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SAFEGUARDING THE BANKING SYSTEM - A NEW PERSPECTIVE ON THE CONSOLIDATION OF THE MACROPRUDENTIAL REGULATION*

Abstract:

The aftermath of the global financial crisis revealed the weaknesses of the financial system and the monetary incentives to be taken into consideration by the policy-makers. Whether it is exposed to specific risks or to systemic risk, the banking system has to be heavily regulated in order to prevent it from collapsing. The macroprudential regulation promotes the stability of the financial system as a whole, and also treats systemic risk as a trigger of a chain reaction caused by the interlinkages in the financial system. Therefore, this paper outlines the role of the macroprudential regulation for achieving the financial stability goal in the context of systemic turbulences. The safeguarding of financial stability should not be understood as a zero tolerance of bank failures or of an avoidance of market volatility but it should avoid financial disruptions that lead to real economic costs. On the one hand, an overlook on the progress of the prudential regulation points out the procyclical aspects of the regulatory requirements so far, such as capital requirements, risk assessment, provisioning; on the other hand, the present paper identifies the improvements of the most recent recommendations on banking regulations, embodied in the Basel III Accord. Hence, the Basel III requirements in terms of capital adequacy, liquidity, the capital and conservation buffers against procyclicality represent unquestionable improvements for the macroprudential regulation. Given the fact that Basel III has established phase-in arrangements from 2013 to 2019, it is important to analyze the progress of its implementation and its impact on the banking system resilience.

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Keywords:

financial stability, systemic risk, banking system, Basel III requirements, regulation

JEL Classification: E52, E58, G01

1. Introduction

We are constantly shown that we live in an evolving world, that has become emerging for all of us, because we keep moving on to another phase. Whether an individual, an organization or a whole system is a pioneer of a new trend, especially in economy, this is a shock that generates the domino effects. In particular, owing to the consequences of the recent financial crisis, we all are 'stakeholders', because the crisis has affected all of us. Therefore, the research rises from the interconnectedness that exists in the financial system and highlights the importance of keeping under control the systemic risk. Moreover, the article emphasizes the need to institutionalize the macroprudential regulators, with specific mandate on the macroprudential surveillance. There is an overheated debate on the potential instruments to measure the systemic risk and to mitigate it. The article continues with a brief statement of the Basel Accords, with emphasis on Basel III and its phases' arrangements. Accordingly, Basel III represents a set of measures supposed to strengthen the regulation, supervision and risk management of the banking sector. To conclude, the aim of the policy makers is to implement clear standards of macroprudential regulation, in accordance with the Basel III measures, in order to prepare the financial system for a future downturn.

2. Objectives

Owing to the tumultuous reality we are going through, as far as it concerns the economic and financial issues, this article highlights the necessity of a clear regulation in order to mitigate inherent risks of the financial system and face a potential crisis with strong pillars to rely on.

Therefore, I begin with defining an essential concept related to the new policy framework, which is the financial stability. Moreover, throughout the research paper I emphasize the importance of this concept. On the other hand, my research focuses on the progress of the macroprudential regulation and its instruments of application so as to reduce systemic risk. These instruments are mainly the toolkit of the Basel Accord III, whose implementation is still in progress. In other words, the paper sets the following objectives: defining financial stability as a challenge for the new policy framework; stating several issues regarding the macroprudential regulation, such as the

importance of the microprudential regulation along with the macroprudential surveillance; the Basel III as a warrant of the macroprudential regulation and a buffer against crisis.

3. Defining financial stability – a challenge for the new policy framework

First of all, there is no universal definition of the financial stability, as opposed to the clear stated fundamental objective of the monetary policy, which is the price stability. Loosely, the financial stability is the situation in which the financial system is able to efficiently allocate savings to investment opportunities, and to overtake shocks, without major damage. From a central bank point of view, which is closer to our approach, the financial stability can be described as the situation characterized by the absence of financial crisis and by a certain stability of the assets' price and interest rates.

Therefore, the reason why policy makers have relied on concepts of financial instability rather than financial stability is that it is difficult to define what is meant by financial stability. Why? On the one hand, stability is a difficult concept to define for an evolving entity such as a financial system. On the other hand, it is difficult to define what is meant by equilibrium in finance, because equilibrium prices and resource allocations today depend on expectations of future outcomes and expectations can be highly volatile if not unstable. (Schinasi, 2008)

The financial stability challenge implies maintaining the smooth functioning of the financial system and its ability to facilitate and support the efficient functioning and performance of the economy.

The central banks are the main authorities who pursue policies meant to maintain the economy stable and protected against volatility and other risks.

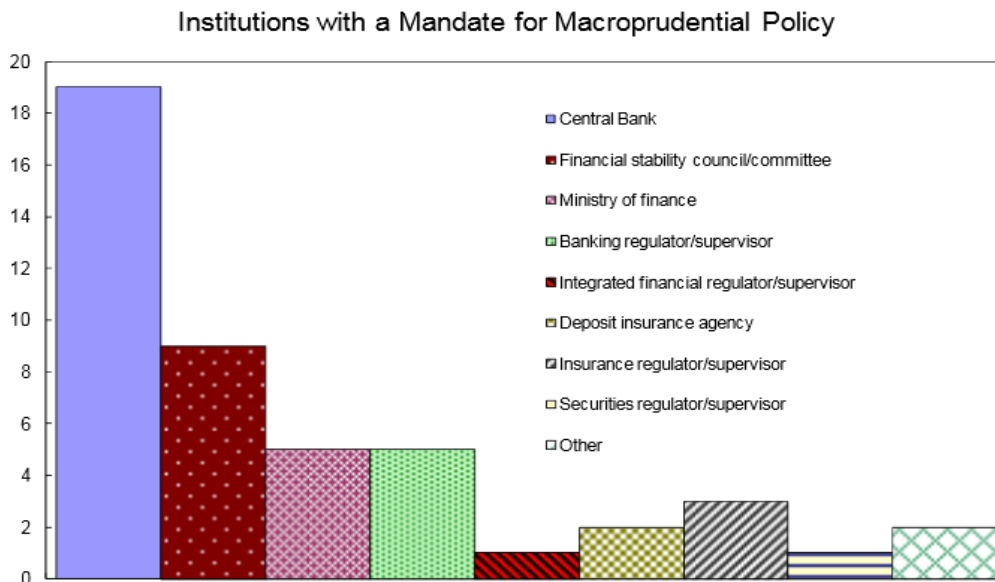
The pursuit of a new “macro-prudential” policy agenda has become a call to arms for many central banks and multilateral institutions (the IMF, the Basel Committee, the Federal Reserve Board, and the European Systemic Risk Board, to name a few). (Calomiris, 2013)

All the classic studies on crises, such as Reinhart and Rogoff, have only focused on banks. However, future research should also consider systemic risk associated with major non-bank financial players.

Regardless the banking system, the “shadow banking system” is also part of the perimeter that can be affected by the systemic risk. For example, AIG, one of the largest insurance companies in the US, had to be rescued with \$182.5 billion in loans. The funding and investment instruments that compose the shadow banking system (e.g., OTC derivatives, securitization, and repurchase agreements) as well as the entities (e.g., insurance companies, money market mutual funds, hedge funds, and finance companies) have been operating outside the focus of surveillance.

These challenges are being currently addressed in the FSB, and the Group of Twenty (G-20) more recently has requested an examination of the contributing role of so-called “shadow banks” to the buildup of systemic liquidity risk (International Monetary Fund, 2011)

Figure no. 1 Institutions with a Mandate for Macroprudential Policy



Source: <http://www.imf.org/external/np/pp/eng/2011/031411.pdf>; pp.37

The recent financial crisis gives many lessons to the policy makers and shows that the aggressive pursuit of macro-prudential policies – policies that alter bank capital requirements, mortgage leverage constraints, and other instruments on a cyclical base to cool down or heat up the financial system as needed– are necessary to combat the cycles of financial boom and downfall that have characterized developed and developing economies over the past decades.(Arnold, Borio, Ellis, Moshirian, 2012) The ongoing global

financial crisis has been a rude awakening that we do not yet have a reliable, effective framework for safeguarding financial stability. In a Basel world, capital and liquidity measures are continuously adjusting in order to reduce the systemic risk that could cause the collapse of the financial system.

4. Issues of the prudential regulation

The prudential regulation is designed to protect the banking system from failure. Since the Basel Committee on Banking Supervision implemented its first Accord in 1988, the measures were more related to monitoring banks' risk management and less to individual transactions. Due to financial market liberalization, all the national financial systems are linked and can cause a chain reaction in the case of a crisis; in order to reduce the systemic risk, the Basel Accords Standards promote the stability of the financial system as a whole.

4.1. The evolution of prudential regulation from micro to macro

The microprudential regulation has targeted the stability of the components of the financial system.

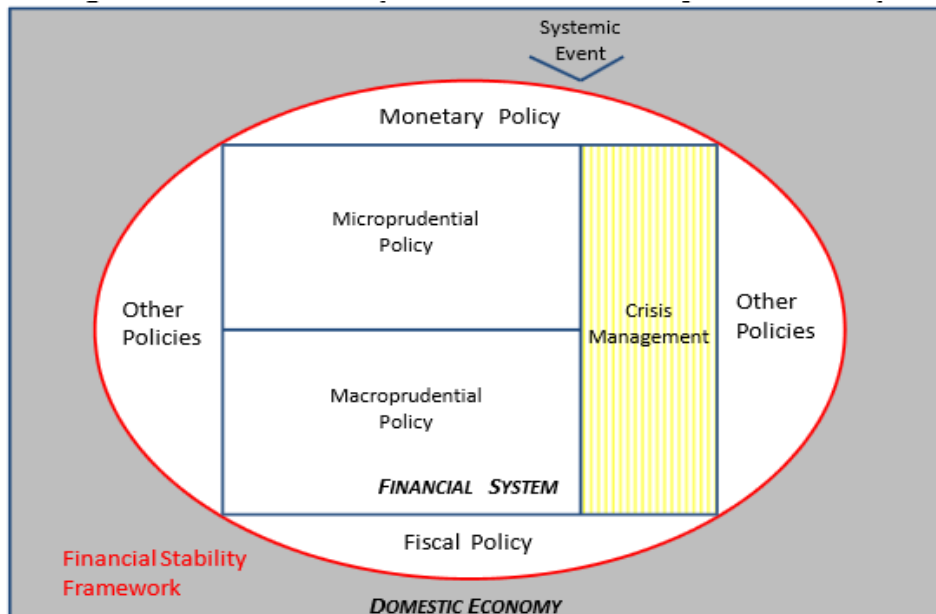
The new architecture of the prudential regulation will face difficult challenges. For example, while the European Systemic Risk Board has responsibilities for macro-prudential supervision and systemic risk at European level, it lacks specific instruments to prevent and to manage those risks. Hence, the challenge consists of finding the adequate toolkit of reducing systemic risk in a flexible, but effective way

Once the ESRB has identified a specific risk, it can signal warnings and make recommendations to specific country authorities, but compliance will depend on actions taken by the authorities and not the ESRB. The central bank should be given a prominent role in macroprudential policymaking and a clear mandate to regulate the banking system in accordance with the macroprudential regulation.

Whereas the Basel II Accord framed the pillars for a microprudential regulation, the Basel III Accord stands for a macroprudential regulation. The Basel II assessment refers to sound banking practice and to protection of depositors at the level of the individual bank. On the other hand, the recent crisis emphasized that the financial cycle is the factor that underlies the severe financial crisis.

This has come to be known as the procyclicality of the financial system; to put it in a nut shell, self reinforcing fluctuations in perceptions and attitudes towards risk, financing constraints and asset prices led to widespread financial distress and macroeconomic dislocations. (Arnold, Borio, Ellis, Moshirian, 2012) This systemic risk is supposed to be neutralized by the countercyclical capital buffer envisaged in Basel III.

Figure no. 2 Financial stability framework and macroprudential policy



Source: *Financial stability framework*; <http://www.imf.org/external/np/pp/eng/2011/031411.pdf>, pp.9

4.2. The new macroprudential regime – a “buffer” against crisis

Even though we can find the term ‘macroprudential regulation’ in Bank for International Settlements (BIS) documents more than 30 years ago, policy makers and authorities hardly put into practice the lessons crisis taught us. Furthermore, the ‘macroprudential surveillance’ – defined as monitoring of conjunctural and structural trends in financial markets so as to give warning of the approach of financial instability – has become a core activity for many central banks. (Davis, Karim, 2009)

The initial two policy objectives of macroprudential regulation are early identification of potential vulnerabilities; and through their public reporting, to encourage financial institutions to do stress testing. The

more difficult policy decision is what to do if there are macroprudential warnings, given the third objective is to promote remedial policies to prevent financial instability.

The procyclicality of the financial system, which is already apparent with Basel I, seems set to worsen with Basel II. It is widely argued that the most desirable means of preventing financial crises is to implement standards which automatically act to prevent “financial fragility” from arising. (Goodhart, 2005) There are several potential instruments to mitigate the systemic risk divided into three categories: credit-related, liquidity-related and capital-related. The challenge is to use those effective in linking macroprudential and microprudential regulation.

One aspect is the appropriate design of a countercyclical regulatory framework. The countercyclical capital buffer and the key policy rate are two instruments serving different objectives. The objective of the countercyclical capital buffer is to increase banks’ resilience to losses in a downturn. The primary objective of monetary policy is low and stable inflation. The key policy rate has a main role in keeping inflation close to 2.5 percent over time without triggering excessive fluctuations in output and employment.

The countercyclical capital buffer is introduced to achieve the broader macroprudential goal of protecting the banking sector and the real economy from the system-wide risks. The buffer is required during periods of excessive credit growth and it is released in an economic downturn. (Basel III Handbook, 2012)

This ongoing research puts an emphasis on the key elements of the macroprudential policy framework, which are: identifying and monitoring systemic risks (along with identifying systemic important financial institutions); collecting the necessary data; permanent assessments of risks to the stability of the financial system as a whole (e.g. trends, scale, probability, timing, system resilience) and their prioritization. (International Monetary Fund, 2011)

5. The Basel III Accord – the warrant of the macroprudential regulation

The Basel III framework is implemented in Europe by the CRD IV package, consisting of a regulation and a directive which needs to be transposed into national law in order to become applicable.

One of the core elements of the Basel III package implemented by the CRR is a revision of the definition of regulatory capital. The aim is to improve both the quality and quantity of banks' capital. This is to be achieved through more stringent uniform criteria for recognising regulatory capital components, stricter and harmonised rules for deductions applied in the calculation of the capital base and expanded disclosure requirements for banks. (Deutsche Bundesbank Monthly Report, June 2013)

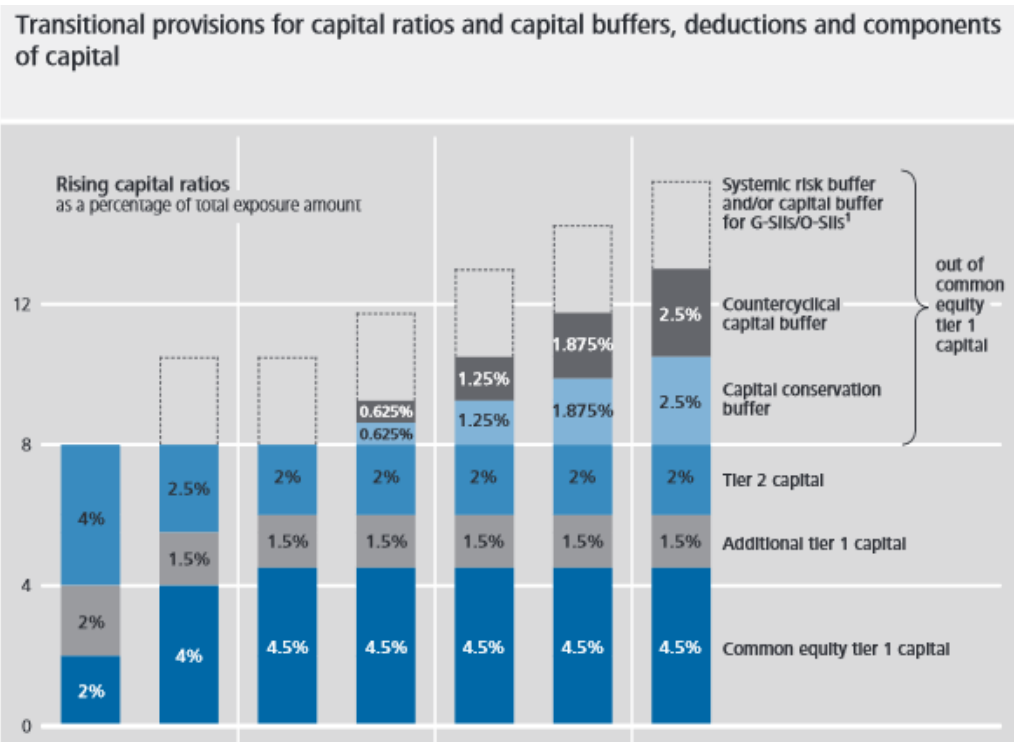
To this end, some elements of the new capital and liquidity regime under Basel III should help mitigate systemic risk. Higher level and quality of capital should improve self-insurance of institutions and, at the margin, better buffer them against the risks associated with credit and asset price cycles. Similarly, the new leverage ratio encourages banks to increase capital commensurate to asset expansion, which in turn should help dampen the rate of bank balance sheet expansion and contraction through the cycle, and the associated amplifications. The new "conservation" buffer, calibrated with systemic risk in mind, will add an extra layer of capital that will build up in good times and cannot be eroded in bad times by earnings distributions. Finally, the new quantitative liquidity rules - the liquidity coverage ratio (LCR) and the net stable funding ratio (NSFR) - should help increase banks' liquidity buffers and lower maturity risk transformation, which in turn should make them more resilient against the transmission and amplification of liquidity shocks.

Such a framework will incentivize banks to make additional investments in their risk measurement systems, though supervisors will have to rely on firms' internal risk management structures, and their own capacity to assess those structures.

In particular, Basel III will correct some of the inputs of the capital function by adding stressed periods or scenarios, in order to make capital requirements less volatile through the cycle. Therefore, Figure no.3 clearly presents the capital tiers' ratios, the additional clauses of

the Basel III standards, outlining the appropriate level of the buffers for a certain capital ratio.

Figure no.3 Capital requirements in Basel III standards



Source: www.bundesbank.de ; *Implementing Basel III in European and national law*

Beyond the toolkit envisaged in Basel III, new tools are also being considered to diminish systemic risks generated from common exposures and interconnectedness in the financial system. Accordingly, the loss absorption capacity of systemically important financial institutions (SIFIs) should be increased; SIFIs are supposed to hold higher capital buffers so as to reduce the spillover impact on others that may result from their failure.

An important task for macroprudential policy is to introduce measures that discourage excessive direct exposures between, and long chain connections across, financial institutions. With Basel II a limit was introduced requiring that institutions have capital no lower than 80% of the capital that would have been required under Basel I. This limit expired at the end of 2009 but was reinstated until the end of 2011 by the Directive 2010/76/EC (CRD III). The proposed EU Regulation concerning Basel III reinstates it until 2015. (Basel III Handbook, 2012)

Macroprudential regimes will be at their most effective when policies are set in a broadly symmetric fashion. In practice, that means tightening macroprudential policy tools when lending practices are exuberant but, just as importantly, loosening those tools either when risks recede or when credit conditions need a boost. Achieving a balance will be a major policy challenge, taking into consideration the requirements set in the Basel III Accord to be implemented until 2019.

6. CONCLUSIONS

The ongoing economic downturn reveals that the framework in place prior to the summer 2007 was inadequate for safeguarding financial stability against a systemic threat emanating from both the real and financial economies around the globe. All lines of defense against imbalances growing to systemic proportions failed to work as intended or hoped, both private and official lines of defense. The safeguarding of financial stability should not be understood as a zero tolerance of bank failures or of an avoidance of market volatility but it should avoid financial disruptions that lead to real economic costs.

The implementation of the Basel III and the feedback of the financial system to its requirements are subject of a future research regarding the macroprudential regulation.

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