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Dublin Group on Finance and the Common Good
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A: The role of Ethics
A3: Subsidiarity in internal structures of financial institutions
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Abstract – This short note aims at emphasizing the crucial role of subsidiarity, both internal and external, for financial institutions' proper functioning. The issues here briefly investigated fall inside the more general debate about corporate governance of financial institutions. These issues have acquired special attention for both policy makers and practitioners in the aftermath of the global financial crisis as many instances of governance failures have been considered as contributory factors somehow generating and surely exacerbating the crisis itself. The argument here presented is based on the premises that even in internal structure of financial institutions integral human development is the key element for common good. In turn, integral human development "*presupposes the responsible freedom of the individual and of peoples: no structure can guarantee this development over and above human responsibility* (Caritas in Veritate, n. 17).

As it is well known, financial institutions provide financial services for their clients or members, that is they act as intermediaries of financial markets. In general terms, they act as a channel between savers and borrowers of funds (suppliers and consumers of capital). According to standard finance textbooks, financial institutions are composed of organizations such as banks, trust companies, insurance companies and investment dealers. There are essentially two types of financial institutions: i) Depository institutions, such as banks, which pay interest on deposits and use the deposits to make loans, ii) Non-depository institutions, such as insurance companies, brokerage firms, and mutual fund companies, which sell financial products. Today however many financial institutions provide both depository and non- depository services, and thus the dividing line among different types of financial institutions is increasingly blurred.

Accordingly to a recent European Banking Authority statement (but similar statements can be found as well in the US context), "*EU legislation requires that institutions have robust governance arrangements, including a clear organisational structure, well defined lines of responsibility, effective risk management processes, control mechanisms and remuneration policies. The internal governance should be appropriate to the nature, scale and complexity of the institution. The main responsibility for internal governance lies with the management body, which is subject to specific suitability requirements. In this respect, the EBA published Guidelines on internal governance and in particular on the assessment of the suitability of members of the management body.*"

In general terms, governance is the process of decision making and the process by which decisions are implemented. Accountability, transparency, equitability are some of the main characteristics of what can be considered as good governance. Another, less mentioned, characteristic of good governance, is the capacity to include and to make each stakeholder feel an important part of the institution's mission. The Organization for Economic Cooperation and Development (OECD) defines corporate governance as: "*a set of relationships between a company's management, its board, its shareholders, and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interests of the company and its shareholders and should facilitate effective monitoring" (*see OECD Principles of Corporate Governance, revised in April 2004).

In the light of the above, it is clear that appropriate organizational structures, policies and other controls may contribute to promote, but by no means do ensure good corporate governance. As clearly indicated in the Caritas in Veritate: "*In the course of history, it was often maintained that the creation of institutions was sufficient to guarantee the fulfilment of humanity's right to development. Unfortunately, too much confidence was placed in those institutions, as if they were able to deliver the desired objective automatically. In reality, institutions by themselves are not enough, because integral human development is primarily a vocation, and therefore it involves a free assumption of responsibility in solidarity on the part of everyone* (Caritas in Veritate, n. 11). Thus, effective corporate governance is the result of both "hard" structural elements and "soft" behavioural factors, the latter being represented by dedicated people - directors, managers, employees, etc. - performing faithfully their duty of care to the institution. The key is therefore to create in the organization an atmosphera promoting competent persons with a clear understanding of their role and a strong commitment to carrying out their respective responsibilities within the institution's mission. This is crucial to make organizational structures and policies effective, and it is exactly the lack of this commitment that greatly contributed to first generate and then exacerbate the effects of the crisis.

In this respect subsidiarity becomes the crucial principle for promoting and giving value to the person: "*Subsidiarity is first and foremost a form of assistance to the human person via the autonomy of intermediate bodies. Such assistance is offered when individuals or groups are unable to accomplish something on their own, and it is always designed to achieve their emancipation, because it fosters freedom and participation through assumption of responsibility. Subsidiarity respects personal dignity by recognizing in the person a subject who is always capable of giving something to others. By considering reciprocity as the heart of what it is to be a human being, subsidiarity is the most effective antidote against any form of all-encompassing welfare state. It is able to take account both of the manifold articulation of plans — and therefore of the plurality of subjects — as well as the coordination of those plans. Hence the principle of subsidiarity is particularly well-suited to managing globalization and directing it towards authentic human development. In order not to produce a dangerous universal power of a tyrannical nature, the governance of globalization must be marked by subsidiarity, articulated into several layers and* *involving different levels that can work together* (Caritas in Veritate, n. 57). Thus, in the light of the catholic social teaching, subsidiarity is able to promote freedom and participation through assumption of responsibility. As mentioned above, these characteristics are the key elements of a good governance, for firms in general and for financial institutions in particular.

As far as economic analysis is concerned, it may be said that the assessment concerning the functioning of a financial institution should be placed within a subsidiarity driven framework, which in the present context acquires concreteness along two different but complementary dimensions. The first dimension is internal to the institution and refers to the capacity to promote the persons involved in the working of the financial institution *("A business cannot be considered only as a "society of capital goods"; it is also a "society of persons" in which people participate in different ways and with specific responsibilities, whether they supply the necessary capital for the company's activities or take part in such activities through their labour",* Centesimus Annus,n. 43). In this vision, the centrality of then person is not an instrument for some end but it is instead a value *per se* originating from his/her freedom. The second subsidiary dimension is external, as it refers to the institution's relationships with the external world. This dimension is based on the convinction that - in the knowledge era - the strength of an institution depends on its capacity to build effective network with other institutions (both financial and non financial), firms, intermediate bodies of society (associations, foundations, etc.). The latter subjects are crucial to promote development since they can guarantee cohesion to the networks of social capital which are today central for the well functioning of modern economic systems.

Someone may argue that the emphasis of this note on human, rather than technical, factors is somehow naïve. A concrete example may help to dissipate this suspicion. Thanks to the extraordinary developments in technology, risk management in the run up to the crisis became highly quantitative and sophisticated, models proliferated in the strong (and ex-post false) belief to be able to capture and measure every kind of risk (the so called economists' syndrome of Physics envy). Fat tails (supposedly rare and extreme events) proved how badly placed was this convinction! The crisis has clearly indicated how important is in risk management to use a blend of qualitative and quantitative techniques. What is today required is "responsible" risk management (and responsibility is a word which refers to humans, not machines and neither algorithms and it is a word, as above explained, strictly connected to subsidiarity).

In sum, it is worth remembering the beautiful sentence of Saint John Paul in the Centesimus Annus: "*In our time, the role of human work is becoming increasingly important as the productive factor both of non-material and of material wealth. Moreover, it is becoming clearer how a person's work is naturally interrelated with the work of others. More than ever, work is work with others and work for others: it is a matter of doing something for someone else" (*Centesimus Annus, n. 31).