BASEL III – A NEW APPROACH TO IMPROVE INTERNATIONAL FINANCIAL STABILITY

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Abstract

In its first part, the article highlights the factors standing at the basis of the modification of the general framework of development of the banking activity in the last decades and the main trends that manifested on the international banking market until the global financial crisis. Thenceforth, the main lessons learned from the global financial crisis for the regulation and supervision authorities are presented. The final part of the article concerns the Basel Committee answer to the global financial crisis, concretised in a reform programme regarding the regulatory framework of the banking activity. The improvements and news brought by the Basel III reform programme take into account the flaws revealed by the global financial crisis and have the purpose to strengthen the stability of the international financial system.

Key-words: *international banking regulation, global financial crisis, financial stability, sub-prime mortgage crisis, securitisation*

JEL Classification: G_{15}, G_{21}

Introduction

The sub-prime mortgage crisis, which transformed into a global financial crisis, raised a series of questions for the regulation and supervision authorities around the world regarding the reform of the current regulatory system of the financial and banking activity. This must comply with the tendencies manifested on the financial markets and take into account the lessons learned from the global financial crisis that was compared with the Great Depression from 1929-1933 due to its ampleness and bad consequences.

In this context, consistent to its mission, the Basel Committee elaborated a set of reform measures regarding the banking activity regulation, known as Basel III, which brings an improvement of the regulatory framework established by the Basel II Accord. The new elements brought to the regulatory system of the banking activity are modalities to improve the international financial stability.

Determining the measures meant to improve the current regulatory system of the international financial activity represents one of the most important dimensions of a more ample package of measures necessary in order to increase the international financial stability.

Literature review

The global financial crisis gave birth in the speciality literature from the entire world to numerous publications regarding the causes that triggered the crisis, the consequences that followed the crisis, its lessons, and last but not least, the reform measures to be made to the current regulatory system of the financial activities.

Borio (2008) makes an assessment of the financial crisis that started in 2007. Mauri and Baicu (2009) mention the main causes that triggered the crisis, the particularities of the crisis and some lessons regarding the regulation of the financial activity. Martin (2009) and Keys, Mukherjee, Seru (2008) point out the role that the securitisation process had in triggering the sub-prime mortgage crisis. IMF (2009) analyses the initial lessons of the crisis. Davies and Green (2008) mention some deficiencies that were noted in the regulation of the financial-banking activity until the crisis begun.

In this context, the Basel Committee adopted a series of reforms meant to improve the current regulatory system of the international banking activity. In 2009, the Basel Committee elaborated the document entitled "Strengthening the resilience of the banking sector", which was submitted to an ample consultative process.

As a result of this process, in July 2010, the Group of Central Bank Governors and Heads of Supervision, the oversight body of the Basel Committee, adopted the main elements of the reform programme.

Besides the improvement of the prudential regulation, Caruana (2010) also specifies other aspects that must be considered in order to ensure the financial stability.

1. **Tendencies manifested on the international banking market**

Under the influence of many factors, among which the most important were the *deregulation* and the *liberalisation of the financial markets, the financial innovations, the increasing competition* in the financial and banking sector and the *technology development*, during the last three or four decades, the general framework in which the banks developed their activity suffered substantial changes, leading to the decline of the traditional banking activity in many countries of the world. For example, if in the USA, in 1974 the commercial banks held 40% of the total lending to the non-financial debtors, in 2005 the market share of the commercial banks had dropped to less than 30% (Mishkin, 2007, p. 257).

In this context, the last decades were marked by profound changes in the contemporary banking systems, concretised in:

- Consolidation through mergers and acquisitions;
- Disintermediation and growth in the off-balance sheet business;
- The development of the securitisation process;
- The intensification of the internationalisation and globalisation process in the financial-banking system.

The above-mentioned processes manifested with different intensities depending on the banking system. Initially, many of these transformations have resulted in the international banking activity and the developed countries market, then other countries including.

In the new context, banks have increasingly turned their attention to providing services and charging fees for such services, whose share started to rise in their total income. Products and services have been diversified, including, in addition to deposits and loans, transactions in securities (investment banking), insurance, investment funds etc. The competition in the banking sector increased and the regulatory process took new forms, emphasising on prudential supervision. Customers began to be increasingly more sophisticated and less loyal, opening accounts at several banks, being also able to transfer their accounts from one bank to another by a simple click on the computer. Moreover, they not only have the possibility to choose among the different local banks, but they can also choose foreign banks and other financial intermediaries. The banks have changed their attitude, being market oriented and client demand oriented and developing marketing strategies regarding the product and services range, as well as regarding the price, the promotion and the delivery channels. The electronic bank concept developed, the ATMs, Home-banking and Internet banking competing and coexisting with the traditional banking subsidiaries. The large companies benefit from cash management services that allow them to manage their liquidities more efficiently.

If traditionally the banks originated credits and kept them to maturity, assuming the non-payment risk (originate-to-hold model), the innovation process and the technological evolutions allowed the development of a new model of banking activity. According to originate-to-distribute model lenders who originated the loans didn't hold them to maturity.

The changing factors created the premises for the banking system to be more and more instable and the propagation of the financial crisis from a country to another to be more rapid and easier. The global financial crisis raised a series of questions regarding the future of the banking activity and the opportunity to return to the traditional financial intermediation based on deposits and credits.

2. Lessons learned from the global financial crisis

According to the IMF (2009) the initial lessons of the crisis have three dimensions: financial regulation, macroeconomic policy and global architecture. With regard to the financial regulation, an important problem revealed by the crisis refers to the shadow banking system (investment banks, mortgage brokers/originators, hedge funds, securitisation vehicles etc.). These institutions have always been lightly regulated, in contrast to deposit taking institutions. In this context, in order to circumvent capital requirements, banks, stimulated by the development of the financial innovation and technology, transferred risk to affiliated entities in the shadow system. Consequently, the perimeter of the financial regulation should be extended to all the financial institutions, which may threaten the financial stability (IMF, 2009).

Development of financial integration process must inevitably lead to the creation of a single regulator for the entire financial system. The promoting of a single regulator for the entire financial system is determined by: minimising the differences between services offered by various financial institutions, increasing the number of financial conglomerates, achieving economies of scale in the regulation (Casu, Girardone, Molyneux, 2006, p. 175).

Davies and Green (2008) point out that in recent years, supervisors have given insufficient attention to liquidity supervision and the relationship between the real economy and developments in the financial plan. Another issue highlighted by the two authors refer to the need to reform the composition of groups and committees with responsibilities in international financial regulation in order to increase the presence of countries with significant weight (first of all, China and Australia, whose banks are increasingly active internationally).

Sub-prime lending crisis has revealed many irregularities in the activity of rating agencies, whose reputation has been severely affected as a result of having overly generous rated securities resulting from the securitisation. Their action has been determined, on the one hand, by the inability to obtain a correct assessment, and secondly by the desire to gain profits even if there was a conflict of interest between them and their clients.

A major cause that triggered the crisis of 2007 was the compensation policy practiced in the financial field. More specifically, the lack of correlation between short-term generous bonuses to employees and medium and long-term risks they imposed on their financial intermediaries. A living proof is that, motivated by the desire to get as many bonuses as possible, employees were not encouraged to make a correct assessment of customers' creditworthiness. Moreover, the financial managers' salaries reached very high levels. Such unsound compensation practices, especially in the major financial institutions, may have adverse consequences on the stability of national and international financial system.

In this context, both national and international supervisors began to pay attention to compensation practices in the financial system to enhance stability. The importance of establishing sound principles for compensation in the financial system is demonstrated by the fact that currently a number of international bodies are involved in this process (the Financial Stability Board – FSB, the Basel Committee, the European Commission, etc.). In international bodies, the Financial Stability Board (FSB), established in April 2009, as successor of the Financial Stability Forum is crucial to establish sound principles of financial compensation. Building on its mandate to promote financial stability, the FSB has developed a set of principles and standards to implement sound compensation practices. Principles set out by the FBS are considering a number of issues among which may be mentioned: the need for financial institutions to constitute a committee (Board Remuneration Committee) in order to oversee the design and operation of compensation; criteria which must satisfy the variable component of remuneration, the importance of transparency on compensation policy. To be effective, these recommendations should be incorporated at the national level (FSB, 2009).

3. **Reform measures of the regulatory system of the banking activity. Basel III**

In 2009, the Basel Committee advanced a document meant to improve the current regulatory system of the banking activity. The document, entitled "Strengthening the resilience of the banking sector" comprises provisions meant to surmount o series of flaws revealed by the global financial crisis. After the end of the consultative process (in April 2010) and as consequence of the suggestions and comments made by the banking and academic community, in July 2010 the Group of Central Bank Governors and Heads of Supervision – GHOS, the oversight body of the Basel Committee, approved the main elements of the reform programme. The July 2010 Accord was reconfirmed in Switzerland on September 12, 2010, being due to be approved in November as well, at the G20 meeting in Seoul.

The measures proposed by the Basel Committee have both a micro-prudential dimension, as they aim at strengthening the resilience of each bank and a macro-prudential dimension aiming at the risks existing at the level of the whole banking system.

The main reform measures comprised in these documents have in view:

1) the raise the quality, consistency and transparency of the capital base. This measure is based on the fact that banks can better absorb the losses if the elements composing the banking capital are qualitatively superior and the level of capitalization is high. To this purpose, the new package reform introduces a new definition of capital;
2) the better risk capture (especially the risks concerning the capital markets activities);
3) the introduction of a leverage ratio. The purpose of this measure is to contain the build up of excessive leverage in the banking system;
4) the introduction of measures meant to build up of capital buffers in good times to be drawn upon in periods of stress;
5) the introduction of a global minimum liquidity standard for internationally active banks. This measure was taken starting from the premise that besides the minimum capital requirements, the international financial stability can be provided also by adequate requirements regarding the credit institutions liquidity.

According to the provisions established by the Basel Committee, these standards will be gradually introduced, over a long period of time until year 2018, so that the banks have the capacity to comply with the new measures.

The reform programme established within the Basel Committee constitute only an important facet of the more ample measures that must be taken for strengthening the financial stability at a global level. For that purpose, the Financial Stability Board is very important, as it has the role to coordinate the global reform programme. Besides the improvement of the prudential regulation, the financial stability can be promoted taking into account other dimensions as well: the macro-economic policies (both monetary and fiscal); the market discipline and the financial sector itself (banks, shareholders, investors, other operators). The financial crisis highlighted a series of flaws regarding the governance, the risk management, due diligence, etc., that must be remedied by the private sector. In order to have the expected effect, these measures imply cooperation and international acceptance (Caruana, Jaime, 2010).

Conclusions

Under the influence of many factors, during the last three decades, the general framework in which the banks developed their activity suffered substantial modifications that led to the decline of the traditional banking activity. By the process of securitisation, the credits were no longer kept in the banks' balance sheet, but were converted in securities and sold on the market.

Besides the opportunities offered to the banks, the change factors created the premises for the financial-banking system to be more and more instable, and the propagation of the financial crisis from a country to another be more rapid and easier. The most recent proof was the global financial crisis that revealed a series of lacks both regarding the macroeconomic policies and regarding the regulatory framework of the financial-banking activity.

In this context, the Basel Committee's answer to the global financial crisis concretised in the adoption of a reform programme regarding the banking activity regulation – Basel III, that aims at being an efficient instrument in strengthening the international financial stability. The concrete implications that the application of these measures presupposed for the banking system represent the starting point for further studies.

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