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Implementing Basel 2 and IAS:
Tendencies, Problems, Solutions

"Basel 2" and "IAS": more competition, less risk

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My intention in these remarks is to set the issues raised by Basel 2 and IAS within a common framework. I shall therefore not consider the technical details but three general aspects:

a) the macroeconomic context in which the new methods will be inserted;
b) the hoped-for effects on the financial system;
c) their transposition by banks and the Italian legal system.

a) *The macroeconomic context*

The entry into force of the new International Accounting Standards and the "Basel 2" capital adequacy accord will be gradual, phased in between 2005 and 2007. Intermediaries and supervisors are making their preparations. The "context" thus consists in a set of present-day realities, plans, expectations and forecasts.

The information now available suggests that the moment is propitious for the non-traumatic introduction of the new methods.

The international economy is subject to the threat of military conflicts, oil shortages, high real-estate prices, the large foreign debt of the United States and a declining dollar. Yet overall the economic picture is the rosiest seen for a quarter of a century. The forecasting scenario for 2005-2006 remains one of inflation-free growth: annual GDP growth of 3 per cent in real terms and price inflation under 2 per cent in the OECD countries, and annual world trade growth of no less than 9 per cent.

This essentially benign macroeconomic situation is accompanied by systemic financial stability. The Financial Stability Forum, in which I have had the honour of participating since its foundation in 1999, is the world's leading financial supervisory body. The Forum sees the debt of firms and households as moderate or sustainable, intermediaries as profitable and well-capitalized, share prices as basically in line with fundamentals, and prudential standards as stronger virtually everywhere. By comparison with the past the indicators of stability are on average higher and have lower although not negligible dispersion.

Italy is no exception as regards low inflation and the stability of the financial system as a whole. Unfortunately, however, it is an exception in its rate of economic growth. From 1992 to 2006 (forecast) the yearly growth rate will come in at a mediocre 1.4 per cent. Yet the cyclical upturn is basically in line with the – modest – expansion of potential output. Moreover, even an economy with slow growth in potential output can be financially efficient and stable. The Italian economy's "growth problem" can be solved.[1] We are not condemned to stagnation. We have a diagnosis. And most important, the therapy is clear.[2] The State must restore the health of the public finances, take care of infrastructure, reduce taxes and rewrite economic law; firms must expand in size and improve in quality with investment and technical progress; banks must select and support the best firms; the trade unions must defend but also moderate wage growth. All are called on to accept competition, not to impede the reallocation of resources. Policies and conduct together – not just government policies, not just the conduct of firms, banks and workers – can bring the Italian economy's long-run growth rate back up to 3 per cent.

b) *The purposes of Basel 2 and IAS*

Taken together, Basel 2 and IAS can appreciably increase efficiency, and above all in this way enhance bank stability.

How? In principle, through stepped-up competition between intermediaries and within the financial markets.

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1 P. Ciocca, *Il tempo dell'economia. Strutture, fatti, interpreti*, Turin, Bollati Boringhieri, 2004, Chapter 14.

2 P. Ciocca and G. M. Rey, "For the growth of the Italian economy", *Review of Economic Conditions in Italy*, No. 2, 2004.

Without competition there cannot be efficiency. Without efficiency, in the long run there cannot be stability. Without stability the drive for efficiency is more difficult, and the free play of competition is impeded. A policy of prudential supervision that – by choice or because obliged by law – ignored competition or, worse, thought it could be sacrificed in the name of stability would be self-contradictory.

I shall back up these propositions – of whose validity the Bank of Italy remains thoroughly and analytically convinced – with a theoretical consideration and empirical evidence.

Simplifying, the theoretical consideration can be quickly set forth. By their nature or in response to the urgings of supervisors, banks are risk-averse. They are in equilibrium if lower returns correspond to lower risk. Competition erodes quasi-rents, the extra profits of oligopoly. Other things being equal, therefore, competition does not induce banks to take on greater risk. On the contrary, by eliminating the quasi-rent "subsidy" of their riskier assets, it recalls them to prudence. Supervisory action works in the same direction. On the theoretical plane there is no conflict between competition and banking stability. Accordingly, on the institutional plane there is no conflict in principle between supervision and antitrust action in banking where – as has been the case in the United States from the very beginning and in Italy since 1990 – the same institution is responsible for both.

The empirical evidence is equally clear. Despite the protracted stagnation of the Italian economy following the dramatic foreign exchange crisis of 1992, in supervising and regulating the banking system the Bank of Italy observed increasingly intense competition and at the same time instability limited to individual banks. In most of the markets for banking products the microeconomic indicators of price and volume testify to heightened competition, the transition from the traditional state of little rivalry to one of sharply stepped-up competition.[3] In the markets for corporate ownership and control, contestability

[3] P. Ciocca, *The Italian Financial System Remodelled*, Basingstoke, Palgrave Macmillan, 2005, especially Chapter 6.

in the banking sector has been boosted by the industry's virtually total privatization and the increased share of overall banking business accounted for by listed banks. The Lerner Index of oligopoly was one fifth lower in banking in 2000-2001 than it had been on average in the 1980s; in the service sector as a whole it was a quarter higher; and in the industrial sector excluding construction it was unchanged at a lower level.[4] On the average, as we can see from the tables and the figure, productivity in banking rose faster between 1990 and 2003 than it had in the 1980s, while the real cost of labour rose more slowly. Nevertheless, profitability declined, not because of larger loan write-downs but because of sharper competition. Meanwhile, since 1990 the number of banks has fallen by nearly 300 to 790, and 800 banks went out of business. Yet the present value of the total losses of the banks that failed or were taken over made good by other banks or by the State during this decade-and-a-half did not even amount to 1.5 per cent of a single year's GDP.

In the field of credit risk, regulations anticipated banking practice rather than following it as in the 1996 market risk amendment to the Basel accord. "Basel 2" fosters efficiency in banking. Banks, large or small, that use more accurate and effective methods of risk assessment and management are rewarded with lower capital requirements. In this sense the new accord introduces a "Darwinian" selection bias for the survival of the fittest banks. It will heighten competition and shift market shares.

The same holds for the new International Accounting Standards, although for different reasons. They are designed to enhance disclosure and transparency. They make the accounts of banks and firms comparable internationally. Potentially, they allow for a more realistic representation of market risk (with the application of fair value accounting for all securities) and of credit risk (with the broad, harmonized notion of "impaired loan", which includes overdue credits). Information and transparency will also intensify competition both between firms and between banks.

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[4] N. Cetorelli and R. Violi, *Forme di mercato e grado di concorrenza nell'industria bancaria dell'area dell'euro*, Quaderni di Ricerche, Ente Einaudi, No. 35, 2003, pp. 37-39 and Table 4, p. 55.

Since advances in competition and efficiency are for these reasons correlated with advances in capital soundness, Basel 2 and IAS together will certainly also strengthen the overall stability of the financial system.

Two qualifiers are needed here, however, one self-evident and the second more debatable.

The first is that Basel 2 will contribute to banking stability above all, and directly, by guaranteeing that banks' capital is better able to cover the risks incurred.

Second, aside from differences of opinion over the informational content of measurements based on fair value, it can be feared that the International Accounting Standards, and in particular those concerning securities, will make for more volatile balance sheets and income statements. This may not necessarily happen, once the impact of the initial transition to the new accounting rules is past; but even if it does, we must not mistake volatility in the operating results of firms and banks for instability of banks' balance-sheets. If "true" variability – or at any rate that which is relevant to the markets – is reflected better in items marked-to-market than valued at cost, then the banks will be called on to take precautions in managing, insuring against and sustaining risks. Prudential supervision itself will focus more sharply on the financial institutions supervised. In itself, better registration of "true" variability is not destabilizing; quite the contrary. In any case consideration is being given to the idea of applying prudential "filters" in calculating supervisory capital that can attenuate improper volatility in the accounts due to the repercussions of fair-value accounting.

c) *The transposition of the new methods*

The extent to which the aims are actually attained will depend on how well the banks make their preparations. But it will also depend on the adaptation of economic legislation.

For banks the change will be profound, at once technical and cultural. From valuations and decisions still largely based on deterministic values, single-value variables and the simple “summing up” of individual items they will move towards widespread use of both objective and subjective probability distributions. The next step will be even more towards considering portfolios as a whole and taking account of the linkages between asset and liability values, the structure of the balance sheet and immunization strategies. It will be less and less common for overall risk to be calculated by adding up the risk of the individual components.

Italian banks are readying themselves. The banking groups that will use advanced internal rating methods from the outset have initiated an especially intensive interaction with the supervisory department of the Bank of Italy.

Basel 2 and IAS also constitute an additional reason for adapting Italian law to the needs of a modern “regulated market economy ”. Albeit in different ways and to a variable extent, three fields of economic legislation will be involved: company law, competition law and bankruptcy law.

Italy’s recent company law reform is now filtering into the concrete reality of firms and banks. The legislation on banking has been coordinated with the Civil Code by Legislative Decree 37/2004. The implementing regulations will follow soon. The aspects on which the Bank of Italy has focused in helping banks to interpret the new company law are a more general notion of equity interest, adaptation of the requisites for bank officers and above all the duties and responsibilities of the board of directors and control bodies in the traditional and new models of governance. For Basel 2 and IAS to have the desired effects, the independence granted to directors – notably in the revised Articles 2381 and 2392 of the Civil Code – must be accompanied by strengthened internal and external controls on operations and accounts.

In applying the legislation intended to safeguard and foster competition in banking, even greater advantage will be taken of the connection between antitrust action and prudential supervision. Credit remains the heart of banking. Competition in the credit market is increasingly vital. As the supervisory authority, the Bank of Italy will have a delicate dual task. It must validate the various internal models of risk control that the banks can use under Basel 2. It will also have to check how these models are used in decision-making and, together with Consob, how the International Accounting Standards are applied. As stochastic methods come into more widespread use, until the ways in which they are employed converge under the pressure of competition the credit "product" and its price will vary – from bank to bank and over time, and perhaps even for the same customer. In the product price/quality/quantity analysis performed for antitrust purposes, the benefits of assigning the antitrust powers to banking supervisors will increase. The supervisory authority is better informed because it has primary responsibility for the validation and checking of the banks' risk models and accounting methods.

Lastly, the urgent need for radical revision of bankruptcy procedures has become even more glaring. In a world in which corporate planning and decision-making are no longer deterministic but probabilistic, the old bankruptcy law, all black-and-white, without shades of grey (liquid-illiquid, solvent-insolvent, revocable loans, impaired loans and bad debts) has become simply impracticable. Even the vested interests that have stymied all attempts at reform for years now will have to recognize the need to rewrite the bankruptcy procedures from top to bottom.

Basel 2 and IAS encourage customized standards where abstract and general principles are hard to apply to concrete cases. This is consistent with the principle that the courts must weigh not so much the outcome of companies' decisions as the process by which they are made. Both extremes must be avoided: having directors' actions governed exclusively by established parameters on the one hand and placing excessive emphasis on the outcome, *ex post facto*, in judging their choices on the other. Ultimately, in any event, jurisprudence will be crucial.

Long-term trends in the Italian banking industry

Demographics

Banks existing at 31.12.1990	1,064
Banks existing at 30.06.2004	790
Banks that went out of business between 1.1.1991 and 30.6.2004	812

Profitability and productivity

	1980-1990	*1991-2003*
	(averages of annual data; percentages)	
Return on equity	11.3	6.0
Operating profit / total assets	1.70	1.39
Rate of change in per capita staff costs at constant prices	0.8	0.1
Rate of change in assets per employee at constant prices	1.0	4.0
Rate of change in gross income per employee at constant prices	1.1	2.2

Listed banks

	1981	***1990***	***2004***
Number	32	47	40
Market share (assets) (1)	23%	30%	80%

Losses of banks that went out of business: 1990 - 2003 (2)

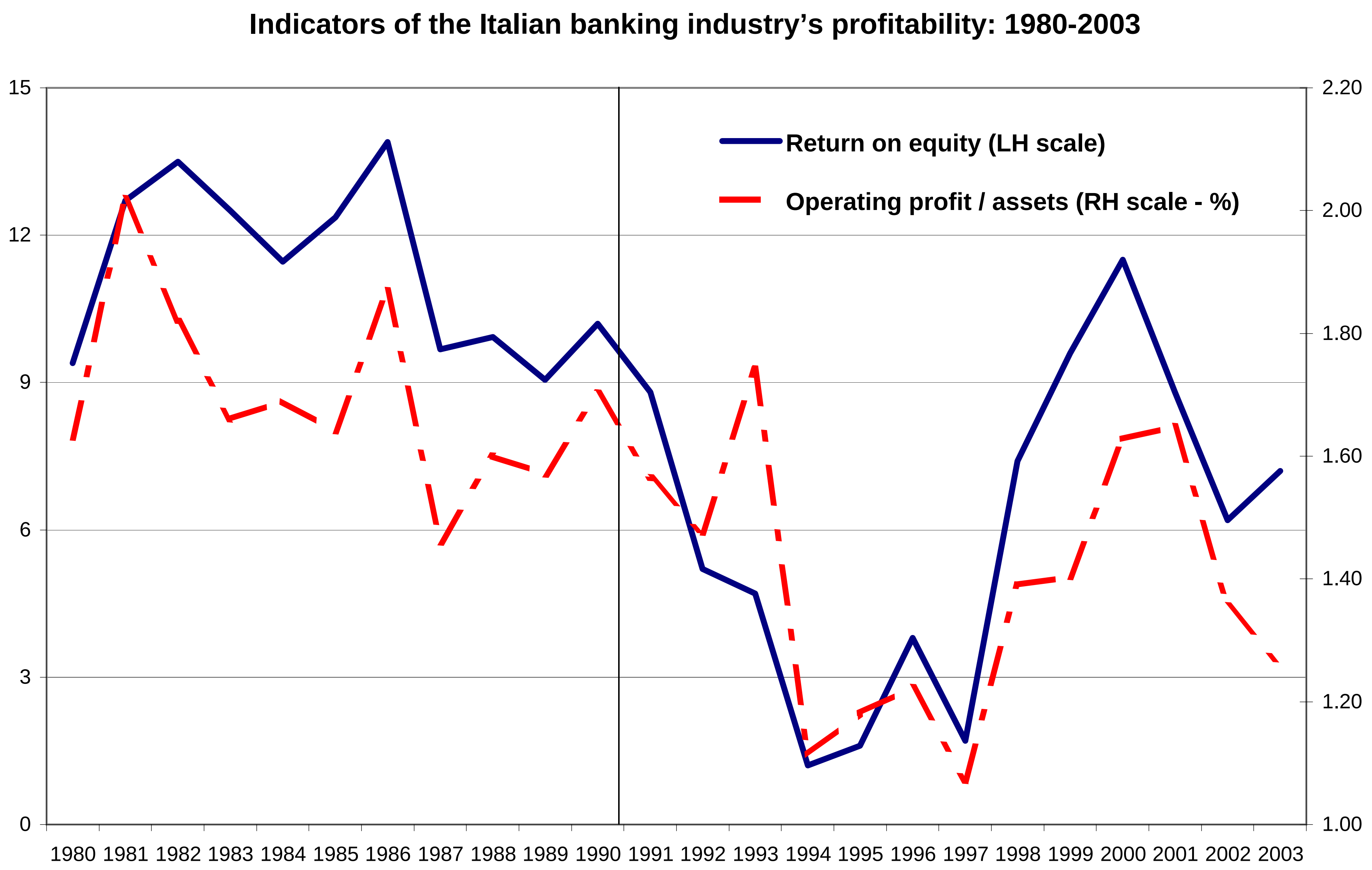
Nominal losses (millions of euros)	12,998
Present value as of 2003 (millions of euros) (3)	17,465
Present value 2003 / GDP 2003 (3)	1.34

1) Directly and through unlisted subsidiaries.

2) Income statement losses between 1990 and 2003 of all the banks that stopped operating, that were merged with other banks, or control of which was acquired by other banks or banking groups.

3) Calculated using the average annual rate on Italian Treasury bills.

	1980-1990	1991-2003
Contribution to formation of the profit rate **(***as a percentage of capital and reserves*)		
Operating profit	45.9	20.19
Net value adjustments, net non-recurring expense / income	–23.2	–8.75
Pre-tax profit rate	22.7	11.4
Taxes	–11.4	–5.4
Return on equity	11.3	6.0


Indicators of the Italian banking industry's profitability: 1980-2003
15
12
9
6
3
0
2.20
2.00
1.80
1.60
1.40
1.20
1.00
Return on equity (LH scale)
Operating profit / assets (RH scale - %)
1980 1981 1982 1983 1984 1985 1986 1987 1988 1989 1990 1991 1992 1993 1994 1995 1996 1997 1998 1999 2000 2001 2002 2003