THE ATRIBUTES OF FINANCIAL REGULATION IN THE RECOVERY PERIOD

BRATU Renate –Doina[1]

"Lucian Blaga" University, Sibiu, Romania

Abstract

In this paper we are trying to underpin the main purposes that financial regulation should aim for in order to contribute at avoiding, as much as possible, the starting of crises, meaning to ensure the early warning signs of the crises, to avoid the creation of nominal bubbles, to create nominal buffers, to avoid (reduce) moral hazard, to manage the failure of nominal market..

Keywords: *financial regulation, crisis, banking sector*

JEL classification: *E12, E58, G28*

1. Introduction

In understanding, accepting and adopting the mitigation mechanisms for the social-economic crises, a determining factor is the financial regulation process. On a logical basis, the correlations between the crisis and the regulation will support the actions taken for maintaining stability and, why not, sustainability on long term of the contemporary financial system. Starting from standard New Keynesian theory we underlying, from our perspective, the main attributes for today's financial regulation, at banking sector level.

2. Sections

Atribute 1 – Ensuring early warning signs for the crises

[1] Teaching assistant, Faculty of Economic Science, e-mail renate.bratu@ulbsibiu.ro

In financial regulations practice, especially the banking one, the specific authorities – central banks and/or authorities for prudential supervison – use certain instruments and techniques of risk evaluation for crises. The evaluation is based upon analyses of the real economy, also of the financial environment. On the basis of these analyses, relevant empirical data are gathered, used within econometric models with the role of warning about the start of the crises. Such models take the form of tests – Early Warning Systems or of other models.

As our scientific quest has aimed – to support the idea of a non-cyclic crisis, we consider that any mathematical method used in predicting crises by the authorities for regulation is not relevant within an evolutionary inherent system, with a complex character and in which act entities with unpredictable behaviours, the economic subjects.

Although in the scenario of an international financial regulation, reformed on principles of coordination, collaboration, continously adapted to the changing environment, its purpose to ensure the early warning signs of crises can be accomplished only by abiding to the principles mentioned above.

If the regulation framework will become flexible and permanently realistic concerning the existing financial situation, this will have the potential of avoiding the accumulation of causes that can start the event called crisis.

Atribute 2 – Avoiding the formation of nominal bubbles

Often, financial crises follow what it seems to be a bubble in the asset prices. Speculative bubbles have, usually, three phases of development (Alle, Gale, 2000): 1. initial phase and development of the financial liberalization or through the conscious decision of the central bank to stimulate the increase in creditation or other similar events; the expansion of credit resulted is accompanied by the increase in asset prices for a period, possibly a few years in which the speculative bubble develops; 2. the phase in which the speculative bubble „explodes" and the asset prices in question „crash", often, in a short period of time, a few days or months, still, sometimes, for a longer period of time; 3. the 3rd phase is characterized by payments stop from many firms that have made loans in order to purchase assets at inflated prices, after this wave of unpayments, bankruptcies follow, then the crisis (banking, foreign-currency, financial, etc.). And, then, difficulties associated to banking or foreign-currency crises generate problems in the real sector of economy that could last for a few years (what we have remarked about recessions).

Always, the bubbles[1] will occur when there is a major uncertainty regarding the real asset depreciation or the expansion of credit. In creating these policies, governments and central banks should take into consideration the possible effects of their actions on the asset prices in order to avoid the creation of such speculative bubbles. It is not important only the simple level of the credit, but, also, the uncertainty concerning its future level (Alle, Gale, 2000).

In our opinion, avoiding the formation of nominal bubbles by financial regulation action can be accomplished in more ways: establishing rigurous principles of banking and non-banking creditation in which the main criterion to represent the evaluation of the real level in the capacity to pay of the customer; then, in closing the transaction, to avoid as much as possible the manifestation of moral hazard; last, but not least, to respect the quantitative indexes specific to creditation so that the customer is aware of and responsible in efficiently managing the debt; responsabilization of the institutions from the perspective of excessive risk-taking in establishing and implementing the strategies of capital flows directly to potential clients, as well as to their own institutional investments; the correlation of the monetary policy to economic policies so that the character of the monetary policy not to induce positive anticipations among the economic subjects regarding the level of asset prices (especially real estate); such anticipations will manifest in a suplimentary request of funds which will stimulate further on the increase in asset prices, and so on.

Atribute 3 – The creation of nominal buffers

In the economic literature, nominal buffers are the total value of owned and in reserve capital that acts like a mitigator of losses especially of those resulted from creditation.

The current financial regulations have established norms for creating such buffers in the banking industry. Practically, these buffers are instruments for best managing risk and avoiding moral hazard. For instance, when performance of risky assets (real estate and shares) is low this buffer is exhausted, and when the risky asset prices is rising (so the speculative bubbles form), the buffer increases to its maximum level.

[1] A few examples of crises which started because, mostly, of an „explosion” of a speculative bubble: the Dutch Tulip, The Southern Sea Bubble from England, The Mississippi Bubble in France, The Great Depression from 1929 in USA, Japan in the 80's and the 90's, then in countries like Norway, Finland, Sweden, Argentina, Chile, Mexico, Indonesia, Malaysia, Thailand, South Korea, and so on.

Consequently, we consider that attaining this purpose of financial regulation should be done in the following manner: revising the suitability norms of capital from Basel II[1], according to the opinion of many authors, on anticyclic criteria, in order to have benign effects on long term upon the banking system stability; a more rigurous verification of the banking assets quality on the basis of which the levels of capital are determined, as buffers; the periodic evaluation of asset guarantee which are at the basis of loans to avoid significant depreciations (especially in the case of an „explosion” of a speculative bubble); the expansion of suitability requirements of capital also at the level of the other institutions which unfold activities in the financial domain (investment banks, investment funds, hedging funds, insurance and reinsurance companies, financial services institutions, brokerage institutions, etc.) even according to the model of banking regulation adopted in this sense; we need to focus, too, on these institutions that present systemic risk (including the cathegory „too big to fail”); adopting measures of discouragement in excessive risk-taking by the financial institutions (respectively avoiding and/or reducing moral hazard).

Atribute 4 – Avoiding/or reducing moral hazard

In the simplest approach, moral hazard is the tendency of excessive risk-taking, both by the financial institutions, from the desire to protect the level of profits, and by the capital clients, from the desire to exercise in activities with different degrees of risk, on the basis of accessed loans.

The global crisis from 2007-2009 has brought into the debate more and more the importance of three problems: the asymmetry of data that determines the opposite selection and moral hazard problems (Agency theory).

The current banking regulation is directed, in relation to the banks, on many topics like (Mishkin, Eakins, 2012, p. 465): ensuring governmental safety, restrictions on asset owning, minimal requirements of capital suitability, prompt punitive actions, authorizing and evaluation, risk

1The Basel II Agreement was adopted at the end of 2008 and proposes a suitability strategy of capital on the basis of three pilars that comprise alternative approaches to risk-evaluation depending on their sensitivity (importance). Besides the procyclic character, there are reproaches of not being clear enough in defining the proposed approaches and that the banks did not succeed to correctly evaluate the risks. They were underevaluated. This fact has provoked the failure in determining their own rates of capital suitability,. The crisis from 2007-2009 sanctioned too low creditation and too reduced capital reserves. More, these regulations had a character of recommendation, which had a reduced impact on their effective implementation within the banks (even if these recommendations were transposed in national legislations).

management evaluation, dissemination of data requirements, consumers protection, competitional restrictions.

Analysing the specific of these activities, we will notice that the majority of them are affected by moral hazard - of the institution and of potential clients. But, in this case, the major fault goes to banks in aggravating these problems. Then, what should the financial regulation do about it? In this situation, we think that reducing or avoiding moral hazard in the financial system should be based on: an increase in responsability concerning the importance of owning information about a certain party involved in a transaction, diminishing the problems of data asymmetry and opposite selection through which there are created the issues of moral hazard; emphasis on the idea of forming financial intelligence among economic subjects. Through financial education and the intelligent use of it (for instance, to protect the value of funds advanced to the bank, through a deposit), economic subjects can limit, indirectly, the tendency of excessive risk-taking by the banks and/or other financial institutions, that is by strengthening the discipline, on the market, of financial institutions on the basis of the attitude of the intermediaries that they work with[1] ; revising the governmental „safety" net function at the level at which to represent a reduction or a prevention of moral hazard and not an aggravation of it; as for us, we support the idea that authorities should give up „rescue at any cost" of financial institutions, action guided according to the policy „privatize the profits and socialize the costs". We agree that responsabilization of the institutions, through their own and effective risk-taking, will lead to the reduction of moral failure and even to an improvement of their own risk management systems; revising of guarantee schemes for deposits in order to contribute, a long with the financial education of the economic subjects, to the awareness that the capital flows in the financial system need to be based on the idea of „privatization" both of the losses and of profits for the financial institutions (even for those of systemic importance); revising the norms concerning the capital requirements through which, as we mentioned in the previous subchapters, the attitude of excessive

1 For instance, the economic subjects, as deponents, can require from banks information regarding the placement of the funds attracted as deposits, as well as specific information concerning the creditation strategy (which is based on the level of attracted deposits, because of the fractional reserve principle). This would deterrmine the banks to disseminate complete information to their clients; the client can ask for explanations in connection to certain risky activities. The result would be the reduction of moral hazard from the banks.

risk-taking is stimulated by the financial institutions in the same time with the fact that the level of profits is being threatened.

We think that the actions of avoiding and reducing moral hazard can affect in a way the development of the financial market (more quantitatively than qualitatively), but the long term effect will be to support the stability of the system.

Atribute 5 – The management of the nominal market failure

The social-economic crisis produces always (at least, the one considered by us non-cyclic) the failure of the nominal market. A traditional reaction to these type of failures, is an emergency action of governmental authorities to restore confidence. Public announcements of calming down are made to the participants on the market, also actions of financial support of problematic institutions, definitive take-overs (nationalizations), the facilitation of strategic mergers, the intervention of the deposit guarantee schemes, and so on. But the traditional actions (for the contemporary social-economic environment) provoke only the aggravation of problems of moral hazard and create the premises for accumulation of new causes for future crises and the failure of financial regulations.

A new architecture of global regulation, based on collaboration, coordination, flexibility and adaptability, will imply rethinking the management of the nominal market failure by transgressing from the policy of „privatize the profits and socialize the losses” to „privatize the profits and the losses”.

2. Conclusions

In understanding, accepting and adopting the mitigation mechanisms for the social-economic crises, a determining factor is the financial regulation process. On a logical basis, the correlations between the crisis and the regulation will support the actions taken for maintaining stability and, why not, sustainability on long term of the contemporary financial system.

3. References

- Agénor, P.R., Silva, L.P., (2010) – Cyclical effects of bank capital requirements with imperfect credit markets, *Journal of Financial Stability*, doi:10.1016/j.jfs.2010.07.002

- Allen,F., Galle, D. (2000) – Bubbles and crises, *The Economic Journal,* 110, no. 460, pp. 236 – 255.
- Bank for International Settlements (BIS) (September 2008). How might the current financial crisis shape financial sector regulation and structure? Már Gudmundsson, Financial Technology Congress 2008, Boston, 23 September 2008, available at www.bis.org.
- Barrell, R., Davis, E.P., Karim, D., Liadze, I., (2010) – Bank regulation, property prices and early warning systems for banking crises in OECD countries, *Journal of Banking and Finance,* doi: 10.1016/j.jbankfin.2010.02.015.
- Bolt, W., Tieman, A.F., (2004) – Bank competition, risk and regulation, *The Scandinavian Journal of Economics,* 106(4), 783 – 804 doi: 10.1111/j. 1467-9442.2004.00389.x
- Busch, A. (2009) – *Banking Regulation and Globalization*, Oxford University Press, UK.
- Currie, C. (2006). A new theory of financial regulation: Predicting, measuring and preventing financial crises. The Journal of Socio-Economics 35 (2006) 48–71.
- de inserat bibliografia de la articolul public
- Fabozzi, F.J., Modigliani, F., Jones, F.J., (2010) - *Foundations of Financial Markets and Institutions*, Fourth Edition, Pearson Educational, New Jersey.
- Grifft- Jones, S. (2009). How To Create Better Financial Regulation & Institutions. Proposals for Reforming Financial Regulation . FES Briefing Paper 2. March 2009, www.fes-globalization.org
- IMF, (2009). Lessons of the Financial Crisis for Future Regulation of Financial Institutions and Markets and for Liquidity Management., http://www.imf.org/external/np/pp/eng/2009/020409.pdf
- Mishkin, F.S., Eakins, S.G., (2012) – *Financial Markets and Institutions,* Seventh Edition, Pearson Education Limited, Edinburgh, England.
- OECD, (1997). Synthesis Regulatory Reform: A Synthesis, http://www.oecd.org/regreform/regulatorypolicy/2391768.pdf
- OECD, (2009). Policy Framework for Effective and Efficient Financial Regulation. Recommendation and Principles, http://www.oecd.org/insurance/insurance/44187223.pdf

- OECD, (2009). The Financial Crisis. Reform and Exit Strategies. http://www.oecd-ilibrary.org/finance-and-investment/the-financial-crisis_9789264073036-en
- OECD, (2010). Policy framework for effective and efficient financial regulation. General guidance and high-level checklist., http://www.oecd.org/finance/financialmarkets/44362818.pdf
- Quick, J. (2000) – A regulator's view on managing other risks in banking, *Risk Management: An International Journal,* Vol. 2., No.3., pp.15-21.