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The Role of Management in the Banking Sector

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Abstract: As well known, in the economic literature the concept of market failure illustrates among other things necessity of a serious regulation framework. In this context, the failure of a bank institution is generally considered to be of more importance than the failure of other types of business firms because of the interconnectedness between banking institutions and its adjacent spill over of systemic risk in space and time. As a result, banking institutions are typically subjected to rigorous regulation, and bank failures are one of the major public policy objectives. In the financial area it is necessary an international regulation framework of banking convergence to approach the topics risk management in terms of quantitative and qualitative indexes of banking institutions. In this respect , the BASEL II mechanism represents the most referential framework of micro prudential banking supervision oriented mostly to risk management of banking instruments and manager behavior in the context of stress test an specific banking efficiency.For exemple, the rating system and the early stage.

Keywords: regulation; risk management; prudential banking supervision

1. Introduction

Effective regulation and supervision of banks and other financial institutions is essential to the financial stability and efficient functioning of any economy because the banking system plays an important role in the payments system and in the mobilization and distribution of savings. Supervision of banks and financial institutions has become difficult in the last decade or so. This is mainly the result of the information technology and banks expanding their business from one country to another. The banking crises and financial crises have also been blamed because of this internationalization of financial institutions, thereby increasing the importance of effective supervision and regulation.

Supervision and regulation are needed to reduce the weaknesses that can pose a threat to the banking system of the country. There has been an ongoing debate on supervision as to whether is it productive or counter-productive. There are two views held in this context; the first view is that supervision is counter productive, as it imposes a cost on end users. Also, it results in a less efficient banking system. It is also believed that it undermines market discipline and therefore removes the penalty associated with excessive risk taking; in other words it creates a moral hazard.

The second view held says that supervision is an essential requirement. Since the markets have become completely free of supervision this encourages banks to take excessive risks. With the advances in technology and new financial innovations and new systems being developed, these factors

pose greater risk to the financial stability of the system and therefore supervision is required. Secondly, it brings confidence in the banking system and also reduces the systemic risk.

2. Preventive Regulation

Preventive regulation can take different forms; some of them are briefly explained below.

a. Anti-competitive measures

Competition limits: This is done by controlling the number of new entrants in the banking field, also by setting rules for new branches to open. The latter should be justified as a case of public need. It also restrains competition through taking measures that force banks to maintain the profitability of existing banks and existing branches.

Restrictions on price competition: this is also a form of preventive regulation. Restrictions on price competition can be an interest rate cartel between banks. Banks determine the common interest rate on deposits and loans.

Administered interest rates: this is also an anti-competitive measure by the government or regulatory authority. In this case the government or regulatory body sets the maximum interest rate that can be used. This was done mostly in US.

The above-mentioned measures were most common in the developed countries but owing to the financial deregulation many of these measures have automatically vanished.

b. Liquidity adequacy:

Specific ratios: this is also a kind of preventive measure where banks are forced to hold a specific certain ratio of liquid assets to their total assets. This is done to ensure that banks have enough cash for unexpected demands. This measure prevents banks from getting into solvency problems.

c. Permissible business activities:

In this measure authorities put restraints on what business banks can actually do. These restraints can be min the form of product diversification.

d. Loan limits:

Regulators control loan size to a single borrower. This is done mostly by fixing the percentage of the bank's capital base. The aim of setting loan limits is to encourage diversification.

On-site loan inspections:

Regulatory authorities send outside auditors to assess the quality of the loan book.

e. Capital adequacy

The reasons for capital adequacy requirement are:

i. To cover setup costs of the bank itself;
ii. To absorb unexpected losses;
iii. To maintain confidence in bank through balance sheet strength;
iv. Capital itself provides a source of lending for a bank's loan portfolio.

The above-mentioned requirements are the form of preventive regulation that stabilizes the banking system and keeps the bank e to an absolute minimum.

2.1 Protective Regulation

Protective regulation involves deposit insurance and lender of last resort (LOLR). Both forms of protective regulation are briefly explained below.

I. Deposit Insurance Scheme:

This type of protective regulation exists in many industrial countries. The main aims of such schemes are to:

i. Prevent systemic collapse (deals with systemic risk);

ii. Protect the consumer. The basic assumption made is that the average retailer cannot assess risk so needs some sort of protection.

In some countries deposit insurance schemes are operated under the control of the government (the UK and the US); in other countries the banking industry organizes them (Germany, France). In countries such as France, Japan and the UK it is obligatory to join deposit insurance schemes, whereas in other countries such as Germany and Italy it is voluntary. The amount of protection also varies from country to country and therefore the regulatory authorities set limits for the amount that could be insured. For example, in Germany and Norway deposit insurance is unlimited. These schemes are funded in different ways in different countries. In the UK there is a minimum amount that every bank has to pay, whereas in other countries it is started when needed.

Although deposit insurance schemes protect customers no prevent from systemic collapse they have been blamed for creating a moral hazard among financial institutions.

Moral Hazard Problem

Deposit insurance encourages banks to undertake greater risks than they otherwise would undertake. This in consequence undermines the soundness of bank, as the bank believes that the bank would be bailed out with the taxpayers' funds. When the depositors are protected they have no incentive to monitor the bank's activities. The moral hazard problem in the 1980's encouraged authorities to reform the deposit insurance schemes. In the US reforms have been designed to reduce the moral hazard problem by computing deposit insurance premiums on a risk related basis, thereby reducing bank risk-taking.

Narrow banking is also another option available to combat the problems associated with deposit insurance. In narrow banking, insurance with no upper limit would be available if deposits are used for transaction purposes, so any other activity taken by the bank would not be covered by the deposit insurance.

To raise awareness among regulators and banks, the Bank of International Settlement has played a very important role by setting standards of capital adequacy and other issues such as electronic banking; also, the disparities among banking regulations between different countries have also been addressed. Moreover, risks arising from different bank exposures have also been communicated to bank management all over the world.

BIS in 1998 through its Basle we accord provided a level playing field by shifting towards harmonization rather than coordination. The main reason behind this shift was the disparities among the countries over capital adequacy, which in future could be harmful. Banks in the high capital standard countries were less able to compete with low capital standards countries. Similarly capital

asset ratios also differed among banks and those banks with less capital/asset ratios were able to expand their balance sheets and thus lend money at a lower margin. This in turn decreased returns for all banks. Banks also began to take higher risk with high risk lending in order to take the business from other banks.

It can be seen from these conditions that the UK and US demanded a level playing field in the global market. They demanded that all the banks should have the same K/A ratio.

2.2 Basle Capital Accord

On July the 15th 1988, the central bankers from the group of ten countries reached a landmark agreement. The Basle can be summarized by dividing it into five main points.

1. Basle was introduced in 1998 and fully implemented by 1993. The banking industry with regard to the capital standards was now regulated on a global basis, in other words, equalizes the capital requirements in all banks from G-10 countries. Another 90 countries also agreed and many countries adopted this accord in a short time.

2. The capital accord strengthened the international banking system by introducing the uniform capital standard in all banks in over 100 countries. This was confined to the Asian financial crisis of 1997 and the 1998 Russian crisis, where as no western bank failed, since these banks had enough capital to prevent themselves from becoming insolvent.

3. Accord took account of different categories of risk of the bank assets and it also incorporated on/off balance sheet items. Items such as cash had been given "0%" risk whereas loans were weighted with a risk of "100%". For the first time banks had to take capital costs into account.

4. A common capital to assets ratio was established at 8% for all the banks. This was the minimum requirement and it was up to national regulators to decide what ratio particular banks should operate at.

5. Each country applying the capital accord was given some latitude with regard to defining capital accord and was also given some flexibility in risk weights to be applied in certain assets. Some argued this by saying that this point undermines the level playing field; accord has a degree of flexibility so a consensus could be formed, generally a level playing field with some bumps.

2.3. Basle Capital Accord Amendments

Many people complained against the validity of accord and raised questions about it being out of date. For this reason between 1993 and 1995 many consultations and discussions took place among the supervisors and bankers. The main points that were discussed between these bankers and supervisors were:

Netting - National supervisors were prepared to recognize that bilateral arrangements existed between the banks and multiple positions can be reduced to single net obligation. Recognition of this point resulted in less capital required by certain banks.

Interest rate risk – Banks were urged to use the correct method for measuring interest rate risk. Also national supervisors will seek to identify high-risk banks and recommend appropriate actions.

Market risk - Since 1988 banks and other financial institutions have become involved with sophisticated products such as securitization and derivatives. Dealing with such sophisticated products exposed banks to other types of risks that they were not exposed to before. During the 1990's there was an increased involvement of banks with new products that had an impact on balance sheets and overall risk position. Therefore it was decided that capital was to be held against potential market risk; this increase was by 1%.

Choices for banks – Banks were provided with the choice of using their own financial model for measuring value at risk (VAR) according to their strength or using the standard model provided by the Basle Committee. These banks had to prove that the models they were to use is 99% correct in predicting the maximum amount that banks can lose over a period of a few weeks.

$$VAR*3 = K$$

K over here shows the capital required for market risk and 3 is the multiplier factor subject to the quality of the bank's risk management system. Exemption of using their own financial model for calculating VAR was restricted to few big banks, while other banks were forced to use the Basle Committee's model.

These amendments provided a flexible style of regulation and also banks could ascertain their capital requirements more easily for new products. Banks tested the financial models in 1997 and fully implemented them in 1998. J. P. Morgan US investment bank developed a computer model that allowed banks to quantify the maximum likely loss they could make on their loan portfolios; they pulled together different types of risks such as consumer loans and corporate bonds into a single number. Many international banks such as Bank of America, BZW, Deutsche Morgan Grenfell, Swiss Bank Corporation and Union Bank of Switzerland backed this model, called Credit Metrics. The old formula of Basle treated a blue chip company and an unemployed person with an overdraft in exactly same way and made no distinction between a well-diversified portfolio and one where all the risks are concentrated in a particular country or sector.

Apart from J. P. Morgan Bankers Trust a New York based wholesale bank also benefited form these new amendments and adopted its own model for capital needed to cushion the swings in the financial market. Many other banks, including some large international institutions, are still using the BIG's simple capital adequacy formulae, which can distort their perception of how profitable their different business lines are.

2.4. Basle Capital Accord II

There was a broad agreement to update the original 1988 formula for calculating how much capital does the bank needs. Yet there is also enough disagreement on the philosophy and details of the new proposals to suggest that their implementation will be difficult and expensive, as banks will have to spend heavily on information technology for new systems. Another disagreement is that it is going to damage a bank's investment in hedge funds. Before the new proposal banks did not have to hold any capital against these funds as they invested through the hedge fund companies and not directly. Therefore the risks were fairly transferred from bank to the hedge fund companies. But following the near collapse of Long-Term Capital Management where many banks were the investors it was feared that if there is no capital against such funds they could trigger a systemic crisis.

The initial paper by the Basle Committee on banking supervision came out in 1999. Amidst disagreements, the aim of this new report is to strengthen the solvency position of the world's banking system. The minimum capital asset ratio is to remain the same at 8% as before; however, there has been a modification for large banks with sophisticated risk management system that can operate on lower capital but still not less than 8%. Basle II has been divided into three pillars:

1. Minimum capital requirement
2. Supervisory requirement and Capital Adequacy
3. Market discipline and greater transparency.

2.4.1. Minimum Capital Requirements

There is a proposal for an increase in risk categories. Also, loans to corporations in emerging economies may end up with lower risk weightings than governments themselves. The introduction of external ratings in relation to inter bank lending and sovereign governments has also been recommended. As mentioned earlier, big banks can use their own internal risk based system but they will be checked at regular intervals. With regard to the internal risk based system small banks will use third party ratings.

For the first time operational risk has been incorporated into Basle II. Operational risk takes into account legal threats and system failures. It is estimated that the operational risk will require 1% of the bank's capital.

Supervisors will determine whether each bank has got sound internal procedures to assess capital adequacy in order to assess the bank's risk portfolio. It is expected from the supervisors that they be up to date with regard to new risk management techniques.

The committee believes that the disclosure requirements and recommendations set out in the package will contribute to market discipline by allowing market participants to assess critical information describing the risk profile and capital adequacy of the banks.

3. Conclusions

The basic framework is the same for two sets of proposals. Therefore the three-Pillar approach has been retained. There are also some differences to the June 1999 proposal; for example, there is greater detail in every aspect of the package. Secondly, the standardized approach to credit risk measurement will more closely align the various risk buckets to the underlying risk. Thirdly, two options have been provided under the internal ratings-based system approach so that more banks can use it. Finally, the focus of measurement of the risk has been changed with interest rate risk shifted from Pillar 1 to Pillar 2, but operational risk remaining in Pillar 1.

The accord is to be finalized by end of the year 2001 and implemented by 2004. For this reason, the committee has consulted supervisors around the world for the development of a new framework. It is expected that many global banks and other financial institutions around the world will implement the accord.

From the above discussion, it is clear that regulatory scene is currently in flux and it is hoped that national regulators along with international organizations will take prompt actions to deal with the

problems facing the current regulatory scene. However, once the disparities and problems are over the international financial system will be stable and the number of bank failures and systemic crises will be reduced.

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