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Isolating the banking system from financial turbulences

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Content

ABSTRACT

The financial system led to the outbreak of the economic crisis that affected much of the global economy since 2007. A huge research activity was performed to identify the causes of the crisis. To restore confidence in financial markets, the relevant authorities, responsibles for ensuring financial stability, have launched a comprehensive review and improvement of the entire architecture of the financial supervision system, impacting on macro and micro-prudential supervisory instruments. Regulation and supervision of the financial system are essential to prevent further crises and, if they still occur, they must create conditions for their proper management reducing the effects on society. Research carried out envisages three pillars, namely *i)* identification of macro-prudential tools to prevent the buildup of systemic risks and to constrain financial booms and to provide enhanced resilience of the banking system; *ii)* analysis of the newly created banking union and the expected impact, in terms of increasing the resilience of the banking system, following the implementation of a Single Supervision Mechanism, a Single Resolution Mechanism and a single deposit guarantee scheme and *iii)* proposing a new architecture of the banking system, to ensure smoothing the financial cycles and a fair distribution to depositors and creditors, both of the benefits during the expansion and of the losses in recession.

Studies highlighted that macro-prudential policies were better positioned than other policies that are aimed at ensuring financial stability, in control and limit the elements that led to the onset of the crisis, namely: *i)* risks generated by the accelerated credit growth, and the assets price growth, driven by the credit growth; *ii)* risks arising from excessive indebtedness and its subsequent reduction; *iii)* systemic liquidity risk and *iv)* risks related to volatile capital flows and foreign currency lending.

Thus, the paper is focusing primarily on macro-prudential policies implemented at national and international level. This analysis will be carried out in two separate chapters, the first one to capture both international macro-prudential experience and the new macro-prudential tools introduced by Basel III and the second to take into account macro-prudential policies applied in Romania. Macro-prudential policies aim to reduce negative externalities from the financial system to the macroeconomic sector, ensuring the overall stability of financial systems. Macro-prudential approach takes into account issues that affect the market as a whole, problems that cannot be identified at the micro-prudential level (Isărescu, 2011). Macro-prudential policies take into account two risk distribution dimensions, distribution in time and across the sector. For these two dimensions, the goal is to increase the resilience of the banking system and to limit the amplitude of financial cycles. This translates in protecting the banks from financial cycles and protecting financial cycles from banks (Borio, 2014). To reduce the magnitude of financial cycles, macro-prudential tools are needed, to control excessive credit growth and asset prices growth. To increase the resilience of the banking system, adequate capital reserves are needed, allowing absorption of shocks in the downward phase. Acting on the two dimensions of risk, macro-prudential policies address the pro-cyclicality of the

banking system, those processes that support themselves and amplify upward and downward periods. The financial cycle cannot be controlled only with macro-prudential policies, other macroeconomic policies must also function efficiently. The answer to certain macro-prudential tools is asymmetric, depending essentially on the national specificities and the risks identified. Although, several tools were used before the crisis in order to control volatile capital flows, their effectiveness has been limited. Emerging economies have been particularly affected, where there were strong incentives for increased flows (significant yield differences, risk diversification and portfolio investment diversification, the exchange rate incentive etc.). In emerging economies it is quite difficult to distinguish the border between excessive capital flows and those required for an optimum economy. While monetary policies were applied, usually in the same direction with the macro-prudential policies, in emerging economies, raising the interest rate to local currencies accelerated the foreign currency lending, amplifying systemic risk. In the category of tools aimed at reducing banks indebtedness and the share of volatile resources, the most effective appear to be taxation on certain categories of resources, minimum reserves requirements, and limiting the loan to deposit ratio. They can reduce the vulnerability of open economies, namely the disintermediation risk generated by sudden reversal of capital flows. Also, limiting foreign currency lending may be effective in reducing excessive credit growth. The most effective tools for controlling credit growth continue to be caps on the loan value into the collateral value ratio (loan to value - LTV) and on the indebtedness of borrowers (debt to income - DTI), particularly when the effects of monetary policy are limited. They are not producing distortion, protecting primarily the real economy, and increasing the resilience of the banking system.

Analyzing macro-prudential tools introduced by the Basel III it can be argue that supplementing the capital requirements may lead to a transfer of risks to unregulated sectors. In addition, their efficiency is not yet established. European Committee for Systemic Risk, responsible for implementing macro-prudential policies across the EU, draws attention to the low relevance of deviation of loan growth relative to GDP growth in some cases, indicator which must be used to determine the countercyclical capital buffers, indicating that it must be taken into account complex sets of information on their application. At the same time, it emphasizes the lack of relevant historical data, indicating the starting point of the effective use of countercyclical capital buffers, allowing normal activity of the banking system and the financing of the economy on a continuous basis. These warnings raise questions about the effectiveness of the proposed instruments. Leverage ratio can be useful, linking total assets to capital owned, however, it may have pro-cyclical effects. Another tool for increasing capital reserves is dynamic provisioning model experienced by Spain, which has proven to be effective and can be easier to implement than complex instruments introduced by Basel III.

In the third chapter we analyze the new architecture of the European banking system supervision through the establishment of a common regulatory framework in the 28 member states of the

European Union and of a Banking Union in the Eurozone and non euro Member States', which it will voluntarily join it. By adopting the new legislative package CRD IV (implementation of Basel III), the Bank recovery and resolution directive and the Deposit guarantee schemes directive, was set a *single rulebook* regarding supervision and treatment of distressed banks. The question of Member States outside the euro area, about the participation in the Banking Union, is whether it should be accelerated, since anyway there is a horizon of joining the euro area and thus to this mechanism. Bank recovery and resolution directive provides that if a bank's financial situation deteriorated irreparably, shareholders, creditors and unsecured depositors will pay their share of losses through an internal capitalization operation (*bail in*). It is estimated that these will increase the cost of funding for banks. Creating a Single Resolution Mechanism is beneficial in the management of failing cross border banking groups, but its success depends on the pooling of resolution funds and guarantee schemes, for which there is still no agreement at interstate level. Funding the resolution schemes would be provided by the banking industry, through contributions to the Resolution Fund, which would increase the cost of loans. The accumulation period for the Resolution Fund is long, its resources being limited in the short term, moreover it is unlikely that the fund could support the resolution of several banks, even if it is intended for use only after application of the internal capitalization procedure *bail in*. The mutualisation of deposit guarantee schemes is still an open question, which is essential, given that the schemes should ensure the compensation of guarantee depositors. Although one of the goals is to support and stabilize the banks without national interest’s interference in the resolution, there are still political forces and national interests against mutualization.

In the last chapter it is proposed a new architecture for the banking system. The banking system was built on the trust that the values deposited for safekeeping can be withdrawn at any time. This assumption is no longer always checked into practice, or it has a high degree of uncertainty. If cornerstone of banking system functioning is affected, it is necessary, in my opinion, to redefine its architecture. The proposed architecture of the banking system goes beyond the resolution principles defined at EU level. Creditors and depositors should participate primarily in the distribution of benefits and then, naturally, to cover the losses. Thus, the risk must be assumed directly and transparently by creditors, together with the benefits, there are no intermediaries. Evolution of creditors’ assets will follow in real time the projected evolution of the system, without accumulating other risks. At the same time, it became evident that losses from real estate bubbles or other types, financed through the banking system cannot be covered by the banks' capital and, in some cases, nor by the states in which they operate.