



## THE IMPACT OF INTERNATIONAL PRUDENTIAL REGULATIONS ON BANKING STRATEGIES: THE CASE OF EMERGING COUNTRIES

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### Abstract:

In recent decades, banking systems have had several critical moments, which urged international banking regulatory authorities (Basel Committee) to develop prudential standards and align them globally. This has had an impact on banking strategic orientations. Hence, this paper is aimed at studying the impact of international prudential regulations, namely the Cooke and McDonough ratios, on these orientations. In this context, an investigation into the literature and an empirical validation have been carried out. The conceptual framework has revealed this regulation does have an impact on banking strategies and international practice shows a tendency towards diversification and mergers and acquisitions. As for the empirical analysis performed on our sample of Tunisian banks, the results show that both ratios impose diversification, a policy dictated by the need to seek resources able to meet the requirements in terms of equities and promote other strategies. So, the international prudential regulation dictates and guides international banking strategies.

**Keywords:** International prudential regulation, Basel I, Basel II, banking strategies, diversification.

## INTRODUCTION:

The financial system in general and the banking system in particular are able to show, by their roles and vocations, reliable indications if an economy is healthy or not. They can even enable investors and stakeholders to anticipate their actions and manage the movement of their capital, hence the importance of banks in the economy and the great interest they are granted by public authorities. These authorities cannot be indifferent to the major role that banks play in the economy and the difficulties they may face. Thus, they have been faced with an urgent need to organize the sector and intervene in the banking business through a specific regulation: "**the prudential banking regulation**," which is interpreted by banks as a set of constraints that are undoubtedly necessary though heavy to bear. In fact, establishing an adequate banking supervision is a challenge for any economy, no matter how developed, emerging or even poor, in an environment characterized by globalization, the emergence of new information and communication technologies (NICT) and deregulation which have led to a wider range of activities offered by banks. Over time, this regulation has taken an international dimension through the Bank for International Settlements (BIS), particularly the Basel Committee, which is the source of **international prudential regulations**, by publishing its two famous provisions (Cooke and McDonough ratios) while seeking a harmonization of prudential standards and financial strength globally. Furthermore, the evolution of financial markets has deeply changed the nature and structure of the financial services sector. Thus, the survival of banks and their development depend on reaching a competitiveness that can meet this objective. To achieve this, banks have to adopt strategies that require an optimal resource allocation and a better monitoring of environmental changes. Changes in banking behavior have been manifested and strategic choices have taken an important place in banks. As a result, and to cope with developments in a changing environment, choosing the right strategy is of paramount importance. We have so far focused on two key concepts: the international prudential regulation, which stands as a constraint though necessary for the control of financial institutions, and the importance of banks and their strategic choices. In fact, the confrontation between the banking activity's external constraints and the bank's internal organization is permanent and these two elements appear to be inseparable. This raises the question of how to consider the nature of the relationship environment / bank, or more precisely, **international prudential regulation versus banking strategy?**

The aim of this paper is to determine the impact of prudential regulations on the international banking strategy and its implications.

### I. INTERNATIONAL PRUDENTIAL REGULATIONS:

Since the mid-1970s, the prudential regulation has been a key concern for authorities in developed countries. In general, such a regulation can be justified by the need to protect depositors.

Indeed, as the banking system plays a central role in payments transactions and savings mobilization, an effective control of financial institutions is essential. Depositor protection is often implemented through a limited or full deposit insurance system which compensates depositors who have "lost" their deposits after a bank bankruptcy.

## 1. History of the international banking regulation:

A number of serious financial crises such as the 1982 Mexican debt crisis, the bankruptcy of the American savings banks and especially the 1987 stock market crash have prompted the need for measures to ensure the security of banking systems and prevent a wave of bankruptcies whose consequences would be significant for the global economy. In this context, a harmonization of prudential standards was the course to be followed: the Cooke ratio of the Basel Committee<sup>1</sup> (or Basel 1).

As highlighted by Servigny Arnaud (2001), "The 1988 Basel Agreement, which took effect in 1992, is an important turning point in terms of international prudential regulation. Following the 1990s great international financial system crises, the limits of the Basel Agreement were determined, which led authorities to consider new rules. Hence, the appearance of a new agreement known as Basel II or "McDonough" ratio.

Since 1998, the Basel Committee has launched the Basel II reform to overcome the weaknesses of the Cooke ratio. In June 1999 and January 2001, this reform was initiated by the publication of "*consultative papers*", documents extensively discussed by representatives of the banking profession. In October and December 2002, a "*Quantitative Impact Study*" was launched with the participation of 250 banks in order to enable the Basel Committee regulators to define the weights of the new ratio. In 2003, a third consultative document was published. The publication of the final agreement was completed in June 2004. During the first half of 2006, the two computing systems (McDonough and Cooke ratios) coexisted to achieve a full implementation of the new ratio for late 2006.

Basel II will be an epistemological break from the 1988 Basel Agreement. The simple and restrictive regulations were in fact substituted by a more open approach consisting of alternative menus and relying on the qualitative assessment of national regulatory bodies.

It should be noted that international regulators have always sought a way to achieve a more effective and a better harmonized banking system, hence the improvements and the development of these guidelines will continue until one day a new Basel III agreement is achieved. Given these considerations, Basel II should be considered as an important step towards a more effective regulation and a better harmonized financial system rather than the conclusion of a long process. Though the history of prudential regulation was greatly accelerated with Basel II, the latter is by no means complete and should continue to adapt to the constant movement of innovation and change in the banking system.

Some authors (Wenger.T, 2004) state that: "*The improvement and development of these guidelines will continue until one day a Basel III Agreement is born. Hopefully, there will be then enough room for the fundamental reflections notably related to the objectives and the most*

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<sup>1</sup> This is a committee that operates under the Bank for International Settlements (BIS). Indeed, the Basel Committee was established in late 1974, under the name of the Committee on Banking Supervision by the Central Bank governors of the Group of Ten, following the serious disturbances affecting international banking and monetary markets (notably Herstatt Bank bankruptcy in West Germany). The members first met in February 1975 and have regularly organized three or four annual meetings ever since.

*appropriate tools to achieve them, as well as a wise increase in the financial organizations involved and subject to regulation outside the banking system”.*

## **2. Reasons for the international banking regulation:**

J. Soubeyran (2004) states that *“The term "prudential supervision" refers to all the frameworks implemented by the banking and financial supervisory authorities of the sector (central banks, regulatory and control bodies, international cooperation and consultation bodies) in order to maintain the latter's stability”.*

Instability is inherent in the banking activity in addition to some price volatility that characterizes the normal functioning of financial markets. But in case of excess, banking and financial crises are triggered, threatening the functioning of the whole financial system. This is referred to as systemic crises. The justifications of this prudential (and mainly international) regulation are now widely accepted. Promoting the introduction of international prudential regulation has been prompted by the following reasons:

- The need to ensure that the banking activity is conducted in a healthy and prudent way to successfully protect the depositors. Indeed, *“Deposit insurance provides a safety net for many creditors, thereby enhancing public confidence in banks and stabilizing the financial system”.* J. Prefontaine and A. Thibeault (1991) state that *“the regulatory effort is aimed at determining the assets ratio to the adequate capital to protect depositors and shareholders”.*
- The need to preserve the stability of the banking system leading to financial security and building confidence, i.e. preventing systemic risk. J. Soubeyran (2004) adds: *“It is also the prevention of systemic risk that may bring the regulator to make use of the “too big to fail” principle (literally meaning “too big to go bankrupt”), that is to say to be more concerned about the fate of large institutions to the detriment of the smaller ones since the formers’ collapse could affect the whole sector, especially when these are highly centered (when a few institutions are sharing the market)”.*

In addition to the two above mentioned principles, a recently stated reason is:

- Market imperfection which is another new incentive leading to the necessity of setting up rules governing the banking activity in order to promote transparency and encourage banks to disclose pertinent information. *“The Basel Committee (1998) considers transparency as a key element in a banking system that is safe, sound and subject to effective control”*<sup>8</sup>. Furthermore, H. Hannoun (2000), *“The third pillar, finally recognizes market discipline as a major contribution to this regulatory practice”.* C. Noyer (2004) states: *“The third pillar of Basel II aims at improving information disclosed to the market by banks ....”*

## **3. International prudential regulation: Basel I & Basel II**

**"While Basel I defines a flat coverage of credit risks to companies by equity, Basel II provides for differentiated requirements according to risks." (Eugen .H, 2003)**

The Basel Committees have made great progress in setting up international standards for prudential supervision of banks and the enhancement of payment systems that link the financial markets together. In recent years, the banking and market prudential authorities have increased their concentration at the international level to cope with problems that go beyond a single jurisdiction. Nevertheless, the changing structure of global finance and the emergence of new actors and new markets require a continuous adaptation of prudential supervision, especially at the level of cooperation.

**a. The rules of equity:**

The Basel Committee proposes two tiers that make up equity and are included in the calculation of solvency ratios:

- **The core:** It is also known as core capital. This Tier includes the social capital and reserves. It should be noted that the Basel Committee integrates disclosed reserves and rejects the hidden ones.
- **Additional equities:** these consist of provisions and subordinated notes.

A condition in this case must be respected: **Tier 1 should always be  $\geq$  Tier 2.**

**b. The Cooke ratio:**

Wenger.T (2004) state that Basel I has been incorporated into the legislation of more than one hundred countries after undergoing some modifications to meet national needs and can be considered a success. Though simple, the Cooke ratio is very certain. A bank must comply at all times with a minimum ratio between the level of its liabilities and that of its equities. The bank must, in fact, maintain a minimum 8% ratio between its equities and its weighted liabilities.

**i. General principle of calculation:**

▪ **Ratio numerator , the bank's equities:**

As already discussed, the ratio distinguishes between "capital equity" (also called "Tier 1"): equity and reserve funds which must represent at least 4% of weighted liabilities, capital-like funds (or "tier 2" ) : reserves not allocated to a particular risk and equity shares that are intermediate between stocks and bonds, revaluation reserves (e.g buildings ... )

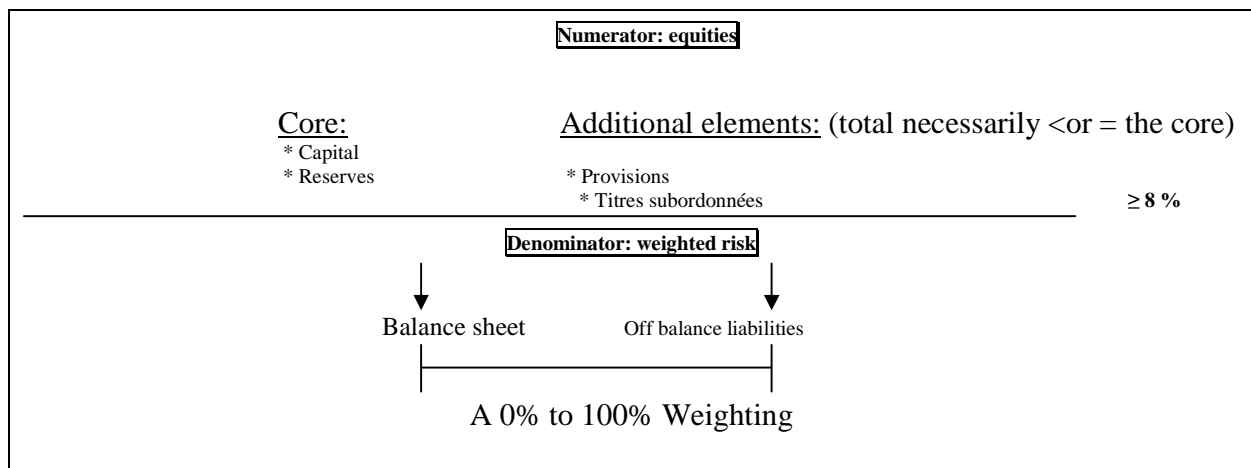
▪ **Ratio Denominator : weighted liabilities:**

Some bank liabilities are taken into account only partially because they are considered less risky, or even not considered at all as they are considered safe (0% weighting).

- 0%: Cash on hand, legal reserves and liabilities on the states or those guaranteed by them.

- 20%: less than one-year dues from banks on local communities.
- 50%: Mortgage loans.
- 100%: business loans, sovereign debt.

Initially, the Cooke ratio concerned only bank loans. Since 1996, it has also been involved in market risks, i.e, the securities held by credit institutions. However, the Cooke ratio excludes the so-called operational risk, that is to say losses due to internal problems at the bank, such as improper recording of transactions or errors in a hedging strategy of markets derivatives.



**Fig.1: Calculation base of the Cooke ratio; Source: Authors.**

## ii. Weaknesses of Basel 1:

Despite the positive points accomplished by the new international prudential regulation, this ratio has some weaknesses that have drawn the attention of financial and banking organizations.

Indeed, several authors have emphasized on the following shortcomings:

- Rigid solvency weights that do not take into account the actual quality of balance sheet assets or credits.
- Very limited consideration of safety and guarantees.
- No consideration of new techniques for reducing credit risks (eg. credit risk derivatives, balance sheet netting arrangements, credit securitization and security-related conventions).
- No consideration of terms.
- No consideration of portfolio diversification.
- According to regulators, banking risks are not adequately and comprehensively taken into account, ie only credit and market risks are taken into account but not the operational ones for example.

Combined, these weaknesses have resulted in an inconsistent relationship between regulatory net capital and risk management undertaken by banks or the level of required net capital.

### c. The "McDonough" ratio

Basel II is mainly aimed at strengthening the banking system stability. The revision that started five years ago was intended only to overcome the weaknesses in Basel I and adapt the guidelines to the new context. The main objective was to abandon the lump sum cover system imposed on banks in order to adopt a minimum net capital regulation that better takes into account risks. The profound changes occurring in banking and financial markets in recent years have allowed financial institutions to improve solvency assessment and risk management. Basel II provisions should take these parameters into consideration. They seek to further harmonize banking supervision standards and reporting requirements between different countries. It is therefore hoped that a better risk management will be achieved while maintaining the same net capital level in the entire banking system. Just like Basel I, the new guidelines on net capitals are recommendations that individual states will have to adapt to their domestic legislation.

#### i. *Basel II structure*

Basel II rests on three complementary pillars. The first pillar, which incorporates Basel I provisions, is related to minimum net capital requirements. The second pillar sets the control process of risk management and capital coverage by the national supervisory authorities. The third one is related to reporting requirements imposed on banks.

##### ▪ *Pillar 1. Capital minimum requirements:*

The previous capital minimum ratio covered only two types of risks in defining weighted assets, credit and market risks. Basel II has included some significant changes in treating credit risk, maintaining unchanged the 1996 framework in market risk and the explicit introduction of operational risk which has led to the inclusion of this risk measurement in a bank's capital ratio denominator. The inclusion of operational risk is one of Basel II major innovations. It refers to all losses that the bank might incur as a result of a malfunction of its internal management processes, human errors or computer problems, or even purely external events such as a fire or flood.

##### ▪ *Pillar 2. Prudential supervision:*

Nathalie. G (2006), the main objective of Pillar 2 is to ensure that banks better assess their capital against their adequacy with regard to their risk profile. It has a number of guiding principles that regulatory authorities should follow in bank supervision such as risk sharing ratios set for the banks, risk management on derivative markets, or crisis management. It enables these authorities to build up equities that exceed those provided for by the first pillar, especially in crisis situations. Andrew .P(2004) find that there is no doubt that if all countries adopted Basel II, Pillar 2, a truly significant advance in the quality of banking supervision across the globe

would be achieved. In conclusion, this pillar shows the national regulatory bodies how to effectively monitor compliance with Basel requirements.

▪ **Pillar 3. Market discipline:**

Basel Committee has sought to encourage market discipline by developing a set of requirements for reporting information that enable market participants to assess with transparency the main data related to the risk profile of a bank and its level of capitalization. These data include information pertaining to internal control information implemented by banks for credit, market and operational risks. Financial communication is thus an instrument of choice in market discipline found Dominique L.L (2005). The objective is to reach a kind of self-discipline by encouraging banks to provide financial markets with relevant information. Therefore, financial markets would spontaneously promote financial institutions whose behaviors are the most virtuous, and in particular those with the most relevant risk control procedures (Pierre-Yves Chanu, 2004).

Basel II stands as a radical reform of banking regulations. The new provisions on capital will have a lasting impact on the financial sector where risk management by banks is not yet well developed. The general orientation of this review, namely a capital that is better suited to risks, should be welcomed. It will support or enhance the efforts of banks and companies to further develop risk management and take into account ratings and solvency. By the time a third agreement, (Basel III) is set up, there is no doubt that the new plan's flexibility and incentives for adoption by the largest possible number of banks, better risk management practices will have strongly contributed to strengthen the robustness of institutions, the soundness of banking systems and thereby financial stability (Christian Noyer, 2004). These results remain to be proved in the coming years especially after the 2007 financial crisis. Thus, one may wonder about the interaction between this crisis and Basel II: What role did this regulatory framework play in the international financial crisis? The process of improving and strengthening the international prudential regulation will continue through the emergence of other ratios according to future conditions and it is up to managers and banking professionals to manifest their ideas.

RPI / TRIAD	Europe	United States	Japan
<b>Cooke ratio</b>	CAD: European solvency ratio (ESR).	PCA: Prompt Corrective Action.	PCA: Prompt Corrective Action and the Big Bang.
<b>McDonough ratio</b>	CAD III: ESR with three pillars.	ANPR: Advance Notice of Proposed Rulemaking.	Directive based on Article 14.2 of the 1981 Banking Act.

Tab.1: The prudential banking regulation and its implementation at the TRIAD level; Source: authors

## II. BANKING STRATEGIES:

In an attempt to redefine the concept of strategy as a clearly identified subject research, some proposals and ways of thinking are presented. The strategy implemented by the strategic processes puts into practice the finalized intentions. The strategic processes create values and aim at amending the conditions of bank insertion in its environment by exploiting the resources



and skills which, under certain conditions, are likely to generate sustainable competitive advantages.

### 1. Definitions: "Panorama from military origin to the company's life"

Over time, several definitions of strategy have been developed. They have emanated from a military origin and were transposed into business life. Linguistically, a strategy is the art of organizing and coordinating a series of operations to achieve a goal. As indicated by P. Lorino and Tarondeau JC (2006) and inspired by military strategies and the principles of war, a company's or a bank's strategy was first defined as *"the art of fighting on the Field competition."* For Andrews: *"The general strategy is the combination of decisions in a company that determines and reveals its objectives and goals, produces the general policy and plans to achieve them, defines the scope of its targeted activities, the type of organization it intends to adopt and the nature of contributions, economic or non-economic, it tries to provide for its shareholders, employees, customers and other interest communities"*. Chandler (1962) states that *"a strategy consists in holding the long term goals and objectives in a business, adopting policy instruments and allocating the necessary resources to achieve those objectives."* According to Ansoff (1986), *"a strategy is the design that the firm undertakes when conducting its activities, specifying the progress rate, the fields of its expansion and divisions, the major forces to exploit and the profit to be made"*. Gelinier provides that: *"a strategy has always been the art of winning a war. It can apply to a company since this latter is waging a war against its competitors to ensure its survival"*. Ansoff states that *"a strategy is not essentially focused on internal business but rather on a company's external affairs and more precisely on the choice of the products it will make and the markets where these products will be sold"*. As for Michael Porter, he considers a *strategy as the art of building long-term defensible competitive advantages*. From the above definitions, especially those of military origin, it can be concluded that:

- The strategy is considered as an art rather than a science and as such the artist's talent (the strategist) is much more important than the technique used.
- Without neglecting the role of the environment, the strategy is an optimal combination of means that can bring out the bank to achieve its objectives.

Thus, it can be concluded that being a strategist is *"to plan a well-defined approach that assumes knowledge of the situation (the enemy), seeking the benefits that can create value and the selection of short and long term targets. This requires the adoption of a set of techniques and analytical methods specific to this approach and a certain state of mind as well as a willingness to act"*.

### 2. Generic strategies in the banking and financial sector:

In banking, the quest for a competitive advantage does no longer adopt the same way followed a few years ago. It now rests on the pursuit of new strategies. In other words, two main generic strategies can be distinguished.

#### a. The two main strategic orientations:

**i. *Exploiting the benefits of the customer relationships bank:***

It is a traditional strategy in the banking industry. It consists in providing differentiated services that are well-adapted to customers' needs. The offers are thus based on exploiting relationships between the bank and its customers. This strategy should rather be implemented at a decentralized level and on neighboring markets. To achieve this end, the banker should deal with information that is qualitative in nature (*soft information*). This approach is relatively costly because it does not benefit from increasing returns to scale. Moreover, it assumes that the bank is responsible for the pooled credit risks. The revenues provided by this strategy primarily come from interest margins on deposits or loans.

**ii. *Exploiting the economies of scale and scope:***

The second strategy is a more recent one in the banking sector. It reflects the rise of the above mentioned distribution function and it is based on the transaction bank model. It consists in exploiting the economies of scale and scope in production, marketing and distribution of credit and other standardized products such as consumer or housing credits. Thus, it requires a centralized organization to minimize the products' unit costs. According to Mr. Dietsch (2005), in Europe, the development of this strategy has no doubt been encouraged by the introduction of a universal banking model which has widened the scope of activities open to banks (second EU directive) and the creation of a single market for banking and financial services. Another development support for this model is the harmonization of prudential rules with Basel I and today with Basel II. These two great strategies summarize the multiple generic strategies that dominate the banking sector. In the next section, we will attempt to examine them and formulate a clear idea.

**b. Possible strategic options for banks:**

Different strategic analysis concepts allow a better understanding of the positions that should be adopted depending on the scope of considered actions. The first ones are based on the results of the company analysis, in terms of strengths and weaknesses, and its environment in terms of opportunities and threats. A second type of concept resumes the framework of Porter generic strategies (1982).

**i. *SWOT analysis strategies*<sup>2</sup>:**

In the framework of a SWOT matrix, a company's objectives in a strategic field must stem from the knowledge of the competitive position occupied at a given time and that of its market share. This diagnosis in terms of "strengths and weaknesses" is to be juxtaposed with the "opportunities and threats" resulting from a changing environment.

**▪ *Conquest strategies:***

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<sup>2</sup> SWOT: Strengths, Weaknesses, Opportunities and Threats.

These are offensive strategies that express a will to power embodied in time. Conquest strategies have been expressed in different areas: the conquest of individuals and professionals, companies and market activities. According to M. Zollinger (1999), "*a conquest strategy is demanding.*" Indeed, a good foundation in the country and home markets, a good knowledge of its skills, and the ability to operate them elsewhere are prerequisites for success.

- ***Reorientation strategies:***

Like any business, the bank evolves according to cycles and meets at certain stages of development critical times that require some changes without putting at risk its survival. The objective in this case is clear. It aims to restore a certain leeway and a range of possibilities. This could be achieved only financially: the sale of equity investments, disinvestments, elimination of failing in sectors...

- ***Consolidation strategies:***

The last component may arise as the result of a major downside that makes renewal a necessary requirement. The priority remains to reinforce and solidify the strengths of the bank, to halt decline and try to preserve the independence of the institution. Over a short period, a list of decisions that meet these changes should be drawn up and the structure reflecting the new trend should be defined. In conclusion, the various strategies outlined in the SWOT matrix have regulated the development of banks over the past twenty years and fueled the traditional debate between diversification and specialization strategies : These strategies are based on variables defining their fields, namely customers, product, technology and geographical area.

- ii. ***Strategies stemming from customer-product and geographical area variables :***

Beyond the constraints and expectations of the environment, the customer-product technology and geographical area variables are the key dimensions that determine the generic strategies in the banking sector. These dimensions allow banks to adopt any combination of the following five types of strategies:

- ***Differentiation strategies:***

The differentiation strategy is to seek a competitive advantage built around the authenticity of the offer that is perceived by the customer. This authenticity must make difficult any imitation or substitution by competitors. The bank should therefore fight against its competitors by implementing means, other than price, so that its consumers see their product as unique, which would possibly make consumers accept a price that is actually higher than that offered by competitors.

- ***Large-scale geographical strategies:***

This is known as internationalization strategy. It can also be defined as "*the large scale or extensive geographical strategy of related activities providing the company with synergies*

for a profitability that is higher than competitors' : shared patents, reputation and image effect, a common information system , skills in human resources or management, .... ". The alternatives followed to materialize this strategy are essentially partnerships and cooperation.

- **Segmentation strategies:**

The segmentation strategy is to divide the market into distinct subsets of customers and focus activity on these groups by offering products and services specific to each target. M. Zollinger (1999) states that "*experience shows that focusing on a limited number of segments leads to a better follow up and risk monitoring.*"

- **Diversification strategies:**

Diversification consists in broadening the bank's sphere of actions and imposing the use of a new set of know-how skills required in the new competitive environment in which the bank operates. The latter should also be involved in new activities (insurance, brokerage ...) that correspond to new products and new markets. Furthermore, the bank should conquer other business sectors through internal growth (launching a new type of financial product) or through external growth (acquisition of a company that is already offering such products). Monique Z. (1999) states that diversification is based on the modification of the definition of strategic scope by institutions in terms of products, customers, technology or geographical area. Within the banking sector as a whole, a trend towards diversification has shown up and targeted individuals and companies. This movement was accompanied by a proliferation of offered services (cash management, factoring, etc.) and has resulted in the presentation of a variety of products covering a wide range of needs. Further activities targeting individuals or companies help the bank offer a well diversified range of products and services.

- **Focus strategies:**

When evolving within a focus strategy framework, the company chooses to target a specific segment of customers. Its development strategy represents an innovation in its offer of products / services that is adjusted to the changing needs of targeted members. Thus, a bank that promotes such a development strategy proceeds to a selection of its users (M-C. Malo et M. Vézina, 2003). From this analysis, it can be concluded that the strategies stemming from customer-product - geographical area variables can be simplified into diversification and specialization strategies.

#### **b. Consequences of the banking strategy, " Activity Restructuring "**

Given the importance allocated to banking professions and the evolution of the banking image (financial innovation, deregulation, globalization, competition, etc...), banks have changed their assessments of the opportunities they are offered and the threats they face. These factors

will undoubtedly change the banks' roles and image. Indeed, they are required to incorporate new professions (e.g financial engineering), reposition themselves to face banking environmental changes and finally choose between a universal bank and a specialized one.

**i. Financial engineering:**

Following the changes that the banking sector has undergone, the banking profession has changed accordingly and is now expected to be innovative. Every bank is now compelled to develop financial engineering capabilities. The term "financial engineering" refers to the adoption of a research activity aimed at finding an authentic product to offer in order to target the right customers and build customer loyalty. The banking strategies based on new professions have given great importance to financial engineering which has become a crucial activity and a means to satisfy customers' needs. Today, any banking activity has, in fact, to revolve around these needs.

**ii. Bank repositioning to cope with the new changes:**

Banks are facing remarkably similar threats and must organize to respond to opportunities that are also more or less the same for all. Therefore, banks have no choice but to follow these changes and new trends. However, the key to a better future is to find out whether they have to reposition themselves by broadening the range of their products or reduce it through specialization. This is, in fact, the strategic choice banks are faced with. So every bank is required to review its strategy and reorient it so that it is primarily aimed at building customer loyalty, and the challenge is to opt for the right strategy.

**iii. The dilemma of universal versus specialized Bank**

In order to increase their services, some banks have turned to "universal" or "general" bank model or "financial supermarkets". This trend appeared interesting for most important financial institutions. Such a strategy may prove beneficial in markets with no legal or administrative barriers. Other banks have chosen a strategy called "shop". It aims to exploit the comparative advantage of the bank in a single or limited number of segments, offering quality products that meet the specific needs of demanding customers. This strategy can lead either to lower costs or differentiation. Moreover, the bank may, accordingly, serve the customer better than competitors. These two choices have marked the banking strategies in recent years as far as competition and the skills available within the bank are concerned. In fact, "Under the effect of increasing competition, all banking groups have undertaken a major effort to rationalize. In terms of structure, this action has taken several forms: seeking to specialize in certain types of activities, some institutions have sold their operation portfolios and associated means in areas where they no longer wished to intervene. Conversely, some groups have sought to strengthen their presence in their core businesses or expand their services to their traditional customers. For example, they started the acquisition of existing institutions" (E. Fournier, 2001).

Strategy / TRIAD	Europe	United States	Japan
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<b>Diversification</b>	+	++	-
<b>Specialization</b>	+	+	-
<b>Internationalization</b>	+	+	+
<b>Merger &amp; Acquisition</b>	+	+	++
<b>Universal Bank</b>	++	+	+

*Tab.2: Banking strategies at the TRIAD; Source: Authors.*

- - : Strategy: least characterizing this region.
- +: Strategy most characterizing this region.
- ++: A strategy that dominates this region.

### III. THE IMPACT OF INTERNATIONAL PRUDENTIAL REGULATIONS ON BANKING STRATEGY : "THEORETICAL FINDINGS"

The performed analysis allowed us to detect a dependency relationship between international prudential regulation and banking strategy. Indeed, the regulation was found to have a significant weight on the behavior of bankers and to dictate their policy choices.

#### 1. Basel I and banking strategies:

The implementation of Basel I led banks to adopt different strategies according to the constraints and the spheres developed. Thus, the agreement has prompted banks to select customers and seek activities that are little- demanding in terms of equity in order to meet prudential requirements, especially a minimum Cooke ratio of 8%. In this regard, banks have converged towards specialization on customers and activities presenting high incomes and requiring little capital. Thus, segmentation and focus strategies have been observed. Furthermore, banks have sought to add products and services to the existing range in order to reward prudential standards and present ratios that meet and exceed the regulatory minimum, which can help build a competitive advantage differentiating them from their competitors. To achieve all this, banks have tried to diversify by developing mergers and acquisitions. These allowed better cross-border transactions between banks of different nationalities. Therefore, these trends have led to the diversification at the level of products and geographical areas, which gave rise to the universal bank model in the global banking sector providing an opportunity for equities that can attract customers at the heart of any strategic direction in recent years. It has been noticed that many banking giants have emerged to meet prudential regulatory provisions.

#### 2. Basel II and banking strategies:

Basel II will continue the development of mergers and acquisitions as it is up to this agreement to overcome the constraints imposed by the new international prudential regulations and to establish holding companies that are able to cope with competition. Indeed, large banks are better prepared to handle new regulatory requirements: "*big is beautiful*". Furthermore, we

will witness the emergence of organizations which are specialized in certain products or services that allow them to meet prudential standards and regulatory requirements. These trends will take place within the same financial conglomerate, i.e. the bank will be in the form of a diversified financial unit involved in numerous action spheres, and every domain will be run by the two specialized units. This banking model is described by L. Bryan as *"the broken up the bank"*. According to several authors, Basel II would be a major conductor of the banking strategy for an extended period: specialized banks will turn to diversification and diversified banks will change the combination of business, and all will act likewise to meet the regulatory framework and maintain or build their reputations. This obviously requires a change in the overall strategy. Basel II may also encourage banks to give up certain activities or geographical areas that require more capital to pay for equities that are able to cover the risks, which is a way towards focus strategy: niche strategy. Risk assessment homogeneity required by Basel II Agreement may facilitate international mergers- acquisitions operations, which promotes strategies on a large geographical scale. So far, only the theoretical impact of these two prudential standards has been dealt with. Now, these will be empirically analyzed in order to validate or overrule them. The international prudential regulation, whether Basel I or Basel II, has prompted banks to adopt some strategic orientations following the imposed constraints and the developed fields. Indeed, following the genesis of these two global standards, several strategies have emerged and expanded significantly. Worldwide, these orientations are dominated by a strategy of diversification that increases the number of domestic and international mergers and acquisitions in order to create universal banks that meet the objective: *"one stop shopping"*.

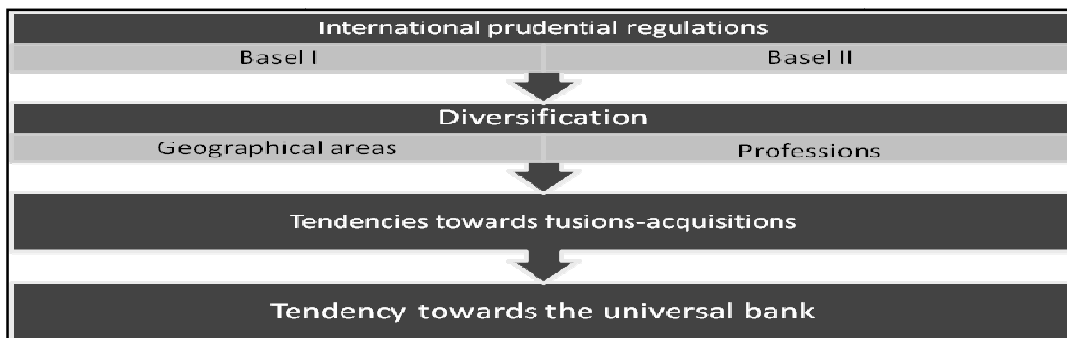


Fig.3: Theoretical impact of Basel I and Basel II on banking strategies; Source: Authors

## Empirical framework:

### I. The impact of international prudential regulation on banking strategies, "empirical Findings"

Our article has so far been based on the study of the relationship between international prudential regulation and banking strategies at the level of both the state of the art and international practice. A further research would be interesting to perform on the banks of emerging countries including those we have studied, namely the Tunisian ones. It should be noted that the evolution of the Tunisian banking and financial environment has also been accompanied by a dynamic banking system owing to the prudential regulation in force. A follow up of these developments could enrich our study and bring about a series of answers to our

problems. For this objective to be achieved, we decided to carry out a survey about Tunisian banks.

### 1. Samples:

The studied sample included 15 Tunisian banks and, for more relevance and variety of responses, banks were provided with two or three questionnaires according to the position of the respondent holds. Overall, the sample consisted of 35 people. In addition, our analysis was based on the operation of three different periods that had marked the Tunisian banking system and especially its prudential regulation, ie before 1986, between 1986 and 1992 and after 1992. In order to study the current relationship between banking prudential regulation and the bank's strategy as well as the variables affecting these two elements, accurate and direct questions were included to come up with the necessary and useful information.

### 2. Empirical results:

To investigate the relationship between the different variables of our empirical research, these were analyzed through the SPSS.10 software to consider the following results:

- R1: the IPR factor of certain banking strategies.
- R2: IPR inhibits other banking strategies.
- R3: The IPR is neutral with regard to the banking strategy.

An analysis of the impact of international prudential regulations on the banking strategy is conducted while testing the following hypotheses:

- H1: the IPR imposes some strategic choices to the bank.
- H2: The IPR favors certain banking strategies.
- H3: the IPR ensures that the bank does not follow certain strategic choices.
- H4: the IPR does not have any effect on the strategic orientation.

#### a. The Tunisian Prudential regulation (TPR) and International Standards:

The field studies have shown the importance the Tunisian prudential regulation (TPR) has acquired especially after 1992 when the Tunisian regulatory reform took place and integration into the harmonization of the international framework was undertaken. 76.7% bankers consider that domestic rules comply with international ones.

However, the TPR developed very slowly compared to international regulations<sup>3</sup>, which was normal for an emerging country. The interviewees relate this finding to the lack of pertinent financial crises, which has reduced the need for prudential standards. This is also due to the available infrastructure at banks in emerging countries and the characteristics of the national banking system. Indeed, authorities in emerging markets have to be involved in the international

<sup>3</sup> 56.7% have mentioned that the procedure is slow.



harmonization process of prudential regulation, but they should also take time to find a mechanism that is well adapted to the specificities of their national banking systems. This explains the Cooke ratio implementation after a certain time with a minimum rate of 5% below the Basel Committee's 8% rate.

As for Basel II, 73.3% of executives reported the need for its implementation in the Tunisian context but with some modifications according to its characteristics. In short, it can be said that implementing this new agreement in emerging countries while complying with the latter's needs raises many problems such as:

- Difficulty in implementing the internal ratings approach (IRB).
- Costly implementation: information technologies (IT) costs and staff training expenses.
- The standardized approach and the problem of credit external rating: the low coverage of emerging regions by credit rating agencies.

However, the implementation of this new prudential standard is still in a preparatory phase in Tunisia. Indeed, Tunisian authorities are trying to implement Basel II Agreement through newsletters reflecting the three pillars of this framework. Here we can cite a regulatory provision referred to by the majority of Tunisian bankers, namely the credit institutions newsletter n ° 2006-19 released by the Central Bank, which came into force in 2008 and aimed at internal control.

We have checked whether this regulation has sought to promote within the Tunisian banks the management and especially the measurement of credit, market and operational risks mentioned by Basel II and pertaining to McDonough ratio calculation (preparation for the adaptation of this ratio). In addition, we noted convergence towards Pillars 2 and 3 through exposing the banking supervisory authorities and encouraging the publication of reliable information through market discipline. These regulatory texts, which adopted Basel II principles, were mainly concerned with the introduction of market and operational risks, internal rating systems, enhanced security and transparency of financial relations, strengthening the accountability of control and decision-making organizations, strengthening prudential ratios, internal control and risk supervision...

In this context, Tunisian bankers insist on the satisfaction of certain conditions for a successful implementation of Basel II in their country:

- The overhaul of information systems and risk management in light of new regulatory reforms in order to comply with Basel II standards.
- The development and implementation of a scoring and internal rating system within the Basel II framework while initializing a competence center to ensure monitoring, the project's sustainability and its integration in the bank's information system.
- The importance of both financial transparency and good governance in the implementation of the rules.
- Banks are required to adjust their management styles, particularly in terms of risk.
- Adaptation of the current accounting framework to Basel II objectives.

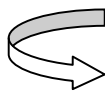
To sum up, three actors are essentially concerned with the implementation of the new framework:

- **Banks:** the overhaul of their systems of information, identification, monitoring, control of various risks and internal control strengthening.
- **Monetary authorities:** a stronger role in the supervision and control of banks.
- **The financial market:** should ensure the reliability and transparency of financial reporting.

As for the implementation timing of Basel II in Tunisia, though nothing has been officially done, banking professionals have been made to understand that the year 2012 may be the year when the sector will shift to Basel II. Prudential regulation in emerging markets is characterized by flexibility with respect to international markets (as mentioned by 46.7% of the respondents). This specificity can be explained by the fact that the TPR is an emerging country's regulation and some sort of flexibility has to be incorporated in order to encourage banks to comply with this framework (5%, for example, were for the Cooke ratio). Furthermore, this regulation is said to be both accurate<sup>4</sup> (easy to interpret) and binding<sup>5</sup> for banking activities (e.g. ignore high-risk credits risk).

#### b. Banking Strategies:

Empirical studies have shown that the strategic attitude has changed from a *random* and *adventurous state* before 1986 to a prudent state after 1992. This is most probably due to the evolution that the TPR has witnessed between these two periods. The rates went from 30% for risky strategies to 86.7% for prudent strategies during the analyzed third period. The bivariate analysis between the importance of prudential regulation and banking behavior supports our findings. Indeed, it can be stated that almost have approved of all interviewees (86.2%) have opted for a prudent behavior.



**The evolution of the prudential regulation over time has played a great role in promoting a prudent banking behavior**

Tunisian banks stipulate that, before 1986, the establishment of their strategies was carried out in a random (voluntarist) manner (as reported by 50% by respondents) according to the existing situation between 1986 and 1992 and even later (73.3% and 63.3%) and especially to its spontaneous establishment after 1992 (23.3%). This appears as a consequence of the TPR evolution throughout the studied period.

Strategy / Period	Before 1986	Between 1986 and 1992	After 1992
Diversification	46.7%	53.3%	70%
Internationalization	0%	0%	6.7%
Specialization	40%	23.3%	10%

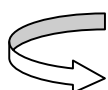
<sup>4</sup> 66.7% of visited banking staff say the TPR is accurate.

<sup>5</sup> 43.3% of visited banking staff say the TPR is restrictive.

<i>Mergers and acquisitions</i>	3.3%	16.7%	13.3%
<i>Others</i>	0%	6.7%	0%

**Tab.3: Strategies according to TPR evolution period; Source: SPSS.10 results**

The setting up of a strategy *has evolved from a deliberate procedure to an emerging one which takes into consideration the conditions of the banking environment.* These different procedures have oriented banking specialization and diversification throughout the first period to a dominance of diversification after 1992 (up to 70%). This result is supported by the fact that the diversification strategy was set up to find the appropriate resources to confront the constraints imposed by the Tunisian banking environment, in particular the minimum regulatory solvency ratio. A cross analysis of changes in the TPR and banking strategies after 1992<sup>6</sup> showed a cause and effect relationship between the evolution of the TPR (transposition of the Cooke ratio) and a tendency towards diversification, and that is essentially to provide sources of income which allow banks to comply with international prudential standards and thereby integrate into the international context. Therefore, there is a relationship between the evolution of this framework and the strategy elaboration. In fact, increasing the minimum statutory ratio from 5% to 8% has prompted banks to find other sources of income to meet this standard, hence a tendency towards diversification.



**The changes in the TPR have had a great impact on strategic choices and prompted banks turn to diversification.**

This summary is approved if we further suggest that the basic choice of a strategy is made at 80% through restructuring according to the prudential regulation after 1992. The role of the 2001 Banking Act, which deals with the diversification of the Tunisian banks, should not be overlooked.<sup>7</sup> The cause and effect bivariate analysis between the strategy and bankers' behavior of and the restructuring variable according to the prudential regulation over the three covered periods confirms this finding. After 1992, this variable witnessed a dramatic increase. In fact, 76.2% of those responding favourably to restructuring in accordance with prudential laws turned to diversification. This finding further confirms previous results that the development of a diversification strategy was a consequence to the emergence of TPR and its convergence towards internationalization. The major influence of the Tunisian prudential regulation in the choice of the diversification strategy is clear. Indeed, 81% of those who have adopted a diversification strategy mentioned the important impact of prudential standards on making such a choice. The increasing influence of prudential standards on strategic choice has prompted banks to turn to diversification with its various forms.

### **c. The impact of Basel I:**

The implications of the Cooke ratio on banking strategies revealed by the analyses performed on Tunisian banks yielded the following results:

<i>Strategy / IPR</i>	<i>Basel I</i>
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<sup>6</sup> 81% of those who approved a real change in the solvency ratio after 1992 reported that their strategy was actually one of diversification.

<sup>7</sup> Currently, diversification refers to a bank that can perform any activity (universal bank). It is mentioned by the Banking Act of July 10th, 2001, which prompted banks to diversify.

	<i>Impose</i>	<i>Foster</i>	<i>Neutral</i>	<i>Limited effect</i>	<i>Avoid</i>	<i>Not available</i>
<i>Diversification</i>	46.7%	43.3%	3.3%	6.7%	0%	0%
<i>Specialization</i>	13.3%	50%	20%	6.7%	10%	0%
<i>internationalization</i>	26.7%	40%	10%	23.3%	0%	0%
<i>Merger &amp; Acquisition</i>	23.3%	63.3%	3.3%	10%	0%	0%

**Tab.4: Impact of Basel I on banking strategies; Source: SPSS.10 software results**

Indeed, 46.7% of interviewees stated that this ratio had imposed the diversification strategy and this was for the same reasons above mentioned, i.e to diversify in order to find resources that can meet regulatory requirements. In fact, the first Basel framework urged banks turn to little demanding activities that require little capital such as market activities, financial engineering and insurance. With regard to other strategies, this ratio plays a supporting role. Bank officials have, with different rates, indicated that the Cooke ratio favors the last three strategies:

50% reported that it promotes specialization: Basel I set up a constraint by imposing compliance with the minimum level of equity, which has led banks to select clients with a low risk weighting and seek activities that are less capital-consuming. These trends have led some banks to specialize. 40% said it promotes internationalization: The application of the Cooke ratio at the international level has prompted banks to internationalize. It is harmonization of this ratio at the global level that has favored such a strategy. 63.3% stipulated that it promotes mergers and acquisitions strategies: a tendency towards these operations to expand activities providing resources and ensuring compliance with a minimum of 8% and even more in a context where this has become a competitive advantage : grow to become stronger in an international banking environment characterized by high- intensity competition.



**Basel I imposes diversification and favours other banking strategies**

**d. The impact of Basel II:**

The impact of Basel Agreement on Banking Strategies is shown in its three pillars:

<i>Strategy / IPR</i>	<i>Basel II</i>																	
	<i>Pillar 1</i>						<i>Pillar 2</i>						<i>Pillar 3</i>					
	<i>I</i>	<i>F</i>	<i>N</i>	<i>Le</i>	<i>Av</i>	<i>Na</i>	<i>I</i>	<i>F</i>	<i>N</i>	<i>Le</i>	<i>Av</i>	<i>Na</i>	<i>I</i>	<i>F</i>	<i>N</i>	<i>Le</i>	<i>Av</i>	<i>Na</i>
<i>Diversification</i>	50	46.7	3.3	0	0	0	20	63.3	10	6.7	0	0	20	56.7	13.3	10	0	0
<i>Specialization</i>	20	50	16.7	10	3.3	0	10	36.7	26.7	23.3	3.3	0	10	40	23.3	23.3	3.3	0
<i>internationalization</i>	23.3	63.3	6.7	6.7	0	0	20	30	23.3	20	6.7	0	13.3	46.7	16.7	23.3	0	0
<i>Merger &amp; Acquisition</i>	36.7	50	3.3	10	0	0	6.7	50	16.7	23.3	3.3	0	6.7	50	23.3	20	0	0

**Tab.5: Impact of Basel I on banking strategies; Source: SPSS.10 software results**

- With: *I*: Imposes, *F*: favors, *N*: Neutral, *Le*: limited effect, *Av*: Avoids and *Na*: not available.

- The table is expressed in percentage.

Pillar 1 is comparable to the Cooke ratio. In fact it has the same impact: 50% of respondents felt that it would impose diversification. Taking into account the three risks (credit, market and operational risks) would encourage banks to change their business portfolio, thereby further diversifying.

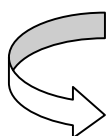
Pillar 2 (supervision by public authorities) is characterized by the fact that it will promote all studied strategies. Those who stated this were as follows: 63.3% for diversification (a more sustained and regular communication between authorities and banks could also encourage the latter to turn to diversification if they provided strong prudential ratios), 36.7% for specialization, 30% for internationalization and 50% for mergers and acquisitions.

Pillar 3 (transparency and market discipline) has the same impact as the previous one. In fact, it favours the four above mentioned strategies with respective rates of 56.7% for diversification, 40% for specialization, 46.7% for internationalization and 50% for merger operations.

In conclusion, it has been found that, whether it is the Cooke or the McDonough ratio, these two international prudential frameworks impose diversification strategies on banks in order to meet the required conditions and the regulatory minima. Furthermore, as mentioned by Tunisian bankers, pillars 2 and 3 of Basel II will always tend to favour all strategies but with different degrees. However, the impact of Basel II is to be confirmed because the results are estimates of a future impact, since Tunisia is currently preparing for a total implantation of this framework. Thus, these results could be improved after a full implementation of Basel II is undertaken. But what we have just presented can be added to the studies related to the impact Basel II that are being exploited in the banking system by the Central Bank and its "Committee on Basel II. These studies are involved in credits, the internal organization of banks...In summary:

<i>Basel II (ratio McDounough)</i>			
<i>Strategy</i>	<i>Pillar 1</i>	<i>Pillar 2</i>	<i>Pillar 3</i>
<i>Diversification</i>	Imposes at 50%	Favours at 63.3%	Favours at 56.7%
<i>Specialization</i>	Favours at 50%	Favours at 36.7%	Favours at 40%
<i>Internationalization</i>	Favours at 63.3%	Favours at 30%	Favours at 46.7%
<i>Merger and Acquisition</i>	Favours at 50%	Favours at 50%	Favours at 50%

Tab.6: Impact of Basel II on banking strategies; Source: Authors.



#### **Basel II**

- **Pillar 1 imposes diversification and favours the choice of other banking strategies.**
- **Pillar 2 favours all banking strategies.**

## **Conclusion:**

At the end of this article, we tried to highlight the impact of international prudential regulations on banking strategies, while studying the resulting impact. Theoretical and international studies seem to have embraced the logic stipulating the existence of an impact between prudential regulation and the banking strategy. However, each research line has been characterized by well-defined and specific reflections. This impact characterizing the regulation and the strategy was expressed in several ways. Some authors have mentioned the important influence of regulation on strategic orientations. Others have suggested that it is only secondarily that the regulation determines the strategy and dictates its choice. However, other authors have focused on the development of certain forms of interaction between these two variables. In the context of this alternative, the ambition of this research was to determine the impact of international prudential regulations on banking strategies, and attempt to clarify the results. Now that these various investigations have been carried out, we have found that, empirically, hypothesis 1 of our study, which stipulates that the prudential regulation imposes strategic choices on banks, was validated especially after 1992 when diversification was imposed. Hypothesis 2 can be easily checked with other strategies regardless of the prudential regulation dealt with. The last two hypotheses were not validated by the two ratios. Whatever the nature of the presented scenarios, we managed to show the impact of the international prudential regulation on banking strategies. In fact, whether Basel I or II, the international prudential regulation guides banks' strategic choices by imposing diversification and encouraging other types of strategies.

Though it may be useful in some respects, this study of the impact of international prudential regulation on banking strategies is not sufficient. Undoubtedly, a more detailed analysis based on the consideration of another line of thought would allow a better understanding of the pertinence of this impact and the probable changes it will bring about. An extension of this study can be carried out especially after a full implantation of Basel II to validate or overrule the results revealed by this investigation. In addition, the echoes of a new tendency towards a new agreement, or Basel III, the increasing number of banks mergers we have recently witnessed, the tendency towards the development of universal banking and particularly the repercussions of the 2007 financial crisis, whose impact is still felt in 2010, are all interesting indicators as they may pave the way for further investigations and provide some continuity for the present study. The concern to increase the size of banks and the future evolution of international prudential regulations towards a possible reform of Basel II may clash, especially with the lack of prudential regulations for banking giants resulting from mergers. It appears therefore interesting to study the impact that may result from the reform of international prudential regulations on

mergers-acquisitions strategies in the context of such a volatile international financial environment.

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