THE NEED TO REFORM THE BANKING SYSTEM – A PREMISE FOR THE IMPLEMENTATION OF THE BASEL III ACCORD

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Abstract: *The application of banking reform measures represents a real challenge for banks in this post-crisis period also leading to the rapid implementation of the Basel III Accord. The causes of financial-economic crisis must be identified and dealt with, one of the difficulties the banks face being that to quantify and take risks. The banking system was characterized by weaknesses in the recent global financial crisis. These weaknesses were related to: too much leverage in the banking; not enough high quality capital to absorb losses and an excessive credit growth based on underwriting standards and under-pricing of liquidity. It is felt the need to move from "deregulation" to an accurate banking regulation process, based on an appropriate mix of macroeconomic policies, that is to the ensurance of a balance between the policies meant to stimulate the demand and those policies which can stimulate the demand. The problem of banking regulation is also taking into account the reactions of the business world which emphasizes the fact that an exaggerated regulating process which supresses innovation would be a major risk.*
Many of the changes in the banking system are inspired by the final draft of the G-20 reunion, that of developed countries, in November 2008, a draft considering the economic re-launch and reform. Basel III considers the reform of the banking system by measures whose cover area is much larger and they refer to both the micro-prudential framework and to the macro-prudential one. The application of all the measures established by Basel III Accord is expected to end by 2019, with different effects in the main segments of banking business: retail, corporate and investment banking. The impact of Basel III implementation in the banking system of the USA is almost similar to that of Europe's, with slight differences regarding the capital and the reduction of mortgage rights, which play a more important role in the USA, the latter having another starting economic point than Europe.

Key words: *banking reforms; macro-economic perspective; monetary policy; bank corporate governance; countercyclical capital, credit crunch, bank leverage.*

JEL Code: *G01, G21*

1. Introduction

After the 2000s, the international financial market has evolved stronger and stronger, an evolution many considered to be one leading to an unrealistic economic growth; starting from the American contagion (Badea, Socol, et al. 2010, 192), determined by the "subprime" loans, with a high risk of not being reimbursed by the debtors and expanding on the European economy. Banking institutions were free to find their own strategies for loans and to establish the assumed levels of risk. Also, (Badea, Socol, et al. 2010, 192), the investment funds transferred mortgage loan packages to investors, which, in combination with derivatives have created a chain reaction, leading to the impossibility for the debtors to pay off their loans. The overvaluation

of real estate properties, concomitantly with the failure to pay the loans have led to the creation of inefficient bank guarantees. The losses have been felt both by investors as well as by banks, thus influencing the international financial-banking relations, a fact which has led to the generalization of the crisis at the global level. The clients' lack of trust in the banking system has been felt especially in the contracting of much less loans, these becoming more expensive, and the liquidities of banking institutions less and less.
What happened in 1929-1933, represents, also, a lesson of the banking crisis which has not been learnt too well. In that time, too, just like in the case of the current crisis (since the end of 2007), the banks went bankrupt and the credits slowed down. The crisis expanded in most of the economies of the Western countries and the state became the refuge for the banking system.
All these problems have led to a reform of the banking sector. If in 1933, the reform (Mâșu și and Gheorghe 2009, 208)meant the devaluation of dollar, economic and social aids, the launch of new projects and works, the self-limitation of agricultural production, that is a series of measures attempting an economic re-launch, we can say that in the present history is repeating and that these crises have a common point the **"credit crunch"** effect, that is the rarefaction of loans. This effect is often associated with the liquidity crisis (Mâșu și and Gheorghe 2009, 209), a reason making us to analyse certain banking regulations and norms, like those of Basel Accords.

2. Opinions and orientations in reforming the banking system

If Basel I Accord, in 1988-1995, by the measures proposed managed to introduce increments of own funds in the banking institutions and by these to improve the economic-financial situation, Basel II, which comes little before the crisis break out (at the end of 2007) contains also recommendations both for governments and for central banks. The recommendations are related both to prudential policies (protection of deponents, measures for the banking institutions in difficulty, the setting up of an appropriate minimum capital of own funds that the banks must comply with), as well as the need to adjust the drawbacks noticed in the banking system, due to failures to appropriately manage the risk, when attempting to ensure a real banking transparency and discipline (Stiglitz 2010 , 202).
There are different opinions belonging to economists and business people regarding then banking regulation activity and the way in which this activity should be carried out. No mater it is about "ten construction sites" of the reform (Mâșu și and Gheorghe 2009, 222), mentioned by C. Chavagneauxin an article; about "nine propositions to end up the crisis "belonging to Lordon F (Lordon 2008, 169); or about "twelve recommendations for the reform application" belonging to Pastre O. and Sylvestre J.M. (Pastre and Sylvestre 2008, 216-218), all have the role to bring a new financial architecture and to build a new banking system.
The sites of the reform could start in Lordon F.'s opinion with "desecuritization "activities, noticing that a part of the disaster made by the crisis has been due to the transformation of debts into bonds, currently being necessary a reverse operation, that of limiting the bonds in a loan portfolio.
The "leverage" is also a risk generator, leading to financial speculations. A reverse operation would be necessary, that of "debt deleveraging" (Lordon 2008, 174-175), by charging some very high percentages of material cover up, in a proportion of 80-90%, with own funds, which would lead to the decrease of such operations.

The anti-speculation monetary policy is part of the activity of Central European Bank, and as Maucour O. (Maucour 2009, 191-205) stated in an article on Basel II, The Basel Committee must propose certain provisions referring to the rating agencies, credit derivatives and the securitization operations that should be added to the Basel II Accord; in this way, there will be prudential rules meant to bring stability to the banking system. Each country's central bank, together with the central banks part of the Basel Committee must set up a minimum level of own funds for the banking institutions. These are propositions by which this Basel II Accord will be updated, changed and completed; many of these changes will be agreed upon and subsequently applied through the Basel III Accord.

Even the problems regarding the change of accounting norms have the role of representing the basis for the reformation of the banking system, because during crisis, together with the decrease of the value of assets, the firms can give up the "real value" of these and adjust the account value in accordance with the market decrease, as it could be seen at the end of 2008. These accounting norms must better reflect the economic value.

A largely debated problem was that of regulating the "tax havens". If the objective of these areas called tax havens was to increase evasion by exiting the fiscally regulated areas and the recording of the trade in the so-called "offshore" financial areas, from now on the regulation of all the financial operators is becoming necessary, which compares tax havens with some "black holes", which should not exist and their disappearance should rebuild the international banking system (Mâșu, Buneci and Gheorghe 2009, 225).

The causes of the current economic-financial crisis should be identified and dealt with, one of the difficulties of banks being that of quantifying and taking risks.

In order to exit the crisis, *"the world economy cannot work continuously with only one engine"* (Rădulescu 2012, 36), that is the American one, from which the crisis started for it expanded worldwide and, in time, it has been noticed that this way of working created economic imbalances. *"Europe, with a much more balanced commerce (from the point of view of deficit/surplus) was playing the role of moderator between the American and Asian flows"* (Rădulescu 2012, 36). That is why there is this stringent need to get to "deregulation" towards a fair banking regulation, based on an appropriate mix of macroeconomic policies, that is towards the ensurance of a balance between the policies meant to stimulate demand and those policies which can stimulate supply.

There is, also, the problem of banking regulation taking into consideration the so-called "exaggerated reactions" of the business world which emphasize the fact that a major risk would be to exaggeratedly regulate thus killing off innovation.

In Stiglitz's opinion, deregulation would have taken place *"when the dangers of excessively taking risks increased, due to the new financial products"* (Stiglitz 2010 , 157). These new financial innovations must help correctly manage the banking risks and not amplify the risk. The bankers should not avoid the rigour of regulations, they must ensure the banking transparency, give up those "innovating" products presenting a high risk for the bank to the detriment of its clients.

3. The effects of G20 reunion on the creation of Basel III Accord

There have been several precursory stages to the setting of Basel III Accord which were the result of the numerous meetings of the G20 Group. The new elements brought into discussion by the group of the 20 member states (at Washington, London, Pittsburgh, Toronto, Seoul) had in view the implementation of new banking regulations and Basel III Accord represented their finality.

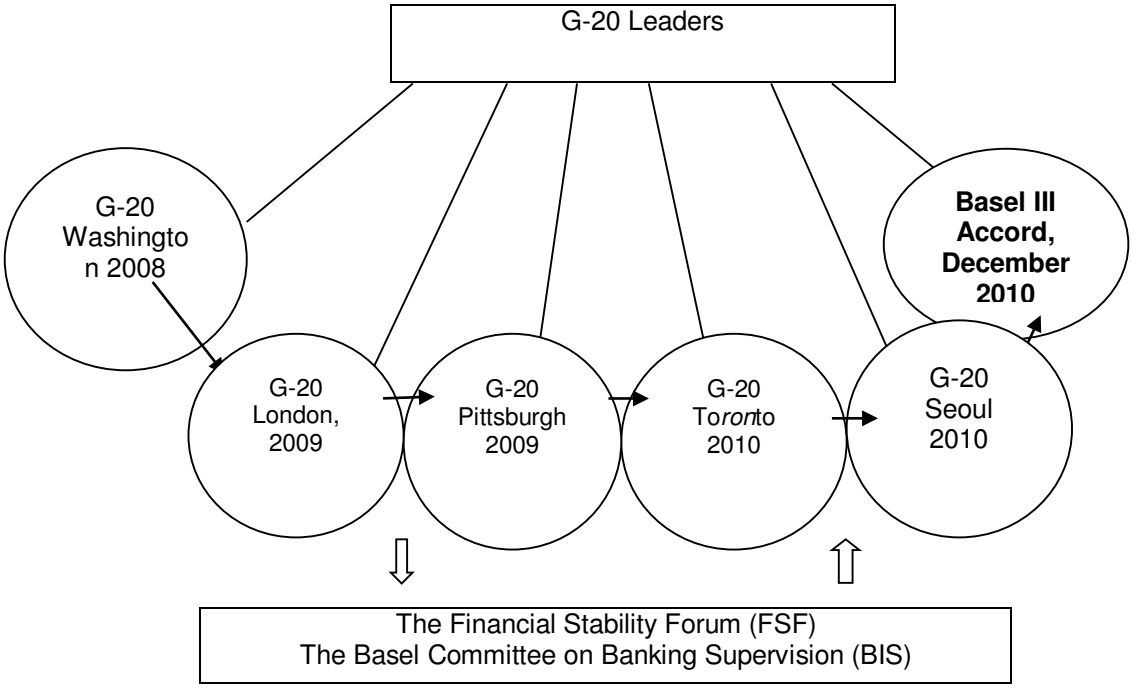


Figure 0. Basel: the creation of Basel III Accord

Source: (Constantinescu, 6), http://www.paneuropa.ro/doc/CRDIV.pdf

Many of the changes in the banking system are inspired by the final document of the G-20 meeting, of developed countries, in November 2008, a document targeting the economic re-launch and reform based on several directions (Mâșu și and Gheorghe 2009, 234):

- **the integrity of financial markets** – can be done by assembling all important banks and by creating ”supervision colleges”;
- **the reformation of some financial institutions** – such as IMF and the World Bank, thus contributing to the financial stability, to the re-launch of loan activity to the emerging countries;
- **exigency and control** – which requires a better banking supervision, carefulness and control in appropriately managing the risks;
- **support for helping the world economy** – to exit the crisis and economic re-launch.

At the G20 Summit in London in April 2009, the debate was centred on problems regarding the harshening of the reforming rules of the financial sector and it was

forecasted that all the members present at this meeting should progressively adopt the regulation framework and the Basel Committee on Banking Supervision and the national authorities develop and agree on a new global framework of these financial institutions which should solve the problems regarding a much stronger, better quality liquidity, as a short-term cover (Financiarul, 25 June 2010). The G20 Group considered that the new Basel III Accord should be finalized by 2011, in this way it could be implemented much sooner.

In September 2009, at Pittsburgh, the G20 Group laid down a report regarding the promotional actions of the financial regulations established, according to which global standards should be implemented constantly so that they ensure *"a permitted and authorized level to fragment the markets, to protect and umpire the rules*" (BIS, 2010). In their opinion, progress can be achieved only with the help of the Decision Group of the trans-border banks, of the Basel Committee on Banking Supervision and of the World Bank, which establish recommendations for authorities on the problem of crisis management and decision making processes.

In 2009, too, the Basel Committee on Banking Supervision published two consultative documents, in December, with the title ***"The Resistance Consolidation of the Banking Sector"*** a document the press and the Internet wrote about, using as a title "Basel III" and a second document: ***"International Framework for Liquidity Risk Measurement, Standards and Monitoring".*** These are part of the activity of the Basel Committee, yet they are just projects not representing a legal framework for a new accord. The news brought by this accord will have a major impact on the banking sector, on the loan offer and on the economic growth problems (Financial News 16 April 2010).

All these meetings continued with those from Seoul and Toronto, in 2010, had as final objective the materialization of this accord, in the same time establishing solutions for the recent economic crisis.

An appropriate solution to exit the crisis came from the G-20 leaders, who had agreed within the International Monetary System to create a Programme for the improvement of the destabilization effects of capital flows, yet together with global liquidity management measures, in order to prevent the shocks.

The introduction of the Basel III Accord is due to several reasons (Nucu 2011, 58) easy to understand:

- **the disastrous effect of banking crises,** noticed by losses of economic productions with approximately 60% of GDP, in the period before the crisis;
- **the frequency banking crises precede one another with** (since1985to present there have been over 30 banking crises in the Basel Committee member states);
- **the benefits brought by the Basel III Accord** which must overcome the cost of implementing this accord, based on the reason that a solid banking system leads to a sustainable development and it has long-term positive effects.

4. Micro and macro-prudential measures at the banking system level

As compared to the other two Basel accords, Basel III targets the reforming of the banking system through measures whose cover area is much larger and which refer both to the micro-prudential framework as well as to the macro-prudential framework.

The immediate objective of these regulations is to limit the risk of new financial-banking crises, which, implicitly, lead to system crises and the need to use a macro-prudential approach based on supervision rules. In order to realize the importance of these rules, we have used a comparison between the macro and micro-prudential perspective:

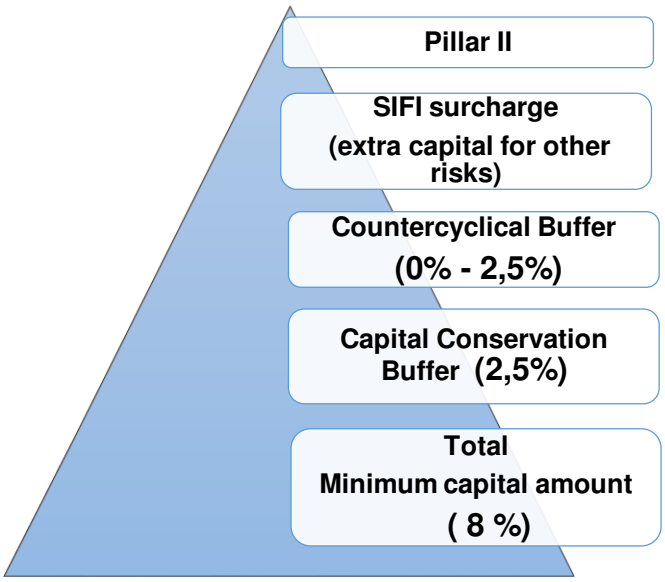
	Macro-prudential Perspective	**Micro-prudential Perspective**
Immediate objectives	Limiting the financial crises so that they do not become systemic	Limiting the difficulties of banking institutions at the individual level
Final objectives	Avoiding the costs regarding the GDP	Protecting both the consumers (investors or deponents) and the banks
Characterization of risk	Considered being dependent on a collective behaviour (endogenous)	Considered being independent from the individual behaviour (exogenous)
Correlation of banking institutions	Important	Not important
Carrying out prudential control	In terms of risk: from the top down	In terms of each banking institution's own risk: from the bottom up

Table 1: The comparison of macro and micro-prudential perspectives at the level of banking institutions
Source: processed after (Borio 2011, 159)

At the **micro-prudential** level there is the need for measures stipulating a consolidation of the quality of banking capital, mainly following own capitals (capital reserves, the reported financial result), the minimal requirements of level I own funds (own funds and hybrid instruments), and the reconfiguration of some eligibility criteria for the instruments necessary to determine level I own funds. Due to the problems emphasized by the current crisis, there is the need for an increase in the exigencies to cover the risks, a limitation of the leverage effect (as an additional measure to the capital requirements) and not in the least the setting up of some liquidity standards, both on short term (30 days) in order to cope with the liquidity crises and on long-term (1 year) for an as solid as possible profile of structural liquidity (Nucu 2011, 59). The **macro-prudential** perspective (RNB Report, 2011, 124) presents anti-cyclic measures:

- the introduction of an anti-cyclic capital damper having the role of banking protection against systemic risks associated to the non-sustainable increase of the credit and of a fix capital preservation damper in order to cover the losses if the bank has financial problems;

- the calculation of the leverage effect in order to limit the level of debt of the banking system during periods of economic boom;
- measures for the systemically important banks, oriented towards the reduction of their bankruptcy probability and impact; the establishment of equal competition conditions they have in view reducing the competitive advantage that these banks have in the area of funding; the reduction of the cost owed to the public sector intervention. Also, they have in view supplementary requirements to diminish the losses, yet, also supplementary capital fees for "capital surcharges" banks.



Graph 1: Topping up further
Source: (Constantinescu, 17), http://www.paneuropa.ro/doc/CRDIV.pdf

Carrying into effect these measures depends on the transition period available to meet the requests. If the period of time is short, banks prefer narrowing their loan offer in order to raise faster the level of capital and to change the structure of assets. If the implementation takes place gradually, in a longer period of time, this impact can diminish and banks can find other ways: profit capitalization, share issue, change in the structure of liabilities, etc. Although the period of transition for the implementation of these measures is either shorter or longer, the consolidation of the financial system is carried out.

5. Conclusions

We could say that the compliance with the terms of Basel III implementation is important for the consolidation of the banking system and the responsibility of this implementation lies not only on the regulating bodies specialized in this implementation, but also on the specialists on problems of risk management, at the level of banks. Also, banking audit has an important role in reviewing and disciplining the efforts to apply these regulations. The application of these measures represents

a serious challenge for banks in this post-crisis period and state uncertainty. The economic growth is quite weak and the sovereign debts have emphasized the fragility of the financial-banking sector.

The application of all the measures established in the Basel III Accord is expected to be over by 2019, with different effects on the main banking business segments: retail, corporate and investment banking. The retail activity and that of corporate banking especially affected by those provisions of Basel III Accord regarding the capital and liquidity superior requirements and the investment banking activity suffers changes at the level of capital markets. The market of OTC derivatives will be affected by the fact that the banks must have a superior level of capital in order to be able to cover, apart from the other risks, the credit risk of the counterparty and the market risk.

The impact of implementing Basel III in the banking sector in the USA is almost similar to that of Europe's; there might be slight differences regarding the capital and the deduction of mortgage rights, which play a more important role in the USA, having another economic starting point than in Europe.

Regarding the regulations proposed by Basel III Accord, they have a more reduced impact at the level of our country. This is due to the fact that the banks are capitalized well enough, this capital being made up of level I own funds which own 80% of total own funds afferent to the banking system, at the end of 2011; capital hybrid instruments are almost missing and the aggregate leverage effect shows a value of 6% (which is according to the requirements), therefore the new norms will be seriously felt at the level of Romanian banking system. The challenge (Nucu 2011, p.68) for the Romanian banking system knows other directions, too, such as: the design, quality of data and the complexity of reporting. Also, an as efficient as possible banking corporate governance and which corresponds to the business model and risk profile is more than opportune for the implementation of the Basel III Accord. Regarding the liquidity standards, The Romanian National Bank stated that liquidity supervision in the case of branches should be the authority's task in the host member state and these standards should be applied both at the individual level and at the consolidated level.

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