are being complied with. They are most effective when they are viewed by management and all other personnel as an integral part of, rather than an addition to, the daily activities of the bank. In fact, when controls are viewed as an addition to the day-to-day activities, they are often seen as less important and may not be performed in situations where individuals feel pressured to complete activities in a limited amount of time. In addition, controls that are an integral part of the daily activities enable quick responses to changing conditions and avoid unnecessary costs. As part of fostering the appropriate control culture within the bank, senior management should ensure that adequate control activities are an integral part of the daily functions of all relevant personnel.

It is not sufficient for senior management to simply establish appropriate policies and procedures for the various activities and divisions of the bank. They must regularly ensure that all areas of the bank are in compliance with such policies and procedures and also determine that existing policies and procedures remain adequate. This is usually a major role of the internal audit function.

Segregation of duties is not limited to situations involving simultaneous front and back office control by one individual. It can also result in serious problems when there are not appropriate controls in those instances where an individual has responsibility. Areas of potential conflict should be identified, minimized, and subject to careful monitoring by an independent third party. There should also be periodic reviews of the responsibilities and functions of key individuals to ensure that they are not in a position to conceal inappropriate actions.

Adequate information and effective communication are essential to the proper functioning of a system of internal control. From the bank’s perspective, in order for information to be useful, it must be relevant, reliable, timely, accessible, and provided in a consistent format. Information includes internal financial, operational and compliance data, as well as external market information about events and conditions that are relevant to decision making. Internal information is part of a record-keeping process that should include established procedures for record retention.

A critical component of a bank’s activities is the establishment and maintenance of management information systems that cover the full range of its activities. This information is usually provided through both electronic and non-electronic means. Banks must be particularly aware of the organizational and internal control requirements related to processing information in an electronic form and the necessity to have an adequate audit trail. Management decision-making could be adversely affected by unreliable or misleading information provided by systems that are poorly designed and
controlled.

In addition to the risks and controls above, inherent risks exist that are associated with the loss or extended disruption of services caused by factors beyond the bank’s control. In extreme cases, since the delivery of corporate and customer services represent key transactional, strategic and reputational issues, such problems could cause serious difficulties for banks and even jeopardise their ability to conduct key business activities. This potential requires the bank to establish business resumption and contingency plans using an alternate off-site facility, including the recovery of critical systems supported by an external service provider. The potential for loss or extended disruption of critical business operations requires an institution-wide effort on contingency planning, involving business management, and not focused on centralized computer operations. Business resumption plans must be periodically tested to ensure the plan’s functionality in the event of an unexpected disaster.

The organizational structure of the bank should facilitate an adequate flow of information - upward, downward and across the organization. A structure that facilitates this flow ensures that information flows upward so that the board of directors and senior management are aware of the business risks and the operating performance of the bank. Information flowing down through an organization ensures that the bank’s objectives, strategies, and expectations, as well as its established policies and procedures, are communicated to lower level management and operations personnel. This communication is essential to achieve a unified effort to meet the bank’s objectives.

Since banking is a dynamic, rapidly evolving industry, banks must continually monitor and evaluate their internal control systems in the light of changing internal and external conditions, and must enhance these systems as necessary to maintain their effectiveness. Monitoring the effectiveness of internal controls can be done by personnel from several different areas, including the business function itself, financial control and internal audit. For that reason, it is important that it is clear who is responsible for which monitoring functions. Monitoring should be part of the daily activities of the bank but also include separate periodic evaluations of the overall internal control process. The frequency of monitoring different activities of a bank should be determined by considering the risks involved and the frequency and nature of changes occurring in the operating environment.

Ongoing monitoring activities can offer the advantage of quickly detecting and correcting deficiencies in the system of internal controls. Such monitoring is most effective when the system of internal control is integrated into the operating environment and produces regular reports for review.

As concerns the internal audit function, it is an important part of the ongoing monitoring of the system of internal controls because it provides an independent assessment of the adequacy of, and compliance with, the established policies and procedures. It is critical that the internal audit function is independent from the day-to-day functioning of the bank and that it has access to all activities conducted by the banking organization, including at its branches.

By reporting directly to the board of directors or its audit committee, and to senior management, the internal auditors provide unbiased information about line activities. Due to the important nature of this function, internal audit must be staffed with competent, well-trained individuals who have a clear understanding of their role and responsibilities. The frequency and extent of internal audit review and testing of the internal controls within a bank should be consistent with the nature, complexity, and risk of the organization’s activities.

It is important that the internal audit function reports directly to the highest levels of the banking organization, this allows for the proper functioning of corporate governance by giving the board information that is not biased in any way by the levels of management that the reports cover.

Internal control deficiencies, or ineffectively controlled risks, should be appropriately reported as soon as they are identified, with serious matters reported to senior management and the board of directors. Once reported, it is important that management corrects the deficiencies on a timely basis. The internal auditors should conduct follow-up reviews or other appropriate forms of monitoring, and immediately inform senior management or the board of any uncorrected deficiencies. In order to ensure that all deficiencies are addressed in a timely manner, senior management should be responsible for establishing a system to track internal control weaknesses and actions taken to rectify them.

9 Results and Conclusions

This paper outlines the current developments in the field of internal controls and Basel II Pillar 2 with ICAAP and the perspective importance for banks’ management boards. Beyond regulatory pressure, the economic value added of internal control functions and a sound ICAAP framework is significant and can be attained with reasonable effort. In response to the present financial crisis, detailed guidelines on internal controls and some of the major ICAAP topics such as stress testing and liquidity and funding risk are evolving in line with Basel III framework.

Many internal control failures that resulted in significant losses for banks could have been substantially lessened or even avoided if the board and senior management of the organizations had established strong control cultures. Weak control cultures often had two common elements. First, senior management failed to emphasize the
importance of a strong system of internal controls, and to ensure that the organizational structure and managerial accountabilities were well defined.

Some banks with control problems had organizational structures in which accountabilities were not clearly defined. As a result, a division of the bank was not directly accountable to anyone in senior management. This meant that no senior manager monitored the performance of these activities closely enough to notice unusual activities, financial and otherwise, and no senior manager had a comprehensive understanding of the activities and how profits were being generated. If management had understood the activities of the division, they may have been able to recognize warning signs (such as an unusual relationship of profit to levels of risk), investigate the operations and take steps to reduce the eventual losses. These problems could also have been avoided if line management had reviewed transactions and management information reports and appropriately discussed about the nature of business transacted. Such approaches provide line management with an objective look at how decisions are being made and ensure that key personnel are operating within the parameters set by the bank and within the internal control framework.

In the recent past, inadequate risk recognition and assessment has contributed to some organizations' internal control problems and related losses. In some cases, the potential high yields associated with certain loans, investments, and derivative instruments distracted management from the need to thoroughly assess the risks associated with the transactions and devote sufficient resources to the ongoing monitoring and review of risk exposures (Caruana, 2010; Corbellini, 2013). Losses have also been caused when management has failed to update the risk assessment process as the organization’s operating environment changed.

As discussed above, bank management will set objectives for the efficiency and effectiveness of activities, reliability and completeness of financial and management information, and compliance with laws and regulations. Risk assessment entails the identification and evaluation of the risks involved in meeting those objectives. This process helps to ensure that the bank’s internal controls are consistent with the nature, complexity and risk of the bank’s on- and off-balance sheet activities (COSO, 2012).

In reviewing banking losses caused by poor internal control, it is also evident that these banks failed to observe certain key internal control principles. Of these, segregation of duties, one of the pillars of sound internal control systems, was most frequently overlooked by banks that experienced significant losses from internal control problems.

Shortcomings in control activities, however, reflect the failure of a variety of efforts to determine that business is being conducted in the expected manner, from high-level reviews to maintenance of specific checks and balances in a business process. This information took the form of periodic reports on the results of operations for all divisions of the organization that informed management of each division’s progress in meeting objectives, and allowed them to ask questions if the results were different from their expectations. Often, the divisions that later reported significant losses at first reported profits - far in excess of expectations for the apparent level of risk - that should have concerned senior management. However, because the deviations from their expectations were positive (i.e., profits), questions were not asked and investigations were not started until the problems had grown to unmanageable proportions.

Some banks have experienced losses because information in the organization was not reliable or complete and because communication within the organization was not effective. Financial information may be misreported internally; incorrect data series from outside sources may be used to value financial positions; and small, but high-risk activities may not be reflected in management reports. Many banks that have experienced losses from internal control problems did not effectively monitor their internal control systems. Often the systems did not have the necessary built-in ongoing monitoring processes and the separate evaluations performed were either not adequate or were not acted upon appropriately by management. In some cases, the absence of monitoring began with a failure to consider and react to day-to-day information provided to line management and other personnel indicating unusual activity, such as exceeded exposure limits, customer accounts in proprietary business activities, or lack of current financial statements from borrowers. In several cases, the organization’s division or activity that caused massive losses had numerous characteristics indicating a heightened level of risk such as unusual profitability for the perceived level of risk and rapid growth in a new business activity. However, due to inadequate risk assessment, the organizations did not provide sufficient additional resources to control or monitor the high-risk activities. In fact, in some instances, the high risk activities were operating with less oversight than activities with much lower risk profiles and several warnings from the internal and external auditors regarding the activities of the division were not acted upon by management.

In some cases, inadequate knowledge and training of internal audit staff in trading products and markets, electronic information systems, and other highly sophisticated areas also contributed to internal audit problems. Because the staff did not have the necessary expertise, they were often hesitant to ask questions when they suspected problems, and when questions were asked, they were more likely to accept an answer than to challenge it.
As concerns the coordination with Pillar 2 and ICAAP, it is evident that they have an additional value for financial institutions which is beyond regulatory compliance. Capital standards should be structured to reflect the business lines and the degree of risk taking chosen by the individual bank.

Regulators and banks are exploring multiple measures to restore financial stability. Proactive and efficient risk management is the key towards fulfilling this objective. Pillar 2 will occupy a central stage, as it requires banks to develop sound risk management processes that will help identify, measure, aggregate, monitor, and control risks.

Moreover, Pillar 2 in the future will focus more on reputation risk, strategic risk, liquidity risk, residual risk and hitherto less visited aspects of other risks. Banks will have to ensure ICAAP incorporates a forward-looking approach for proactive capital and performance management that is aligned with banks’ risk profile.

Nevertheless, each bank should make efforts to detect gaps in its fulfillment of requirements as early as possible so that it can take the appropriate measures in a timely and economical manner. Closing these gaps quickly mainly serves to improve the bank internal risk management and thus also enhances the bank’s ability to ensure its risk-bearing capacity. For this reason the bank should develop a master implementation which covers planning and budgeting of all ICAAP tasks. The fundamental concept behind the ICAAP should not only be communicated to the top management of the bank, but to all relevant organizational units, by applying an appropriate communication policy and setting best practices.

Finally, as concerns data quality and its elaboration, it is especially important because it determines the reliability and accuracy of calculated results (e.g. risk indicators, capital calculation). The process of data quality assurance begins with accurate data capture and goes as far as ensuring data availability in the ICAAP. Especially for risk management, it is necessary and worthwhile to ensure timely automated evaluations due to the large data quantities involved and the sometimes complex calculation algorithms used.

This paper is only a first outline of a possible, but more effective integration of the most relevant Pillar of Basel II in banking running with the evolution and improvement of the internal control system. Banks and regulators seem to be proactive for a real coordination of rules and controls to make regulations really aligned avoiding interpretation or misunderstanding which can be translated into differently risk based strategic decisions. Finally, banks should determine the methods and procedures which best suit their needs, as these determine the validity of the internal controls, of the ICAAP as well as the required implementation resources.

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