

## **PAPER PROPOSAL (GRADUATE SESSION)**

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### **1. TITLE**

**LOCAL GOVERNANCE AND BANK REGULATION: THE ITALIAN COOPERATIVE CREDIT SYSTEM**

**(Currently work in progress).**

### **2. AIMS AND SCOPE OF THE PAPER**

The aim of the paper is to study the behavior of financial institutions in order to provide a framework for the regulation of banks with respect to their size as well as a number of features comprising organizational and legal aspects. In order to make the study feasible, I will focus on the cooperative credit banks, particularly those that operate in different Italian regions, and compare them with standard commercial banks. On average, cooperative banks are small institutions with a distinctive managerial and governance system. The European Association of Cooperative Banks (EACB) defines cooperative banks as 'a beacon of stability in a rapidly changing environment. The principles established over a century ago of good governance based on democracy and permanent direct control by the members of management and strategy of the enterprise are a fundamental point of reference and a definite asset'.

Specifically, my research aims to investigate a number of features related to the Italian cooperative credit banks, namely: their performance, quality of credit and loans and the deposit insurance scheme, the propensity to undertake risk, replacement of poorly performing management, and the functioning of different disciplining mechanisms (i.e. creditors, board of directors) in these banks. Upon the analysis of these features and their comparison with other banks, I will discuss the implications of these differences for the regulation of the cooperative banks. The fundamental question is: Should be financial regulation uniform for all types and sizes of financial institutions or, should it differ according to the banks' typology and to its related governance specifics?

I chose to study Italian cooperative credit banks since I assume that they offer important insights on banking. The Italian cooperative credit system has been included in a number of studies on banking competition and regulation. The study by Angelini and Cetorelli (2003) discusses shifts in competition in the Italian banking industry in relation to the Second European Banking Directive and on the basis of data from Italian cooperative credit banks as well as other Italian banks over the period 1983-1997. On the other hand, Caleffi (2006) provides a legal analysis of the Italian cooperative banks and emphasises their distinctive legal and socio-economic traits.

Following the scheme provided by Cotič-Svetina and Jaklič (2008, 293), local banks (in particular cooperative credit banks) play an important role in regional clusters and the so-called 'marshallian industrial districts' (Becattini, 1990) in which local firms, institutions and the local labour force are closely related. The study suggests that relations among locally clustered actors are indispensable in knowledge-building and transfer. By contrast, my research focuses on economic and financial aspects of regional clusters in which cooperative banks often play a leading role. It can be argued that, despite the vital contribution to the economic growth in Italy and their economic significance, an indepth economic and financial assessment of cooperative credit banks from the point of view of both their governance and regulation is currently missing. My paper aims to fill such a gap.

The 2007-2008 financial crisis suggests a reappraisal and a redefinition of financial regulation from a national rather than international perspective. The rationale for such an argument comes from the idea that domestic regulators are better equipped to supervise banks and financial institutions and set appropriate guidelines for their conduct. Rodrik (2009) convincingly argues that a global financial regulation is neither feasible nor prudent. Instead, he argues, nations should be in charge of implementing their own regulations on the basis of some 'sensible rules'. Such a point of view is particularly fruitful when it comes to cooperative credit banks and other small financial institutions.

I contribute to the existing literature by analysing the governance aspects of cooperative banks. By studying how these banks are governed and what disciplining mechanisms are in place, I will build a fundament for a discussion on the efficiency of a 'universal' financial regulation for these banks. There are some potential drawbacks which need to be considered carefully: Cornforth (2004) argues that, since there exists relatively little theoretical work on the governance of cooperative banks and similar mutual associations, many of the proposals to improve governance in such organisations have been impractical or ineffective. This constitutes an additional motivation to further pursue the goals of the research.

The goals of the present research should be formally achieved by publishing (at least) two articles in peer-reviewed economics journals. Ideally, the research should constitute the basis for a comparative study between cooperative credit banks in different European macro-regions or in specific countries. To achieve all of the above-mentioned goals, I will rely on the econometric analysis and use some case-studies, which will enable me to compare and contrast cooperative credit banks with their competitors such as large commercial banks, and thereby assess both their characteristics and their economic significance.

### **3. BROADER SCIENTIFIC AREA OF THE PAPER**

#### **3.1 The regulation and governance of banks**

Dewatripont and Tirole (2003) suggest that an adequate analysis of the banking regulation must start with a careful understanding of banking and why regulation is needed in that sector. As other enterprises, they are subject to failure and their activity needs to be regulated and supervised. Even though the terms 'regulation' and 'supervision' are sometimes used interchangeably, they actually refer to separate activities (Barth et al., 2004)<sup>1</sup>. This paper

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<sup>1</sup> Regulation refers to the rules that govern the behavior of banks and their activities. Conversely, supervision refers to the activity of monitoring banks and applying prudential norms to bank operations in order to ensure that they are operating safely, following rules and regulation.

centres on the regulation of banks; supervision is also taken into account since the two are often related and complement each other.

Banks are typically characterized by their ability to reduce information asymmetries between borrowers and savers (Diamond, 1984; Fama, 1985). Although banks are *not* directly involved in the production of material goods or ideas, they influence such activities by allocating capital, financial resources and by providing financial services. As summarized by Dewatripont and Tirole (2003), banks perform the following activities:

- *reduction of the transaction costs associated with direct finance;*
- *transformation of short-term liabilities in the long-term loans required by firms;*
- *delegated monitoring (usually, the monitoring of borrowers on behalf of the investors);*
- *provision of the payment mechanism, which enables payments among consumers.*

Contemporary economic systems would be very different without a well-developed financial intermediation. Could market economies without financial intermediation and banking activity function at all? Banks provide important functions in terms of corporate finance, economic growth and development. A poor governance of banks can have dramatic effects: as noted by Levine (2004, 3), 'banking crises have crippled economies, destabilized governments, and intensified poverty. When bank insiders exploit the bank for their own purposes, this can increase the likelihood of bank failures and thereby curtail corporate finance and economic development'.

Both single intermediaries such as individual banks and large financial markets are subject to failures. A failure occurs for instance when savings and capital are badly allocated, or when a significant number of firms take on debts that are unable to timely repay. A significant number of defaults on loans and a low quality of credit and loans may represent the beginning of a systemic financial crisis with repercussions on the economy. Minsky (1982; 1986) observes that single financial units are often exposed to financial fragility, and can be categorised as: *i) hedge-financing units; ii) speculative-financing units; iii) Ponzi financing units*. From this point of view, the financial fragility of an economy depends on the proportion of Ponzi units and speculative units in that economy.

This observation provides a strong argument for the regulation and supervision of financial institutions, particularly banks, which can create a panic among depositors that can spread from bank to bank. There are also a number of externalities, such as spillovers of bank failures and competition for limited resources, exerted by banks which furtherly justify regulation. Nonetheless, one should ask whether it is sensible to apply the same type of regulation to different banking typologies. Regulators should address such a question adequately so to avoid mistakes from the past, in fact their activity has been recently challenged by a number of scholars (see for instance Onado, 2009).

The regulation and supervision of financial institutions are costly activities. There are at least two sources of cost associated with bank supervision, namely: *(a) the direct regulatory costs;* and *(b) the compliance costs borne by the regulated firms*. The effectiveness of such activities has been often questioned. Whether a regulated financial intermediation outperforms a non-regulated one is still a debated issue. Some scholars argue that the regulation of banks is essential to prevent mismanagement, fraud and financial speculation. There are three specific arguments for regulation (Matthews and Thompson, 2008, 189): *first*, consumers lack market

power; *second*, depositors are largely unable to monitor banks; *finally*, there exists the need to ensure the safety and stability of the banking system.

Conversely, advocates of the 'free banking' and the '*laissez-faire*' school argue that regulation is largely inefficient in preventing financial failures and assert that the banking industry operates according to a mechanism of self-regulation. Any external interference is viewed as potentially harmful or – at best – unnecessary. Indeed, it is argued that from the point of view of an intertemporal profit-maximizing behaviour, good banks are able to outperform less competitive ones and set the standards for them too. As a result, bad banks are encouraged to improve their services and overall performance (Dowd, 2003).

### 3.2 The need to redesign banking regulation in the aftermath of the 2007-2008 crisis

The 2007-2008 financial crisis suggests a redefinition of regulation and supervision, and promotes the idea that a well-designed regulation is a 'public good' rather than an obstacle to competition and the market economy. As Arner states, the task of regulation and supervision is 'to ensure that financial intermediaries operate in a prudent manner and that they hold capital and reserves sufficient to support the risks that arise in their business. In addition, regulations can be, themselves, a source of vulnerability to the extent that they are too lax, too intrusive, poorly designed, outdated or inadequately implemented. Strong and effective financial regulation and supervision therefore provide a necessary public good' (Arner, 2007, 196).

One of the main problems that need to be addressed in terms of banking regulation is whether the latter has to be redesigned from an international, national or regional perspective to better adapt to different banking typologies. Distinctive traits such as the size of banks and the geographic area in which they operate can be observed together with their propensity to undertake risks. Jiménez et al. (2007) provide evidence that smaller banks' incentives to take risks are more affected by the stance of the monetary policy than those from large banks. In addition, 'the effect of the stance of monetary policy on credit risk-taking further depends on bank liquidity and ownership type, and on the level of banking competition and new borrower entry in the local area' (Degryse et al., 2009, 185).

A number of scholars argue in favour of an international financial regulation which should comprise the regulation of banks. In 1998, Eatwell and Taylor recommended the establishment of a World Financial Authority with the aim to create a framework of a truly international regulation. Similarly, Kern et al. (2007) argue that since financial institutions are international and banking operations often have international dimensions, policy formation and implementation should also be international. They assert: 'international decision making and standard setting should be effective in devising principles of efficient regulation, accountable in terms of transparency and clear lines of decision-making authority' (Kern et al., 2007, 271).

Provided that costs are repaid by benefits, an international financial regulation is relevant to financial conglomerates, multinational banks and large investment banks that operate internationally. An international set of rules is essential to regulate both their activities and their risks. Ideally, such a regulation should encourage a safe competition and promote an international economic growth. However, one may ask whether such a regulation is viable when it comes to small players operating on a local, regional or – at best – national level. The results from the paper should be particularly useful to shed light on this last point.

#### 4. THE ITALIAN AND EUROPEAN COOPERATIVE CREDIT BANKS: THE PROBLEM OF AN EFFICIENT CORPORATE GOVERNANCE

According to Angelini and Cetorelli (2003), cooperative banks are somewhat similar to US credit unions and their characteristics put them in a 'niche position' which gives them extra market power (Angelini and Cetorelli, 2003, 666). Arguably, their limited size prevents them from being bailed out in case of failure. Although cooperative banks represent an interesting topic which needs to be addressed separately, they have been somehow neglected by scholarly research: for example, the 2005 edition of the *Oxford Dictionary of Finance and Banking* does not provide a separate entry on cooperative banks (but it does provide one on both credit unions and building societies, namely their counterparts in the US and UK).

The cooperative credit system can be thought of as an autonomous banking system. As specified by their statute (*statuto*, it.), cooperative banks provide credit primarily to their members, even though it may be argued that this guideline has been relaxed over time. As a consequence, they resemble some characteristics observed in ownerless savings banks from countries such as Norway: their goals include promoting saving in society and offering bank services to a wide range of citizens. (Bohren and Josefsen, 2009). Regulators and policy-makers need to recognise such characteristics. The main thesis of my paper is that these specifics in governance and management in the cooperative banks have some implications also for their regulation. Stated otherwise, I argue that since they behave differently than other (typical commercial or universal) banks, they should be regulated differently.

Arguably, banks that operate exclusively in 'domestic markets' (Mrak, 2002, 519) require a different type of regulation, namely a distinctive set of rules and a number of separate guidelines, different from those aimed at international commercial banks. Why should a research on the regulation of banks pay particular attention to the Italian cooperative credit banks? To start with, they matter to the regional economy: they are local banks that operate in one of the 20 Italian regions. In Northern regions such as Veneto, they are particularly important to SMEs and regional clusters: out of nearly 400 Italian cooperative credit banks, 40 operate in the Veneto region (Malvestio, 2006).

In order to exist, a cooperative credit bank must have at least 200 members. The members' assembly entitles the board of directors, which normally represents the community in which the bank operates. I assume that cooperative credit banks based in different European countries have a similar governance structure and that the network to which they belong reinforces such similarities. In my discussion on the governance structure of the Italian cooperative credit banks, I will adopt a microeconomic model developed by Dewatripont and Tirole (2003), and based on an earlier paper in which the authors consider the optimal control of firms.

According to the latest estimates ([www.creditocooperativo.it](http://www.creditocooperativo.it)), the number of deposits and savings collected by the Italian cooperative credit banks amounts to 119,9 billion Euros, whereas their capital (*patrimonio*, it.) amounts to 17,6 billion Euros. Italian cooperative banks are based on solidaristic principles and are specialised in retail banking and in loans to small and medium-sized enterprises (SMEs): indeed, they provide 22% of the total loans to SMEs from the agricultural sector, and 11% of the total loans to non-profit organisations in Italy. They constitute a decentralised network which is governed by banking and cooperative

legislation. Since cooperative banks are present in most EU member states, my research is relevant to other countries and its implications are not limited to the Italian banking system.

## **5. TENTATIVE RESEARCH METHODOLOGY AND TESTING MODEL(S)**

### **5.1 Problem definition**

The problem of an efficient banking regulation can be approached from different perspectives and with different methods. The present research does *not* aim that much to investigate the regulation of banks with respect to market structure, bank conduct or bank strategy. Instead, regulation is considered in relation to corporate governance, namely the corporate governance of cooperative credit banks. What is the best approach to address such an argument? Does the existing research address the problem of banking regulation in a sufficient way? How can one improve existing analyses and obtain new insights on the governance of banks? These are some of the questions that inspire my research.

Studies on Italian cooperative credit banks are mostly descriptive and based on qualitative aspects; a quantitative approach to the analysis of corporate governance in cooperative credit banks could provide valuable insights both for regulators and policy-makers on the one hand, and cooperative credit bank managers on the other. My paper attempts to fill such a gap and therefore both complement and expand the above-mentioned studies with a sound quantitative analysis.

It is important to provide a definition of corporate governance in banking. According to Crespi et al. (2002, 4-5), the corporate governance of banks refers to 'the various methods by which bank owners attempt to induce managers to implement value-maximizing policies'. These methods can be either external to the firm (as the market for corporate control); or internal (as a disciplinary intervention by shareholders or from the board of directors). Good banking performance is generally matched with good corporate governance. Conversely, poor corporate governance often results in poor performance, insufficient risk management, and may eventually produce large losses. Therefore, bank performance and the quality of risk management can be included as measures of corporate governance.

### **5.2 Governance structure of Italian cooperative credit banks**

The study from Dewatripont and Tirole (2003) considers issues related to moral hazard in banking and the implications for the regulation of banks. To cite the authors, 'the theory is based on the idea that managers do not like outside interference in their management' (p. 20). The model applied to banks predicts that when some verifiable performance measure (such as riskiness of loans, reserves, and capital-to-loans ration) falls below some threshold, the control of the bank should shift away from its shareholders to its creditors. Such a discussion is particularly relevant in turbulent times.

Dewatripont-Tirole's model is made of two periods,  $t = 1, 2$ .

In period 1, the firm's management chooses an unobservable effort level  $e \in (\underline{e}, \bar{e})$  with  $\underline{e} < \bar{e}$ .

At the end of the first period, two signals are observable, namely:

- $v$  is 'verifiable', 'contractive', 'objective';
- $u$  is 'non-verifiable', 'non-contractive' and 'subjective'.

(For simplicity, it is assumed that  $v$  and  $u$  are independently distributed on  $[0,1]$  conditionally on  $e$ ).

The firm's long-term profit, which depends on action  $A$  at the end of period 1, is realized in period 2. After the effort is chosen and the first-period signals are realized, the outsiders who are granted control choose some non-contractible action  $A$ . The firm's capital structure specifies the control structure, namely which claim-holder has the right to choose  $A$  for the realization of the contractible signal  $v$ .

An analysis of banking starts from the consideration that bank deposits are typically held by small depositors. The study by Dewatripont and Tirole ultimately suggests the limits of a *laissez-faire* approach to banking: the management cannot be monitored and disciplined solely by the equity-holders since they appear to be biased in favour of managers. Therefore, debt-holders should take an active role in disciplining management, particularly in turbulent times. The problem arises from the fact that small depositors cannot perform such a task. Therefore, particularly in bad times, public agencies such as the FDIC should discipline managers on behalf of small depositors.

As firms behave differently with respect to size, industry, and geographic area, banks too operate differently with respect to size, operational structure and typology, geographic area etc. The aim of the research is to provide an application of the model and discuss its relevance to cooperative credit banks in order to discover whether they behave accordingly or differently as suggested by Dewatripont and Tirole. In fact, it can be argued that cooperative credit banks cannot be assessed on the basis of a profit-maximizing tendency that most other banks pursue. Furthermore, the scholars adapt their model to a previous version on firms analysis, yet – as noted by Crespi et al. – 'many of the lessons from non-financial firms cannot just be extended to financial institutions' (Crespi et al., 2002, 5).

### 5.3 Corporate governance in cooperative banks: What is special and what implications does this have for the regulation of cooperative banks?

A discussion of the governance in cooperative credit banks is particularly interesting since they have a very specific structure and governance model. Even if their organizational rules can vary according to their respective national legislations, according to the International Cooperative Banks Association cooperative banks share a number of common features:

- i) Customer-owned entities:* the needs of the customers meet the needs of the 'owners'. The main goal of a cooperative bank is *not* to maximize profit but to provide the best possible products and services to its members. Some cooperative banks only operate with their members but most of them also admit non-member clients to benefit from their services.
- ii) Democratic member control:* cooperative banks are owned and controlled by their members, who democratically elect the board of directors. Members have equal voting rights, according to the cooperative principle of 'one person, one vote'.
- iii) Profit allocation:* a significant part of the yearly profits, benefits or surplus are allocated to constitute reserves. Only a part of these profits can be distributed to members, with legal or statutory limitations in most cases.

These specifics should consequently have an impact on the incentives and behavior of the bank decision-makers, the managers. Due to the fact that they are not strongly profit-oriented, the incentives of the bank managers to undertake risky activities should be, in principle, lower than in other banks. In fact, existing literature on bank governance suggests that (since managers pursue the interest of the shareholders), commercial banks have profit-maximization as their goal and therefore pursue riskier strategies. A recent study by Bohren and Josefsen (2009) on Norwegian banks substantiate this point of view: in fact, Norwegian ownerless savings banks controlled by non-owner stakeholders are less risky, smaller and grow more slowly than commercial banks. The main conclusion from the study is, however, that performance is *not* systematically higher in owned firms than in ownerless firms (banks)<sup>2</sup>.

Cooperative banks pursue a diversity of goals (such as to promote saving in society) and are encouraged to distribute part of their earnings for social purposes. Since the shareholders' pressure for higher profitability is weaker, the motivation for these banks to undertake into risky activities should be lower. Consequently, the board of directors in a cooperative bank may be more inclined to, for example, penalize the management for undertaking risk than in normal banks.

In my empirical analysis, I will follow the analysis of Cihák et al. (2009) and other existing research on management turnover in banks. However, this research mostly centers on large and publicly listed banks. An investigation from the point of view of cooperative banks is expected to provide an original contribution to the literature. The focus on small banks is potentially fruitful in many ways: for example, they provide a kind of 'laboratory setting' for the examination of market discipline and corporate governance (Cihák et al., 2009, 5). The executive turnover can be modeled as a function of bank's risk profiles, losses, and a set of control variables. As in Cihák et al. (2009), I will attempt to isolate the disciplining effects arising from different stakeholders (regulator, depositors) and explore how each of them individually exerts discipline.

The analysis of the management turnover will be limited to the cooperative banks since the data on management turnover in other banks are difficult to find. In particular, it is difficult to distinguish between forced and voluntary change in the top management. Thus, I will limit my empirical analysis to the sample of cooperative banks. In the continuation, the sample of cooperative banks will be merged with the data for other, non-cooperative banks in order to detect the differences in risk-exposure, performance and productivity between the cooperative and non-cooperative banks. I will proceed in two steps. First, I will perform an empirical analysis of the impact of bank type, ownership and creditors' discipline on bank performance and risk exposure. The focus here is, in particular, to test whether cooperative banks perform differently in terms of profitability and risk, holding other factors (such as bank size) constant.

I will partly replicate the methodology and the empirical analysis adopted by Crespi et al. (2002) in the research on governance mechanisms in Spanish financial intermediaries. The paper is interesting since savings banks – defined as 'commercial non-profit firms' – are very relevant institutions within the Spanish banking system and control about half of the Spanish retail banking. Savings banks compete with each other and with commercial banks. Their profits are either retained or employed to fund social programs. It is interesting to observe that

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<sup>2</sup> This result is somehow surprising since the observed relationship between stakeholder structure and economic performance is largely inconsistent with agency theory.

their ownership form is a private foundation with representatives from regional authorities, city halls, workers and depositors.

The variables included for my empirical analysis will partly depend on the availability of the data but should (in principle) include:

*Dependent variables:* PERFORMANCE, RISK, or (for cooperative banks) MANAGEMENT TURNOVER.

*Independent variables:* SUPERVISION DUMMY, OWNERSHIP TYPE, GROWTH, STRUCTURE OF ASSETS AND DEPOSITS.

In conclusion, in the final part of the paper, I will discuss the implications of my empirical analysis for bank regulation. As stated at the beginning, I expect to provide valuable insights on the regulation of banks with respect to their governance, ownership specifics, and size.

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