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## CRISIS THREAT AND BANKING REFORM TRENDS

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**JEL Classifications:** G21

**Key words:** Bank crisis, banking institutions, banking reforms, crisis management.

**Abstract:** The concepts of regulatory changes, published by individual experts as well as institutions responsible for the financial market, are burdened with the experience of the last subprime credit crunch. Beyond the field of interest there are risks that have appeared in the last years and require decisive actions from banks, e.g. in the area of Internet banking or compliance. These areas seem to need some institutional support for the sector. The author suggests that crisis shock must be fought with the intervention shock, i.e. with a number funds of a number of institutions and huge amounts.

ISSN: 1804-0527 (online) 1804-0519 (print)

PP. 52-56

### Crisis cannot be ruled out

Banking is far more crisis prone than other sectors, which is due to a number of factors (e.g. see Hefernan, 2005). Banks are characterised by a high financial leverage, they are exposed to liquidity gap, their operation is based on numerous settlement and credit connections and in crisis they may tend to stay on the market at any expense. Their owners exert pressure on the bank value growth and annual dividend, and the income growth may at times result from taking higher risk (Slawinski, 2007, p.12).

Also excessive legal and supervision restrictions, e.g. those hindering competition, product diversification and price strategy, may determine the escalation of crisis. Eventually, crisis may be imported through the contagion effect.

Bank crisis threatens others with contagion. The domino effect may appear for a variety of reasons. Heuristics based customers' reactions are hardly predictable, and the connections of financial entities constitute the network that is often not really transparent.

These factors are beyond control of the management of a single bank, hence crises in banks cannot be ruled out.

Professor Jajuga (2010, p.30) forecasts the following most important changes within the sector of banking and risk, the sources of which underlie in the financial market itself:

- more frequent financial crises;
- rise in systemic risk, which to a large extent is transferred to households;
- growing role of derivatives;
- dynamic development of financial innovation;
- deregulation of the financial market;
- development of new segments of the financial market (e.g. real estate market instruments, hedge funds, Islamic finance segment instruments).

Within the research programme of the Collegium of Business Administration in 2007 and 2009 the author carried out research, respectively in 36 and 37 banks, of the probability of crisis in the nearest five years. The appearance of threats resulting in the necessity of banking reform was regarded likely by as many as 58 percent of respondents in 2007 and 75% in 2009 (Table 1).

Thus, the majority of banks are aware of the threats that may trigger crisis in the banking sector, and the moderate optimism of 2007 declined.

TABLE 1. MAY THE NEAREST YEARS SEE THREATS THAT WILL RESULT IN THE NECESSITY OF REFORM OF SOME BANKS?

Description	Responses in the examined 37 banks in 2009 in percentages	Responses in the examined 36 banks in 2007 in percentages
1. Next year (please choose one answer):		
1. very likely	2.7	0.0
2. likely	48.6	19.4
3. not very likely	45.9	69.4
4. unlikely	2.7	11.2
2. In the next 5 years (please choose one answer):		
1. very likely	8.1	8.3
2. likely	75.7	58.3
3. not very likely	16.2	30.6
4. unlikely	0.0	2.8

Source: own research

When answering the question about the potential factors that in the nearest 5 years may cause bank crisis and the necessity of implementation of a repair programme,

respondents could point to many answers choosing out of 20 different factors, both internal and external. They could also point to other factors. In the group of external factors,

most answers concerned the crisis in the economy of the country (88.9 percent of indications in 2007 and 97 percent in 2009) as well as the threat of collapse of another domestic or foreign bank in which interbank deposits are kept (44.4 percent of indications in 2007 and 60.6 percent in 2009).

### **Concepts of reforms in international banking**

1. The R. Corrigan Report published in August 2008 presents important findings. The conclusions were supported by investment banks presidents. The report entitled *Systemic Risk Control. Road to Reform* claims among others that „financial excesses result from the human conduct in the condition of intense competition between large integrated financial brokers, who in the rising phase of the cycle promote undertaking risk, and in the declining phase are risk averse” (Van Duyn, 2008). Corrigan claims that risk management is closer to art than science.

The document contains among others the following recommendations:

- limiting excessive risk undertaken by financial institutions;
- accounting reforms to include off-balance vehicles in the balance;
- creation of new criteria for refined investment (structured products);
- regulation of credit derivative issues;
- establishment of a clearing house and investment in technologies, which would enable fast settlement of transactions and fast determination of involvement of particular entities (Van Duyn, 2008).

2. Due to the important experience of Japan, it is worth describing Takenaka's (2008) recommendations. Japan's experience shows that fiscal and monetary policies are not enough. What is important is the microeconomic activity such as accounting principles, transparency and the compensation rule. If no micro activity is undertaken, the macro result will be negative. In order to prevent panic on the financial market, according to Takenaka, 11 reforms are to be made:

- correction of the solvency coefficient to limit the credit cycle;
- development of benchmarks to discourage herd instinct behaviours;
- current market valuation to assess liabilities;
- leverage reduction; limits should be resumed here on the international scale and involve the whole financial sector;
- expansion of regulatory principles, including risk, in the whole financial sector;
- coercion of international cooperation: change in rules in one country may destabilise other countries;
- improvement of supervising personnel competencies (experience in commercial institutions);
- elimination of conflict of interests in the model of business rating agencies;
- professionalisation of supervisory council members and elimination of connections with managers;

- consolidation of settlements of OTC transactions and trading in credit swaps; transparency of money flows in this area;
- standardisation of trans-border transaction security to enhance credibility.

3. The solution to the problem of crisis of the whole financial system was offered Pedersen and Roubini (2009). The model of systemic risk regulation is part of the project published by the university. According to them the consent to Lehman Brothers bankruptcy resulted in such serious systemic consequences that the world financial system collapsed and is still contending with its consequences.<sup>1</sup> The authors claim that the New Capital Agreement ignores systemic threats as it analyses only the risk of collapse of each bank separately. It seeks limitations of individual bank bankruptcy treating both isolated and systemic bankruptcies in the same way. Admittedly, the systemic crisis is more dangerous than individual collapses.

Pedersen and Roubini present two challenges concerning lowering the risk brought by the liquidity crisis. Systemic risk should be first evaluated and then controlled. They define the degree in which systemic risk may contribute to the general financial crisis as probable. The degree may be estimated on the basis of standard methods of risk management. Not generally though, but examining the degree every sales department or unit may contribute to the overall risk of a given bank. The authors suggest two methods of systemic risk management. Firstly, the regulator would assess the systemic risk of each bank separately as a sum of risks of individual departments, the higher the risk, the higher the level of the bank's own capital. Secondly, every financial institution would have to buy insurance against its systemic risk. In the case insurance compensation, the money would not be paid to the company but to the regulator responsible for the stability of the financial system. It would motivate a bank to limit its systemic risk (and as a consequence the insurance premium), and also to assess the risk on the basis of the market (insurance cost). It would also reduce fiscal costs and moral dilemmas in the case of anti-crisis aid from the state. Because the financial sector in a given country may not be able to afford enough capital for systemic risk insurance, the premium could be partially paid by the government. The authors think that it is a better solution than the consent to bankruptcy or spending billions in order to rescue systematically threatened financial institutions.

It is undoubtedly an original solution but in my opinion it is too costly, and the assessment of systemic risks of individual departments in every bank is too difficult. It may be expected that numerous indirect connections with other partners will be concealed.

4. P. Volcker (economic adviser to president B. Obama, former FED Chairman), the Chairman of the Group of Thirty<sup>2</sup>, an international organisation of economists having impact on politics, in January 2009, announced a report containing the plan of protection of the world financial system. The plan includes 18 crucial recommendations within the area of bank management, supervision and regulation.<sup>3</sup>

<sup>1</sup> Pedersen L., Roubini N., A proposal to prevent wholesale financial failure, *Financial Times*, 30.01.09

<sup>2</sup> Prof. L. Balcerowicz represents Poland in the Group of Thirty.

<sup>3</sup> See: Iwaniuk W. Paul Volcker chce chronić świat przed kolejnym kryzysem finansowym, (Paul Volcker wants to protect

The most important are:

- strengthening supervision over large banks and achieving the situation in which none of them can become so large as to not collapse, because of the consequences for the whole financial system;
- necessary legal regulation of rules of activity of rating agencies;
- investment and hedge funds should be subject to supervision similar to that of bank supervision;
- regulations should concern venture capital and hedge funds;
- exotic derivatives should be eliminated from the market;
- guidelines on pays in financial institutions should be developed;
- international cooperation is necessary within the area of implementation of new regulations.

5. Complex assessment of crisis and solutions for the future are comprised in the de Larosiere Group Report.<sup>1</sup> The report was published in February 2009 and is an official document of the European Commission.

The report identifies causes of the international financial crisis of 2007-2008 and its impact on the European Union. It makes suggestions of the restructuring of the institutional system including the regulatory and other instruments of crisis prevention.<sup>2</sup>

The diagnosis of the present situation regards as improper the current system of regulation of the financial system as a whole, including also non banking institutions, rating companies etc. The supervision of the financial system is regarded as not efficient enough. It is estimated that the existing regulations are pro-cyclical and do not account for the real problems connected with liquidity in individual banks. The connections between macroeconomic policy (e.g. transmission of monetary policy impulses) and regulatory policy is considered insufficient.

The proposals made in the Larosiere Group report are multidirectional. The most crucial ones are the activities to enhance the flexibility of regulatory tools concerning the operation of the financial sector, improvement of risk management in the financial institutions, ensuring comparability of supervision standards in individual countries as well as the improvement of the financial supervision (systems of early alert, speed of supervision response, stricter sanctions for disobeying the law and so on).

The repair policy is presented at the beginning of the Report. The Larosiere Group proposes the implementation of a more restrictive macroeconomic policy as well as analyses of financial systems from the perspective of potential risk for the stability of banks and companies, which should be understood as avoiding lax monetary policy and excessive liquidity as well as encouragement to the enhancement of capital security. Another element is the effective reform of the Basel II system, which should allow stricter rules of off-balance instruments, measuring and

limiting the risk of excessive liquidity, creating one definition of own funds, increasing minimum capital requirements, tightening standards of financial liquidity management and strengthening regulations in relation to bank internal auditing and risk management.

Another recommendation is "combination of banking systems." All the areas of systemic character should be regulated and supervised in a suitable way.

Hedge funds should be obliged to inform about their activity through hedge funds managers control. Another area is securitisation papers and derivative markets. The derivative instruments should be standardised and simplified. What is more, in the EU there should be one capitalised clearing house for Credit Default Swaps (CDS). The last recommendation within the repair policy concerns investment funds, where supervision should be enhanced through e.g. tighter control of depositors and depositaries.

Some details are worth focusing on. The Report suggests the creation of the European structure: European Systemic Risk Council to be headed by the European Central Bank Governor. It is important to prepare and implement an early alert system to be an effective measure to predict threats. It would be founded under the auspices of the ESRC and the European Economic and Social Committee. At the same time, ESRC would have the right to issue alert announcements in relation to risk at the macroeconomic level with reference to the duties of the relevant institutions of the EU or members countries. In the case of threats beyond the Union, the ESRC would have a duty of undertaking joint actions with the IMF, the EU Financial Stability Forum and the Based-based Bank for International Settlements. In the area of the systemic changes in bank supervision the Report suggests the establishment of the European System of Financial Supervision) in order to strengthen the transnational activities and coordination.

The implementation of the proposals of the Report is to be carried out in stages and completed in 2012.

6. Committee on the Global Financial System of the Bank for International Settlements in Basel in 2008 published seven recommendations for central banks in relation to anti-crisis actions.<sup>3</sup> They are as follows:

- financial turbulence may give rise to two distinct situations either of which may hinder the central bank to maintain market interest rates close to the target rates determined in the monetary policy. Firstly, there may appear unpredicted changes in the aggregated demand for liquid reserves. Secondly, there may be situations in which the central bank will have to grant huge credit at the same time maintaining the aggregated net supply of reserves in accordance with the interest rate policy. However, operational activities should ensure achieving the desired interest rates;
- improper operation of interbank money market may result in the insufficient distribution of central bank reserves, and as a consequence it may intensify tensions on the financial markets. In order to effectively distribute the liquid reserves, central banks should be able to carry out operations with a number of partners (commercial banks) based on a wide scope of security;

the world against another financial crisis) Rzeczpospolita, 16.01.09.

<sup>1</sup> See: The high-level group on financial supervision in the EU, Report, Chaired by J. de Larosiere, Brussels, 25 February, 2009, www.ec.europa.eu

<sup>2</sup> Prof. L. Balcerowicz is among the outstanding experts to have prepared the Report.

<sup>3</sup> Committee of World Financial System BIS: Central Bank Operations in Response to the Financial Turmoil, CGFS Papers, no. 31, July 2008.

- within the period of financial turbulence determinants of the lack of liquidity may pose a great threat for the effective transmission of monetary policy and financial stability. In this situation central banks must be prepared to extend their brokerage activities and if need arises they should undertake steps beyond the correction of aggregated supply or reserve distribution;
- trans-border liquidity distribution channels may prove blocked in the condition of market turbulence. In order to get well prepared for this, central banks should undertake steps to strengthen their ability to solve problems within international distribution of liquidity. What they can do is to establish or maintain permanent swap lines among one another and to accept development and maintenance of ability to accept assets denominated in foreign currencies of liabilities registered as collateral for their operations;
- false information and mistaken interpretation of central banks operations are more probable and costly in the period of stress. In such conditions central banks should enhance their channels and methods of communication with market participants and the media;
- in stressful situations the unfavourable market perception of an entity making use of permanent credit operations may, at the end of the day, reduce the effectiveness of these operations as additional sources of financing. Central banks should continue to make effort in order to get rid of this kind of understanding of credit operations at the end of the day, e.g. through better explanation of their roles as well as the development of new types of operations which would not be associated with earlier cases of rescue aid;
- expecting central banks to act in favour of mitigating poor functioning of financial markets may give rise to moral hazard through weakening stimuli of market participants to manage liquidity cautiously. Central banks should carefully analyse the assumed benefits from actions in favour of restoring liquidity in relation to the potential costs of these actions;

### **Work in the European Union**

The improvement of ability to absorb shocks will be implemented through modified rules of risk management and new regulations.

The capital management policy may become a special area of bank activity determined by the new regulations. The new rules on risk management recommended by the International Bank Supervision Committee in Basel, introduced in the EU in 2008 make every bank maintain funds at the risk adequate level. The last crisis showed that the quality of specific assets of banks including those largest was very low in some cases, and the losses incurred by banks lowered capital adequacy ratios drastically.

It appeared that the present regulatory solutions are not sufficient and banks ought to increase their capital base. The work of the Basel Committee in this area resulted in the publication of a consultative document with major regulatory plans. A minimum level of capital adequacy is to be maintained. However, the structure of banks' own funds is to be improved, equity capital should decisively

grow in the structure, whereas hybrid instruments ought to be limited.<sup>2</sup> It is to improve the ability to absorb losses.

Another change announced by the Committee is the introduction of the so-called financial leverage ratio. This instrument, which is not connected directly with risk assessment, would limit excessive increase of the bank balance as well as its off-balance liabilities in relation to own capital. Its introduction may be difficult due to varying accounting standards within the EU.<sup>3</sup> Two models of the leverage ratio are considered, i.e. the relation between capital of the 1<sup>st</sup> category and the exposure value as well as the relation between own funds total and the exposure value.<sup>4</sup>

The last crisis shows the strength of pro-cyclical regulatory solutions. When the economic situation deteriorated and the quality of bank working assets declined, the due caution demanded limiting the scale of operation, and as a consequence separating the economy from credit. In order to prevent this, capital buffers should be built in the time of good economic situation to be consumed in the time of bad situation. According to the proposal of the Committee, the capital buffer would be created from profits. The size of it is under discussion with the Union countries but the original proposal concerns the buffer equal to the regulatory minimum.<sup>5</sup>

### **Conclusion**

The concepts of regulatory changes, published by individual experts as well as institutions responsible for the financial market, are burdened with the experience of the last subprime credit crunch. Beyond the field of interest there are risks that have appeared in the last years and require decisive actions from banks, e.g. in the area of Internet banking or compliance. These areas seem to need some institutional support for the sector.

According to professor M. Iwanicz-Drozdowska, "in majority of countries there are no clearly defined rules of responsibility and competence in the area of crisis management. In this respect, the key role ought to be played by the state authorities responsible for possible funding of repair activities."<sup>6</sup>

In my opinion, the experience in solving crises show that the crisis shock must be fought with the intervention shock, i.e. with a number funds of a number of institutions and huge amounts - what is essential is the psychological shock in relation to investors, clients and brokers.

Risk management requires a look at the appearing problems not only on a macro, but also on the micro scale. The crisis in individual banks may be culpable. It may come as the contagion effect; such banks should be granted special aid from the state.

<sup>1</sup>See: Polska wobec światowego kryzysu gospodarczego - część II. Wnioski z dyskusji, broszura, NBP, Warsaw, 2010.

<sup>2</sup> Op. cit. Polska wobec światowego..., (Poland in relation to the economic crisis - part II) Wnioski z dyskusji, (Discussion conclusions), p. 51.

<sup>3</sup> Op. cit. p. 52.

<sup>4</sup> Olszak M. Co zmienić w Bazylei II?, (What is to be changed in Basel II) Bank no. 5/2010.

<sup>5</sup> Op. cit. Polska wobec światowego..., (Poland in relation to...) p. 52.

<sup>6</sup> Op.cit. Iwanicz-Drozdowska M. Bezpieczeństwo rynku usług finansowych. Perspektywa Unii Europejskiej, (Security of the market of financial services. European Union Perspective) Oficyna Wydawnicza SGH, Warsaw, 2008, p. 95.

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