NEW INTERNATIONAL FINANCIAL REGULATION: NECESSITY OR REQUIRED BY CRISIS

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The global economic and financial crisis showed the limits faced by the international financial system. International financial regulations in general, and especially the banking sector regulations, should be refined and adapted to build a stronger and stable international financial system. We analyze the main trends in international regulations: the proposed amendments on capital requirements, the introduction of a global standard for liquidity and indebtedness, the winding-up directive, as well as their impact on the Romanian financial system.

Keywords: international regulations, global standard, winding-up directive

JEL classification: G01, G21

Introduction

The actual economic crisis made it clear that the way markets, financial institutions and international financial agents function needs reanalyzing, which led to a different level of understanding the way these institutions function but also to realizing the need to establish new rules, regulations and procedures. Due to the fact that the crisis is constructed as following: banking crisis →financial crisis →economic crisis, it becomes stringent the need to establish the rules on financial and bank markets; so the concept of financial stability exceeds reporting on country level, a certain financial stability on international markets level is needed. What began as a banking crisis on the American market has all the chances to become countries' crises (the example of Greece). Romania was affected by the international crisis, first through the banking and financial channel, and then through the commercial channel; none the less the problems out country is facing are not due exclusively to the international situation but more to great existing unbalances: rapid growth of income as opposed to the level of productivity, the current account deficit of over 10% before the crisis, a oversized state apparatus etc. It is necessary to understand the concept of financial stability, so according to The National Bank of Romania, stability is : "…a financial system, indifferent to the its size or complexity, is stable when it has the capacity to facilitate economic performances and to correct eventual unbalances that could happen as a result of adverse shocks[394]" or in Cerna(2008) "financial stability is a characteristic of the financial system, which is the ability to absorb financial unbalances that can emerge as a result of endogenous or exogenous factors of relevant size and unanticipated, by this reaching specific performance[395]". On an international level there are different organisms, governmental and non-governmental, that trace, recommend or implement different actions regarding the stability of

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[394] Raport privind stabilitatea financiara, 2006 , http://www.bnro.ro .
[395] Cerna Silviu &altii in Stabilitatea financiara, pg.12, Editura Universitatii de Vest, 2008.

financial systems like: The Bank of International Regulations through Basel I and Basel programs, Financial Stability Board, International Association of Insurance Supervisors, International Association of Deposit Insurers, together with different commercial banks. In Romania, the Romanian National Bank writes, beginning 2006, "Reports on financial stability", a document that is interested in : the international economic and financial context, the financial market and its risks, the infrastructure of financial markets, the institutions of the financial markets. The main indicators used in analyzing the financial stability are[396]:

-the system of indicators proposed by the International Monetary Fund (financial soundness indicator);

-stress-testing, that means a series of response tests of the financial system, to the factors of speculative pressure;

-early warning systems;

-other methods of analyzing and evaluating financial stability.

Even though there is large number of indicators at the disposal of the national and supra-national surveillance authorities, the world economic crisis has showed that new regulations are necessary. Implementing the Basel II recommendations in the EU has been realized by[397] : Banking Consolidation Directive 2006/48/EC (BCD), Capital Adequacy Directive 2006/49/EC (CAD), which together have constituted the Capital Requirements Directive (CRD). CRD aims to ensure the financial soundness of credit institutions (banks, investment forms, etc) the Directive stipulates how much of their own financial resources such institutions must have in order to cover their risks and protect their depositors[398]. Basel II implemented through CRD, begining January 1st 2007, is based on 3 pillars[399]:

1. Minimum Capital Requirements. That aims minimum capital levels, credit risk, operational risk and market risk.
2. Supervisory Review. Regarding management risk and transparence of surveillance.
3. Market discipline. Completes the first two pillars by developing means of disseminating information to market participants giving them the necessary information regarding the level of capital, risk exposure and risk management.

Evolution of the world economy, the rise of interconnectivity at a global level, development of security and especially the economic crisis has made CRD out of date, new instruments and regulations being necessary in order to face the current challenges. So, beginning 2011, two new amendments, CRD 2 and CRD 3 will become effective, completing and bringing up to date CRD/Basel II, and also another amendment, CRD 4 is taken into consideration for the future.

Table 1. Capital Requirements Directive[400]:

CRD 2	CRD 3	CRD 4
quality of firms capital	higher capital requirements for re-securitisations	*further counter-cyclical measures;*

[396] Dupa Cerna Silviu &altii in Stabilitatea financiara, pg.79, Editura Universitatii de Vest, 2008.

[397] Strengthening Capital Standards 3, Financial Services Authority, December 2009, pg.3, http://www.fsa.gov.uk/

[398] Ibidem.

[399] International Convergence of Capital Measurement and Capital Standards, A Revised Framework, June 2004, pg. 6, http://www.bis.org/publ/bcbs107.htm

[400] Strengthening Capital Standards 3, Financial Services Authority, December 2009, pg.7, http://www.fsa.gov.uk/

CRD 2	CRD 3	CRD 4
management of large exposures	upgrading disclosure standards for securitisation exposures	*dynamic 'buffering' of loans;*
supervision of cross-border banking groups	strengthening capital requirements for the trading book	*liquidity standards*
CRD 2	CRD 3	CRD 4
risk management of securisations		*foreign currency mortgages;*
different operation on the CRD hybrid capital instruments		*supplementary measures (possible leverage ratio)*

CRD 2 & 3

Improving the quality of firms capital will be made by establishing criteria for assessing the eligibility of hybrid capital to be counted as part of a firm's overall capital. The proposals specify the features that hybrid capital must have regarding permanence, flexibility of payments and loss absorbency to be eligible as Tier 1 capital. Hybrid capital is define as being " ... a form of debt that has been substituted for equity. This type of capital has both debt and equity features. This covers a variety of instruments, such as preference shares, that are not pure equity but have traditionally been deemed close enough to it to count towards a bank's tier one capital ratio - the key measure of financial strength"[401]

Table 2[402]: Characteristics of hybrid capital	
Type of instrument	Permitted features
Undated	Cannot have an option to redeem in the first five years
	No incentives to redeem allowed within first ten years
	Can be included within any bucket depending on features
	Calls allowed in 35% and 15% buckets
Dated	Must have an original maturity of at least 30 years
	No incentive to redeem allowed
	Must have a 'lock-in' feature (eg. may not be repaid if in breach of capital requirements at maturity) and supervisors may stop repayment
	Calls allowed after five years
	Included within the 15% bucket

[401] According with http://lexicon.ft.com/term.asp?t=hybrid-capital

[402] Strengthening Capital Standards 3, Financial Services Authority, December 2009, pg.27, http://www.fsa.gov.uk/

Effects of this measure: rise in the capital cost for affected companies, but also they will lead to a rise in companies' capitalization, lower bankruptcy risk, reduces contagion risk, lowers the impact of future financial crises (reduces moral hazard).
Large exposures management regime will applies to exposures to counterparty or a group of connected clients. The basic limit is set to 25% of the company capital resources, but isn't considered that this limit could equal up to 50% of the TIER 1 (and up to 100% of the CORE TIER 1) CRD 3 will enhance CRD by adding higher capital requirements for re-securitisations (the 5% skin proposal), upgrading disclosure standards for securitisation exposures and strengthening capital requirements for the trading book.

CRD 4

If CRD 2 and 3 continue to base themselves on the Basel II paradigm, CRD 4 aims the strong reformation of the financial system, but especially the banking system, by introducing new requirements and measures like: counter-cyclical measures, dynamic buffering of loans, quantitative liquidity standards and systemically important financial institutions. foreign currency mortgages and possible an leverage ratio. One of the most important one is the liquidity standard which is set to be implemented with CRD 4. It will two components: liquidity coverage ratio and net stable funding ratio. The liquidity coverage ratio "identifies the amount of unencumbered, high quality liquid assets an institutions holds that can be used to offset the net cash outflows it would encounter under an acute short-term stress scenario"[403], so it will will deal with the liquid assets on the short-term. The net stable funding ratio measures " the amount of longer-term, stable sources of funding employed by an institution relative to the liquidity profiles of the assets"[404].
Dynamic buffering loans (dynamic provisioning) will help to deal with the pro-cyclical in the banking sector, allowing early detection of credit losses in loan portfolios, enabling bank to build up a buffer in good times that can be used in bad times. They have an anti-cyclical nature that enhances the stability of the banking system as a whole.

Table 3[405]

Historic cost accounting						**Dynamic provisioning**					
Balance sheet	1	2	3	4	5	**Balance sheet**	1	2	3	4	5
Loans balance sheet value	100	100	100	100	100	Loans balance sheet value	100	100	100	100	100
Stock of specific provisions	0	0	1	4	5	Stock of specific provisions	0	0	1	4	5
Loans balance sheet value net	100	100	99	96	95	Stock of expected loss provisions	1	2	2	0	0
						Stock of total provisions	1	2	3	4	5
						Loans balance sheet value net	99	98	97	96	95

403 International framework for liquidity risk measurement, standards and monitoring, BIS, December 2009,pg. 11, http://www.bis.org/publ/bcbs165.htm
404 ibidem
405 Exemple After Financial Stability Review- Dynamic provisioning: issues and application, pg 131, www.bankofengland.co.uk

Income statement						Income statement					
Net interest income	2	2	2	2	2	Net interest income	2	2	2	2	2
Specific provision charge	0	0	1	3	1	Expected loss provision charge	1	1	1	1	1
Total P&L	2	2	1	-1	1	Total P&L	1	1	1	1	1

Dynamic provisions are being already applied in Spain since 2000. The mechanics is as follows406: -the total provisions are the sum of specific (dot.espe) and general (dot.gen) provisions.

$$dot.gen_t = \alpha \, \Delta C_t + \left(B - \frac{dot.espe_t}{C_t}\right) * C_t$$

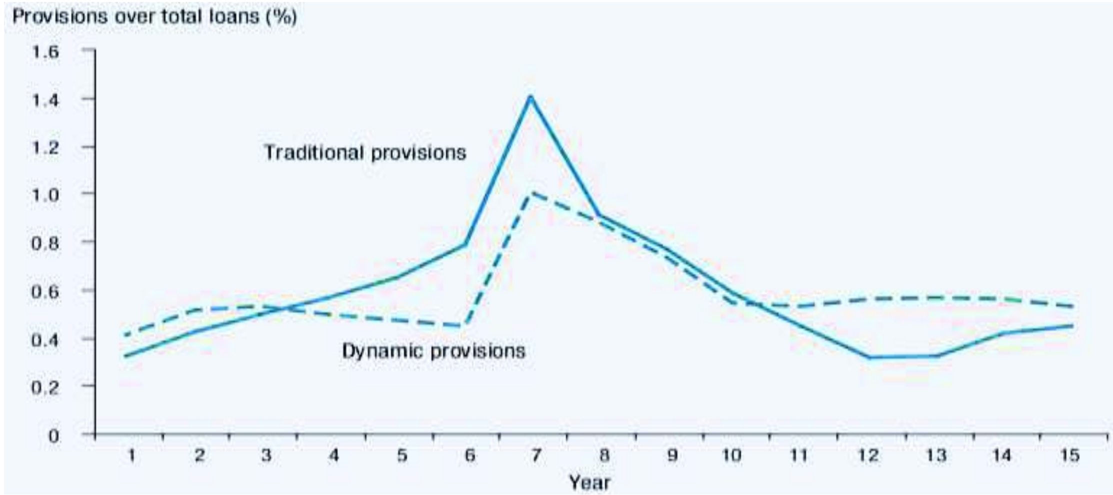
Where C_t is the stock of loans and its variation (positive in a lending expansion, negative in a credit crunch), covers the latent loss, and beta is the average specific provision for a full lending or business cycle. There are 6 risk buckets, each with a different alpha and beta, they are:

	Alpha %	Beta %
Negligible risk, represented by cash and public sector exposures.	0	0
Low risk – mortgages with a loan-to-value ratio below 80% and exposures to corporations with A rating or above.	0.6	0.11
Medium-low risk, mortgages with a ratio above 70% and other collateral loans.	1.5	0.44
Medium risk, other loans (corporate exposures below A rating, SME)	1.8	0.65
Medium-high risk, consumer durables financing.	2	1.1
High risk, credit card and overdrafts.	2.5	1.64

While there levels may not be able to cover the all losses in case of an economic crisis they have proved useful in Spain. In 2007 the level of accumulated provisions was407 1.3 % of the total consolidated assets, while the capital and reserve represented 5.8 %.

Fig. 1[408]The evolution of traditional versus dynamic provisions

[406] Dynamic Provisioning, The experience of Spain, pg. 2, www.rru.worldbank.org
[407] Ibidem, pg. 6
[408] Ibidem, pg 4.



It can be observed that using the dynamic provisions the banks exposures is not so pro-cyclical, and it offers them a buffer to use in moments of stress. The experience of Spain is very important for implementing such a method throw CRD 4, even if know Spain has a level of unemployment close to 20% it's banking system is stable.

Conclusions

The global economic crisis has shown that current systems, especially Basel II, are no longer sufficient to cope with new type of challenges of global and financial type, even though Basel II was not the best safety net for the financial sector (or to the banking sector in particular) it was still better than the lack of any legislation. Thus the new rules and regulations issued by international supervisors are develop on the skeleton of Basel 2; CRD 2 & 3 & 4 will improve the current system, specifically by an increase in the stability of the financial sector. The CRD 2 directives which included proposals to be implemented by the end of 2010, but especially in discussions CRD 3 & 4, shows that we are heading towards a new approach both at micro as macro stability,

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