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The Politics of Banking: Regulatory Capture, Thin Political Markets, Ideology and Beyond

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A Monica Bellucci,
l’altra metà del cielo, l’altra metà della terra,
l’altra metà dell’amore

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Foreword

Dario Aversa, Peter Cincinelli*

The global financial crisis in 2008 has raised profound doubts about the adequacy of supervision of financial markets. The Financial Stability Forum (FSF), in its April 2008 *Report on Enhancing Market and Institutional Resilience*, outlined four forces that contributed and increased the procyclicality in the financial system by providing some solutions to mitigating it. Four areas of weaknesses were identified: *a*) the Basel II capital accord; *b*) loan loss provisioning; *c*) compensation arrangements; *d*) valuation and leverage. The accounting standard–setters have substantially addressed these weaknesses. Given their relevance to the financial sector, particular attention has been devoted to the loan loss provisioning as a critical issue to effective financial reporting and separately to prudential supervision.

The accounting standards can have a crucial impact on the financial system, especially via their potential influence on the behaviour of

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economic agents. Financial statements provide signals regarding the financial and economic decisions. Moreover, financial analysts and shareholders assess the quality of management on the basis of accounting figures and on management decisions. Accounting standards can modify, in a certain way, the financial institutions behaviours and have an impact on financial stability. According with the European Central Bank (ECB), financial stability can be defined as a

> condition in which the financial system, comprising financial intermediaries, markets and market infrastructures, is capable of withstanding shocks and the unravelling of financial imbalances, thereby mitigating the likelihood of disruptions in the financial intermediation process which are severe enough to significantly impair the allocation of savings to profitable investment opportunities. (ECB, «Financial Stability Review», December 2006)

However, the quality of financial statements depends on the accounting standards. For example, in the European context, the introduction of the new accounting framework — the International Financial Reporting Standards (IFRSs), has been captured the attention of the European financial sector and also its impact on the financial system as a whole. Accounting standards have a direct impact on supervisory work conducted by central banks, by giving to the banks the guidelines and the ideas to calculate financial and regulatory ratios. Changes in the accounting rules may affect market perception, the financial ratios and the reports that supervisors use for assessing both the condition of each bank and the global condition of the financial system.

In this book, three contributions outline a framework for assessing how and to what extent the accounting standards meet financial stability aims. The first chapter "Accounting for Europe's Economy and Society", Yuri Biondi provides an interesting and valuable excursus regarding the convergence path of international accounting since the seventies. Focus will be devoted to the alternative accounting models (i.e., fair value against historical costs) and to some issues raised by International Accounting Standards.

Karthik Ramanna, in the second chapter entitled "Thin Political Markets in Accounting and Beyond", discusses the ways in which thin political markets generate capture in two ways distinct from the classic collective – action scenario: *a*) the nature of necessary expertise is tacit of implicit; *b*) the issues at stake evince little interest from the general public or its intermediaries such as the media or politicians.

The third chapter, edited by Dario Aversa and Peter Cincinelli, outlines the role played by the Italian banks during the global financial crisis and their contribution to the economic growth by using the Banking Granular Residual technique. The empirical results show how the contribution, in term of economic growth is positive for mutual banks (BCC) where instead, the commercial banks (SpA) show a negative relationship.

Financial information is crucial for the economy because of it forms the basis on which economic and financial agents and the authorities take their decision. Since the financial stability perspective has been at the centre of accounting discussion, it is important that accounting standards effectively contribute to a further strengthening of it. Sound principles lead markets, banks and other financial institutions to create conditions in which the financial system is capable of withstanding shocks and the unravelling of financial imbalances, by mitigating the likelihood of disruption in the financial intermediation process.

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1. Accounting for Europe's Economy and Society

Considerations for Financial Stability Economic Development and the Public Good

Yuri Biondi*

Abstract: International accounting convergence led by the International Accounting Standards Board (IASB) has been fostering an accounting revolution by introducing a market basis of accounting. This accounting model makes general reference to current values (mark–to–market, fair value) instead of corporate realised revenues and invested costs, which were central to the previous model (historical cost). This accounting revolution was consistent with the global financial architecture based upon transnational financial markets which was established since the seventies. However, among the main jurisdictions and monetary areas worldwide, only Europe has adopted the international accounting standards (IAS–IFRS), substantially delegating its accounting legislative and regulatory process to the IASB. This delegation has been raising major quarrels with European constituencies, including (i)

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resistance against the (full) fair value measurement of financial instruments (2003–05); (ii) opposition to amendment of IAS on segment reporting (2006); (iii) forced suspension of fair value measurements and impairments amid the North–Atlantic financial crisis (October 2008); (iv) an institutional conflict over the evaluation of distressed Member States' sovereign bonds (August 2011). The Maystadt Report of 2013 reviewed and summarised these concerns with both the accounting model, and the governance of Europe's accounting standards–making. It recommended including further considerations for Europe's financial stability and public good, while it did consider the option to establish an Accounting Standards Board of Europe.

Accounting for the European Private Sector: Reconsidering Accounting Objectives for Economy and Finance

a) *Accounting for Europe's Economy and Society: Considerations for Financial Stability, Economic Development and the Public Good. Which Accounting Regulation for Europe's Economy and Society* by Yuri Biondi, «Accounting, Economics, and Law: A Convivium», 7 (2), 2017, pp. 65–77. Retrieved 27 Feb. 2020, from doi: 10.1515/ael-2017-0018.

b) *On the Accounting Regulation for the European Private Sector* by Arnaldo Canziani, https://doi.org/10.1515/ael-2017-0015.

c) *The Need to Reform the Dangerous IFRS System of Accounting* by Jacques Richard, https://doi.org/10.1515/ael-2017-0017.

d) *International Financial Reporting Standards (IFRS): Stress Testing in Financialized Reporting Entities* by Colin Haslam, https://doi.org/10.1515/ael-2017-0016.
e) *Open Debate on Accounting for the European Private Sector* by Imke Graeff, https://doi.org/10.1515/ael-2017-0024.

I wish to thank all the speakers and the participants to this workshop organised under the auspices of the European Parliament. This workshop purports to convene academics, policymakers, lawmakers and a broader audience to discuss and share views and analyses on accounting regulation in Europe. Speakers and attendees were invited on the basis of their interest in accounting regulation, in view to address the broader, overarching issues raised by this regulation. We do not aim at providing a technical debate, for we understand what Mr Karthik Ramanna explained before, that is, that this kind of professional expertise often belongs to a restricted number of experts, and it is often shared among circles of five to fifty specialists who can cope with the technicalities of one accounting issue. To be sure, these technicalities shall remain the outcome of our contribution when recommendations are concerned — as for eventual recommendations shall be translated in some standards or principles of reference, but we do aim at addressing the more general and overarching implications of accounting regulation. In particular, this panel shall raise the debate on Private Sector Accounting Regulation in Europe.

2.1. International Accounting Convergence since the Seventies: An Accounting Revolution

A double movement has characterised accounting regulation since the Seventies. On the one hand, the provision of accounting standards has been progressively delegated to independent accounting bodies issuing specialised accounting standards. This is the case for US (FASB) and Europe (lASB). On the other hand, this legislative delegation to independent accounting bodies has fostered the emergence of a new accounting model, a phenomenon described by academic literature as "accounting revolution".

This new accounting model has been replacing the well–established framework of accounting which was rooted in local jurisdictions and contexts, with a new framework which appears to put the (financial) market at the core of accounting representation and corporate accountability. Accounting is then supposed to rely upon current market prices of reference and adopt a shareholder primacy orientation[1]. This new reference to financial markets and investors replaces the old–fashioned

1. Biondi, Yuri (2012), *What Do Shareholders Do? Accounting, Ownership and the Theory of the Firm: lmplications for Corporate Governance and Reporting*, «Accounting, Economics, and Law: A Convivium», Vol. 2, lssue 2, June. DOl: http://dx.doi.org/10.1515/2152-2820.1068.

notion of stewardship and accountability of the enterprise entity to its stakeholders (including shareholders) in line with the public good as defined and enforced by contract, regulation and social norms. Under the lFRS, accounting standards purport to

> financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity. Those decisions involve buying, selling or holding equity and debt instruments, and providing or settling loans and other forms of credit. (lASB 2010, *The Conceptual Framework for Financial Reporting*, OB2)

As a matter of fact, accounting cannot be disconnected from its institutional context and role. But international accounting convergence has been disseminating this new accounting model, for the alleged sake of a better economic representation through the so–called fair value accounting basis — that is, current market value basis — as if markets could be made accountable through themselves. From this perspective, accounting is no longer required to contribute to the institutional framework which works *for the market*, but it is asked to take reference *from the market* to establish the suitable accounting basis (especially through reference to current market prices). lnternational accounting convergence aims at making accounting from the market, no longer for the market[2].

2. Bensimhon, Larry & Biondi, Yuri (2013), *Financial Bubbles, Common Knowledge and Alternative Accounting Regimes: An Experimental Analysis of Artificial Spot Security Markets*, «Ac-

2.2. Alternative Accounting Models: Fair Value against Historical Cost

In sum, fair value aims to apply a (financial) market basis of accounting, referring to current values (mark–to–market) and evaluating assets and liabilities in isolation according to a balance sheet accounting approach (stock method). Taking a dualistic perspective, this model opposes the historical cost accounting approach, which aims to track and represent the ongoing economic and financial process of the business firm over time and in situation, in view to determine the revenues accrued to the going concern and its financial position according to an income statement accounting approach (flow method). The priority is given to matching invested costs and generated revenues through time, looking at accounting elements as combined and deployed throughout the evolving enterprise entity process (going concern)[3].

counting for or from the Market? The Japanese Accounting Review», Vol. 3, pp. 21–59. DOI: http://dx.doi.org/10.2139/ssrn.1934227.

3. Biondi, Yuri (2005), *The Firm as an Entity: Management, Organization, Accounting*, Università degli Studi di Brescia Working Paper No. 46, August. DOI: http://dx.doi.org/10.2139/ssrn.774764.

2.3. The Accounting Revolution and the New Global Financial Architecture

This accounting revolution came along with the new global financial architecture based on global financial markets. Since the 70s, the previous global financial architecture organised under the Bretton–Woods Accords was disbanded (1972) and progressively replaced with a new financial system which is supposed to be global and working through integrated financial markets (see for instance the Lippmann conference). These globally integrated financial markets were expected to self–regulate through market mechanisms dictated by the price system. In this context, the accounting revolution supposes that global financial markets can also provide information by themselves (as predicted by theories grounded on efficiency of financial markets), through a new market–based communication thread — yet called accounting — and where accounting information simultaneously comes from the market. This appears to involve a sort of schizophrenic self–reference of accounting, now both an input and an output of market price equilibrium formation[4].

From this perspective, we find a first layer of financial regulation where accounting regulation is made dependent on the market, along

4. Biondi, Yuri & Giannoccolo, Pierpaolo (2015), *Share Price Formation, Market Exuberance and Financial Stability Under Alternative Accounting Regimes*, «Journal of Economic Interaction and Coordination», Vol. 10, Issue 2, pp. 333–362. DOI: http://dx.doi.org/10.2139/ssrn.2277218.

with a second layer where financial markets are made dependent on themselves to self–regulate, as if regulation were an emergent property of the financial system itself. The global financial architecture appears to have been somewhat flawed by this market–basis assumption or belief.

The context provided by this market–based financial architecture sheds a new light on the quest for a global set of accounting standards. Both FASB and IASe were established in 1973 and fostered a (financial) market basis for accounting. This market–basis quest that is central to the fair value accounting model was reinforced by the alliance between the FASB and the IASB, made official since 2001, but existing since 1993 at least. In particular, this explains the replacement of the previous well–established accounting model, which was based on the idea of the business firm as a going concern represented through a historical cost accounting basis. The consideration of time is certainly one of the most striking differences between the two accounting models. Fair value accounting bases upon an equilibrium pricing where transactions are simultaneous and occur beyond history and hazard. Historical cost accounting tracks and represents transactions as occurring in the business firm through historical time and circumstances.

Notably and indisputably, this latter model was widespread and universal before the fair value revolution. The notion of the business firm as a going concern was accepted by virtually all the major juris-