

# CORPORATE GOVERNANCE AND INTERNAL CONTROL DEFICIENCIES IN FINANCIAL INSTITUTIONS: DIRECT CAUSES OF SANCTIONS BY THE SUPERVISORY AUTHORITY

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## Abstract

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The present study represents an original and empirical investigation on the topic of prudential vigilance and financial sanctions inflicted to financial intermediaries by the Bank of Italy during the period between 2013-2016.

This paper seeks to analyse the trend of sanctions during the period between 2013 and 2016 and if sanctions in 2016 were influenced by the dimension of the financial institution, corporate governance and financial reporting items of the previous year (2015).

Consequently the study was divided into two parts: in the former a unique dataset was accumulated and considers all the documents and related information on the financial penalties inflicted by Banca d'Italia in the period between 2013 and 2016. For the second part, a multivariate regression model was elaborated with variables linked to specific types of sanctions and items of the 2015 financial reporting standards of all the Italian financial institutions involved and we hand-collected data by downloading the financial reporting standards from the websites of each entity and by analysing in depth the information regarding those sanctions.

Misconduct, corporate governance and internal control deficiencies, and the dimension of the financial entities are of major concern because this sector is based on trust.

**Keywords:** Sanctions, Financial Intermediaries, Causes, Corporate Governance, Banca d'Italia, Multivariate Regression Model

## 1. INTRODUCTION

Over the past decade, with the financial crisis, the banking and financial industry has experienced high financial penalties and increased scrutiny by regulatory boards. On the one hand, several banking professionals assume that the number and the amount of penalties have lowered bank profitability to an extent that it has created uncertainty concerning the solvency and the business model of these entities (Köster and Pelster, 2017).

In Italy, the banking system was very fragmented from the very beginning in 1936 when there were 2070 banks in the country, many of which were very small. This situation has increased the need for the country to supervise the banking system and since the beginning of the 20th century; this supervision has been exercised by the Banca d'Italia. This task was confirmed and extended in 1993 by Legislative Decree 385/1993 (TUB) and

subsequently by Legislative Decree 58/1998 (TUF). With the birth of the European Union, the need for integrating Italian and European vigilance increasingly became important (De Rynck, 2016). For this reason, in June 2012, a process of integration of the European banking market started, starting with a very important point, namely SEVIF. The European System of Financial Supervision (SEVIF) was established as a decentralized system of micro-prudential and macro-prudential authorities with a view to ensuring consistent and uniform financial supervision within the EU, composed of the various national and European supervisory authorities. It is the formal-legal point of departure of the single supervisory system.

The long European legislative process concluded with Regulation no. 1024/2013 on 15 October 2013, which assigned specific tasks to the European Central Bank on prudential supervisory policies for credit institutions, thus laying the

foundations for the first pillar of the banking union, the Single Supervisory Mechanism (SSM).

Based on these observations, this paper seeks to answer two main questions: first, how was the trend of sanctions during the period between 2013 and 2016, after the Single Supervisory Mechanism (SSM)? Second, were sanctions in 2016 influenced by the dimension of the financial institution, corporate governance and financial reporting items of the previous year (2015)?

To answer these research questions, the study was divided into two parts: in the former, a unique dataset was accumulated that consider all the documents and related information on the financial penalties inflicted by Banca d'Italia in the period between 2013 and 2016. For the second part, we elaborated a multivariate regression model with variables linked to specific types of sanctions and items of the 2015 financial reporting standards of all the Italian financial institutions involved and we hand-collected data by downloading the financial reporting standards from the websites of each entity and by analysing in depth the information regarding those sanctions.

Using this unique dataset of financial penalties, this paper is the first that (a) tries to analyse the trend and composition of financial penalties in Italy in the period between 2013 and 2016 and (b) aims at focusing on the real causes, in particular those immediately in the nearest past (2015), which might have had an impact on the amount of sanctions inflicted in 2016.

Misconduct and the resulting financial penalties are of major concern especially in the banking sector because this sector is based on trust (Köster and Pelster, 2017). Consequently, the risk of reputational damage due to financial penalties is more severe in the banking sector (European Central Bank, 2016). That is due not only to its financial intermediation and transformation function but also by the systemically relevance of the banking sector for the entire economy.

In addition, financial sanctions may hamper the capacity of these entities to fulfil their intermediation duties and thus limit access to new credit in the economy (European Central Bank, 2016).

These elements suggested conducting analyses on this topic and focusing on the financial sector.

This research represents an original contribution in the field because a multivariate analysis of regression was first implied to analyse the main causes related to financial penalties inflicted to financial institutions in Italy.

In addition, this study suggests complementing the literature that deals with corporate misconduct and its implication on firms' policy (Agrawal et al., 1999; Fich and Shivdasani, 2007; Nguyen et al., 2016). Further, this research contributes to the debate on the effectiveness of regulatory enforcement actions (Schuknecht, 2004). Delis et al. (2016) considered regulatory intervention in response to capital adequacy and liquidity concerns and its impact on bank risk. Finally, this study might extend the research that examines whether shareholders benefit from corporate misconduct (Bhagat et al., 1998; Bizjak and Coles, 1995; Griffin et al., 2004).

Furthermore, the present work differs from other studies that analysed the impact of financial penalties on the performance of banks (Köster and Pelster, 2017) or the impact of corporate and risk governance on the business management of financial institutions (Aebi et al., 2012).

Its originality also lies in the choice of the sample analysed with the regression model, which represent the entire population of sanctions inflicted in 2016.

The remainder of the study is structured as follows: Section 2 presents the Literature Review and the Theoretical Background regarding the evolution of banking supervision in Europe and Italy, with particular attention to the role of Banca d'Italia. Section 3 describes the data and sample and the empirical methodology implied for this analysis. Section 4 presents the results, while in Section 5 the discussion of them is presented. Finally, Paragraph 6 deals with conclusions.

## 2. LITERATURE REVIEW AND THEORETICAL BACKGROUND

The importance of the banking system requires careful and prudent vigilance (Barth et al, 2004, 2013) trying to avoid bankruptcy (Barth et al, 2006) able with its intervention to maintain the stability and liquidity of the supervised bank (Berger et al., 2016). In particular, banking supervision should monitor the supervised entity to have an adequate asset structure, but that is not enough. In fact, the supervised subject must also have a close observance of norms and governance able to lead it to deal with market risks (de Haan and Vlahu, 2015; Barakat and Hussainey, 2013).

The crucial point in the supervisory system was to initiate a process of homogenization of a common (Schuler, 2003) and strong control (Wymeersch, 2014) in all the Member States that came to an end with Regulation no. 1024/2013, which assigned the European Central Bank specific tasks relating to the prudential supervisory policies of credit institutions, namely the Single Supervisory Mechanism (SSM).

SSM identifies significant and non-significant institutions, outlining a different *modus operandi* depending on the supervised subject:

- direct supervision, coordinated by the so-called Joint Supervisory Team (including staff of both competent national authorities and the European Central Bank) implemented on significant entities (120 banking groups representing 85% of total banking activities);
- indirect supervision by the competent national authorities, under the BCE close scrutiny, on the least significant entities, very numerous in the economic fabric of certain Eurozone countries.

With this scaffolding, therefore, in Italy, the Bank of Italy has a joint supervisory role for the BCE staff on significant bodies and a direct supervision of the less important bodies.

Many studies dealt with the issues of supervision of individual states and in particular, the changes implemented in the European system (Gren et al., 2015). Some scholars highlighted the need for such integration as these States belong to

the Union (Goldstein and Veron, 2011), while other scholars also questioned the effectiveness of central bank supervision on individual banks (Masciandaro et al., 2013).

In particular, the Italian market, the one we focused on, is varied and fragmented.

Penalty measures are an important "weapon" (instrument) for Banca d'Italia. These sanction measures, from 1993 until now, have undergone significant changes in the light of numerous national and then Community legislation.

Initially, under Legislative Decree 385/1993, entities subject to pecuniary administrative sanctions were people covering administrative and managerial functions as well as employees within financial and banking intermediaries, i.e. those legal entities, which were reported in the regulatory apparatus of the Single Banking Act (Testo Unico Bancario - TUB).

The administrative sanction was issued following non-compliance with specific standards in the TUB itself.

A second important step in the history of legislation on sanctioning measures was Legislative Decree 58/1998, passed to history as "Single Text of Finance" (Testo Unico della Finanza - TUF), where there is a list of cases that may impose sanctions on those who, by performing administrative or managerial duties or being employees of companies and entities, do not comply with the specific provisions.

The years since 2012 have seen a sharp acceleration in the process of integration of the financial system with the entry into force of the Single Supervisory Mechanism (SSM).

The innovations introduced by the aforementioned Regulation concern sanctioning measures: in fact, for the relevant banks, the BCE has the power to impose pecuniary sanctions against the legal person for violations of European standards for the purposes of carrying out its tasks applicable (European Union regulations, regulations or decisions of the BCE itself). In other cases (breach of national rules, including in the transposition of European directives, violations by natural persons, non-pecuniary sanctions), the sanction is determined by the National Supervisory Authority at the request of the BCE.

On the contrary, as regards smaller banks defined as less significant, the BCE has the power to impose pecuniary penalties only for breaches of regulations and decisions directly issued by the BCE. In all other cases, the sanctioning power belongs to Banca d'Italia, without any reference to the BCE's opinion.

As mentioned, the most profound change has been in the case of larger institutions: a sanction of any regulatory source (European or national) cannot be fulfilled without the BCE's approval.

### 3. EMPIRICAL DESIGN

#### 3.1. Data and Research Questions

For the empirical analysis on the sanctions inflicted by Banca d'Italia in the period between 2013 and 2016, we hand-collected information regarding the typology and the amount of sanctions by reading

and analysing all the reports and official documents published on the website of the Italian Central Bank.

The majority of the financial institutions examined here do not provide specific information on misconduct-related expenses in their annual reports. These expenses are typically aggregated with other expenses. Moreover, not all the institutions considered are listed on the stock exchange, therefore some data could not be considered in order to provide a homogeneous analysis for all the items of the sample.

In addition, to elaborate the multivariate regression analysis we downloaded the 2015 financial reporting standards by the websites of the financial institutions sanctioned. Comprehensively we analysed eighty-one types of sanctions related to thirty-two financial institutions.

Our analysis is based on the following hypotheses:

- *H1*: The sanctions of the financial institutions in 2016 are higher and more numerous in small entities with governance deficiencies.
- *H2*: The specific type of sanction linked to corporate governance deficiencies has a huge and negative impact on the amount of financial penalties.]

These two hypotheses are tested in the following two steps of analysis in order to answer two research questions:

- *RQ1*: How was the trend of sanctions during the period between 2013 and 2016, after the Single Supervisory Mechanism (SSM)?
- *RQ2*: Were sanctions in 2016 influenced by the dimension of the financial institution, corporate governance and financial reporting items of the previous year (2015)?

#### 3.2. Methodology

The empirical analysis is divided into two parts: the former is related to the analysis of the trend of sanctions in the period between 2013 and 2016; the latter consists of a quantitative analysis of a multivariate regression model (ANOVA).

In the first part, the analysis is mainly conducted by emphasising the role of Banca d'Italia and by analysing qualitatively the several typologies of sanctions.

Reports related to sanctions inflicted to financial entities in the period between 2013 and 2016 published on the web-site of Banca d'Italia were analysed.

We classified all sanctions into the following seven clusters:

- Sanctions related to corporate governance and internal control deficiencies, related to the Board of Directors and General Director;
- Sanctions related to audit committee deficiencies;
- Sanctions related to violations of the anti-money laundering regulation;
- Sanctions related to violations of Legislative Decree 231/2001, on the penal responsibility of the entity;
- Sanctions related to non-compliance with the regulation and incentivisation regulations of Testo Unico della Finanza (TUF);
- Sanctions related to non-compliance with the transparency and reporting regulations of

Testo Unico della Finanza (TUF) and Testo Unico Bancario (TUB);

- Sanctions related to non-compliance with the personal required characteristics of the corporate governance board members included in Testo Unico della Finanza (TUF).

Afterwards we considered the trend in the period between 2013-2016 and we analysed specifically the composition per each item.

In the second part, we aimed at discovering which were the possible causes of the sanctions inflicted in 2016 by Banca d'Italia, by considering variables related to the same sanctions and to the 2015 financial reporting standards.

We firstly calculated the Pearson correlation ratio ( $p$ ) between the different variables and thanks to this ratio, we can analyse the impact (the positive or negative correlation) of the different potential causes on the amount of financial penalties.

It is necessary to underline the following conditions:

- if  $p > 0$  there is a direct correlation;

$$SANCTIONS_t = \alpha + \beta_1 N.Sanctions_t + \beta_2 DummyMoneyLau_t + \beta_3 DummyINTCont_t + \beta_4 DummyAUDITCOMM_t + \beta_5 DummyDEFAULT_t + \beta_6 DummyMERGER_t + \beta_7 Assets_{t-1} + \beta_8 ROE_{t-1} + \varepsilon_t \quad (1)$$

where,  $SANCTIONS_t$  is the dependent variable that expresses in euro the amount of the sanctions inflicted in 2016 by Banca d'Italia,  $N.Sanctions$  represents the number of sanctions undergone by each financial institution in 2016,  $DummyMoneyLau$  is a dummy variable that expresses the presence or absence of the type of sanction related to violation of the anti-money laundering regulation in 2016,  $DummyINTCont$  represents a dummy variable that expresses the presence or absence of the type of sanction related to deficiencies in the internal control system and in the Board of Directors (included the General Director) in 2016,  $DummyAUDITCOMM$  is a dummy variable that expresses the presence or absence of the type of sanction related to deficiencies of the audit committee in 2016,  $DummyDEFAULT$  is a dummy variable that expresses if the financial institution was in the process of winding-up in 2016,  $DummyMERGER$  is a dummy variable that expresses if the financial institution was merged in 2016 or earlier,  $Assets$  represent the institution size in 2015,  $ROE$  instead is the performance of the institution measured in 2015.

#### 4. RESULTS

As regards the first part of the analysis the research focuses on the analysis of the trend of sanctions in the period between 2013-2016 as it represents the most important period of the entire sanctioning history and has brought into force a fundamental reform of the SSM in 2014.

During the period considered, the Bank of Italy issued 245 sanctioning measures covering 211 different institutions for a total of 584 irregularities found.

The analysis of sanction measures is based on the postponement of the sanction (ante-post SSM) and on the type of entity concerned.

- if  $p = 0$  there is no correlation;
- if  $p < 0$  there is an indirect correlation;
- if  $0 < p < 0.3$  the correlation is weak;
- if  $0.3 < p < 0.7$  the correlation is moderate;
- if  $p > 0.7$  the correlation is strong.

After this analysis, we concentrated on the multivariate regression (ANOVA).

Regression analysis was chosen as it is usually used to predict the value of one or more responses from a set of predictors and to estimate the linear association between the predictors and responses.

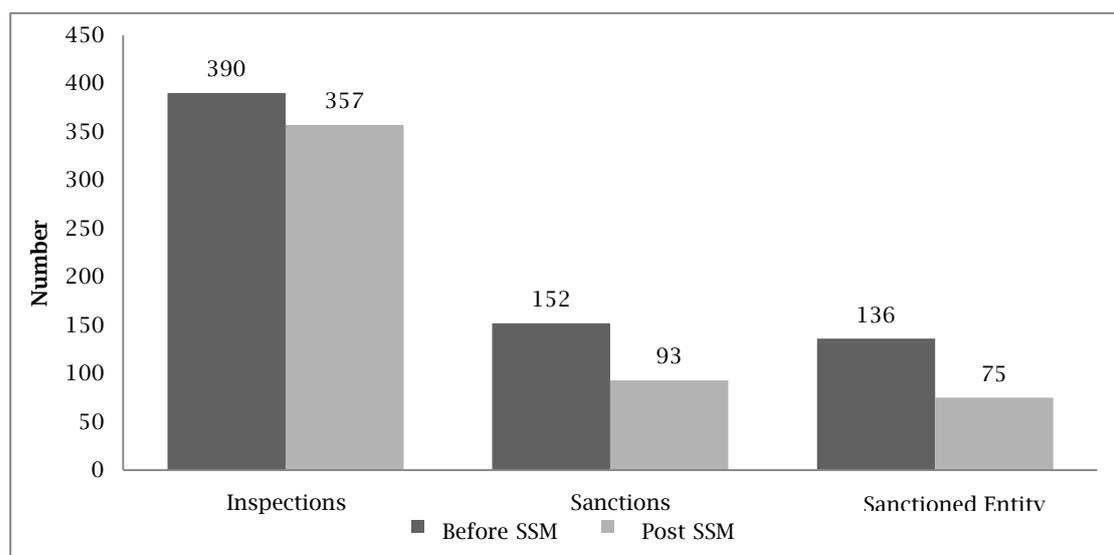
In this case, the model elaborated represents the first attempt to try to catch up the profound causes of the penalty system, by considering the interactions of variables in the period between 2015 and 2016, in order to demonstrate if sanctions derive from incorrect business management actions related to the nearest period of analysis.

Therefore we elaborated the following multivariate regression model:

The time division is used only for the first type of analysis: in other cases, we considered all sanctioning measures altogether, without distinction before and after SSM. That because, apart from the direct violations of European norms and the 15 significant Italian institutions, Banca d'Italia continues to inspect all other non-significant banking institutions and all non-bank financial intermediaries directly, by imposing sanctions in accordance with National legislation. For these reasons, SSM ante sanctions can be considered along with those imposed after the introduction of the SSM as far as the same recipients are concerned, are based on the same rules and are endowed with the same procedure.

SSM ante and post periods are comparable as they have almost the same duration. The data on sanctioning measures is given in Figure 1.

As shown in Figure 1, the number of inspections carried out by the Banca d'Italia in the two periods considered decreased by about 8% (from 390 to 357). If we added the inspections carried out directly by the Bank of Italy on less significant banking institutions and on non-bank financial intermediaries, also the audit activity on significant institutions, we would see that supervisory activity increased. In addition, adding to the 357 inspections carried out directly by the Bank of Italy and the 78 carried out in the two-year period 2015-2016 jointly by Banca d'Italia and the BCE on major institutions, inspections increased (435 SSMs against 390 before SSM) and this result is a testimony to the difficult time that the Italian financial system (especially the banking system) is passing on and, secondly, the constant consideration of the audit activity as a valid watchdog.

**Figure 1.** Banca d'Italia inspections, number of sanctions and entities sanctioned before and after SSM introduction

Source: figure elaborated by the authors.

It can be noted that the most significant figure relates to the number of sanctioning measures issued during the period under consideration. Indeed, while inspections decreased by 8%, sanctions decreased by 39% from 152 to 93. We can interpret the same data in a different way: in the ante SSM period 152 out of 390 inspections ended up with a sanction, in 39% of cases. In the biennial post SSM, the same percentage fell to 26% (93 out of 357). If we also consider, as mentioned before, the joint Banca d'Italia-BCE inspections on major institutions that did not bring any sanctions in the two-year period 2015-2016, the percentage reaches even 21% (93 out of 435).

Considering the set of sanctions imposed, a noteworthy variable is the typology of the sanctioned body. As we have previously analyzed, it is not the body that is sanctioned, but the physical person who, alternatively:

- has the powers of direction, administration, and control,
- is an employee of the company with responsibility for specific functions,
- acts on the basis of relationships that determine its insertion into the organizational structure, it should not apply one or more of those rules in the same provision.

Comprehensively, the subjects sanctioned by Banca d'Italia in the period between 2013-2016 were 300 Boards of Directors, 68 Boards of Auditors together with Boards of Directors, 171 Board of Auditors, 37 Legal Representatives, 5 Shareholders and 3 Audit Firms.

In most of the cases, the individuals sanctioned form the corporate governance and internal control boards, as members of the board of directors or general managers or deputy directors. If we also consider the fact that in 12% of cases the administrative body was jointly sanctioned by the control body, we see that in almost two cases on

three, on average, the administrative function was responsible for several kinds of deficiencies. Furthermore, the control body (Board of Auditors) was often responsible for non-compliance with regulatory provisions. That is certainly not an unexpected result considering the importance of the internal control body for each financial institution.

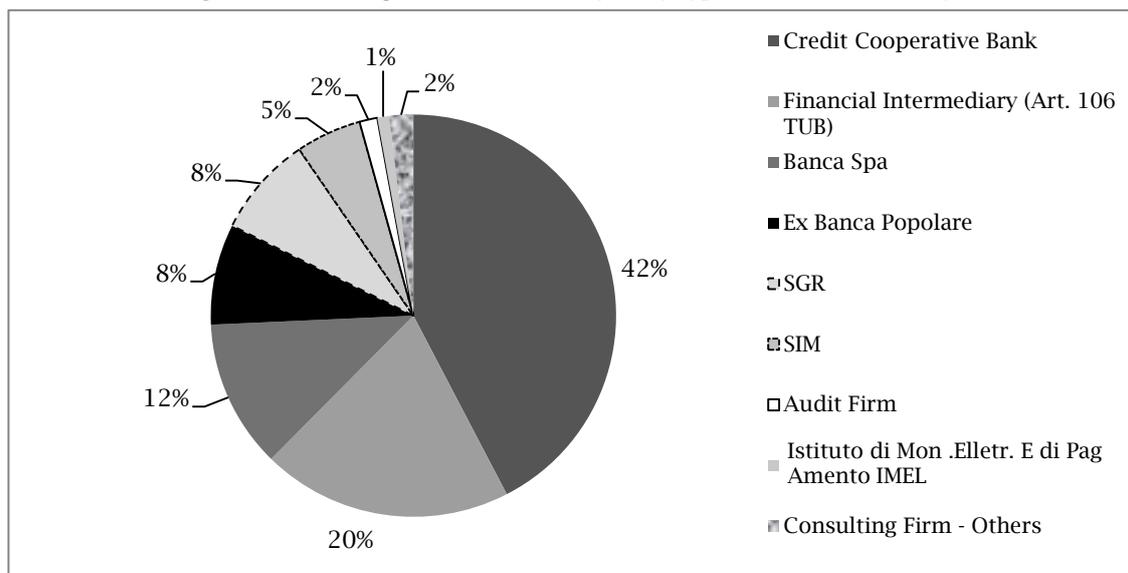
Regarding, on the other hand, anti-money laundering legislation, Legislative Decree 231/2007 provides for administrative responsibility for the body: this aspect come back to us when we are going to analyze the measures on the basis of sanctioned physical persons.

Although the recipients of the measures are almost always natural persons, it should not be forgotten that these sanctions are the result of their work within the supervised entities. It goes without saying that the entity in question has almost always a certain responsibility for not having avoided or for having late identified misconduct by any subject that has a more or less apical position within the organisational chart.

It is therefore consistent to carry out an analysis on some of the variables of the institution in which the person in question carries out his duties, in the light of the intrinsic responsibility of the same body. In other words, without prejudice to the responsibility of the sanctioned natural person, we cannot assure that the legal person is without any responsibility: in the presence of a proper control system, it can and must be minimized the possibility of non-compliance behaviour by each individual subject.

As a result, by analyzing the legal entities affected by sanctions, 211 institutes are involved in the four-year period, some of which are subject to two or more sanctions over the period considered.

In the figure below the percentage distribution can help analyze the subject.

**Figure 2.** Percentage distribution analysis by type of sanctioned entity

Source: figure elaborated by the authors.

As can be seen from Figure 2, the most recurring type of institution is the banking institution in the form of a cooperative company, which is the recipient of a sanction measure in 42 % of cases (89 institutions sanctioned).

A credit cooperative bank is a member-owned financial cooperative, democratically controlled by its members, and it operates for the purpose of promoting thrift, providing credit at competitive rates and providing other financial services to its members. More than fifty percent of total Italian banks are credit cooperative banks (BCCs). They usually are small banks (according to the classification of Banca d'Italia) and their total weight on the loan market is 8 %. In addition, they are particularly relevant for Small and Medium Enterprises (SMEs). In the Italian context, credit cooperative banks base their organisation and mission on mutualism and localism (Zago and Dongili, 2014). In 2016 there were 371 credit cooperative banks, 4,311 bank counters, 1,250,922 shareholders and 36,000 employees.

Subsequently, financial intermediaries registered in the Single List under art. 106 TUB (reformed with Legislative Decree 141/2010, which made the subjects included in the general register ex 106 TUB and the special one ex 107 TUB in a single bulletin) are the most present in the sanction (42 entities). We find, therefore, the classic banks organized in the form of joint-stock companies, which also include the former savings banks, which are sanctioned in 12 % of cases (25 entities). The same percentage drops to 8 % for former popular banks (17 institutions), as well as for savings management companies (SGRs) and 5 % for mobile brokerage firms (11 SIMs).

Two Payment Institutions (IMEL - Istituto di Moneta Elettronica e di Pagamento), which are companies, other than banks and electronic money institutions, authorized to provide payment services were sanctioned.

Overall, banking institutions are targeted by the sanction in 131 of 211 (about two times out of three).

Once we understand whether and how the sanction system has changed after the introduction of the SSM and analyzed who, in terms of both legal entity and natural person, is the subject of the sanction with greater frequency, it is fundamental to pay attention to the object of irregularities found during the inspection by Banca d'Italia that caused the imposition of the sanction.

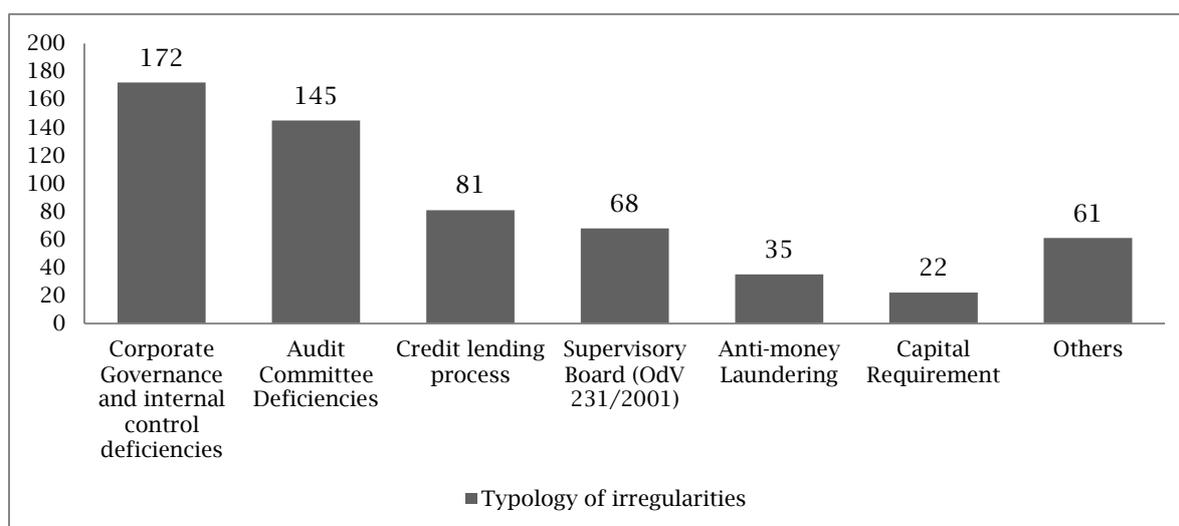
The data are shown in Figure 3.

Comprehensively, in the four-year period considered, Banca d'Italia issued 245 sanctioning measures for 211 different institutions for a total of 584 irregularities found.

The most common type of irregularity detected, 172 cases on the 584 analyzed, is the lack of governance, internal control system and organization found in the body.

In the present case, it can only be the administrative body to be considered to be the principal responsible, since it is precisely the task of "governing" the undertaking in question.

It is certainly not a case that we are in a situation where the board of directors is called upon to respond substantially to poor management nearly as many times as it is recognized a responsibility also to the controlling body.

**Figure 3.** Typology of irregularities found by Banca d'Italia

Source: figure elaborated by the authors

A further type of irregularity found (found 145 out of 584) is represented by the lack of controls carried out by that body, typically the board of auditors, specially used for internal control of the company. The Board of Statutory Auditors (Audit Committee) is responsible for ensuring compliance with the law and the articles of association, compliance with the principles of sound administration and in particular the adequacy of the organizational, administrative and accounting structure adopted by the company and its proper functioning. From the analysis of the sanctions, we find a series of disregarded norms that are found almost in all sanctioning measures issued because of weaknesses in controls by the control body. The Board of Statutory Auditors is required to comply with specific provisions that Banca d'Italia emanates to contain risk in its various configurations, corporate governance, administrative and accounting organization, as well as internal controls and remuneration and incentive systems. Therefore, the control body must not only verify that the organizational and accounting administrative arrangements work concretely but must rather verify its compliance with Banca d'Italia instructions.

Continuing our analysis of the irregularities found, it is important to consider the role of credit management, which characterizes the corporate life of most of the institutions targeted by sanctioning measures. This irregularity was found in 81 cases to 584, so this is quite common. As already pointed out, two-thirds of the sanctioned entities are bank institutions: of course this is not surprising that most of Banca d'Italia's audit work is focused on banks, that is, the type of business most present in the Italian financial sector.

In the organization of the credit lending process and in the management of the related risk, in terms of the undisputed rule, Banca d'Italia always refers to that "corpus" of the aforementioned rules in the absence of controls by the board of auditors and weaknesses in governance and in the system of internal controls for administrative bodies.

This aspect has a clear explanation: first, the credit process, being the credit of the banking core business, is inexorably intertwined with corporate governance and its way of giving rules, processes, systems to manage all the risks the company faces. Second, credit risk is a variable directly attributable to management in the strict sense: if the process is not performing properly, responsibility can only be of the body who decides how to "run a bank," so the administrative body.

In 12 % of cases (68 out of 584), the Bank of Italy had to impose a penalty for erroneous or omitted notification to the Supervisory Body ex 231/2001. In Italy, as mentioned above, Legislative Decree 231/2001 introduced for the first time the administrative responsibility of the company. In fact, the person responsible for the offenses committed in his or her interest or to his advantage by the body responsible for representing, administering or managing the institution or its organizational unit with financial and functional autonomy and by people that, in fact, also exercise and control the same. The company does not answer if people have acted in the sole interest of either their own or a third party.

The law entrusts Banca d'Italia with the task of verifying compliance with the anti-money laundering obligations of primary and secondary legislation and the adequacy of its organizational and procedural arrangements by its supervised entities. To this end, Banca d'Italia may carry out inspections and request the performance or transmission of documents, records, and any other useful information.

Sanctions by Banca d'Italia are imposed in the presence of two cases, that is, in cases of organizational deficiency in the controls by the supervised party or in gaps in the manner of holding the Unique Informatics Archives (on whose topics Banca d'Italia was called to regulate). One aspect that makes sanctions in this case different from all others issued by Banca d'Italia is the subject of the sanction. In all other cases, it was the natural person who, in the exercise of his duties, did not have to fulfil certain obligations deriving from the various standards mentioned above, thus being punishable.

The legal person, the body in which that person operated, was only "affected by the sanction", even though it was obliged solely for the sanction, with a right of recourse on the natural person. In this particular case, on the other hand, it enters, so to speak, "on the scene" a further discipline, that of the administrative liability of the bodies ex D.Lgs. 231/2001. In the above-mentioned decree, it is evident that the body is responsible for failing to comply with the rules governing the recruiting, recycling and use of money, property or assets of unlawful origin. Here is the reason why in all of these cases (35 out of 584) impose a pecuniary administrative sanction "on behalf of the company in the person of the legal representative pro tempore", not "in charge of the persons indicated below" as evidenced by the reading of the measures being analyzed.

Finally, the last category of sanctions analyzed when the body does not have the minimum capital. In this type, we find 22 cases on 584 (about 4 %). The minimum capital requirement is very important as it concerns the prudential vigilance of the watchdog.

Finally, in the other category, a variety of different and disparate disadvantages of behaviour that cannot be recommended in the previous categories have been identified.

As regards the second part of the analysis, we considered the impact of determinant causes on the amount of sanctions inflicted by Banca d'Italia in 2016 to all the financial institutions involved.

We first analysed the Pearson correlation ratio (Table 3) among the variables well described in the previous paragraph and involved in the multivariate regression analysis.

Table 1. Pearson correlation ratio

		Sanctions	N. Sanctions	Dummy MoneyLau	Dummy INTCont	Dummy AUDIT COMM	Dummy DEFAULT	Dummy MERGER	Assets	ROE
Sanctions	Pearson	1	,364*	-,146	,330	,348	-,166	,172	,842**	-,126
	Sign. (two-tailed)		,040	,425	,066	,051	,409	,391	,000	,549
	N	32	32	32	32	32	27	27	24	25
N.Sanctions	Pearson	,364*	1	,303	,277	,409*	,325	-,147	,262	-,099
	Sign. (two-tailed)	,040		,092	,125	,020	,098	,463	,217	,639
	N	32	32	32	32	32	27	27	24	25
Dummy MoneyLau	Pearson	-,146	,303	1	-,333	-,234	,036	-,279	-,109	,131
	Sign. (two-tailed)	,425	,092		,062	,198	,860	,159	,614	,532
	N	32	32	32	32	32	27	27	24	25
Dummy INTCont	Pearson	,330	,277	-,333	1	,701**	-,153	,366	,201	-,269
	Sign. (two-tailed)	,066	,125	,062		,000	,446	,061	,347	,194
	N	32	32	32	32	32	27	27	24	25
Dummy AUDIT COMM	Pearson	,348	,409*	-,234	,701**	1	,113	,225	,242	-,249
	Sign. (two-tailed)	,051	,020	,198	,000		,575	,258	,254	,231
	N	32	32	32	32	32	27	27	24	25
Dummy DEFAULT	Pearson	-,166	,325	,036	-,153	,113	1	-,454*	-,285	,254
	Sign. (two-tailed)	,409	,098	,860	,446	,575		,017	,188	,241
	N	27	27	27	27	27	27	27	23	23
Dummy MERGER	Pearson	,172	-,147	-,279	,366	,225	-,454*	1	,130	-,325
	Sign. (two-tailed)	,391	,463	,159	,061	,258	,017		,554	,130
	N	27	27	27	27	27	27	27	23	23
Assets	Pearson	,842**	,262	-,109	,201	,242	-,285	,130	1	-,268
	Sign. (two-tailed)	,000	,217	,614	,347	,254	,188	,554		,205
	N	24	24	24	24	24	23	23	24	24
ROE	Pearson	-,126	-,099	,131	-,269	-,249	,254	-,325	-,268	1
	Sign. (two-tailed)	,549	,639	,532	,194	,231	,241	,130	,205	
	N	25	25	25	25	25	23	23	24	25

Note: \*. Correlation is significant at level 0,05 (two-tailed).

\*\* Correlation is significant at 0,01 (one-tailed).

Source: table elaborated by the authors

The variable called Sanctions, which represents the dependent variable in the multivariate regression analysis, is positively correlated with the number of sanctions undergone by each financial institution in 2016 and the size of each entity.

The other correlations are less relevant in our study, but we briefly summarize them. The number of sanctions is positively correlated with the dummy audit committee, which in turn is positively correlated with the dummy internal control. The dummy default is negatively correlated with the dummy M&A.

This table allows to introduce the results linked to the ANOVA regression model, described in the previous paragraph.

The model is based on the following null and alternative hypothesis:

$$H_0: \beta_1 = \beta_2 = \beta_3 = \beta_4 = \beta_5 = \beta_6 = \beta_7 = \beta_8 = 0 \quad (2)$$

$$H_1: \beta_1 \neq \beta_2 \neq \beta_3 \neq \beta_4 \neq \beta_5 \neq \beta_6 \neq \beta_7 \neq \beta_8 \neq 0 \quad (3)$$

The following Table summarizes the results derived from the application of the model.

**Table 2.** The results of the multivariate regression

	(1)	Tolerance	VIF	Condition Index
Constant	16,595.834			1
N.Sanctions	1.77**	.541	1.847	1.872
DummyMoneyLau	-.128**	.655	1.527	2.590
DummyINTCont	.035**	.439	2.276	2.763
DummyAUDITCOMM	.035**	.480	2.085	2.981
DummyDEFAULT	-.030**	.504	1.983	4.595
DummyMERGER	.122**	.649	1.542	6.755
Assets	.794*	.695	1.439	6.943
ROE	.196*	.812	1.232	9.270
Observations	23			
R	.886			
R <sup>2</sup>	.785			
R <sup>2</sup> adj	.663			
F	6.405			
p-value	0.001			
Durbin-Watson	2.152			
Cook's Distance	.000			
Leverage	.106			

Note: a. Dependent Variable: Sanctions

b. Predictor: (const), ROE, N.Sanctions, DummyMoneyLau, Assets, DummyMERGER, DummyAUDITCOMM, DummyDEFAULT, DummyINTCont

\* significance at 5%; \*\* significance at 1%

Table 2 shows that the multivariate model explains in both sectors more than 70% of the entire population. As the sample represents the entire population of financial institutions that were sanctioned by Banca d'Italia in 2016, the F value is low but the significance of the model is high.

Problems of collinearity emerge with the DummyIntCont and DummyAuditComm. In fact VIF is quite higher than 2, Tolerance index is lower than 0,50 but the Condition Index is lower than 3.

Cook's distance and leverage confirm that the model well represents the entire population.

All independent variables are considered significant, in particular, the extremely significant (1% significance) variables are the one that considers the number of sanctions inflicted in 2016, the dummy variable linked to violations of the anti-money laundering regulations, internal control deficiencies, audit committee deficiencies, default and the dummy variable linked to M&A.

Therefore the null hypothesis can be rejected for those variables.

Consequently, to answer RQ2 it can be affirmed that the dimension is a significant element that deeply influences the amount of the financial penalties, and as regards corporate governance, sanctions related to deficiencies in the internal control system and audit committee affected in a significant way the sanctions, such as the default condition of the financial institution or the M&A operation. In addition, the same can be noted for ROE (performance of the financial institution).

As a consequence, the second hypothesis can be confirmed.

Despite the fact that this model represents the first attempt to analyse the causes and possible relationships between several diverse elements and the sanctions inflicted by Banca d'Italia, it needs to be implemented with other variables that correctly reflect the impact of deficiencies and bad actions of the management and corporate governance boards of those institutions in the period before 2015.

## 5. DISCUSSION

As regards the first step of the empirical analysis and to answer RQ1, the significant reduction in sanctions in the period under consideration after the introduction of SSM, first of all, might be due to changes at the cultural level, giving rise to the first concrete results of 'Regulators' activities. In addition, most of the sanction measures contain causal deficiencies in controls and risk management, especially credit and operating risk. It is clear that without an adequate control system and a coherent organizational structure, involving both corporate governance and risk management, the profitability of each financial institution might suffer, regardless of the presence of these sanctions. Therefore *hp2* can be confirmed.

In addition, sanctions can affect the reputation of those entities, as the reputational risk more than anything else affects the financial world, a world where customer confidence in the system is fundamental (Ingo, 2016; Fiordelisi et al., 2013). A sanction by the supervisory authority is certainly not good news for a company that is operating in a sector such as the financial one, so sensitive to the reputational issue, or may have profound operational implications, especially in the short term, for example, in obtaining the liquidity needed for the banking management operation.

Such a massive presence of credit cooperative banks as recipients of sanctions is certainly a weakness in this particular way of "doing bank activities": a way, as we know, relegated to small realities, particularly linked to the territory, and sometimes that makes it hard to adapt to the ever-changing banking world.

Apart from some exceptional cases, sanctioning measures in recent years did not concern large institutes that have a capillary presence almost all over the national territory.

From the analysis of correlation, there emerged that the dependent variable (Sanctions) is positively correlated with the number of sanctions and the dimension of the financial intermediary.

Therefore, the bigger the financial institution the higher the financial penalty was in 2016.

Consequently, entities with more numerous sanctions were also those that had the higher financial penalty in 2016.

This result does not confirm the first hypothesis of the analysis. And this represents a significant element for our discussion.

The econometric model of multivariate regression also confirms that the variables implied are all significant. In particular, the diverse typologies of sanctions have a huge and negative impact on the amount of sanctions inflicted on the financial institution.

In addition, if the financial entity was experiencing a process of winding-up or a M&A operation in 2016, that condition was also significant for the determination of the financial penalty.

The dimension of the financial intermediary was extremely important even in this second step of analysis because the analysis confirms what emerged in the correlation analysis.

As regards the influence of the corporate governance boards, this analysis is propaedeutic to a much more deepened research as in this context we just considered the impact of two different clusters of sanctions on the comprehensive amount of penalty.

This model however allowed to consider as important also the performance of the financial institution in 2015 and the number of sanctions inflicted by Banca d'Italia.

## 6. CONCLUSION

From a careful analysis of the various sanctions, there emerge that the subject sanctioned are members of the internal audit firm (board of statutory auditors) and administration (board of directors): this peculiarity is the object of this provision with respect to all the other relationships analyzed.

The importance of good governance and a good system of controls is the basis for "running" a bank and is one of the most important points in the controls and the corresponding sanctions. About two-thirds of sanctions inflicted by Banca d'Italia concern these issues, as proof of the centrality of the subject. Indeed, the majority of penalties are organizational shortcomings, related to the internal controls system, credit controls and credit deficiencies, which are crucial for banks, especially local ones. It is no coincidence that on these matters the entire banking world has not only concentrated its resources over the last few years but testing the internal control system is becoming more and more a strategic competitive advantage in the financial business. Another common characteristic among the entities receiving these measures is that many cases have been examined, and then the undertakings have either been subjected to crisis or embedded procedures which, individually considered, do not necessarily result in a situation of instability, but often such extraordinary operations are the means to heal situations that an enterprise cannot overcome. This analysis also provides an important starting point because it points out that irregularities found by the supervisory authority inherent in the minimum capital requirement are often the prelude to worse situations. Prudential

supervision, therefore, is an effective means of control to guarantee the stability of the system: this consideration is by no means a disadvantage in a complex economic context such as the present one.

Over the last two years, all significant banks within the European Union have strengthened from the balance sheet but the average value of their listed shares fell by 20% (Crosio, 2017). This is due to the fact that the costs in terms of increased vigilance did not have a positive impact on the assessment of major institutions and therefore of the banking system as a whole. For a full analysis, however, we must not dwell on short-term results, but it is necessary to assess the impacts of the supervisory system in the long run, which is why we cannot yet reach a judgment on the new system Supervision implemented by the BCE.

By closing this in-depth analysis, we cannot say with certainty that the sanctioning power recognized by the Bank of Italy has the capacity to counteract any form of a banking crisis or to direct the whole financial system to the road of efficiency and compliance at all levels.

However we can conclude by saying that first of all, the reduction in the number of measures between 2013-2014 and 2015-2016, not accompanied by a reduction in supervisory activity, is a signal that the work of Banca d'Italia is giving its results. The banking system has become increasingly careful in terms of compliance with the complex regulatory framework in the reference sector, benefiting all the stability of the system.

Secondly, but not less important, the sanctioning measure is a necessary but not sufficient weapon in the arsenal of any vigilance body. Certainly, this tool can only be used by Banca d'Italia in its supervisory action. The vigilance has changed dramatically following the European harmonization process, which has reached its peak with the introduction of the Single Supervisory Mechanism.

Right after this turn, many feared a complete loss of powers by Banca d'Italia: on the less significant level, however, it retained sanction powers on most issues.

Another important issue is related to the central role of corporate governance and internal control boards. Both phases of analysed underlined the fundamental position of the governance in running financial entities and the causal relationship with the amount of sanctions inflicted by Banca d'Italia.

Furthermore, by considering that the majority of entities subjected to financial penalties were little and less structured institutions, the higher sanctions were inflicted to those realities considered bigger according to the level of assets.

These considerations help introduce all the limits of this research and the possible developments of analysis. First of all, it is necessary to underline that this research represents the first step of a far deeper analysis and, as we mentioned above, this econometric model is the first attempt to try to catch up the possible causes that influenced the penalty system of Banca d'Italia in 2016. It is obvious that there would be other items and situations that might have affected the determination of the sanction in 2016. This is the reason why this analysis presents several

opportunities to be furthered and improved with other variables. It would be useful to analyse the profiles and the background of the members of the governance boards, or the financial reporting standards of the previous three years in order to consider their eventual relevance and influence on financial penalties.

It would be interesting to compare and contrast the Italian situation with that of other European countries, such as France or Germany. To do that, it might be also helpful an empirical qualitative investigation, through a multiple-case study.

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